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Business & Personal Financial Planning

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SUMMIT FINANCIAL, LLC.
2020 Year-End Tax & Overall Planning Considerations

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Planning Alert
December 2020

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This Planning Alert focuses on many year-over-year changes to income, gift, and estate taxation under current law. Unless otherwise noted, all year-over-year changes in this Planning Alert that are scheduled to occur will take effect on January 1, 2021. This overview points out some items that you may wish to consider either before year-end or to take advantage of planning opportunities in certain key areas impacting individual taxpayers. IRS announced adjustments for 2021 are incorporated in this material and the planning ideas presented in it. Due to the volume and complexity of tax legislation, we will provide comments primarily in areas that we feel are important to your continued planning.

Income Tax Rates for 2020 & 2021

Year 2020			Year 2021	
Single [$]	Joint [$]	Tax Rate	Single [$]	Joint [$]
0 - 9,875	0 - 19,750	10%	0 - 9,950	0 - 19,900
9,876 - 40,125	19,751 - 80,250	12%	9,951 - 40,525	19,901 - 81,050
40,126 - 85,525	80,251 - 171,050	22%	40,526 - 86,375	81,051 - 172,750
85,526 - 163,300	171,051 - 326,600	24%	86,376 - 164,925	172,751 - 329.850
163,301 - 207,350	326,601 - 414,700	32%	164,926 - 209,425	329,851 - 418,850
207,351 - 518,400	414,701 - 622,050	35%	209,426 - 523,600	418,851- 628,300
518,401+	622,051+	37%	523,601+	628,301+

Capital Gains and Qualified Dividends Tax Rates for 2020 & 2021

Year 2020			Year 2021	
Single [$]	Joint [$]	Tax Rate	Single [$]	Joint [$]
0 - 40,000	0 - 80,000	0%	0 - 40,400	0 - 80,800
40,001 - 441,450	80,001 - 496,600	15%	40,401 - 445,850	80,801 - 501,600
441,451+	496,601+	20%	445,851+	501,601+

Individual Income Tax Planning

- *Standard deductions increase in 2021, as follows:
  - Married couples filing jointly = $25,100 (up from $24,800 in 2020).
  - Single taxpayers & married taxpayers filing separately = $12,550 (up from $12,400 in 2020).
  - Heads of household = $18,800 (up from $18,650 in 2020).

- *The personal exemption for tax year 2021 remains at $0.00.

- *Continued suspension of the PEASE phase-out of itemized deductions through 2025.

- *Alternative minimum tax ("AMT") exemptions increase in 2021, as follows:
  - Married couples filing jointly = $114,600 in 2021 (up from $113,400 in 2020).
  - Single taxpayers = $73,600 (up from $72,900 in 2020).

- Medical expenses remain an itemized deduction in excess of 10% of adjusted gross income ("AGI") for tax year 2021 as they were for 2020.

- *Itemized deduction for either state & local income taxes or sales taxes, plus property taxes, is still limited to $10,000 in 2021. While this limit impacts itemized deductions, it also reduces AMT exposure for many taxpayers.

- Itemized mortgage interest deduction is still allowed for acquisition debt up to $750,000 for debt incurred after 12/15/2017. The itemized interest deduction for home equity debt is only allowed for loans to buy, build, or substantially improve the residence.

- *Itemized deduction for casualty losses remains limited to losses in federally declared disaster areas.

- *Miscellaneous itemized deductions subject to a 2% AGI floor, such as professional fees, investment expenses and unreimbursed business expenses, remain nondeductible through 2025.

- *Itemized deduction of cash contributions directly to public charities was increased from 60% of AGI to 100% for 2020 as part of the CARES Act but is scheduled to return to 60% of AGI in 2021.

- *Individual taxpayers continue to receive a 20% deduction on "qualified business income" from pass-through entities, though certain restrictions and limitations apply.

- For FICA tax purposes, there is an extra Medicare tax of 0.9% on earnings received from employment, exceeding $200,000 for single taxpayers and exceeding $250,000 for married couples filing jointly.

- There continues to be a net investment income tax ("NIIT") which applies an additional 3.8% surtax on investment income if modified AGI is $200,000 for single taxpayers and $250,000 for married couples filing jointly.

