2020 Year-End Tax Planning

As the end of the year approaches, various tax planning opportunities may be available to help reduce your tax burden. New laws and the rapidly changing environment brought on by the pandemic have presented new tax challenges and opportunities. Having the right tax strategy will help you navigate through this time of disruption and change in order to minimize your overall tax burden. To take advantage of any such strategy, implementation needs to be completed by the end of the tax year. This planning summary highlights several potential tax-saving opportunities for individuals and businesses to consider.

YEAR-END TAX PLANNING FOR INDIVIDUALS

Capital Gains

The timing of transactions generating capital gains and losses should be considered whenever possible. Attention should also be paid the holding period of the investment as long-term capital gains (i.e., gains from assets held for more than one year) are taxed at preferential rates whereas short-term capital gains are taxed at ordinary income tax rates. In addition, short term capital losses are limited to $3,000 per year ($1,500 for married individuals filing separately) with any additional losses carried over to subsequent years.

Income & Deductions

The timing of income and deductions may enable you to claim larger deductions, credits and other tax breaks for a tax year due to various tax calculations that are affected by varying levels of adjusted gross income (AGI). These include deductible IRA contributions, child tax credits, higher education tax credits and deductions for student loan interest. Postponing or accelerating income may be advantageous for taxpayers who anticipate being in a lower tax bracket either this year or next year due to changes in financial circumstances.

Net Investment Income Tax

The 3.8% net investment income tax (NIIT) is levied on the lesser of net investment income (NIIT) or the amount by which modified AGI (MAGI) exceeds certain dollar amounts: $250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separate returns and $200,000 for single individuals. With this additional tax, the maximum net capital gains rate is 23.8% in 2020. As year-end nears, a taxpayer's approach to minimizing or eliminating the 3.8% surtax will depend on his/her estimated MAGI and NII for the year.

Itemized Deductions

Many taxpayers will not be able to itemize because of the high basic standard deduction amounts that apply for 2020 and because many itemized deductions have been eliminated. No more than $10,000 of state and local taxes may be deducted, while medical expenses, including amounts paid as health insurance premiums, are deductible only to the extent that they exceed 10% of AGI for all taxpayers. Miscellaneous itemized deductions remain nondeductible. To maximize the benefits of both the standard deduction and itemized deductions, consider adjusting the timing of deductible expenses, i.e., "bunching," so that they are higher in one year and lower in another year. Two COVID-related changes for 2020 may be relevant here: (1) Individuals may claim a $300 above-the-line deduction for cash charitable contributions on top of their standard deduction, and (2) the percentage limit on charitable contributions has been raised from 60% of modified adjusted gross income (MAGI) to 100%.

Required Minimum Distributions

Required minimum distributions (RMDs) that usually must be taken from an IRA or 401(k) plan have been waived for 2020. This includes RMDs that would have been required by April 1 if you hit age 70½ during 2019. So if you do not have a financial need to take a distribution in 2020, you do not have to. Note that because of a recent law change, plan participants who turn 70½ in 2020 or later need not take required distributions for any year before the year in which they reach age 72.

Qualified Charitable Distributions

If you are age 70½ or older by the end of 2020, have traditional IRAs and especially if you are unable to itemize your deductions, consider making 2020 charitable donations via qualified charitable distributions from your IRAs. These distributions are made directly to charities from your IRAs, and the amount of the contribution is neither included in your gross income nor deductible as an itemized deduction. However, you are still entitled to claim the entire standard deduction.

Annual Gift Tax Exclusion

Make gifts sheltered by the annual gift tax exclusion before the end of the year; doing so may save gift and estate taxes. The exclusion applies to gifts of up to $15,000 made in 2020 to each of an unlimited number of individuals. You cannot carry over unused exclusions from one year to the next. Such transfers may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax.

