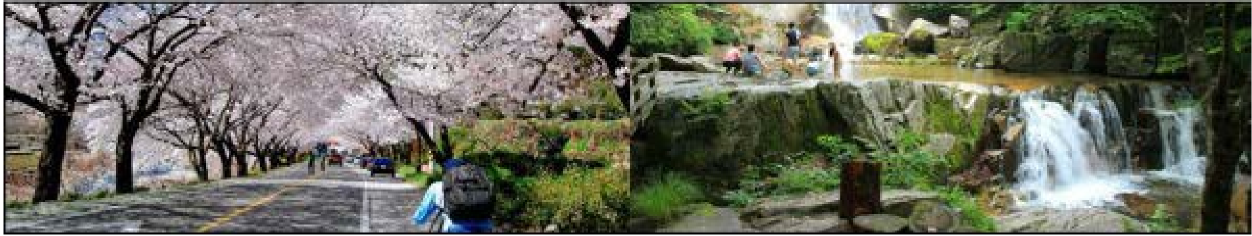

FINANCIAL PERSPECTIVES

Data by:

Teri M. Kaye, CPA

Year-End Tax Planning for Calendar Year 2021

December 6, 2021

The FMA ADVISOR is published periodically for the exclusive use by clients and associates of Financial Management Associates, LLC. The information herein was obtained from sources that we believe are reliable, but we do not guarantee its accuracy. Neither the information, nor any opinion expressed, constitutes a solicitation of the purchase or sale of any securities, commodities, or funds. Please note that past performance is no guarantee of future results.

Executive Summary

Year-end tax planning not only provides an estimate of your 2021 tax liability, it can also reveal opportunities to lower your overall tax liabilities! For cash basis taxpayers, defer income and accelerate expenses, bunch itemized deductions, use all the pre-tax and tax-deductible benefits available for medical costs and retirement funding. Consider harvesting capital losses to offset capital gains and deferring capital gains through an investment in a qualified Opportunity Zone Fund or business. Dispose of passive activities to free up suspended loss. Purchase and place certain fixed assets into service before January 1, 2022 to write off the entire cost in 2021. Knowing the rules and your business and personal tax situations allows our team to provide relevant and meaningful planning tips!

As the end of the year approaches, it is a good time to think of planning moves that will help lower your tax bill for this year and possibly the next. Initially thought to be more significant, the newly signed Infrastructure and Jobs Act contained very few tax provisions. The Build Back Better bill, as passed by the House and now being considered in the Senate contains many tax law changes – but the most significant ones in terms of income and estate and gift tax expansion and rate changes for individuals and corporations were dropped by the House prior to passage. And some provisions of the 2017 Tax Cuts and Jobs Act that were delayed or changed due to Covid-19 relief legislation became effective for 2021 or will be for 2022.

Net operating losses for both individuals and businesses from 2021 and after can only be carried forward, not back. And they can only offset 80% of future taxable income in any given tax year. In addition, interest expense limitations have tightened for higher income taxpayers to limit the deductible business interest expense.

One of the most detrimental tax provisions from the 2017 TCJA was the limitation on "Excess Business Losses" ("EBL") to $500,000 for married filing joint taxpayers. The EBL limitations mean that "business losses" above the limits cannot be deducted to offset "non-business income" – even when you have a complete disposition of a passive activity, or cumulative losses on pass-through entities in which you materially participate and have tax basis to deduct the losses. Under current law, the excess converts to a net operating loss, so you can use it against up to 80% of your 2022 (or later) taxable income. Under the proposed Build Back Better legislation, the excess would remain an EBL, with the EBL for prior years mixing with the fresh EBLs each year. This would limit the use of the losses to the $500K annual cap.

Whether or not tax increases become effective next year, the standard year-end approach of deferring income and accelerating deductions to minimize taxes will continue to produce the best results for all but the highest income taxpayers, as will the bunching of deductible expenses into this year or next to avoid restrictions and maximize deductions.

If proposed tax increases do pass, however, the highest income taxpayers may find that the opposite strategies produce better results: Pulling income into 2021 to be taxed at currently lower rates, and deferring deductible expenses until 2022, when they can be taken to offset what would be higher-taxed income. This will require careful evaluation of all relevant factors.

