Planning Strategies

November 2020

Post-Election Tax Planning Update

Joe Biden campaigned on raising taxes on dividends and capital gains for persons earning over $1 million a year. He's also pushed for eliminating stepped-up basis at death and estate tax increases. However, it remains to be seen what tax changes will actually be enacted in 2021 or when they will take effect. We advise focusing on what we do know and what can be done this year before any tax changes take effect. We urge that you use caution. The decisions you make about your finances should be well thought out and not made out of fear or on a whim.

Last month, we issued a 2020 Year-End Planning Update focusing on estate and gift tax planning this year. Below we review a few major themes that affect high net-worth individuals, starting with current federal income tax rates and brackets, which were enacted in December 2017 as part of the Tax Cuts and Jobs Act (TCJA).

Income tax brackets

For 2020, federal income tax brackets are as follows:

Tax Rate	Single	Married Filing Jointly
10%	$0 to $9,875	$0 to $19,750
12%	$9,876 to $40,125	$19,751 to $80,250
22%	$40,126 to $85,525	$80,251 to $171,050
24%	$85,526 to $163,300	$171,051 to $326,600
32%	$163,301 to $207,350	$326,601 to $414,700
35%	$207,351 to $518,400	$414,701 to $622,050
37%	$518,401 or more	$622,051 or more

In addition, there is a separate set of rates and brackets for qualified dividends and long-term capital gains. These income brackets run side-by-side with the ordinary income brackets. For example, a single person with over $441,451 of taxable income would pay tax at the rate of 20% on all qualified dividends and long-term capital gains.

Tax Rate	Single	Married Filing Jointly
0%	$0 to $40,000	$0 to $80,000
15%	$40,001 to $441,450	$80,001 to $496,600
20%	$441,451 or more	$496,601 or more

Under current law, these rate brackets are slated to adjust slightly upward in 2021. However, given the outcome of the recent election, tax rates and brackets could be revamped in 2021 if Congress passes a new tax package. Candidate Joe Biden proposed adjusting the top rate from 37% to 39.6%. He also proposed increasing the federal tax rate on capital gains and dividends to 39.6% for people earning more than $1 million a year. In addition, the 3.8% Obamacare surtax on net investment income would still apply unless the statute is struck down by the Supreme Court in a case now pending.

Could there be a retroactive tax increase in 2021?

With the election of Joe Biden as the 46th President of the United States, it appears that many of President Trump's tax cuts could be rolled back next year. However, if or when that will happen is not certain. One important qualifier is that the Democrats may not have a majority in the Senate. The results of two Senate races in Georgia will not be known until January.

These outcome of these races could be determinative of how likely Biden could push through a tax increase in 2021. So, it's difficult to predict any tax changes for 2021 and whether they will be retroactive to January 1, 2021. However, it is possible that new income tax rates could be enacted midway through 2021 and be effective as of January 1, 2021.

It's not just the tax rates that could change

When we think of a tax increase, we often think of tax rates going up. But you should also expect that if tax rates are increased in 2021 many rules and policies could be changed as well. These could include:

- Elimination of tax-free like-kind exchanges under section 1031
- Change of tax treatment of 'carried interest'
- Loss of stepped-up basis at death
- Repeal or limitation of favorable rules under the Tax Cuts and Jobs Act
- Reinstatement of the SALT deduction for state and local taxes
- Reinstatement of the Pease limitation on itemized deductions
- Changes to the estate and gift tax laws
- Increased tax enforcement by the IRS

Accelerating income in 2020

Normally, tax advisors recommend deferring taxable income, if possible, to a later tax year all other things being equal. However, if you expect to have a large amount of income from a sale or other transaction that could occur in 2020 or 2021, it may be advantageous to accelerate the taxable income in 2020 to capture today's tax rates and rules. However, this should be considered carefully for your specific situation with the help your tax advisor.

Roth IRA conversions might make sense in 2020

If we assume that income tax rates will increase next year and that they will remain higher for some time, 2020 may be a good year to convert a traditional IRA to a Roth IRA. With a Roth IRA, neither you nor your spouse would have a Required Minimum Distribution (RMD) during your lifetime and withdrawals would be free of federal and state income tax. However, when you convert a traditional IRA to a Roth, you must pay income tax on the amount converted. The analysis of whether that makes economic sense is very fact dependent and the results vary based on assumptions about longevity, future tax rates, state of residence, rates of return, etc. In doing a Roth conversion analysis, it also helps to examine relative certainties, such as current versus future tax rates and brackets, and your state of residence. One strategy is to do partial Roth conversions over several years instead of one big conversion in a single year. A slower process of converting can prevent you from tipping into higher tax brackets and paying more tax than necessary. However, given the current political climate, it's anyone's guess whether we have the luxury of time or not. If you're thinking about a Roth conversion, now is a good time to see if it makes sense for you.

What are back-door Roth contributions?

