# Year-End Planning in a Climate of Uncertainty

Authored By: Heather L. Schreiber, RICP®

With December just a calendar flip away, many people will have a solid estimate of the income they'll report this year. Usually, seasonal tax planning will focus on cutting the amount due the following April.

This year, though, follows 2020 as a time of great uncertainty. Significant tax changes have been proposed, and some action is likely before the end of 2021 or sometime during 2022. Tax planning should focus on future years in addition to future months.

## Watching Washington

This past spring, President Biden unveiled the American Families Plan, the largest social safety net package since the New Deal, with $3.5 trillion in additional spending, which included various tax increases to offset the anticipated cost.

That said, tax legislation comes from legislators, not the Executive Branch. Congress has been debating changes in tax law, which may be connected to other priorities such as infrastructure. There's no telling what may be included in any bill that's eventually passed.

As of this writing, the proposal closest to reality is a tax bill that was approved by the House Ways and Means Committee in September. For now, the measures included in this bill provide the nearest thing to a roadmap for year-end planning. Here are the key components:[1]

## Increasing Income Tax

It's noteworthy that the major tax proposals have focused on a very narrow band of taxpayers, those with extremely high incomes. Generally, those affected would be people with taxable income (after deductions) over:

- $450,000 on joint returns
- $400,000 for single filers and married people filing separately
- $425,000 for heads of households
- $12,500 for estates and trusts

The top income tax rate would increase from 37% up to 39.6%. Various proposed surtaxes could push this rate above 46% for taxpayers reporting income well into seven figures. Apparently, the other current tax rates, which are relatively low by some historical standards—wouldn't increase.

In addition, the current top tax rate on long-term capital gains would increase from 20% to 25% and up to nearly 32% if surtaxes are triggered. Again, the basic 15% rate on such gains and the bargain 0% rate for those with modest income don't seem to be endangered.

## Aiming At Retirement Accounts

The House bill adds some revenue-raising provisions related to retirement accounts. Once more, the main targets are taxpayers with $400,000+ in taxable income, as spelled out previously.

**High income, huge retirement accounts**
Individuals reporting steep income may face painful mandates if they've accumulated over $10 million in Individual Retirement Accounts (IRAs) and Defined Contribution (DC) plans such as 401(k)s. They'd have to withdraw 50% of the excess amount each year under the House plan. With aggregated retirement funds over $20 million, the requirement would be a 100% distribution of the amount over the threshold.

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What's more, there are no age restrictions on these requirements, and the money must come from Roth accounts first, in the case of retirement accounts over $20 million, reducing the opportunity for further tax-free investment buildup.

Going forward, taxpayers with those high incomes and those ample account numbers won't be allowed to contribute to IRAs or DC plans.

**Shutting the Roth back door**

At certain income levels (modified Adjusted Gross Income over $140,000 for single taxpayers in 2021, for example), Roth IRA contributions are prohibited. A "backdoor" workaround has evolved: make a non-deductible IRA contribution, free of income limits, and immediately convert those traditional IRA dollars to Roth IRA money.

To curtail such maneuvering, the House bill would bar taxpayers with taxable income over the thresholds listed above from converting IRA and employer-sponsored plan money to Roth accounts.

In addition, the House bill would prohibit all employee after-tax contributions held in qualified plans and after-tax IRA contributions from being converted to a Roth IRA, regardless of income level. This roadblock would apply to all distributions, transfers, and contributions made in taxable years beginning after 2021.

## Eroding The Estate Tax Exemption

The House bill would also reduce the current $11.7 million exemption to $5 million (indexed to roughly $6.2 million in 2022), with ongoing inflation adjustments. The estates of decedents dying after 2021 could face this squeeze.

In another measure that might impact estate tax planning, the House bill would pull grantor trusts back into a decedent's taxable estate when the decedent is the deemed owner of the trust. This provision, which would apply to future trusts and future transfers, raises questions about the future of irrevocable life insurance trusts, now widely used to shield insurance proceeds from estate taxes.

## Costly Changes for Companies

Among various business-related proposals is an increase in the corporate income tax rate from a flat 21% to a graduated tax that climbs to 26.5%, as follows:

- 18% on the first $400,000 of income
- 21% on additional income up to $5 million
- 26.5% on higher income
- Personal service corporations would face a flat 26.5% tax rate, regardless of income.

Other business proposals in the House bill apply the maximum 20% Qualified Business Income (QBI) deductions up to $400,000 of AGI for single filers or $500,000 on joint returns. Owners of pass-through entities such as S corporations and LLCs might face some surtaxes on business income reported on individual tax returns. (The latter proposal would apply to people with high taxable income, as defined above.)

## Year-End Strategies Checklist

The proposals described above generally would take effect at the start of 2022 (the higher capital gains tax rate would be retroactive to September 13, 2021). However, it's unclear whether any tax bill will be enacted, what the precise changes will be, or when the new rules will apply.

