Special Report:

Year-End Tax Planning for 2021

October 2021

atlas

Contents

Introduction

At the end of 2021, the United States is still recovering from the COVID-19 pandemic and tax professionals are dealing with the multiple changes in the tax rules designed to help the country cope with the economic impact of the disease. These rules should be considered in year-end tax planning, along with other changes in the law and existing provisions that impact end-of-year planning.

As of press time, major tax changes from recent years generally remain in place, including lower income tax rates, larger standard deductions, limited itemized deductions, elimination of personal exemptions, an increased child tax credit, and a lessened alternative minimum tax (AMT) for individuals, a major corporate tax rate reduction and elimination of the corporate AMT, limits on interest deductions, and generous expensing and depreciation rules for businesses. And non-corporate taxpayers with certain income from pass-through entities may still be entitled to a valuable deduction.

However, two tax bills are currently being debated, which will complicate year-end planning. How these will end up is not entirely clear, ATLAS will continue to monitor developments.

Whatever Congress decides to do, the time-tested approach of deferring income and accelerating deductions to minimize taxes will still work for most taxpayers, as will the bunching of expenses into this year or next to avoid restrictions and maximize deductions.

To assist you in developing year-end tax planning strategies for your clients, the ATLAS CPAs tax experts have analyzed current tax rules to identify the unique opportunities and challenges facing taxpayers in the current year. Information has been provided by Thomson Reuters.

This special report discusses the year-end issues faced by individuals, as well as businesses and business owners and provides sample checklists.

Year-End Tax Planning for 2021: Individuals

What's new for individuals in 2021?

Many taxpayers will have switched to working from their home office in 2020 and 2021 due to the COVID-19 pandemic causing employers to rethink the traditional 9-5 in-office work schedule. Tax advisors should work with their clients to determine if expenses connected with the client's at-home workspace are deductible.

The $10,200 unemployment compensation exclusion (which applied for benefits received in 2020) no longer applies for 2021.

Individuals with AGI under a certain amount are eligible for a recovery rebate credit/economic impact payment of $1,400, plus an additional $1,400 for their spouse (if filing a joint return), and $1,400 for each dependent.

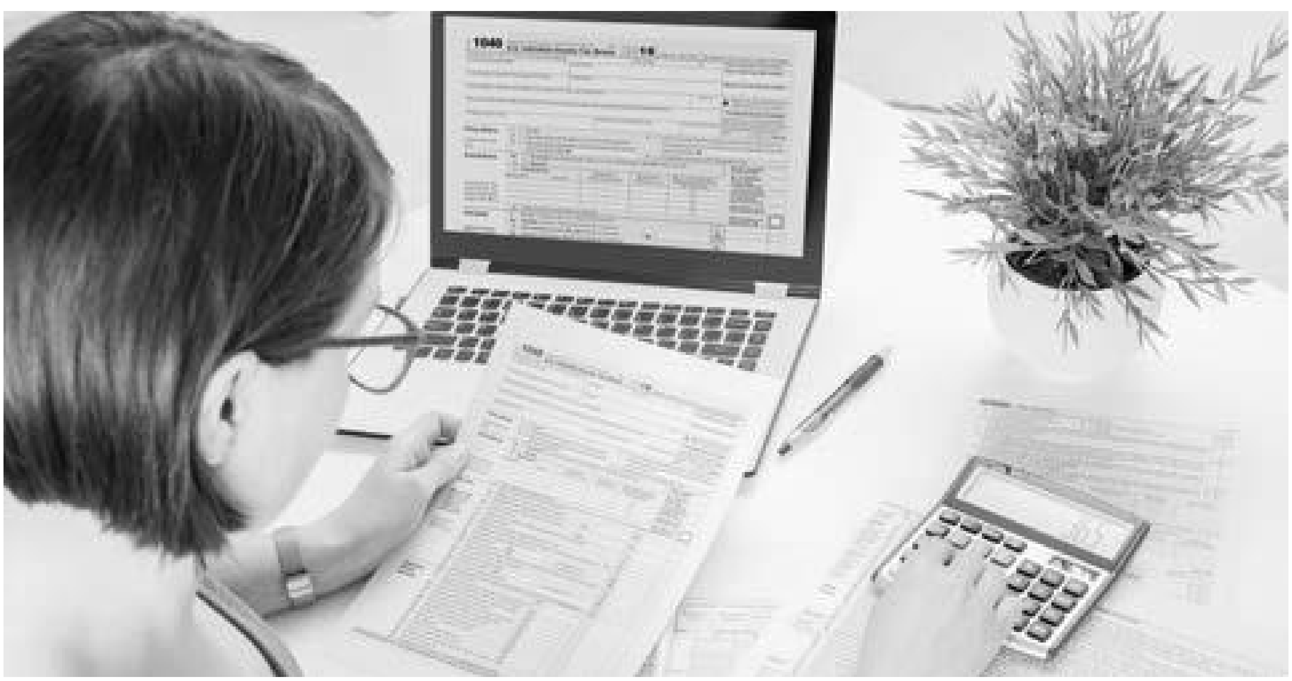
The premium tax credit is increased for the current year and next year. The premium tax credit is further increased for taxpayers who receive unemployment compensation in the current year.

The child and dependent care credit is enhanced and made refundable.

Pending legislation

As of press time, pending legislation is wending its way through Congress. Potential changes under consideration include:

- Increased tax rates on high-income individuals
- An increase in (or elimination of) the $10,000 annual limit on the state and local tax (SALT) deduction
- An increase in the corporate tax rate
- Limitations on the interest expense deduction
- Limits on the orphan drug credit



Filing status and dependents

When recommending year-end tax planning strategies, review the taxpayer's expected filing status this year and next and the number of dependents the taxpayer expects to claim in each year.

What's new?

The child tax credit (CTC) has changed as follows:

- The CTC is increased to $3,000 per child ($3,600 for children under 6 as of the close of the year), from $2,000.
- The increased amounts ($1,000/$1,600) are phased out at modified AGI of over $75,000 for singles, $112,500 for heads-of-households, and $150,000 for joint filers and surviving spouses, at a rate of $50 for each $1,000 (or fraction thereof) of modified AGI over the applicable threshold. This phase-out does not apply to the first $2,000 of the CTC, only the increased amounts. But the first $2,000 is still subject to the older phase-out rules.
- The age limit on a qualifying child is increased to include a child who has not turned 18 by the end of the year.
- IRS has been making temporary advance payments to taxpayers totaling 50% of the taxpayer's CTC on a monthly basis since July.

Filing status

A taxpayer's marital status for the entire year is determined as of December 31. A taxpayer who is married (or divorced) as of the end of the year is treated as if they were married (or single) all year long. Taxpayers who are separated or divorcing need to consider tax implications of property settlements, alimony, child support, retirement plan allocations, and other related items.

Properly timing when the change in marital status occurs can save taxes. If married filing joint or married filing separate status will result in more total tax than if each spouse files a separate return using single (or head of household) filing status, ending the marriage prior to year-end could result in tax savings. In contrast, if married status results in lower tax liability, delaying the divorce or legal separation until the beginning of next year might be advisable. Note that this may not apply in a community property state and other liability concerns related to joint filing may outweigh the potential tax benefit.

If two high-income taxpayers are planning to wed, advise on the effect of a potential marriage penalty. A "marriage penalty" exists whenever the tax on a couple's joint return is more than the combined taxes each spouse would pay if they weren't married and each filed a single return. The marriage penalty effect can apply to joint filers whose income falls into the 35% bracket. Even for taxpayers below the 35% bracket, a marriage penalty can nevertheless kick in through the tax treatment of

Recommendation: In joint custody situations, taxpayers planning to claim head of household status should maintain records of the amount of time a child spends in each household.

other items including:

- Student loan interest deduction
- Net investment income tax (NIIT)
- Deductible contributions to traditional IRAs by taxpayers who are active participants in an employer-sponsored retirement plan
- Child tax credit and additional child tax credit
- State and local tax deduction
- Qualified business income (pass-through) deduction
- Additional 0.9% Medicare tax
- Taxable amount of social security
- Related party and constructive ownership rules

A taxpayer who currently qualifies for head of household tax status may benefit from pulling more income into this year if changed circumstances (such as getting married) will end their head of household status next year. Accelerating income may also benefit certain widows or widowers whose spouses died in 2020 and who are entitled to use joint return rates in 2021, but not in 2022.

Dependents

Although the deduction for dependency exemptions is $0 for 2018–2025, certain tax deductions and credits (including the child tax credit for qualifying children under 18) are available with respect to the taxpayer's dependent. A dependent is defined as either a qualifying child or a qualifying relative.

