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Evaluating Year End Planning Opportunities Amid Tax Reform Uncertainty

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Benjamin Franklin advised, "Don't put off until tomorrow what you can do today." This adage feels particularly applicable to high net worth individuals concerned over potential tax reform under a new presidential administration.

Year-end 2020 represents a unique window to contemplate planning opportunities, as taxpayers face a dilemma: act now in 2020 to lock in potential tax savings or wait until 2021 to see whether President-elect Joe Biden's tax proposals[1] will gain traction in Congress. The risk is future tax reform could potentially be applied retroactively to January 1, which, while rare, is not unprecedented.

The outlook for tax reform legislation in 2021 largely hinges on which party controls the Senate; Republicans currently hold a narrow edge (50-48), with the final two seats – both for Georgia – to be decided in special run-off elections[2] on January 5, 2021. Should Republicans win at least one of those Senate seats, Republicans would retain control of the Senate, which would, in turn, greatly reduce the odds of significant near-term tax reform.

For more information on the outlook for future tax reform, please see our recent article, "Tax Reform: On Hold for Now?"

[1] *The Tax Foundation, "Details and Analysis of President-elect Joe Biden's Tax Plan" (October 22, 2020).*
[1] *FiveThirtyEight.com, "Georgia's Runoffs Will Determine Control Of The Senate. Here's What We Know So Far." (November 11, 2020)*

Planning Considerations Tied to Potential Tax Reform

Using the Lifetime Gift Tax Exemption

The Tax Cuts and Jobs Act (TCJA), passed in December 2017, approximately doubled the estate exemption – from $5.49 million per person in 2017 to $11.18 million per person in 2018. The increased exemption amounts, under TCJA, are scheduled to run through 2025, after which the basic exclusion amount (BEA) is set to revert to the 2017 level of $5 million per person, plus inflation adjustments.

The lifetime gifting exemption currently stands at $11.58 million per person (with a top federal estate tax rate of 40 percent), though President-elect Joe Biden has proposed to “return the estate tax to 2009 levels” which would imply an exemption of $3.5 million per person (plus inflation adjustments), with a top federal estate tax rate of 45 percent.

Importantly, the Treasury Department and IRS issued final regulations in November 2019 clarifying that taxpayers taking advantage of the increased exemption amounts would not be subject to a clawback, should the exemption amount decrease from current levels.

High net worth individuals should evaluate current assets and assess how much might be needed for their remaining lifetime, with consideration to gift ‘excess assets’ to loved ones, which would reduce the size of an otherwise taxable estate. Depending on the size of an outright gift, estate planning which incorporates making gifts to trusts may be advisable to provide parameters/ safeguards for the intended beneficiaries.

Individuals who are likely to one day have a taxable estate should also consider direct payments (to the educational/medical provider) for tuition and medical expenses, which do not constitute gifts, as well as annual exclusion gifts ($15,000 for 2020 and 2021). Such gifts can be an effective strategy for further reducing the size of a taxable estate.

Keep in mind that any gifts in excess of the annual gift tax exclusion ($15,000 to each donee) should be properly recorded on a gift tax return.

Accelerating Long-Term Capital Gains

The following table summarizes the tax rate for long-term capital gains, as of 2020:

Filing Status	0% rate	15% rate	20% rate
Single	Up to $40,000	$40,001 – $441,450	Over $441,450
Married filing jointly	Up to $80,000	$80,001 – $496,600	Over $496,600
Married filing separately	Up to $40,000	$40,001 – $248,300	Over $248,300
Head of household	Up to $53,600	$53,601 – $469,050	Over $469,050

Source: Internal Revenue Service. Note: the table above does not factor in the 3.8% Net Investment Income Tax (NIIT) to which certain high-income taxpayers may also be subject.

President-elect Joe Biden has proposed increasing the tax on long-term capital gains (as well as qualified dividends) to the top ordinary income rate for individuals with taxable income over $1 million. With a proposal to raise the top ordinary income tax rate from 37 percent to 39.6 percent, this proposed change to the taxation of long-term capital gains, if passed, could be substantial.

