

# TAX PLANNING GUIDE

YEAR-ROUND STRATEGIES TO MAKE THE TAX LAWS WORK FOR YOU



2020  
2021

# Tax planning in unprecedented times

A graphic showing the year '2020' in large, bold, black font, set against a background of a sunset or sunrise over water, with the numbers reflected below.

**I**t has become a cliché in 2020, but what word other than “unprecedented” can be used to describe the events we’ve experienced this year? During such times, tax planning is far from top of mind. But it’s still important. Smart tax planning can provide much-needed financial relief to individuals and businesses that need it.

To take advantage of all available breaks, you need to be aware of some major changes under this year’s Coronavirus Aid, Relief and Economic Security (CARES) Act and last year’s Setting Every Community Up for Retirement Enhancement (SECURE) Act. You also can’t forget about the massive Tax Cuts and Jobs Act (TCJA) that generally went into effect two years ago but still impacts tax planning. Plus, it’s possible that there could be more tax law changes before year end — or that the potential for changes next year could affect 2020 planning.

This guide provides an overview of some of the most significant tax law changes going into effect this year and other key tax provisions you need to be aware of. It offers a variety of strategies for minimizing your taxes in the current tax environment. Use it to work closely with your tax advisor to identify the best strategies for your particular situation. He or she also can keep you apprised of any new tax law developments that might affect you.

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## Deductions might provide bigger tax-saving opportunities this year



**A**lthough most TCJA provisions went into effect a couple of years ago, that 2017 law is still having a significant impact on planning for income and deductions. For example, the TCJA generally reduced tax rates, and deductions save less tax when rates are lower. The TCJA also reduced or eliminated many deductions. But the CARES Act has enhanced a few deductions, and it's possible more tax breaks could be enhanced before year end. Proper timing of deductible expenses and taking advantage of other breaks can help maximize your tax savings.

### Standard deduction vs. itemizing

Taxpayers can choose to either itemize certain deductions or take the standard deduction based on their filing status. Itemizing deductions when the total will be larger than the standard deduction saves tax, but it makes filing more complicated.

The TCJA nearly doubled the standard deduction for each filing status. Those amounts are to be annually adjusted for inflation through 2025, after which they're scheduled to drop back to the amounts under pre-TCJA law. (See Chart 1 for 2020 amounts.)

The combination of a higher standard deduction and the reduction or elimination of many itemized deductions means that some taxpayers who once benefited from itemizing are now better off taking the standard deduction.

**CHART 1** 2020 standard deduction<sup>1</sup>

Filing status	Standard deduction
Singles and separate filers	\$12,400
Heads of households	\$18,650
Joint filers	\$24,800

<sup>1</sup> Taxpayers age 65 or older or blind can claim an additional standard deduction: \$1,300 if married, \$1,650 if unmarried.

## State and local tax deduction

Under the TCJA, through 2025, your entire itemized deduction for state and local taxes — including property tax and the greater of income or sales tax — is limited to \$10,000 (\$5,000 if you're married filing separately).

Deducting sales tax instead of income tax may be beneficial if you reside in a state with no, or low, income tax or you purchased a major item, such as a car or boat.



## Home-related breaks

Consider both deductions and exclusions in your tax planning:

**Property tax deduction.** As noted earlier, through 2025 your property tax deduction is subject to the limit on deductions for state and local taxes.

**Mortgage interest deduction.** You generally can claim an itemized deduction for interest on mortgage debt incurred to purchase, build or improve your principal residence and a second residence. Points paid related to your principal residence also may be deductible. Through 2025, the TCJA reduces the mortgage debt limit from \$1 million to \$750,000 for debt incurred after Dec. 15, 2017 (\$500,000 and \$375,000, respectively, for separate filers), with some limited exceptions.

**Home equity debt interest deduction.** Through 2025, the TCJA effectively limits the home equity interest deduction to debt that would qualify for the home mortgage interest deduction. (Under pre-TCJA law, interest was deductible on up to \$100,000 of home equity debt used for any purpose, such as to pay off credit card debt or to buy a car.)

**Home office deduction.** If you're an employee and work from home, under the TCJA, home office expenses aren't deductible through 2025 — even if your employer has required you to work from home during the pandemic. Why? For employees, this is a miscellaneous itemized deduction subject to the 2% of adjusted gross income floor, and the TCJA suspended such deductions. (If you're self-employed, you may still be able to deduct home office expenses. See page 21.)

**Personal casualty and theft loss deduction.** Through 2025, the TCJA suspends this itemized deduction except if the loss was due to an event officially declared a disaster by the President.

**Rental income exclusion.** If you rent out all or a portion of your principal residence or second home for less than 15 days, you don't have to report the income. But expenses directly associated with the rental, such as advertising and cleaning, won't be deductible.

**Home sale gain exclusion.** When you sell your principal residence, you can exclude up to \$250,000 of gain (\$500,000 for married couples filing jointly) if you meet certain tests. **Warning:** Gain that's allocable to a period of "nonqualified" use generally isn't excludable.

**Loss deduction.** If you sell your home at a loss and part of your home is rented out or used exclusively for your business, the loss attributable to that portion may be deductible.

**Moving expense deduction.** Under the TCJA, through 2025, work-related moving expenses are deductible only by active-duty members of the Armed Forces (and their spouses or dependents) who move because of a military order that calls for a permanent change of station. (If you're eligible, you don't have to itemize to claim this deduction.)

### Tax-advantaged saving for health care

If medical expenses not paid via tax-advantaged accounts or reimbursable by insurance exceed a certain percentage of your adjusted gross income (AGI), you can claim an itemized deduction for the amount exceeding that "floor." The TCJA had reduced the floor from 10% to 7.5% for 2017 and 2018, and late last year this floor was extended to 2019 and 2020.

**WHAT'S  
NEW!**

### You might be able to deduct more charitable donations this year

Generally, donations to qualified charities are fully deductible — but only if you itemize deductions. Fortunately, the CARES Act allows taxpayers who claim the standard deduction to deduct up to \$300 of cash donations to qualified charities in 2020.

If itemizing no longer will save you tax because of the increased standard deduction, you might benefit from "bunching" donations into alternating years so that your total itemized deductions in those years would then surpass your standard deduction. You can then itemize just in those years.

For large donations, discuss with your tax advisor which assets to give and the best ways to give them. For example, making large cash donations this year might be beneficial because the CARES Act increased the 2020 deduction limit for such gifts to public charities from 60% of adjusted gross income (AGI) to 100% of AGI.



Eligible expenses may include health insurance premiums, long-term-care insurance premiums (limits apply), medical and dental services, and prescription drugs. Mileage driven for health care purposes also can be deducted — at 17 cents per mile for 2020.

Consider bunching elective medical procedures (and any other services and purchases whose timing you can control without negatively affecting your or your family's health) into alternating years if it would help you exceed the applicable floor and you'd have enough total itemized deductions to benefit from itemizing.

You may be able to save taxes without having to worry about the medical expense deduction floor by contributing to one of these accounts:

**HSA.** If you're covered by a qualified high-deductible health plan, you can contribute pretax income to an employer-sponsored Health Savings Account — or make deductible contributions to an HSA you set up yourself — up to \$3,550 for self-only coverage and \$7,100 for family coverage (plus \$1,000 if you're age 55 or older) for 2020. HSAs can bear interest or be invested, growing tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax-free, and you can carry over a balance from year to year, allowing the account to grow.

