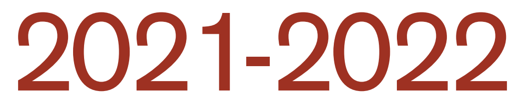

TAX PLANNING GUIDE

Year-round strategies to make the tax laws work for you

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“Uncertainty” is the watchword for 2021 tax planning

After the tumultuous year that was 2020, “uncertainty” remains the watchword in 2021, especially when it comes to tax planning. The shift of political control in Washington and the evolving pandemic and U.S. economic situation could result in more tax law changes — or not.

To take advantage of all available breaks, you first need to be aware of relevant tax law changes that have already gone into effect. While major changes under 2020’s CARES Act have largely expired, some have been extended or even expanded by the Consolidated Appropriations Act (CAA), signed into law late last year, or the American Rescue Plan Act (ARPA), signed into law in March. The latter two laws include other tax law provisions as well. You also can’t forget about the massive Tax Cuts and Jobs Act (TCJA) that generally went into effect three years ago but still impacts tax planning. Finally, you need to keep an eye out for more tax law changes that could affect 2021 planning.

This guide provides an overview of some of the most significant tax law changes going into effect this year and other key tax provisions you need to be aware of. It offers a variety of strategies for minimizing your taxes in the current tax environment. Use it to identify the best strategies for your particular situation with your tax advisor, who also can keep you apprised of any new tax law developments that might affect you.

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What can you deduct in 2021?

Although most TCJA provisions went into effect a few years ago, that 2017 law is still having a significant impact on planning for income and deductions. For example, the TCJA reduced or eliminated many deductions. It also generally reduced tax rates, and deductions save less tax when rates are lower. But be aware that increasing the top 37% rate back to the pre-TCJA rate of 39.6% has been proposed. It's also possible some tax breaks could be enhanced. Whatever happens, proper timing of deductible expenses and taking advantage of other breaks can help maximize your tax savings.

Standard deduction vs. itemizing

Taxpayers can choose to either itemize certain deductions or take the standard deduction based on their filing status. Itemizing deductions when the total will be larger than the standard deduction saves tax, but it makes filing more complicated.

The TCJA nearly doubled the standard deduction for each filing status. Those amounts are to be annually adjusted for inflation through 2025, after which they're scheduled to drop back to the amounts under pre-TCJA law. (See Chart 1 for 2021 amounts.)

The combination of a higher standard deduction and the reduction or elimination of many itemized deductions means that some taxpayers who once benefited from itemizing are now better off taking the standard deduction.

State and local tax deduction

Under the TCJA, through 2025, your entire itemized deduction for state and local taxes — including property tax and the greater of income or sales tax — is limited to $10,000 ($5,000 if you're married filing separately). Increasing or eliminating the limit has been discussed. Check with your tax advisor for the latest information.

Deducting sales tax instead of income tax may be beneficial if you reside in a state with no, or low, income tax or you purchased a major item, such as a car or boat.

Home-related breaks

Consider both deductions and exclusions in your tax planning:

Property tax deduction. As noted earlier, unless proposed tax law changes come to fruition, through 2025 your property tax deduction is subject to the limit on deductions for state and local taxes.

CHART 1 2021 standard deduction

Filing status	Standard deduction[1]
Singles and separate filers	$12,550
Heads of households	$18,800
Joint filers	$25,100

[1] Taxpayers who are age 65 or older or blind can claim an additional standard deduction: $1,350 if married, $1,700 if unmarried.

Mortgage interest deduction. You generally can claim an itemized deduction for interest on mortgage debt incurred to purchase, build or improve your principal residence and a second residence. Points paid related to your principal residence also may be deductible. Through 2025, the TCJA reduces the mortgage debt limit from $1 million to $750,000 for debt incurred after Dec. 15, 2017 ($500,000 and $375,000, respectively, for separate filers), with some limited exceptions.

Home equity debt interest deduction. Through 2025, the TCJA effectively limits the home equity interest deduction to debt that would qualify for the home mortgage interest deduction. (Under pre-TCJA law, interest was deductible on up to $100,000 of home equity debt used for any purpose, such as to pay off credit card debt or to buy a car.)

Home office deduction. If you're an employee and work from home, under the TCJA, home office expenses aren't deductible through 2025 — even if your employer has required you to work from home during the pandemic. Why? For employees, this is a miscellaneous itemized deduction subject to the 2% of adjusted gross income (AGI) floor, and the TCJA suspended such deductions. (If you're self-employed, you may still be able to deduct home office expenses. See page 11.)

Personal casualty and theft loss deduction. Through 2025, the TCJA suspends this itemized deduction except if the loss was due to an event officially declared a disaster by the President.

Rental income exclusion. If you rent out all or a portion of your principal residence or second home for less than 15 days during the year, you don't have to report the income. But expenses directly associated with the rental, such as advertising and cleaning, won't be deductible.

