Ten Steps to a Smarter Tax Return

Karen Chan
Financial Education & Consulting, LLC

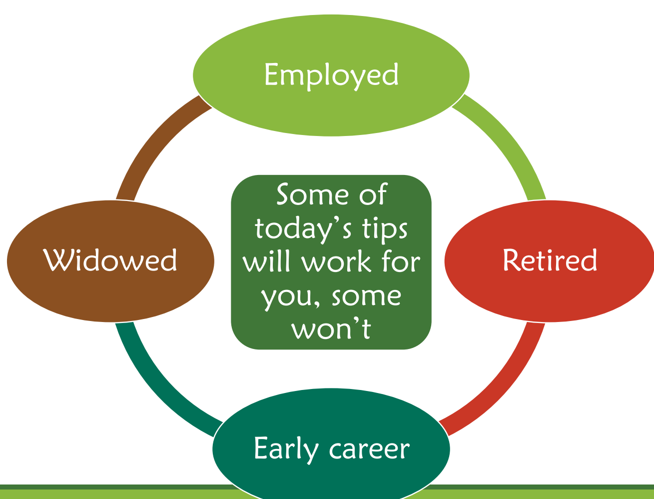
About Karen Chan

- Certified Financial Planner™ who does not take clients – education only.
- 27 years doing financial education
- 18 yrs - Consumer Economics Educator, University of IL Extension
- Karen Chan Financial Education LLC since 2012

Today's Program

- Education, not advice.
- Concepts, not tax prep.
- Dollar amounts are for 2020.
- Consult a qualified financial professional for income tax, estate planning or other advice specific to your situation.

Links to additional information on these strategies are posted at https://karenchanfinancialed.com/resources/smarter-tax-return/.



Don't count on itemizing.

Only about 10% of people have itemized since 2018.

Standard or itemized, whichever is greater

Standard deduction 2020 (2021)

- Single $12,400 ($12,559)
- Head of household $18,650 ($18,00)
- Married filing jointly $24,800 ($25,100)

Itemize-able Deductions

- Medical, dental exceeds 7.5% AGI
- Real estate + state income OR sales tax: Limit $10,000
- Home mortgage interest & points only if used to buy, build, improve
- Charitable contributions
  - Bunch every other year?
  - Donor advised fund?

What might change?

The value of itemized deductions could be capped at 28% for those making over $400,000.

The standard deduction may drop back to previous level (about half) in 2026.

Some deductions don't require itemizing.

Adjustments to Income
(Formerly Above-the-Line Deductions)

- IRA contribution*
- Student loan interest*
  - Tuition & Fees deductions (NA after 2020)
- HSA contributions NOT made through payroll deduction
- Self-employed
  - Retirement plan contributions
  - Health, LTC insurance
  - ½ Soc. Sec./self employment tax

* Income limits

Defer tax

Tax deferral is most valuable if you will be in a lower tax bracket when you pay the tax. That is less certain now than in the past.

Tax-deferred retirement accounts

- Employer plans: 401(k), 403(b), 457, etc.
- Traditional IRAs
  - Beginning in 2020: no age limit to contribute but must have earned income
- Best result if current tax bracket is higher than will be in retirement.
  - Tax rates are expected to rise in 2026.
  - A drop in income might compensate.

Tax-free growth

Reduces future taxable income – and therefore future taxes.

Roth Accounts

- Distributions of growth are tax-free if:
  - Account open 5 years AND
  - Either 59½, dead, or disabled
- Contributions can be withdrawn tax free at any time.
  - Roth IRAs only: Distributions deemed to come from contributions first, then growth.

College Savings Plans

- Tax-free growth if used for qualifying expenses
- Coverdell Education Savings Accounts
- 529 Plans: prepaid tuition & savings
- Contribute to IL plan = State tax credit

Part of your wages may be tax-free.

More powerful than tax deferral. This income is not taxed, EVER.

