5 TAX PLANNING STRATEGIES TO CONSIDER NOW FOR YOUR CLIENTS' 2020 TAX RETURNS

TAX PLANNING TIPS FOR 2020

The Tax Cut & Jobs Act passed in late 2017 was one of the most sweeping changes to the tax laws in recent memory. These new rules have impacted the financial planning and tax strategies that financial advisors provide to their clients. With one tax filing season under the rules behind us, and another on the horizon, here are some tax strategies for financial advisors and their clients for 2020 to consider in conjunction with their financial planning strategies.

While the list of tax planning issues that could be considered is a vast one, we wanted to focus on a few that dovetail with the financial planning work that advisors regularly do with their clients.

One of the areas that was left largely unimpacted by tax reform was retirement plans. There were few additional limits or restrictions on contributions or the tax treatment of retirement savings vehicles. In one form or another, much of your financial and tax planning for your clients as we approach 2020 will entail their use of their various retirement plans. There are a number of tax strategies surrounding retirement plans for you to consider for your clients when getting them prepared for 2020 and beyond.

CONSIDER THESE FIVE STRATEGIES:

1. REVISIT CONTRIBUTION LIMITS

2. ASSET LOCATION OPTIMIZATION

3. TARGET ROTH CONVERSIONS

4. INCORPORATE RMDS FOR CHARITY

5. RECONSIDER ROLLOVERS

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1. CONTRIBUTE TO RETIREMENT PLANS

Retirement plan contributions were largely untouched by the Tax Cut and Jobs Act and remain a great tax planning and tax reduction vehicle for your clients.

IRA contribution limits for 2019 are $6,000 for those under 50 and $7,000 for those who are 50 or over at any point during the year. These limits did not change for 2020. Depending upon their income, clients may be able to make a pre-tax contribution to a Traditional IRA, an after-tax contribution or a contribution to a Roth IRA.

More important than any current year tax deduction that might be available, the money contributed to an IRA grows tax-deferred (or tax-free in the case of a Roth) until withdrawn in retirement. This helps keep taxable income from interest, dividends and capital gains out of your client's income reducing their annual income in the years leading up to retirement.

For those clients who are self-employed, you might suggest contributing to a SEP-IRA.

- Contribution limits range up to $56,000 for 2019 (and $57,000 for 2020) and contributions can be made up until their tax filing date, including extensions, for the calendar year. In addition, the account can be opened up until their filing date, including extensions, as well.
- Contributions are made by the client's business and serve as a deductible business expense. Earnings grow tax-deferred inside of the account until withdrawn at retirement.
- For clients whose income might cause them to butt up against the limits for the 20% pass-through deduction for their business via the section 199-A rules, this deduction can help these clients stay under those limits in some cases.
- SEP-IRAs can be opened by any type of business entity.
- Business owners can choose to fund their SEP or not each year, funding levels can vary year-to-year as well.
- A SEP-IRA is best for smaller, family-owned business or those who are self-employed.

A SIMPLE IRA is small business retirement plan that is also conducive to the solo self-employed.

- Contributions can be made up to $13,000 for 2019 (and $13,500 for 2020).

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- Employers are required to make a 3% matching contribution or a 2% non-elective contribution for all employees, which is a deductible business expense.
- SIMPLE plans are best suited for small businesses with 100 or fewer employees
- Accounts can only be opened by certain types of business entities
- Employers are required to match the employee's contributions up to 3%
- Once the account is funded, it is 100% vested to the employee

2. ASSET LOCATION

A key consideration for investors is where their investments are held. By this we mean in what type of account are various types of investments held. For those with taxable accounts as well as tax-deferred (or a tax-free account in the case of a Roth) retirement accounts, the location of asset classes among their accounts can have tax implications.

For example, it can make sense to hold equities offering the opportunity for favorable long-term capital gains treatment when sold for a gain in a taxable account. Qualified dividends from these holdings are also eligible for preferential tax treatment.

Conversely, investments that generate interest such as bonds might be better off if held in tax-deferred retirement accounts. This allows the client to defer the taxes on this income until retirement (or avoid it altogether in the case of a Roth account).