To be a qualifying child, an individual must be under 19 at the end of the year or a full-time student who is under 24 (the age test).

For dependents that need to meet a residence, support, or income test, review whether these tests are likely to be met before year-end.

Increasing and decreasing AGI

For individuals, year-end tax planning commonly involves methods for increasing and decreasing AGI. Generally, taxpayers will aim to decrease AGI to reduce their overall tax liability. But, there are some instances when it will make sense for the taxpayer to increase AGI in a particular tax year.

Legislation now pending before Congress may raise tax rates on high-income taxpayers beginning in 2022. If that happens, it may make sense for those taxpayers to pull income into 2021 and defer deductions to 2022.

Caution: Any decision to accelerate income from a later year into an earlier one should take into account the time value of money.

What's new?

The carryover period for unused amounts in a health flexible spending arrangement (health FSA) is expanded as follows:

- For plan years ending in 2021, FSAs may allow participants to carry over any unused benefits or contributions to 2022.
- Plans may extend the grace period for a plan year ending in 2021 to 12 months after the end of the plan year, with respect to unused benefits or contributions remaining in a health FSA or dependent care FSA.
- FSAs may allow an employee who ceases participation in the plan during calendar year 2021 to continue to receive reimbursements from unused benefits or contributions through the end of the plan year in which the participation ceased.

There is a special carry forward rule for dependent care FSAs

Who should increase AGI?

A taxpayer who expects to be taxed at a higher rate next year should explore strategies to increase AGI this year by accelerating the recognition of income. An individual taxpayer might be in a higher tax bracket next year if:

- The taxpayer is graduating from school or a training program and moving into the paid workforce.
- Head-of-household or surviving spouse status ends after this year.
- The taxpayer plans to get married next year and will be subject to a marriage penalty.
- The taxpayer expects to be eligible for one or more credits next year (e.g., the child tax credit) that is subject to phaseout when AGI reaches specified limits and is otherwise not eligible for the credit this year.
- The taxpayer was unemployed for part or all of 2021 because of the COVID-19 pandemic but has found or expects to find a new job.

Who should decrease AGI?

A taxpayer who expects to be subject to the same or a lower tax rate next year should consider deferring income recognition. A taxpayer might be in a lower tax bracket next year if:

- The taxpayer becomes eligible for head-of-household status next year.
- The taxpayer expects to have a lower income next year due to retirement, job change, or other circumstances.
- The taxpayer is currently a child who will escape the kiddie tax next year and be in a lower bracket than their parents.

Observation: Child tax credits phase out in $50 increments meaning that, for some taxpayers, a $1 increase in AGI can trigger a $50 reduction in the credit.

Caution: The savings bond election can't be reversed without IRS consent. The taxpayer must, in all future years, pay tax annually on interest as it accrues, and not in the year the bonds mature or are redeemed.

Numerous tax benefits phase out at specified AGI thresholds. As year-end nears, taxpayers who otherwise qualify for a tax benefit should consider strategies to reduce AGI this year to keep their income level below the relevant phaseout threshold. Some tax benefits that are limited by AGI (or modified AGI) include:

- Nondeductible Roth IRA contributions
- Deductible traditional IRA contributions
- Child tax credits
- Qualified adoption expenses
- Student loan interest deductions
- Maximum amount of nonpassive income that can be used to offset passive losses from an active participation rental real estate activity

How to increase or decrease AGI before year-end

Taxpayers may be able to accelerate recognition of income by:

- *Accelerating installment sale gain.* A taxpayer who has unrealized profit on obligations arising out of installment sales made in prior years could sell part or all of the obligations or negotiate with the buyer for accelerated payments.
- *Recognizing savings bond interest.* A taxpayer can redeem U.S. Saving Bonds, or, for unmatured Series EE or I bonds, elect to report interest each year as it accrues. That way, all the income accrued through the end of this year (including interest that accrued in earlier years) is taxed in 2021.

Taxpayers may be able to reduce or defer recognition of income by:

- *Recognizing capital losses*. Taxpayers with unrecognized capital losses should consider recognizing those losses this year to offset capital gains that would otherwise be subject to the 15% or 20% capital gains tax rate. Capital losses can also offset up to $3,000 ($1,500 in the case of a married taxpayer filing a separate return) of ordinary income if capital losses exceed capital gains by at least that amount. Recognizing capital losses to offset capital gains can also reduce the amount of income subject to the net investment income surtax.
- *Increasing contributions to 401(k) plans, SIMPLE pension plans, Keogh plans.* Some individuals may be able to reduce AGI by increasing contributions to retirement plans such as 401(k) plans, SIMPLE pension plans, and Keogh plans.
- *Making IRA contributions.*Taxpayers have until the tax return filing deadline next April to make IRA contributions for 2021. Unlike Keogh plans, which must be in existence by year-end, IRAs can be set up when the contribution is made next year. Taxpayers might want to make IRA contributions earlier rather than later to maximize tax-deferred income on the contributed amount. Eligible taxpayers can also deduct contributions to Traditional IRAs, subject to limitations.

- *Increasing contributions to a health savings account (HSA) or health FSA.* Individuals who are covered by a qualifying high deductible health plan (and are generally not covered by any other health plan that is not a qualifying high deductible health plan) may make deductible contributions to an HSA, subject to certain limits. Becoming HSA-eligible before year-end can salvage an HSA contribution made earlier in the year.
- *Deferring debt cancellation events*. If a taxpayer is planning to make a deal with creditors involving debt reduction; reacquire outstanding obligations for less than face amount; or planning some other debt reduction transaction that may result in the recognition of taxable income, postponing action until January can defer recognition of cancellation of indebtedness (COD) income.

Caution: When determining whether to defer debt cancellation, consider whether the taxpayer might be eligible to exclude COD income under an exception in Code Section 108 for insolvency, bankruptcy, certain student loans, and other circumstances.

Capital gains and losses

The appropriate year-end planning strategy for capital gains and losses depends on many factors including an individual's taxable income, tax rate, amount of adjusted net capital gain, and whether the individual has unrealized capital losses. For high-income taxpayers, planning must also take into account the 3.8% net investment income tax (NIIT).

What's new?

Under proposed legislation, top capital gains tax rates would increase from 20% to 25%. The rate increase would apply for purposes of both the regular tax and the AMT.

When to recognize gains and losses

As year-end approaches, the taxpayer's income, gains, and losses for the year become more certain. This provides strategic planning opportunities. Many of these strategies also apply to reducing the impact of the NIIT.

Recognizing long-term capital gains may be beneficial if the taxpayer will be subject to a higher rate in the future. For taxpayers with taxable income below the zero-rate threshold amount, consider recognizing long-term gains up to the threshold amount.

Caution: Watch out for the wash sale rules if the replacement bond is purchased within 30 days of the sale of the old bond and the bonds are substantially identical.

Avoid recognizing long-term capital losses if taxable income from long-term capital gains and other sources will be below the zero-rate threshold amount, or if the taxpayer will be subject to a higher rate next year. However, taxpayers who have no capital gains should consider recognizing capital losses up to $3,000 ($1,500 in the case of a married taxpayer filing a separate return), which can be used to offset ordinary income.

Taxpayers holding municipal bonds that have decreased in value may benefit from a bond swap. This enables a taxpayer to recognize a loss for the decline in a bond's value while maintaining the cash flow generated by the bond. A bond swap is especially beneficial if the taxpayer has short-term capital gains that can be offset by the bond's capital loss, or the taxpayer's overall net capital loss after the bond disposition is $3,000/$1,500 or less (which the taxpayer can offset with other ordinary income).

Taxpayers can use the installment method to defer gain recognition on the sale of eligible assets. Under an installment sale, gain is recognized in the year payments are received. A like-kind exchange can also be used to defer gain on eligible exchange property.

Taxpayers should consider donating appreciated securities to an exempt organization instead of selling the securities and donating cash to the organization. That way, the gains will not be included on the donor's return.

Selling a principal residence? Strategic timing can yield tax benefits. A taxpayer who sells property used as a principal residence for at least two of the five years before the sale may exclude up to $500,000 in gain if married and filing a joint return. Taxpayers with another filing status (single, head-of-household and married filing separately) may exclude up to $250,000. A surviving spouse can qualify for the higher $500,000 exclusion if the sale occurs not later than 2 years after the decedent spouse's death, if the requirements for the $500,000 exclusion were met immediately before death, and the survivor did not remarry before the sale.

