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To Our Clients and Friends:

So far, the events of 2020 presented unique and unprecedented challenges. The COVID-19 crisis brought significant unemployment, business closures, and an enormous amount of uncertainty. The outcome of the November election presents additional challenges. Depending on the outcome of the November election, we may see tax reform legislation next year. This legislation may lead to increased tax rates. We may also see additional COVID-19 legislation before the end of the year. As the end of the year approaches, we will explore tax planning strategies in response to these challenges.

The past 12 months have seen several major tax law changes. In response to the COVID-19 emergency, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law in March. In addition, the Taxpayer Certainty and Disaster Tax Relief Act (Disaster Act) and the Setting Every Community Up for Retirement Enhancement (SECURE) Act were passed in December 2019. The Disaster Act extended many beneficial provisions that had expired or were set to expire. Barring additional extenders, many of these provisions will expire again at the end of the year. The SECURE Act, on the other hand, made significant changes to the retirement rules. We will highlight planning techniques stemming from these recent bills, as well as other year-end planning ideas.

Year-end Planning Strategies for Individuals

Take Advantage of Generous Standard Deduction Allowances. For 2020, the standard deduction amounts are $12,400 for singles and those who use married filing separate status, $24,800 for married joint filing couples, and $18,650 for heads of household. Those age 65 and over are allowed an additional $1,300 (married) or $1,650 (unmarried). If your total annual itemized deductions for 2020 will be close to your standard deduction amount, consider making additional expenditures before year-end to exceed your standard deduction and reduce your taxable income.

The easiest deductible expense to accelerate is included in your house payment due on January 1. Accelerating that payment into this year will give you 13 months' worth of interest to deduct in 2020. Mortgage insurance premiums for eligible taxpayers also are deductible in 2020 but will once again be disallowed in 2021 barring extension.

Also, consider state and local income and property taxes that are due early next year. Prepaying these bills before year-end may increase the amount of state and local income taxes included in your itemized deductions. However, the maximum amount you can deduct for state and local taxes is $10,000 ($5,000 if you use married filing separate status).

Warning: Prepaying state and local income and property taxes may have negative consequences if you expect to owe Alternative Minimum Tax (AMT) this year. These deductions for state and local taxes are completely disallowed under the AMT rules. Therefore, prepaying these expenses may do little or no good if you are subject to AMT. Contact us if you are unsure about your exposure to AMT.

Accelerating other expenditures could cause your itemized deductions to exceed your standard deduction in 2020. For example, consider making larger charitable donations this year and smaller contributions next year to compensate. The CARES Act offers two unique opportunities for charitable minded taxpayers in 2020. Individuals who do not itemize will be allowed an "above the line" deduction of up to $300 in 2020.

For those who do itemize, the CARES Act increases the limit on charitable deductions to 100% of the individual's Adjusted Gross Income (AGI) for cash contributions made to public charities in 2020. Note there is no requirement that the contributions be related to COVID-19.

Among the provisions of the Disaster Act set to expire in 2020 is the reduced threshold for the medical expense deduction. You might consider accelerating elective medical procedures, dental work, and vision care. For 2020, medical expenses are deductible to the extent they exceed 7.5% of AGI. This 7.5% threshold is set to increase to 10% in 2021.

Cancellation of Debt (COD) Relief. Individuals can exclude up to $2 million ($1 million if not married filing jointly) of COD income from qualified principal residence indebtedness that is cancelled in 2020 because of their financial condition or decline in value of the residence. Debt cancelled after 12/31/20 still qualifies, but only if discharged pursuant to a written binding agreement entered into prior to 1/1/21.

Traditional IRA Contributions for All. The SECURE Act removed the age restriction on making traditional IRA contributions. Individuals over the age of 70½ who are still working in 2020 are no longer prohibited from contributing to a traditional IRA. However, if you are over age 70½ and considering making a charitable donation directly from your IRA (known as a *Qualified Charitable Distribution* or *QCD*) in the future, making a deductible IRA contribution will affect your ability to exclude future QCDs from your income. Please contact us for further explanations of QCDs and how they can be an effective way to give to charity and reduce your taxable income.