***Provision scheduled to sunset ("expire") after 2025.**

Actions to Consider

- The CARES Act enabled people with required minimum distributions ("RMDs") due in 2020 to skip taking an RMD for the 2020 tax year. Clients who are in a lower tax bracket in 2020 than they expect to face in 2021 should consider converting Traditional IRAs to Roth IRAs during 2020.
- Clients (or spouses), who otherwise cannot make IRA contributions due to income limits and do not have large pre-tax IRAs, should consider backdoor Roth conversions. This strategy involves making a non-deductible IRA contribution and waiting for a "cooling off period" (typically 30 days) before converting the IRA to a Roth IRA with little or no tax consequence, since only the gain during the cooling off period would be taxable. Here, it should be noted that all of a person's IRA accounts are considered together when calculating the tax on a Roth conversion. So, if someone has a sizable pre-tax IRA and attempts to convert a non-deductible IRA into a Roth IRA, the conversion will be largely taxable, because you cannot convert only non-deductible contributions.
- Focus income tax planning on reducing or deferring income, as appropriate, to possibly take advantage of the tax backets and lower income tax rates under current tax law and avoid additional 3.8% and 0.9% taxes.
- Consider incomplete gift non-grantor trusts (e.g. NINGs, DINGs and WINGs) to avoid state income tax.
- Discuss with your accountant whether your withholding & estimated tax payments are sufficient to assure that you have paid at least 90% of your 2020 or 110% of your 2019 tax bill by year-end to avoid penalties.
- If you are selling a small business or other appreciated property, consider an installment sale to defer income beyond this tax year.
- Residents of states with no state income tax should consider making large purchases in 2020 or 2021 to take an itemized deduction for any sales tax on their purchases in the most beneficial tax year.
- Consider a Section 1031 like-kind exchange of real estate held for non-personal use to defer income into future years.
- Consider investing in Qualified Opportunity Zone Funds to defer the tax on prior capital gains and potentially eliminate capital gains tax on the Qualified Opportunity Zone Fund's appreciation from the date of investment.
- Exercise incentive stock options in years where the AMT will not apply due to the AMT exemption.
- Before deciding whether to conduct your business via a pass-through entity (like an S corporation, limited liability company, partnership, or sole proprietorship), compare the advantages and disadvantages of pass-through entities with their C corporation counterpart, which is only taxed at a 21% federal rate. Here, it should be noted that President-elect Biden has proposed increasing corporate tax rates in future years.
- **Methods to consider for reducing AGI:**
  - If possible, time your receipt of income to delay it from being currently taxable.
  - Make sales that straddle 2 years to spread additions to AGI over two tax periods.
  - Use installment sales to realize capital gains over the installment period, versus solely in the year of sale.
  - Own and live in your primary residence for at least 2 of the last 5 years before selling it to exempt $250,000 of the resulting gain ($500,000 for married couples) from capital gains tax.
  - Wait until you own an appreciated asset for at least 366 days before selling it, so that its growth is taxed at lower long-term capital gains rates, instead of ordinary income tax rates.
  - When rebalancing a taxable portfolio, use qualified dividends from outperforming positions to add to lower performing positions, versus automatically re-investing dividends into the security that generated them and later selling part of that holding to generate funds which you will add to other positions you hold.
  - Hold highly appreciated assets until death, so that they receive an income tax basis step-up to fair market value at your death. Note that President-elect Biden has proposed eliminating the basis step-up at death.

