Individual Income Tax Tips 2021

With Congress simultaneously facing pressing deadlines on budget and debt ceiling issues, while still considering President Joe Biden's Build Back Better agenda, year-end tax planning will be especially challenging in the next couple of weeks.

Tried-and-true year-end tax planning strategies include deferring income, accelerating deductions, offsetting capital gains and losses, and funding charitable contributions. In the current federal income tax environment, those standard approaches may be in question.

Income and deductions

Deferring income into next year might be managed through the billing and receivables process of cash-basis businesses. Tax proposals across the board call for an increase in the top individual income tax rate, effective for tax years beginning after Dec. 31, 2021. For pass-through business entities, deferral may actually push income into a higher-tax year.

Perhaps the counterintuitive strategy of accelerating income into this year would be prudent.

Accelerating income may even include consideration of cashing out IRAs in excess of the annual required minimum distribution. Also, an S Corporation proposed change generally would subject all S Corporation Schedule K-1 earnings — not just a reasonable Form W-2 salary — to Medicare taxes totaling 3.8% for taxable income exceeding $400,000 single or $500,000 married filing jointly. Further, the Section 199A qualified business income deduction might be maximized in 2021 if a proposed cap is enacted for 2022.

Accelerating deductions into this year might be managed through the purchasing and payables function of cash-basis businesses. For pass-through business entities, acceleration may pull deductions into a lower-tax year. Perhaps the counter-intuitive strategy of deferring deductions into next year would be prudent.

Uncertainty arises from a proposal to not only increase the top 37% individual income tax bracket back to 39.6%, but also to drop the threshold for the top 2022 married filing jointly bracket from a projected $647,850 to $450,000. A 3% surcharge would apply to modified adjusted gross income in excess of $5 million.

So, not only would the top tax rate increase, it also would apply to more taxable income.

Capital gains and losses

Standard year-end tax planning includes offsetting capital losses against capital gains. With the stock market up by double digits during much of the year, many portfolios do not have capital losses to harvest against capital gains.

That leaves just choosing the timing of recognizing capital gains for year-end planning. Legislative proposals cast a dark cloud this year. An increase in the top capital gains tax rate from 20% to 25% has been embraced, with a retroactive effective date proposed in a House Ways and Means Committee bill to transactions after Sept. 13, 2021.

Passive loss partnership interests

Sometimes called a burned-out tax shelter, a passive investment may have suspended passive loss carryforwards that will be deductible only against passive income or upon disposition of the investment and may have remaining unrecovered tax basis.

An abandonment of the investment before year-end generally would accelerate the suspended passive loss carryforwards as ordinary deductions and recover the remaining tax basis as a capital loss, or perhaps even as an ordinary loss if the partner is allocated no partnership liabilities.

A House Ways and Means proposal provides that if any partnership interest becomes worthless or is abandoned during the taxable year, the character of the loss generally would be capital. The presence or absence of partnership liabilities would not be determinative. The proposal would apply to taxable years beginning after Dec. 31, 2021.

Charitable contributions

Charitable contributions traditionally are among the most flexible of year-end planning strategies, since mailing a check even on New Year's Eve counts as a current year itemized deduction. While the percentage of taxpayers itemizing deductions dropped dramatically when the Tax Cuts and Jobs Act of 2017 doubled the standard deduction, even non-itemizers avoid the capital gains tax on appreciated assets donated to charity.

Also, non-itemizers are allowed a 2021 tax deduction for cash contributions up to $300 single or $600 married filing jointly. A slight change from 2020 is that the deduction is not above the line, so it is deductible but will not reduce adjusted gross income.

Note that the IRS has been successfully challenging syndicated conservation easements and the related charitable contribution deductions. A House Ways and Means Committee proposal provides limitations on deductions for qualified conservation contributions made by pass-through entities.

State tax payments

Before the $10,000 overall limit on state and local tax deductions was enacted in the Tax Cuts and Jobs Act of 2017, an acceleration of fourth quarter state tax estimated payments — and even the estimated state tax balance due — was a standard year-end tax planning strategy, as long as the accelerated amounts would not have been disallowed under the alternative minimum tax.

Although the specifics have not been finalized, there is considerable interest in Congress to expand or eliminate the cap on the state and local tax deduction. In that case, deferring payments into next year, if not incurring underpayment penalties, may be indicated.

Estate and gift taxes

For high-net-worth clients, specialized estate and gift tax planning advice may be warranted, given proposed reductions in the unified credit, restrictions on grantor trusts, elimination of minority and marketability discounts for nonbusiness assets, taxation of unrealized capital gains and elimination of stepped-up basis.

Retirement savings

For high-net-worth clients, specialized retirement plan advice may be warranted, given proposed contribution limits for large account balance plans, required minimum distribution increases for large account balances, Roth conversion restrictions and IRA alternative investment prohibitions.

Year-end tax planning

Even if many of the tax changes included in the Build Back Better agenda and in Congressional proposals are not enacted by year-end, once the ideas have been floated in Washington, they are worth keeping an eye on. Too many times, tax changes slip into a new law at the last minute.

Last-minute tax legislation that makes year-end tax planning a challenge is nothing new, but this year seems especially challenging. Clear and well-documented client communication might be particularly important.