Observation: The wash sale rule applies only when stock or securities are sold at a loss. As a result, a taxpayer can recognize a gain on the sale of stock or securities in 2021 and then buy the substantially identical stock or securities back immediately without having to worry about the wash sale rule.

Wash sales

The "wash sale" rule prevents a taxpayer from recognizing a loss on disposition of stock or securities when substantially identical stock or securities are bought and sold within a 61-day period (30 days before or 30 days after the date of sale). Thus, a taxpayer can't sell the stock or securities to establish a tax loss and simply buy it back the next day. The wash sale rule also applies if the taxpayer acquires an option to buy substantially identical stock or securities or if the taxpayer acquires substantially identical stock via their IRA. However, it is possible to partially preserve an investment position while realizing a tax loss by using one of these techniques:

- Double up. Buy more of the same stock or securities, then sell the original holding at least 31 days later. The risk here is of further downward price movement.
- Wait. Sell the original holding and then buy the same stock or securities at least 31 days later.
- Shift investments. Sell the original holding and buy similar securities in different companies in the same line of business. In the case of mutual fund shares, sell the original holding and buy shares in another mutual fund that uses a similar investment strategy. A similar strategy can be used with Exchange Traded Funds.

Constructive sales

Under the constructive sale rules, an appreciated financial position in stock is treated as sold, causing the taxpayer to recognize gain if the shareholder enters into a short sale of the same or substantially identical property, or enters into an offsetting notional principal contract, a put option, or similar transaction. The constructive sale causes the shareholder to recognize gain as if the appreciated shares were sold at fair market value on the date of the short sale or other similar transaction.

Under an exception to the constructive sale rules, however, gain may still be deferred with a short sale against the box, or other similar transaction, if (1) the transaction is closed before the 31st day after the close of the tax year; (2) the taxpayer holds the appreciated stock throughout the 60-day period beginning on the date the transaction is closed; and (3) at no time during that 60-day period is the taxpayer's risk of loss on the appreciated stock reduced by an option to sell, a short sale, or other similar position with respect to substantially identical stock.

Short sellers who want to defer a year-end gain on a short position to the beginning of the following year should wait until after year end to begin to cover their short position. Those that want to take a year-end gain on a short position, for example to be able to use a recognized loss, can do so as late as the last trading day of the year by purchasing the stock that will be used to close the short position.

Caution: While maximizing current Code Sec. 1231 losses may produce a currently deductible ordinary loss, it also may cause future Code Sec. 1231 gains to be taxed as ordinary income rather than capital gain. Net Code Sec. 1231 gains are treated as ordinary to the extent of net Code Sec. 1231 losses for the previous five tax years that haven't been offset by Code Sec. 1231 gains in an intervening tax year.

Installment sales

An installment sale can be an effective technique for closing certain transactions this year while deferring a substantial part of the tax on the sale to later years.

Consider using the installment sale method when selling Code Sec. 1231 property if the taxpayer has already recognized losses from sales of other Code Sec. 1231 property and would otherwise recognize a net Code Sec. 1231 loss this year. A net Code Sec. 1231 loss is treated as an ordinary loss that offsets ordinary income and is not subject to capital loss limits. Taxpayers have until the due date of their return (including extensions) to decide whether to elect out of installment reporting.

Many types of transactions are not eligible for the installment sale method including sales at a loss, sales of stock or securities traded on an established securities market, and gain that's recapturable under Code Sec. 1245.

Dealers in property generally are barred from reporting current sales or dispositions under the installment method. However, dealers may use the installment method on sales of farm property, and on certain sales of timeshares and residential lots, if the seller elects to pay interest on the tax deferred by installment reporting.

Passive activity limitations

Losses generated by passive activities may only be used to offset passive activity income. Passive activity credits may be used only to offset tax on income from passive activities, with a carryover of any unused credits. In addition, the 3.8% NIIT applies to income from passive activities, but not from income generated by an activity in which the taxpayer is a material participant. Taxpayers can employ several year-end strategies for managing passive activity limitations.

Increase participation in the activity before year-end to satisfy the material participation test. A taxpayer can satisfy the material participation test by participating in an activity more than 500 hours during the tax year, participating more than 100 hours if no one else does more, or participating more than 500 hours in all the taxpayer's "significant participation activities."

Illustration: Javier owns interests in a restaurant, a shoe store, and an orange grove. Each of these ventures has several full-time employees. As of October 31, Javier has worked 200 hours in the restaurant, 200 hours in the shoe store, and 75 hours in the orange grove. If, by the end of the year, he puts in another 26 hours in the orange grove, he will have participated more than 500 hours in all his significant participation activities and the material participation standard will be satisfied.

To facilitate the preceding strategy, consider taking advantage of the one-time opportunity to regroup activities for the purpose of applying the passive activity rules.

Consider sale of the passive activity. If a taxpayer disposes of their entire interest in the activity in a fully taxable transaction, then any loss from the activity for the tax year of disposition (including losses carried over from earlier years), over any net income or gain for the tax year from all other passive activities (including carryover losses from earlier years), is treated as a non-passive loss. However, suspended passive activity credits are not freed up when the activity that generated them is sold, but the taxpayer may elect to increase the property's basis by the amount of the unused credits.

Caution: If a passive activity is disposed of by means of an installment sale, suspended losses will become available for use in offsetting nonpassive income only as the buyer makes payments and in proportion to the amount of gain recognized with respect to these payments. To avoid this result, elect out of the installment method.

Real estate professionals can deduct some rental realty losses. For eligible taxpayers, losses and credits from rental real estate activities in which the taxpayer materially participates are not treated as passive and can be used to offset nonpassive activity income.

If possible, becoming more active in rental and business activities (including those conducted through partnerships and S corporations) will convert these activities from passive to nonpassive by meeting one of the material participation standards.

Caution: The non-itemizer charitable deduction that applied for the 2020 tax year was an above-the-line deduction. The deduction for 2021 is deducted from AGI in arriving at taxable income.

Standard and itemized deductions

By acting now, before December 31, taxpayers can maximize opportunities to reduce taxable income, whether itemizing deductions or claiming the standard deduction.

What's new?

- The lowered medical expense floor of 7.5% is made permanent.
- Temporary suspension of the AGI percentage limitations for charitable contribution deductions was extended for the 2021 tax year for contributions made by December 31, 2021.
- The temporary charitable contribution deduction for non-itemizers was extended through December 31, 2021, with modifications.
- Deductible out-of-pocket educator classroom expenses now include those for personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of COVID-19.

Non-itemized deduction: charitable contributions

For 2021, an individual who doesn't itemize deductions for the tax year is entitled to deduct eligible charitable contributions up to $300 ($600 for a joint return). Eligible contributions must be in cash, and be made to a public charity, and not be made to a Code Sec. 509(a)(3) supporting organization or to establish or maintain a donor advised fund.

Above-the-line deductions: educator expenses

Eligible educators can deduct up to $250 of unreimbursed qualified expenses. Eligible educators are K-12 teachers, instructors, counselors, principals, or aides who worked at least 900 hours during a school year in a school providing elementary or secondary education. If both taxpayers on a joint return are eligible educators, each can deduct up to $250 of qualified expenses, for a maximum deduction of $500.

Eligible purchases include items such as books, supplies (athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services), other equipment and supplementary materials used in the classroom, and personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of COVID-19. Supplies purchased to facilitate online instruction are also eligible. Professional development expenses qualify for the deduction when they're related to either the curriculum in which the teacher provides instruction or the students for whom they provide instruction.

Above-the-line deductions: health savings accounts

Individuals or employees who were covered by a high-deductible health plan at any time during the year and make contributions to an HSA may be eligible for an above-the-line deduction. For 2021, the maximum deduction for an eligible individual with self-only coverage under an HDHP is $3,600. For an individual with family coverage under an HDHP, the limit is $7,200. Individuals who are age 55 or older can make catch-up contributions in addition to their regular contributions for the year. The annual catch-up contribution limit is $1,000.

Becoming eligible in December can salvage a contribution for the entire year. For computing the annual HSA contribution, taxpayers who are eligible individuals in the last month of the tax year are "deemed eligible" during every month of that year. Thus, they can make contributions for months before they were enrolled in an HDHP.

Taxpayers may make contributions at any time before the contribution deadline, which is the due date (without extensions) for filing the individual's return for the year of the contribution.

Caution: A taxpayer who contributes to an HSA under the "deemed eligible" rule must remain eligible during the entire testing period (a 12-month period beginning with the last month of the tax year). Otherwise, any contributions made during a month when the taxpayer was "deemed eligible" are includible in gross income and subject to a 10% penalty tax.