Retirement Planning

- **Maximize qualified retirement plan contributions for 2021:**
  - The 401(k), 403(b), 457 and thrift savings plan elective deferral limit is $19,500 (unchanged from 2020).
  - People age 50 or older can elect to defer an extra $6,500 annually to their 401(k), 403(b), 457 and thrift savings plans as a catch-up contribution (unchanged from 2020).
  - The annual limit for elective deferrals plus employer contributions to defined contribution plans is $58,000 (up from $57,000 in 2020) and is $64,500 for people age 50 or older (up from $63,500 in 2020).
  - The compensation limit for calculating retirement plan contributions is $290,000 (up from $285,000 in 2020).
  - Adopt a profit-sharing plan or add it onto your 401(k) before year-end.
  - Consider adopting a defined benefit plan or cash balance plan for your business by year-end. If adopted by year-end, clients can fund a defined benefit plan or profit-sharing plan up to the due date of their tax return next year, plus extensions.
  - The yearly benefit limit under defined benefit plans is $230,000 (unchanged from 2020).
- **IRA contribution limits for 2021:**
  - The IRA contribution limit is $6,000 and catch-up contribution limit for taxpayers age 50 or older is $1,000 (unchanged from 2020).
  - The AGI phase-out range for making deductible contributions to a traditional IRA where the contributor participates in a workplace retirement plan is $66,000 to $76,000 (up from $65,000 to $75,000 in 2020).
  - The AGI phase-out range for married couples who file jointly to make deductible contributions to traditional IRAs, if the contributing spouse actively participates in a workplace retirement plan, is $105,000 to $125,000 (up from $104,000 to $124,000 in 2020).
  - The AGI phase-out range for married couples who file jointly to make deductible contributions to traditional IRAs, where solely the non-contributing spouse actively participates in a workplace retirement plan, is $198,000 to $208,000 (up from $196,000 to $206,000 in 2020).
  - The AGI phase-out ranges for contributing to Roth IRAs are $125,000 to $140,000 for single taxpayers (up from $124,000 to $139,000 in 2020) and $198,000 to $208,000 for married taxpayers who file jointly (up from $196,000 to $206,000 in 2020).
  - The annual contribution limit for SEP IRAs is $58,000 (up from $57,000 in 2020), and the compensation limit for calculating the maximum contribution SEP IRA participants can make rises to $290,000 (up from $285,000 in 2020). SEP IRAs can be adopted & funded after year-end up to the due date of your return, plus extensions.
  - The SIMPLE IRA elective deferral limit is $13,500 (unchanged from 2020) and catch-up contribution limit for taxpayers who are 50 or older is $3,000 (unchanged from 2020).
- **Know what type of retirement income helps or hurts:**
  - Taxable payments from pension plans, IRAs and Social Security are not considered "net investment income" for purposes of the additional 3.8% tax. However, the above types of retirement income increase AGI which may lead to other investment income being exposed to the additional 3.8% tax.
  - Payments from a Roth IRA are neither income nor taxable and will not raise the recipient's Medicare premiums nor increase the recipient's taxes on his or her social security benefits.
- Also, consider using a non-qualified deferred compensation plan to defer income, but realize that existing tax law contains provisions which include transfers of employer stock to an employee in the employee's income.

Investment Planning

- Harvest tax losses up to the sum of your capital gains, plus another $3,000 which is deductible against ordinary income; excess losses harvested this year can be carried forward to future years.

  Cautions:

  - New Jersey does not allow capital loss carryovers for state income tax purposes, so you may wish to limit losses you harvest to your gains.
  - Keep in mind the wash sale rule, which can cause losses to be disallowed as offsets against income, when identical securities are purchased within 30 days before or after the sale.

- Hold income yielding investments, such as high yield bonds, REITs, securities that pay nonqualified dividends and high turnover mutual funds & hedge funds, inside tax deferred accounts like your IRA, 401(k), pension plan, and tax deferred annuity.
- Conversely, hold passive or low turnover equities and municipal bonds inside your taxable accounts.
- Recognize what items are excluded from the 3.8% net investment income tax:
  - Tax-free municipal bond interest but not capital gains from the sale of municipal bonds.
  - Life insurance proceeds, loans against policy cash value & surrender proceeds up to the tax basis in the policy.
  - Property received by gift or inheritance.
  - Capital appreciation of assets that are donated to charity.
  - Income from real estate activity, earned by a "qualified professional" who spends more than 750 hours during the year actively involved in real estate, as long those hours equal more than 50% of the professional's total working hours throughout the year.
  - Income from rental real estate activities in which a qualified real estate professional participates more than 500 hours during the year or more than 500 hours in 5 of the most recent 10 years.
  - S corporation shareholders & partners in a partnership who materially participate in the business, but not if the business gets its income from trading financial instruments or commodities.

