2020 Tax Update for Investors

SILICON VALLEY TAX COACH

Presented by Russell Barnett, EA, CTS

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About The Presenter

Russell Barnett, EA, CTS is an Enrolled Agent and Certified Tax Strategist in San Jose, CA, where he is CEO of Silicon Valley Tax Coach - a proactive tax planning, outsourced accounting, and tax compliance firm.

We work with business owners and high net worth investors to analyze their overall tax situation and then identify opportunities to proactively apply legal tax minimization strategies in order to reduce the tax burden on the business and on the owner - leaving more profit to reinvest, save, and spend on things other than taxes!

Over the past three years alone we have helped our clients legally reduce their taxes by more than $4.8 million - this is how we are different from a typical tax office which merely record history rather than looking ahead.

It's not just about how much you make - it's about how much you keep!

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Background and Presentation Topics

2020 has been a year of turbulence and chaos. We are all living through it and are well aware of the changes that the coronavirus pandemic have forced on our families and businesses.

In response to this pandemic, Congress has passed multiple bills which made sweeping changes to the tax code - some of which are retroactive! I will be going over the changes which most directly impact investors and explaining how they apply.

Toward the end of the presentation I will spend a little time explaining some general tax issues that investors face and provide a few ideas on how to defer or reduce taxes on investment income.

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The Families First Coronavirus Response Act (H.R. 6201)

- Signed on March 18, 2020
- Mandates employer provided leave for coronavirus related illness and/or quarantine
- Provides payroll tax credits to cover the cost of up to two weeks off for most employees
- Provides payroll tax credits to cover 2/3 of the cost of up to 2 weeks off to care for others related to the coronavirus.
- Employers must also offer unpaid sick leave for coronavirus related illness and/or quarantine.
- These credits are also available for self-employed individuals who were unable to work due to coronavirus related illness and/or quarantine

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IRC §139 Employer Disaster Assistance

- Section 139 of the internal revenue code is existing law that pre-dates the coronavirus pandemic, unlike the FFCRA and CARES Act
- During federally declared disaster events employers can provide non-taxable payments to employees in order to help pay for increased costs that result
- The payments do not need to be accounted for as long as they are reasonable (interpret that how you will…)
- Disaster assistance payments are nontaxable to the employee and deductible by the business.

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The Coronavirus Aid, Recovery, and Economic Stability Act (H.R. 748)

- Signed on March 27, 2020
- Directed IRS to mail out Economic Impact Payments (stimulus checks)
- Changed certain IRA rules for 2020
- Changed certain employer retirement plan rules
- Changed charitable donation deduction rules for 2020
- Provided broad extensions of time to file most tax returns and to make most tax payments
- Modified net operating loss (NOL) rules for 2018-2020
- Modified business loss limitations for 2018-2020
- Created the Paycheck Protection Program (PPP) loans
- Created Employee Retention Credits

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Economic Impact Payments (A.K.A. Stimulus Checks)

- Provides advance payments of a 2020 tax credit
- $1200 per taxpayer ($2,400 for a married couple filing jointly) + $500 for each dependent under the age of 18.
- Subject to income limitations
- "Trues Up" but does not "True Down" when reconciled on 2020 tax returns

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Changes to IRA RMD Rules for 2020

- No Required Minimum Distribution (RMD) for IRAs and other individually held retirement accounts for 2020
- Also applies to inherited IRA and Roth IRA accounts
- There was a window to return 2020 RMDs that were taken before the CARES act was signed, but this expired on August 31, 2020

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Coronavirus Related Distributions

The CARES Act allows persons affected by the coronavirus to withdraw up to $100,000 from a retirement account without penalties.

You will pay tax on this ratably over 2020, 2021, and 2022

There is nothing that prohibits converting a coronavirus related distribution to a Roth IRA account.

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Coronavirus Related Distributions, Continued

A taxpayer can repay a coronavirus related distribution to a qualified retirement account within 3 years, and it will be treated as if the distribution was never made. This means that the distribution is not taxable if repaid!

If part or all of the distribution was taxed in prior years you can amend those returns and claim a refund of taxes paid on the coronavirus related distribution.

If filing jointly, each spouse can separately take coronavirus related distributions of up to $100,000 if they qualify.

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Coronavirus Related Distributions, Continued

Who can take a coronavirus related distribution?

- A taxpayer who has been diagnosed with COVID-19
- A taxpayer whose spouse or dependent(s) have been diagnosed with COVID-19
- A taxpayer who experiences adverse financial consequences due to COVID-19 or because their work/business income has decreased as a result of the pandemic, or their spouse
- A taxpayer who was unable to work/had reduced hours due to lack of childcare during the pandemic, or their spouse

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Changes to Employer Retirement Plan Loan Rules

- Maximum loan limit for employer retirement plans (such as a 401(K)) is temporarily raised from $50,000 to $100,000, or the employee’s vested benefit under the plan.
- Any loan payments due between March 27, 2020 and December 31, 2020 may be deferred for up to 1 year. Interest accrues during this deferral.
- Note that the CARES Act uses language such as “may” or “can” rather than “shall” or “must”, so each employers will need to decide whether to make these changes to their plan or not.

