2020 Year-End Tax Strategies

by Suzy Grainger, Sales & Marketing Manager DRDA CPAs & Business Consultants

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Tax Reduction Strategies in Light of Biden's Win

There are many things we know about tax planning between now and December 31, 2020, yet uncertainties abound. The elephant in the planning room is who gets elected in the November third general election and the lingering questions are: when will it be decided, and what does it mean for you? Polls indicate a Democratic victory is likely. One of the things we learned from the 2016 election is that polls can be wrong. So, what does a Biden victory mean for the future and what can you do now to plan during this uncertainty? The time to create these strategies is now as the window of opportunity will be very tight or closed the longer you wait for the smoke to clear.

What a Biden Victory Means

Joe Biden's tax plan impacts everyone, but the change varies based on your income level.

High income taxpayers earning in excess of $400,000

1. Increasing individual income tax rates
   Ordinary income brackets would go up for individuals increasing the top tax bracket to 39.6%. Additionally, 12.4% FICA tax would be imposed on wages over $400,000 raising the effective rate to over 50%.
2. Elimination of the Qualified Business Income tax deduction for pass-through business owners. This potentially increases the tax bracket for high earners by 10% (from 29.6% for those eligible for the QBI deduction to the proposed highest rate of 39.6%).
3. Like-kind exchanges (Section 1031 Exchanges) would be eliminated.
4. Other issues
   - Long-term capital gains and qualified dividend tax rates would increase to ordinary income tax rates for income over $1 million.
   - The 3.8% Obamacare surtax on net investment income would remain in place.

Middle- and low-income taxpayers

- Flat retirement contribution credit of 26%
  This would eliminate the deduction for retirement plan contributions essentially making them all Roth contributions, but it would provide a refundable tax credit equal to 26% of the contributed amount. In other words, you put $100 into your IRA, you get no deduction, but the government puts $26 into that account as well. This is a benefit to low and middle income taxpayers and puts them on a level playing field with high income taxpayers who received a larger tax benefit because they paid tax and paid it at a higher rate providing significant benefits for retirement plan contributions. Now you get a benefit whether you pay tax or not.
- Enhancements to personal income tax credits
  1. Higher Child Tax Credit (increased from $2,000 for children under 17 to $3,600 for children under 6 and $3,000 for all other children under 17).
  2. Child and Dependent Care Credit (from $3,000 to $8,000 for one child, and from $6,000 to $16,000 for two or more).
  3. The First-time Homebuyer Credit would be reintroduced as a refundable and advanceable credit of up to $15,000, and
  4. A brand-new proposed Caregiver Credit would provide $5,000 for informal long-term caregivers.

Gift and Estate Tax Changes

Gift and estate tax changes are significant. The Biden plan eliminates the step-up in basis rules that currently apply to inherited assets and reduces the exclusion amounts from $11.58 million to $5.79 million. This will create an effective double tax on inheritance. The first tax being at the fair market value of the assets in relation to the exclusion and the second when the beneficiaries sell inherited assets and have to recognize the gain on the asset that would already have been taxed for estate tax. If you are thinking about estate planning and gift transfers you may want to do so before December 31, 2020.

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Uniform Gift and Estate Tax Transfers

Acceleration of transfers under the uniform gift and estate tax transfers provisions may be appropriate. For a married couple leaving property to children, the tax effect could be as much as 5,000,000. Luckily, you don't need to die to take advantage of these changes:

- Accelerated gifting can be accomplished with numerous types of trusts.
- Accelerated gifting can be accomplished with the transfer of family limited partnership interests sooner rather than later.

With Biden Winning the Election Traditional Tax Strategies May Not Work

Deferring or Accelerating Income

High income taxpayers will more than likely want to accelerate income as tax brackets may be higher next year. Low to mid-level income earners will want to be more traditional and defer income.

Paying Tax Deductible Expenses or Deferring Them

Low to midlevel earners will want to pay them in 2020. High income taxpayers will want to defer some deductible expenses to next year under the assumption that tax rates will rise, and they will receive greater benefit using them next year.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act Provisions to Act on Now

Business Tax Provisions

Five-year NOL carryback for losses generated in the 2018, 2019 and 2020 tax years

Net operating losses from the 2018, 2019, and 2020 tax years can now be carried back five tax years and the CARES Act suspends (i.e., removes) the 80%-of-taxable-income limitation through the 2020 tax year. This is a unique opportunity to secure permanent tax savings by using losses against income generated in prior years at higher tax rates. In 2015, corporations may have been subject to a 35% (individuals 39.6%) tax rate so carrying back a net operating loss would be much more beneficial than a carryover to 2021 with a 21% (37% for individuals) tax rate. In this case consider ways to accelerate deductions and defer income to increase the NOL available to be carried back.

