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Midyear Tax Planning Letter

To Our Clients and Friends:

The past year has been challenging to say the least. Hopefully the COVID-19 crisis, which affected all of us in some ways, is nearing the end. While it has been difficult to focus attention on much other than the health and safety of our loved ones, tax planning can't take a back seat forever. In addition to normal midyear planning ideas, legislation enacted by both the current and former administrations may provide opportunities to save a little tax and maybe keep a little more money in your pocket. President Biden has released a plan that, if enacted, would result in higher tax rates for both individual and corporate taxpayers. Time will tell, but there is certainly a possibility that that the rates in effect today could increase in the near future. At this time, it's too soon to say what the new rates will be or when they will be effective, if at all. As always, we are monitoring these developments and will alert you as soon as new legislation is signed into law. For now, it's a good time to get a handle on what your 2021 income might look like, so that, if legislation is passed, we will be able to project how it affects you.

Here are some ideas to think about over the summer.

Consider Adjusting Your Tax Withholding or Estimated Payments

No taxpayer likes to be surprised with a large tax bill (or a smaller-than-anticipated refund) come tax filing season. In many cases, this occurs because individuals didn't adjust their tax withholding or estimated payments to account for changes in income. For those accustomed to receiving refunds every year, an unexpected tax bill can be a real hardship. Fortunately, there's still time to make sure the right amount of federal income tax is being withheld from your paycheck for 2021.

IRS Form W-4 is used to tell your employer how much tax to withhold from each paycheck. Many taxpayers simply don't have the correct amount of tax withheld. The IRS has a tool to assist taxpayers in completing Form W-4. If you haven't reviewed your withholding recently, you should consider using the IRS's "Tax Withholding Estimator," available at **www.irs.gov/individuals/tax-withholding-estimator**. You will need your most recent pay stubs (for both spouses if married filing a joint return), details of other sources of income, and a copy of your most recent tax return. However, keep in mind that the calculator isn't perfect. If you want more precise results, we would be happy to put together a 2021 tax projection for you.

If you make estimated tax payments throughout the year (if you're self-employed, for example), we can take a closer look at your tax situation for 2021 to make sure you're not underpaying or overpaying.

Take Advantage of Lower Tax Rates on Investment Income

Income from an investment held for more than one year is generally taxed at preferential capital gains rates. Those rates are 0%, 15%, and 20% for most investments. (Higher-income individuals may be subject to an additional 3.8% net investment income tax.) The rate that applies is determined by your taxable income. For example, the 0% rate applies if your 2021 taxable income doesn't exceed $80,800 (for joint filers), $54,100 (for heads of household), or $40,400 (for other individuals). The 20% rate doesn't kick in until your taxable income exceeds $501,600 (for joint filers), $473,750 (for heads of household), $250,800 (for married filing separate), or $445,850 (for other individuals).

If your taxable income hovers around these threshold amounts, there are ways to reduce your income to take advantage of a lower capital gains rate. For example, you could make deductible IRA contributions or reduce taxable wages by deferring bonuses or contributing to employer retirement plans. If you're over the age of 70½, making contributions to a qualified charity with a direct distribution from your IRA also is a good way to lower income. If you own a business and use the cash method of accounting, you can wait until the end of the year to send out some client invoices. That way, you won't receive payments until early 2022. Also, you can postpone taxable income by accelerating some deductible expenses this year. If possible, you should get your income low enough to qualify for the 0% rate. But, if you are subject to a higher tax rate next year, strategies that defer tax, like delaying billing, can push income into a higher bracket. Hopefully, we will know more before year-end.

If your income is too high to benefit from the 0% rate, consider gifting investments (like appreciated stock or mutual fund shares) to children, grandchildren, or other loved ones. If these individuals will be in the 0% or 15% capital gains tax bracket when they later sell the investments, any gain will be taxed at the lower rates, as long as you and your loved one owned the investments for more than one year. This strategy has two risks, however. First, there are gift tax consequences if you transfer assets worth over $15,000 during 2021 to a single recipient. Second, all children under age 18 and most children age 18 or age 19–23 who are full-time students are subject to the Kiddie Tax rules. Kiddie Tax rates are tied to the parent's tax bracket. The Kiddie Tax limits the opportunity for parents to take advantage of the 0% capital gain rate by gifting appreciated property to their children, including college age children.

Time Investment Gains and Losses

Under the current rules, the 2021 federal income tax rates on long-term capital gains are 0%, 15%, and 20% for most categories of long-term gain. As mentioned earlier, the maximum 20% rate affects singles with 2021 taxable income (including long-term gains) above $445,850, married joint-filing couples with income above $501,600, heads of households with income above $473,750, and married individuals who file separate returns with income above $250,800. Higher-income individuals may also be hit by the 3.8% NIIT, which can result in an effective marginal federal rate of up to 23.8% (20% + 3.8%) on long-term gains. Under President Biden's proposed tax plan, the rate on long-term gains would increase to 39.6% for taxpayers making over $1 million, which when combined with the NIIT, would result in a marginal rate on long-term gains of up to 43.4% (39.6% + 3.8%).

