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CERTIFIED PUBLIC ACCOUNTANTS

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BUSINESS SOLUTIONS WORLDWIDE

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Dear Clients and Friends (and Future Clients!):

As December 31st approaches, now is an excellent time to consider planning moves that could lower your tax bill for this year and possibly next.

Despite major tax changes from recent years generally remaining in place, including lower income tax rates and larger standard deductions, the time-tested approach of deferring income and accelerating deductions to minimize taxes still works for many taxpayers. So, too, does bunching expenses into this year or next to minimize income taxes overall.

2021 continues to provide additional challenges in tax planning. Below we have included summaries of tax planning strategies for Individuals and Business. At the end of the letter, we have also included a summary of the most important proposals in the Build Back Better tax bill currently being considered by Congress. This bill is not yet law and the items referenced may change drastically in the final bill or the bill may not be passed.

The following may help you save tax dollars if you act before year-end based on how current tax law stands. Not all will apply to you, obviously, but we can certainly help you determine which do and which could if you were to implement certain strategies. Please take a look at the list below for items to consider and reach out to us with any questions. We look forward to hearing from you!

Year-End Tax Planning for Individuals

High Investment Income – *Interest, Dividends, Capital Gains, and other Investment Income*

- A 3.8% surtax is charged on unearned income which is the **lesser** of:
    - (1) **N**et **I**nvestment **I**ncome (**NII**) – the total of your investment income, or
    - (2) the excess of **M**odified **A**djusted **G**ross **I**ncome (**MAGI**) over
        - $250,000 for joint filers or surviving spouses
        - $125,000 for a married individual filing a separate return
        - $200,000 for all others

- **Strategies** include (but are not limited to) **controlling the timing** of:
  - Realized capital gains
  - Retirement plan contributions
  - Paying bonuses to employees from a pass-through entity
- Be mindful this surtax is **not charged** on distributions from IRAs and most other retirement plans.

<u>Long-term capital gains (held more than one year)</u>

- These are taxed at a rate of **0%**, 15% or 20%, depending on taxable income
- The **0% tax** applies when taxable income is **below:**
  - $80,801 for joint filers / $54,101 for head of household/ $40,401 for all others
- The **20% tax** applies when taxable income is **over**:
  - $501,601 for joint filers/ $473,751 for head of household/ $445,851 for single/$250,801 for married filing separately
- **Consider maximizing the amount of gains subject to no tax** if you fall into this lowest threshold, especially if your income will increase significantly next year or if you have capital losses in excess of $3,000 that will be suspended anyway.
  - ***Example:*** Unrealized long-term capital gains of $10,000. Wages (and no other income) Year 1: $20,000, Year 2: $90,000. Sell the position in Year 1 and pay $0 in tax on the gain. Sell the position in Year 2 and pay 15% tax or $1,500.
- **The "Wash Sale" Rule** ordinarily applies when a security, including a stock or bond is sold at a loss and then repurchased within 30 days. For tax purposes, no loss is recognized until the final sale of that asset.
  - These rules do not currently apply to cryptocurrencies or NFTs. Any losses can be recognized when they are sold, even if they are immediately repurchased.
  - It is expected that this rule will change in the near future.
- **Washington State Capital Gains Tax of 7%** is currently scheduled to apply to capital gains for residents of Washington and certain sales sourced to Washington that occur on or after *<u>January 1, 2022</u>*. It's still possible that this tax may be struck down in court or overturned through the referendum. The tax would apply to net long-term **capital gains over $250,000**.
  - The tax would not apply to real estate, including a residence, or sales of a "family-owned" businesses that had less than $10,000,000 of revenue in the previous 12-months and that meets certain other criteria.
  - There is a deduction of up to $100,000 for charitable donations in excess of $250,000 made to a Washington based non-profit.
  - Any capital gains recognized by the end of 2021 would not be subject to this tax.
- **Cryptocurrencies** can create taxable income even if you do not sell them. If any cryptocurrency you hold underwent a "hard fork" in 2021, you will have additional capital gain income to plan for.