While anyone can convert their traditional IRA to a Roth IRA, there are strict limits on who can make a contribution to a Roth IRA. For 2020, the maximum that can be contributed to an IRA is the lesser of (a) $6,000 ($7,000 if you're 50 or older) or (b) your earned income for the year. In addition, Roth contributions are limited based on your filing status and income. For example, if you are married and file a joint income tax return, then you may contribute up to those limits if your income is less than $196,000 ($124,000 if you are single). And you may contribute a reduced amount if your income is between $196,000 and $206,000 ($124,000 to $139,000 if you are single).[1] If you are ineligible to make a contribution to a Roth IRA, you can still contribute by making a non-deductible contribution to a traditional IRA and then converting that IRA to a Roth. This is known as a "back-door" Roth contribution. However, there is one wrinkle—the pro rata rule.

The pro-rata rule for Roth conversions: There's no free lunch

The IRS will not allow you to "cherry pick" by simply converting an after-tax funded IRA and realizing zero taxable income on the conversion to a Roth IRA. Instead, they apply a pro-rata rule that will force you to realize income based on the tax status of all of your traditional IRAs. If 70% of your IRAs consist of pre-tax money, then 70% of the IRA will be taxed on the conversion amount. To avoid taxes and penalties on early withdrawals, you should plan to pay the tax from non-IRA funds.

[1] Similar rules apply to Roth 401(k)s but with a higher contribution limit.

Roth IRAs are subject to special rules such that withdrawals taken within 5 years of conversion may be subject to a 10% tax penalty unless an exception applies. Further, withdrawals of earnings, if taken within 5 years of a contribution to a Roth IRA, are also subject to a penalty tax, as well as income tax, if taken before age 59½. Because of the complexity of these rules, we advise that you consult with your tax advisor before making a Roth conversion.

IRAs: Required Minimum Distributions

One of the biggest unexpected tax changes in 2020 was the suspension of Required Minimum Distributions (RMDs) from IRAs. In March of 2020, in response to the COVID-19 pandemic, Congress enacted the CARES Act which suspended RMDs for the year. The CARES Act and subsequent IRS guidance allowed those who had already taken RMDs to return those amounts to their IRA without incurring a tax or a penalty. Thus, anyone who otherwise would have been forced to take an RMD in 2020 could keep the funds invested inside their IRA for an extra year. The last day to rollover an RMD taken in 2020 was August 31, 2020. By law, the RMD suspension will expire at the end of 2020 and RMDs will commence again in 2021. As part of a second coronavirus relief package, Congress is considering extending this deadline and allowing both 2020 and 2019 RMDs to be returned as well. But, as the year draws to a close, it's not clear what will happen with further tax relief.

The SECURE Act, which passed only a few months earlier at the end of 2019, included a permanent modification that delays the RMD requirement to age 72 for anyone who had not already turned age 70½ by December 31, 2019.

IRAs: Review beneficiary designations

The SECURE Act made another major change to the rules governing inherited IRAs. Under the old rule, beneficiaries (other than a spouse) who inherited an IRA before January 1, 2020, would take RMDs from the IRA based on their life expectancy. A young beneficiary could stretch out the withdrawals over a long period of time, which allowed for a prolonged period of tax deferred investing. This was very advantageous. However, the SECURE Act changed all that.

Under the new rule, if an IRA owner dies in 2020 or later, the designated beneficiaries of the inherited IRAs must withdraw the entire IRA by the end of the 10th year following the death of the owner. However, unlike the old rule, annual RMDs are no longer required. Spouses may still roll over an IRA they inherit from their spouse into their own IRA. The SECURE Act carves out exceptions to the 10-year rule for minor children of the deceased owner, beneficiaries not less than 10 years younger than the owner, and for any disabled or chronically ill beneficiaries. For people in those categories, the old stretch rules still apply. In addition, accumulation trusts for disabled or chronically ill beneficiaries also qualify for the stretch treatment.

Many pre-2020 beneficiary designations name a conduit trust as the IRA beneficiary. These types of trusts direct that all IRA withdrawals taken by the trustee must be paid out directly to the trust beneficiary (rather than accumulated and invested). Under the new 10-year rule, this change may cause an unforeseen problem as it can force a large distribution into the hands of the beneficiary in a single year, which can tip the recipient into a high tax bracket and cause other issues. We strongly advise reviewing your IRA beneficiary designation forms this year.

Charitable contributions and QCDs

Traditionally, the end of the year is the time when most people make their charitable contributions, partly to secure an income tax deduction for the current year. This is still true for 2020, with a few twists.

The CARES Act modified the rules for charitable contributions. The CARES Act added a new above-the-line $300 deduction (or $600 per married couple filing jointly) for anyone who takes the standard deduction. Next, the CARES Act allows you to deduct up to 100% of Adjusted Gross Income (AGI) for cash donations to any public charity other than a Donor Advised Fund (DAF). This is up from the normal limit of 60% for cash gifts to public charities and applies only for the 2020 tax year. There was no change for donations of appreciated property. Donations of appreciated stock to public charities continue to follow the previous rules, and qualify for a deduction up to 30% of AGI. Further, cash gifts to private foundations and DAFs are not covered by the CARES Act exception.