Until we know exactly where the capital gain rates will fall in 2022, the best strategy at the moment is to be prepared. If rates increase, as the President's plan indicates, it might make sense to sell winners before year-end and hold on to losers until January. At this point, it's just too early to make any decisions. However, we should be mindful of what's coming and have a plan in place to time your transactions to result in the best possible outcome.

As you evaluate investments held in your taxable brokerage accounts, be mindful of your holding period. For most taxpayers, the federal income tax rate on long-term capital gains (gains on assets held for over a year) is still much lower than the rate on short-term gains. This will remain true in many cases even if the long-term capital gain rates increase in 2022. Under the proposed plan, only taxpayers making over $1 million will be affected. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling to qualify for the lower long-term capital gain tax rate.

Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year-end can also be a tax-smart idea. Again, we need to wait and see what the capital gain rates will be in 2022. Any capital losses taken before year-end will offset capital gains from other sales this year, including high-taxed short-term gains from securities owned for one year or less. Under the current rules, the maximum rate on short-term gains is 37%, and the 3.8% NIIT may apply too—which can result in an effective marginal rate on short-term gains of up to 40.8% (37% + 3.8%). Future tax legislation could increase the maximum rate on short-term gains, but it could still be significantly higher than the rate on long-term gains for taxpayers making less than $1 million. Whatever happens, you won't have to worry about paying a high rate on short-term gains if they can be sheltered with capital losses.

If capital losses for this year exceed capital gains, you will have a net capital loss for 2021. You can use that net capital loss to shelter up to $3,000 of this year's higher-taxed ordinary income from salaries, bonuses, self-employment, and so forth ($1,500 if you're married and file separately). Any excess net capital loss will be carried forward to 2022.

Selling enough loser securities to create a net capital loss that exceeds what you can use this year might also make sense. You can carry forward the excess capital loss to 2022 and beyond and use it to shelter both higher-taxed short-term gains and long-term gains recognized in those years.

Take Advantage of Expanded Credits for Kids

Signed into law on 3/11/21, The American Rescue Plan Act of 2021 (ARPA) ushered in several provisions that could help save taxes, including the expansion of two familiar credits.

Child Tax Credit. ARPA expands the Child Tax Credit for 2021, making it fully refundable for eligible taxpayers. The credit is increased from a maximum $2,000 per eligible child to $3,000 or $3,600 in 2021 depending on the child's age. Children under 6 qualify for the $3,600 credit while those between 6 and 17 qualify for the $3,000 credit.

The increased credit amounts are subject to phase-out. Married filing joint taxpayers with AGI of $150,000 or less will be able to take advantage of the full amount of the credit, as will heads of household with AGI of $112,500 or less. Single and married filing separate taxpayers will receive the full credit until AGI exceeds $75,000. The credit phases out at a rate of $50 for every $1,000, or portion thereof, that AGI exceeds the threshold.

Not only is the child tax credit refundable for 2021, the IRS will issue advanced payments (50% of the credit) to qualifying taxpayers. Payments are set to be delivered over a six-month period beginning in July 2021 with the balance claimed on your 2021 return. Beware, while eligibility for these advanced payments is based on the income reported on your most recently filed tax return (either 2019 or 2020), your actual eligibility for the credit will be determined when you file your 2021 return. Therefore, if you receive advanced payments and are later determined to be ineligible due to an increase in your income, you will need to repay the advances by increasing your tax liability on your 2021 return. If you anticipate this, please let us know. The IRS is also supposed to establish a method to allow you to let them know about a change in eligibility.

Child and Dependent Care Credit. ARPA also expanded the Child and Dependent Care Credit for 2021 making it fully refundable for eligible taxpayers. For 2021, the amount of expenses that can be considered when computing the credit is increased from $3,000 to $8,000 for taxpayers with one qualifying child or dependent and from $6,000 to $16,000 for taxpayers with 2 or more qualifying individuals. Like the Child Tax Credit, this will also be phased out based on your income. For taxpayers with AGI above $125,000, the percentage is reduced by 1% for each $2,000 increment above $125,000 until AGI reaches $185,000. For taxpayers with AGI between $185,001 and $400,000, the applicable percentage is 20%. The applicable percentage begins to phase out again for taxpayers with AGI above $400,000, dropping 1% for each $2,000 above $400,00. Therefore, the credit is completely phased out when AGI exceeds $440,000.

As you can see, your ability to take advantage of these provisions depends on your 2021 income. If you know that you will be near one of these income phase-out amounts, we should meet to discuss scenarios where deferring income to 2022 or accelerating deductions into 2021 might make sense for you.

Check Your Deduction Strategy

It's generally best to itemize your deductions if you have significant personal expenses. However, don't rule out the standard deduction. For 2021, joint filers can enjoy a standard deduction of $25,100. The standard deduction for heads of household is $18,800, and single taxpayers (including married taxpayers filing separately) can claim a standard deduction of $12,550.

