ADVANCED PLANNING

Tax Strategies

The Year-End Tax Conversation That May Save You Money

START THIS IMPORTANT YEAR-END DISCUSSION.

As the year nears its close, it's a good time to consider reaching out to your advisors, including your accountant, financial professional, and, perhaps, attorney. Before you file this year's tax return, you may be able to implement tax strategies that could save you money.

Discover these opportunities as you read through this article.

PERSONAL TAX OPPORTUNITIES FOR INDIVIDUALS AND FAMILIES

Gifting

You can take advantage of making lifetime gifts that will reduce your overall taxable estate. And, if the gift is made to a qualified charity, it may also reduce taxable income for the current tax year.

In 2020, **individuals may gift up to $15,000** per recipient; for **married couples, it's $30,000** per recipient. This is referred to as the *annual gift tax exclusion* and represents the amount anyone can give away every year without paying gift tax. The gift can be made to anyone, with no limit on the number of recipients. However, the gift must be a "present interest" gift, meaning the recipient must be able to use and enjoy it right away; otherwise, it isn't an exclusion gift, and is counted against the donor's lifetime gift tax exemption amount. The lifetime gift tax exemption amount is currently $11,580,000 per taxpayer in 2020.

Use It or Lose It

Setting up a gifting program has several important tax advantages, including reducing the size of your taxable estate and removing appreciation on the gifted amount outside your taxable estate. If you don't make any gifts during the calendar year, that year's annual gift tax exclusion is lost forever.

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Timing Is Everything

Mailing a gift in late December does not qualify it as a current year gift if the recipient receives it in January of the following year. In the case of checks, a recipient must cash the check on or before December 31 for the gift to qualify as a gift made in the year given. This could make it convenient for you, the donor, to double up on gifting to an individual by giving him or her two checks at year-end holidays, one post-dated to and not deposited until the following year.

The Gift of Education

You may be interested in creating or contributing to **529 Plan** accounts for children or young relatives. Contributions can be made by December 31 as annual exclusion gifts, up to the $15,000 limit. Gifts to 529 accounts can also be accelerated with five years' worth of annual exclusions, or $75,000, allowing you, the donor, to make a significant gift without using any of your lifetime exemption. Note that, if the five-year cumulative gift is made, you'll forgo the ability to utilize any intervening increase in the annual exclusion amount for the same beneficiary.

ABLE Accounts, which are similar to 529 Plans but specifically for disabled individuals, do not permit five-year accelerated funding.

Gifting Through a Trust

You may be leery about giving cash or property directly to a family member or other person. Using a trust to hold the assets can be the solution. So long as the intended recipient is a trust beneficiary, you may still exclude the gift from tax and reporting requirements, provided certain rules about beneficiary notifications and withdrawal privileges are followed.[1]

An **Irrevocable Life Insurance Trust (ILIT)** can be a good way to leverage gifts and provide for family members, including children and grandchildren (and also your (the grantor's) spouse, if the trust document provides your spouse access to policy cash values). The trust is the owner and beneficiary of a life insurance policy and gifts made to the trust can be used to pay premiums. If the ILIT is properly drafted and administered, the trust can receive the life insurance death benefit free of income and estate taxes.[2]

Where you do not have time to establish a written trust before year-end, it is even possible to make annual exclusion gifts in trust without a written trust document. You can discuss so-called parol or oral trusts with your tax and legal advisors to see if such an opportunity is available.

[1] For a gift to qualify for the "annual exclusion," it must be a "present interest" gift. For the gift to be considered a present interest gift, the trust beneficiaries should be given "Crummey powers of withdrawal" over gifts made to the trust.

[2] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.

Lifetime Gift Tax Exemption

In addition to annual exclusion gifts, you may be able to make tax-free gifts of cash and other assets by using the lifetime exemption mentioned earlier. The exemption amount is indexed for inflation, and is currently $11,580,000 per taxpayer in 2020.

If you're **married to someone who is not a U.S. citizen**, gifts or transfers of property up to $157,000 can be made in 2020 without tapping into your (the donor's) lifetime gift tax exemption amount referenced above.

There are several perennial reasons to gift using the lifetime exemption. Most notably, it can be an effective strategy for removing future appreciation from a donor's estate. However, for year-end purposes, probably the most compelling reasons change from year to year; your tax advisor can provide you with expert guidance.