Retroactive refund for bonus depreciation

The CARES Act expands bonus depreciation to qualified improvement property which applies to almost any improvement to the interior of a building that is either owned or leased. It's retroactive which allows you to fully deduct qualified improvement property (QIP) as far back as January 1, 2018. If you filed 2018 and 2019 returns before the law changed, you can choose whether to reflect the additional retroactive deduction entirely in the 2020 year with an accounting method change, or amend both the 2018 and 2019 returns to apply bonus depreciation for QIP in each of those prior years. Under the Tax Cuts and Jobs Act (TJCA, Trump's original tax cuts), these types of improvements were supposed to have a 15-year life and be eligible for 100% bonus depreciation. A drafting error eliminated both benefits. The CARES Act retroactively fixes this issue for improvements acquired on or after Jan. 1, 2018.

The retroactive fix presents an opportunity for many taxpayers to accelerate depreciation, either by filing a Form 3115, Application for Change in Accounting Method, or, in some cases, by filing an amended tax return. Qualified improvement property is now eligible for 100% bonus depreciation, retroactive to property acquired and placed in service after 2017.

Other Changes

- 100% bonus depreciation extends through 2022. Bonus depreciation will be available for used property as well as new property. The 100% deduction is allowed for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023.
- Sec. 179 expensing is $1,040,000 and the phaseout threshold increased to $2,259,000.
- Businesses with average annual gross receipts of $25 million or less in the three prior tax years are eligible to use the cash method of accounting.

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Individual Tax Provisions

Early Withdrawal from Retirement Accounts for Coronavirus-Related Purposes

The CARES Act removes the 10% penalty on an early withdrawal from retirement accounts, in most cases for up to $100,000 of distributions for coronavirus-related purposes made on or after Jan. 1, 2020. A distribution is coronavirus-related if made to an individual:

- Who is diagnosed with SARS-CoV-2 or with COVID-19 by a test approved by the Centers for Disease Control and Prevention?
- Whose spouse or dependent is diagnosed with SARS-CoV-2 or COVID-19; or
- Who experiences, due to SARS-CoV-2 or COVID-19, adverse financial consequences because of being quarantined, being furloughed or laid off, having work hours reduced, or being unable to work due to lack of child care or the closing or reducing hours of a business the individual owns or operates.
- The $100,000 distribution can be included in income in equal installments over a three-year period.

Waiver of required minimum distributions (RMDs) for 2020

The CARES Act waives the RMD rules for certain defined contribution plans and IRAs during 2020. The waiver does not apply to defined benefit plans (i.e., pensions).

Above-the-line charitable deduction
The CARES Act created an above-the-line deduction of up to $300 for cash contributions from taxpayers who don't itemize. If you would like to take advantage of this provision, make sure to donate before the end of the year.

Uncertainties Associated with Payroll Protection Program (PPP) Loan Recipients

A significant number of small to mid-sized businesses received Payroll Protection Loans. Applications for forgiveness are currently being filed and are due within ten months from the end of their chosen covered period (8 or 24 weeks). Some recipients will qualify for full forgiveness and some will not. This contingency and the Treasury Department's initial ruling on expenses which will qualify the recipient for forgiveness has created a significant uncertainty.

This Year or Next?

Many borrowers won't know until 2021 how much of their loan will be forgiven. So, several uncertainties exist:

- Will the forgiveness create taxable income in 2020 when the proceeds are received, and expenses are incurred?
- Alternatively, will the forgiveness create taxable income in 2021, when the borrower receives confirmation their loan is forgiven?
- How do you treat the expense used to quality for forgiveness in the meantime?

For federal purposes, PPP loan forgiveness may be excluded from gross income by an eligible recipient by the CARES Act. However, the IRS issued a notice in April 2020 stating that expenses associated with the tax-free income are nondeductible. This guidance was consistent with historic IRS guidance regarding nontaxable income and related expenses but has the net effect of essentially reversing the tax-free benefit of the exclusion on the loan forgiveness.

Per the IRS, allowing businesses to deduct these expenses would result in business owners receiving a "double" benefit. This goes against Congress's intent which was for the loan forgiveness to be tax-free. The IRS position reverses that position and eliminates any benefit, let alone a double benefit. If a business has $100,000 of PPP loans forgiven and excluded from its income, but then is required to add back $100,000 of denied business expenses, the result is the same as if the loan forgiveness was fully taxable. While the IRS guidance doesn't appear to align with Congress's expressed intention, there hasn't been a law or ruling to rectify this obvious error despite discussion in Congress about fixing it.