Observation: A distribution that is not used to pay qualified medical expenses is includable in the gross income of the account holder. In addition, such a distribution generally is subject to an additional 20% tax. However, the 20% penalty tax does not apply to distributions made on account of death or disability or after the account holder reaches age 65. HSA contributions can also be used to pay for qualified expenses of a spouse or dependent who is not covered by the HDHP.

Itemized deductions: charitable contributions

Individuals may deduct contributions to charitable organizations up to a certain percent of their "contribution base" (generally, AGI). For 2021, as in 2020, qualified contributions are disregarded in applying this percentage limitation. Thus, an individual can potentially make and deduct eligible contributions sufficient to offset 100% of AGI.

For year-end planning, it's beneficial to review whether an individual has charitable contribution carryovers from a prior year. If income will decline, care should be taken to use the carryovers before they expire.

Caution: Contributions to Code Section 509(a)(3) organizations (supporting organizations), donor advised funds, or split interest trusts do not qualify for this temporary suspension of the percentage limitation.can also be used to pay for qualified expenses of a spouse or dependent who is not covered by the HDHP.

An individual with low basis, highly appreciated stock may want to consider funding a charitable remainder trust with the stock. The trust can sell the stock without incurring any income tax and make distributions over time to the current individual beneficiary (or beneficiaries) that will be taxed at the then-current rates in the years of distribution. The donor can also claim a charitable deduction in the year the trust is funded, equal to the value of the charitable remainder interest, subject to limitations.

Itemized deductions: medical expenses

A taxpayer can deduct medical expenses only to the extent the expenses exceed 7.5% of AGI. When the taxpayer expects to have expenses this year and next, it's important to determine whether bunching the expenses into either 2021 or 2022 can help ensure the taxpayer exceeds the deduction threshold in at least one of the two tax years. Similarly, for a taxpayer who expects to itemize deductions in either 2021 or 2022, but not both years, bunching expenses into the itemizing year can achieve tax savings.

A taxpayer might accelerate expenses by buying new prescription eye wear now and/or having orthodontic work done before the end of the year instead of putting it off until January or paying any unpaid medical or dental bills before the end of the year. A taxpayer generally can't deduct payments made this year for services that will be performed next year or later. However, special exceptions apply for (1) certain entrance fees to life care facilities allocable to medical care and paid in connection with obtaining lifetime care, and (2) certain medical insurance premiums paid by a taxpayer who is under 65 during the tax year for insurance covering medical care for the taxpayer, spouse, or dependent after the taxpayer reaches 65.

Observation: One way to maximize the benefit of deductions is "bunching" – deferring or accelerating deductions into a single tax year in order to exceed the standard deduction or other thresholds. Bunching can be especially beneficial for taxpayers subject to the alternative minimum tax (AMT). A taxpayer who is subject to the AMT gets no benefit from the standard deduction.

Observation: Careful timing of year-end payments remitted by credit card or check can yield tax savings. Eligible medical expenses remitted by credit card before the end of the year are deductible on this year's return, even if the taxpayer isn't billed for the charge until January. If a taxpayer pays by check dated and postmarked no later than December 31, it will count as a payment incurred this year even if the payee doesn't deposit the check until January 1 or later (assuming that the check is honored when first presented for payment).

Recommendation: To ensure that medical expenses paid for dependents will be allowed, the taxpayer should be prepared to prove the amount of support provided. Advising clients on best practices for documenting expenses and support will ensure a smoother tax season and fewer hassles down the road.

Illustration: Gabi contributed more than half of her mother's support during the tax year. She anticipates that her own medical expenses will exceed 7.5% of her AGI, and that she will be able to itemize her deductions. In December, her mother incurs substantial medical expenses. If Gabi's mother will not receive any tax benefit from these expenses, Gabi should consider paying the medical bills directly before year end. Gabi can then add these expenses to her own medical expenses when calculating the deduction on her return.

Observation: Generally, deductions for state and local business taxes are not subject to the limit – that is, taxes deducted on an individual's Schedule C (Profit or Loss from Business); Schedule E (Supplemental Income and Loss); or Schedule F (Profit or Loss from Farming) (i.e., paid or accrued in carrying on a trade or business or in connection with the production of income). However, property taxes included in a home office deduction are subject to the SALT cap.

Taxpayers can deduct the medical expenses paid for medical dependents, subject to the overall AGI floor. The test for determining whether an individual qualifies as a dependent for medical deduction purposes is less stringent than that used to determine whether an individual is a dependent for other tax purposes.

The taxpayer can deduct medical expenses paid for a medical dependent even if the dependent received gross income of $4,300 or more, filed a joint return, or if the taxpayer (or spouse if filing jointly) could be claimed as a dependent on someone else's return.

Itemized deductions: state and local taxes

Taxpayers who itemize their deductions can deduct certain taxes paid to state and local governments. However, through 2025, the Tax Cuts and Jobs Act limits the state and local tax (SALT) deduction to $10,000 ($5,000 for marrieds filing separately). The SALT deduction cap applies to the aggregate deduction for nonbusiness state and local taxes including real and personal property taxes, income taxes, and (by election) general sales taxes.

Taxpayers with fluctuating income should try bunching their SALT payments, itemizing their deductions in one year and taking the standard deduction in the next. For this strategy to work, however, the tax must have been assessed before the payment is made (as determined by the state or local jurisdiction). Taxpayers can elect to deduct sales and use tax in lieu of income taxes. Accelerating the purchase of a big-ticket item into this year is a good way to achieve a higher itemized deduction for sales taxes.

Caution: If educational expenses that were paid and deducted in 2020 are refunded in 2021, be mindful of the tax benefit rule – the taxpayer may need to include the benefit amount in income this year, even if the student is no longer the taxpayer's dependent.

Education

Taxpayers who are paying or saving for their own or their dependents' education have several opportunities to maximize education-related tax benefits before year-end.

What's new?

- For tax years 2021-2025, discharges of many public and private student loans are excluded from gross income.
- The above-the-line deduction for qualified tuition and related expenses was repealed
- Qualified emergency financial aid grants under the CARES Act are excluded from the gross income of college and university students.
- The different phaseout rules for the American Opportunity Tax Credit (AOTC) and the Lifetime Learning Credit are replaced with a single phaseout.

AOTC or Lifetime Learning Credit

There are two credits that taxpayers can claim to offset the cost of education: the AOTC and the Lifetime Learning Credit. Both credits phase out for higher-income taxpayers.

AOTC is a credit for qualified education expenses paid for an eligible student for the first four years of higher education. The maximum annual AOTC is $2,500 per eligible student and it is refundable up to $1,000.

The Lifetime Learning Credit is a credit up to $2000 per return for qualified tuition and related expenses paid for eligible students enrolled in an eligible educational institution. This includes undergraduate, graduate, and professional degree courses, and courses to acquire or improve job skills. There is no limit on the number of years a taxpayer can claim this credit.

Taxpayers can claim credits for eligible expenses paid for education that begins this year or during the first three months of next year. A taxpayer who hasn't already maximized education credits for the student this year should consider making the spring tuition payment before year-end.

Student loan interest deduction

Interest paid on a qualified student loan is deductible up to $2500 per return, except for married taxpayers filing separate returns, for whom it is denied. This deduction phases out at higher income levels. Taxpayers who might fall within the phase out range for the student loan interest deduction this year should try to shift income to next year so that their current-year income falls below the phase-out threshold.

Student loan interest deductions might be lower this year for some taxpayers due to COVID-19 relief that reduced the interest on certain student loans to 0% and suspended certain student loan payments. Taxpayers should consider whether making additional student loan payments before December 31 will enable them to fully utilize the student loan interest deduction.

The allocation of payments between principal and interest for purposes of the deduction may not match the allocation stated on Form 1098-E from the lender or loan servicer. A taxpayer may be able to claim a deduction for payments allocated to principal by the lender to the extent the payments represent unpaid capitalized interest. For tax purposes, a payment generally applies first to stated interest that remains unpaid as of the date the payment is due, second to any loan origination fees allocable to the payment, third to any capitalized interest that remains unpaid as of the date the payment is due, and fourth to the outstanding principal.

Savings bonds

If certain requirements are met, an individual who redeems Series EE bonds issued after 1989 or Series I bonds may exclude all or part of the interest income on those bonds that would otherwise be taxable, to the extent used to pay the cost of attending college, vocational school, or other post-secondary educational institution (for the individual, a spouse, or a dependent). The exclusion phases out above a specified income threshold.

Caution: The exclusion applies only to bonds issued after the individual has reached age 24. A bond bought by a parent and issued in the name of their child under age 24 does not qualify for the exclusion by the parent or child.

