tax and financial ISSUES

2021 Year-End Tax Update and Checklists

The House of Representatives passed the Build Back Better Act on November 19, 2021. The Senate then released a portion of their version of the Build Back Better Act on December 13, 2021 to very little fanfare. Several days later reports claimed the tax bill would likely not be passed until 2022 due to ongoing negotiations led by several factions within the Democratic Party.

While there is uncertainty whether the bill will ever be enacted, we do have a framework of what will likely be included within any revenue bill.

☐ **The top individual ordinary income tax rate will remain at 37%.**

☐ **The top long-term capital gain/qualified dividend tax rate will remain 20%.**

☐ **An increase in the state and local tax deduction. The caveat here is that it will likely be limited to taxpayers who are not considered "high-income taxpayers."**

- The House version of the bill included a maximum deduction of $40,000 for single filers (plus trusts and estates), or $80,000 for joint filers. There is no income limitation for claiming the deduction under the House version.
- The Senate version hasn't been finalized, but the Senators spearheading the legislation are considering a removal of the $10,000 cap but limiting the deduction to taxpayers under a defined income level. The income thresholds have ranged from $400,000-$550,000 for single filers and $800,000-$1,000,000 for joint filers.

☐ **High-Income taxpayers:**

- **Surcharge on high-income individuals, estates, and trusts.** A new code section would impose a tax on modified adjusted gross income (AGI) over $10 million of 5% for Individuals ($5 million for married filing separate taxpayers) and $200,000 for an estate or trust, plus 3% of modified AGI over $25 million ($12.5 million for married filing separate taxpayers) and $500,000 for an estate or trust
- **Net investment income tax.** Expands the reach of the net investment income tax to high-income taxpayers (those over $400,000 if filing single, or $500,000 for joint filers) to include income derived in the ordinary course of a trade or business. This impacts owners of pass-throughs whose distributive share of nonpassive income is not subject to self-employment tax.
- **Small business stock.** Legislation would disallow the 75% and 100% exclusions for taxpayers with adjusted gross income (AGI) over $400,000 or for trusts or estates.

☐ **Wash-sale rules.** The bill would make commodities, foreign currencies, and crypto assets subject to the wash-sale rules.

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Strategically Plan the Timing of Additional Income or Deductions in 2021

Our year-end position is that while traditional tax planning involves accelerating deductions and deferring income, this is a year where we recommend the acceleration of income **only if the economics make sense.**

A. LOOK FOR SITUATIONS WHERE GENERATING INCOME IN 2021 WILL RESULT IN NO ADDITIONAL TAX OR WILL BE SUBJECTED TO A LOWER MARGINAL RATE THAN IT WOULD BE IN 2022.

☐ **Realize capital gains:**
- If you have excess (non-deductible) capital losses;
- If your long-term gains will be subject to the 0% rate;
- If your long-term gains will be taxed at 15% this year and could be subject to the higher 20% rate in 2022;
- If you're concerned that your long-term gains may be subjected to the proposed high-income surcharge in 2022 ($5 million or more in total income).

☐ **Realizing passive income** where you have blocked passive activity losses.

☐ **Realizing investment income** where you have blocked investment interest deductions.

☐ **Roth IRA conversions.** Converting traditional IRAs to Roth IRAs below a marginal rate of 25% is recommended as we believe rates will only go up in future years.

☐ **If you're concerned that your ordinary income rate** will be subject to the high-income surcharge.

Do not forget to consider the state income tax impact on any income acceleration into 2021.

B. DEVELOP STRATEGIES FOR TAKING ADDITIONAL 2021 DEDUCTIONS OR POSTPONING UNTIL 2022.

Know where additional deductions will produce little or no tax benefit.

☐ If your childcare expenses are already above the tax credit or salary reduction limits.

☐ If your rental losses are already blocked by the passive loss rules.

☐ If your losses or deductions will throw you into a 0%, 10%, or 12% tax bracket.

☐ If you won't have enough deductions to itemize and instead will use the standard deduction (Single/Married Filing Separate = $12,550; Head of Household = $18,800; Married Filing Jointly = $25,100).

☐ Consider electing into a state's SALT workaround if your business qualifies and in doing so you receive an immediate tax benefit at the federal and state tax level. These elections may not make sense for every taxpayer, so make sure an analysis of the tax benefit is done before proceeding.

☐ Consider the possibility that the state and local tax cap of $10,000 might be repealed. If you're not receiving a tax benefit from state tax payments (i.e., income and real estate taxes) in 2021, consider postponing payment to 2022.

