GMS Surgent
CERTIFIED PUBLIC ACCOUNTANTS AND ADVISORS

GMS SURGENT 2020 YEAR-END TAX SAVING TIPS

In the last several weeks, we have communicated with you regarding strategies and tips to consider in light of the pending Biden presidency. Below are year-end tax planning ideas and suggestions.

INDIVIDUAL TAX

Even though the election is over, there is still uncertainty regarding future tax policy. This uncertainty will remain until the January 5th runoff election in Georgia, clearly making year-end tax planning more difficult. If the Democrats win both seats in the runoff election, the Senate would be evenly split 50-50 with an effective Democrat majority with the Vice President as a tiebreaker.

Biden has indicated that he would like to propose various tax increases, such as:

- For taxpayers with over $400,000 of income:
  - An increase in the top individual income tax rate to 39.6% (currently 37%)
  - The elimination of the 199A pass-through deduction. For those shareholders/ partners that are currently able to take advantage of this deduction, the current top tax rate on the pass-through income is effectively 29.6% (37% top tax rate X 80% taxed after deduction = 29.6%) – a full 10% less than the proposed top tax rate.
  - Capping of itemized deductions at 28%
  - Imposing social security taxes on earned income over $400,000. It is not clear at this time whether Biden's proposal includes only the individual 6.2% or if employers would also be required to pay their 6.2% share on this income as well.
- For taxpayers with over $1 million in income:
  - Raising the capital gains rate to the top ordinary tax rate (39.6%). This would nearly double the tax rate on capital gain income for these taxpayers.

Planning Point: Consider accelerating income into 2020 or delaying deductions to take advantage of the known, lower tax rates. This strategy needs to be balanced against liquidity needs during this period of economic disruption.

The 2020 standard deduction is increased to $24,800 for married taxpayers filing jointly, $12,400 for married filing separately or single filers, and $18,650 for heads of households. In addition, there is a $300 above-the-line charitable deduction allowed for 2020 for taxpayers who claim the standard deduction.

Planning Point: Depending on your situation, it might make sense to "bunch" certain types of deductions (such as charitable contributions, and real estate/income tax payments up to the $10,000 limit below) into one year to increase your itemized deductions above the standard deduction amount.

As a reminder, remember that while personal exemptions are eliminated, dependency is still important for purposes of determining filing status and claiming child tax credits.

Certain itemized deductions remain limited or eliminated altogether.

- Real estate and state and local income tax deductions are capped at $10,000 combined.

Planning Point: Note that for a business/rental property, real estate and certain other taxes are still deductible as business expenses against the income of the business/rental. Also, certain states have enacted a mechanism whereby an entity can make a state tax payment and is allocated a credit that the partners/shareholders can claim on their state income tax return. The point of this is to circumvent the $10,000 cap mentioned above and has been blessed by the IRS.

- Mortgage interest is deductible on up to two homes on total qualifying debt up to $750,000. Existing mortgages incurred on or before December 14, 2017 are "grandfathered" under the old tax laws. Mortgage debt that is refinanced is also grandfathered under the old laws to the extent that the resulting debt does not exceed the amount refinanced. Interest expense incurred on home equity debt is now disallowed; however, if the home equity loan is used to buy, build, or substantially improve the taxpayer's home that secures the debt, the interest on the debt is still deductible. (Note: If mortgage proceeds are invested into a business, there may be an ability to deduct the related interest expense against the business income).

- Miscellaneous itemized deductions, such as unreimbursed business expenses, tax return preparation fees, investment advisor fees, etc. remain eliminated.

Planning Point: Employees that incur job-related expenses should consider requesting that their employer reimburse them.

- The medical expense deduction is allowed to the extent medical expenses exceed 7.5% of AGI.

Planning Point: Consider bunching medical deductions in a year to potentially result in a tax benefit.

- Charitable contributions remain deductible, subject to percentage limitations based on adjusted gross income. For 2020, the limitation is 100% of adjusted gross income for cash contributions to most charities (the limitation returns to 60% for 2021).

Planning Point: Consider bunching charitable contributions, perhaps via a contribution to a donor-advised fund, in one year if doing so will increase your total deductions above the standard deduction amount for that year.