We have compiled a list of actions based on current tax rules that may help you save tax dollars if you act before year-end. Not all actions will apply in your situation, but you (or a family member) will likely benefit from many of them. We can narrow down the specific actions that you can take once we meet with you to tailor a particular plan. In the meantime, please review the following list and contact us at your earliest convenience so that we can advise you on which year-end tax-saving moves to make.

Year-End Tax Planning Moves for Individuals:

Higher-income individuals must be wary of the 3.8% surtax on certain unearned income. The surtax is 3.8% of the lesser of: (1) net investment income (NII), or (2) the excess of MAGI (modified adjusted gross income) over a threshold amount ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case).

- As year-end nears, the approach taken to minimize or eliminate the 3.8% surtax will depend on the taxpayer's estimated MAGI and NII for the year. Some taxpayers should consider ways to minimize (e.g., through deferral) additional NII for the balance of the year, others should try to reduce MAGI other than NII, and some individuals will need to consider ways to minimize both NII and other types of MAGI. An important exception is that NII does not include distributions from IRAs or most other retirement plans.
- Pending legislative changes in the Build Back Better bill expand the reach of the Net Investment Income Tax ("NIIT"). The 3.8% NIIT proposed to be effective after this tax year would subject high income (e.g., phased-in starting at $500,000 on a joint return; $400,000 for most others) S shareholders, limited partners, and LLC members to NIIT on their pass-through income and gain that is not subject to payroll tax. Accelerating some of this type of income into 2021 could help avoid NIIT on it under the potential 2022 rules, but would also increase 2021 MAGI, potentially exposing other 2021 investment income to the tax.
- The 0.9% additional Medicare tax also may require higher-income earners to take year-end action. It applies to individuals whose employment wages and self-employment income total more than an amount equal to the NIIT thresholds, above. Employers must withhold the additional Medicare tax from wages in excess of $200,000 regardless of filing status or other income. Self-employed persons must take it into account in figuring estimated tax. There could be situations where an employee may need to have more withheld toward the end of the year to cover the tax. This would be the case, for example, if an employee earns less than $200,000 from multiple employers but more than that amount in total. Such an employee would owe the additional Medicare tax, but nothing would have been withheld by any employer.
- Long-term capital gain from sales of assets held for over one year is taxed at 0%, 15% or 20%, depending on the taxpayer's taxable income. If you hold long-term appreciated-in-value assets, consider selling enough of them to generate long-term capital gains that can be sheltered by the 0% rate. The 0% rate generally applies to net long-term capital gain to the extent that, when added to regular taxable income, it is not more than the maximum zero rate amount (e.g., $80,800 for a married couple; estimated to be $83,350 in 2022). If, say, $5,000 of long-term capital gains you took earlier this year qualifies for the zero rate then try not to sell assets yielding a capital loss before year-end, because the first $5,000 of those losses will offset $5,000 of capital gain that is already tax-free. Or, if you want to minimize capital gains due to NIIT, consider harvesting capital losses in taxable accounts or making an investment into an Opportunity Zone Fund or Business.
- Postpone income until 2022 and accelerate deductions into 2021 if doing so will enable you to claim larger deductions, credits, and other tax breaks for 2021 that are phased out over varying levels of AGI. These include deductible IRA contributions, child tax credits, higher education tax credits, and deductions for student loan interest. Postponing income also is desirable for taxpayers who anticipate being in a lower tax bracket next year due to changed financial circumstances. Note, however, that in some cases, it may actually pay to accelerate income into 2021. For example, that may be the case for a person who will have a more favorable filing status this year than next (e.g., head of household versus individual filing status), or who expects to be in a higher tax bracket next year. That's especially a consideration for high income taxpayers who may be subject to higher rates next year under proposed legislation.