High-income taxpayers who could be impacted by this proposal should coordinate with an accountant to determine whether capital gains should be accelerated into the 2020 tax year.

Accelerating Charitable Donations

Itemized deductions typically provide a tax benefit equal to a taxpayer's marginal income tax bracket. A taxpayer in the 37 percent federal income tax bracket generally receives a 37 percent benefit for the total of itemized deductions.

President-elect Joe Biden proposed limiting the benefit of itemized deductions to 28 percent for individuals with more than $400,000 of taxable income. If passed, there could be a significant disconnect between a taxpayer's marginal tax bracket (say, 37 or 39.6 percent) versus the benefit provided by itemized deductions (28 percent).

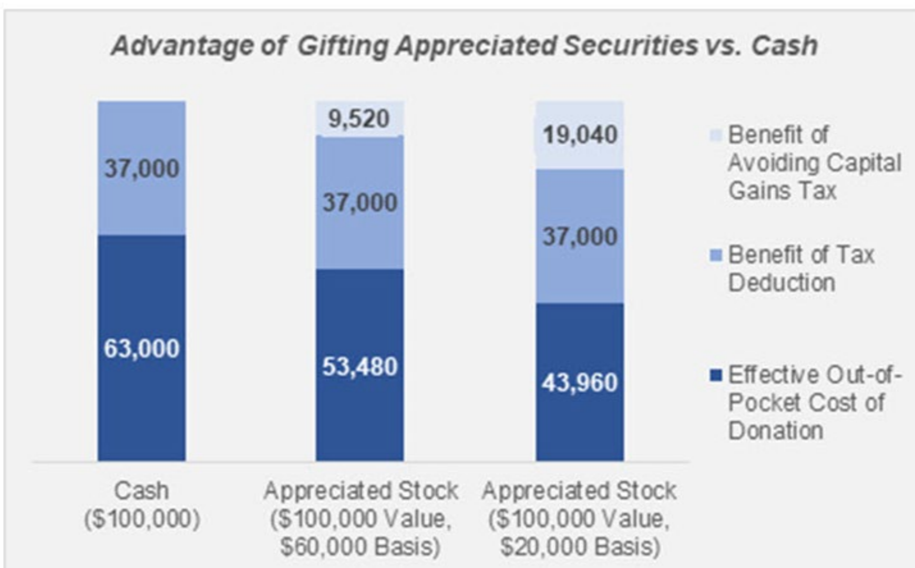
Charitably inclined individuals who could be affected by this change should evaluate whether to accelerate charitable gifts prior to year-end. This consideration may also be particularly beneficial for taxpayers who experienced higher-than-normal income in 2020, as increased charitable giving shields a portion of income from otherwise being taxed at a higher rate.

Coordination with an experienced accountant is advisable, given certain adjusted gross income (AGI) limits that apply to charitable gifts. Should charitable gifts exceed the AGI limits, the excess becomes a charitable carryforward to be used within the next five years, albeit potentially subject to the proposed 28 percent limit.

Of special note, while the Tax Cuts and Jobs Act increased the deduction for cash contributions to public charities to 60 percent of adjusted gross income (previously 50 percent AGI limit), the Coronavirus Aid, Relief, and Economic Security (CARES) Act increased the deduction for contributions to public charities (other than donor-advised funds) to 100 percent of AGI for the 2020 tax year. As a result of this CARES Act-provision, high income taxpayers may have a unique 2020 charitable planning opportunity.

Gifting Long-Term Appreciated Securities Rather than Cash

With equity markets near all-time highs, investors with taxable accounts may hold highly appreciated equity positions. From a tax planning standpoint, gifting long-term appreciated securities is an efficient charitable-giving strategy as the charity receives the same economic benefit as a cash donation, while the taxpayer receives a tax deduction for the full market value of the gift and avoids paying capital gains taxes on the gifted security.



