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Midyear Tax Planning Letter

To Our Clients and Friends:

We hope that you and your loved ones are safe as you deal with the current COVID-19 crisis. What an incredibly difficult year this has been! This most recent tax season was unlike any we've ever experienced. With the spring deadline postponed until July 15, we're still busy preparing returns. While it may seem odd to discuss 2020 midyear planning while you're still waiting to file your 2019 tax return, there are many opportunities that should be addressed sooner rather than later.

In response to the COVID-19 emergency, President Trump signed into law on 3/27/20 the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The CARES Act is a massive piece of legislation aimed at providing much needed relief during an uncertain time in our country. Among its many provisions, the Act offers some immediate tax-saving opportunities.

In addition to the CARES Act, the Taxpayer Certainty and Disaster Tax Relief Act (Disaster Act) and the Setting Every Community Up for Retirement Enhancement (SECURE) Act, both passed in December 2019, provide tax planning opportunities for this year. The Disaster Act extended (retroactively to 2018, in some instances) many beneficial provisions in the tax law that had expired or were set to expire. The SECURE Act, on the other hand, made significant changes to the retirement rules. We'll highlight planning techniques stemming from these recent bills, as well as other midyear planning ideas.

It's possible that additional COVID-19-related tax changes could be implemented as the year progresses. We also need to keep in mind that 2020 is an election year. While we don't anticipate significant tax law changes if President Trump is reelected, a new occupant of the Oval Office would almost certainly lead to tax reform (with possible higher tax rates). As always, we're paying close attention to the ever-changing tax environment to discover tax planning opportunities that could put more cash in your pocket. In the meantime, here are some ideas to evaluate this summer while you have time to think about them.

Consider Adjusting Your Tax Withholding or Estimated Payments

No taxpayer likes to be surprised with a large tax bill (or a smaller-than-anticipated refund) come tax filing season. In many cases, this occurs because the individual didn't adjust his or her tax withholding or estimated payments to account for changes in income. For those accustomed to receiving refunds every year, an unexpected tax bill can be a real hardship. Fortunately, there's still time to make sure the right amount of federal income tax is being withheld from your paycheck for 2020.

IRS Form W-4 is used to tell your employer how much tax to withhold from each paycheck. When the Tax Cuts and Jobs Act (TCJA) (a major tax reform bill passed in December 2017) limited certain itemized deductions and reduced the personal exemption to zero, many taxpayers simply weren't having the correct amount of tax withheld. An updated version of Form W-4, which takes the TCJA changes into account, was released near the end of 2019. Although the revised form is more complicated than prior versions, it should increase the accuracy of your withholding amounts.

The IRS also designed a more robust tool to assist taxpayers in completing the new Form W-4. If you haven't reviewed your withholding recently, you should consider using the IRS's "Tax Withholding Estimator," available at **www.irs.gov/individuals/tax-withholding-estimator**. You will need your most recent pay stubs, details of other sources of income, and a copy of your most recent tax return. However, keep in mind that the calculator isn't perfect. If you want more precise results, we would be happy to put together a 2020 tax projection for you.

If you make estimated tax payments throughout the year (you're self-employed, for example), we can take a closer look at your tax situation for 2020 to make sure you're not underpaying or overpaying.

Also, if you've already filed your 2019 return and applied an overpayment to 2020, but would now prefer a refund, you have until 7/15/20 to file a superseded return and request a refund. This may be beneficial if you're experiencing financial hardship due to the COVID-19 crisis.

Amended Returns

Ordinarily, an amended tax return is only filed when an error or omission is discovered after a return has been filed. Even then, you might decide not to amend in situations where the resulting tax reduction wouldn't be significant enough to justify the cost of preparing and filing the amending return. That said, with the current COVID-19 situation, any opportunity to put a little money back in your pocket is worth pursuing. All three of the major tax laws passed within the last six months contain retroactive provisions that could make amending your 2018 and/or your 2019 return (if already filed) worth the cost.

The SECURE Act repealed the changes to the "Kiddie Tax" brought about by the TCJA. Under the TCJA, if your child was subject to the Kiddie Tax in 2018, his or her net *unearned income* in excess of $2,100 was taxed using estate and trust brackets instead of your marginal rate. Since higher tax rates are reached at much lower income levels for estates and trusts than for individuals, it's quite possible that your child paid more tax than necessary in 2018 (if you weren't in the higher brackets). Since the change is retroactive (at the taxpayer's election), it might make sense to review your child's 2018 return to see if it would be beneficial to amend.