As year-end approaches, consider paying next year's costs in advance if the costs paid during the year are less than the savings bond redemption proceeds during the year. For taxpayers planning to contribute to a 529 plan this year, consider redeeming bonds up to the contemplated contribution amount.

For clients planning to buy bonds as a year-end gift, consider feasibility of gifting cash to the parent of the child to enable the parent to buy the bonds in the parent's name. That way, if the bonds are redeemed to pay for the child's education, the exclusion may be available depending on the parents' income situation at redemption time.

Observation: Although the Code doesn't limit annual contributions to 529 plans, each state has aggregate limits per beneficiary.

Coverdell and 529 Plans

A 529 plan, also known as a qualified tuition plan, is a tax-advantaged savings plan designed to encourage saving for education costs. 529 plans are sponsored by states, state agencies, or educational institutions and contributions to such plans are considered completed gifts for federal gift tax purposes.

529 plans enable participants to prepay tuition costs for a particular beneficiary or contribute to an education savings account established to pay a beneficiary's elementary and secondary tuition and higher education expenses, certain apprenticeship programs, and up to $10,000 of student loan debt.

Taxpayers may also contribute up to $2,000 annually to a tax-exempt Coverdell Education Savings Account (Coverdell ESA) for an individual under age 18 (and special needs beneficiaries of any age). The maximum contribution is reduced ratably for modified AGI between $190,000 and $220,000 for joint filers, and between $95,000 and $110,000 for others.

Disaster losses

Observation: A non-casualty loss may be a disaster loss if incurred in the course of a trade or business or profit-seeking transaction.

Observation: The COVID-19 pandemic is a federally declared disaster.

Taxpayers with disaster losses in the current tax year need to determine whether to take them on this year's return or elect to deduct them in the immediately preceding year.

What's new?

Federally declared disasters for 2021 include the COVID-19 pandemic (continuing from 2020), Tropical Storm Elsa, Hurricane Ida, and several other storms.

Federally declared disasters

For 2018-2025, individuals are not allowed to deduct personal casualty losses unless they are attributable to a federally declared disaster. A taxpayer may elect to deduct a disaster loss in the tax year before the year the loss occurred, instead of in the year the loss occurred (the "preceding year disaster loss deduction"). A disaster loss is a loss that occurs in a disaster area and is attributable to a federally declared disaster.

Deducting disaster losses in the prior year

Net disaster losses of individuals are allowed as an addition to the standard deduction, subject to the $500 per-casualty floor, but exempt from the 10%-of-AGI limitation.

An election to deduct a disaster loss for the year before the year in which the loss occurs is made on an original return or an amended return for the preceding year. The original return or amended return must be filed on or before six months after the original due date for the taxpayer's return for the disaster year. So, a calendar-year taxpayer who suffers a disaster loss in 2021 has until October 17, 2022 (because October 15 is a Saturday), to file an original or amended 2020 return to deduct the loss for 2020.

Earned income tax credit

The earned income tax credit (EITC) is determined based on a taxpayer's earned income from wages and other sources.

What's new?

- In determining their EITC for 2021, taxpayers may elect to substitute their earned income for 2019 if that 2019 amount is greater than the earned income for the taxpayer's earned income for 2021.
- The maximum age for the EITC is eliminated for this year.
- The disqualified income threshold is raised from $3,650 to $10,000.
- A qualifying child is taken account for the EITC credit even if the taxpayer does not meet the identification requirements with respect to the qualifying child.
- The EITC is expanded for taxpayers with no qualifying children. For this year, for taxpayers with no qualifying children:
  - The 7.65% credit percentage and phaseout percentage is increased to 15.3%.
  - The $4,220 earned income amount is increased to $9,820.
  - The $5,280 phaseout amount is increased to $11,610. (The $5,000 increase for married taxpayers filing a joint return stays the same, so the phaseout amount this year for joint filers is $16,610.)

- The EITC rules under which certain separated married people do not need to file jointly have been relaxed. An individual will not be treated as married if the following apply:
  - The individual is married (as defined in Code Sec. 7703(a));
  - The individual does not file a joint return for the tax year;
  - The individual lives with their qualifying child for more than half of the tax year; and
  - Either (1) during the last six months of the year, the individual does not have the same principal place of abode as their spouse, or (2) the individual has a written separation agreement or a decree requiring one spouse to make payments for the support or maintenance of the other spouse.

Maximum EITC amount

An eligible individual is allowed an EITC equal to the credit percentage of earned income (up to an "earned income amount") for the tax year, subject to a phaseout. The maximum EITC for 2021 is $1,502 (for taxpayers with no qualifying children), $3,618 (one qualifying child), $5,980 (two qualifying children), and $6,728 (three or more qualifying children).

Disqualified income

A taxpayer may earn up to $10,000 of disqualified income in 2021 and still qualify for the EITC. Disqualified income is, essentially, investment income along with rents and royalties not derived from a trade or business, and includes:

- interest or dividends included in gross income;
- tax-exempt interest;
- net income from nonbusiness rents or royalties;
- capital gain net income for the year (but not Code Sec. 1231 gains); and
- net income from passive activities

Taxpayers who believe they could have greater than $10,000 of disqualified income in 2021 should attempt to reduce or postpone receiving payments until 2022.

Alternatively, taxpayers may try to postpone items of disqualified income until 2022. However, they should be careful that their strategy is not foiled by the constructive receipt doctrine.

Caution: The $10,000 limit is a cliff, and there is no phase-out range. A taxpayer who earns $10,001 of disqualified income is denied the EITC entirely.

Illustration: Mary, an individual who would otherwise be eligible for the EITC owns a building with three apartments. She lives in one unit and rents the other two out for $900 each per month. She has $11,000 in deductible expenses associated with the units. If Mary rents out each unit for all 12 months of the year, she will have $10,600 in disqualified income (($900 x 2 x 12) - $11,000) and will not be able to take the EITC.
If Mary cuts the rent by $26 to $874, she will only have $9,976 in disqualified income (($874 x 2 x 12) - $11,000) and will qualify for the credit.

Retirement

Required minimum distributions (RMDs) were suspended for 2020 due to COVID considerations; this relief was not extended into 2021. Thus, RMD rules apply in 2021 and may require year-end action to avoid penalty.

What's new?

- IRA owners and qualified retirement plan retirees who turn age 72 this year have until April 1, 2022, to take their first RMD. Older plan participants must take their RMDs by the end of this year.

Caution: Those turning 72 this year who wait until next year to take their first RMD must take a second one by the end of 2022, possibly subjecting them to a higher tax rate. (Also, see NIIT considerations, below.)

Contributing to tax-advantaged accounts

A special rule allows taxpayers to deduct certain retirement savings contributions made after year-end. Under this rule, a contribution is treated as made on the last day of the tax year if (a) it is identified as being made for that year, and (b) it is made by the due date of the taxpayer's return, including extensions.

Caution: A qualified retirement plan generally must legally exist by the taxpayer's year-end to claim a deduction for the post-year-end contribution.

Post-year-end traditional IRA contributions are deductible in the prior year if the IRA is established by the tax return due date, without extensions, and the contribution is made by that date. COVID-related return filing postponements for 2019 and 2020 tax years also extended the IRA contribution deadlines, but no such postponements have yet been made for 2021.

Proposed retirement plan changes

Under pending legislation that would be effective for tax years beginning after 2022, high-income taxpayers and others with very large retirement plan and/or IRA accounts would be subject to new contribution limits, distribution requirements, and penalties. Aggregate plan accumulations could not exceed $10-million, annual additions would be limited, increased minimum distributions would be required, and new excise taxes could be imposed on violations. New restrictions would also apply to conversions from IRAs and employer plans to Roth IRAs.

Net investment income tax considerations

Converting a traditional IRA to a Roth IRA will increase modified AGI, and potentially expose income (or more income) to the 3.8% NIIT. If possible, time year-end conversions to keep MAGI below the applicable NIIT threshold. If other net investment income will be lower next year, consider delaying the conversion.

For NIIT purposes, investment income doesn't include distributions from tax-favored retirement plans, such as qualified employer plans and IRAs. However, taxable distributions from these plans, including RMDs, are included in MAGI, potentially exposing other investment income to the extra tax. Taxpayers nearing the MAGI threshold, or who already exceed it because of other income, may have an RMD planning opportunity. The first RMD can be taken without penalty as late as April 1 of the year following the year the participant reaches age 72 (or, if older, retires). The additional distribution may cause the taxpayer to be in a higher tax bracket or become subject to the 3.8% NIIT. However, when making the two RMDs in separate years causes both years to be adversely affected, rather than just one, consider delaying the first distribution into the second year if that doesn't result in it being taxed at a higher rate.

