GMS SURGENT 2021 YEAR-END TAX SAVING TIPS

Previously, we communicated with you regarding strategies and tips to consider in light of the pending Build Back Better Act. This past Saturday, December 11, 2021, a Senate committee released its version of the Build Back Better Act (the "Act"), and while most of the tax-related items are similar in both versions, there is one noticeable difference regarding the state and local tax deduction that is pointed out later. Please note that it is also possible that the entire Act will collapse, or at least be postponed until a future date (in 2022, presumably).

Note: The following items are not included in the Act in its current form, and for that reason are departures from what President Biden previously proposed:

- No increase in the individual ordinary income tax rates for taxpayers with income below $10 million.
- No increase in capital gains tax rates for individual taxpayers with income below $10 million.
- No change in gift, estate, or GST exemption amounts.
- No changes to step-up in basis rules at death.
- No proposed taxes on unrealized appreciation.
- No changes to grantor trust rules.
- No changes to C corporation income tax rates.
- No change to the 20% qualified business income tax deduction under IRC 199A.

That being said, there are some things to think about as the year comes to a close. It's still not too late to consider the following year-end tax planning ideas and suggestions.

INDIVIDUAL TAX/TRUSTS

The following proposals are still part of the framework:

- A surcharge on non-corporate taxpayers, as follows:
  - 5% to individuals with modified adjusted gross income (MAGI) in excess of $10 million (married filing jointly or single filers)/$5 million for married filing separate.
  - An additional 3% to individuals with MAGI in excess of $25 million (married filing jointly or single filers)/$12.5 million for married filing separate.
  - For non-grantor trusts, the 5% surcharge applies if income is in excess of $200k, and the additional 3% surcharge applies if income is in excess of $500k.
  - These surcharges would be effective beginning in 2022, and apply to all income over the income thresholds.

Planning Point, individual: Consider accelerating the sale of a business (or other significant amounts of income) into 2021, to avoid the surcharge(s).

Planning Point, non-grantor trust: The same strategy applies. However, a trust may be able to reduce income subject to the surcharge(s) via charitable contribution planning.

- Individual taxpayers with adjusted gross incomes over $400k, and all estates and trusts, would be able to exclude only 50% of eligible qualified small business stock ("1202 stock") gain, to be effective for all sales after September 13, 2021, with an exception for sales subject to a written, binding contract that was in effect on or before that date.

- The net investment income tax of 3.8% would be expanded to include active business income from S corporations, for taxpayers with MAGI in excess of $500k joint/$400k single, and to trusts and estates, for tax years beginning after December 31, 2021.

Planning Point: Consider accelerating income into 2021 to avoid the surcharge.

- An increase in the state and local tax (SALT) deduction from $10,000 to $80,000 is proposed as part of the House Act, to be effective from 2021 through 2031. *Note: the Senate Finance Committee's version of the Act included no language in regards to the SALT deduction. Instead, a "Placeholder for Compromise on Deduction for State and Local Taxes" was included.*

Planning Point: This is more difficult to plan for, especially given that the Senate Finance Committee's version does not specify an increase in the SALT deduction. Despite this fact, for taxpayers with significant state tax payments due in a given year, consider making some of the Quarter 4 payment in 2021 and the remaining amount in 2022 to maximize the deduction, or consider making all (or none) of the Quarter 4 payment in December of 2021 vs. January of 2022 to maximize the deduction. Note that consideration must be given to the alternative minimum tax (AMT).

- In regards to IRAs:
  - Certain taxpayers with IRA balances in excess of $10 million and income in excess of $450k joint/$400k single would see restrictions in regards to additional IRA contributions and would see increased required minimum distributions.
  - There would be no future Roth conversions of retirement assets for taxpayers over the $450k/$400k threshold amounts, to be effective after December 31, 2031.
  - Backdoor Roth conversions would be eliminated effective after December 31, 2021.

- **Planning Point:** Consider making a backdoor Roth contribution in 2021.