IRA owners over age 70½ may make a donation up to $100,000 directly from their IRA to a public charity (other than a DAF). Such Qualified Charitable Distributions (QCDs) will help you meet your RMD requirement and are excluded from taxable income. Although QCDs are allowed in 2020, there is much less of an incentive to make them since all RMDs have been suspended for 2020. However, QCDs should regain their popularity in 2021 when RMDs resume.

The SECURE Act includes a new rule affecting QCDs that requires an IRA owner to include a portion of the QCD in taxable income if the owner made deductible contributions to the IRA after attaining age 70½. This is not likely to cause too many problems but it is something to be aware of.

With the enactment of the TCJA and limits on the deduction of state and local taxes and increased standard deduction, many people who were charitably inclined made larger gifts to Donor Advised Funds in order to bunch their charitable giving in a single year in order to capture a deduction. This is still a viable strategy for anyone looking for a charitable deduction in 2020.

State income taxes

More than ever people are focused on high state income taxes. We've all heard about the growing number of people exiting high-tax states like California and New York to move to low-tax states like Texas and Florida. This is still a viable tax-saving option but must be done carefully so as to avoid being dragged back into the high-tax state's web. After you move, there are many rules and pitfalls to consider if you plan to maintain a presence (such as a second home) in the high-tax state. You will need to watch how many days you spend there and be able to document your presence each day of the year. Further, these states also may assert that you have not changed your domicile if you retain too many contacts with the state. If there's an audit, it's a very fact-intensive review. Third party records, such as electronic toll, cell phone and credit card statements are essential to proving your case.

Another unforeseen consequence of the 2020 pandemic is how working from home could subject employees who live and work in different states to a double state income tax. Under standard tax rules, a person who lives in State A is subject to income tax on all of their income as a resident. If that resident works in State B, he or she is taxed by State B on wages earned there but is allowed a tax credit by State A for the taxes owed to State B. The credit prevents double taxation. Now add a global pandemic to the mix. What happens when a resident of State A cannot enter the office in State B and has to work from home? In that case, both States A and B say that that person owes taxes to their state without any credit. In this scenario, state tax rules are not working together to achieve a fair result. To add fuel to the fire, both States A and B are under tremendous budget crunches and need all the revenue they can get. This is the new reality that many commuters in major metropolitan areas like New York are facing.[2]

Republicans and Democrats in Congress have realized this problem and are proposing a federal solution, although they have very different bills and there doesn't appear to be any agreement yet. Some states have taken a lenient approach because of COVID-19. However, other states are digging in and insisting on getting their tax dollars. If Congress can pass another coronavirus relief package this year, federal legislation could resolve this issue. Two bills are pending on Congress: the HEROES Act was proposed by House Democrats and the HEALS Act by Senate Republicans. Both bills include a version of relief from double state taxation. They also include a myriad of other relief programs.

2020-2021: An inflection point

Clearly, we are at an inflection point politically and in terms of taxation. While we anticipate potential tax increases in 2021 under a President Biden, we don't expect a wholesale revamping of the tax code, especially if the two Georgia Senate seats don't go to the Democratic candidates. However, much was promised by Democratic candidates during the campaign season who advocated novel ideas such as a wealth tax or a deemed capital gain at death.

[2] Note that in some states reciprocity agreements exist that prevent double taxation. For example, Maryland has a reciprocity agreement with Pennsylvania, Virginia, West Virginia and Washington, DC.

On the other hand, both of these types of taxes, if challenged in court, might well be held unconstitutional by the more conservative Supreme Court. We expect that traditional notions of income and estate taxation will remain in place for the near term but that tax rates could be increased and certain tax breaks may partially disappear.

Checklist of year–end items

As we make our way toward the end of 2020, we provide you a list of items that you may wish to discuss with your accountant, attorney or investment counselor:

- Consider accelerating income in 2020
- Donor Advised Fund for charitable giving
- Defer RMDs from IRAs in 2020
- Consider a Roth IRA conversion
- Make year-end gifts to family ($15,000 annual exclusion)
- Consider using the full amount of your estate and gift tax exemption in 2020 ($11.58 million)
- Evaluate tax aspects of your state of domicile

We invite you to contact your Portfolio Manager or Client Advisor at 1919 Investment Counsel to discuss year-end planning strategies.

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Warwick M. Carter, Jr. is a Principal at 1919 Investment Counsel based in New York. As a Senior Wealth Advisor, his primary focus is generational wealth planning for high net worth individuals and families. He also advises on philanthropic planning. When giving advice, Warwick takes a comprehensive approach to assessing all aspects of a client's tax, financial and family situation. Warwick works closely with Portfolio Managers and Client Advisors in all of our offices to integrate wealth strategies with a client's investments. He regularly meets with outside advisors to devise appropriate solutions that will help grow wealth in a tax-aware way over the long term.

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About 1919 Investment Counsel

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