For clients investing in alternative assets, asset location should be a key consideration. Many alternatives have tax implications that can be avoided or mitigated by housing these investments inside of an IRA. These can include investments in:

- Commodities and futures
- Structured settlements
- Hedge funds
- Private equity
- Private debt
- Crowdfunding

Certainly, investing decisions should not be tax-driven, but when feasible it makes sense to consider the tax implications of asset location.

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3. ROTH CONVERSIONS

With the lower tax brackets in place for 2019 and 2020 at this point, a Roth conversion might be a good strategy for some of your clients. With a Roth conversion, the amount converted from a Traditional IRA account to a Roth will be taxed in the year of conversion. Beyond the lower tax rates currently in place, you might suggest a Roth conversion for clients whose income is variable, perhaps due to incentive compensation from their job or other reasons, in years where their income is lower than normal.

One change under the new tax rules did impact Roth conversions. The ability to recharacterize a Roth conversion was eliminated. This means that once a Roth conversion is completed, the decision is final. For this reason, you might consider having clients do these conversions late in the year.

Roth conversions are a tax planning tool that stretches beyond the year in which they are completed. Roth IRAs offer your clients tax diversification down the road in retirement as nobody knows what changes in the tax laws the future holds. Having at least a portion of their retirement assets in an account that won't be taxed can help in planning withdrawal strategies once your clients hit retirement.

Another feature of Roth IRAs is that they are not subject to requirement minimum distributions at age 70½ like a Traditional IRA. This makes Roth a valuable estate planning tool for clients looking to leave these assets to their heirs. This is also a tax planning tool for clients who don't need to take these funds to support their retirement lifestyle.

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BACKDOOR ROTH

For clients who earn too much to contribute to a Roth IRA, a backdoor Roth might be a good strategy. A backdoor Roth is a means for high income investors to fund a Roth IRA. It ultimately involves doing a Roth conversion as discussed previously.

For all of the reasons listed in the prior section, a backdoor Roth conversion can make sense for your higher income clients.

There are some variations on how a backdoor Roth might work. In all cases it involves funding a Traditional IRA and converting some or all of these funds to a Roth IRA account.

For those who wish to do an annual contribution, they might consider making an after-tax contribution to their Traditional IRA. The backdoor Roth conversion may or may not entail taxable income.

If the client has other funds in a Traditional IRA account, this will cause some or all of the money converted to be taxable.

For example, if the client is under 50 and contributes the full $6,000 to a Traditional IRA account for 2019 on an after-tax basis and wishes to convert this amount to a Roth:

- If the client only has after-tax funds in their Traditional IRA accounts, they can convert the full amount tax-free. Note that earnings on tax-free contributions would be subject to taxation upon conversion since no taxes have been paid on these funds.
- If, for example, they previously had $94,000 in a Traditional IRA all of which was contributed on a pre-tax basis, then 94% or $5,640 of the $6,000 conversion would be subject to taxes. When doing a Roth conversion, the amount converted will be taxed based on the proportion of pre-tax funds to taxable funds (including earnings) in all of the client's Traditional IRA accounts.

For clients who are working and have access to a workplace retirement plan like a 401(k), you might consider having them do a reverse rollover of any pre-tax funds to their 401(k) if the plan accepts these types of rollovers and if the plan's investment lineup offers solid investing options for them. By doing this you can eliminate or drastically reduce the portion of pre-tax funds in their Traditional IRA accounts, paving the way for backdoor Roth conversions that can be done with minimal or no taxes each based on annual after-tax contributions to their Traditional IRA account.

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4. QUALIFIED CHARITABLE DISTRIBUTIONS

For your clients who are least age 70½ and who have charitable inclinations, using some or all of their required minimum distributions (RMD) to make charitable contributions can help them satisfy their charitable inclinations while helping their own tax situation.

Clients must take their RMD from IRAs and other retirement accounts. These distributions are subject to income taxes at ordinary income tax rates.

With the changes in the tax laws beginning with the 2018 tax year, fewer people are able to itemize deductions. This may include many of your clients, especially older clients who may not have a mortgage. They may still want to make charitable contributions regardless of any tax benefits they may or may not be able to derive.