Gift and estate tax

Besides the typical year-end estate planning considerations, substantial proposed estate tax legislative changes could come into effect in 2022, requiring reevaluation of many estate plans.

What's new?

The annual gift tax exclusion, now $15,000, will increase to $16,000 in 2022.

Annual gift tax exclusion

For 2021, up to $15,000 of gifts made by a donor to each donee is excluded from the amount of the donor's taxable gifts. The exclusion increases to $16,000 in 2022. A gift that qualifies for the exclusion is not subject to gift tax or Generation-Skipping Transfer Tax.

Unused annual exclusions can't be carried over and are forever lost. It is best to make exclusion-eligible gifts as early as possible so as not to lose any of their benefit.

Since the limitation is per-donor/donee pair, a married couple could, for example, gift another married couple up to $60,000 and still qualify for the exclusion under the split gift rule.

Illustration: Alex and Eliza are married. Alex transfers $30,000 to their adult child, George. If Eliza agrees to split the gift, the $30,000 will be treated as if Alex and Eliza each individually gave $15,000 to George. If George is also married, Alex or Eliza could also transfer $30,000 to George's spouse and treat that transfer as a split gift qualifying for the exclusion.

Recommendation: If a gift is made by check near the end of the year and the donor wants to qualify for this year's exclusion, the donee should deposit the check before year-end so there's no doubt as to when the gift was made.

Gifting income-producing or appreciated property

The donor and donee can realize overall income tax savings when income-earning property is given to a donee who is in a lower income tax bracket than the donor or who is not subject to the NIIT. Estate tax can also potentially be saved because both the value of the gift on the date of transfer and its post-transfer appreciation (if any) are removed from the donor's estate. Income can also be shifted to lower-bracket family members by giving them appreciated property to be sold by them at a gain. A valid gift of property that is completed before the property is sold generally shifts the tax liability on the gain from donor to donee, subject to Kiddie Tax rules.

Observation: Gifts to minors may be made through custodians designated under the Uniform Transfers to Minors Act (and predecessor acts) as adopted by various states. Such gifts generally qualify for the annual exclusion.

Tuition and medical expenses

Tuition payments made directly to an educational institution and medical expenses paid directly to a medical care provider are exempt from gift and Generation-Skipping Transfer (GST) tax. These payments don't count toward the annual gift tax exclusion amount or lifetime unified credit and the donor does not need to file a gift tax return to report the gift.

For this purpose, primary, secondary, preparatory schools, high schools, colleges, and universities are considered "educational institutions." The tuition gift tax exclusion applies to payments for "tuition" only and not for other educational expenses such as books, supplies, and room and board. A donor might want to consider making tuition payments directly to the educational institution while using the $15,000 ($16,000 in 2022) annual exclusion to make a direct gift to the student, or a contribution to a 529 plan, to cover additional expenses such as books, supplies and room and board.

An alternative for those willing and able to make larger current gifts is to elect to take contributions to a 529 plan that exceed the annual gift tax exclusion into account ratably over the five-year period starting with the calendar year of the contribution, thus allowing a $75,000 gift made in 2021 ($80,000 in 2022) to qualify for annual exclusions.

The definition of medical care is broad and includes medical insurance. However, payments to medical providers for cosmetic surgery don't qualify for the exemption unless the surgery corrects a birth defect or disfigurement from injury or disease.

Gifts to minors

The annual exclusion for gifts applies only in the case of "present interests," which can be tricky when dealing with gifts to minors. However, a gift to a minor will be considered a present interest (and qualify for the exclusion) if the gifted property, and all the income generated by the property, may be spent for the minor's benefit before reaching age 21 and any amount not spent by then will go to the minor upon reaching age 21.

Effect of the kiddie tax

The "kiddie tax" can limit tax savings from intrafamily gifts of income-producing property. Under the kiddie tax rules, a child pays tax at the trust and estate marginal rate on the child's unearned income over the kiddie tax exemption amount ($2,200 for 2021; $2,300 for 2022) if that tax is higher than the tax the child would otherwise pay on the income. Alternatively, the parent can elect in some cases to include the child's income on the parent's return.

Children 18 and older can increase their earned income to exceed more than half of their support and thus avoid the kiddie tax on their unearned income. This does not apply for children under age 18. Also note that in all cases, the child's earned income can be sheltered by the child's standard deduction and other deductions, and earned income in excess of those deductions will be taxed at the child's tax brackets.

Election by complex trusts and estates

Complex trust and estate distributions made within the first 65 days of the year may electively be treated as paid and deductible in the prior year. Thus, fiduciaries can wait until next year to decide whether the payments may be more profitably imputed back to 2021 via the 65-day rule or treated as 2022 payments. If an entity elects to treat a 2022 distribution as paid in 2021, the distribution is taxable to the beneficiary in 2021. The election doesn't have to be made for the entire amount distributed; it can apply to only part of the amounts distributed to a beneficiary.

Proposed estate tax changes

Pending legislation could make some significant changes to estate and gift taxes effective after year-end.

The basic gift and estate tax exclusion amount, currently $11.7 million (as much as $23.4 million for married couples) as indexed for inflation, is scheduled to be halved for estates of decedents dying after 2025. The pending legislation would accelerate this reduction to 2022.

Special use valuation currently can reduce the estate tax value of farm and closely held business real estate by up to $750,000. The proposed legislation would increase this amount to $11.7 million, indexed for inflation, for estates of decedents dying after 2021.

There would be major changes to the transfer tax treatment of grantor trusts: Assets of a grantor trust would be included in the grantor's gross estate. Termination of grantor trust status during the grantor's lifetime or distributing trust assets to someone other than the grantor or the grantor's spouse, generally would be treated as a taxable gift.

Sales of assets between the grantor and a grantor trust (other than a fully revocable trust) would be taxed as other asset sales are. The changes would apply to trusts created and contributions to pre-existing trusts on or after enactment of the provisions.

Minority ownership, lack of control, and similar factors, would not result in a valuation discount, to the extent the transferred asset isn't actively traded or used in the conduct of an active trade or business. The provision would be effective for transfers after the date of enactment.

Charitable contribution deduction rules would be tightened for syndicated conservation easement transactions.

Year-End Tax Planning for 2021: Businesses

What's new for businesses in 2021?

Congress passed numerous provisions in 2020 and 2021 aimed at providing relief to businesses affected by the COVID-19 pandemic, including forgivable Paycheck Protection Program loans and payroll tax credits. Businesses may use one or both programs to pay certain expenses but may not "double dip." For detailed guidance on navigating the aftermath of COVID-19 relief, see Checkpoint's Forensic Toolkit: Analysis of the interplay between COVID-19 payroll tax credits and the Paycheck Protection Program.

Another issue to consider is whether telecommuting employees temporarily working in a state due to the impact of COVID-19 create nexus for income or sales and use tax for an employer who does not otherwise operate in that state. Some states have issued specific guidance on this issue. Customizable State Charts on Checkpoint provide an easy way to navigate the latest guidance from each state on telecommuting.

Cash vs. accrual method

Any entity, other than a tax shelter, that meets an inflation-adjusted average annual gross receipts test ($26 million for tax years beginning in 2021; $27 million for 2022) can use the cash method of accounting. A C corporation that is a qualified personal service corporation (PSC) is also allowed to use the cash method, regardless of average annual gross receipts, provided it does not maintain inventories for tax purposes.

Use of the cash method provides year-end planning opportunities for shifting income and deductions with an eye to tax savings. Taxes can easily be deferred by (a) postponing billings until next year, and (b) accelerating deductible expenditures into this year, subject, however, to the passive activity limitations and the at-risk rules.

Although income-deferral and deduction-acceleration are standard year-end tax planning strategies, this year may favor doing the opposite. That's because tax legislation under consideration in Congress could raise the top individual, capital gain, and corporate tax rates. If changes like those were enacted, accelerating income into this year might subject it to a lower tax rate, and deferring deductions into next year could allow them to be taken against higher taxed income

For cash method taxpayers, business expenses are generally deductible when paid. To increase recognition of expenses for the current year, these taxpayers should consider paying invoices received before year-end, and even prepaying some expenses where feasible. However, a

business that could be subject to increased rates next year might want to defer expense payments until then, where feasible from a business standpoint. Note, however, that some prepayments made by cash method taxpayers, such as prepaid compensation, must be prorated over the period to which they apply.