Analysis assumes taxpayer subject to highest federal tax bracket (37%) and capital gains subject to 23.8% federal tax rate. Analysis assumes charitable gifts to qualified public charities.

Investors who have a portfolio overweight to equities may use charitable gifting as a means to rebalance back to target weights. In doing so, an investor is able to achieve philanthropic goals while avoiding having to sell appreciated equities to return to a desired target allocation.

Keep in mind that gifts of long-term appreciated securities to qualified public charities (including donor-advised funds) are limited to 30 percent of adjusted gross income (AGI) while similar gifts to a private foundation are limited to 20 percent of AGI. As noted earlier, charitable gifts in excess of the AGI limits result in a charitable carryforward that can be used over the next five years.

Consider a Roth Conversion

With income tax rates at historically favorable levels, individuals who believe their future tax rate might be higher than their current tax rate might consider converting a portion, or all, of existing Traditional IRA assets to a Roth IRA. Assuming the Traditional IRAs have no basis, the amount of the conversion is treated as taxable income. In exchange, the Roth IRA grows tax-free with qualified distributions also treated as tax-free.

This strategy can be beneficial for individuals with a taxable estate, as the tax cost for the conversion effectively reduces the size of the estate, while the named beneficiaries one day receive a very tax-favorable asset (compared to inheriting a Traditional IRA). In some cases, high net worth individuals might pair a Roth conversion with the aforementioned accelerated charitable giving strategy, as the charitable deduction reduces the effective tax cost of the conversion.

Individuals with notable assets, but with lower-than-normal income in 2020, might also consider this strategy, as it allows the taxpayer to essentially pay a reduced rate on the conversion while taxable income is low.

Note: There are a number of factors (time horizon, overall net worth, tax bracket, etc.) to evaluate whether a Roth conversion might ultimately be beneficial.

Review Estate Plans & Retirement Account Beneficiaries

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, enacted on January 1, 2020, effectively eliminated what was known as “the stretch IRA,” for which a beneficiary could stretch required minimum distributions (RMDs) for an inherited IRA over their lifetime (example: John Smith, age 92, names his great grandson Billy, age 20, as the beneficiary of his $2 million Traditional IRA). Under the SECURE Act, most non-spouse beneficiaries will be required to fully withdraw all inherited IRA assets by the end of the tenth year after the IRA holder died. Estate plans which previously incorporated this “stretch” strategy are now outdated and in need of updating.

Periodically reviewing and updating estate plans is a recommended best practice in light of potentially changing estate planning rules and limits. Individuals who have recently experienced a significant life event (marriage, divorce, birth/adoption) may also need to make updates to existing estate plans.

General Planning Considerations

Harvest Losses

Review unrealized gains and losses in taxable investment accounts and harvest losses where available. Realized losses can offset other realized gains; to the extent that realized losses exceed realized gains, net realized losses can offset up to $3,000 of ordinary income with any remainder resulting in a loss carryforward to be used in future years.

Beware of the “wash sale rule” which states that a loss cannot be realized for tax purposes if a substantially identical position was bought within 30 days before or after the sale. As a practical example, an investor could sell an actively managed equity fund and could redeploy the sales proceeds to an equity index fund. In doing so, the investor recognizes a tax loss while also keeping similar, but not identical, portfolio exposure to capture a subsequent market recovery.

With markets having recovered substantially from the March 2020 lows associated with the COVID-19 pandemic, investors may have limited loss harvesting opportunities, although international equity value funds, REITs and MLPs could be potential candidates.

Analyze Mutual Fund Year-End Capital Gain Distributions

Mutual funds are required to pass along capital gains to fund shareholders. Regardless of whether the fund shareholder actually benefited from the fund’s sale of underlying securities, the shareholder will receive the capital gain distribution if the mutual fund is held as of the dividend record date.

Mutual fund families typically provide estimates for year-end dividend distributions over the course of October and November, with such distributions most commonly paid in December.