- If you believe a Roth IRA is better for you than a traditional IRA, consider converting traditional-IRA money invested in any beaten-down stocks (or mutual funds) into a Roth IRA in 2021 if eligible to do so. Keep in mind that the conversion will increase your income for 2021, possibly reducing tax breaks subject to phaseout at higher AGI levels. This may be desirable, however, for those potentially subject to higher tax rates under pending legislation.
- It may be advantageous to try to arrange with your employer to defer, until early 2022, a bonus that may be coming your way. This might cut as well as defer your tax. Again, considerations may be different for the highest income individuals.
- Many taxpayers won't want to itemize because of the high basic standard deduction amounts that apply for 2021 ($25,100 for joint filers, $12,550 for singles and for marrieds filing separately, $18,800 for heads of household), and because many itemized deductions have been reduced or abolished, including the $10,000 limit on state and local taxes; miscellaneous itemized deductions; and non-disaster related personal casualty losses. You can still itemize medical expenses that exceed 7.5% of your AGI, state and local taxes up to $10,000, your charitable contributions, plus mortgage interest deductions on a restricted amount of debt, but these deductions won't save taxes unless they total more than your standard deduction. In addition to the standard deduction, you can claim a $300 deduction ($600 on a joint return) for cash charitable contributions. Some states have adopted work-around rules for the SALT cap and in the Build Back Better proposals, the SALT cap is lifted to $80,000 for married filing joint taxpayers for 2021.
- Some taxpayers may be able to work around these deduction restrictions by applying a bunching strategy to pull or push discretionary medical expenses and charitable contributions into the year where they will do some tax good. For example, a taxpayer who will be able to itemize deductions this year but not next will benefit by making two years' worth of charitable contributions this year. The COVID-related increase for 2021 in the income-based charitable deduction limit for cash contributions from 60% to 100% of MAGI assists in this bunching strategy.
- Consider using a credit card to pay deductible expenses before the end of the year. Doing so will increase your 2021 deductions even if you don't pay your credit card bill until after the end of the year.
- If you expect to owe state and local income taxes when you file your return next year and you will be itemizing in 2021, consider asking your employer to increase withholding of state and local taxes (or make estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into 2021. But this strategy is not good to the extent it causes your 2021 state and local tax payments to exceed $10,000, unless Build Back Better is enacted in its current form.
- Required minimum distributions RMDs from an IRA or 401(k) plan (or other employer-sponsored retirement plan) have not been waived for 2021, as they were for 2020. If you were 72 or older in 2020 you must take an RMD during 2021. Those who turn 72 this year have until April 1 of 2022 to take their first RMD but may want to take it by the end of 2021 to avoid having to double up on RMDs next year.
- If you are age 70 or older by the end of 2021, and especially if you are unable to itemize your deductions, consider making 2021 charitable donations via qualified charitable distributions from your traditional IRAs. These distributions are made directly to charities from your IRAs, and the amount of the contribution is neither included in your gross income nor deductible on Schedule A, Form 1040. However, you are still entitled to claim the entire standard deduction. (The qualified charitable distribution amount is reduced by any deductible contributions to an IRA made for any year in which you were age 70 or older, unless it reduced a previous qualified charitable distribution exclusion.)

- Take an eligible rollover distribution from a qualified retirement plan before the end of 2021 if you are facing a penalty for underpayment of estimated tax and increasing your wage withholding won't sufficiently address the problem. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2021. You can then timely roll over the gross amount of the distribution, i.e., the net amount you received plus the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2021, but the withheld tax will be applied pro rata over the full 2021 tax year to reduce previous underpayments of estimated tax.
- Consider increasing the amount you set aside for next year in your employer's FSA if you set aside too little for this year and anticipate similar medical costs next year.
- If you become eligible in December of 2021 to make HSA contributions, you can make a full year's worth of deductible HSA contributions for 2021.
- Make gifts sheltered by the annual gift tax exclusion before the end of the year if doing so may save gift and estate taxes. The exclusion applies to gifts of up to $15,000 made in 2021 to each of an unlimited number of individuals. You can't carry over unused exclusions to another year. These transfers may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax.
- If you were in federally declared disaster area, and you suffered uninsured or unreimbursed disaster related losses, keep in mind you can choose to claim them either on the return for the year the loss occurred (in this instance, the 2021 return normally filed next year), or on the return for the prior year (2020), generating a quicker refund.
- If you were in a federally declared disaster area, you may want to settle an insurance or damage claim in 2021 to maximize your casualty loss deduction this year.