The Disaster Act also made several retroactive changes that could lead to a situation where amending a prior-year return makes sense. If you had any debt forgiven on your principal residence and included that amount in income in 2018, we can amend your return to exclude that cancellation of debt income. If you paid Mortgage Insurance Premiums (PMI) in 2018 and itemized your deductions for that year, those payments can be included with other mortgage interest expense and deducted on an amended return. In addition, the Disaster Act brought back, among other things, the deduction for eligible tuition and fees and the credit for qualified energy saving improvements made to your home.

The CARES Act also contains multiple retroactive tax law changes that may have a significant effect on small business owners, including revised Net Operating Loss (NOL) rules, accelerated depreciation options, and other provisions that may allow a larger deduction than would have been available prior to the CARES Act. Whether you're a direct owner of a sole proprietorship or own a business through a pass-through entity (such as a partnership or an LLC), you may be able to take advantage of one or more of these retroactive changes. For more information on opportunities to amend your personal return for small business-related issues, please refer to the "Planning for Small Businesses" section later in this letter.

While not every taxpayer will be able to take advantage of all these changes, there's a good chance that at least one may apply to you. If so, filing an amended return can provide some sorely needed cash flow in these uncertain times.

Take Advantage of Lower Tax Rates on Investment Income

Income from an investment held for more than one year is generally taxed at preferential capital gains rates. Those rates are 0%, 15%, and 20% for most investments. (Higher-income individuals may be subject to an additional 3.8% net investment income tax.) The rate that applies is determined by your taxable income. For example, the 0% rate applies if your 2020 taxable income doesn't exceed $80,000 (for joint filers), $53,600 (for heads of household), or $40,000 (for other individuals). The 20% rate doesn't kick in until your taxable income exceeds $496,600 (for joint filers), $469,050 (for heads of household), or $441,450 (for other individuals).

If your taxable income hovers around these threshold amounts, there are ways to reduce your income to take advantage of a lower capital gains rate. For example, you could make deductible IRA contributions or reduce taxable wages by deferring bonuses or contributing to employer retirement plans. If you're over the age of 70½, making contributions to a qualified charity with a direct distribution from your IRA also is a good way to lower income. If you own a business and use the cash method of accounting, you can wait until the end of the year to send out some client invoices. That way, you won't receive payments until early 2021. Also, you can postpone taxable income by accelerating some deductible expenses this year. If possible, you should get your income low enough to qualify for the 0% rate.

If your income is too high to benefit from the 0% rate, consider gifting investments (like appreciated stock or mutual fund shares) to children, grandchildren, or other loved ones. Chances are these individuals will be in the 0% or 15% capital gains tax bracket. If they later sell the investments, any gain will be taxed at the lower rates, as long as you and your loved one owned the investments for more than one year. This strategy has two risks, however. First, there are gift tax consequences if you transfer assets worth over $15,000 during 2020 to a single recipient. Second, all children under age 18 and most children age 18 or age 19–23 who are full-time students are subject to the Kiddie Tax rules. Fortunately, Kiddie Tax rates are once again tied to the parent's tax bracket rather than the brackets for estates and trusts. The Kiddie Tax limits the opportunity for parents to take advantage of the 0% capital gain rate by gifting appreciated property to their children, including college age children. Please contact us if you have any questions.

Retirement Plans

If you're affected by COVID-19 and find yourself in need of additional cash flow, the CARES Act contains several taxpayer-friendly provisions for retirement plan distributions taken prior to the end of 2020. For taxpayers under age 59½, COVID-19-related withdrawals up to $100,000 from a qualified retirement account [IRA, 401(k), 403(b), etc.] aren't subject to the normal 10% early withdrawal penalty. While all 2020 withdrawals are still subject to income tax, you have a couple of options to limit the tax burden. First, you may elect to spread the income tax payments over three years rather than pay all of the tax in 2020. You also may recontribute the amount withdrawn to another qualified account within the next three years rather than the standard 60-day rollover timeframe. (No tax is due if you recontribute within the three-year window.) Even if you don't need the cash, this is an opportunity to move funds out of an employer-sponsored plan and into an IRA that you can control.

To qualify for these special rules, you (or your spouse or dependent) must have been diagnosed with COVID-19 or been affected financially as the result of a layoff, reduction in hours, or another inability to work due to COVID-19. If you think you may be eligible, please contact us to review your situation.

If you have funds in a traditional IRA and have been considering converting the account to a Roth IRA, 2020 might be a great year to execute that plan. Current tax rates are relatively low. Given the current economic situation and the possibility of leadership changes following the November elections, it's unlikely tax rates will decrease anytime soon. It's also possible that your income from other sources is down, driving you into a lower tax bracket. Since the CARES Act suspended Required Minimum Distributions (RMDs) for 2020, if you already budgeted to pay tax on your RMD, rolling that distribution to a Roth IRA could be a perfect move. No RMD for 2020 also means that 100% of the distribution can be classified as a rollover.