**FSA.** You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit — not to exceed \$2,750 in 2020. The plan pays or reimburses you for qualified medical expenses. What you don't use by the plan year's end, you generally lose — though your plan might allow you to roll over up to \$550 to 2021. Or it might give you a 2½-month grace period to incur expenses to use up the previous year's contribution. In response to the COVID-19 crisis, the IRS has temporarily made FSAs a little more flexible. Contact your employer for details. If you have an HSA, your FSA is limited to funding certain permitted expenses.

### More considerations

Keep in mind that it's possible that legislation could be signed into law that would suspend or alter some of the TCJA provisions affecting deductions or make other changes to deduction rules. Check with your tax advisor for the latest information.

Also be aware that there are other types of taxes that could affect you and should be factored into your planning, such as the alternative minimum tax (AMT). Your tax advisor can help you determine if you're among the small number of taxpayers who still need to plan for the AMT after the TCJA. ■

## Changing focus for tax savings



**W**hen it comes to family and education, much of the focus in 2020 has been on the impact of the COVID-19 crisis, whether it's finding daycare, managing remote learning or simply having the entire family home nearly 24-7 for extended periods. But it's also an important year to be sure you and your family take advantage of available credits, deductions and other tax-saving opportunities.

### Child, dependent and adoption credits

Through 2025, the TCJA expands tax credits for families, doubling the child credit and adding a “family” credit for dependents who don't qualify for the child credit:

- ▲ For each child under age 17 at the end of 2020, you may be able to claim a \$2,000 credit. The credit still phases out for higher-income taxpayers (see Chart 2), but the income ranges are much higher than before the TCJA.
- ▲ For each qualifying dependent other than a qualifying child (such as a dependent child age 17 or older or a dependent elderly parent), a \$500 family credit is now available. But it's also subject to the income-based phaseout.

If you adopt in 2020, you may qualify for the adoption credit — or for an employer adoption assistance program income exclusion. Both are \$14,300 for 2020, but the credit is also subject to an income-based phaseout. (See Chart 2.)

Finally, if you qualified for an Economic Impact Payment for a child under the CARES Act but didn't receive it, you can claim a credit for it on your 2020 income tax return.

### Dependent care breaks

A couple of tax breaks can help offset the costs of dependent care:

**Tax credit.** For children under age 13 or other qualifying dependents, you may be eligible for a credit for a portion of your dependent care expenses. Generally, the credit equals 20% of the first \$3,000 of qualified expenses for one child or 20% of up to \$6,000 of such expenses for two or more children. So, the maximum credit is usually \$600 for one child or \$1,200 for two or more children.

**FSA.** For 2020, you can contribute up to \$5,000 pretax to an employer-sponsored child and dependent care Flexible

Spending Account. The plan pays or reimburses you for these expenses. You can't claim a tax credit for expenses reimbursed through an FSA. In response to the COVID-19 crisis, the IRS has temporarily made FSAs a little more flexible. Contact your employer for details.

### “Kiddie tax”

The “kiddie tax” generally applies to unearned income beyond \$2,200 (for 2020) of children under age 19 and of full-time students under age 24 (unless the students provide more than half of their own support from earned income). The TCJA had made the kiddie tax harsher, taxing income subject to the tax according to the tax brackets used for trusts and estates.

Before 2018, such income was generally taxed at the parents' tax rate. In many cases, the TCJA would have caused children's unearned income to be taxed at *higher* rates than their parents' income, because higher rates kick in at much lower income levels for trusts and estates.

**CHART 2** 2020 child and education breaks<sup>1</sup>:  
Are you subject to a phaseout?

Tax break	Modified adjusted gross income phaseout range	
	Single / Head of household <sup>2</sup>	Married filing jointly
Child credit	\$ 200,000 – \$ 240,000	\$ 400,000 – \$ 440,000
Adoption credit	\$ 214,520 – \$ 254,520	\$ 214,520 – \$ 254,520
ESA contribution	\$ 95,000 – \$ 110,000	\$ 190,000 – \$ 220,000
American Opportunity credit	\$ 80,000 – \$ 90,000	\$ 160,000 – \$ 180,000
Lifetime Learning credit	\$ 59,000 – \$ 69,000	\$ 118,000 – \$ 138,000
Tuition and fees deduction <sup>3</sup>	\$ 65,000 – \$ 80,000	\$ 130,000 – \$ 160,000
Student loan interest deduction	\$ 70,000 – \$ 85,000	\$ 140,000 – \$ 170,000

<sup>1</sup> Assumes one child or student. Amounts may vary for more than one child or student. Other rules and limits might reduce the break.

<sup>2</sup> These ranges also apply to married taxpayers filing separately, except that separate filers aren't eligible for the American Opportunity or Lifetime Learning credit or the tuition and fees or student loan interest deduction.

<sup>3</sup> Eligible taxpayers with modified adjusted gross incomes (MAGIs) up to the bottom of the range can deduct up to \$4,000. Those with MAGIs exceeding the bottom but not exceeding the top can deduct up to \$2,000.



Fortunately, tax legislation signed into law at the end of 2019 returned the kiddie tax to pre-TCJA law, retroactive to 2018. If your family paid the kiddie tax for 2018 under the TCJA rules, you might be eligible for a refund for a portion of that tax.

### 529 plans

If you're saving for education expenses, consider a Section 529 plan. You can choose a prepaid tuition plan to secure current tuition rates or a tax-advantaged savings plan to fund education expenses:

- ▲ Although contributions aren't deductible for federal purposes, any growth is tax-deferred. (Some states do offer tax breaks for contributing.)
- ▲ Distributions used to pay qualified postsecondary school expenses (such as tuition, mandatory fees, books, supplies, computer equipment, software, Internet service and, generally, room and board) are income-tax-free for federal purposes and typically for state purposes, making the tax deferral a permanent savings.
- ▲ The TCJA permanently allows tax-free distributions for elementary and secondary school tuition of up to \$10,000 per year per student.
- ▲ The SECURE Act allows the plans to be used to pay up to \$10,000 of student loans per beneficiary.
- ▲ The plans usually offer high contribution limits, and there are no income limits for contributing.
- ▲ There's generally no beneficiary age limit for contributions or distributions.
- ▲ You can control the account, even after the child is of legal age.
- ▲ You can make tax-free rollovers to another qualifying family member.
- ▲ A special break for 529 plans allows you to front-load five years' worth of annual gift tax exclusions and make up to a \$75,000 contribution (or \$150,000 if you split the gift with your spouse) per beneficiary in 2020.

The biggest downside of 529 plans may be that your investment options — and when you can change them — are limited.

### ESAs

Coverdell Education Savings Accounts are similar to 529 savings plans in that contributions aren't deductible for federal purposes, but plan assets can grow tax-deferred and distributions used to pay qualified education expenses are income-tax-free. ESAs are worth considering if you'd like to have direct control over how your contributions are invested or you want to pay elementary or secondary school expenses in excess of \$10,000 or that aren't tuition.