Year-End Tax Planning Moves for Businesses & Business Owners:

- Taxpayers other than corporations may be entitled to a deduction of up to 20% of their qualified business income. For 2021, if taxable income exceeds $329,800 for a married couple filing jointly, (about half that for others), the deduction may be limited based on whether the taxpayer is engaged in a service-type trade or business (such as law, accounting, health, or consulting), the amount of W-2 wages paid by the business, and/or the unadjusted basis of qualified property (such as machinery and equipment) held by the business. The limitations are phased in; for example, the phase-in applies to joint filers with taxable income up to $100,000 above the threshold, and to other filers with taxable income up to $50,000 above their threshold.
- Taxpayers may be able to salvage some or all of this deduction, by deferring income or accelerating deductions to keep income under the dollar thresholds (or be subject to a smaller deduction phaseout) for 2021. Depending on their business model, taxpayers also may be able increase the deduction by increasing W-2 wages before year-end. The rules are quite complex, so don't make a move in this area without consulting us.
- More small businesses are able to use the cash (as opposed to accrual) method of accounting than were allowed to do so in earlier years. To qualify as a small business a taxpayer must, among other things, satisfy a gross receipts test, which is satisfied for 2021 if, during a three-year testing period, average annual gross receipts don't exceed $26 million (next year this dollar amount is estimated to increase to $27 million). Not that many years ago it was $1 million. Cash method taxpayers may find it a lot easier to shift income, for example by holding off billings till next year or by accelerating expenses, for example, paying bills early or by making certain prepayments.
- Businesses should consider making expenditures that qualify for the liberalized business property expensing option. For tax years beginning in 2021, the expensing limit is $1,050,000, and the investment ceiling limit is $2,620,000. Expensing is generally available for most depreciable property (other than buildings) and off-the-shelf computer software. It is also available for interior improvements to a building (but not for its enlargement), elevators or escalators, or the internal structural framework), for roofs, and for HVAC, fire protection, alarm, and security systems.

- The generous dollar ceilings mean that many small and medium sized businesses that make timely purchases will be able to currently deduct most if not all their outlays for machinery and equipment. What's more, the expensing deduction is not prorated for the time that the asset is in service during the year. So expensing eligible items acquired and placed in service in the last days of 2021, rather than at the beginning of 2022, can result in a full expensing deduction for 2021.
- Businesses also can claim a 100% bonus first year depreciation deduction for machinery and equipment bought used (with some exceptions) or new if purchased and placed in service this year, and for qualified improvement property, described above as related to the expensing deduction. The 100% write-off is permitted without any proration based on the length of time that an asset is in service during the tax year. As a result, the 100% bonus first-year write-off is available even if qualifying assets are in service for only a few days in 2021.
- Businesses may be able to take advantage of the de minimis safe harbor election (also known as the book tax conformity election) to expense the costs of lower-cost assets and materials and supplies, assuming the costs aren't required to be capitalized under the UNICAP rules. To qualify for the election, the cost of a unit of property can't exceed $5,000 if the taxpayer has an applicable financial statement (AFS, e.g., a certified audited financial statement along with an independent CPA's report). If there's no AFS, the cost of a unit of property can't exceed $2,500. Where the UNICAP rules aren't an issue, and where potentially increasing tax rates for 2022 aren't a concern, consider purchasing and placing in service qualifying items before the end of 2021.
- A corporation (other than a large corporation) that anticipates a small net operating loss (NOL) for 2021 (and substantial net income in 2022) may find it worthwhile to accelerate just enough of its 2022 income (or to defer just enough of its 2021 deductions) to create a small amount of net income for 2021. This allows the corporation to base its 2022 estimated tax installments on the relatively small amount of income shown on its 2021 return, rather than having to pay estimated taxes based on 100% of its much larger 2022 taxable income.
- Year-end bonuses can be timed for maximum tax effect by both cash- and accrual-basis employers. Cash basis employers deduct bonuses in the year paid, so they can time the payment for maximum tax effect. Accrual-basis employers deduct bonuses in the accrual year, when all events related to them are established with reasonable certainty. However, the bonus must be paid within two and a half months after the end of the employer's tax year for the deduction to be allowed in the earlier accrual year. Accrual employers looking to defer deductions to a higher-taxed future year should consider changing their bonus plans before year end to set the payment date later than the 2.5-month window or change the bonus plan's terms to make the bonus amount not determinable at year end.
- To reduce 2021 taxable income, consider deferring a debt-cancellation event until 2022.
- Sometimes the disposition of a passive activity can be timed to make best use of its freed-up suspended losses. Where reduction of 2021 income is desired, consider disposing of a passive activity before year-end to take the suspended losses against 2021 income. If possible 2022 top rate increases are a concern, holding off on disposing of the activity until 2022 might save more in future taxes.