Capital gain distributions can be either short-term or long-term. Short-term capital gain dividends are treated as ordinary income and thus cannot be offset by realized losses. In contrast, long-term capital gain dividends are treated as capital gains and can be offset by realized losses.

It is important to review unrealized gains and losses across mutual fund holdings in taxable accounts and to compare those figures against capital gain distribution estimates to determine if selling a mutual fund position before the year-end distribution would produce a tax savings.

Satisfy Required Minimum Distributions (RMDs) using the IRA Charitable Rollover

The SECURE Act raised the beginning age for required minimum distributions (RMDs) to 72, from age 70½, previously. However, the Coronavirus Aid, Relief, and Economic Security (CARES) Act waived Required Minimum Distributions (RMDs) for the 2020 tax year.

The SECURE Act did not adjust the age 70½ requirement for taxpayer eligibility to make a Qualified Charitable Distribution (QCD) up to $100,000 each year from an IRA to qualified 501(c)(3) charitable organizations (donor-advised funds, private foundations and supporting organizations are excluded). A qualified charitable distribution neither counts as an itemized deduction nor as taxable income, though it does count towards satisfying the RMD for that year.

This strategy may be beneficial for charitably inclined individuals who receive a greater tax benefit from the increased standard deduction rather than itemized deductions.

Note: While taxpayers can still make a QCD in 2020, with 2020 RMDs being waived under the CARES Act, it may instead be beneficial to delay any QCDs until 2021.

Evaluate When to Collect Social Security Retirement Benefits

Individuals nearing eligibility for Social Security retirement benefits should give proper consideration for when to start benefits. A recent study[3] estimated that only 4 percent of retirees start their Social Security benefits at the most optimal time, with retirees effectively forfeiting a collective $3.4 trillion in potential retirement income. A review of 2016's new Social Security recipients[4] showed nearly 60 percent of individuals collected benefits before their full retirement age (FRA), with only 10 percent waiting beyond full retirement age. Nearly a third opted to begin receiving benefits at age 62, despite a significant benefit reduction. While general guidance is to wait (if possible) until age 70 to collect a higher benefit, there are a number of important factors to consider:

- anticipated life expectancy
- income needs for the interim years when benefits would be delayed
- availability of spousal benefits

[3]*United Income, "The Retirement Solution Hiding in Plain Sight" (June 2019)*

[4]*"It's Tempting to Take Social Security at 62. You Should Wait." By Peter Finch. The New York Times. August 31, 2018.*

Consider a Change in State Residency?

Changing your primary state of residency is not as simple as spending more than half the year in a new state. With many states more aggressively contesting such residency changes, individuals should take extra precaution to ensure that "facts and circumstances" support the case for changing resident states.

Some of the factors that support a new domicile include days spent in the new state for the year, driver's license registration, voter registration, medical and dental care providers, country club or social club memberships, official mailing address to which mail and bills are sent, location of family heirlooms and artwork and more.

For more information, please contact any of the professionals at Fiducient Advisors.

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Nick provides investment consulting services to nonprofit organizations, corporate executives, family trusts and other high net worth investors. He services clients by providing advice and expertise on asset allocation, portfolio design, investment policy statements, manager search process and overall investment management. Nick heads the firm's Financial Planning Committee. Prior to joining the firm in 2007, Nick was a Senior Financial Planner with The Ayco Company where he provided comprehensive advice to affluent clientele. Nick earned a BA in Finance and Economics from the University of Illinois at Urbana-Champaign. He obtained the designation of Certified Financial Planner (CFP®) from the College of Financial Planning and is a CFA® charterholder and member of the CFA Society of Chicago. Nick enjoys long distance running (having completed four marathons and multiple half-marathons) and spending time with his family., portfolio design, investment policy statements, manager search process, fiduciary stewardship, and overall investment management. Steve also produces financial market commentary and supports capital market research at the firm. Prior to joining the firm in 2017, Steve was an Associate Client