**WHAT'S  
NEW!****CARES Act provides tax relief for student loans**

Normally, one tax break might be available to you if you're paying off student loans: an interest deduction up to \$2,500 *per tax return* (subject to an income-based phaseout; see Chart 2 on page 7.)

Under the CARES Act, an additional tax break may be available: Employers can provide up to \$5,250 toward employee student loan payments on a tax-free basis in 2020. The payment can be made to the employee or the lender. (You can't take a student loan interest deduction for any loan payment for which the exclusion is available.)

But the \$2,000 contribution limit is low, and it's phased out based on income. (See Chart 2 on page 7.) Also, contributions can generally be made only for beneficiaries under age 18. When the beneficiary turns age 30, the ESA generally must be distributed, and any earnings may be subject to tax and a 10% penalty.

### Education credits and deductions

If you have children in college now or are currently in school yourself, you may be eligible for a credit or deduction:

**American Opportunity credit.** The tax break covers 100% of the first \$2,000 of tuition and related expenses and 25% of the next \$2,000 of expenses. The maximum credit, *per student*, is \$2,500 per year for the first four years of postsecondary education.

**Lifetime Learning credit.** If you're paying postsecondary education expenses beyond the first four years, you may benefit from the Lifetime Learning credit (up to \$2,000 *per tax return*).

**Tuition and fees deduction.** Instead of claiming one of the credits, in certain circumstances you might be better off *deducting* up to \$4,000 of qualified higher education tuition and fees.

**Warning:** Income-based phaseouts apply to these breaks. (See Chart 2 on page 7.) If your income is too high for you to qualify, your child might be eligible.

### ABLE accounts

Achieving a Better Life Experience accounts offer a tax-advantaged way to fund qualified disability expenses for a beneficiary who became blind or disabled before age 26. For federal purposes, tax treatment is similar to that of Sec. 529 college savings plans.

Under the TCJA, through 2025, 529 plan funds can be rolled over to an ABLE account without penalty if the ABLE account is owned by the beneficiary of the 529 plan or a member of the beneficiary's family. Such rolled-over amounts count toward the ABLE account annual rollover and contribution limit (\$15,000 for 2020). ■

## Tax planning for investments in an uncertain market



**T**he stock market dropped precipitously when it became clear that COVID-19 was a pandemic that would have a worldwide impact and significantly affect Americans and the U.S. economy. As of late August, the market had largely recovered. But economic, political and pandemic uncertainty could cause volatility to resume. Such uncertainty also makes tax planning for investments challenging. There are many other factors to evaluate before deciding whether to sell or hold an investment, such as investment goals, time horizon, risk tolerance, factors related to the investment itself, fees and charges that apply to buying and selling securities, and your need for cash. But taxes are still important to consider.

### Capital gains tax and timing

Although time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. Your marginal long-term capital gains rate can be as much as 20 percentage points lower than your ordinary-income tax rate, even with the reductions to most ordinary-income rates under the TCJA.

The long-term gains rate applies to investments held for more than 12 months and remains at 15% for middle-bracket taxpayers. A 20% rate still applies to higher-income taxpayers.

Because of TCJA-related changes to the brackets, through 2025, the 20% rate kicks in before the top ordinary-income rate does. (See Chart 3 at right and Chart 9 on page 31.) Higher rates also still apply to certain types of assets. (See Chart 3.) But taxpayers in the bottom two brackets generally continue to enjoy a 0% long-term capital gains rate.

Holding on to an investment until you've owned it more than one year may help substantially cut tax on any gain.

### Being tax-smart with losses

Losses aren't truly losses until they're realized — that is, generally until you sell the investment for less than what you paid for it. So while it's distressing to see an account statement that shows a large loss, the loss won't affect your current tax situation as long as you still own the investment.

**CHART 3** What's the maximum 2020 capital gains tax rate?

Type of gain	Rate <sup>1</sup>
Short-term (assets held 12 months or less)	Taxpayer's ordinary-income tax rate
Long-term (assets held more than 12 months)	15%
<b>Some key exceptions</b>	
Long-term gain of certain higher-income taxpayers	20% <sup>2</sup>
Most long-term gain that would be taxed at 10% or 12% based on the taxpayer's ordinary-income rate	0%
Long-term gain on collectibles, such as artwork and antiques	28%
Long-term gain attributable to certain recapture of prior depreciation on real property	25%

<sup>1</sup> In addition, the 3.8% net investment income tax (NIIT) applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds \$200,000 (singles and heads of households), \$250,000 (married filing jointly) or \$125,000 (married filing separately).

<sup>2</sup> The 20% rate applies only to those with taxable income exceeding \$441,450 (singles), \$469,050 (heads of households), \$496,600 (joint filers), or \$248,300 (separate filers).

Realized capital losses are netted against realized capital gains to determine capital gains tax liability. If net losses exceed net gains, you can deduct only \$3,000 (\$1,500 for married taxpayers filing separately) of losses per year against ordinary income (such as wages, self-employment and business income, interest, dividends, and taxable retirement plan distributions). But you can carry forward excess losses until death.

If you don't have enough gains to absorb losses, you could be left with losses in excess of the annual ordinary-income deduction limit. So think twice before selling an investment at a loss. After all, if you hold on to the investment, it may recover the lost value. In fact, a buy-and-hold strategy works well for many long-term investors because it can minimize the effects of market volatility.

Of course, an investment might continue to lose value. That's one reason why tax considerations shouldn't be the primary driver of investment decisions. If you're ready to divest yourself of a poorly performing stock because, for example, you don't think its performance will improve or your investment objective or risk tolerance has changed, don't hesitate solely for tax reasons.

Plus, building up losses for future use could be beneficial. This may be especially true if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future gains, or if tax rates increase.

## Mutual funds

Mutual funds with high turnover rates can create income that's taxed at ordinary-income rates. Choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

Also pay attention to earnings reinvestments. Unless you or your investment advisor increases your basis accordingly, you may report more gain than required when you sell the fund. Brokerage firms are required to track (and report to the IRS) your cost basis in mutual funds acquired during the tax year.

Finally, beware of buying equity mutual fund shares late in the year. Such funds often declare a large capital gains distribution at year end. If you own the shares on the distribution's record date, you'll receive and be taxed on the full distribution amount even if it includes significant gains realized by the fund before you owned the shares.

### CASE STUDY 1

### Turning a capital loss into a tax-saving opportunity



Malcolm's year-to-date net realized losses are \$13,000. His portfolio includes \$20,000 of stock that he paid only \$10,000 for. Malcolm has been thinking about selling it to diversify his portfolio and because year-to-date the stock had dropped from \$30,000 to \$20,000 in value and he's not confident it will recover.

But he's been concerned about the capital gains tax.

His tax advisor suggests that now might be a good time to sell the stock because his \$10,000 gain would essentially be tax-free: The gain would absorb \$10,000 of losses, leaving Malcolm with a \$3,000 net loss, the maximum that he could use to offset ordinary income.

## Income investments

Some types of investments produce income in the form of dividends or interest. Here are some tax consequences to consider:

**Dividend-producing investments.** Qualified dividends are taxed at the favorable long-term capital gains tax rate rather than at your higher ordinary-income tax rate.

**Interest-producing investments.** Interest income generally is taxed at ordinary-income rates. So stocks that pay qualified dividends may be more attractive taxwise than other income investments, such as CDs and taxable bonds. But also consider nontax issues, such as investment risk, rate of return and diversification.

