CTM
CPAs & Business Advisors

Year-End Tax Strategies (and More) for 2020 - Q&A

Presented by Managing Partner Scott Weingart, JD, CPA

Questions submitted by attendees

1. I am converting my IRA to a Roth. Does the 3-year spread of paying taxes still apply?

This is a question that has commentators from all corners of the financial world throwing their two cents in and around the topic. As you are aware, the CARES Act relaxed the rules regarding retirement plan distributions by creating "CRDs" (Coronavirus-related distributions).

For the 2020 tax year only, the 10% early distribution penalty is waived on distributions up to $100,000 from certain retirement plans (IRA's included). The income tax on a CRD is still due, but can be paid ratably over three years.

All or a portion of the CRD can be repaid at any time over this three-year period. For instance, if a taxpayer has business losses, those losses may absorb the full distribution making reporting the full CRD in 2020 a smart tax move. 2020 is the first year (at least) 1/3 of the CRD income recognition is required, so any tax paid on amounts later recontributed could only be refunded by filing an amended return.

It's important to know, however, not everyone is eligible to take a CRD.

The IRS has defined a "qualified individual" as someone:

- *who has been diagnosed with COVID-19 (or whose spouse or dependents have been diagnosed COVID-19),*
- *who has experienced adverse financial consequences as a result of the virus by having been quarantined, furloughed, laid off, reduced work hours, etc.,*
- *who is unable to work due to lack of childcare, or*
- *whose business has been affected by a closing or by a reduction of business hours.*

IRS Notice 2020-50 expands this list but essentially, the individual must have suffered illness or adverse financial consequences due to the pandemic. Provided you are/were a "qualified individual" in 2020, you can take the distribution.

This is important because the individual informs the IRS that they are a "qualified individual" on a new Form on his or her income tax return. The Form's sole purpose is to report these special distributions.

The 1099-R reporting of the CRD is sent to the IRS so it can match the income to the return. The controversy really stems from a simple interpretation of this language: "the amount can be repaid to an eligible retirement plan." Some advisors are taking the position that a CRD repaid to ANY plan, qualifies for the 3-year deferral.

To get yourself closer to some certainty, you have to look beyond the CARES Act.

The IRS has confirmed in several writings that a repayment of a CRD would be treated as a "tax-free rollover"....and that the option for deferring income over three years only applies to amounts that would have been tax-free if rolled over. This is never the case with Traditional to Roth rollovers. (They're always taxable.)

While the IRS has yet to fully come out and state that the income generated by a CRD contributed/converted to a Roth absolutely, positively does NOT qualify for the 3-year deferral, we at CTM feel we will see some affirmative guidance that addresses this in no unspoken terms.

The spirit of the law was to get people access to cash without getting hammered by taxes....and not to defer an otherwise fully taxable Roth conversion for the year it was done.

As with almost every facet of the CARES Act (which was an extremely voluminous and QUICKLY written piece of legislation), some of the text left tax treatment open for discussion. The IRS has been pretty swift in eliminating ambiguities all year.

You could entertain covering 1/3 (or even 1/2) of your balance now and the rest in about a week, pushing the next half or 1/3 into 2021. Also, if you have business losses, you may have enough shelter with those to absorb a "regular" conversion.

2. **If you had a child in 2020 in between stimulus packages (April)? Can you apply for the stimulus credit for that specific child on your 2020 return?**

Yes. Children born, adopted, or even just a change in dependency (i.e., the child wasn't claimed as a dependent in a prior year, but now is) will garner a stimulus "payment" provided all other requirements are met.

For "new" dependents in 2020, you will get a credit on your 2020 return, filed in 2021 since the cash payments are based on the number of dependents on your previously filed return (2019). You'll get the payment one way or another.

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3. Is the state 529 deduction in Illinois only $10,000 a donor for 2020?

Yes. The maximum deduction for Illinois 529 plans (Bright Start/Bright Directions) is $10,000 per taxpayer ($20,000 on a married filing joint return). The contribution must be made by December 31st to qualify as a 2020 deduction. We recommend not waiting until December 31st to move the funds - do it a day or two before to be sure it gets credited to 2020.

4. Are you aware of the research and development tax credit for small business enacted last year? Any maximums except income?

The Research and Development Tax Credit has actually been around since the early '80s. It used to be so nuanced that many businesses historically missed out on tax savings due to its complexities. Over the years, different pieces of legislation have tried to simplify the computation.

In 2015, the R&D Tax Credit was made permanent and its availability was opened to start-ups (targeted towards companies with no revenues). Several boutique firms specialize in this area, as the record-keeping is vital to the credits being respected by the IRS. We recommend our clients with R&D activities use these firms.

The credit can offset federal income tax, alternative minimum tax for "eligible small businesses" (meaning, businesses with an average of $50 million or less in gross receipts over the past three years), state income tax (in most states), and even up to $250,000 of payroll tax for 5 years for start-ups and qualified small businesses.

Any federal income tax credit not used in the current year can be carried back or carried forward to certain tax years. In general, the credit is calculated as a percentage of the company's expenses related to R&D activities. The computation is quite detailed and involves figures from several years of operations. Qualified R&D expenditures include expenses such as wages, materials, supplies, payments to third-party contractors for research and more.

Start-ups and small businesses can potentially qualify for up to $1.25 million (or $250,000 each year; up to five years) of the federal R&D Tax Credit to offset the (FICA) portion of annual payroll taxes. For this benefit, companies must have less than $5 million in gross receipts for the credit year and generally, have no more than five years of gross receipts.

There are a lot of considerations with this credit and we would be happy to guide you to the proper sources that can secure the maximum tax savings for you.

5. Can you make an IRA contribution and later convert to an existing Roth opened earlier when you qualified?

Yes. Prior to 2018, there were income limitations on direct contributions to Roth IRAs as well as conversions. While the income limitations are still in place for direct contributions, anyone, regardless of income levels, can do a Roth conversion. The amount converted is almost always taxable.

You can convert "old" Traditional IRA money (in part or in total) to a Roth IRA in any year. If the Roth was opened at a time when you were eligible to directly contribute or if it was funded from another Traditional IRA rollover/conversion and has just held still for several years, it is perfect to use for any future Traditional IRA conversions.

You could even do a Traditional to Roth IRA conversion every year, subject to the annual contributions limits. Your other income will determine if one year is a better conversion year than another.