Things Change

The tax code is ever evolving. It's one of the more important reasons that this year-end tax conversation should take place. There are many proposals in Congress that could impact your future gifting decisions. These include reducing the lifetime exemption. The potential implications of this proposal are beyond the scope of this article, and you should consult your tax and legal advisors to assess the need for any action.

Giving Back: Charities

Direct gifts to charity involve an outright transfer of cash or property, which must be received by the charity on or before December 31 for you, the donor, to benefit from an income tax deduction in the current year. Year-end gifts to charity can provide you with a current tax deduction. In addition, if the value of the deduction exceeds the allowable amount based on your adjusted gross income (AGI), the unused portion can be carried forward and deducted for the next five tax years.

The deduction for charitable contributions **cannot exceed 60% of AGI**, and lower percentage limits can apply, depending on the type of donated property and the type of recipient organization. The **60% limit applies to gifts to qualified organizations** that are public charities or private operating foundations, such as churches, certain educational organizations, hospitals, and certain medical research organizations associated with hospitals. Most organizations can tell you whether or not they are 60% limit organizations.

Deductions for charitable contributions made to **organizations that are NOT 60% limit organizations cannot be more than 30% of AGI**. Organizations that are not 60% limit organizations include veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private, non-operating (grant-making) foundations.

Capital gain property is property that would have resulted in realized long-term capital gains had it been sold. See the chart to follow for a general summary of AGI deduction limits by type of gift and charity, respectively.

PERCENT OF AGI THAT CAN BE DEDUCTED		
Type of Gift	**Type of Charitable Recipient**	
	Public Charity	**Private Charity/Foundation**
Cash	60%	30%
Ordinary Income	50%	30%
Capital Gain	30%	20%
Gifts Made by C-Corp, or Entity Taxed as Corporation (regardless of type of property transferred)	10%	10%

Charitable trusts may be established for the sole benefit of a charity, or for the benefit of charities and individual non-charitable beneficiaries ("split-interest trusts"). Depending on the type of split-interest charitable trust, the income and the principal from the gift is split between you, the donor, and the named charity. If a split-interest trust qualifies as a **charitable remainder trust** or a grantor **charitable lead trust**, the donor can claim a charitable deduction for the value of the interest passing to a charity. Remainder trusts and lead trusts can be settled during your (the grantor's) life or at death.

A Charitable Solution: Required Minimum Distributions

Many wealthy people may not need the money they've accumulated in their tax-qualified and Roth IRAs. A person age 72 or older can make direct charitable gifts from an individual retirement account of up to $100,000 per year to public charities (other than donor advised funds and supporting organizations) without including the IRA distributions in taxable income. Most grant-making private foundations are ineligible recipients, but private operating foundations are eligible. **The amount of the contribution counts toward the required minimum distribution for the year**.

This provision applies only to traditional IRAs and Roth IRAs. Special rules apply to the ordering of distributions where the account owner has previously made non-deductible contributions.

Gifting Qualified Land Conservation Easements

A donation of a conservation easement involves granting the rights to control development of real property to a qualifying public or private land trust. The land trust stewards the property and ensures that the provisions of the easement are followed.

In most cases, the grant is for perpetuity, and is always irrevocable. When donating an easement, you don't give up ownership of the property, however: You can continue to use it, and give or devise it to anyone, subject to the easement. But the easement has the effect of reducing the property's market value, giving rise to a federal charitable income tax deduction, based on the change in value, before and after the placement of the easement.

An easement may require the property to remain agricultural, to remain or revert to wildlife habitat, to maintain certain historical features (causing even urban properties to qualify), or to be limited to any of a certain number of uses, even if the property isn't devoted to any of them presently. The federal income tax deduction limit for a qualified conservation easement is currently 100% of AGI for agricultural property and 50% of AGI for all other types of land. The unused federal charitable deduction can be carried forward for 15 years. In addition, the estate is allowed an exemption of 40%, up to $500,000, on the already-reduced value of the land for estate tax purposes.

Moreover, the income tax savings from the conservation easement can be used to fund a life insurance policy that will restore the value of the land for the benefit of your heirs.