No one likes to see the value of their retirement account plummet like many of us saw earlier this year, but perhaps there's a silver lining to that decrease in your traditional IRA's value. The depressed value in your IRA means a rollover distribution in a market downturn will contain more assets. Once in the Roth IRA, the recovery of value and ultimate withdrawal will be tax free. Of course, there are possible disadvantages. For instance, increasing your 2020 income could mean more of your Social Security payments will be subject to income tax or result in increased Medicare premiums. Also, unlike a few years ago, the ability to "undo" this conversion no longer exists. Once you convert, it's permanent. All factors should be considered along with your overall retirement plan. Please contact us with any questions.

Last, but not least, the SECURE Act removed the age limitation for deductible contributions to a traditional IRA. So, if you're over the age of 70½ and have earned income, you may want to consider making a deductible IRA contribution in 2020.

Is this the Perfect Storm for Roth Conversions?

It could be. However, you must understand that a Roth conversion is treated as a taxable distribution from your traditional IRA because they're deemed to receive a payout from the traditional account with the money then going into the new Roth account. So, doing a conversion will trigger a bigger federal income tax bill for the conversion year. Even so, right now might be the best time to convert a traditional IRA into a Roth IRA. Here are three reasons why.

Low Current Tax Rates Thanks to the TCJA. Today's individual federal income tax rates might be the lowest we will see for some time. Thanks to the Tax Cuts and Jobs Act (TCJA), rates for 2018-2025 were reduced. For example, the top rate was reduced form 39.6% for 2017 to 37% for 2018-2025. However, the rates that were in effect before the TCJA are scheduled to come back into play for 2026 and beyond. Depending on political developments, rates could increase much sooner than 2026. Also, increased rates may be needed to help the federal government recover some of the expenses related to the COVID-19 crisis. Believing that rates will only go back to the 2017 levels in the aftermath of the COVID-19 pandemic might be, shall we say, overly optimistic.

This Year's Tax Rate Might Be Lower Due to the COVID-19 Fallout. You won't be alone if your 2020 income takes a hit from the COVID-19 crisis. If that happens, your marginal federal income tax rate for this year might be lower (maybe much lower) than what was expected just a short time ago. A lower marginal rate translates into a lower tax bill if you convert a traditional IRA into a Roth account this year.

However, watch out if we're talking about converting a traditional IRA with a large balance (say several hundred thousand dollars or more). The conversion would trigger a substantial amount of extra taxable income, and you could wind up paying federal income tax at the top three rates of 32%, 35%, and 37% on a big chunk of that extra income. That said, paying 32%, 35%, and 37% might seem like the "good old days" before too long.

Lower IRA Balance Due to Stock Market Decline Means Lower Conversion Tax Bill. Just a short time ago, the U.S. stock market averages were at all-time highs. Then, the COVID-19 crisis happened, and the averages dropped significantly. Depending on how the money in your traditional IRA was invested, the account might have taken a substantial hit. Nobody likes seeing their IRA balance go south, but a lower balance means a lower tax bill when (if) you convert the traditional IRA into a Roth account. When the investments in the Roth account recover you can eventually withdraw the increased account value in the form of federal-income-tax-free qualified Roth IRA withdrawals.

In contrast, if your account remains in traditional IRA status, any account value increase from now on will be treated as high-taxed ordinary income when it's eventually withdrawn. While the current maximum federal income tax rate for individuals is "only" 37%, what will it be five years from now? Nobody knows, but betting it will be lower than 37% seems inadvisable.

Check Your Deduction Strategy

It's generally best to itemize your deductions if you have significant personal expenses. However, don't rule out the standard deduction. For 2020, joint filers can enjoy a standard deduction of $24,800. The standard deduction for heads of household is $18,650, and single taxpayers (including married taxpayers filing separately) can claim a standard deduction of $12,400.

Unfortunately, the TCJA suspended or limited many of the itemized deductions. There are talks of possible legislation that might repeal or relax some of these limitations. The most discussed limitation at the moment is the cap on the deduction for State and Local Taxes (SALT), which is currently $10,000 ($5,000 if married filing separately). Nothing has been passed yet, so the $10,000 limitation continues to apply. In an attempt to work around this limitation, several states enacted programs that provide state tax credits to individuals who contribute to charitable funds. In 2019, the IRS issued final regulations that require taxpayers to reduce their charitable contribution deduction by the amount of any state or local tax credit received. Fortunately, the IRS also released guidance that generally allows taxpayers to treat payments disallowed as charitable contribution deductions under the regulations as state or local taxes.

