Client Letter | 2020 Year-End Tax Planning

Article Note:

Our guest author, Tracy Lasecke at Silicon Valley Wealth Advisors in San Jose, CA, has provided us with a year-end tax planning letter for you to use (or modify) to accommodate your clients

December 2020

Dear Client –

Welcome to Fall and the changing colors of autumn leaves. This tax letter will bring light tax planning challenges and opportunities brought about by the CARES Act (2019) and SECURE Act (2020). Uncertain economic times provide opportunities in tax planning. We hope that you and your family are safe and looking forward to the holidays that follow.

This letter will cover:

- CARES Act provisions
- SECURE Act provisions
- Strategies for your Required Minimum Distributions (RMDs)

CARES Act Provisions

Retirement Plan Withdrawals and Loans

Individuals may withdraw up to $100,000 from qualified retirement accounts (IRA, as well as some 401(K) and 403(B) accounts) for coronavirus-related purposes without being subject to the 10 percent early withdrawal penalty. This assumes that the employer has opted into this provision. Additional relief is provided in that the income from these distributions is subject to tax over a three-year period. Individuals may recontribute amounts withdrawn to eligible retirement funds within three years (regardless of that year's contribution limit).

The act also increases 401(K) retirement plan loans to the *lesser of* $100,000 or the participant's vested account balance and allows participants to delay loan repayments for up to a year. Note that this assumes that the employer has opted into this provision.

Strategy Note: We highly recommend that withdrawals and loans from your retirement plans should be used as a last resort. Consider other options before pursuing this course of action.

Charitable Contributions

For those tax filers who do not itemize: The Act creates an "above the line" deduction of up to $300 for charitable contributions for taxpayers who do not itemize. This means that if you do not itemize your deductions, and therefore would normally lose the tax-deductibility of your donations, and your charitable donation will be tax-deductible on your 2020 tax return. Please note, you cannot contribute to a Donor Advised Fund for the "above the line" deduction.

Strategy Note: If you a) do not itemize, and b) are charitably inclined, make sure to take advantage of this up to the $300 limit.

Strategy Note: If you **a)** do not normally itemize, **b)** got a stimulus check, and **c)** want to help in this time of national crisis, consider using $300 of your stimulus as a charitable donation.

For those tax filers who do itemize: In normal years, the amount you can donate to charity, and be tax-deductible, is capped at 60% of Adjusted Gross Income (AGI). Under the CARES Act, there is no cap in the tax year 2020, and you can deduct charitable gifts up to 100% of AGI. By way of example, if your household AGI is $100,000, in normal years, you could claim a tax deduction for charitable donations of up to $60,000. This year your maximum charitable deduction would be $100,000. Please note that this does *not* apply to Donor Advised Funds.

Strategy Note: If you a) itemize your deductions, b) are charitably inclined, and c) want to super-size your charitable giving, then 2020 is a great year to do so.

Please note that the CARES Act does not change Qualified Charitable Distributions (QCD) rules, which are tax-advantageous for those who wish to give to charity.

Strategy Note: We provide more information on QCD strategies below.

529 College Saving Accounts Refunds

Were your child's college classes canceled? Were they asked to leave their on-campus housing? Did you receive a refund for tuition, housing, other fees? The bad news for taxpayers is that you may owe taxes and penalties on these refunds if they came out of a 529 account.

The good news is that the CARES Act allows you to re-contribute that money back into a 529 account for the same beneficiary. Recontributed refunds will not have federal income taxes or penalties associated with them, provided that you recontribute a refund within 60 days of receiving it, and the recontributed amount does not exceed the amount of the refund.

Please note that your original withdrawal will trigger a 1099-Q tax form from your 529 provider. This will not be changed by the fact that you recontributed the funds. Work with your tax professional to make sure you get the credit for the re-contribution.

Strategy Note: if you a) took money out of a 529 this year, and b) received a refund from the school you paid with the 529 funds, then you *must* recontribute those funds to a 529 within 60 days of the refund to avoid tax consequences.