To Gift or Not to Gift: Managing Tax Cost Basis

Because income-tax rates for the highest income earners are comparable to the maximum gift and estate tax rate of 40%, it is important to consider the basis of an asset prior to making a gift. Whereas assets held until death get a step-up in basis to their fair market value, assets transferred by gift do not get the same treatment. Instead, the lesser of your (the donor's) cost basis or the asset's fair market value carries over to the recipient and becomes the recipient's basis. For this reason, gifts of cash or assets with a higher basis may make more tax sense in the long run than gifting low-basis assets.

Maximizing Annual Limits for Qualified Defined Contribution Plans and IRAs

For **traditional and Roth IRAs**, December 31 doesn't present an actual funding deadline; taxpayers have until April 15 both to establish and to make contributions to their accounts for 2020.

In the case of **defined contribution plans**, December 31 does present a cutoff for wage earners, who may not make elective deferrals for 2020 after that date. However, year-end strategies are largely restricted to increasing the employee's plan contribution rate because plans generally do not allow participants to make lump sum deposits outside of the wage cycle.

You May Wish to Consider These Two Retirement Savings-Related Tax Strategies

HIGH INCOME EARNERS STRATEGY:

If your total compensation exceeds the Social Security wage base ($137,700 in 2020), you may wish to consider increasing your defined contribution payroll deduction rate after your year-to-date earnings exceed the wage cap. At that point, your employer will stop deducting the 6.2% OASDI (Social Security) tax from wages, creating an additional savings opportunity for you, with no decrease in take-home earnings.

IRA CONVERSION STRATEGY:

As year-end approaches, you could make a partial Roth IRA conversion. Since your probable full-year compensation is understood by this time, a partial Roth IRA conversion may be structured to "fill out" part or all of the highest tax bracket you will occupy. For example, if your annual earnings will finish at $250,000 (married filing jointly – 2020) for the year, $78,950 of that will be included in the 24% federal income tax bracket. This leaves $76,600 "left" in the bracket before the next highest tax rate of 32% applies. If you are comfortable paying 24% tax on the conversion, but no more, there may be an opportunity to convert up to $76,600 of a traditional IRA to a Roth IRA without entering a higher tax bracket. (Combined with your lower-tiered income, the actual effective rate will be less than 24%). This example assumes a federal filing status of married, filing jointly.

TRADITIONAL AND ROTH IRAS	
Contribution Limits	2020
Regular	$6,000
Catch-Up*	$1,000

*Only taxpayers age 50 and over are eligible to make catch-up contributions.

Roth Contribution Phase-Out		
Modified Adjusted Gross Income (MAGI) phase-out range for contributions to Roth IRAs		
Married filing jointly: $196,000 – $206,000 (2020)	Married filing separately: $0 – $10,000 (2020)	Single filer: $124,000 – $139,000 (2020)

No annual income limit for determining ability to convert traditional IRA to Roth IRA continues.

TRADITIONAL IRA DEDUCTIBILITY RULES			
Filing Status	Covered by Employer's Retirement Plan?	Modified AGI 2020	2020 Deductibility
Single	No	Any amount	Full deduction
	Yes	$65,000 or less $65,001 – $74,999	Full deduction Partial deduction
		$75,000 or more	No deduction
Married filing jointly	Neither Spouse Covered	Any amount	Full deduction
	Both Spouses Covered	$104,000 or less $104,001 – $123,999	Full deduction Partial deduction
		$124,000 or more	No deduction
	One Spouse Covered for Covered Spouse	$104,000 or less $104,001 – $123,999	Full deduction Partial deduction
		$124,000 or more	No deduction
	One Spouse Covered for Non-Covered Spouse	$196,000 or less $196,001 – $205,999	Full deduction Partial deduction
		$206,000 or more	No deduction

QUALIFIED PLANS	
	2020
Maximum elective deferral to retirement plans (e.g., 401(k), 403(b), and 457 plans, and Salary Reduction Simplified Employee Plans (SARSEPs))	$19,500
Maximum elective deferral to SIMPLE 401(k) plans	$13,500
Limit on annual additions to SEP plans	$57,000
Annual compensation threshold requiring Simplified Employee Plan (SEP) contribution	$600
Limit on annual additions to defined contribution plans	$57,000
Maximum annual compensation taken into account for contributions	$285,000
Annual benefit limit under defined benefit plans	$230,000
Threshold amount for definition of highly compensated employee	$130,000
Threshold amount for definition of key employee/officer in top-heavy plans	$185,000
Catch-Up Contribution Limits for Other Qualified Plan Types	2020
401(k), 403(b), SARSEP, and 457 plans	$6,500
SIMPLE plans	$3,000