Acceleration of expenses is more difficult for accrual method taxpayers. For them, expenses generally aren't deductible until property is delivered or services are performed. This may be advantageous, however, if tax rates are higher next year, in which case businesses may want to delay some deliveries, or performance of some services. However, prepaid expenses may be deductible in the current year under certain circumstances. For example, when the taxpayer reasonably expects the property or services to be provided or performed within 3.5 months after making the payment, or when the recurring item exception applies, generally when economic performance occurs within 8.5 months after the close of a tax year. The recurring item exception must be consistently applied for a type of item or all items from one year to the next, so it is unlikely that IRS would approve a switch from that method to generate a short-term tax advantage, and, in any event, businesses may not want to forego its advantages permanently. For ratable service contracts, taxpayers can treat economic performance as occurring on a ratable basis over the term of the service contract when certain conditions are met.

The timing of year-end bonus payments is an area where both cash- and accrual-basis employers have some opportunity to time deductions. Cash-basis employers deduct bonuses in the year they are paid, so they can time the payment for maximum tax effect. Accrual-basis employers, on the other hand, deduct a bonus in the accrual year, when all events related to it are established with reasonable certainty.

However, the bonus must be paid within 2.5 months after the end of the accrual employer's tax year for the deduction to be allowed in the earlier 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.

Depreciation and expensing

Acquiring qualifying property and placing it into service before year-end can result in a full expensing or bonus depreciation deduction for 2021. However, there are many considerations when planning year-end purchases. An important one is the possibility of increased tax rates next year, which may make deferring deductions more beneficial.

What's new?

For 2021, the maximum amount of section 179 property that can be expensed is $1,050,000. That full amount is available until qualifying property placed in service during the year reaches $2,620,000, at which point a phase out begins.

Bonus depreciation

A 100% first-year deduction for the adjusted basis of depreciable property is allowed for qualified property acquired and placed in service during the year. Qualifying property includes tangible property depreciated under MACRS with a recovery period of 20 years or less, most computer software, qualified film, television, and live theatrical productions, and water utility property. Possible higher tax rates next year might make some businesses want to defer placing bonus-depreciation-eligible property into service until next year, or to opt out of bonus depreciation on their tax return for this year.

Section 179 expensing

Taxpayers (other than estates, trusts, and certain noncorporate lessors) can also elect to deduct expenses for the cost of eligible property placed in service in the taxpayer's trade or business during the tax year, subject to limitations.

Property eligible for expensing includes:

- Tangible Code Sec. 1245 property (generally, machinery and equipment), depreciated under the MACRS rules, regardless of its depreciation recovery period;
- Off-the-shelf computer software;
- Qualified improvements to building interiors;
- Roofs, HVAC systems, fire protection systems, alarm systems, and security systems.

The eligible property can be new or used.

For 2021, the maximum amount of section 179 property that can be fully expensed is $1,050,000. That limit phases out dollar-for-dollar once the amount of section 179 property placed in service during the tax year exceeds $2,620,000 (complete phase-out at $3,670,000 of expense-eligible property placed in service).

Businesses have much flexibility in choosing whether to elect expensing in response to possible late year legislation. The election can be made or revoked as late as the due date for filing an amended return for the election year.

Business interest deductions

The Internal Revenue Code limits the deduction of business interest expenses. The deduction limit on business interest doesn't apply to businesses with 3-year average gross receipts of $26 million or less for 2021 ($27 million or less for 2022). The limitation also does not apply to deductions for interest paid by vehicle dealers on carried inventory. In addition, some real estate related businesses can opt out of the limitation, if they forego accelerated depreciation.

Observation: Two changes made by the Tax Cuts and Jobs Act will become effective on January 1, 2022, unless they are changed by pending legislation. First, businesses will be required to amortize research and development expenses over a five-year period. Second, the limitation on business net interest deduction is reduced to 30% of earnings before interest and taxes (EBIT) instead of earnings before interest, taxes, depreciation, and amortization (EBITDA).

What's new?

- The deduction limit for net business interest expense for 2021 is limited to 30% of an affected business's adjusted taxable income, down from the more generous 50% limit that applied in 2019 and 2020 as an assist to businesses struggling with COVID-related challenges.
- The deduction limit doesn't apply to businesses with 3-year average gross receipts of no more than $26 million for 2021 ($27 million for 2022). Interest that can't be deducted due to the limitation is carried forward indefinitely.

Possible tightened deduction for some

For tax years beginning after 2021, pending legislation would limit the interest deductibility of U.S. corporations with 3-year average net interest expense exceeding $12 million that are members of an "international financial reporting group." The interest deduction would be limited to their proportionate share of the group's net interest expense, determined by a formula that compares the domestic corporation's EBITDA to that of the group. This new deduction limit would apply along with the regular one; whichever limit is more restrictive would apply. Interest disallowed because of the proposal could be carried forward for only five years.

Qualified business income deduction

Through the end of 2025, eligible taxpayers can deduct up to 20% of qualified business income (QBI) from a domestic sole proprietorship, partnership, S corporation, trust, or estate, and up to 20% of the combined qualified real estate investment trust (REIT) dividends and publicly traded partnership income (PTP) of the taxpayer. The combined deduction cannot exceed 20% of the excess of the taxpayer's taxable income over net capital gain for the year. Trades or businesses involving the performance of services in fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business whose principal asset is the reputation or skill of one or more of its employees or owners do not qualify for the QBI deduction unless their income is below a phase-out threshold.

What's new?

- For 2021, specified service businesses qualify for the QBI deduction if their taxable income is less than $329,800 for married filing joint returns, $164,925 for married filing separate returns, or $164,900 for single and head of household returns. The deduction phases out ratably over the next $50,000 of taxable income over the thresholds ($100,000 phaseout for joint return filers).

Year-end strategies

Taxpayers with income near the threshold for this year may benefit from accelerating deductions or deferring income, to the extent possible, so their taxable income falls below the threshold. Similarly, if the taxpayer is well below the threshold this year but expects to exceed it next year, consider options to pull more income into 2021. This could have the added benefit of lower tax on the accelerated income in the event of higher tax rates next year.

Legislation proposed to be effective for post-2021 tax years would limit the QBI deduction for taxpayers other than corporations to $500,000 on a joint return, $250,000 for separate filers, $10,000 for estates and trusts, and $400,000 for others.

Net operating losses

Changes to the NOL deduction effective this year as well as other recent-year changes will impact year-end planning opportunities and strategies.

What's new?

Some recent changes to the NOL deduction and carryback rules are worth noting:

- 2018, 2019, and 2020 NOLs may be carried back five years and carried forward indefinitely; and
- Post-2020 NOLs may not be carried back (except for farm losses, which may be carried back two years), but may be carried forward indefinitely.
- Starting with the 2021 tax year, the NOL deduction is subject to an 80% of taxable income limitation (not counting the NOL or the qualified business income deduction)

NOLs from before 2018 could be carried back two years and carried forward only 20 years.

What this boils down to is that for earlier tax years, NOL carryovers and carrybacks could fully offset taxable income, but unused losses couldn't be carried forward indefinitely. Starting with the 2021 tax year, deductions for NOLs generated after 2017 are limited by the 80% standard, but unused losses may be carried forward indefinitely.

Under current law for the 2021 tax year, NOL carryforwards of noncorporate taxpayers are increased by their nondeductible "excess business losses," which are, with many modifications, the excess of the taxpayer's aggregate trade or business deductions for the tax year over its aggregate gross business income or gain plus $250,000 ($500,000 for joint return filers), as adjusted for inflation.

However, pending legislation that would be effective starting with the 2021 tax year would not make excess business losses NOL carryforwards. Rather, it would carry them forward to the next tax year as business deductions, making them potentially subject to the excess business loss limitation in that year.

Making the most of NOLs

A taxpayer that may have difficulty taking advantage of the full amount of an NOL carryforward this year should consider shifting income into and deductions away from this year. By doing so, the taxpayer can avoid the intervening year modifications that would apply if the NOL is not fully absorbed in 2021. This may also avoid potentially higher tax rates next year on the accelerated income and increase the tax value of deferred deductions

When to avoid an NOL

A corporation (other than a large corporation) that anticipates a small NOL this year and substantial net income next year 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 this year. This will permit the corporation to base its estimated tax installments next year on the lower amount of income shown on its 2021 return, rather than having to pay estimated taxes based on 100% of its much higher 2022 taxable income.

Partnership and S corporation losses

What's new?