High Wages or Self-employment Income – Wages, Independent Contracting, Business Owner

- An additional Medicare tax of 0.9% is levied on wages and when self-employment income exceeds:
  - $250,000 for joint filer / $125,000 for married filing separate / $200,000 for all others
- **Employers must withhold** this tax on wages in excess of $200,000 regardless of filing status or other income.
- **Self-employed** persons **need to include** this tax when calculating their tax estimates.
- **Individuals with two employers** may need to request to increase their withholding near year end if their income totals in aggregate exceed the above thresholds.
  - ***Example:*** Employer 1 wages = $125,000. Employer 2 = $150,000. Neither is over $200,000 but in total they are.

Phased Out Deductions and Credits

- With higher **A**djusted **G**ross **I**ncome (**AGI**), certain deductions & credits are **phased out**:
  - Deductible IRA contributions (Phaseout depends on a number of factors)
  - Child tax credits (Phaseout begins $150,000 Joint / $75,000 Single / $112,500 HOH)
  - Higher education tax credits (Phaseout begins $138,000 joint / $69,000 others)
  - Student loan interest deduction (Phaseout begins $140,000 joint / $70,000 others)
- Consider which tax bracket you will be in each year – you may want to move **more retirement plan distributions** or **ask a bonus be deferred** to a year **when you make less money** or **sell appreciated stock after your wedding** to take advantage of that income being taxed at a lower rate.
- **Charge** deductible expenses to a **credit card i**n 2021 but pay in 2022

Required Minimum Distributions from traditional IRAs or 401(k) plans – aged 70 ½ or higher

- **Reinstated** for 2021 – for those who turned 70 ½ in 2020 or later, you now only need to take distributions in the year you reach age 72.
- Consider making charitable donations directly to a charity from your retirement accounts – called a "**Q**ualified **C**haritable **D**istributions (**QCD**)." These are especially beneficial if you would not already be itemizing your deductions. These QCDs do not provide a deduction on Schedule A, but instead are never treated as income. Making these tax-exempt distributions will reduce the amount of IRA contributions that may be deducted for any year in which the contributor was age 70½ or older unless a previous QCD income exclusion was reduced by that post-age 70½ contribution.

Itemizing deductions

- Only if higher than **standard deduction**:
    - $25,100 for joint filer / $12,550 for single / $18,800 for head of household
- **Only $10,000 of state and local taxes** may be deducted – this **limits planning** payment of personal **real estate** or **state income taxes** in one year or another
    - Business Owners consider "SALT Cap Workaround" (discussed below) for taxes paid to states other than Washington
- Still **no deduction for** unreimbursed employee expenses, investment expenses or tax preparation fees
- **Medical expenses** in excess of 7.5% of your **AGI**, **certain personal home interest** and **investment interest expense** still included.
- Individuals may claim $300 for charitable contributions in cash even if using the standard deduction. If itemizing**, the deduction can be 100%** of modified adjusted gross income **for 2021.**
- **Consider bunching expenses in one year or another** to:
    - Exceed the medical expense AGI limit – try to schedule procedures before end of year, or delay if possible.
    - Take advantage of the high charity limit of 2021 – **make additional donations before the end of the year,** including donations to a donor advised fund!

Savings

- Consider **converting traditional-IRAs into a Roth IRA** in 2021, known as a "backdoor Roth", if eligible. *The current tax bill is scheduled to eliminate this strategy starting January 1, 2022 for certain taxpayers, subject to taxable income limitations.* This will increase your income for the year, however.
- If you don't think you'll itemize deductions after reaching age 70½**, contribute** as much as you can **to traditional IRAs** this year – you must have "earned income" to do so. Then when you reach 70½, **make a QCD** (as referenced above). This effectively converts otherwise nondeductible charitable contributions that you make that year and those later into deductible ones while simultaneously keeping such QCDs out of your income.
- Compare your medical costs this year to what you anticipate next year and consider if you contributed enough to your employer's health **F**lexible **S**pending **A**ccount (**FSA**).
- If you become eligible in December of 2021 to make **H**ealth **S**avings **A**ccount (**HSA**) contributions, you can make a full year's worth of deductible contributions for 2021. If you haven't already made the maximum contribution for the year, consider maxing out your contribution.

