TAX ARTICLE

INSIGHT: TAX PLANNING STRATEGIES FOR INDIVIDUALS DURING THESE UNPRECEDENTED TIMES

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The Covid-19 relief legislation and the depressed stock market allow for or adjustments to retirement plans and employment or business-related equity holdings. Rachel Efthemes, Olga Lubomirsky, and Allison Towle of Mazars examine tax-advantaged opportunities to modify your retirement planning, exercise nonqualified stock options, and diversify concentrated positions.

On March 27, 2020, President Trump signed the Coronavirus Aid, Relief and Economic Security Act (the "CARES Act"), as the government's Phase 3 response to the Covid-19 crisis. The current environment is extremely challenging on many levels, but the new tax laws and provisions introduced by the CARES Act, along with the current state of the economy significantly change the landscape for tax planning and create many possible opportunities.

Required Minimum Distributions, Roth IRA Conversions, and Waiver of Early Withdrawal Penalty

The CARES Act waives required minimum distributions (RMDs) from certain defined contribution plans and individual retirement accounts (IRAs) for the 2020 tax year. This will not only give your portfolio the potential to grow and hopefully recover from any recent decrease in value but will also lower your taxable income and related tax liability for the 2020 tax year.

You may be wondering what happens if you've already taken your 2020 RMD. Under normal circumstances, RMDs are not eligible for rollovers; however, the CARES Act will allow you to roll over your 2020 RMD to an IRA or other eligible retirement plan to avoid paying tax on that initial distribution under limited circumstances. If you took your RMD anytime from Feb. 1 through May 15, you have until July 15 to roll over that distribution and avoid paying tax on that amount.

Roth IRA Conversion

Another opportunity to consider in conjunction with the waiver of 2020 RMDs is the conversion of a traditional IRA to a Roth IRA. This is a particularly beneficial strategy now, because not only could your 2020 taxable income be reduced (due to the absence of the 2020 RMD in addition to other potential losses as a result of the current economic environment), but also the tax effect of the conversion will be lower when the value of the assets in the account being converted are depressed.

There are two main advantages of a Roth IRA versus a traditional IRA.

- Roth IRAs have no minimum distribution requirements, so you can leave the assets in your account to continue to grow tax free even after you reach age 70 1/2. Additionally, if you're fortunate enough to not need the cash flow during your own retirement, this would be a great opportunity to leave those assets to your heirs.

- Any withdrawals you decide to take in the future would be tax free, unlike traditional IRAs, which are subject to ordinary income rates in the year of withdrawal.

Waiver of Early Withdrawal Penalty

On the flip-side to deferring RMDs, the CARES Act also allows you to access money in your retirement accounts if necessary without the usual penalties, if you've been affected by the Covid-19 crisis. This relief may be available to you if:

You, your spouse, or another dependent has been diagnosed with Covid-19 by a test approved by the Centers for Disease Control and Prevention; or

You have suffered financial consequences due to Covid-19 (such as quarantine, job loss, furlough, reduction in hours, inability to work due to lack of child care, or loss of your business).

Even during these unprecedented times, tapping into your retirement account is an important decision and should only be taken as a last resort. If you were affected and determine this is necessary to bridge the gap, you may withdraw up to a total of $100,000 from your retirement accounts between now and Dec. 31, 2020 without being subject to 10% early withdrawal penalty.

If you take a coronavirus-related distribution of pre-tax money from your retirement account, you will have to pay tax on that income. However, you also have the opportunity to pay those taxes over a three-year period beginning in 2020. Furthermore, you may also repay some, or all, of the distribution to your plan and essentially pay yourself back within three years of the distribution and avoid paying tax on the distribution.

Exercise of Nonqualified Stock Options

Nonqualified stock options (NSOs) are a benefit that many companies include in employee compensation packages. When you exercise NSOs, you must include the difference between the exercise price and the fair market value of the stock at the date of exercise in your taxable income for that year, and the income is subject to ordinary income rates.

If you currently hold NSOs, exercising them now may be beneficial when many stock prices have declined, as your taxable ordinary income may be greatly reduced since the spread between the exercise price and value of the stock may have decreased. This is assuming that the value of the stock is still greater than the exercise price of the options, as you would not want to exercise the options if the value of the stock is "under water" or has declined below the exercise price.

For example, let's assume you decide to exercise your NSOs at an exercise price of $10 per share, and the fair market value of the stock is currently $15 per share, whereas six months ago the fair market value of the stock was $25 per share. As a result, you would only recognize $5 per share of taxable ordinary income now rather than $15 of taxable income per share that you would have reported and paid tax on if you exercised the same NSOs six months earlier.

