THE 2020 TAX PLANNING PARADOX

ACCELERATE INCOME TO LOWER YOUR TOTAL TAX LIABILITY

As 2020 winds down, it's time to consider year-end planning. It's an unusual year, with taxpayers experiencing losses due to the economic downturn and the possibility of higher income tax rates next year. Consequently, we need to rethink the traditional year-end advice of deferring income and accelerating deductions to minimize one's total tax liability over the years. Accelerating income in 2020 has several advantages. First, the Tax Cuts and Jobs Act reduced the maximum individual tax rate from 39.6% to 37%. Second, many taxpayers will be in a lower tax bracket this year from losses incurred in this economic downturn. Third, accelerating income increases a taxpayer's adjusted gross income (AGI) limitation for charitable contributions. The CARES Act suspends the traditional 60% AGI limitation and permits individual taxpayers to take a charitable contribution deduction for qualifying cash contributions made in 2020 to the extent such contributions do not exceed the taxpayer's AGI.

Here's a rundown of some ways to accelerate income in 2020.

Convert a traditional Individual Retirement Account (IRA) to a Roth IRA. Assets held in traditional IRAs have several disadvantages compared to assets held in Roth IRAs: Distributions in excess of basis are taxable as ordinary income, required minimum distributions must begin once a taxpayer reaches age 70½ (72 for taxpayers who attain age 70½ after December 31, 2019), and early withdrawals before age 59½ are subject to a 10% penalty unless one of several exceptions apply.

One way to mitigate these disadvantages while accelerating income in 2020 is to convert the traditional IRA to a Roth IRA. In doing so, the taxpayer will accelerate the ordinary income tax liability that would otherwise be due upon distribution had the assets remained in the traditional IRA. Conversion in 2020, while the asset values are likely to be temporarily lower than normal, reduces the tax liability while allowing the future recovery in value plus all appreciation to avoid taxation.

The earning power of the account is maximized because there will be no required minimum distributions during the taxpayer's lifetime (heirs will be subject to the required minimum distribution rules). While the income taxes have been paid on the converted amount, distributions from the converted amounts only remain subject to the 10% early withdrawal penalty for five years unless the taxpayer has attained age 59½.

The earnings and appreciation on the account can be distributed tax and penalty-free, provided the account is at least five years old and the IRA owner is at least 59½. Other distributions qualifying for tax-free treatment include those (i) made to a beneficiary (or estate) after the death of the Roth IRA owner, (ii) made due to the Roth IRA owner's disability, or (iii) made under first-time homebuyer exception.

Elect out of installment sales. The installment sale rules require taxpayers who sell property where at least one of the payments will be received in a subsequent taxable year to recognize a portion of the gain as each payment is received. By electing out of the installment method, a taxpayer may recognize the entire gain in the year of sale. The election must be made on a timely filed return (including extensions) and is irrevocable once made.

Trigger an inclusion event for opportunity zone investments. The Tax Cuts and Jobs Act permitted taxpayers to defer tax on capital gains invested in a qualified opportunity fund (QOF) until the earlier of an inclusion event or December 31, 2026. Presidential candidate Joe Biden has proposed subjecting capital gains to a 39.6% ordinary income tax rate for those taxpayers with over $1 million in income. Thus, there exists the possibility that a deferral until December 31, 2026, will result in a capital gains tax on the deferred gain at a rate of 39.6% instead of the current 23.8%. Inclusion events include a gift, disposition or sale of the QOF. In addition, for those QOFs held in a grantor trust, the termination of the grantor trust status for reasons other than the death of the grantor is also an inclusion event.

Harvest capital gains. Harvesting capital gains is an ideal strategy to hedge against a future increase in the capital gains tax rate. Here, a taxpayer can increase their cost basis by selling an appreciating investment and then use the sales proceeds to repurchase the same or a similar investment.

While the sale will realize a taxable gain, the repurchase of the investment will provide a stepped-up cost basis and later yield a lower gain when the investment is sold in the future – when the capital gains tax rate is higher. The wash sale rules, which dissuade harvesting tax losses, do not apply to harvesting capital gains.

Forgo like-kind exchanges. The Tax Cuts and Jobs Act limited the nonrecognition of gain from like-kind exchanges to exchanges of real property not primarily held for sale. When a transaction qualifies as a like-kind exchange, nonrecognition treatment is mandatory. To avoid the imposition of the like-kind rules, a taxpayer merely needs to actually or constructively receive cash or other boot in the transaction. For deferred gains on prior like-kind exchanges, taxpayers can trigger the gain recognition by selling the replacement property.

Exercise stock options. Nonqualified stock options (NQSO) are a useful tool for taxpayers who are looking to accelerate income because they generate taxable compensation equal to the fair market value of the shares less the exercise price when exercised. Employees may be offered the ability to defer their income tax liability on the exercise by making a Section 83(i) election. The Section 83(i) election is a useful cash conservation strategy that allows an employee to exercise more options before additional appreciation drives up the amount taxed as ordinary compensation without an immediate cash outlay for income taxes. However, the election to defer will not be useful to those looking to accelerate income to the current year for tax planning purposes.

Incentive stock options (ISO) are taxed upon disposition of the ISO shares rather than upon exercise of the option. The sale proceeds minus the exercise price of ISO stock are taxed at capital gain rates, provided the sale occurs not sooner than 1 year after exercise and 2 years after grant of the option. Earlier dispositions of the ISO shares generate taxable compensation equal to taxation as a NQSO, with any excess gain taxed as capital gains.

Restricted stock awards are generally taxed to the employee when the shares vest unless the employee elects to be taxed upon receipt of the unvested shares by making a Section 83(b) election.

Declare and pay C corporation dividends.
C corporations are well-known for their "double taxation" concept. That is, a C corporation is taxed on its earnings, and any dividend paid from the C corporation's earnings are also taxable to the shareholder while not being deductible to the corporation. To avoid the second layer of tax, shareholders often cause the C corporation to retain earnings rather than distribute dividends. However, shareholders may find the low tax rates and losses in 2020 an ideal time to pull cash out of their C corporations by taking dividends.

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