Carefully Manage Investment Gains and Losses in Taxable Accounts. If you hold investments in taxable brokerage firm accounts, consider the tax advantage of selling appreciated securities that you held for over 12 months. The federal income tax rate on long-term capital gains recognized in 2020 is typically 15% for most taxpayers, although it reaches a maximum of 20% at higher income levels. The 3.8% Net Investment Income Tax (NIIT) can also apply at higher income levels.

Current year capital losses and prior year net capital losses are also available to offset current year capital gain income. These losses can "shelter" income by reducing current year capital gain income. If capital losses exceed capital gains for the year (a net capital loss), then you can use the excess to offset up to $3,000 ($1,500 if you use married filing separate status) of current year ordinary income. Examples of ordinary income are salaries, bonuses, self-employment income, interest income, and royalties, among others. Any net capital loss greater than $3,000 is carried forward to next year and beyond.

In fact, having a capital loss carryover into next year and beyond could work to your advantage. The carryover can be used to shelter both short-term and long-term gains recognized next year and beyond. This can give you extra investing flexibility in those years because you will not have to hold appreciated securities for over a year to receive a preferential tax rate. The current top federal rates on net short-term capital gains are 35% and 37% (plus the 3.8% NIIT, if applicable). You may find a 2020 net capital loss carryover beneficial, especially if new legislation leads to increased tax rates in 2021.

Take Advantage of 0% Tax Rate on Investment Income. A potential silver lining to a down year may be the ability to harvest some long-term capital gains at favorable rates. For 2020, single filers can take advantage of the 0% income tax rate on long-term capital gains and qualified dividends from securities held in taxable brokerage firm accounts if their taxable income is $40,000 or less. For heads of household and joint filers, that limit is increased to $53,600 and $80,000, respectively.

While your income may be too high to benefit from the 0% rate, you may have children, grandchildren, or other loved ones in the 0% bracket. If so, consider giving them appreciated stock, or mutual fund shares that they can sell and pay 0% tax on the resulting long-term gains. Gains will be long-term, as long as your ownership period plus the gift recipient's ownership period (before the sale) equals at least one year and one day. Gifting stocks that pay qualified dividends may also allow you to shift income to individuals with lower tax rates. These qualified dividends may be tax-free if the recipient falls within the 0% tax rate bracket.

Warning: If securities are given to someone who is under age 24, the Kiddie Tax rules could potentially cause some of the resulting capital gains and dividends to be taxed at the higher rates that apply to the individual's parent. There may also be gift tax consequences to transferring stock to others. In 2020, transfers valued at a total of $15,000 to any one individual for the year are exempt from the gift tax. Transfers to trusts are more complicated and may not qualify for this $15,000 Gift Tax Annual Exclusion. An individual can currently exclude up to $11.58 million ($23.16 million for joint filers) of transfers from the gift tax over his or her lifetime. However, proposed legislative changes may significantly reduce this lifetime exemption while increasing the gift tax rates. Please contact us if you have questions about the Kiddie Tax or the Gift Tax.

Convert Traditional IRAs into Roth Accounts. The current tax rates as well as the prospect of higher rates make for an excellent opportunity to convert Traditional IRAs into Roth accounts. The current tax rates are still relatively low compared to a few years ago. Current rates are scheduled to remain unchanged until 2026. Depending on the outcome of the November election, rates could increase much sooner. Also, your income may be lower in 2020 due to the financial fallout of COVID-19. A silver lining of a reduction in income is that you are likely in a lower tax bracket than normal. The CARES Act suspended Required Minimum Distributions (RMDs) for 2020. If you already budgeted to pay tax on your 2020 RMD, consider rolling that distribution to a Roth IRA. You would pay tax on the rollover amount, but the tax paid may be less than in years past if you experienced a decrease in income this year. Distributions from Roth accounts are tax-free so long as certain conditions are met. Thus, rolling your 2020 RMD amount into a Roth account this year may protect you against tax rate increases in the future.