Charitable Planning

- Donating appreciated stock to charity rather than cash both eliminates the capital gains tax from selling shares and prevents a corresponding AGI increase if shares were sold.
- The CARES Act allows people using the standard deduction to deduct up to $300 of cash contributions as an "above-the-line deduction."
- Clients who are at least age 70 ½ can direct a yearly total of up to $100,000 from their IRAs to charity as a qualified charitable distribution ("QCD"). The amount directed to charity counts toward the IRA owner's annual required minimum distribution but is excluded from federally taxable income. This donation strategy is helpful for clients who use the standard deduction and will not benefit from an itemized charitable deduction. The recipient of the IRA distribution must be a §501(c) (3) charity and cannot be a donor advised fund nor private foundation. Here, note that special rules apply for people who both contribute to an IRA after age 70 ½ under the SECURE Act and make QCD's, as their deduction for IRA contributions may be limited.
- Should limits on itemized deductions cause you to lose the benefits of itemizing in future years, consider making a sizable gift to a Donor Advised Fund ("DAF") in 2020 to the extent deductible, in order to bunch your charitable giving into a single tax year; then, recommend grants from the DAF to other charities in 2020 and later years.

Estate Planning

Gifting

- The annual gift tax exclusion remains at $15,000 ($30,000 for gift-splitting couples) and must be utilized by year-end or the benefits it can provide for the 2020 tax year will be lost.

- Payments made directly to a service provider for another person's tuition & medical expenses do not reduce the annual exclusion gift you can make to that person and are not subject to gift taxes.

- The lifetime estate & gift tax exemption increases to $11.7 million per person in 2021 ($23.4 million per married couple), constituting an increase from $11.58 million per person in 2020 ($23.16 million per married couple).
  - Note that President-elect Biden has proposed reducing the estate & gift tax exemption to $3.5 or $5 million per person.
  - Without Congressional action, the lifetime estate & gift tax exemption will return to much lower levels ($5 million indexed for inflation) at the start of 2026 as will the generation-skipping transfer tax exemption for the same amount. Thus, clients should be aware of the possibility that their exemption may drop significantly in the future, unless it is used.

- Valuation discounts and gift amplifying strategies are vital planning tools for families with a net worth, exceeding the above noted exemption levels.

- When making gifts to an irrevocable trust, it is important to remember that gift-splitting is available to couples and that the trust may require issuing withdrawal notices regarding the gifts. Couples must file a gift tax return as part of making split gifts.

Healthcare Proxies, HIPAA Authorizations & Powers of Attorney for Adult Children

Parents can no longer make medical decisions for a child nor access his or her medical records, once the child reaches the age of majority for the state, where he or she lives. In many states, like NJ, NY and CT, the age of majority is only 18. To address these issues, parents should have majority age children execute Health Care Proxies & HIPAA Authorizations, authorizing them to make medical decisions, if those children become incapacitated. Parents should also ask majority age children to implement Living Wills & Durable Powers of Attorney, so they are well positioned to help those children in times of lost lucidity.

Trust Taxation

Yearly net investment income that is retained by a trust is subject to a 3.8% tax on 2021 income above $13,051 (up from $12,950 in 2020). This income threshold coincides with the bracket measure above which trust income is exposed to the highest 37% federal income tax rate. Consider distributing trust income to beneficiaries who are in lower tax brackets to reduce annual taxes.

Trust & Estate Income Tax Rates for 2020 & 2021

Year 2020 Rate Brackets [$]	Tax Rate	Year 2021 Rate Brackets [$]
0 – 2,600	10%	0 - 2,650
2,601 - 9,450	24%	2,651 - 9,550
9,451 - 12,950	35%	9,551 - 13,050
12,951+	37%	13,051+

Miscellaneous Planning

- **Health Savings Accounts ("HSAs"):**
  - For 2021, people are limited to making HSA contributions of $3,600 for themselves only (up from $3,550 in 2020) and $7,200 for their families (up from $7,100 in 2020).
  - HSA participants who are 55 or older can make additional $1,000 catch-up contributions.
  - Contribute the maximum allowed to your HSA by year-end, especially since remaining HSA funds can be rolled over from one year to the next.
- **Flexible Spending Accounts ("FSAs"):**
  - In 2021, people are limited to making FSA contributions of $2,750 (unchanged from 2020).
  - Clients are advised to use the remaining funds in an FSA as soon as possible, since carryover to future years is limited; although the plan may provide a grace period of no more than 2 ½ months after plan year-end to incur qualified medical expenses and still be reimbursed.
  - Alternatively, plans can provide that up to $550 may be carried forward to the next year without granting a 2 ½ month grace period.

Please contact us if you would like to discuss how you are impacted by any of the above; we would be happy to cover strategies that may be appropriate for you to incorporate into your current tax & long-term planning.