Tax Strategies for 2021 Filing

After the CARES Act and SECURE Act, taxpayers have new tactics to consider for the 2020 tax season

The 2020 tax year will require a fresh set of eyes for many people. To recap what's happened in the past year, the SECURE Act was passed in December 2019, expanding retirement savings options and causing many individuals to adjust their tax and estate plans. Then, three months into 2020, we were hit with COVID-19, which resulted in the CARES Act. The election results, which have kept the nation largely divided, mean we probably won't see significant changes to these strategies any time soon.

So there's a lot to keep in mind this tax season. At the moment, these are the important things to know about your 2020 tax planning:

YEAR-END TAX PLANNING CHECKLIST

Tax Rates, Estate and Retirement Planning

The top tax bracket for 2020 remains at 37%, and that rate applies to taxpayers with taxable income of $518,400 and higher for single filers, and $622,050 and higher for married couples filing jointly.

While the lifetime gift and estate tax exemption amount increased to $11.58 million for 2020, Biden has proposed reducing this exemption under his administration. The annual gift tax exclusion amount is still at $15,000. The estate tax exemption is scheduled to fall back to $5 million (adjusted for inflation) in 2026. As 2026 approaches, if your estate falls between those two figures, you may want to look for ways to take advantage of the larger exemption before it expires.

If you took a coronavirus-related distribution (CRD) in 2020, for tax purposes, you can recognize the income over three years, or you can recognize 100% of the distribution this year. If you expect to be in a higher tax bracket in 2021 and 2022, you will probably want to recognize all the income in 2020.

- The 2020 contribution limits to most forms of retirement plans have increased from 2019:
  - 401(k), 403(b) and 457 plans: to $19,500 (up from $19,000)
  - Traditional and Roth IRAs: to $6,000 (same as 2019)
  - SIMPLE IRAs: to $13,500 (up from $13,000)
  - SEP IRAs: to $57,000 (up from $56,000)

If you're covered by an employer-sponsored retirement plan, your ability to deduct contributions to a Traditional IRA starts to phase out at $65,000 in Modified Adjusted Gross Income ($104,000 for married filers), and is fully phased out once MAGI reaches $75,000 ($124,000 for married filers). If you're over that threshold, you can still make a non-deductible contribution as long as you have earned income equal to or greater than the contribution amount.

- For 2020, full contributions to a Roth IRA are only allowed for joint taxpayers with AGI below $196,000 (singles below $124,000), with contributions fully phased out at $206,000 ($139,000 for singles).
- If you're 50 or older, you are probably eligible for a "catch-up" contribution over the normal limit. The catch-up amounts for 2020 are $1,000 for IRAs, $6,500 for 401(k), 403(b) and 457 plans, and $3,000 for SIMPLE IRAs.
- Due to the CARES Act, Required Minimum Distributions (RMDs) have been waived for 2020, so even if you're over 72, you are not required to take a distribution from your IRA this year. Before the SECURE Act, the RMD age was 70 ½. While IRA owners who turned 70½ during 2019 are still considered to be in their RMD phase under pre-SECURE Act rules, those who did not take their RMD by December 31, 2019, can waive both their 2019 and 2020 RMD under the CARES Act.
- The RMD rules apply to Traditional IRAs and, in most cases, employer retirement plans. Roth IRAs, however, are exempt from these rules.

Charitable Contributions and Other Itemized Deductions

After the 2017 Tax Cuts and Jobs Act (TCJA) raised the standard deduction amounts, many taxpayers began using a bunching strategy - accelerating or deferring deductible expenses to gather more of them into a single year. Most deductible expenses, such as taxes and mortgage interest, aren't flexible enough to be moved from one year to the next, but charitable contributions lend themselves perfectly to this strategy.

In order to deduct a charitable gift this year, you have to mail a check or charge your credit card by the end of the year for gifts that go directly to a charity. The TCJA expanded the deductibility of cash gifts by allowing them to offset up to 60% of AGI (up from 50% in 2017), but under the CARES Act, you can deduct up to 100% of AGI if the gift is made directly to a public charity.

If your income is unusually high in 2020, you may want to consider accelerating future giving into this year. You might also consider making that gift to a donor-advised fund, which lets you take the tax benefit immediately without having to commit to a hard dollar amount for the charitable gift later. In other words, you can fund the account with a large gift upfront and use the account to make discretionary gifts later. Cash gifts to donor-advised funds are still subject to the normal 60% of AGI limitation for 2020. Be prepared to take this action early, because many fund companies have deadlines in early December to allow for ample processing time.

Even though the CARES Act waived the RMD rules for 2020, you can still make charitable gifts by utilizing a Qualified Charitable Distribution (QCD), which is a distribution from an IRA that is transferred directly to a charity. The withdrawal from the IRA isn't included in taxable income, although the donation is also non-deductible.

- The TCJA capped the state and local tax (SALT) deduction at $10,000, meaning any taxes paid during the year in excess of that amount are non-deductible. If you have already reached the $10,000 threshold for 2020, try to defer any additional state tax payments for as long as possible.
- The TCJA temporarily made it easier to deduct medical expenses, by decreasing the AGI threshold from 10% to 7.5%. This was set to expire after 2019, but has since been extended through 2020, so you may want to group elective items (dental or vision exams, prescription refills, etc.) into this year as much as possible.
- The personal exemption amount has been temporarily reduced to $0 through 2025, meaning there is no longer a flat deduction amount for dependents. The child tax credit has been around for many years, but the TCJA expanded the size and scope of the credit. The credit amount increased from $1,000 to $2,000 for children under age 17. A separate $500 credit is available for any dependent who doesn't qualify for the $2,000 credit. The total credit begins to be phased out for couples with income over $400,000 and singles over $200,000, the same as for 2019.

Planning For Capital Gains & Losses

For 2020, married taxpayers with taxable income below $80,000 (singles below $40,000) can realize tax-free long-term capital gains (assets held more than one year). If you're below those levels for 2020, consider realizing some tax-free gains this year. Once you exceed those income levels, long-term gains will be subject to a 15% tax rate.

Taxpayers in the highest capital gains bracket (couples with taxable income over $496,600 and singles over $441,450) are subject to a 20% marginal tax. Couples with MAGI above $250,000 for 2020 ($200,000 for singles) will also owe a 3.8% tax on their investment income over those thresholds.

College Savings Plans

One advantage of gifting to a 529 college savings plan is that five years' worth of gifts can be made in one year. With the annual gift exclusion at $15,000 for 2020, a taxpayer can gift up to $75,000 at one time to a 529 plan – double if the gift comes from a couple. A little known fact is that you can make retroactive contributions to a plan and still have those count after December 31, so if you're considering this, you may want to wait until early 2021. That would allow you to still contribute $15,000 to the 529 for 2020 before doing the 2021 through 2025 gifts next year.

Funding a Coverdell Education Savings Account can also provide tax-free income for education expenses. You can contribute up to $2,000 per year per beneficiary under 18 years old for both college and K-12 expenses. Contributions are limited to married couples with Modified AGI below $220,000 ($110,000 for singles).

Given all the changes, this promises to be a complicated tax year for many people. While Baird does not offer tax or legal advice, our Financial Advisors regularly work with clients' attorneys and tax professionals to help ensure that all aspects of wealth management are addressed, and can help you sort out which strategies are right for you. For more information, see our guide to Tax Planning.