Consider accelerating deductions if they'll provide a tax benefit.

☐ If your year-to-date realized gains exceed realized losses, consider realizing additional losses to reduce your overall gain.

- A situation you want to avoid is paying tax on capital gains in 2021 but having non-deductible losses in 2022 because total losses exceed total gains and the allowable $3,000 capital loss deduction. Taking capital losses to offset capital gains can also avoid the surtax on investment income.

☐ Think about your charitable giving strategy.

- Review how the Consolidated Appropriations Act, 2021 extended the benefit of charitable giving in 2021.

    1. The limitation on deductible cash contributions has been increased to 100% of Adjusted Gross Income. To qualify, the individual must itemize and:
        - Contributions must be to a qualified charitable organization;
        - Contributions must be in cash;
        - The taxpayer must elect the application of this section with respect to such contribution;
        - Contributions cannot be made to a "supporting organization" as defined in IRC sec. 509(a)(3);
        - Contributions cannot be made to establish or maintain an existing donor advised fund; and
        - Excess contributions can be carried forward for five years.

    2. Other charitable deduction limitations weren't changed by the CARES Act.
        - Gifts of marketable securities are still limited to 20-50% depending on recipient and holding period of the capital asset.
        - Donor-advised fund limitations fall under public charity rules, but the CARES Act specifically excluded contributions to donor-advised funds and the limitation maximum is still 60% of Adjusted Gross Income.

- It may make more sense to lump two years' worth of charitable contributions into one year to take advantage of itemizing if you otherwise get a tax benefit from your charitable contributions in 2021 and 2022.

If you believe steps should be taken to accelerate income or deductions or review your business entity structure, it's best to act now before the new year when legislation could potentially be made retroactive to January 1st.

C. REVIEW YOUR ESTATE, GIFT, AND GENERATION SKIPPING TAX PLAN

The initial proposals of the Biden tax plan were to reduce the current estate tax exemption (currently $11.7 million per individual with portability) back to the previous $5 million threshold adjusted for inflation. The enactment of this proposal which now looks unlikely. The higher current exemption is set to expire Dec. 31, 2025.

The IRS has issued a ruling that it will not clawback any large taxable gifts if the estate tax exemption reverts to prior lower thresholds. This is an instance where you may want to "use it before you lose it."

It's also worth noting that valuation discounts have been in the crosshairs for years. These could very well be on the chopping block again under the Biden administration. If eliminated, the gifting of noncontrolling interests in family-owned businesses could become significantly more expensive from a gift tax perspective.

☐ We recommend that you review your estate plan with your counsel before year-end. Make sure appropriate changes are made before a potential change in the estate tax is made.

☐ Review gifting opportunities:

- The present interest annual exclusion gift: According to Rev. Proc. 2020-45, the annual exclusion for 2021 is $15,000. The annual gift tax exclusion will increase to $16,000 per donee in 2022.
- Unlimited transfers **directly** to educational institutions for tuition: These amounts are not considered taxable gifts. If amounts are not paid directly to the educational institution, they are considered gifts.
- Unlimited transfers **directly** to medical care providers for medical expenditures: These amounts are not considered taxable gifts. If amounts are not paid directly to the medical care provider, they are considered gifts.
- **Gifts to 529 plans:** These are considered gifts that reduce your annual exclusion ($15,000 maximum per donee in 2021). However, there is an exception that allows 5 years of gifts in 1 year - a maximum of $75,000 in 2021.

D. REVIEW YOUR 2022 MANDATORY RETIREMENT PLAN DISTRIBUTIONS SHORTLY AFTER YEAR-END.

Starting in 2022, the newest life expectancy and distribution period tables will apply to both owners of retirement accounts (IRA, 401(k), 403(b)), as well as their beneficiaries, to calculate required minimum distributions. Please review this impact with your financial advisor, or if you manage your own account(s), the custodian to make sure you are distributing the correct amount.

These tables reflect an increase in life expectancies from the 2002 regulations. Beginning in 2022, owners or beneficiaries will be required to distribute less than previously required.

2021 Year-End Tax Planning: Routine Follow-ups

1. TAXPAYERS SHOULD MAKE SURE THAT WITHHOLDING AND/OR TAX DEPOSITS ARE ADEQUATE TO AVOID UNDERPAYMENT PENALTIES.

☐ Review tax estimates to make sure tax deposits (including withholding) are sufficient to avoid underpayment penalties. We recommend updating your estimate before year-end if income has changed materially during the year.