Planning Point: Consider making a donation of long-term highly appreciated securities to receive the tax deduction at the fair market value and avoid the tax on the capital gains.

Planning Point: Consider making a contribution through a state-sponsored tax credit program such as Pennsylvania's EITC/OSTC programs. These programs essentially redirect Pennsylvania taxes to certain educational/ scholarship organizations.

Planning Point: Consider making a qualified charitable distribution from an IRA. If over age 70 ½, individuals can instruct that up to $100,000 from an IRA be sent directly to a charity. This counts toward the RMD requirement (note that there is no RMD requirement for 2020) and it also excludes the RMD as income. This strategy reduces taxable income while still allowing the same standard deduction. Even though there is no RMD requirement for 2020, this may still be a strategy to consider for certain individuals who are taking the standard deduction.

Planning Point: Remember to get contemporaneous acknowledgement letters from the charitable organization for all charitable contributions.

- The overall business loss limitation ($518,000 for joint returns in 2020) has been suspended for 2018, 2019, and 2020. Beginning in 2021, any overall net amount of loss from partnerships, S corporations, and sole proprietorships that exceeds the threshold amount cannot offset other income sources and must be carried forward to each subsequent year where it will be considered part of the overall business loss in that year.

Planning Point: Any losses that were previously limited on a 2018 or 2019 tax return can be claimed via the filing of an amended return.

- The deduction for alimony payments made remains eliminated for divorces entered into after December 31, 2018. Alimony received is no longer taxable for divorces entered into after this date as well.

- The child tax credit remains at $2,000, of which $1,400 is refundable. There is also a $500 nonrefundable credit for qualifying dependents other than children. The adjusted gross income level at which these credits are subject to phase-out is $400,000 for married taxpayers filing jointly.

- Balances in Section 529 plans have historically been available to be used for post-secondary education expenses. Section 529 plans also allow up to $10,000 (per student, per year) to be used for K-12 education. Many states also allow a tax deduction against the state taxable income for contributions to a Section 529 plan.

- The alternative minimum tax (AMT) is retained with higher exemption amounts. In addition, the exemption phase-out range increases to $518,400 for single filers and $1,036,800 for married taxpayers filing jointly. This, together with the significant reduction in the amount of deductible real estate and state and local income taxes and miscellaneous itemized deductions will continue to reduce the number of taxpayers subject to the AMT.

Planning Point: It may be advantageous to recognize additional ordinary income in a year when AMT applies because the AMT rate is often less than the taxpayer's marginal tax rate.

- Some taxpayers may be able to take advantage of a 0% capital gains tax rate. For married taxpayers filing jointly with incomes not exceeding $80,000, there is a 0% rate available for long-term capital gains and qualified dividends. For single taxpayers the 0% rate is available if the taxpayer's income does not exceed $40,000.

Planning Point: Consider gifting appreciated stock to take advantage of tax rate differences. For example, a parent subject to a 20% capital gains tax (plus 3.8% net investment income tax) could gift appreciated stock to his 24-year old graduate student son subject to a 0% capital gains tax rate, so that the son could then sell the stock for a lower tax bill.

- Tax harvesting is the selling of stocks and other investments to generate capital losses that can be utilized to offset capital gains. Also note that tax gain harvesting may be advisable to avoid "hanging" capital losses at the state level, as certain states do not provide for carryovers of unused losses.

- Consider disposing of a passive investment before year end in order to trigger the recognition of prior suspended passive losses.

- Taxpayers may be able to receive very favorable tax treatment on the sale of investments if the proceeds are reinvested in business property and/or real estate located in a "Qualified Opportunity Zone" within 180 days. Note that due to COVID-19, taxpayers now have until December 31, 2020 to invest if their 180 day period would have ended between April 1, 2020 and December 31, 2020.

> **Planning Point:** The Federal QOZ program is intended for projects with long-term hold (greater than 10 years) considerations. The program has limited impact on short holding period projects (under 5 years).

- Employees and business owners should always max out their retirement plan contributions, including any employer matches, as they are able.