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Changes to Net Operating Loss (NOL) Rules for 2018-2020

Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), NOLs were automatically carried back 2-5 years (depending on the timing and nature of the loss), allowing business owners to claim a refund of previously paid taxes in those years. TCJA changed the laws so NOLs from 2018 through 2026 are now only carried forward.

The CARES Act suspended this change for tax years beginning after January 1, 2018 and before December 31, 2020.

This change is retroactive, and 2018 and 2019 returns that were filed before the CARES Act was signed may be amended to carry eligible NOLs back instead of forward.

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Changes to Business Loss Limitations for 2018-2020

- Pre-TCJA, all qualified business losses could offset other income without limitation.
- TCJA changed this so only up to $250,000 ($500,000 for a joint return) could be offset, with any remainder carrying forward as an NOL.
- The CARES Act exempted farm losses from this limit, and losses in years that began after January 1, 2018 and before December 31, 2020.

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Depreciation Fix for Qualified Improvement Property

- TCJA contained a technical error which caused Qualified Improvement Property (QIP) to have a depreciable life of 39 years instead of 15. This caused QIP to be ineligible for accelerated deduction using bonus depreciation or §179.
- This was not Congress' intent, and multiple lawmakers wrote the IRS explaining this. The IRS replied that they do not have the ability to apply the law differently than it is written.
- The CARES Act corrected this error, retroactive to 2018. Amended returns can be filed to reflect the corrected laws.

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Changes to Donation Deductions

Congress anticipated that charitable giving will generally decline in 2020 due to many taxpayers having less and/or unstable income.

- The CARES Act temporarily removed the 60% of Adjusted Gross Income (AGI) cap on many deductible charitable donations
- This change applies only to cash donations made in 2020 to qualifying charities.
- Donations of property (ie: stock, donations of household items to Hope, etc.) do not qualify
- Donations to charitable remainder trusts or donor advised funds generally do not qualify

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Changes to Donation Deductions, Continued

- The CARES Act added a charitable deduction as an adjustment to income for taxpayers who use the standard deduction rather than itemizing, beginning in 2020.
- Only monetary donations qualify, and the deduction is limited to no more than $300 per year - regardless of filing status.
- This change is <u>permanent</u> and does not expire.

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Proposed Regulations for §1031 Exchanges

- 1031 exchanges have long been used by investors to defer paying tax on capital gain when they sell appreciated real estate or other business assets and immediately purchase similar property
- TCJA greatly curtailed the benefit by tightening what property qualifies for this treatment – only real property, not personal property even when included in a sale of real property (think appliances that might be included when you sell an investment property, etc.).
- On June 12, 2020 the IRS released proposed regulations clarifying some of the changes from TCJA.
- Under these proposed regulations some types of personal property can be part of the 1031 exchange.

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Taxes that Investors Pay

Investors pay several kinds of tax when they file their returns:

- Federal income tax on ordinary income (wages, interest, non-qualified dividends, short term capital gain, rental income, etc) (a maximum of 37%)
- A special tax rate on most long-term capital gains and on qualified dividends (0%, 15%, or 20%, depending on your income level)
- A special tax rate on long-term capital gain on the sale of collectibles and precious metals, gems, etc. (a maximum of 28%)
- Net investment income tax (3.8% of net investment income)
- State income tax on the state they live in, and sometimes in the state where they own investment property (assuming these states levy an income tax).

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Taxes that Investors Pay, Continued

Net Investment Income Tax is a 3.8% surcharge on taxable (after all deductions) investment income that falls over the threshold of $200,000 for non-joint returns, or $250,000 for jointly filed returns.

This tax was created as part of the Affordable Care Act and is also sometimes referred to as a Medicare surtax since that is what it funds.

Investment income is generally defined as interest, dividends, capital gains, business income if you do not actively work in the business, and rental income if you are not a real estate professional. As the name suggests, the tax is calculated on your NET investment income.

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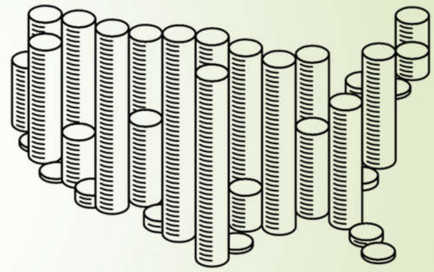
Opportunity Zone Investments – §1400(Z)

- The TCJA created a new provision in the tax code under §1400(Z) which is meant to incentivize investment in underdeveloped areas of the country.
- Each state designated which areas qualify for this investment, so you will need to do some research to find out where they are when you are researching your investment options.
- Much of the low hanging fruit has already been picked off, but there are still investment opportunities.



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Opportunity Zone Investments, Continued

Investing in an Opportunity Zone (OZ) or in a qualifying company or fund that does provides some great incentives:

- Any amount of capital gain (long or short), from any source, can be reinvested in an OZ within 180 days and have the federal tax on that gain deferred until 2026 or until you sell the investment, whichever is soonest.
- Unlike with a §1031 exchange, it does not have to be gain from the sale of real property
- If you still own the OZ investment in 2026 you will only need to pay 95% of the deferred federal tax. The remaining 5% is forgiven.