☐ Holders of mutual funds in non-tax deferred accounts should review year-end capital gain distributions. This could be an atypical year for some shareholders. Distributions occur as early as the week after Thanksgiving until year-end. Each fund will provide distribution information on their website, so do give this a look over if you're concerned.

2. WITH INTEREST RATES AT HISTORIC LOWS, IT'S TIME TO RESTRUCTURE YOUR DEBTS WHERE POSSIBLE TO ENSURE DEDUCTIBILITY AND REDUCE FINANCIAL RISK.

☐ Pay down nondeductible debt first.

☐ Consider paying down debt that produces deductions that are part of blocked passive activity losses.

☐ Lock in fixed rates.

☐ **Caution:** When refinancing grandfathered acquisition debt, you must meet several limitations if you want to keep the old $1,000,000 debt limit. Debt will not be recognized as grandfathered if:

- it is an increase over the previous loan balance;
- it is extended after the original term has completed,
- it has principal that is not amortized over its term, and
- it is extended longer than the current term remaining of the original long with a maximum of 30 years (i.e. If 25 years remain on a 30-year mortgage, the refinance cannot exceed 25 years. In the event you have a balance with a term longer than 30 years you cannot extend beyond 30 years to meet the requirements for refinancing grandfathered debt).

3. MAKE SURE THAT YOU ARE MAKING MAXIMUM USE OF THE FOLLOWING TAX BENEFITS:

☐ $3,000/year capital loss deduction allowance.

☐ $25,000 rental loss allowance for owners with active participation in the ownership and management of rental real estate. (Warning: This benefit is phased out as Adjusted Gross Income increases from $100,000 to $150,000.)

☐ The American Rescue Plan Act (ARPA) increased the child tax credit: $3,600 for eligible children below the age of 6, and $3,000 for eligible children between the ages of 6-17. The legislation also included a provision that allowed for monthly advance payments of the child tax credit which equal 50% of the credit you're expecting to qualify for on your 2021 return. The other half will be claimed on your tax return.

- **Trap for the unwary:** Advance credit payments may turn into a liability if it is later determined that you received more than what you're eligible for.

☐ ARPA increased the dependent care exclusion to $10,500 ($5,250 for single filers).

☐ Deductible IRA contributions (Maximum $6,000 per individual). Individuals over age 50 can make an additional "catch-up" contribution of $1,000. Non-working spouses may have deductible IRA's available if Adjusted Gross Income tests are met.

Note that deduction phase-out ranges are increased annually for individuals who have pension coverage. The phase-out point begins for individuals with pension coverage at $66,000 of AGI for single and head of household filers, and $105,000 of AGI for joint filers with pension coverage. Individuals are completely phased out at AGI levels of $76,000 for single and head of household filers, and $125,000 for joint filers. The phase-out point for spouses without pension coverage starts at $198,000 of AGI when the other spouse has pension coverage.

☐ $100,000 per year exclusion of charitable distributions from IRA accounts by individuals aged 70 ½ or older.

☐ Review whether 100% bonus depreciation or IRC section 179 expensing is more beneficial for property used in a trade or business. To qualify for bonus depreciation the property categorization must meet the MACRS recovery period of 20 years or less.

The maximum deduction under Section 179 expensing is $1,050,000 and the phase-out-threshold begins at $2,620,000 million of asset additions. The expense allowance is completely phased out if $3,670,000 of purchases are made.

☐ The optional standard mileage reimbursement rate for 2021 is 56 cents per mile.

4. PAY ATTENTION TO FINANCIAL HOUSEKEEPING.

☐ Shareholders who have advanced money to their incorporated businesses should evidence the transaction with a note and should charge an adequate rate of interest. Failure to do so could cause the loan to be recharacterized as a capital contribution.

☐ Loans between family members should be evidenced with a note and an adequate rate of interest should be charged. The rate of interest should be at or above the applicable federal rate for the month the loan was made. Avoid any disguised gift tax issue by having a written debt instrument with appropriate interest, a repayment schedule, and an expectation that the amount will be repaid.

☐ If you are married to a foreign national, make sure your spouse has an ITIN (Individual Tax Identification Number). E-filing is not allowed without one.

☐ Apply for Social Security numbers for dependents.

☐ Change Social Security name records for name changes due to marriage or divorce. (Note: Names used on tax returns must agree exactly to the spelling used by the Social Security Administration, including the use of abbreviations and initials.)

☐ Obtain documentation for charitable contributions. Gifts of $250 or more must be substantiated by a written acknowledgment from the donee organization.

☐ Obtain appraisals for non-cash contributions exceeding $5,000.