Other tax rules and strategies remain similar to prior years. See the following:

- Mortgage interest is deductible on up to two homes on total qualifying debt up to $750,000. Existing mortgages incurred on or before December 14, 2017 are "grandfathered" under the old tax laws. Mortgage debt that is refinanced is also grandfathered under the old laws to the extent that the resulting debt does not exceed the amount refinanced. Interest expense incurred on home equity debt is now disallowed; however, if the home equity loan is used to buy, build, or substantially improve the taxpayer's home that secures the debt, the interest on the debt is still deductible. (Note: If mortgage proceeds are invested into a business/investment, there may be an ability to deduct the related interest expense against the business/investment income).

- Miscellaneous itemized deductions, such as unreimbursed business expenses, tax return preparation fees, investment advisor fees, etc. remain eliminated.

Planning Point: Employees that incur job-related expenses should consider requesting that their employer reimburse them.

- The medical expense deduction is allowed to the extent medical expenses exceed 7.5% of AGI.

Planning Point: Consider bunching medical deductions in a year to potentially result in a tax benefit.

- Charitable contributions remain deductible, subject to percentage limitations based on adjusted gross income. For 2021, the limitation is 100% of adjusted gross income for cash contributions to most charities (the limitation returns to 60% for 2022).

Planning Point: Consider making a donation of long-term highly appreciated securities to receive the tax deduction at the fair market value and avoid the tax on the capital gains.

Planning Point: Consider making a contribution through a state-sponsored tax credit program such as Pennsylvania's EITC/OSTC programs. These programs essentially redirect Pennsylvania taxes to certain educational/ scholarship organizations.

Planning Point: Consider making a qualified charitable distribution from an IRA. If over age 70 ½, individuals can instruct that up to $100,000 from an IRA be sent directly to a charity. This counts toward the RMD requirement and also excludes the RMD as income. This strategy reduces taxable income while still allowing the same standard deduction.

Planning Point: Consider bunching charitable contributions, perhaps via a contribution to a donor-advised fund, in one year if doing so will increase your total deductions above the standard deduction amount for that year. Careful consideration must be given so that the contribution deduction is taken at higher marginal tax rates to maximize tax savings.

Planning Point: Remember to get contemporaneous acknowledgement letters from the charitable organization for all charitable contributions.

- The overall business loss limitation was suspended for 2018, 2019, and 2020. Beginning in 2021, any overall net amount of loss from trade or business partnerships, S corporations, and sole proprietorships that exceeds the threshold ($524,000 for a joint tax return) amount cannot offset other income sources and must be carried forward to each subsequent year where it will be considered part of the overall business loss in that year.

Planning Point: Any losses that were previously limited on a 2018, 2019, or 2020 tax return can be claimed via the filing of an amended return.

- The deduction for alimony payments made remains eliminated for divorces entered into after December 31, 2018. Alimony received is no longer taxable for divorces entered into after this date as well.

- For 2020, the child tax credit was $2,000. For 2021, the credit is increased to $3,000 for children age 6 through 16, and $3,600 for children age 5 and younger. There is also a $500 nonrefundable credit for qualifying dependents other than children. The MAGI level at which the $2,000/$500 credit amounts are subject to phase-out is $400k for married taxpayers filing jointly. For the increase in credits, the phase-out begins at MAGI of $150k for married taxpayers filing jointly. The increase is for 2021 only; an extension into 2022 is included in the proposed Build Back Better Act.

- Balances in Section 529 plans have historically been available to be used for post-secondary education expenses. Section 529 plans also allow up to $10,000 (per student, per year) to be used for K-12 education. Many states also allow a tax deduction against the state taxable income for contributions to a Section 529 plan.

- The alternative minimum tax (AMT) is retained with higher exemption amounts. In addition, the exemption phase-out range increases to $523,600 for single filers and $1,047,200 for married taxpayers filing jointly. This, together with the significant reduction in the amount of deductible real estate and state and local income taxes and miscellaneous itemized deductions will continue to reduce the number of taxpayers subject to the AMT.

