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Financial Planning Tax Tips in 2020

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July 2020

On occasion, accelerating income taxes can make sense.

For many people, the confluence of the global pandemic and subsequent economic recession has potentially caused the following: employment termination, reduced hours, work furloughs, the elimination of RMDs for 2020 (the CARES Act), and significantly less capital gains due to the precipitous drop in the stock market. Thus, it is safe to assume that for many, 2020 income will be much lower than the booming yesteryear of 2019.

Due to the (hopefully) temporary drop in taxable income, this year may be an opportune time to consider various financial planning strategies to increase taxable income by accelerating income recognition and suspending deductions. I know what you may be thinking as you read this – "Wow, Dan, this sounds counter-intuitive! Doesn't the time value of money concept teach us that tax deferral and deduction accelerations are more important than the opposite?" Not always. In certain circumstances, and when income is temporarily lower than normal, making financial plans to accelerate income and push back deductions could be wise.

Additionally, 2020 may be an opportune year as it may get ahead of some of the future "sunset provisions" of the recently passed Tax Cut and Jobs Act. In 2025, estate tax exemptions will not be the only thing to sunset back to their previous levels ($11.58m to $5m, adjusted for inflation). In addition, individual tax rates (excludes corporate) will also sunset to previously higher brackets.

Long-short: it may be wise to consider offering a slice of pie to Uncle Sam in 2020, when the overall pie is smaller. Some strategies to take advantage of this include the following:

Roth IRA: If a termination, reduced hours, or work furlough has lowered your income, you may be able to take advantage of a 2020 Roth contribution that was not previously allowed due to income thresholds. Roth IRAs are not subject to required minimum distributions (RMDs). While inherited Roth IRAs (like traditional IRAs) also need to be distributed over 10 years, the tax-free distribution benefit may provide the future owner of the inherited Roth IRA with more after-tax income. In considering a Roth IRA, be mindful of the adjusted gross income (AGI) thresholds (< $139,000 individuals; < $206,000 couples) and the Roth IRA Five Year Rule (for distributions to be tax-free, you must have owned the Roth for at least 5 years or until 59.5 years old, whichever is longer).

"Back Door Roth IRA": If your AGI is too high to contribute to a Roth IRA directly and you contribute to a qualified plan (i.e. 401k), you can still get money into a Roth IRA through the "back door." Here's how it works:

1. Open a traditional IRA and make "non-deductible" contributions
    a. If your modified AGI > $124,000 (individuals) and $196,000 (couples), and you contribute to an employer 401k, IRA contributions are not deductible
    b. Contribution limits are $6,000 or $7,000 if over 50 years old
2. Convert "non-deductible" IRA into a Roth IRA through a Roth conversion

The main benefit of doing a "back door" contribution to a Roth IRA is that you are still able to do a Roth conversion and take advantage of a temporarily lower tax bracket, albeit through a few more steps. In addition, you are also eliminating future RMDs altogether. However, be mindful that the "pro rata rule" still applies. That is, when converting an IRA through the "back door," the IRS uses the "pro rata rule" to determine the taxes owed on conversion of non-deductible IRA to Roth. The "pro rata rule," formula is the total non-deductible contributions divided by the total value of IRA(s) multiplied by the amount converted. For example, let's assume Sue has $1,000,000 in all of her IRAs. Of this sum, $600,000 is pre-tax contributions, $200,000 is non-deductible contributions, and $200,000 is investment earnings. If Sue converts her non-deductible IRA into a Roth, she owes taxes on 20% ($200,000/$1,000,000) of whatever is converted from her non-deductible IRA into a Roth IRA.

Non-Qualified Stock Options (NQSO): If you have NQSO with a short expiration window and you expect your 2020 income to be temporarily lower, exercising them now may be a good strategy to consider. Recall that for NQSO, the difference between the grant price and fair market value (FMV) at exercise is considered taxable income. Additionally, many NQSO come with an expiration date of ten years from the grant date. However, you can benefit from this strategy by exercising the NQSO that are close to expiration and taking advantage of a lower tax bracket. The subsequent sale of NQSO are longterm capital gains (if held for more than one year) and are taxed on the difference between the sale price and FMV at exercise. Be mindful to make sure that your company offers a "cost-less" exercise of your options so that you do not have to pay for the cost (exercise price multiplied by number of shares) out of pocket.

NUA (net unrealized appreciation) in qualified plans: This might be a strategy to consider if company stock makes up a good portion of your qualified plan (401k). While normal distributions from qualified plans result in ordinary income tax, NUA however, under IRC (402)(e)(4), allows transfer of company stock out of a 401k, while paying ordinary income on the cost basis only. The benefits of this are that you are paying ordinary income tax on the cost basis only and, post transfer, you realize capital gains on the difference between new basis and FMV at sale. For example, assume Jane has a 401k ($1,000,000) in stock XYZ with a basis of $120,000. She can utilize NUA and pay ordinary income taxes on $120,000 cost basis. When Janes sells, she will realize more advantageous capital gains on the difference between basis and FMV. Without NUA, the entire distribution is taxed as ordinary income.

Partial annuity distribution: When you take a partial withdrawal from an annuity, the money comes out on a LIFO (last in first out) basis, unless the annuity was held prior to 8/14/1982. In short, earnings are distributed first and are taxable as income and your basis (post contributions) is distributed last. Therefore, if you have an annuity, are over age 59.5, and are in need of cash-flow, it could be advantageous to take a partial distribution in a lower tax year. It is important to be mindful that distributions prior to age 59.5 are subject to an additional 10% penalty and many annuities come with "surrender" penalties. When considering this strategy, make sure that a contingent deferred sales charge is not in effect.

Accelerate installment payments: Some people sell real-estate through an installment sale as a way to spread out capital gain tax obligations. The sale is often financed by a note from the seller for a certain term (i.e. ten years). Each installment payment by the buyer results in a prorated capital gain tax to the seller. If the seller convinces the buyer to accelerate installment payments, or if the seller sells the installment note to a third party, income is accelerated. The benefit to this strategy is that the seller accelerates capital gain income in the current year (lower tax bracket) vs. deferring to future year (higher tax bracket). When considering this option, be mindful that the IRS scrutinizes the sale of installment notes to any family member. Additionally, accelerating installment payments can also accelerate depreciation recapture tax.

For the same reasons it may make sense to accelerate income, it may be wise to consider suspending deductions. The deduction could be more valuable when larger income warrants their use.

Defer charitable contributions into donor advised fund (DAF): Since state and local tax deductions are capped at $10,000, many use a DAF to increase itemized deductions above the standard deduction. You may consider deferring your 2020 DAF contribution to a following year, to optimize charitable deductions in a year where income is high (not low). A DAF contribution deferral may afford you opportunity to bunch multiple charitable contributions into a future year. Be mindful to not let the tax tail wag the dog. Charitable organizations and non-profits you support may need the money in 2020 now more than ever.

Like any tax strategy, the efficacy depends on personal circumstance. Additionally, the strategies of accelerating income may result in unintended consequences like the following: increase in Medicare premiums, triggering of AMT, phasing out of itemized deductions and personal exemptions, lower net social security benefits, higher capital gains rates (20% vs. 15%).

As always, your team at Osborne Partners recommends that you speak with your CPA or tax advisor before making tax decisions. We would be happy to be a part of these conversations.