- Taxpayers are able to make contributions directly to Roth IRA's depending on income amounts. If income is above the threshold for this, taxpayers may be able to make a backdoor Roth IRA contribution. (Note that this "backdoor" strategy may not work if you have other IRA balances, including SEP IRA's.) This is a highly advisable consideration for younger taxpayers with many years of earned income ahead of them.

- Due to COVID-19, required minimum distributions from IRA's are not required for 2020.

> **Planning Point:** For certain taxpayers, it might be advisable to consider accelerating other income into 2020 to take advantage of the lower tax rates available due to the absence of the RMD.
>
> **Planning Point:** Consider a Roth IRA conversion in 2020 due to the absence of the RMD.

BUSINESS TAX

- Unless Congress acts, there is no deduction for expenses paid with PPP funds in 2020, regardless of which year the forgiveness occurs, provided there is a reasonable expectation of forgiveness. This additional income should be considered in your planning.

- The 199A (20% qualified business income deduction) for sole proprietorships, certain rentals, and passthrough businesses may reduce your tax bill if applicable. As discussed at the beginning of this alert, Biden has proposed eliminating this deduction for taxpayers with income over $400,000.

> **Planning Point:** At the entity level, review compensation structure prior to year-end, and revisit partnership agreement allocations.
>
> **Planning Point:** If a business is operating as a sole proprietorship or a solely-owned LLC, consider an S election with salary compensation to the owner. This may provide the ability to increase the 199A deduction and it also may decrease the Social Security taxes paid by the owner.
>
> **Planning Point:** At the entity or individual level, consider increasing retirement plan funding levels and other tax strategies for certain business types to fall below income limits.
>
> **Planning Point:** At the individual level, consider whether aggregation elections are available or beneficial; and if not available, whether factors can be changed to allow for aggregation.

- The deduction for entertainment expenses is still eliminated. In addition, the deduction for certain meals provided to employees is reduced to 50% until 2025, and then eliminated after 2025.

> **Planning Point:** Consider creating separate general ledger accounts to separate the 0%, 50%, and 100% deductible amounts to achieve the maximum tax deduction.

- The immediate expensing (via enhanced "bonus depreciation" rules) is allowed for certain types of assets (tangible personal property, certain nonstructural, nonresidential interior property) placed into service in a trade or business between September 28, 2017 and December 31, 2022. For years beginning after December 31, 2022, the amount of the deduction is decreased.

- The Section 179 expensing election is available for nonresidential building improvements such as roofs, HVAC equipment, fire protection and alarm systems, and security systems, as well as for tangible personal property used to furnish lodging, such as residential rental property or a hotel. The maximum value that may be deducted for the Section 179 election is $1,040,000, with a phase-out that begins at $2,590,000 of property placed into service.

- Certain qualified improvement property ("QIP") (nonstructural, interior, nonresidential, placed into service after the building was first placed into service) are now allowed a 15-yr tax life, and qualify for bonus depreciation and 179 expensing. This results from a technical correction that had been expected. Prior to this correction, this property had a 39-yr tax life.

> **Planning Point:** Taxpayers that placed QIP in service in their 2018, 2019, or 2020 tax year have the option to file a Form 3115, *Application for Change in Accounting Method*, with their current-year return to claim the missed depreciation, or to file an amended return or Administrative Adjustment Request for the year the QIP was placed in service.
>
> **Planning Point:** Consider a cost segregation study to split out the cost of the purchase of a building, for example, into assets with shorter depreciable lives.
>
> **Planning Point:** Consider accelerating income into a year in which there are significant depreciation deductions available.

- There is a $10,000 cap on the total amount of property and state and local income taxes that may be deductible as an itemized deduction at the individual level. To circumvent this cap, certain states (CT, LA, MD, NJ, OK, RI, and WI with more states presumably following) have provided a mechanism whereby a business entity such as a partnership or S corporation makes a state income tax payment and is allocated a credit that the partners/shareholders can claim on their state income tax return.