☐ Get auto usage records compiled. Businesses should make sure that the personal use value of company autos is included in the employee’s W-2.

☐ Make sure that documentation for meal expenses and other deductions is adequate to withstand an IRS audit. With a possible significant increase in IRS funding to enhance audit rates of tax returns, taxpayers may want to focus on making sure they have documentation to support all deductions and credits on their tax returns. Do not dispose of the year’s appointment book if you intend to rely on it to support business deductions. **Entertainment expenses are no longer deductible.**

☐ Get taxpayer ID numbers for 1099 and W-2 recipients (including daycare providers) by having them complete Form W-9.

☐ Document participation in business activities if you feel that this may be an issue in applying the passive loss rules (or if you are claiming exemption from the Net Investment Income tax on the sale of partnership interests or S-corporation stock). The general cutoff point for material participation is 500 hours per year. The cutoff for status as a Qualified Real Estate Professional is 750 hours.

☐ Update your tax basis records for investments, especially for mutual funds with dividend reinvestment. Also update basis records for improvements done to real estate.

☐ If you have received any gifts of investment property during the year, ask the donor for the carryover basis information.

☐ Get business activities segregated into separate bank accounts for 2022.

☐ If your deductions will change radically in 2022, be sure to adjust your withholding accordingly using Form W-4.

5. REVIEW 2021 BENEFIT PLAN OPTIONS WITH YOUR EMPLOYER.

☐ 401(k) plan contribution rate and investment choices. (Don't forget to elect the bonus contributions if you're 50 or older.) The maximum elective deferral for 2022 has increased to $20,500). The catch-up contribution for individuals 50 years or older is $6,500.

☐ Non-qualified deferred compensation plan elections.

☐ Dependent care assistance salary reductions.

☐ Compensation paid in the form of mass transit passes. (The Tax Cuts and Jobs Act eliminated the deduction for employers but retained the pre-tax benefit for employees.)

☐ Health savings account contributions

☐ Flex spending account contributions

Having health insurance coverage with a high deductible policy entitles you to make contributions to a Health Savings Account (HSA). Minimum qualifying policy deductibles are $1,400 for single coverage or $2,800 for family coverage. The maximum HSA contribution for 2022 is $3,650 for single coverage or $7,300 for family coverage. Bonus contributions of $1,000 will be allowed for those individuals age 55 or more. **Individuals enrolled in Medicare cannot make HSA contributions**.

The maximum annual contribution limit for a flex spending account for 2021 was $2,750. The limit increases to $2,850 for 2022. Participants can carry over up to $550 (of 2021 contributions) in unspent contributions if the plan has not adopted the 2 ½ month grace period rule. (This allows 2 ½ months after year-end to spend unused funds.) The $550 carryover will not reduce the current year's FSA contribution. Caution: Taking advantage of the carryover rule will prevent HSA contributions. The 2022 contribution carry over is indexed for inflation and will be $570.

Action: If you plan on making HSA contributions for 2022, clear out the flex spending account before year-end.

Looking to 2022

This letter is a guide to minimize your tax exposure by highlighting key income tax impacts of past, current, and pending federal and state legislation. We generally do not elaborate on the administrative costs that current and former legislation have on compliance, but this year is an opportune time to highlight where we are now and where we think we are heading.

Over the past ten years, the complexity of tax filings has evolved from a straightforward administrative process to an art form. Electronic filing was supposed to simplify and streamline the process, but with it came more disclosure and filing requirements. Subsequent federal and state legislation expanded what is and isn't taxable, informational disclosures, and ambiguities – which still lack guidance. The end goal, we believe, is the attempt to tax more than one's economic income. This is achieved by limiting previous tax benefits and redefining income for tax purposes.

Another issue we face is the lack of uniformity between what is taxable at the federal and state level. Some states have rolling conformity (i.e., they conform to the Internal Revenue Code as the changes occur), while others have static conformity (i.e., they conform to the Internal Revenue Code as of a specific date). Complexity arises when states have different definitions of income, exclusions, deductions, or credits that create a widely different outcome for taxpayers whose income is subject to multi-state taxation. State laws are evolving faster than federal law due to widening budget gaps and states seeing their tax base deplete faster than ever before.

To stay in front of these changes and provide the level of service our clients expect requires a level of thoroughness and due diligence not seen at every firm. Ultimately, we believe the impact of future legislation, when combined with the long-lasting effects of a pandemic still roiling taxing authorities and their ability to timely process prior filings, will increase compliance tenfold. We will continue to streamline the process to the best of our ability, along with keeping our level of detail and service our clients are accustomed to.