Gifts

- Gifts of up to $15,000 in 2021 can be made to an unlimited number of individuals and be excluded from gift taxes. Unused annual exclusions can't be carried forward.
- The gift tax annual exclusion amount will increase to $16,000 for 2022.

Casualty and Theft Losses

- **Only deductible** if attributable to:
  - A **federally** declared disaster **and**
  - **Exceed** $100 per casualty **and**
  - **Exceed** 10% of AGI **and**
  - Such losses were **uninsured** or **unreimbursed**.
- Consider your choice of **deducting** such losses either on the return the **year of the loss or the one prior** to generate a quicker refund. When settling an insurance or damage claim, keep this timing option in mind to determine **which year** it is best to take the excess loss.

Working Remotely

- If you have temporarily moved because of the pandemic, you may have to file a state tax return even if you have not permanently moved. The rules are complex and differ significantly from state to state.
  - Many states require a *non-resident return* for any income earned while working in that state.
  - If you have moved to another state with the intent to stay OR if you have been in a state for **183 days or more**, you may be required to file a *resident tax return*.

Year-End Tax-Planning for Businesses & Business Owners

Qualified Business Income Deduction (QBID) – the 20% deduction for pass-through entities

- C corporations are **not** eligible
- Sole proprietors, partnerships (including LLCs taxed as such) and S corporations **are** eligible
- Certain service type businesses (such as law, accounting, health, and consulting) are excluded once certain thresholds of income are met. These exclusions are phased in with the QBID being reduced with 2021 taxable incomes from (no reduction for incomes below the lower threshold and no QBID for those with incomes above):
  - Joint filers – $329,800 to $429,800
  - Single and Head of household - $164,900 to $214,900
  - Married filing separate - $164,925 to $214,925
- Strategies to **maximize the QBID** include:
  - **Timing** income or deductions to fall under the above thresholds and make all income eligible
  - **Paying "reasonable" wages** to increase the amount of deduction allowed:
    - To an employee-owner of an S-Corp or
    - To any other employee included bonuses paid by year end

  - **Placing in service equipment** before year-end because of the limitation on taxable income (equipment expensing, bonus depreciation or Section 179 will also reduce total income)
- Because of the relative newness of this deduction, there are many nuances that are not common knowledge and are relatively complex – **please reach out to us** to help you with planning for these!

Cash Method of Accounting

- If, over the 3-year testing period, **average gross receipts do not exceed $26 million**, a business may be eligible to use the cash method of accounting as opposed to the accrual method. This opens the possibility of reducing income by holding off billings and paying expenses a little earlier. Your business **may be able to change** to this method.
- Taxpayers on the cash method can increase current year deductions by paying down accounts payable before the end of the year.

Depreciation

- ***The IRC §179 deduction***
  - Qualified property can be expensed in 2021 up to $1,050,000, which begins to be reduced when property worth over $2,620,000 is placed in service. This isn't prorated so the **full amount** can be **expensed** if placed in service by the **end of December**.
    - Off-the-shelf software
    - Machinery & equipment
    - Qualified improvement property (generally, any interior improvement to a **nonresidential** building's interior, but not for enlargement of a building, elevators or escalators, or the internal structural framework)
    - Roofs
    - HVACs
    - Fire protection, alarm, and security systems
    - Sport utility vehicles, limited to $26,200 per vehicle
  - **Limited** to taxable income

- ***Bonus depreciation***
  -
    - **Not limited** to taxable income and eligible when assets are **placed in service**
    - New and some used machinery and equipment
    - Certain land improvements not qualified for IRC §179
    - Qualified improvement property (as listed in ***The IRC §179 deduction*** *section*)
  - Also not prorated, so assets placed in service by the **end of December** are eligible for the full amount of depreciation!

Other Expensing Strategies

- ***Expense Materials and Supplies***
  - Expense when inventory UNICAP rules don't apply (generally, when the company's gross receipts do not exceed $26 Million)
  - Generally, $2,500, but up to $5,000 when the business files an "applicable financial statement"
  - Could help **accelerate deductions** with purchases of supplies and low-dollar equipment made before year-end

- ***Business Meals*** purchased from a restaurant are **100% deductible for 2021 and 2022**
  - Food purchased as office snacks and coffee is still only 50% deductible along with other food purchased from a grocery store
  - These meals should be separately identified from other food purchases in your records, and you must keep receipts for all purchases in order to claim this deduction
  - Entertainment remains non-deductible, and food not separately invoiced from entertainment remains non-deductible.