Planning Point: It may be advantageous to recognize additional ordinary income in a year when AMT applies because the AMT rate is often less than the taxpayer's marginal tax rate.

- Some taxpayers may be able to take advantage of a 0% long-term capital gains tax rate. For married taxpayers filing jointly with taxable incomes not exceeding $80,800, there is a 0% rate available for long-term capital gains and qualified dividends. For single taxpayers not subject to kiddie tax rules, the 0% rate is available if taxable income does not exceed $40,400.

Planning Point: Consider gifting appreciated stock to take advantage of tax rate differences. For example, a parent subject to a 20% capital gains tax (plus 3.8% net investment income tax) could gift appreciated stock to his 24-year old graduate student son subject to a 0% capital gains tax rate, so that the son could then sell the stock for a lower tax bill.

- Tax harvesting is the selling of stocks and other investments to generate capital losses that can be utilized to offset capital gains. Also note that tax gain harvesting may be advisable to avoid "hanging" capital losses at the state level, as certain states do not provide for carryovers of unused losses.

- Consider disposing of a passive investment before year end in order to trigger the recognition of other current year or prior year suspended passive losses.

- Taxpayers may be able to receive very favorable tax treatment on the sale of investments if the proceeds are reinvested in business property and/or real estate located in a "Qualified Opportunity Zone" within 180 days.

Planning Point: The Federal QOZ program is intended for projects with long-term hold (greater than 10 years) considerations. The program has limited impact on short holding period projects (under 5 years).

- Employees and business owners should always max out their retirement plan contributions, including any employer matches, as they are able.

BUSINESS TAX

- Proceeds from a forgivable PPP loan are tax-free, and the expenses deducted with PPP loan proceeds are deductible, per the IRS, and in most states. For any state in which these rules do not apply, the additional income should be considered in your planning.

- The 199A (20% qualified business income deduction) for sole proprietorships, certain rentals, and passthrough businesses may reduce your tax bill if applicable.

Planning Point: At the entity level, review compensation structure prior to year-end, and revisit partnership agreement allocations.

Planning Point: If a business is operating as a sole proprietorship or a solely-owned LLC, and is not able to maximize the deduction via the current business structure, consider an S

election with salary compensation to the owner. This may provide the ability to increase the 199A deduction and it also may decrease the Social Security taxes paid by the owner.

Planning Point: At the entity or individual level, consider increasing retirement plan funding levels and other tax strategies for certain business types to fall below 199A income limits.

Planning Point: At the individual level, consider whether aggregation elections are available or beneficial; and if not available, whether factors can be changed to allow for aggregation.

- The deduction for entertainment expenses is still eliminated. In addition, the deduction for certain meals provided to employees is reduced to 50% until 2025, and then eliminated after 2025. However, for 2021 and 2022, meals purchased from a restaurant qualify for a 100% deduction. Team-building expenses such as employee happy hours and holiday parties also qualify for a 100% deduction.

Planning Point: Consider creating separate general ledger accounts to separate the 0%, 50%, and 100% deductible amounts to achieve the maximum tax deduction.

- The immediate expensing (via enhanced "bonus depreciation" rules) is allowed for certain types of assets (tangible personal property, certain nonstructural, nonresidential interior property) placed into service in a trade or business between September 28, 2017 and December 31, 2022. For years beginning after December 31, 2022, the amount of the deduction is decreased from 100% to 80%, then decreases by 20% each year thereafter.

- The Section 179 expensing election is available for nonresidential building improvements such as roofs, HVAC equipment, fire protection and alarm systems, and security systems, as well as for tangible personal property used to furnish lodging, such as residential rental property or a hotel. The maximum value that may be deducted for the Section 179 election is $1,050,000, with a phase-out that begins at $2,620,000 of property placed into service.