Income & Payroll Taxes

- State & Federal income tax
- FICA (Social Security) payroll tax
  - 6.2% up to maximum taxable earnings: $137,700 in 2020 ($142,800 in 2021)
  - No savings if wages > max taxable earnings
- Medicare payroll tax: 1.45% of earnings

Employee Benefits That Avoid Income & Payroll Tax

Flexible spending accounts
- Healthcare
- Dependent care
- Commuter

Health & dental insurance premiums

Education assistance

Health Savings Accounts

- Must have **high deductible health plan**
  - 2020: $1350 individual, $2700 family
  - 2021: $1400/$2800
- Contribution limits – by April 15
  - 2020: $3550 single, $7100 family
  - 2021: $3600/$7200
  - + $1000 if account owner ≥ age 55
- No tax when used for qualified healthcare expenses

Health Savings Accounts

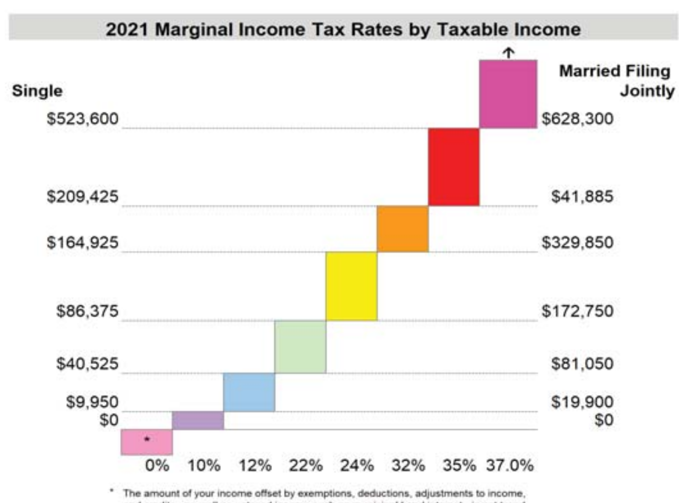
- No income limits
- If payroll deduction, avoids FICA and Medicare taxes as well as income tax
- If not payroll deduction
  - 1040 Sch1 - Adjustment to Income
  - No effect on FICA & Medicare tax

Health Savings Accounts

- Tax-free growth is a hidden benefit of HSAs.
- You can pay out of pocket health care expenses with other money, and let this account grow.
- Request reimbursement whenever you wish.

Take advantage of swings in income.

This strategy works because of our progressive tax system, with its marginal tax brackets.



Type of income = different tax rates

Ordinary Income: Marginal Rate*	Long-Term Capital Gains & Qualifying Dividends	Muni-bond interest, Roth distributions
0%	0% (0)	0%
10%	15% (18.8)	
12%		
22%		
24%		
33%		
35%	20% (23.8)	
37%		

* Rates for 2018-2025 **If subject to 3.8% Net Investment Income Tax

Lower income years

- Early career
- Unemployment
- Gap years between retirement and receiving Social Security or required distributions from retirement plans

Fill up lower tax brackets (1)

- Cash in savings bonds.
- Workers: Contribute to a Roth instead of tax-deferred.
- Sell & repurchase appreciated assets.
  - Pay LT gains tax @ 0% or 15%
  - Higher basis on new shares

Caution: Limits on gains taxed at 0% and 15% (2021 #s)

- Based on **total taxable income**
  - Ordinary income + LT capital gain, qualified dividends
- 0% until reaches $40,400 (single) or $80,800 (married filing jointly).
- 15% until $445,850/$501,600
- Then 20%

Fill up lower tax brackets (2)

Age 59 ½ to 72

- Take voluntary distributions from retirement accounts.
- Convert to Roth if $ not needed.
- Results in smaller future RMDs which could:
  - Reduce future tax rate
  - Reduce portion of future Social Security subject to income tax

High income years…

- Worker: Contribute to traditional retirement account, not Roth.
- Avoid selling appreciated assets.
- Sell losers to harvest tax losses.
  - Can't claim loss if you repurchase same/similar asset within 30 days before or after (wash sale)

Reduce taxable income on sale on sale of home

You might avoid tax on all your profit.

$250,000 exclusion each for you & spouse

Profit – Exclusions = Taxable income

- Own & live in home $\geq$ 2 of past 5 years
- Primary residence
- At least 2 years since last claimed
- Reduced for non-qualified use (rental, vacation home) after 1/1/2009

Beware…

- Moving out of home & selling later (3 years max)
- Getting married, divorced
- Death of spouse
  - Can use deceased spouse's exemption if not remarried and sell within 2 years of date of death

Maximize tax benefit from retirement accounts

Avoid penalties, maintain tax deferral, even avoid tax on certain RMDs.

