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INSIGHTS

FINANCIAL PLANNING

Year-end Tax-planning Moves

THE BIG PICTURE

Tax planning may well be a year-round job, but the fourth and final quarter of the year is where the rubber meets the road.

Many of the most common strategies used for lowering one's annual tax bite take weeks or months to execute and must be implemented by Dec. 31. (Contributions to a traditional IRA are the notable exception, as prior-year contributions can be made all the way up to the tax-filing deadline of the following year.)

The strategies that some financial professionals suggest include:

- **Accelerating or deferring income/deductions as appropriate.**
- **Harvesting investment losses or gains.**
- **Contributing to your 401(k).**
- **Making required minimum distributions from your IRA, if you are older than age 72.**

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“Any tax planning that has an end-of-year deadline should be set up and processed by mid-December,” said Nancy Coutu, a principal with and cofounder of Money Managers Financial Group in Chicago. “There is no recourse if you miss the window.”

Review Income

For many people, the starting point for year-end tax planning is calculating their projected income for the current year and comparing it with the previous year. This review is especially important for those whose take-home pay fluctuates, like independent contractors, small-business owners, or commission-based sales people.

Many people saw their tax bill go down in the wake of the Tax Cuts and Jobs Act of 2018. In fact, most taxpayers no longer itemize due to the generous standard deductions ($24,800 for married filing jointly and $12,400 for single filers in tax year 2020). Also, the once dreaded alternative minimum tax (AMT) has been modified so that most taxpayers won’t be affected.

Many people lean on a tax specialist or financial professional to help analyze income and maximize deductions, but don’t wait for the last minute to seek their advice, said Coutu.

“With holidays and weekends, along with millions of these types of transactions taking place at the same time, there is too much room for errors and little time to correct them,” she said.

Delay Income/Accelerate Tax Deductions

Those who earned more income this year may be able to lower their tax liability by accelerating deductions and deferring compensation income where possible.

For cash-basis taxpayers who report income and deductions in the year they are received, which is the case for most employees, some payroll departments may be willing to distribute year-end bonuses on or after Jan. 1, 2021. Additionally, it may be possible to exercise nonqualified stock options next year instead of this year.

Those who invoice for services rendered may also wish to hold off for an extra couple of weeks to ensure that payment will be received in the new year.

Another tactic some people use to potentially lower their tax bill, if they are charitably inclined, is to donate appreciated stock or securities to a qualified charity, which generally yields a tax deduction equal to the full market value (up to certain limits) as long as the asset was owned for at least a year.

Additionally, some taxpayers accelerate deductions they would normally take next year to the last few weeks of December, such as estimated state income tax bills or January property tax bills. Be aware that under the Tax Cuts and Jobs Act, which took effect in 2018, a taxpayer’s deduction for state and local income, sales, and property taxes is limited to a combined total deduction of $10,000, or $5,000 if married filing separately. Any amount above that limit is not deductible.

Yet another way to potentially lower taxable income is to harvest any losses they may have in an investment portfolio to offset capital gains. The IRS allows taxpayers to offset all capital gains in a portfolio in a given year with their investment losses. Any excess loss can be used to offset ordinary income up to $3,000 per year ($1,500 for married individuals who file separately) until the loss is used up.[1]

Investors should be cautious about using this strategy, tax professionals point out.

“You wouldn’t want to sell an investment you would otherwise want to hang on to just to claim the loss,” said Mark Luscombe, a certified public accountant and attorney, and principal federal tax analyst for Wolters Kluwer Tax & Accounting, a tax, accounting and auditing services firm in Riverwoods, Illinois. The sale must make sense for your overall investment strategy, he said in an interview.

Investors also need to be aware of the wash sale rule. Taxpayers cannot claim a deduction when they sell or trade stocks at a loss and then repurchase those shares (or a substantially identical security) within 30 days before or after that date.

Accelerate Income/Delay Deductions

The reverse is true for those who anticipate a higher tax bill next year. In that case, it may make sense to accelerate income into this year and delay generating deductions, which could have greater value in tax year 2021, said Coutu.