Unfortunately, the TCJA suspended or limited many of the itemized deductions. Although there have been talks of possible legislation that might repeal or relax some of these limitations, to date, no changes are expected for 2021. The most discussed limitation at the moment is the cap on the deduction for State and

Local Taxes (SALT), which is currently $10,000 ($5,000 if married filing separately). Nothing has been passed yet, so the $10,000 limitation continues to apply.

Taxpayers, who have itemized deductions just under (or just over) the standard deduction, should consider bunching state and local taxes into alternating years by paying two years' worth of taxes in a single calendar year. But, the effect of the $10,000 cap must be considered.

In addition to bunching state and local taxes, consider bunching charitable contributions. In addition to merely timing when you make charitable donations, consider donating to donor-advised funds. Also known as *charitable gift funds* or *philanthropic funds*, donor-advised funds allow donors to make a charitable contribution to a specific public charity or community foundation that uses the assets to establish a separate fund. Taxpayers can claim the charitable tax deduction in the year they fund the donor-advised fund and schedule grants over the next two years or other multiyear periods. If you have questions or want more information on donor-advised funds, please give us a call.

On another note, COVID-19 legislation temporarily increased the limit on cash contributions to public charities and certain private foundations from 60% to 100% of adjusted gross income for contributions made in 2021. Note that the donation doesn't have to go to a COVID-19-related cause. So, for taxpayers who itemize deductions, 2021 is a great time to make charitable contributions, especially if the AGI limit would otherwise come into play.

For those who won't itemize in 2021, there is an "above the line" deduction for cash charitable contributions up to $300 ($600 for those married filing joint). For older taxpayers (over age 70½) who won't be able to itemize, but still want to make contributions, a qualified charitable distribution from an IRA is a great way to give to charity.

Planning for Small Businesses

If you own a business, consider the following strategies to minimize your tax bill for 2021.

Employee Retention Credit. The CARES Act created an Employee Retention Credit (ERC) that provides a payroll tax credit for business owners who continue to pay employees during a calendar quarter while their business is fully or partially shut down due to COVID-19 related restrictions or whose business suffers a significant decline in gross receipts. For 2021, the credit is refundable and capped at 70% of qualified wages and certain health insurance coverage up to $10,000 per employee. ARPA extended the credit through the end of 2021. For quarters one and two of 2021, the credit applies to your business' Social Security tax. For quarters three and four of 2021, the credit applies to your business' Medicare tax. The credit is capped at $7,000 per quarter per employee ($28,000 for the year), and is claimed on your quarterly payroll report, Form 941.

If your business participated in the Paycheck Protection Program (PPP) and used the proceeds of your PPP loan to pay eligible costs, you can still claim the ERC. If your PPP loan was forgiven, the wages paid with the proceeds are not qualified wages for the ERC.

As you can imagine, this is a fairly complex area. If you feel like your business may be eligible for the ERC, please reach out to us.

Excess Business Losses. To ease the burden on small business owners, the CARES Act temporarily removed the limit on Excess Business Losses (EBLs) that the TCJA implemented for 2018 through 2020. Beginning in 2021, taxpayers will once again see a possible limit on their ability to deduct business losses from sole proprietorships or pass-through entities, such as partnerships and S corporations, if the combined loss exceeds $262,000 ($524,000 for joint fliers). The excess loss is converted to an NOL and carried forward, subject to the NOL limits. The excess loss is converted to a net operating loss, which is carried forward, subject to limits. Keep this limit in mind when you are projecting your 2021 income for estimated tax payments as well as for determining how any future tax increases (which the President has said will be targeted towardtaxpayers with taxable income over certain amounts) affect you.

Section 179 Expense and Bonus Depreciation. If your business has a need to purchase new or used machinery or equipment prior to year-end, you may be able to expense the entire cost in 2021. Under Section179, taxpayers can elect to expense up to $1,050,000 of qualified purchases, subject to taxable income limitations. Alternatively, your business can take advantage of 100% first-year bonus depreciation. Unlike the Section 179 deduction, claiming 100% bonus depreciation is not limited to taxable income, although the excess business loss limitation discussed earlier could apply. Many factors can affect this decision includingcurrent and future tax rates. With the possibility of higher rates in 2022, the best choice may be to wait until the new year to acquire assets. If you're thinking of acquiring a business property we can help you navigate that decision. Please keep, in mind, we never want tax savings to be the only factor in the decision of when to acquire assets.

Please Contact Us

We hope you found some ideas in this letter that might be useful. If there is anything here that piqued your interest, please let us know. The goal of this letter is to get you thinking about tax planning ideas and potential moves we can make to help maximize cash flow prior to the end of the year. We are continuously monitoring future developments and will do our best to keep you informed of the latest tax law changes. Please don't hesitate to contact us if you want more details about any of the topics discussed or just have questions or concerns.

Best regards,