- Pending legislative changes to the 3.8% NIIT proposed to be effective after this tax year would subject high income (e.g., $500,000 of modified AGI on a joint return; $400,000 for most others) S shareholders, limited partners, and LLC members to NIIT on their pro rata shares, distributive shares, and partnership income and gain that is not subject to FICA or SECA tax. The increased tax would be phased in over the first $100,000 of MAGI over the $500,000 threshold ($50,000 phaseout range for marrieds filing separately).

Accelerating some of this type of income into 2021 could help avoid NIIT on it under the proposed 2022 rules, but would also increase 2021 MAGI, potentially exposing other 2021 investment income to the tax.

Losses and shareholder or partnership basis

A shareholder can deduct its pro rata share of S corporation losses only to the extent of the total of its basis in the S corporation stock and debt. This determination is made as of the end of the S corporation tax year in which the loss occurs. Any loss or deduction that can't be used on account of this limitation can be carried forward indefinitely.

If a shareholder wants to claim a 2021 S corporation loss on its own 2021 return, but the loss exceeds the basis for its S corporation stock and debt, it can still claim the loss in full by lending the S corporation more money or by making a capital contribution by the end of the S corporation's tax year (in the case of a calendar year corporation, by December 31).

Similarly, a partner's share of partnership losses is deductible only to the extent of their partnership basis as of the end of the partnership year in which the loss occurs. Basis can be increased by a capital contribution, or in some cases by the partnership itself borrowing money or by the partner taking on a larger share of the partnership's liabilities before the end of the partnership's tax year.

Passive activity limitations

The impact of the passive activity loss limitation rules must also be considered. Limited partners always have passive activity interests except to the extent IRS regs say otherwise. If an individual who is a limited partner meets the material participation test under the 500-hours-of-participation rule, the five-of-ten-years-of-material-participation rule, or the any-three-prior-year-material-participation rule for a personal service activity, the partner is treated as materially participating in any activity of the limited partnership. This will affect the application of the passive activity rules to their share of any income, gain, loss, deduction, or credit attributable to the limited partnership interest and to any gain or loss from the activity recognized on the sale or exchange of the interest.

Year-End Tax Planning for 2021: Practice Aids

Extenders and expiring provisions 2021

Provisions scheduled to expire at the end of 2021:

- Mortgage insurance premium deduction
- Health coverage tax credit
- CARES Act charitable deduction for nonitemizers (with modifications)
- The increased income limit for charitable deductions for itemizers
- Computation of Adjusted Taxable Income Without Regard to Any Deduction Allowable for Depreciation, Amortization, or Depletion (business interest deduction limitations)
- Three-year depreciation for racehorses two years or younger
- Accelerated depreciation for business property on an Indian reservation
- American Samoa Economic Development Credit
- Indian Employment Tax Credit
- Mine Rescue Team Training Credit
- 12.5% increase in annual LIHTC authority
- Payroll tax credits for COVID-19 sick and family leave
- Employee Retention Credit
- Prevention of partial plan termination
- Credit for electricity produced from certain renewable resources
- Energy credit (construction must begin before 2022)
- Other energy-related credits

Provisions extended through December 31, 2025:

- CARES Act exclusion for employer payments of student loans
- Exclusion for canceled mortgage debt
- New Markets Tax Credit
- Work Opportunity Credit
- Empowerment Zone Tax Incentives
- Employer Credit for paid family and medical leave

Provisions made permanent:

- 7.5% floor for the medical expense deduction
- Exclusion of benefits for volunteer firefighters and emergency medical responders
- Business Tax Extender Provisions Made Permanent
- Credit for Certain Expenditures for Maintaining Railroad Tracks

Year-End Tax Planning Checklist for Individuals

- Determine whether the client's marital status has changed during the year. Has there been a change in the number of their dependents?
- High-income taxpayers must be careful of the 3.8% net investment income (NII) tax. Taxpayers who may be subject to this tax should consider ways to minimize NII for the remainder of the year by, for example, not selling stock or other investment property.
- Analyze capital gains. Should the client consider selling capital loss assets to shelter capital gains?
- Clients should postpone income until next year and accelerate deductions into this year if doing will enable the client to claim larger claim larger deductions, credits, and other tax breaks for this year that are phased out over varying levels of AGI. Postponing income to next year also is desirable for taxpayers who anticipate being in a lower tax bracket next year due to changed financial circumstances.
- In some cases, it may pay to actually accelerate income into 2021. For example, that may be the case for a person who expects to be in a higher tax bracket next year or who will have a more favorable filing status this year than next (e.g., head of household versus single filing status). This will also apply to individuals who will be subject to a higher tax rate next year under pending tax legislation.
- Clients interested in converting a traditional IRA to a Roth IRA should consider converting traditional-IRA money invested in any beaten-down stocks (or mutual funds) into a Roth IRA in the current year if eligible to do so. Keep in mind, however, that such a conversion will increase AGI for the current year, and possibly reduce tax breaks geared to AGI.
- Consider whether a client should defer a year-end bonus from an employer until next year. Be careful of the doctrine of constructive receipt.
- Determine whether the client should take the standard deduction or itemize. It may be advantageous to push itemized deductions into next year and take the standard deduction this year. Be careful, though, many itemized deductions are disallowed:

  — Miscellaneous itemized deductions are disallowed.

  — Taxpayers can only deduct medical expenses to the extent they exceed 7.5% of AGI.

  — No more than $10,000 of state and local taxes may be deducted.

  — Personal casualty and theft losses are deductible only if they're attributable to a federally declared disaster and only to the extent the $100-per-casualty and 10%-of-AGI limits are met.
- Two temporary, COVID-related changes to watch out for this year:

  — Individuals may claim a $300 above-the-line deduction for cash charitable contributions on top of their standard deduction ($600 on a joint return).

  — The percentage limit on charitable contributions has been raised from 60% of modified AGI (MAGI) to 100%.
- Consider whether to employ a bunching strategy to pull or push discretionary medical expenses and charitable contributions (and SALT payments, if the limits are repealed) into the year where they will do some tax good. Individuals could consider using a credit card to pay deductible expenses before the end of the year. Under the cash method of accounting, these expenses are deductible in the current year, even if the credit card bill is paid after the end of the year.
- If the client has education expenses, have they taken full advantage of the AOTC and Lifetime Learning Credit? If not, consider trying to accelerate expenses into this year.
- The age requirement to take RMDs from a 401(k) plan or IRA has increased to 72. The requirement to take RMDs is back, as it was only suspended for 2020 and not 2021.
- Taxpayers who are 70-1/2 or older by the end of the year should consider whether to make a charitable contribution (qualified charitable distribution, or QCD) from their traditional IRA. QCDs are excluded from the taxpayer's income but are not deductible. However, the taxpayer may still claim the entire standard deduction.
- Review with clients the amount set aside for next year in their employer's health FSA and HSAs to ensure they're able to fully utilize these amounts in 2020. Roll them over to the next year to the extent necessary and possible.
- Make sure clients are taking full advantage of their annual gift tax exclusion ($15,000 for 2021), if they sometimes run up against (or exceed) this amount.
- Consider whether to claim uninsured, unreimbursed casualty or theft losses related to a federally declared disaster on this year's return or on last year's return. The client should settle insurance or damage claims related to this disaster by year's end to claim the deduction.
- For low-income clients, analyze the changes to the EITC to determine how the amounts of and eligibility for the credit have changed.
- Review whether the client has any kiddie tax issues.

Year-End Tax Planning Checklist for Businesses

- Keep an eye on whether Congress will raise the corporate tax rate and accelerate income into the current tax year (and postpone deductions to next year) if this looks likely.
- Review issues related to the Qualified Business Income deduction, with particular attention to where the client stands on the dollar thresholds and amount of W-2 wages.
- If the client has placed less than $1,050,000 of section 179 property in service during the year, consider whether to place more of such property in service to take full advantage of the limits.
- Consider whether the client can take advantage of the 100% bonus depreciation deduction. This write-off is available without proration, even if qualifying assets are in service for only a few days in the current year.
- Consider purchasing items that qualify for the de minimis safe harbor ("book-tax conformity") election under the repair regs.
- Consider whether a corporate client that anticipates a small net operating loss (NOL) for the current year and substantial net income next year may find it worthwhile to accelerate just enough of next year's income (or to defer just enough of its current deductions) to create a small amount of net income for the current year. This will permit the corporation to base its estimated tax installments for next year on the relatively small amount of income shown on its current return, rather than having to pay estimated taxes based on 100% of its much larger next-year taxable income.
- Consider whether the client can postpone cancellation of debt income by deferring a debt-cancellation event until next year.
- If the client has a passive activity with suspended losses, consider disposing of the activity before the end of the year to take the losses.
- Review business interest paid or incurred by the client to see if limitations apply.