With so much on the table and so little certain about the future, yearend tax planning is challenging. Still, there are steps financial professionals can urge clients and their tax professionals to take in November and December that have a high probability of paying off:

**Run the numbers on itemizing**

The standard deduction for 2021 is $12,550, or $25,100 on joint tax returns; higher numbers are available for taxpayers 65 or older and those who

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are legally blind. To lock in lower taxes on the returns they file next year, clients who expect to have even more deductions by itemizing should consider boosting their charitable contributions by year-end. Donating appreciated equities might help reallocate portfolios while avoiding capital gains tax, and simultaneously getting a full deduction after more than a one-year holding period.

Conversely, taxpayers who plan to take the standard deduction might consider forgoing charitable donations this year and bundling them into next year or every third year. The itemized deduction may exceed the standard deduction every other or every third year by bundling donations, providing some tax benefit for philanthropy.

**Use IRA donations, if qualified**
People 70-1/2 or older can take qualified charitable distributions (QCDs.) To do so, they transfer traditional IRA dollars directly to a qualifying charity, up to $100,000 per year.

QCDs don't generate a tax deduction, but they reduce income dollar for dollar up to the amount of the QCD, which is an even better deal. What's more, a QCD can be used regardless of whether the taxpayer itemizes or takes the standard deduction. A QCD will also satisfy required minimum distributions (RMDs), which start at age 72. By taking QCDs as part or all of their RMDs, seniors can hold down RMD-generated increases in taxable income.

**Make sure RMDs are satisfied**
The RMD waiver that applied in 2020 was not extended to 2021, so execute all RMDs by the end of this year. Any shortfall might trigger a 50% penalty.

Solo 401(k) owners also are subject to RMDs beginning at age 72, regardless of whether they continue to work. Employees, however, may use the year in which they retire, if later than age 72, as their first RMD year.

**Make sure any employer match will be received**
Suppose Wendy Jones, with a $100,000 salary, works for a company that matches 401(k) contributions, dollar-for-dollar, up to 6% of pay. Wendy should confirm plan contributions during 2021 are at least $6,000 to take full advantage of the employment benefit.

**Evaluate Roth conversions for 2021**
Even though the House bill limits tax rate increases to the highest bracket, there is no guarantee that other brackets will remain at current levels. Therefore, moving some tax-deferred money in retirement accounts to the Roth side in 2021 can be a savvy move, especially if the converted dollars will be taxed at 22% or 24%. For perspective, a couple filing jointly can have taxable income up to $326,600 and remain in the 24% tax bracket for this year. All Roth distributions eventually can be tax-free if held for at least 5 years and meet one of the qualifying events (age 59 ½, death, or disability and first-time home purchases subject to a dollar limitation).

Under current law, Roth conversions can no longer be undone, so making the decision near year-end is prudent as estimated income becomes the most accurate. Individuals who have lost spouses in 2021 should also consider a Roth conversion this year while they can still file as married, filing jointly. Next year, they generally must file as a single taxpayer, usually in a higher tax bracket.

**Similarly, consider rolling after-tax balances from employer-sponsored plans and traditional IRAs to Roth IRAs by year-end**
If the House bill passes, such rollovers no longer would be permitted, regardless of income level. (For traditional IRA rollovers to Roth IRAs, pro-rata distribution rules require looking at the makeup of all traditional IRAs to calculate the tax obligation.)

**Open a Roth IRA and fund it by year-end.**
Such a move provides a jump-start on the 5-year holding requirement for tax-free distributions of

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gain. This holding period begins on January 1 of the year for which the contribution or conversion is made, so starting now lowers the required wait to just over 4 years. A qualifying event, such as being at least age 59-1/2, also must be satisfied for completely tax-free distributions.

**Taxpayers in the 37% bracket for this year should consider accelerating income into 2021 and deferring deductions until 2022**
This might mean more dollars taxed at 37% instead of 39.6%, should the top income tax rate increase, under the House proposal.

**Make gifts now**
The annual gift exclusion in 2021 is $15,000. Individuals can give assets valued up to $15,000 to an unlimited number of recipients without owing gift tax or reducing their lifetime gift tax exemption. Individuals with large estates might consider gifting even larger amounts, up to the balance of their $11.7 million lifetime gift tax exemption, which will avoid gift tax and preserve the higher exemption, should the number significantly reduce under the proposed tax bill.

**Consider moving money in taxable accounts to selected annuities or life insurance policies**
Such contracts may continue to defer income tax on any investment gains, regardless of income level.

## Changing Times

Progress—or the lack of it—on tax legislation is likely to continue from now until the end of 2021, and perhaps spill over into next year. Financial Professionals should keep up with current developments, relying on informed sources and working with the client's tax and legal advisors. By knowing about any laws enacted in 2021 and what's anticipated in the months to follow, savvy suggestions can be tailored to help individual clients trim their tax bills.

## Sources:

[1]https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/SubtitleISxS.pdf

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