Perhaps the overall value of your retirement account suffered because of the economic downturn. The depressed value in your IRA means a rollover distribution will contain more assets. Once in the Roth IRA, the recovery of value and ultimate withdrawal will be tax free.

Consider Intrafamily Loans. Interest rates are at a historic low and continue to decrease. This scenario creates an attractive opportunity for those interested in assisting family members financially and transferring assets in a tax-efficient manner.

Individuals who wish to lend money to relatives may do so at interest rates lower than what commercial lenders offer, thus allowing the lendee to save money on interest. There is a minimum rate charged by the lender called the Applicable Federal Rate (AFR). Loans with interest rates below the AFR may be subject to gift tax rules. While it is generally advisable to stay above the AFR to avoid gift tax consequences, individuals can use the annual and lifetime gift exclusions to maximize the benefit to the lendee.

To ensure the loan is an arm's length transaction, follow these steps: (1) have a properly worded and signed document, (2) file the documents with the necessary authorities, (3) provide the lendee with a formal document that summarizes the amount of interest paid each year, and (4) either collect the loan payments or establish that the payments will be gifted. Please contact us if you are interested in taking advantage of intrafamily loans.

Year-end Planning Strategies for Small Businesses

Net Operating Losses (NOLs). The CARES Act temporarily relaxed many of the NOL limitations that were implemented under the Tax Cuts and Jobs Act (TCJA). If your small business expects a loss in 2020, you can carry back 100% of this loss to the prior five tax years. If you had an NOL carried into 2020, you can claim a deduction equal to 100% of your 2020 taxable income.

Establish a Tax-favored Retirement Plan. If your business does not already have a retirement plan, now might be the time to consider one. Current retirement plan rules allow for significant deductible contributions. For example, if you are self-employed and set up a SEP-IRA, you can contribute up to 20% of your self-employment earnings, with a maximum contribution of $57,000 for 2020. If you are employed by your own corporation, up to 25% of your salary can be contributed with a maximum contribution of $57,000.

Other small business retirement plan options include the 401(k) plan (which can be set up for just one person) and the cash balance pension plan. Depending on your circumstances, these other types of plans may allow larger deductible contributions.

The SECURE Act offers an additional incentive for establishing a retirement plan in 2020. The credit for employers that adopt a new eligible plan is increased from $500 to a maximum of $5,000, and a $500 credit has been added for new small employer plans with an auto-enrollment feature.

Contact us for more information on small business retirement plan alternatives, and be aware that if your business has employees, you may have to cover them too.

Take Advantage of Generous Depreciation Allowances. 100% first-year bonus depreciation is available for qualified new and used property that is acquired and placed in service in calendar-year 2020. That means your business might be able to expense the entire cost of some or all of your 2020 asset additions on this year's return. So, consider making additional acquisitions between now and year-end.

Also, the CARES Act made a technical correction to the TCJA that retroactively treats a wide variety of interior, non-load-bearing building improvements [known as *Qualified Improvement Property (QIP)*] as eligible for bonus deprecation (and hence a 100% deduction). Alternatively, if you elect out of bonus depreciation, you can depreciate QIP over 15 years (rather than the 39 years provided by the TCJA). Small businesses can take advantage of this provision by filing for a change in accounting method or by amending the applicable return. Contact us for more details.