On another note, the CARES Act temporarily increased the limit on cash contributions to public charities and certain private foundations from 60% to 100% of adjusted gross income for contributions made in 2020. Note that the donation doesn't have to go to a COVID-19-related cause. However, with the increased standard deduction and limits on itemized deductions, it's likely that fewer taxpayers will be able to deduct charitable contributions for 2020.

For those in that predicament, consider bunching or increasing charitable contributions in alternating years. This may be accomplished by donating to donor-advised funds. Also known as *charitable gift funds* or *philanthropic funds*, donor-advised funds allow donors to make a charitable contribution to a specific public charity or community foundation that uses the assets to establish a separate fund. Taxpayers can claim the charitable tax deduction in the year they fund the donor-advised fund and schedule grants over the next two years or other multiyear periods. This strategy provides a tax deduction when the donor is at a higher marginal tax rate while actual payouts from the account can be deferred until later. If you have questions or want more information on donor-advised funds, please give us a call.

For those who won't itemize in 2020, the CARES Act allows a new "above the line" deduction for cash charitable contributions up to $300. For older taxpayers (over age 70½) who won't be able to itemize, but still want to make contributions, a qualified charitable distribution from an IRA is a great way to give to charity. We welcome the opportunity to help you put together a charitable giving plan that suits your goals.

Planning for Small Businesses

If you own a business, consider the following strategies to minimize your tax bill for 2020. Thanks to the retroactive nature of many portions of the CARES Act, an opportunity to file amended returns also may be available in certain circumstances.

NOLs. The TCJA eliminated the ability to carry back NOLs arising after 2017 and limited the benefit of NOLs carried forward to subsequent years to 80% of taxable income. To assist small business owners who may have incurred losses as a result of the COVID-19 crisis, the CARES Act temporarily removed the TCJA limitation. Because the new law is retroactive, you can now carry losses that originated in 2018 through 2020 back five years. This means you could carry a 2018 NOL back as far as 2013. Since tax rates were higher in 2017 and earlier years, carrying back an NOL should be much more beneficial than carrying that loss forward. If you had a loss in 2018, 2019, or expect a loss in 2020, its imperative that we review your options. Carrying back a loss could be a great way to increase cash flow.

Excess Business Losses. To further ease the burden on small business owners, the CARES Act also retroactively removed the limitation on Excess Business Losses (EBLs) that the TCJA implemented for 2018 through 2020. Under the TCJA, beginning in 2018, taxpayers were unable to deduct business losses from sole proprietorships or pass-through entities, such as partnerships and S corporations, if the combined loss exceeded $250,000 ($500,000 for married joint fliers). (Those amounts were adjusted annually for inflation after 2018.) The excess loss was converted to an NOL and carried forward, subject to the NOL limitations discussed earlier. Since this is a retroactive law change, if your losses were limited in either 2018 or 2019 (if that return has already been filed), you should strongly consider filing an amended return to generate a refund.

Business Interest Expense. The CARES Act relaxed the limitation on the deductibility of business interest expense. Under the TCJA, the deduction was generally limited to 30% of Adjusted Taxable Income (ATI). For 2019 and 2020, that limit is generally increased to 50% of ATI. Unless the taxpayer elects out, a special rule for partnerships allows 50% of any excess business interest allocated to a partner in 2019 to be deductible in 2020 and not subject to the ATI limitation. The remaining 50% is subject to the normal ATI limitation rules.

Better Depreciation Rules for Real Estate Qualified Improvement Property (QIP). The CARES Act includes a technical correction to the TCJA that is retroactive to 2018. The new rule allows much faster depreciation for real estate QIP that is placed in service after 2017. *QIP* is defined as an improvement to an interior portion of a nonresidential building that is placed in service after the date the building was first placed in service. However, QIP doesn’t include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

The retroactive correction allows you to claim 100% first-year bonus depreciation for QIP expenditures placed in service in 2018–2022. Alternatively, you can depreciate QIP placed in service in 2018 and beyond over 15 years using the straight-line method.

Amending a 2018 or 2019 return to claim 100% first-year bonus depreciation for QIP placed in service in those years could result in an NOL that can be carried back to a prior tax year to recover taxes paid in that year, as explained earlier. There also is an option to file an accounting method change for the business in lieu of amending returns. We will work with you to determine if it’s better to claim 100% bonus depreciation or deduct the cost of QIP over 15 years.

Please Contact Us

As we said at the beginning, the goal of this letter is to get you thinking about tax planning ideas and potential moves we can make to help maximize cash flow prior to the end of the year. We recognize that these are unique times, and want to make sure you know that we're here to help you navigate the uncertainty that the current COVID-19 situation has created. We will continue to monitor future developments and do our best to keep you updated with the latest tax law changes. Please don't hesitate to contact us if you want more details about any of the topics discussed or just have questions or concerns.

Best regards,

Brian Crelin, CPA

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