**Bonds.** These also produce interest income, but the tax treatment varies:

- ▲ Interest on U.S. government bonds is taxable on federal returns but exempt by federal law on state and local returns.
- ▲ Interest on state and local government bonds is excludable on federal returns. If the bonds were issued in your home state, interest also may be excludable on your state return.
- ▲ Tax-exempt interest from certain private-activity municipal bonds can trigger or increase the alternative minimum tax (AMT), but the AMT now occurs much more rarely.
- ▲ Corporate bond interest is taxable for federal *and* state purposes.
- ▲ Bonds (except U.S. savings bonds) with original issue discount build up “interest” as they rise toward maturity. You’re generally considered to earn a portion of that interest annually — even though the bonds don’t pay this interest annually — and you must pay tax on it.

## 3.8% NIIT

Taxpayers with modified adjusted gross income (MAGI) over \$200,000 (\$250,000 if married filing jointly and \$125,000 if married filing separately) may owe the net investment income tax, in addition to other taxes already discussed here. The NIIT equals 3.8% of the lesser of your net investment income or the amount by which your MAGI exceeds the applicable threshold. Net investment income can include capital gains, dividends, interest, passive business income, rental income and other investment-related income (but not business or self-rental income from an active trade or business).

Many of the strategies that can help you save or defer income tax on your investments can also help you avoid or defer NIIT liability. And because the threshold for the NIIT is based on MAGI, strategies that reduce your MAGI could also help you avoid or reduce NIIT liability. ■

## Why businesses can't neglect tax planning in 2020



**T**ax planning is probably the last thing on most business owners' minds as they deal with the financial, operational and HR challenges of the COVID-19 crisis. But businesses can't afford to neglect tax planning this year. Taking full advantage of available tax breaks — including temporary relief in response to the crisis — is critical. And changes under the TCJA still demand attention, too.

### Business structure

Income taxation and owner liability are the main factors that differentiate one business structure from another. Many businesses choose entities that combine pass-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations. The TCJA significantly changed the tax consequences of business structure.

The now-flat corporate rate (21%) is significantly lower than the top individual rate (37%), providing significant tax benefits to C corporations and helping to mitigate the impact of double taxation for their owners. But, the TCJA also introduced a powerful deduction for owners of pass-through entities. (See page 15.)

For tax or other reasons, a structure change may be beneficial in certain situations. But there also may be unwelcome tax consequences that effectively prevent such a change.

**CHART 4** 2020 income tax differences based on business structure

Pass-through entity or sole proprietorship	C corporation
One level of taxation: The business's income passes through to the owner(s).	Two levels of taxation: The business is taxed on income, and then shareholders are taxed on any dividends they receive.
Losses flow through to the owner(s).	Losses remain at the corporate level.
The top individual tax rate is 37%, but, for eligible taxpayers, up to 20% of qualified business income is deductible.	The flat corporate tax rate is 21%, and the top rate on qualified dividends is 20%.

## Sec. 199A deduction for pass-through businesses

Through 2025, the TCJA provides the Sec. 199A deduction for sole proprietorships and owners of pass-through entities. The deduction generally equals 20% of qualified business income (QBI), subject to limits that can begin to apply if 2020 taxable income exceeds the applicable threshold — \$163,300 or, if married filing jointly, \$326,600. The limits fully apply when 2020 taxable income exceeds \$213,300 and \$426,600, respectively.

QBI is generally defined as the net amount of qualified items of income, gain, deduction and loss that are effectively connected with the conduct of a U.S. business. When the income-based limit applies, the 199A deduction generally can't exceed the greater of the owner's share of:

- ▲ 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or
- ▲ The sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

Another limitation for taxpayers subject to the income-based limit is that the 199A deduction generally isn't available for income from "specified service businesses." Examples include businesses that provide investment-type services and most professional practices (other than engineering and architecture).

The W-2 wage and property limitations and the service business limitation don't apply if your taxable income is under the applicable threshold. In that case, you should qualify for the full 20% deduction.

## Projecting income

Projecting your business's income for this year and next can allow you to time income and deductions to your advantage. It's generally — but not always — better to defer tax, so consider:

**Deferring income to next year.** If your business uses the cash method of accounting, you can defer billing for products or services at year end. If you use the accrual method, you can delay shipping products or delivering services.

**Accelerating deductible expenses into the current year.** If you're a cash-basis taxpayer, you may pay business expenses by Dec. 31, so you can deduct them this year rather than next. Both cash- and accrual-basis taxpayers can charge expenses on a credit card and deduct them in the year charged, regardless of when the credit card bill is paid.

**Warning:** Don't let tax considerations get in the way of sound business decisions. For example, the negative impact of these strategies on your cash flow or customers may not be worth the potential tax benefit.



**Taking the opposite approach.** If your business is a pass-through entity and it's likely you'll be in a higher tax bracket next year, accelerating income and deferring deductible expenses may save you more tax over the two-year period. This may be true for many businesses affected by the COVID-19 crisis.

## Depreciation

For assets with a useful life of more than one year, you generally must depreciate the cost over a period of years. In most cases, the Modified Accelerated Cost Recovery System (MACRS) will be preferable to other methods because you'll get larger deductions in the early years of an asset's life.

But if you make more than 40% of the year's asset purchases in the last quarter, you could be subject to the typically less favorable midquarter convention. Careful planning can help you maximize depreciation deductions in the year of purchase.

Other depreciation-related breaks and strategies may be available and, in many cases, have been enhanced by the TCJA:

**Section 179 expensing election.** This allows you to currently deduct the cost of purchasing eligible new or used assets, such as equipment, furniture, off-the-shelf computer software, and, under the TCJA, qualified improvement property, certain depreciable tangible personal property used predominantly to furnish lodging, and the following improvements to nonresidential real property: roofs, HVAC equipment, fire protection and alarm systems, and security systems.

### WHAT'S NEW!

#### CARES Act QIP correction increases deductions — retroactively

Prior to the TCJA, qualified retail improvement property, restaurant property and leasehold improvement property were depreciated over 15 years under the modified accelerated cost recovery system (MACRS). The TCJA classifies all of these property types as qualified improvement property (QIP).

Congress intended QIP placed in service after 2017 to have a 15-year MACRS recovery period and, in turn, qualify for 100% bonus depreciation. (See "Bonus depreciation" at right.) But, the statutory language didn't define QIP as 15-year property, so QIP defaulted to a 39-year recovery period, making it ineligible for bonus depreciation.

The CARES Act includes a technical correction to fix this drafting error. Restaurants, retailers and other businesses that have made qualified improvements during the past two years can claim an immediate tax refund for the bonus depreciation they missed. Businesses investing in QIP in 2020 and beyond also can claim bonus depreciation going forward, according to the phaseout schedule. In some cases, however, it might be more beneficial to claim depreciation over 15 years.

For qualifying property placed in service in 2020, the expensing limit is \$1.04 million. The break begins to phase out dollar for dollar when asset acquisitions for the year exceed \$2.59 million.

**Bonus depreciation.** This additional first-year depreciation is available for qualified assets, which include new tangible property with a recovery period of 20 years or less (such as office furniture and equipment), off-the-shelf computer software, and water utility property.