Required Minimum Distributions (RMDs)

Required Minimum Distributions (RMDs) for 2020 have been suspended. These are usually required in the year the account owner turns 72 years old (changed from 70.5 in 2019 by the SECURE Act). Congress deemed that many in retirement would be hurt by the requirement to take a distribution from their retirement accounts when the holdings are down in value. With RMDs being suspended this year, you can consider a Roth IRA conversion since your taxable income could be lower and it might be an attractive time to take advantage of this. Please see more information about Roth IRA conversions under the SECURE Act section below.

Strategy Note: Instead of taking your RMD this year, consider a Roth conversion of a similar amount (see more below).

SECURE ACT

The SECURE Act was enacted into law in December 2019 and made some major changes to the tax code just weeks before they went into effect. Some of the changes in the SECURE Act have caused us to reevaluate some of the tried-and-true strategies we have recommended in past years.

Loss of the Lifetime “Stretch” for Inherited IRA Accounts

The provision with the greatest effect (and which may present the biggest and hardest planning challenge) is the elimination of the lifetime “stretch” option for IRAs. Prior to the SECURE Act, non-spouse beneficiaries were entitled to stretch out the withdrawal of their inherited retirement account in accordance with their life expectancy. Under the SECURE Act beneficiaries are required to withdraw their entire inherited retirement account within 10 years of the original owner’s death (with some limited exceptions).

In most instances, withdrawal over a 10-year period (rather than over the course of the beneficiary’s lifetime) will result in substantially less tax-deferred growth, as well as more taxes due (and more quickly) upon withdrawal from the account. This may possibly move the taxpayer into a higher tax bracket. Blindly spreading withdrawals evenly over a 10-year period may not be the most tax-efficient approach. Therefore, knowing the taxpayer’s year-by-year taxable income expectations (bonuses, bad years for business, exercising stock options, anticipated layoffs, projected year of retirement, etc.) will become critical if the goal is to minimize the taxation on the withdrawals.

Here are a few strategies to consider when planning for the loss of the lifetime “stretch” IRA option.

Roth conversions – While it may not feel like it, tax rates are at historic lows, so it could be a good plan to accelerate Roth conversions so beneficiaries can avoid being taxed rapidly on distributions. This is an especially applicable strategy if the beneficiaries are in a higher tax bracket than the original account owner. However, individuals with legacy priorities (a grandchild, for example) may not be motivated to accelerate Roth conversions under the SECURE Act. That grandchild will not benefit from long-term tax-free growth from the inherited Roth because even beneficiary Roth IRAs need to be totally distributed within 10 years.

Qualified charitable distribution (QCD) We think that the QCD is one of the smartest and underutilized strategies available to taxpayers. If an individual is older than 70½, he or she is entitled to make tax-free gifts of up to $100,000 per year from their IRA. To count toward the RMD, the contribution must be paid directly to the charity. QCDs may become more advantageous after the SECURE Act because IRAs will become a less attractive inherited asset. Therefore, tax-free depletion of the IRA may be more beneficial, instead of making contributions direction from your non-IRA assets.

Life insurance – While not a new strategy, the coordination of life insurance with your estate plan may become more potent under the SECURE Act. Taking withdrawals from a retirement account to pay for premiums on a life insurance policy could be more advantageous than leaving a retirement account to a beneficiary. Beneficiaries typically receive life insurance death benefits tax free (and usually inheritance tax-free too). Depending on a variety of factors – the insurability of the individual, the size of the total estate, the tax rate of the beneficiary, etc. – the total death benefit payable to the beneficiaries may well exceed what they would receive as a beneficiary of an IRA.

General estate planning – It may make sense for account owners to revise their estate plans to take a more specific "asset-by-asset" approach, rather than simply splitting assets by percentage. For example, an account owner might earmark IRA assets to be distributed to minors or individuals in lower tax brackets (or charity) and designate a larger portion of non-IRA assets to those with higher incomes (and benefit from the step-up in basis). Also, of note, if you have minor children, there are some changes in the SECURE Act that may want to you to update your Trust document.

Strategy Note: Discuss the SECURE Act with us, your financial advisor, and your Estate Planning Attorney ("your finance team") to make sure your goals are being addressed under the new set of rules.

Provisions provided under the CARES Act and SECURE Act will affect each of us differently depending on our individual situation's specifics. Contact us if you have questions.

Above all else, please stay safe, and here's to a happy and prosperous 2021.

Sincerely,