Rules for Owners

- Distributions before age 59 ½
  - 10% early distribution penalty unless exception.
- Moving $ between accounts
  - Use **direct rollover** (employer plan to IRA) or **trustee-to-trustee transfer** (IRA to IRA) to avoid errors, taxable distributions, penalties.
- Annual RMDs beginning at age 72, by Dec. 31
  - 1st RMD deadline: April 1 of following year
  - 50% penalty for RMD not taken

Beneficiaries: New rules effective 2020

All beneficiaries must deplete inherited account within 10 years, except use life expectancy for:

- Spouse
- Disabled
- Minors until 18, then 10 years
- $\leq$10 yrs. younger than deceased

Spouse Beneficiary Options

- Leave in name of deceased = distribute within 10 years
- Treat as your own = distribute over your lifetime + 10 years for beneficiaries you name

Qualified Charitable Distributions Avoid Tax

- From IRAs only, up to $100,000 annually
  - Counts toward your RMD
- Age 70 ½ or older <u>on day of distribution</u>
- Must go directly to charity
- Usually has greater tax benefit than itemizing charitable contributions, esp. through 2025 due to larger standard deduction.

Understand Tax Basis for Gifts vs Inheritances

Basis is the value of an item for tax purposes.

Gifted vs inherited= different basis for recipient

Taxes on sale

Gifted assets keep (lower) tax basis of original owner.

Inherited assets receive a step-up (or down) in basis.

Taxes on sale

Gift vs sale	House
Purchase price	$75,000
Value on date of death	$200,000
Sold for	$225,000
Taxable amount if gifted during lifetime	$150,000
Taxable amount if received at death	$25,000

What might change?

The Biden administration has discussed doing away with the step-up in basis at death.

Married Couples: Plan for tax changes for survivor

Higher taxes can be an unpleasant surprise.

Income usually drops by less than 50% (I)

- Potential impact on survivor
  - Higher marginal tax bracket,
  - Higher LT cap gains bracket
  - Higher Medicare cost tier
  - Tax on greater portion of Social Security benefits

Income usually drops by less than 50% (II)

- Strategy: Accelerate ordinary income into years before death of 1st spouse.
  - Take voluntary distributions from traditional retirement accounts
    - Convert to Roth if not needed
  - Cash in savings bonds with accumulated interest

Jointly owned assets receive a step-up in basis on ½ value.

- Original basis on survivor's half; stepped up basis on deceased's half.
- Selling after death of 1st spouse results in less profit & possibly less tax.
  - Weigh against possible higher tax bracket for survivor.

Timing of sale	House
Purchase price - basis	$80,000
Value on date of death, 1st spouse	$200,000
New basis: (½ * $80,000) + (½ * $200,000)	$140,000
Sold for	$225,000
Taxable amount if sold before death of 1st spouse	$145,000
Taxable amount if sold after death of 1st spouse	$85,000

What might change?

The Biden administration has discussed doing away with the step-up in basis at death.

Tax Efficiency using Asset Location

Type of income = different tax rates		
Ordinary Income: Marginal Rate*	Long-Term Capital Gains & Qualifying Dividends	Muni-bond interest, Roth distributions
0%	0% (0)	0%
10%	15% (18.8)	
12%		
22%		
24%		
33%		
35%	20% (23.8)	
37%		

* Rates for 2018-2025 **If subject to 3.8% Net Investment Income Tax

Retirement accounts create ordinary income

Distributions from traditional retirement accounts & annuities are taxed as ordinary income, **regardless of the source.**

Assets that will appreciate

- Preserve tax advantages of capital assets held long term by owning them in taxable accounts.
  - Long term capital gains if owned more than 1 year
  - Tax on gains is deferred until sold
  - Losses offset gains
  - Step up in basis at death

Assets that generate ordinary income

- Use tax-deferred accounts for assets that themselves already generate ordinary income.
- Examples:
  - Actively managed mutual funds that regularly generate short term capital gains, which are taxed as ordinary income.
  - Real estate investment trusts
  - High dividend-paying stocks

Assets with highest growth potential

- Use Roth accounts for assets whose value may increase the most
- Goal: avoiding the greatest amount of taxable income possible.

Municipal bonds

- Municipal bonds generate tax-free income & should always be owned in taxable accounts.
  - Muni income would be turned into taxable income at ordinary rates if owned in a tax-deferred account.
  - There is nothing to gain by owning them in Roth accounts; the income is already tax-free.

Low-return assets

- Extremely low interest-rates today
- CDs, money market accounts, bonds & bond funds produce ordinary income, but very little.
  - No great benefit holding them in tax-deferred or Roth accounts
  - No great disadvantage in taxable accounts.
- If interest rates increase significantly, consider holding in tax-deferred accounts.

What might change?

The Biden proposal would end the step-up in basis at death. This would reduce some of the benefit of asset location.

Visit http://karenchanfinancialed.Com/ to:

- Find links to resources.
- Sign up for quarterly notices of upcoming workshops.

Karen Chan
Financial Education & Consulting, LLC