Under the TCJA, through Dec. 31, 2026, the definition has been expanded to include used property and qualified film, television and live theatrical productions. For qualified assets placed in service through Dec. 31, 2022, bonus depreciation is 100%. For 2023 through 2026, bonus depreciation is scheduled to be gradually reduced. For certain property with longer production periods, these reductions are delayed by one year.

In addition, qualified improvement property is now eligible for bonus depreciation. (See “What’s new!” at left.)

**Warning:** Under the TCJA, in some cases a business may not be eligible for bonus depreciation. Examples include real estate businesses that elect to deduct 100% of their business interest and dealerships with floor-plan financing, if they have average annual gross receipts of more than \$25 million for the three previous tax years.

### **Vehicle-related depreciation**

Purchases of new or used vehicles may be eligible for Sec. 179 expensing, and buying a large truck or SUV can maximize the deduction. The normal Sec. 179 expensing limit (see above) generally applies to vehicles with a gross vehicle weight rating of more than 14,000 pounds. A \$25,900 limit applies to vehicles (typically SUVs) rated at more than 6,000 pounds, but no more than 14,000 pounds.

But even if you prefer to buy a smaller vehicle, you can still potentially enjoy a valuable first-year deduction. Vehicles rated at 6,000 pounds or less are subject to the passenger vehicle limits; contact your tax advisor for details.

If you use a vehicle for business and personal purposes, the associated expenses, including depreciation, must be allocated between deductible business use and nondeductible personal use. **Warning:** If business use is 50% or less, you won’t be able to use Sec. 179 expensing or the accelerated regular MACRS; you’ll have to use the straight-line method.

## Meals, entertainment and transportation

The TCJA has changed some of the rules for deducting meal, entertainment and transportation expenses, as well as employee reimbursements of such expenses. Here's a closer look at what's deductible and what's not:

**Meals.** Under the TCJA, business-related meal expenses, including those incurred while traveling on business, have remained 50% deductible. But, the TCJA expanded the 50% disallowance rule to meals provided via an on-premises cafeteria or otherwise on the employer's premises for the convenience of the employer. (Such meals used to be 100% deductible.)

**Entertainment.** Under the TCJA, these expenses are no longer deductible.

**Transportation.** Employer deductions for the cost of providing commuting transportation to an employee (such as hiring a car service) aren't allowed under the TCJA, unless the transportation is necessary for the employee's safety. The TCJA also eliminated employer deductions for the cost of providing qualified employee transportation fringe benefits (for example, parking allowances, mass transit passes and van pooling). However, those benefits are still tax-free to recipient employees. Transportation expenses for business travel continue to be 100% deductible, provided they meet the applicable rules.

## Employee benefits

Offering a variety of benefits not only can help you attract and retain the best employees, but also may save tax because you generally can deduct your contributions:

**Qualified deferred compensation plans.** These include pension, profit-sharing, SEP and 401(k) plans, as well as SIMPLEs. You take a tax deduction for your contributions to employees' accounts. (For information on the benefits to employees, see page 22.) Certain small employers may also be eligible for a tax credit when setting up a retirement plan.

**HSAs, FSAs and HRAs.** If you provide employees with a qualified high-deductible health plan (HDHP), you can also offer them Health Savings Accounts. (See page 5.) Regardless of the type of health insurance you provide, you can offer Flexible Spending Accounts for health care. (See page 5.) If you have employees who incur day care expenses, consider offering FSAs for child and dependent care. (See page 6.)

A Health Reimbursement Account is another option. It reimburses an employee for medical expenses up to a maximum dollar amount. Unlike an HSA, no HDHP is required. Unlike

WHAT'S  
NEW!

## COVID-19 tax relief for employers



To help employers retain their workforces and provide paid leave during the COVID-19 crisis, legislation signed into law in March has offered some tax relief:

**Payroll tax credit.** Under the CARES Act, this credit is generally available to employers whose operations have been fully or partially suspended because of a COVID-19-related governmental shutdown order. Employers whose gross receipts have dropped more than 50% compared to the same quarter in the previous year (until gross receipts exceed 80% of gross receipts in the earlier quarter) are also typically eligible.

Employers whose workforces exceed 100 employees may claim the credit for employees who've been furloughed or had their hours reduced because of the reasons noted. If an employer has 100 or fewer employees, it can qualify for the credit regardless of whether there have been furloughs or hour reductions.

The credit equals 50% of up to \$10,000 in compensation, including health care benefits, paid to an eligible employee after March 12, 2020, through Dec. 31, 2020.

**Payroll tax deferral.** The CARES Act enables employers to delay payment of their share (6.2% of wages) of the Social Security payroll tax. Businesses can pay the tax over the next two years, with the first half due by Dec. 31, 2021, and the second half due by Dec. 31, 2022. Also, an Aug. 8 presidential memorandum offers a deferral of the employee share of Social Security taxes for many employees, but, as of this writing, there are open questions about this. Contact your tax advisor for the latest information.

**Paid leave credit.** The Families First Coronavirus Response Act generally requires employers with fewer than 500 employees to provide paid leave in certain COVID-19-related situations. Covered employers generally can take a federal payroll tax credit for 100% of the qualified sick and family leave wages they pay each quarter, up to \$511 per day for leave taken for the employee's own illness or quarantine and \$200 for leaves taken to care for others.

Additional rules and limits apply to these breaks, and it's possible they could be expanded or extended by the time you're reading this or that additional relief for employers could become available. Check with your tax advisor for the latest information.

an FSA, any unused portion can be carried forward to the next year. But only the employer can contribute to an HRA.

**Fringe benefits.** Certain fringe benefits aren't included in employee income, yet the employer can still deduct the portion, if any, that it pays and typically also avoid payroll taxes. Examples are employee discounts, group term-life insurance (up to \$50,000 per person) and health insurance.

**Warning:** You might be penalized for not offering health insurance. The Affordable Care Act can in some cases impose a penalty on “large” employers if they don’t offer full-time employees “minimum essential coverage” or if the coverage offered is “unaffordable” or doesn’t provide “minimum value.”

**WHAT'S  
NEW!**

**CARES Act temporarily eases some  
TCJA rules to help struggling businesses**



To provide COVID-19 relief, the CARES Act has temporarily eased the TCJA rules in a couple of areas:

**Interest expense deduction.** Generally, under the TCJA, interest paid or accrued by a business is deductible only up to 30% of adjusted taxable income (ATI). Taxpayers with average annual gross receipts of \$25 million or less for the three previous tax years generally are exempt from the limitation. Some other taxpayers are also exempt — check with your tax advisor for more information.

The CARES Act increases the interest expense deduction limit to 50% of ATI for the 2019 and 2020 tax years. (Special partnership rules apply for 2019.) It also permits businesses to elect to use 2019 ATI for the 2020 calculation, which may increase the deduction.

**Loss deductions.** A loss occurs when a business's expenses and other deductions for the year exceed its revenues:

- 1. Net operating losses (NOLs).** For NOLs that arise in 2018 and later tax years, the TCJA generally reduces the maximum amount of taxable income that can be offset with NOL deductions from 100% to 80%. In addition, the TCJA generally prohibits NOLs incurred in 2018 and later tax years from being carried back to an earlier tax year — but it allows them to be carried forward indefinitely (as opposed to the 20-year limit under pre-TCJA law).