Net operating losses

- C Corporations (other than a "large corporation") anticipating a small 2021 net operating loss and substantial 2022 net income **may wish to accelerate** some of its 2022 income to 2021 to, instead, create a 2021 profit. This will permit basing its 2022 estimated tax payments on the small 2021 profit rather than on the much larger 2022 profit.
- **2021 net operating loss** may **no longer be carried back** to offset taxable income in previous tax years except for farming and property and casualty insurance company losses which can still be carried back two years. However, net operating losses can now be carried forward indefinitely until used.

State Tax Issues

- ***"SALT Cap Workaround***" – Currently on the individual tax return, only $10,000 of state taxes—state income tax or sales tax, and real estate tax—can be deducted on Schedule A (there is a proposal in the Build Back Better Bill to increase this limit to $80,000). The SALT Cap Workaround would allow an S-Corp or Partnership to make tax payments on behalf of an individual that would be deductible on business return and pass a credit to the individual. 20 states have enacted rules allowing this.
  - The rules can be complex but to take advantage of this estimated payments must be made by March 15 in many states.

- ***Employees Working Remotely –*** During the pandemic many states waived their rules that required a business to file income and/or sales tax returns if they had an employee working remotely in their state due to COVID. These rules have now expired or are expiring. *If you have employees now working in states where you have not previously filed, you will now have a filing obligation.*

Other ideas and considerations

- Consider **deferring a debt-cancellation** event until 2022 to reduce 2021 taxable income.
    - *PPP loan forgiveness* does not create taxable income for most taxpayers
- Consider **disposing of a passive activity** in 2021 if doing so will allow you to deduct suspended passive activity losses.
- Consider paying bonuses before year end, if a cash-basis taxpayer, or accruing bonus before year and paying them before March 15 if accrual basis.
- The threshold for **E**xcess **B**usiness **L**oss (**EBL**) has been **reinstated for 2021** and is $524,000 for joint filers and $262,000 for all other filers. Those taxpayers **whose investment income in the past has been offset by business losses** should strongly consider **preparing a projection** to make sure they are not surprised by an unfavorable mismatch under this reinstatement.
- The Employee Retention Credit (**ERC**) is no longer available for most taxpayers. If you have already reduced your employment tax deposits in anticipation of claiming the ERC for the fourth quarter of 2021, you may need to do some additional planning.

Build Back Better Tax Considerations

This is the tax proposal currently being considered by Congress. ***This bill is not yet law.*** The provisions contained below may change drastically in the final bill, and the bill may not be passed at all. However, we expect that if the bill does pass, it will happen close to or even after Christmas, leaving very little time for action.

Surtax on High Income Taxpayers

- A 5% surtax is charged on modified Adjusted Gross Income in excess of $10 million.
- An additional 3% surtax would apply modified adjusted gross income in excess of $25 million

3.8% Net Investment Income on Trade of Business Income

- The 3.8% Net Investment Income Tax would apply to income from businesses (S Corporations and Partnerships) for taxpayers earning more the $400,000 annually/$500,000 for joint filers.

State and Local Tax (SALT) Limitation on Schedule A

- The deduction for state taxes on Schedule A would be increased from $10,000 to $80,000 for tax years beginning 2021 through 2030.

§1202 Stock Gain Exclusion

- The 75% and 100% exclusion rates for certain qualified small business stock will not apply to taxpayers with adjusted gross income over $400,000 on sales made after September 13, 2021. The 50% exclusion remains for all taxpayers.

Proposals Dropped from the Final House Bill

These proposals were dropped from the final House Bill. While there has been discussion around them, they are not in the current bill. It's possible, but not considered likely, that they could be reinstated in the Senate or during reconciliation.

- The new 25% top capital gains rate
- The increase of the top tax bracket to 39.6%
- Graduated business income tax rate increase up to 26.5%

These are just a few of the year-end steps that can help you save taxes. Please call us to find out which works best for you.

Very truly yours,

Your Team at Hellam Varon & Co., Inc.