Managing Gains and Losses to Your Advantage

To take advantage of **capital gains or losses** for 2020, assets must be sold by December 31, 2020. For tax year 2020, long-term capital gains rates can vary from 0% to 20%, depending on the taxpayer's highest ordinary income tax bracket. In addition, high-income earners may pay an additional 3.8% tax on capital gains.

Since capital gain and loss is aggregated on the year, taking losses can sometimes make sense to offset or eliminate tax on gains. If you don't wish to cash out of a loss position because you believe in a security's long-term appreciation potential, you should know that a loss can be realized on a security, and it can then be repurchased, as long as 30 days elapse between the transactions.

The tax deduction for capital losses is limited to $3,000 per taxpayer per year, but excess loss may be carried forward for an unlimited number of tax years.

TWO QUICK IDEAS: POTENTIAL TAX DEDUCTIONS TO CONSIDER

1. **Change from a "pay-as-you-go" approach to income and property taxes.** Taxpayers can pay these taxes even before the taxes are due, and be credited later. The advantage is that paying next year's taxes this year is a deductible expense on this year's federal Form 1040, Schedule A.
2. **Make January's mortgage payment by December 31.** The interest portion of the payments will show up on the taxpayer's 1098 mortgage interest statement for the current year. It's important not to apply the money solely toward mortgage principal, as payment of principal is non-deductible. Rather, the payment should be remitted to the mortgagee as the ordinary, scheduled monthly payment of principal and interest, so the interest portion can be deducted.

YEAR-END TAX STRATEGIES FOR BUSINESS OWNERS

Self-employed individuals or business owners with relatively few employees may consider **establishing certain qualified plan types by year-end**; they'll have until April 15, 2021, (or October 15, 2021, if an extension is requested) to actually fund such plans for 2020. A self-employed business owner, for example, can set up an **individual 401(k)** or **Roth 401(k)** or **defined benefit plan** this year and fund it for 2020 in 2021.

Under the 2020 solo **401(k)** contribution rules, a plan participant can make a maximum employee deferral contribution in the amount of $19,500 ($26,000 with the over-50 catch-up). That amount can be made pre-tax or after-tax (Roth). The business itself can make a 25% (approximately 18% in the case of a sole proprietorship or single member LLC) **profit sharing contribution**, up to a combined maximum, including the employee deferral, of $57,000. However, only the employer portion can be contributed after December 31 to qualify for the tax year.

One of the main benefits of a solo 401(k) is the opportunity to make higher contributions. Under most retirement plans that a self-employed taxpayer could establish, the maximum annual deductible contribution is 25% of the business owner's compensation.

A **defined benefit plan**, while more complex, may afford a much larger deductible contribution than a defined contribution plan. These plans are open to any type of business and all owners and employees without restriction.

While many people may think of them as only suitable for large businesses, the fact is that they may be even more appropriate for small businesses because they can be **designed to provide a more significant benefit to the owners** than certain other types of retirement plans.

Many middle-aged business owners can benefit from this type of plan if they have strong cash flows and want a way to accelerate savings for retirement. This may be especially true for those who got a late start or whose businesses took time to hit their strides. Because defined benefit retirement benefits are based upon individual income history, a participant may be able to experience the same lifestyle he or she enjoys today while in retirement.

The Important Role of Life Insurance

Chances are that a business owner who has the cash flow necessary to fully fund a defined benefit pension plan **may also need life insurance for income protection, wealth transfer, or an estate strategy**. Life insurance may be owned by the plan, subject to certain "incidental benefit" rules, with the effect of causing the cost of the business owner's personal life insurance coverage to qualify for a tax deduction.

You may be able to take advantage of many tax strategies before the end of the year. Working with a team that includes you, your financial professional, and your tax and legal advisors, there are several opportunities to potentially lower your tax bills. Start this important conversation now and you may be able to save on your year-end federal income tax.

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