Under the CARES Act, taxpayers are now eligible to carry back NOLs arising in 2018 through 2020 tax years to the previous five tax years. The CARES Act also allows taxpayers to potentially claim an NOL deduction equal to 100% of taxable income for prior-year NOLs carried forward into tax years beginning before 2021.

- 2. Pass-through entity “excess” business losses.** Through 2025, the TCJA applies a limit to deductions for current-year business losses incurred by noncorporate taxpayers: Such losses generally can't offset more than \$250,000 (\$500,000 for married couples filing jointly) of income from other sources, such as salary, self-employment income, interest, dividends and capital gains. (The limit is annually adjusted for inflation.) “Excess” losses are carried forward to later tax years and can then be deducted under the NOL rules.

The CARES Act temporarily lifts the limit. Taxpayers can deduct 100% of business losses arising in 2018, 2019 and 2020.

If any of these changes reduce your tax liability for previous years, you may be able to file amended returns to receive a refund now.

## Tax credits

Tax credits reduce tax liability dollar for dollar, making them particularly beneficial:

**Research credit.** This credit gives businesses an incentive to increase their investments in research. Certain start-ups (in general, those with less than \$5 million in gross receipts) can, alternatively, use the credit against their payroll tax. While the credit is complicated to compute, the tax savings can prove significant.

**Work Opportunity credit.** This credit is designed to encourage hiring from certain disadvantaged groups, such as certain veterans, ex-felons, the long-term unemployed and food stamp recipients. The maximum credit is generally \$2,400 per hire but can be higher for members of certain target groups — up to \$9,600 for certain veterans. The credit is scheduled to expire on Dec. 31, 2020.

**New Markets credit.** This gives investors who make “qualified equity investments” in certain low-income communities a 39% credit over a seven-year period. The credit is scheduled to expire on Dec. 31, 2020.

**Family medical leave credit.** The TCJA created a tax credit for qualifying employers that begin providing paid family and medical leave to their employees. The credit is equal to a minimum of 12.5% of the employee’s wages paid during that leave (up to 12 weeks per year) and can be as much as 25% of wages paid. Wages taken into account when computing the Families First Act paid leave credit don’t qualify. (See “What’s new!” on page 19.) The credit is scheduled to expire Dec. 31, 2020.

Additional rules and limits apply to these credits, and expiring credits might be extended. Other credits may also be available to you. Check with your tax advisor for more information.

## The self-employed

If you’re self-employed, you have to pay both the employee and employer portions of employment taxes on self-employment income. (See “What’s new!” on page 19 for possible deferral opportunities.) The employer portion is deductible “above the line,” which means you don’t have to itemize to claim the deduction.

In addition, you can deduct 100% of health insurance costs for yourself, and for a spouse and children, too. This above-the-line deduction is limited to net self-employment income. You also can take an above-the-line deduction for contributions to a retirement plan (see page 22) and, if eligible, an HSA (see page 5) for yourself.

If your home office is your principal place of business (or used substantially and regularly to conduct business) and that’s the only use of the space, you probably can deduct home office expenses from your self-employment income. ■

## Revisit retirement planning but remain steadfast if possible



**W**hile retirement planning was only minimally affected by the TCJA, other tax law changes going into effect this year plus the impact of the COVID-19 crisis mean you should revisit it in your tax planning. Tax-advantaged retirement plans can help you build and preserve your nest egg — but only if you stay steadfast to the extent possible.

### 401(k)s and other employer plans

Contributing to a traditional employer-sponsored defined contribution plan is usually a good first step:

- ▲ Contributions are typically pretax, reducing your taxable income.
- ▲ Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions.
- ▲ Your employer may match some or all of your contributions.

Chart 5 shows the 2020 employee contribution limits. Because of tax-deferred compounding, increasing your contributions sooner rather than later can have a significant impact on the size of your nest egg at retirement. Employees age 50 or older can also make “catch-up” contributions. If your employer offers a match, at *minimum* contribute the amount necessary to get the maximum match so you don’t miss out on that “free” money.

### More tax-deferred options

In certain situations, other tax-deferred saving options may be available:

**You’re a business owner or self-employed.** You may be able to set up a plan that allows you to make much larger contributions than you could make to an employer-sponsored plan as an employee. You might not have to make 2020 contributions, or even set up the plan, before year end.

**Your employer doesn’t offer a retirement plan.** Consider a traditional IRA. You can likely deduct your contributions, though your deduction may be limited if your spouse participates in an employer-sponsored plan. You can make 2020 contributions until the 2020 income-tax-return-filing deadline for individuals, *not* including extensions. (See Chart 5 for the annual contribution limits.)

## Roth alternatives

A potential downside of tax-deferred saving is that you'll have to pay taxes when you make withdrawals at retirement. Roth plans, however, allow tax-free distributions; the tradeoff is that your contributions don't reduce your current-year taxable income:

**Roth IRAs.** An income-based phaseout may reduce or eliminate your ability to contribute. But estate planning advantages are an added benefit: Unlike other retirement plans, Roth IRAs don't require you to take distributions during your lifetime, so you can let the entire balance grow tax-free for the benefit of your heirs.

**Roth conversions.** If you have a traditional IRA, a partial or full conversion to a Roth IRA can allow you to turn tax-deferred future growth into tax-free growth and take advantage of a Roth IRA's estate planning benefits. The converted amount is taxable in the year of the conversion. Discuss with your tax advisor whether a conversion makes sense for you.

**"Back door" Roth IRAs.** If your income is too high to make Roth IRA contributions and you don't have a traditional IRA, consider setting up a traditional account and making a nondeductible contribution to it. You can then immediately convert the contributed amount to a Roth account with minimal tax impact.

**Roth 401(k), Roth 403(b), and Roth 457 plans.** Employers may offer one of these in addition to the traditional, tax-deferred version. No income-based phaseout applies, so even high-income taxpayers can contribute.

## Early withdrawals

Early withdrawals from retirement plans should be a last resort. With a few exceptions (see "What's new!" on page 24 and page 25 for a 2020 exception), distributions before age 59½ are subject to a 10% penalty on top of any income tax that ordinarily would be due

**CHART 5 Retirement plan contribution limits for 2020**

	Regular contribution	Catch-up contribution <sup>1</sup>
Traditional and Roth IRAs	\$ 6,000	\$ 1,000
401(k)s, 403(b)s, 457s and SARSEPs <sup>2</sup>	\$ 19,500	\$ 6,500
SIMPLEs	\$ 13,500	\$ 3,000

<sup>1</sup> For taxpayers age 50 or older by the end of the tax year.

<sup>2</sup> Includes Roth versions where applicable.

**Note:** Other factors may further limit your maximum contribution.



on a withdrawal. Additionally, you'll lose the potential tax-deferred future growth on the withdrawn amount.

If you must make an early withdrawal and you have a Roth account, consider withdrawing from that. You can withdraw up to your contribution amount without incurring taxes or penalties.

Another option: If your employer-sponsored plan allows it, take a plan loan. You'll have to pay it back with interest and make regular principal payments, but you won't be subject to current taxes or penalties. (You can't borrow from an IRA.)