Diversifying Concentrated Positions and Wash Sale Rules
There are a few different strategies if you own concentrated stock positions that may make up a large portion of your overall portfolio. Currently, you may have an opportunity to sell concentrated positions that, although the stock price may have recently declined, would still generate capital gains. These gains may be offset if you have other realized losses that were generated due to the economic downturn. In contrast, if the concentrated position has declined to the point that it would generate losses, you may find it beneficial to not only get out of the concentrated position, but also harvest those losses to offset other capital gains you may have recognized elsewhere.

Another opportunity is to diversify your portfolio and decrease the risk associated with owning one single security. The advantage in the current environment is again that any gains you recognize on the sale of the concentrated position may be offset by other realized losses, and you may be able to also maintain the exposure to a certain sector by purchasing securities in the same industry as the security that was sold.

However, you need to be mindful of the wash sale rule when selling securities that constitute a concentrated position or otherwise. The wash sale rule was intended to discourage individuals from selling securities at a loss simply to claim a loss for tax purposes and then repurchasing the same or "substantially identical" securities within 30 days before or after the date of the sale.

For example, if you sold 100 shares of Exxon stock on March 15 for $1,000 and you originally paid $5,000 for that stock two years ago, you would have a long-term capital loss of $4,000 to offset other capital gains. If you subsequently repurchased 100 shares of Exxon stock on April 1, because you still want to own the stock and the price is lower than average; your original loss of $4,000 would be deferred since the repurchase was within the 30-day window.

There are ways you can sell a security to recognize the loss and still avoid the wash sale rule. One option is by selling the securities to generate the loss and buying an investment in the same sector that suits your investment and portfolio allocation goals. For example, you could sell 100 shares of Coca Cola and buy 100 shares of Pepsi Co stock or sell your position in the Vanguard Index 500 fund and subsequently purchase a similar position in the Vanguard Total Market Index ETF. Another, riskier strategy would be to simply purchase additional shares of the depressed security and then wait 31 days to sell the shares you originally held at a loss. However, this strategy is riskier and would increase your sector exposure for that 30-day period.

Any decision regarding investments should take into consideration the risk and reward of the investment strategy and should be discussed with your investment advisor.

Net Operating Losses (NOLs)
As a result of stay-at-home orders, social distancing, and forced closures implemented to minimize the spread of Covid-19, many businesses are expected to suffer significant losses in 2020. Many of these businesses are structured as pass-through entities and, therefore as a business owner, you would report these losses on your personal income tax returns. The CARES Act provided additional relief by reinstating the five-year NOL carryback for losses arising in any taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2021. These were previously only allowed to be carried forward to future years. In addition, any NOLs that were generated after Dec. 31, 2017, were subject to a taxable income limitation. The CARES Act temporarily suspends this rule until after Dec. 31, 2020, to allow an NOL to fully offset income.

These changes allow you to carry back previous years' losses that you were previously required to carry forward by amending your prior year returns to recognize the additional losses sooner rather than later. This will provide you with critical cash flow and liquidity from the prior year refund during the Covid-19 emergency. When considering carrying back of federal losses, you should also review the applicable state rules to determine if the losses can be carried back at the state level as well.

Excess Business Losses
The 2017 tax law limited your ability to deduct excess business losses under tax code Section 461(l) for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026. Excess business losses are the amounts by which the total deductions attributable to all your trades or businesses, including pass-through entities, exceeds your total gross income and gains attributable to those trades or businesses in any given year.

If you file as single, you can take excess business losses up to $250,000, or $500,000 if you file jointly with your spouse, with any excess over that amount carrying forward to be applied against income in future years. For example, if your filing status is single, and you incurred a trade or business loss of $300,000 and had no other trade or business income in 2018, you could only deduct $250,000 against your other 2018 income, leaving the excess $50,000 to be carried forward and applied against your 2019 income.

The CARES Act amended this limitation for tax years beginning after Dec. 31, 2017, through Dec. 31, 2020, by reinstating your ability to deduct excess business losses that would have otherwise been disallowed. If you had losses limited in 2018 and/or 2019, you should consider amending your returns to take advantage of the losses to their fullest extent and again generate refunds to obtain cash flow that is especially essential during the Covid-19 crisis.

These are just a few of the tax planning strategies to consider in the current environment as a result of the CARES Act and other relief efforts in reaction to the Covid-19 global crisis. It remains to be seen what other coronavirus-relief packages may be passed by Congress to assist you through this uncertain time, but talk has already begun on "Phase 4" of the stimulus.

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