While there is no charitable deduction for making a QCD, the amount of your client's RMD that is subject to federal taxes (check the client's state for information on state taxes) is reduced by the amount of the QCD. Besides the tax savings aspect, this can help reduce their income used to calculate their costs for Medicare Part B.

Using some or all of their RMD as a qualified charitable distribution can provide your clients with the best of both worlds so to speak. Qualified charitable distributions (QCD) work as follows:

- Your client must be at age 70½ at the time of the distribution.
- They can direct up to $100,000 of their RMDs to a qualified charitable organization. The charity must be eligible to receive tax-deductible contributions. This is a total across all accounts.
- QCDs cannot be made to a donor-advised fund, a private foundation or similar entities. Your client cannot receive a benefit, such as attending a function put on by the charity, from the donation.
- QCDs can be made from Traditional IRA accounts, inherited IRA accounts, SEP-IRAs and SIMPLE IRA accounts.
- The distribution must be made directly from the client's account in the form of a check made payable to the organization.

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5. RETIREMENT PLAN ROLLOVERS

You may have clients who will be leaving their employer for any number of reasons in 2020. Managing the disposition of their old 401(k) or other type of employer sponsored retirement plan is important from both a retirement planning perspective and from a tax perspective.

When rolling retirement plan assets over to an IRA account it's desirable to have your client do a trustee-to-trustee transfer. This eliminates the possibility of them triggering a taxable event, even if unintentionally, by the client withdrawing the funds in cash and then doing a rollover. Taxes at the client's ordinary tax rate are due on withdrawals, if they are under 59½ a 10% penalty could apply.

Retirement plan rollovers to an IRA offer:

- Continued tax-deferral of the money until withdrawn in retirement (tax-free if in a Roth account).
- The ability to invest these funds in a manner that is consistent with the overall investment and financial planning strategies that you have in place for the client.
- The ability to consolidate the client's retirement savings.
- The ability to diversify their retirement assets into areas such as alternative assets if desired.

Rollovers can be made from employer plans including:

- 401(k) plan
- Profit sharing plan
- 403(b) plans
- Governmental 457(b) plans

For clients with company stock held in their retirement plan, you might consider a technique called net unrealized appreciation or NUA. Under the NUA rules, the shares of the company stock are distributed to a taxable brokerage account, while the rest of the assets in the retirement plan account would be rolled over to an IRA as normal.

Using NUA will result in your client paying taxes on the value of the shares based on their original cost basis. If the shares are then held for at least a year, any subsequent sale of the shares will be taxed at preferential long-term capital gains rates. For shares that have appreciated greatly since the client acquired them inside of the plan, this can result in substantial tax

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savings versus rolling the shares over to an IRA and paying taxes on the money at ordinary tax rates when withdrawals are made from the IRA. NUA also offers a form of tax diversification for those with substantial amounts already in tax-deferred retirement accounts.

TAX STRATEGIES AND FINANCIAL PLANNING GO HAND-IN-HAND

As the saying goes, the "tax dog should not wag the investing tail." That said, your clients look to you as their financial advisor to provide tax-smart financial planning and investing strategies.

Taking the tax implications into account can result in real tax savings for your clients. This is money that can be used to fund their retirement or other financial goals. As you work with your clients to get them ready for 2020, keep these and other tax strategies in mind as applicable to your clients.

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ABOUT US

STRATA Trust Company has quickly catapulted to become a premier national custodian for alternative assets and non-exchange traded investments in self-directed IRAs. STRATA has over $2 billion in assets under custody, and for over a decade has helped over 35,000 investors nationwide use their retirement account funds to invest.

With offices in Waco and Austin, Texas, our team's vast experience in handling the details and complexities that real estate transactions require is unrivaled. Our seasoned team's experience in the custody of alternative assets spans over 350 years. With a well-established reputation for honesty and integrity, STRATA is committed to delivering responsive, flexible and innovative solutions.

At STRATA, we work to ensure that the highest standards for safety and soundness are met. As a subsidiary of Horizon Bank, SSB, STRATA is a Texas-chartered trust company regulated by the Texas Department of Banking, which has long set the benchmark among state banking regulators. Strict controls are in place to ensure the safety of uninvested cash, and independent auditors are retained to conduct regular audits of our operations.