Early distribution rules also become important if you change jobs or retire. It's usually best to request a direct rollover from your old plan to your new plan or IRA. If you receive a lump sum payout, you'll need to make an indirect rollover within 60 days to avoid tax and potential penalties.

### Required minimum distributions

Historically, after a taxpayer reaches age 70½, he or she has had to begin to take annual RMDs from his or her IRAs (except Roth IRAs) and, generally, from any defined contribution plans. However, the age has increased — see “What's new!” below. In addition, the RMD rule has been waived for 2020 — see “What's new!” at right.

#### WHAT'S NEW!

#### Could you be affected by SECURE Act changes?

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, signed into law in late 2019, makes a variety of tax law changes related to retirement plans. Here are some of the most significant changes that could affect your nest egg:



- Allows penalty-free IRA withdrawals of up to \$5,000 for the birth or adoption of a child,
- Repeals the maximum age of 70½ for making traditional IRA contributions,
- Increases the age for beginning required minimum distributions (RMDs) from age 70½ to age 72, for taxpayers who didn't turn age 70½ before Jan. 1, 2020 (that is, were born after June 30, 1949), and
- Reduces the time period for distributions to 10 years for beneficiaries — other than surviving spouses and certain others — inheriting IRAs after Dec. 31, 2019.

The SECURE Act also includes many provisions intended to make employer-sponsored retirement plans more readily available. Contact your tax advisor or employee benefits advisor for more details.

**WHAT'S  
NEW!**

## CARES Act provides tax relief for retirement plan owners



In response to the COVID-19 crisis, the CARES Act provides some temporary relief to retirement plan owners:

**Owners who need funds from their accounts to help them financially survive the crisis.** The act waives the 10% early withdrawal penalty — along with providing additional tax advantages that taxpayers age 59½ and older can also benefit from — on COVID-19-related distributions up to \$100,000. These generally are 2020 withdrawals made by someone who has been (or whose family has been) infected with COVID-19 or who has been economically harmed by the virus.

Distributions may be recontributed to the retirement plan over the three-year period starting the day after the withdrawal. If distributions *aren't* recontributed, income tax payments can be spread out over three years. Many additional rules apply, so contact your tax advisor for details.

**Owners who *don't* need funds from their accounts this year.** The act waives retirement plan required minimum distributions for 2020. This potentially allows owners to avoid having to sell plan investments during a down market, giving time to recover lost value and providing continued tax deferral.

When RMD rules are applicable, if you don't comply, you can owe a penalty equal to 50% of the amount you should have withdrawn but didn't. You can avoid the RMD rule for a non-IRA Roth plan by rolling the funds into a Roth IRA.

Waiting as long as possible to take distributions generally is advantageous because of tax-deferred compounding. But a distribution (or larger distribution) in a year your tax bracket is low may save tax. Be sure, however, to consider the lost future tax-deferred growth and, if applicable, whether the distribution could: 1) cause Social Security payments to become taxable, 2) increase income-based Medicare premiums and prescription drug charges, or 3) affect tax breaks with income-based limits.

If you've inherited a retirement plan, consult your tax advisor about the distribution rules that apply to you.

### **IRA donations to charity**

Taxpayers age 70½ or older are allowed to make direct contributions from their IRA to qualified charitable organizations up to \$100,000 per tax year. A charitable deduction can't be claimed for the contributions. But the amounts aren't included in taxable income and, in years when RMDs are required, can be used to satisfy the RMD. A direct contribution might be tax-smart if you won't benefit from the charitable deduction. (See "What's new!" on page 4.) ■

## Taking the right steps now can save taxes later



**E**state planning is about much more than reducing taxes; it's about ensuring your loved ones are provided for after you're gone and that your assets are passed on according to your wishes. And because the TCJA has put estate, gift and generation-skipping transfer (GST) tax exemptions at record-high levels, far fewer taxpayers are worrying about these taxes. But the high exemptions currently are available only through 2025. And it's possible the limits could be reduced sooner. So whether or not you'd be subject to estate taxes under the current exemptions, it's a good idea to consider whether there are steps you can take now to save taxes later.

### Estate tax

While the TCJA keeps the estate tax rate at 40%, it has doubled the exemption base amount from \$5 million to \$10 million. The inflation-adjusted amount for 2020 is \$11.58 million. (See Chart 6.)

Without further legislation, the estate tax exemption will return to an inflation-adjusted \$5 million in 2026. So taxpayers with estates in the roughly \$6 million to \$11 million range (twice that for married couples), whose estates would escape estate taxes if they were to die while the doubled exemption is in effect, still need to keep potential post-2025 estate tax liability in mind in their estate planning. It's also possible the exemption could be reduced sooner than 2026.

### Gift tax

The gift tax continues to follow the estate tax, so the gift tax exemption also has increased under the TCJA. (See Chart 6.) Any gift tax exemption used during your lifetime reduces the estate tax exemption available at death. Using up some of your exemption during your lifetime can be tax-smart, especially if your estate exceeds roughly \$6 million (twice that if you're married). (See Case Study 2 on page 28.)

**CHART 6** 2020 transfer tax exemptions and rates

	Estate tax	Gift tax	GST tax
<b>Exemption</b>	\$11.58 million <sup>1</sup>	\$11.58 million	\$11.58 million
<b>Rate</b>	40%	40%	40%

<sup>1</sup> Less any gift tax exemption already used during life.

You also can exclude certain gifts of up to \$15,000 per recipient in 2020 (\$30,000 per recipient if your spouse elects to split the gift with you or you're giving joint or community property) without depleting any of your gift and estate tax exemption.

**Warning:** Each year you need to use your annual exclusion by Dec. 31. The exclusion doesn't carry over from year to year. For example, if you don't make an annual exclusion gift to your granddaughter this year, you can't add \$15,000 to your 2021 exclusion to make a \$30,000 tax-free gift to her next year.

### **GST tax**

The generation-skipping transfer (GST) tax generally applies to transfers (both during your lifetime and at death) made to people more than one generation below you, such as your grandchildren. This is in addition to any gift or estate tax due. The GST tax continues to follow the estate tax, so the GST tax exemption also has increased under the TCJA. (See Chart 6.)

The GST tax exemption can be a valuable tax-saving tool for taxpayers with large estates whose children also have — or may eventually have — large estates. With proper planning, they can use the exemption to make transfers to grandchildren and avoid any tax at their children's generation.

### **State taxes**

Even before the TCJA, many states imposed estate tax at a lower threshold than the federal government did. Now the differences in some states are even more dramatic. To avoid unexpected tax liability or other unintended consequences, it's critical to consider state law. Consult a tax advisor familiar with the law of your particular state.

### **Exemption portability**

If one spouse dies and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption. This exemption "portability" provides flexibility at the time of the first spouse's death, but it has some limits. Portability is available only from the most recently deceased spouse, doesn't apply to the GST tax exemption and isn't recognized by many states.

And portability doesn't protect future growth on assets from estate tax like applying the exemption to a credit shelter (or bypass) trust does. Such a trust offers other benefits as well, such as creditor protection, remarriage protection, GST tax planning and possible state estate tax benefits.

**CASE  
STUDY 2****Taking advantage of valuation discounts**

Celia had been planning to begin succession planning for her business in a few years. But with the events of 2020, she decided she should start planning sooner. So she made an appointment with her tax and estate planning advisors.