- Certain qualified improvement property ("QIP") (nonstructural, interior, nonresidential, placed into service after the building was first placed into service) are now allowed a 15-yr tax life, and qualify for bonus depreciation and 179 expensing. Note that improvements which enlarge a building do not qualify as QIP.

Planning Point: Consider a cost segregation study to split out the cost of the purchase of a building, for example, into assets with shorter depreciable lives.

Planning Point: Consider accelerating income into a year in which there are significant depreciation deductions available.

- There is a $10,000 cap on the total amount of property and state and local income taxes that may be deductible as an itemized deduction at the individual level. To circumvent this cap, certain states have provided a mechanism whereby a business entity such as a partnership or S corporation makes a state income tax payment and is allocated a credit that the partners/shareholders can claim on their state income tax return.

- The maximum allowable deduction of interest expense for certain businesses cannot exceed 30% of the business' EBITDA (earnings before interest, taxes, depreciation, and amortization). Many businesses with average annual gross receipts of less than $26 million are not subject to this limitation. However, an entity that is defined as a "tax shelter" (i.e. more than 35% of losses are allocated to limited partners) is subject to the limitation even if gross receipts do not meet the $26 million threshold.

Planning Point: This 30% limitation can be avoided by an election available to "real property trades or businesses" that by definition are engaged in: leasing, construction, development, acquisition, operation, management, or brokerage of real property. Such an election would necessitate the use of a less favorable depreciation method.

- Many small businesses can use the cash method of accounting, as opposed to the accrual method of accounting. To qualify for the cash method, the taxpayer must have average gross receipts for the preceding three years of less than $26 million. The cash method of accounting may allow taxpayers to defer tax reporting of revenue until the following year by deferring customer payment due dates until the following year and may allow the acceleration of expenses into the current year, such as by paying bills early or prepaying certain expenses.

- In a closely-held business setting, consider employing children to perform work for the business. This shifts income to the child's usually lower tax bracket from the parents, and it provides for an ability for the child to make a Roth IRA contribution. In addition, depending on the business structure, self-employment taxes may be avoided by doing this as well.

- State tax business compliance has become more complex as states are increasingly looking for additional revenues. A recent Supreme Court case paved the way for states to assess sales tax nexus depending on factors such as the dollar value of sales in that state or the number of sales made in that state. This could potentially require out-of-state sellers to collect and remit sales tax in states in which they do not do business or have a physical presence.

- For state income tax purposes, many states have adopted "economic presence" standards, which may require the filing of tax returns in a given state for certain businesses that "direct business activities" into the state, even if the out-of-state seller does not have any physical presence in the state.

Planning Point: Many states offer voluntary disclosure programs where taxpayers can voluntarily reveal themselves. In addition, some states offer amnesty programs that may provide enhanced benefits such as reduced or eliminated penalty waivers assessed on tax amounts due.

- The C corporation rate remains at 21% and the C corporation AMT is still repealed. This may make a C corporation appear more attractive to certain businesses but the "double taxation" of C corporation earnings still applies. In addition, state corporate income taxes may make the C corporation option remain unattractive to businesses in many states, as the C corporation tax rate may be higher than the pass-through rate.

ESTATE AND GIFT TAX

- The basic exemption for federal estate and gift tax purposes is $11.7 million per individual in 2021. (Note that many states have a much lower threshold for filing and/or paying state death taxes). The higher exemption amounts are scheduled to return to the prior (much lower) amounts after December 31, 2025, so it may be advisable to take steps to reduce your estate while the above exemption amounts are available. Assuming the exemption amounts are reduced in the future, IRS regulations grandfather any gifting done under the higher exemption amounts. Both the Federal estate and gift tax exemptions are indexed for inflation.

Planning Point: The annual exclusion amount remains at $15,000 per donor, per donee, in 2021 (and increases to $16,000 in 2022). This may provide an ability to reduce the size of your taxable estate over time.

With the year quickly drawing to a close, there is still time to consider some of the above tax planning ideas. Please reach out to us if you would like to discuss further.

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