<u>Claim 100% Bonus Depreciation for Heavy SUVs, Pickups, or Vans.</u> The 100% bonus depreciation provision significantly impacts first-year depreciation deductions for new and used heavy vehicles used over 50% for business. Heavy SUVs, pickups, and vans are treated for tax purposes as transportation equipment that qualifies for 100% bonus depreciation. However, 100% bonus depreciation is only available when the SUV, pickup, or van has a manufacturer's Gross Vehicle Weight Rating (GVWR) above 6,000 pounds. The GVWR of a vehicle can be verified by looking at the manufacturer's label, which is usually found on the inside edge of the driver's side door where the door hinges meet the frame. If you are considering buying an eligible vehicle, doing so and placing it in service before the end of this tax year could significantly offset income on this year's return.

<u>Claim First-year Depreciation Deductions for Cars, Light Trucks, and Light Vans.</u> For both new and used passenger vehicles (meaning cars and light trucks and vans) that are acquired and placed in service in 2020, the luxury auto depreciation limits are as follows:

- $18,100 for Year 1 if bonus depreciation is claimed.
- $16,100 for Year 2.
- $9,700 for Year 3.
- $5,760 for Year 4 and thereafter until the vehicle is fully depreciated.

Note that the $18,100 first-year luxury auto depreciation limit only applies to vehicles that cost $58,500 or more. Vehicles that cost less are depreciated over six tax years using percentages based on their cost. Contact us for details.

Take Advantage of Generous Section 179 Deduction Rules. For qualifying property placed in service in tax years beginning in 2020, the maximum Section 179 deduction is $1.04 million. The Section 179 deduction phase-out threshold amount is $2.59 million.

Time Business Income and Deductions for Tax Savings. If you conduct your business using a pass-through entity (sole proprietorship, S corporation, LLC, or partnership), your shares of the business's income and deductions are passed through to you and taxed at your personal rates. If you assume next year's individual federal income tax rate brackets will be roughly the same as this year's, the traditional strategy of deferring income into next year while accelerating deductible expenditures into this year makes sense if you expect to be in the same or lower tax bracket next year. Deferring income and accelerating deductions will, at a minimum, postpone part of the resulting tax consequences from 2020 until 2021.

However, if you expect higher rates next year, then take the opposite approach. Accelerate income into this year (if possible) and postpone deductible expenditures until 2021. That way, more income will be taxed at this year's lower rate instead of next year's higher rate. Contact us for more information on timing strategies.

Watch out for Business Interest Expense Limit. The CARES Act temporarily relaxed the unfavorable TCJA limitation on a taxpayer's deduction for business interest expense. Under the TCJA, the deduction was limited to the sum of (1) business interest income, (2) 30% of adjusted taxable income, and (3) floor plan financing interest paid by certain vehicle dealers. For 2020, the 30% limit has been increased to 50% of adjusted taxable income. Barring additional legislation, the limit will go back to 30% in 2021. The rules for businesses conducted as partnerships, LLCs treated as partnerships for tax purposes, and S corporations are especially complicated.

Fortunately, many businesses are exempt from the interest expense limit rules under the *small business exception.* Under this exception, a taxpayer is generally exempt from the limit if average annual gross receipts are $26 million (the inflation-adjusted amount for 2020) or less for the three-tax-year period ending with the preceding tax year.

Certain real estate and farming businesses with average annual gross receipts above the threshold also are exempt if they choose to limit their depreciation deductions. Given the technical correction provided by the CARES Act allowing for more favorable deductions of QIP, taxpayers who made the election to limit depreciation are now able to retroactively revoke that election.

The CARES Act also allows businesses to elect to use their 2019 adjusted taxable income in calculating their 2020 limitation. If average annual receipts are typically over the applicable threshold ($26 million for 2020), but not by much, some judicious year-end tax planning may allow your business to qualify for the small business exception for at least some years. Contact us for details if you think your business might be affected by the interest expense limit.

Conclusion

This letter only covers some of the year-end tax planning strategies that could potentially benefit you, your loved ones, and your business. Please contact us if you have questions, want more information, or would like us to help in designing a year-end planning package that delivers the best tax results for your circumstances.

Very truly yours,

Abeles and Hoffman, P.C.

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