Year-End Planning in 2021

November 2021

The window of opportunity for many current-year tax-saving moves closes on December 31, so it is imperative to evaluate your current financial planning situation while there is still time to affect your bottom line for the 2021 tax year.

INTRODUCTION

As we head into the final months of 2021, we are encouraging all our clients to consider year-end planning strategies in order to positively affect their financial situations. In this month's newsletter, we will address several year-end planning considerations that will help not only from a planning standpoint, but also from a tax mitigation standpoint as well. At the end of this month's commentary, we provide a brief update on tax legislations that are being considered in Washington D.C.

A Review of Federal Income Tax Brackets - 2021

Rate	For Single Individuals	For Married Individuals Filing Joint Returns	For Heads of Households
10%	Up to $9,950	Up to $19,900	Up to $14,200
12%	$9,951 to $40,525	$19,901 to $81,050	$14,201 to $54,200
22%	$40,526 to $86,375	$81,051 to $172,750	$54,201 to $86,350
24%	$86,376 to $164,925	$172,751 to $329,850	$86,351 to $164,900
32%	$164,926 to $209,425	$329,851 to $418,850	$164,901 to $209,400
35%	$209,426 to $523,600	$418,851 to $628,300	$209,401 to $523,600
37%	$523,601 or more	$628,301 or more	$523,601 or more

Source: Internal Revenue Service

INCOME TAX STRATEGIES

INCOME TIMING STRATEGIES - A standard year-end practice for income timing strategies is to consider deferring income to the following year. If you received a large bonus this year or some other form of unusual compensation and you believe you will be in a lower tax bracket next year, deferring income to 2022 would be prudent. Ways to take advantage of this would be to:

- *Defer year-end **bonuses***
- *Defer the sale of **capital gain property** (or take installment payments rather than a lump-sum payment)*
- *Postpone **receipt of distributions** (other than required minimum distributions) from retirement accounts*

On the other hand, considering whether to accelerate deductions is always important too. Possible accelerated deductions for year-end could include:

- ***Consider paying medical expenses** in December rather than January, if doing so will allow you to qualify for the medical expense deduction.*
- ***Prepay deductible interest.***
- *Make sure the **mortgage payment** is made before year-end, and consider prepaying certain other expenses, such as **state income tax**. (However, do not bother prepaying interest, insurance premiums, or rent on investment property; these prepayments cannot be deducted.)*
- *Make **deductible alimony** payments early.*
- *Make next year's **charitable contributions** this year.*
    - *These may be made by check or credit card. Coordinate charitable planning and tax planning by considering the donation of appreciated securities.*
- ***Business expenses** deductible on Schedule C. This may be the perfect time for self-employed individuals to upgrade their computers or purchase office furniture. Charges to a credit card qualify if they are made before year-end, even if the credit card balance is not paid until the following year.*
- *Contributions to **529 plans**. Taxpayers who take a state tax deduction need to get their contributions in by December 31.*

CHARITABLE GIVING STRATEGIES - Charitable giving is an efficient technique used during year-end planning. To take advantage of tax benefits, you should consider directing as much charitable giving as possible in a high tax year. This way, you can receive maximum itemized deductions and allow yourself to receive the standard deduction for the following year. This process can be done through a Donor-Advised Fund.

MAKE SURE YOU ARE WITHHOLDING ENOUGH - In order to mitigate the amount of money owed when filing taxes, look at how much your employer is withholding. If you realize that you owe a large amount, change your election rate so that your employer increases the federal withholding per pay period. With this action, you are avoiding a potential estimated tax penalty due to under-withholding. This process goes both ways, therefore if you have significantly overpaid in taxes, you may be able to reduce the withholding and effectively put money back in your pocket.

REDUCE AMT LIABILITY- Alternative Minimum Tax was created to prevent the very rich from using "loopholes" to avoid paying taxes. AMT, however, now affects a substantial number of middle-income taxpayers. AMT is triggered by events such as the standard deduction, large deductions for state, local, personal property, and real estate taxes, or exercising incentive stock options. AMT is a complex topic - if you believe it might affect your bottom line, talk to a tax professional about your situation.

REVIEW BUSINESS TAX STRUCTURE - For the closely-held business owner – once again the decision to be taxed as a C Corporation vs. a passthrough entity (S Corp, Partnership, Sole Proprietor) should be reviewed. Both the immediate and long-term impacts of the decision should be carefully considered.