For example, a taxpayer may be able to collect on debts and accounts receivable owed, settle any taxable lawsuits or insurance claims, or take distributions from an IRA or retirement plan (if the circumstances are such that it will not produce an early withdrawal penalty).

Taxpayers can also consider postponing charitable gifts until next year (to save the deduction for when it’s needed more), or pay December’s deductible expenses on Jan. 1, 2021, assuming they can do so without late payment penalties.

Similarly, in a lower tax bracket year, it may make sense for individuals to sell highly appreciated stocks, bonds, funds, and other assets (that no longer fit with investment goals) to harvest capital gains.

Fund Your 401(k), 403(b), and 457 Plans

One of the more common ways people lower their tax liability is to increase contributions to a tax-deferred retirement savings plan, like 401(k), 403(b), or 457 plans.

If payroll deductions are not on track to take 401(k) contributions to the limit, which is $19,500 for tax-year 2020, a taxpayer could adjust his or her elective deferral higher for the remaining weeks of the year. Those 50 or older can make additional catch-up contributions of $6,500.[2]

Those who can’t afford to max their account should not despair. Even a small increase in annual contributions can potentially boost their savings, especially if their retirement savings plan involves an employer’s matching contribution. Plus, of course, there is an immediate tax benefit for your contribution.

Watch Your RMDs

Sometimes, the best way to minimize a tax bill is by dodging avoidable penalties.

Those age 72 or older are required to start taking minimum distributions every year from most tax-deferred accounts, including their

traditional IRA and 401(k).[3] The RMD age had been 70 ½ until passage of the SECURE Act in 2019 raised the age requirement to 72.

In most cases, the deadline for taking an RMD is Dec. 31. An exception is made for those taking their first RMD, in which case they have until April 1 of the year after they reach 72 to take their distribution. (Those who do so, however, will need to take two RMDs that first year, one for the prior year, and one for the current year.)

Failure to take an RMD, or the full amount, by the appropriate deadline will result in a hefty 50 percent excise tax on the amount not withdrawn.

Put more simply, if you were required to take out a minimum $5,000 from an IRA, but missed the deadline, you would owe the IRS $2,500, plus the ordinary income tax owed on the RMD because the contributions were originally made on a pretax basis.

For the ultimate tax deduction, some also consider donating their RMD to charity.

"If you are making charitable contributions this year, consider contributing your RMD directly to a qualified charity in order to avoid paying income taxes on the distribution, up to $100,000," said Coutu, noting tax-free gifts yield a bigger benefit for both the donor and the charity. "To make sure that the transaction is completed prior to the end-of-year deadline, allow extra time for the transaction to be completed."

Health plan tactics

For those who pay for an individual or family high-deductible health insurance plan that qualifies for a health savings account, there is also the potential to roll over money tax free from an IRA to fund the HSA, said Coutu. (Generally, that only makes sense if the taxpayer has no other funds with which to make an HSA contribution. Otherwise, they would typically be better off leaving their IRA untouched and funding their health savings account with deductible contributions from other income.)

The contribution limit is $3,550 for an individual and $7,100 for a family in 2020. (That limit is $1,000 higher for those 55 or older.) To qualify, the deductible has to be at least $1,400 for an individual or $2,800 for a family, said Coutu.

"You can then get this money out tax free from the HSA if used for medical expenses," she said, noting that such rollovers can only be done once in a lifetime.

By Shelly Gigante
Shelly Gigante specializes in personal finance issues. Her work has appeared in a variety of publications and news websites.

[1]Internal Revenue Service, "Helpful Facts to Know About Capital Gains and Losses," Jan. 17, 2020.

[2]Internal Revenue Service, "401(k) contribution limit increases to $19,500 for 2020; catch-up limit increases to $6,500," September 19, 2020.

[3]Internal Revenue Service, "Retirement Topics — Required Minimum Distributions (RMDs)," Jan. 28, 2020. Any discussion of taxes is for general information purposes only, does not purport to be complete or cover every situation, and should not be construed as legal, tax or accounting advice. Clients should confer with their qualified legal, tax and accounting advisors as appropriate.

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