They recommended that she begin leveraging her gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. So, for example, if the combined discount is 25%, in 2020 she can gift an ownership interest equal to as much as \$20,000 tax-free because the discounted value doesn't exceed the \$15,000 annual exclusion.

If her business has declined in value because of 2020 events, a silver lining is that Celia may be able to transfer an even larger portion of her business tax-free.

But she doesn't want to transfer ownership interests to her children who aren't active in the business. Her advisors suggest that she can still potentially benefit from valuation discounts on transfers of other assets to them by setting up a family limited partnership. She can fund the FLP with public stock and real estate, and then gift limited partnership interests.

Celia's advisors warn her that the IRS may challenge valuation discounts; they recommend a professional, independent valuation. The IRS also scrutinizes FLPs, so she must be sure to properly set up and operate hers.

So married couples should still consider these trusts — and consider transferring assets to each other to the extent necessary to fully fund them at the first death. Transfers to a spouse (during life or at death) aren't subject to gift or estate tax as long as he or she is a U.S. citizen.

**Tax-smart giving**

Giving away assets now will help reduce the size of your taxable estate. Here are some strategies for tax-smart giving:

**Choose gifts wisely.** Consider both estate and income tax consequences and the economic aspects of any gifts you'd like to make:

- ▲ To minimize *estate tax*, gift property with the greatest future appreciation potential.
- ▲ To minimize *your beneficiary's income tax*, gift property that hasn't appreciated significantly while you've owned it.
- ▲ To minimize *your own income tax*, don't gift property that's declined in value. Instead, consider selling the property so you can take the tax loss and then gifting the sale proceeds.

**Plan gifts to grandchildren carefully.** Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts to a grandchild that don't qualify for the exclusion to be tax-free, you generally must apply both your GST tax exemption and your gift tax exemption.

**Pay tuition and medical expenses.** You may pay these expenses without the payment being treated as a taxable gift to the student or patient, as long as the payment is made directly to the provider.

**Make gifts to charity.** Donations to qualified charities aren't subject to gift tax. They may also be eligible for an income tax deduction, but this deduction may benefit fewer taxpayers than in the past. (See "What's new!" on page 4.)

**Consider "taxable" gifts.** Making some gifts beyond annual exclusion gifts and using some or all of your lifetime exemption can make sense if you have a large estate. These "taxable" gifts can protect transfers from gift and estate tax, even if the exemption drops in the future. They also remove the future appreciation from your estate.

You do, however, need to keep in mind your beneficiaries' income tax. Gifted assets don't receive the "step-up" in basis that bequeathed assets do. This means that, if beneficiaries sell assets gifted to them, their taxable capital gains will be determined based on *your* basis in the assets. So their capital gains tax could be higher than if they inherited the same assets.

## Trusts

Trusts can provide a way to transfer assets and potentially enjoy some tax savings while preserving some control over what happens to the transferred assets. For those with large estates, funding them now, while the gift tax exemption is high, may be particularly tax-smart. Here are some types of trusts to consider:

**A qualified personal residence trust (QPRT).** It allows you to give your home to your children today — removing it from your taxable estate at a reduced gift tax cost (provided you survive the trust's term) — while you retain the right to live in it for a certain period.

**A grantor-retained annuity trust (GRAT).** It works on the same principle as a QPRT, but allows you to transfer other assets; you receive payments back from the trust for a certain period.

**A GST — or "dynasty" — trust.** It can help you leverage both your gift and GST tax exemptions. And it can be an excellent way to potentially lock in the currently high exemptions while removing future appreciation from your estate. ■

## What's your marginal tax rate?



**Y**our marginal tax rate is the rate you'll pay on your next dollar of income, so in your planning it's important to know what it likely will be. Two years ago, the tax brackets underwent significant changes under the TCJA.

### Pay attention to thresholds

The TCJA replaced graduated tax rates for corporations with one flat rate. (See Chart 7.) When businesses are structured as pass-through entities, income is taxed at the owners' individual rates. (See Chart 9.) So, there are now some big differences between tax rates for corporations and pass-through entities (though the TCJA has provided a new deduction for pass-throughs; see page 15).

For individuals, the taxable income thresholds vary significantly based on filing status. (See Chart 9.) The thresholds for estates and trusts are much lower. (See Chart 8.) There are also AMT rates to consider. (See Chart 9.)

The AMT is a separate tax system that disallows some deductions and treats certain income items differently. You must pay the AMT if your AMT liability exceeds your regular tax liability. Because of TCJA changes such as the reduction or elimination of many itemized deductions and a substantial increase to the AMT exemptions, far fewer taxpayers are subject to AMT risk.

**CHART 7** 2020 corporate income tax rates

Tax rate	Type of corporation
21%	C corporation
21%	Personal service corporation

**CHART 8** 2020 estate and trust income tax rate schedule

Tax rate	Tax brackets
10%	\$ 0 – \$ 2,600
24%	\$ 2,601 – \$ 9,450
35%	\$ 9,451 – \$ 12,950
37%	Over \$ 12,950

**CHART 9** 2020 individual income tax rate schedules

Tax rate		Regular tax brackets	
		Single	Head of household
10%	\$	0–\$ 9,875	\$ 0–\$ 14,100
12%	\$	9,876–\$ 40,125	\$ 14,101–\$ 53,700
22%	\$	40,126–\$ 85,525	\$ 53,701–\$ 85,500
24%	\$	85,526–\$ 163,300	\$ 85,501–\$ 163,300
32%	\$	163,301–\$ 207,350	\$ 163,301–\$ 207,350
35%	\$	207,351–\$ 518,400	\$ 207,351–\$ 518,400
37%		Over \$ 518,400	Over \$ 518,400
		Married filing jointly or surviving spouse	Married filing separately
10%	\$	0–\$ 19,750	\$ 0–\$ 9,875
12%	\$	19,751–\$ 80,250	\$ 9,876–\$ 40,125
22%	\$	80,251–\$ 171,050	\$ 40,126–\$ 85,525
24%	\$	171,051–\$ 326,600	\$ 85,526–\$ 163,300
32%	\$	326,601–\$ 414,700	\$ 163,301–\$ 207,350
35%	\$	414,701–\$ 622,050	\$ 207,351–\$ 311,025
37%		Over \$ 622,050	Over \$ 311,025
Tax rate		AMT brackets	
		Single	Head of household
26%	\$	0–\$ 197,900	\$ 0–\$ 197,900
28%		Over \$ 197,900	Over \$ 197,900
Exemption		\$ 72,900	\$ 72,900
Phaseout <sup>1</sup>		\$ 518,400–\$ 810,000	\$ 518,400–\$ 810,000
<b>Note:</b> Consult your tax advisor for AMT rates and exemptions for children subject to the “kiddie tax.”			
		Married filing jointly or surviving spouse	Married filing separately
26%	\$	0–\$ 197,900	\$ 0–\$ 98,950
28%		Over \$ 197,900	Over \$ 98,950
Exemption		\$ 113,400	\$ 56,700
Phaseout <sup>1</sup>		\$ 1,036,800–\$ 1,490,400	\$ 518,400–\$ 745,200

<sup>1</sup> The AMT income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.





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