INVESTMENT PLANNING STRATEGIES

RECOGNIZE CAPITAL GAINS/LOSSES - Without fail, most investors are hesitant to sell out of positions that are at a loss and eager to cash in on positions that are at a gain. However, it is important to evaluate the merits of "tax-loss harvesting". Losses still have tax value, and realizing or "harvesting" losses is a way for investors to offset capital gains taxes. Review your portfolio to see if there are any losses and determine if taking these losses would be beneficial to offset any capital gains.

REBALANCE PORTFOLIOS - As always, the end of the year is a good time to rebalance portfolios. Now would be a prudent time to consult your advisor and review your investment objectives. When considering making changes in portfolios, it is important to note that you should not make investment decisions for tax reasons alone. Your main guide should always be the underlying investment decision, especially for regular events like rebalancing your portfolio.

RETIREMENT PLANNING

FUND RETIREMENT ACCOUNTS - We strongly suggest that you contribute the minimum amount necessary to your retirement plan in order to receive your entire employer's match. Do not leave free money on the table. Contributions to your 401(k) are automatically deducted from each paycheck. Contributions for tax-year 2021 must be made by the end of the year to count against 2021 income.

- The 401(k)-contribution limit is $19,500 for 2021 and the catch-up limit is $6,500.
- For an IRA contribution, the maximum amount you can contribute in 2021 is $6000, or $7,000 if you are 50 or older. The sooner you contribute to these plans, the longer your assets can grow tax deferred. Don't forget that if you are married, you can make a contribution to your spouse's IRA, even if he or she is not working.

PERFORM ROTH CONVERSION BEFORE DECEMBER 31st - A way to mitigate tax liabilities for your heirs is to utilize a Roth IRA conversion. This process involves taking a Traditional IRA and transferring all or some of the balance into a Roth IRA. You will be subject to taxation, however, your tax payment now will help your beneficiaries in the future. When your beneficiaries inherit the Roth IRA, they will have to take ***required minimum distributions*** **(RMD)**, but if the account has been open for at least 5 years, they will not have to pay federal income tax. This is an advantageous transfer of wealth practice because you can pass down assets to beneficiaries who will most likely be in the "earnings" period of their lifetimes and in high tax brackets.

ROTH IRA RMDs:

If the original account owner died on or after January 1, 2020, in most cases you will need to fully distribute your account within ten years following the death of the original owner. However, there are exceptions if you are considered an eligible designated beneficiary. Eligible designated beneficiaries include a minor child of the original account owner, a disabled or chronically ill individual, or any other person who is not more than ten years younger than the deceased account holder. If you are an eligible designated beneficiary, you can still withdraw RMDs based on your age.

"MEGA" BACK-DOOR ROTH CONTRIBUTIONS - Depending on the outcome of the pending legislation in Congress, this could be the last year you can make up to $38,500 of after-tax contributions to your 401k, and immediately convert those amounts to Roth IRAs. Check with your employer to see if they allow after-tax contributions, and if they do, check with your advisor to see if this strategy makes sense for you.

QUALIFIED CHARITABLE DISTRIBUTION - If you are over 70½, you may be eligible to transfer up to $100,000 from your IRA to a charity without paying taxes on the distribution. This is called a Qualified Charitable Distribution or QCD. Moreover, a QCD satisfies the RMD requirement if certain rules are met.

ESTATE PLANNING STRATEGIES

The end of the year is a time to reflect not only on your current financial situation, but also your personal situation. Major life events significantly impact estate planning strategies. Marriage, divorce, the birth of children and grandchildren are all factors that need to be taken into consideration for your estate plans.

STRATEGIES TO REDUCE ESTATE TAX - A standard estate planning practice is to utilize as much of the estate tax exclusion as possible. Individuals are currently able to transfer up to $11.7 million ($23.4 million for a married couple) without incurring any federal estate tax. Any remaining exclusion can be used to offset estate taxes at death.

Currently, this taxation threshold has been slated to "sunset" in 2026, so we would encourage high net worth individuals to consider using as much of their exemption in 2021 as their circumstances allow.

The annual exclusion gift tax limit is $15,000 for the 2021 tax year. This number is used for any gift given to any person, and there are no tax ramifications. This is a savvy wealth transfer technique that utilizes gifting to pass down assets to your designated beneficiaries, and at the same time, effectively avoid paying gift and estate taxes.

Best practices to mitigate taxes for beneficiaries are to utilize structured sales or gifting strategies throughout the owner's lifetime. Other strategies that can be considered to deal with a smaller exemption in the long-term can potentially include the use of Grantor Retained Annuity Trusts (GRATs), Charitable Lead Annuity Trusts (CLATs), and sales to Intentionally Defective Grantor Trusts (IDGTs).