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Opportunity Zone Investments, Continued

- If you hold the investment for at least 10 years, when you sell it the basis for federal purposes is the sale price. In other words, there is no federal tax due on any appreciation if you hold the investment for at least 10 years.

Note: CA does NOT conform to §1400(Z), so you will not receive deferral of state tax on the gain that is reinvested and will owe state tax on any appreciation when the investment is sold.

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Passive Loss Limitations

- Real estate investments frequently show a loss for tax purposes - even when cash flow positive - due to depreciation deductions. Other passive investments such as partnership interests can also show a passive loss which flows through to the investor's personal tax return.
- Passive losses can be fully offset against any amount of passive income, but Congress has restricted the ability to use passive net losses to offset tax on nonpassive income.
- If your AGI is lower than $150k per year you can deduct a qualifying net passive loss of up to $25K per year. The remainder (if any) will be carried forward to be used in a future year.

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Passive Loss Limitations, Continued

- Passive losses generally cannot offset other types of investment income, even if they originate from the same partnerships! It is common to see an investment partnership that is passing through taxable capital gain along with a disallowed passive rental or other business loss.
- Suspended losses are fully deductible in the year the underlying investment is disposed of. Losses are tracked separately for each investment for this reason.
- A smart, proactive tax strategy will seek to find passive income generating investments for tax free cash flow, or to find other ways to effectively utilize these losses!

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Real Estate Professional Status for Taxes

- By statute, all rental real estate income is considered passive in nature, regardless of whether you actively participate, and is therefore subject to passive loss limitations
- There is an exception for real estate professionals
- This is a HEAVILY AUDITED issue because so few taxpayers who claim this exception actually qualify, so be diligent in your record keeping and know the rules
- Real estate professionals do not pay net investment income tax on rental income as such activities are not considered to be investment income

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Real Estate Professional Status, Continued

A real estate professional is a taxpayer who:

- Spends more than 50% of their working time materially participating in real estate trades or businesses
- Can **document** at least 750 hours working in real estate trades or business (this is what trips most people up in audit!)
- "Real estate trades or business" can mean a lot of different things, including brokering, developing, constructing, and managing real property
- Everything boils down to the facts and circumstances of each taxpayer when determining whether they qualify for this treatment

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Cost Segregation Studies

- Rental real estate is depreciated over 27.5 years (residential) or 39.5 years (commercial)
- Larger properties (not SFRs, usually) often have numerous components within them that qualify for a shorter depreciation period, such as 5, 7, or 10 years, but are not easily separated from the main building
- A cost segregation study can be done by a qualified engineering team which will identify these items and their cost, allowing for a larger deduction now instead of a smaller deduction over a much longer period of time
- Form 3115 is used to capture a large "catch-up" deduction in the year of the study

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Cost Segregation Studies, Continued

- Be aware of recapture issues and plan around them if the property will eventually be sold
- This is not creating new deductions, merely accelerating depreciation on what already exists
- Can create "boot" if you try to §1031 exchange, after TCJA
- These are not cheap; the cost is typically between $3,500 and $50,000 depending on the size of the building and the complexity of construction

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Bundling Deductions to Maximize Tax Savings

With the higher standard deductions created by TCJA, coupled with its $10,000 limit on deductible state and property taxes, many taxpayers who might have itemized before 2018 may not do so every year.

Consider timing your charitable giving and property tax payments for multiple years to maximize the deductibility of these items. Sometimes you might not itemize in either of two years, but can itemize in one of them if you "bundle" 2 years worth of payments into one calendar year.

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Donating Property vs Cash

Consider donating appreciated assets such as stocks, real estate, art, etc. instead of donating cash. In most cases you will receive a charitable deduction of the asset's full fair market value at the time of transfer, while avoiding tax on the investment's appreciation.

If you are donating assets *other than publicly traded securities* and the value is higher than $5,000 you will need an appraisal on the donated item. Most charities receiving such a donation will be more than happy to arrange this for you upon request.

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Donor Advised Funds

A donor advised fund is a brokerage account that many different people can donated to, and then control when and where that contribution is donated to various charities over time. The donors receive the full charitable donation deduction in the year the DAF contribution is made.

Many DAFs can accept stock as well as cash, so this is a way to reap the benefits of donating stock even if the charities you are contributing to do not have the ability to accept that kind of donation.

This is commonly used to take a large charitable deduction in a high income year while continuing to donate at the usual rate. In other words you can obtain a deduction for multiple years' contributions at once.

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Qualified Charitable Distributions from an IRA

If you are required to take a distribution from your IRA you can fulfill this requirement by making a qualified charitable distribution (QCD) to a charity of your choice. This distribution will not be taxed as income on your return but will count against your RMD.

This is a great strategy for taxpayers who donate to charities but do not itemize deductions

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Thank you!

If you have questions about this presentation or want to discuss proactive tax planning, please visit www.svtaxcoach.com and click "Book Appointment" at the top of the site to schedule a phone call or Zoom consultation with Russell.

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