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What to do in the meantime:

- We hope a ruling in the borrowers' favor will be issued prior to the due date for filing their tax return for 2020.
- We recommend that all expenses used to qualify a borrower for loan forgiveness be classified as a separate range of accounts or in a separate department. You must keep track of the expenses used on your PPP Loan Forgiveness Application to achieve loan forgiveness.

With respect to tax payments and filing of returns, we think most will extend their returns hoping to get clarification. The significance of the difference can be huge, for instance, if the loan was $2,500,000. For year-end tax planning, we have to adhere to the current IRS position that the PPP loan forgiveness expenses are not deductible and plan your returns and tax payments accordingly in order to avoid potential penalties and interest. Should Congress or the President correct the IRS, you will receive a refund rather than a penalty bill.

Estimated Tax Payments

All of this uncertainty impacts tax planning, particularly estimated tax and extension payments for 2020. In order to conserve cash, many have chosen not to take advantage of the ES payment safe harbor of 110% of prior year tax and are paying based on current year projected taxable income. With one quarterly estimated tax payment remaining this tax year, you'll need to plan for this in making the final payment. However, no matter what you decide for estimates, a decision will ultimately need to be made at extension time.

Other Significant Items for Individuals

- The stimulus payment or Recovery Rebate is an advance refundable tax credit on 2020 taxes. This means you get to keep all the money with no taxes due on it regardless of how much you owe (or don't owe) for 2020. If your income is lower in 2020 than 2019, any additional credit you are eligible for will be refunded or reduce your tax liability when you file your 2020 tax return.
- Net operating losses from 2018, 2019 and 2020 may be carried back to obtain refunds of taxes paid in the prior five years. This is a change from a previous law that repealed the two-year carryback of net operating losses.
- Higher standard deduction:
  1. Married filing jointly: $24,800
  2. Married filing separately: $12,400
  3. Head of household: $18,650
  4. Single: $12,400
- Retirement account changes:
  1. The contribution limit for 401(k) plans is $19,500 with a catch-up contribution of $6,500 for taxpayers age 50 and older.
  2. The beginning age for required minimum distributions (RMDs) has changed from 70 ½ to 72. This applies only to account owners who turn 70 ½ after 2019.
  3. Starting in 2020, inherited IRAs generally need to be withdrawn within 10 years. There are exceptions for surviving spouses, minor children, and beneficiaries who are not more than 10 years younger than the account owner. Inherited accounts of individuals who died before 2020 aren't affected by this change.
  4. IRA contribution limits remain unchanged at $6,000 plus $1,000 catch-up contribution for individuals 50 and older.
- Higher contribution limits for Health Savings Accounts:
  1. Self-only coverage: $3,550
  2. Family coverage $7,100
- Higher cap on Social Security payroll taxes: The maximum amount that is subject to Social Security payroll taxes rose to $137,700 for 2020.
- Foreign earned income exclusion: For taxpayers working abroad, the foreign earned income exclusion rose to $107,600 for 2020.

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Significant Business Tax Elements

- For 2020 the corporate tax rate is anticipated to be 28% under a Biden presidency.
- The standard mileage rate for business miles is 57.5 cents per mile.
- 100% bonus depreciation extends through 2022. Bonus depreciation will be available for used property as well as new property. The 100% deduction is allowed for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023.
- Sec. 179 expensing is $1,040,000 and the phaseout threshold increased to $2,259,000.
- Businesses with average annual gross receipts of $25 million or less in the three prior tax years are eligible to use the cash method of accounting.
- Like-kind exchanges are limited to exchanges of real property that is not primarily held for sale.
- A deduction for an activity generally considered to be entertainment, amusement or recreation is disallowed.
- Businesses may still generally be able to deduct 50% of business meals. The 50% limitation will be extended to meals that meet the requirements for de minimis fringe benefits or for the convenience of the employer (100% deductible previously). Such amounts (de minimis/for the convenience of the employer) paid after December 31, 2025, will not be deductible.
- For pass-through entities (partnership, S corporation, or sole proprietor), individuals are allowed to deduct 20% of qualified business income. Generally, the 20% deduction is limited to the greater of 50% of the W-2 wages paid with respect to the business or the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis of newly acquired qualified property. However, the wage limitation doesn't apply for taxpayers below the threshold amount of $163,300 ($326,600 in the case of a joint return). Specific service trades or businesses (accounting, health, law, consulting, athletics, financial services) will be excluded from the definition of a qualified business for taxpayers with taxable income in excess of the threshold amount of $163,300 ($326,600 for a joint return). The deduction is applied to partnerships and S corporations at the partner or shareholder level.

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