- The maximum allowable deduction of interest expense for certain businesses cannot exceed 50% of the business' EBITDA (earnings before interest, taxes, depreciation, and amortization). The 50% limitation decreases to 30% in 2021. Many businesses with average annual gross receipts of less than $26 million are not subject to this limitation. However, an entity that is defined as a "tax shelter" (i.e. more than 35% of losses are allocated to limited partners) is subject to the limitation even if gross receipts do not meet the $26 million threshold.

> **Planning Point:** This 50% limitation can be avoided by an election available to "real property trades or businesses" that by definition are engaged in: leasing, construction, development, acquisition, operation, management, or brokerage of real property. Such an election would necessitate the use of a less favorable depreciation method.

- Many small businesses can use the cash method of accounting, as opposed to the accrual method of accounting. To qualify for the cash method, the taxpayer must have average gross receipts for the preceding three years of less than $26 million. The cash method of accounting may allow taxpayers to defer tax reporting of revenue until the following year by deferring customer payment due dates until the following year and may allow the acceleration of expenses into the current year, such as by paying bills early or prepaying certain expenses.

- In a closely-held business setting, consider employing children to perform work for the business. This shifts income to the child's usually lower tax bracket from the parents, and it provides for an ability for the child to make a Roth IRA contribution. In addition, depending on the business structure, self-employment taxes may be avoided by doing this as well.

- State tax business compliance has become more complex as states are increasingly looking for additional revenues. A recent Supreme Court case paved the way for states to assess sales tax nexus depending on factors such as the dollar value of sales in that state or the number of sales made in that state. This could potentially require out-of-state sellers to collect and remit sales tax in states in which they do not do business or have a physical presence.

- For state income tax purposes, many states have adopted "economic presence" standards, which may require the filing of tax returns in a given state for certain businesses that "direct business activities" into the state, even if the out-of-state seller does not have any physical presence in the state.

Planning Point: Many states offer voluntary disclosure programs where taxpayers can voluntarily reveal themselves. In addition, some states offer amnesty programs that may provide enhanced benefits such as reduced or eliminated penalty waivers assessed on tax amounts due.

- The C corporation rate remains at 21% and the C corporation AMT is still repealed. This may make a C corporation appear more attractive to certain businesses but the "double taxation" of C corporation earnings still applies. In addition, state corporate income taxes may make the C corporation option remain unattractive to businesses in many states, as the C corporation tax rate may be higher than the pass-through rate. Biden has proposed increasing the rate to 28%.

ESTATE AND GIFT TAX

- The basic exemption for federal estate and gift tax purposes is $11.58 million per individual in 2020. Note that many states have a much lower threshold for filing and/or paying state death tax. These higher exemption amounts are scheduled to return to the prior (much lower) amounts after December 31, 2025, so it may be advisable to take steps to reduce your estate while the above exemption amounts are available. Assuming the exemption amounts are reduced in the future, IRS regulations grandfather any gifting done under the higher exemption amounts. Both the Federal estate and gift tax exemptions are indexed for inflation.

Planning Point: Joe Biden has indicated that he'd prefer to see a decrease in the estate and gift exemptions of $11.58 million per individual. In light of this, it is advisable to consider whether any gifting should be done in 2020 to reduce your estate.

> **Planning Point:** The annual exclusion amount remains at $15,000 per donor, per donee, in 2020 (and 2021). This may provide an ability to reduce the size of your taxable estate over time.

With the year quickly drawing to a close, there is still time to consider some of the above tax planning ideas. Please reach out to us if you would like to discuss further.

About Us

GMS Surgent is a mid-sized, full service, certified public accounting and advisory firm serving business and individual clients located primarily (but not limited to) the Greater Philadelphia area. We warmly invite you to click around our website to learn a little more about our firm, our clients and the ways in which our services could benefit you.

"Personal Attention – Valuable Results”, is the principal component of our mission statement. It highlights the GMS Surgent commitment to forging strong relationships and ensuring constructive communication while earning consistently effective results for our clients. It plays an essential role throughout every aspect of our firm, guides our actions and acts as a benchmark for the services we provide.

This information is of a general nature. It may omit many details and special rules and is current only as of its published date. Please contact us for more information and how it pertains to your specific tax or financial situation.