WHAT'S GOING ON IN WASHINGTON?

A month ago, we wrote that in early September the House Ways and Means Committee's $3.5 Trillion proposal included significant income and estate tax provisions that would result in what we called a "seismic shift" in the trust and estate planning landscape.

Some of the most significant income and estate tax planning provisions included increases in top marginal tax rates, top capital gains rates, a reduction of the federal estate tax-exempt level, and most notably, a significant restriction in the ability to make transfers to irrevocable grantor trusts after 2021, and presumably the ability to sell assets on a tax-free basis to grantor trust after the date of enactment – which could still occur in 2021.

The Democratic party's bill ran into some headwinds in Congress – from moderate/centrist members of the democratic party itself – notably Senator Joe Manchin in West Virginia and Senator Kyrsten Sinema of Arizona. Those senators objected to the price of the bill – estimated around $3.5 Trillion. After some negotiations and a fair amount of wrangling, pared-down versions of the bill were proposed – in the $2 trillion range.

On October 28th, President Biden unveiled a new further slimmed-down framework for Democrats' $1.75 trillion social-spending and climate legislation that includes funding for universal prekindergarten, billions in renewable energy tax credits, and an expansion of the Affordable Care Act, as well as tax increases on companies and wealthy individuals. This compromise required eliminating a number of proposals that were priorities for the president and progressives on Capitol Hill, including Medicare coverage for dental and vision, free community college, a national paid family and medical leave program, and reduced prescription drug prices. Talks are currently ongoing – including bringing back paid family leave provisions.

Here are some of the highlights of the current version of the "Build Back Better" plan that impact income tax, estate, and trust planning (a detailed analysis can be found here):

- Major tax provisions would raise money from large corporations and high-income households.
- A 15% corporate minimum tax would affect companies that are profitable but report relatively low tax rates.
- U.S.-based multinational companies would face a different 15% minimum tax on their foreign income. They would pay at least 15% in each country in which they operate, as part of the U.S. participation in an international agreement.
- Corporate stock buybacks would face a new 1% excise tax.
- On individual income taxes, the plan includes a 5% surtax on adjusted gross income above $10 million and an additional 3% on adjusted gross income above $25 million. That would effectively raise the top tax rates on ordinary income and capital gains. Taxing adjusted gross income means that people affected by those surtaxes wouldn't be able to deduct charitable contributions and state and local taxes.
- High-income business owners would face a 3.8% tax on active business income. Currently, levies of that amount are applied on their wages, self-employment income and investment income.
- The following surtaxes will be effective for tax years beginning on or after Dec. 31, 2021:
  - Surtax of 5% on the modified adjusted gross income of a trust or estate above $200,000
  - Additional 3% surtax on the modified adjusted gross income of a trust or estate above $500,000
- The gain exclusion for Qualified Small Business Stock (QSBS – Section 1202 of the Code) will be reduced to 50% of the gain from 100% where the taxpayer is a trust for sales and exchanges occurring after Sept. 13, 2021, unless further to a binding contract in effect on that date and not materially modified after that date. In addition, the excluded gain would be an AMT preference item.

WHAT DIDN'T MAKE IT IN:
Many of the revenue raisers from the previous legislative text that originated from the House Ways and Means Committee were dropped from the latest version:

- No change in estate, gift, and generation-skipping transfer tax exemption amounts.
- No change to the applicability of valuation discounts.
- Proposed changes to the corporate tax rate, the estate tax, and trusts aren't mentioned in the framework and may not happen.
- No change to estate inclusion of grantor trusts.
- No change to the treatment of sales or exchanges with grantor trusts.
- The much-discussed new tax on billionaires' unrealized capital gains and a plan to require banks to report annual account flows to the Internal Revenue Service.
- The framework doesn't specifically mention changes to the $10,000 cap on state and local tax deductions, but Democratic lawmakers expect to relax or repeal that.

OBSERVATIONS:

- Democrats also plan to roughly double the size of the IRS with an eye toward tougher enforcement of tax laws.
- Both the House and the Senate still have to pass the revised proposal, so more changes could be coming. As a result, individuals need to be mindful that this legislation could change again or may not pass at all.
- This version of the legislation reinforces the "paradigm shift" away from the emphasis on estate taxes to planning techniques driven by income tax considerations.

CONCLUSION

A lot to digest, but don't rush to make hasty decisions around taxes. As always, consult professionals who can help you determine a strategy that is ideally suited for your personal situation.

Sincerely,

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