YEAR-END TAX PLANNING FOR BUSINESSES

Net Operating Losses

If a taxpayer will incur a net operating loss for 2020, the loss it generally may be carried back five years or forward indefinitely. Alternatively, taxpayers may elect to waive the carryback period and instead, choose to carry forward losses. Taxpayers should be aware that deductions for losses arising after 2017 and carried forward to 2021 are limited in 2021 and later years to 80% of taxable income.

Qualified Business Income Deduction

Taxpayers other than corporations may be entitled to a deduction of up to 20% of their qualified business income. The deduction may be limited based on whether the taxpayer is engaged in a service-type trade or business (such as law, accounting, health or consulting), the amount of W-2 wages paid by the trade or business and/or the unadjusted basis of qualified property held by the trade or business.

Limitation on Business Interest Expense

The deduction for net interest expenses incurred by a taxpayer is limited to the sum of business interest income, 50% of the business's adjusted taxable income (ATI) and floor plan financing interest. Taxpayers with average annual gross receipts of $26 million or less are exempt from the limit. Further, the limitation does not apply to the trade or business of being an employee, electing real property trades or businesses, electing farming businesses or certain regulated utilities. Taxpayers may elect to substitute 2019 ATI for 2020 ATI. Further, taxpayers may elect out of the increase to 50% of ATI and use the standard 30% of ATI to determine their limitation.

Cash Method of Accounting

More small businesses can now use the cash (as opposed to accrual) method of accounting. To qualify as a small business, a taxpayer must satisfy a gross receipts test. For 2020, the gross-receipts test is satisfied if during a three-year testing period, average annual gross receipts do not exceed $26 million. Cash method taxpayers may find it a lot easier to shift income. For example, holding off billings until next year, accelerating expenses, paying bills early or by making certain prepayments.

Accelerated Deprecation

Businesses can claim a 100% bonus first year depreciation deduction for machinery and equipment bought used (with some exceptions) or new if purchased and placed in service this year. The 100% write-off is permitted without any proration based on the length of time that an asset is in service during the tax year. As a result, the 100% bonus first-year write-off is available even if qualifying assets are in service for only a few days in 2020.

Taxpayers purchasing equipment may make a §179 election, which allows them to expense (i.e., currently deduct) otherwise depreciable business property, including computer software and qualified real property. The expensing deduction can be claimed regardless of how long the property is held during the year. The Tax Cuts and Jobs Act (TCJA) expanded the definition of section 179 property to include qualified improvements to nonresidential real property, which means certain improvement to a building's interior and for improvements such as roofs, HVACs, fire protection systems, alarm systems and security systems.

De Minimis Safe Harbor Election for Materials and Supplies

Businesses may be able to take advantage of the de minimis safe harbor election (also known as the book-tax conformity election) to expense the costs of lower-cost assets and materials and supplies, assuming the costs do not have to be capitalized under the Code Sec. 263A uniform capitalization (UNICAP) rules. To qualify for the election, the cost of a unit of property cannot exceed $5,000 if the taxpayer has an applicable financial statement. If there's no AFS, the cost of a unit of property cannot exceed $2,500.

Payroll –Year-End Bonuses

In general, a taxpayer's liability for non-owner employee bonuses accrues and is deductible for the current year, even though the bonus is paid in the following year. If all the events are satisfied that fix the liability and the taxpayer does not have a unilateral right to cancel the bonus at any time prior to payment. Generally, the taxpayer may accelerate the bonus deduction into the current year while the employees will report the income in the following year if they are cash method taxpayers. Furthermore, any compensation arrangement that defers payment will be currently deductible only if paid within 2½ months after the employer's year-end.

Charitable Contributions

A charitable contribution deduction is available to businesses. A corporation is generally allowed to deduct charitable contributions up to 10% of its taxable income. Under the CARES Act, the corporate limitation is increased to 25% of taxable income for contributions made in calendar year 2020. Contributions by pass-through entities are allocated to individual equity interest holders and are subject to the individual's limitations.

Contact Us

Please contact your Melton & Melton Tax advisor or email us to discuss your specific tax situation and create a personalized year-end tax plan.