Home sale gain exclusion. When you sell your principal residence, you can exclude up to $250,000 of gain ($500,000 for married couples filing jointly) if you meet certain tests. ***Warning:*** Gain that's allocable to a period of "nonqualified" use generally isn't excludable.

Loss deduction. If you sell your home at a loss and part of your home is rented out or used exclusively for your business, the loss attributable to that portion may be deductible.

Moving expense deduction. Under the TCJA, through 2025, work-related moving expenses are deductible only by active-duty members of the Armed Forces (and their spouses or dependents) who move because of a military order that calls for a permanent change of station. (If you're eligible, you don't have to itemize to claim this deduction.)

WHAT'S NEW!

2021 provides bigger charitable deduction opportunity for some taxpayers

Generally, donations to qualified charities are fully deductible — but only if you itemize deductions. Fortunately, the CARES Act allowed taxpayers who claim the standard deduction to deduct up to $300 of cash donations to qualified charities in 2020, and the CAA has extended this break to 2021 — and increased the maximum deduction to $600 for married couples filing jointly.

If itemizing no longer will save you tax because of the increased standard deduction, you might benefit from "bunching" donations into alternating years so that your total itemized deductions in those years would then surpass your standard deduction. You can then itemize just in those years.

For large donations, discuss with your tax advisor which assets to give and the best ways to give them. For example, making large cash donations this year might be beneficial because the deduction limit for such gifts to public charities is 100% of adjusted gross income (AGI) for 2021. This is a CAA one-year extension of a CARES Act provision that increased the normal 60% of AGI limit to 100% for 2020.

Tax-advantaged saving for health care

If medical expenses not paid via tax-advantaged accounts or reimbursable by insurance exceed a certain percentage of your AGI, you can claim an itemized deduction for the amount exceeding that "floor."

New! In late 2020, the 7.5% floor (which had in recent years been a temporary reduction from 10%) was made permanent.

Eligible expenses may include health insurance premiums, long-term-care insurance premiums (limits apply), medical and dental services, and prescription drugs. Mileage driven for health care purposes also can be deducted — at 16 cents per mile for 2021.

Consider bunching elective medical procedures (and any other services and purchases whose timing you can control without negatively affecting your or your family's health) into alternating years if it would help you exceed the applicable floor and you'd have enough total itemized deductions to benefit from itemizing.

You may be able to save taxes without having to worry about the medical expense deduction floor by contributing to one of these accounts:

HSA. If you're covered by a qualified high-deductible health plan, you can contribute pretax income to an employer-sponsored Health Savings Account — or make deductible contributions to an HSA you set up yourself — up to $3,600 for self-only coverage and $7,200 for family coverage (plus $1,000 if you're age 55 or older) for 2021. HSAs can bear interest or be invested, growing tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax-free, and you can carry over a balance from year to year, allowing the account to grow.

FSA. You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit — not to exceed $2,750 in 2021. The plan pays or reimburses you for qualified medical expenses. (If you have an HSA, your FSA is limited to funding certain permitted expenses.) What you don't use by the plan year's end, you generally lose — though your plan might give you a 2½-month grace period to incur expenses to use up the previous year's contribution.

New! Your plan might allow you to roll over all unused amounts to 2022 under the CAA.

More considerations

Keep in mind that legislation could be signed into law that would suspend or alter some of the TCJA provisions affecting deductions or make other changes to deduction rules. Check with your tax advisor for the latest information.

Also be aware that there are other types of taxes that could affect you and should be factored into your planning, such as the alternative minimum tax (AMT). Your tax advisor can help you determine if you're among the small number of taxpayers who still need to plan for the AMT after the TCJA.

Bigger tax breaks for parents and others this year

Recent tax law changes have temporarily expanded breaks for parents and others with dependents, as well as for taxpayers with student loans. These are only some of the many tax-savings opportunities related to children and education, and it's important to take advantage of all that are available to you.

Child, dependent and adoption credits

Under the TCJA, these two tax credits for families are available through 2025:

1. For each child under age 17 at the end of the tax year, you may be able to claim a $2,000 credit. The credit phases out for higher-income taxpayers (see Chart 2) but the income ranges are much higher than before the TCJA. This credit has been expanded for 2021. See "What's new!"

2. For each qualifying dependent other than a qualifying child (such as a dependent child over the age limit or a dependent elderly parent), you may be able to claim a $500 family credit. But it's also subject to the income-based phaseout.

If you adopt in 2021, you may qualify for the adoption credit — or for an employer adoption assistance program income exclusion. Both are $14,440 for 2021, but the credit is also subject to an income-based phaseout. (See Chart 2)

"Kiddie tax"

The "kiddie tax" generally applies to unearned income beyond $2,200 (for 2021) of children under age 19 and of full-time students under age 24 (unless the students provide more than half of their own support from earned income). Such income is generally taxed at the parents' tax rate.

529 plans

If you're saving for education expenses, consider a Section 529 plan. You can choose a prepaid tuition plan to secure current tuition rates or a tax-advantaged savings plan to fund education expenses:

- Although contributions aren't deductible for federal purposes, any growth is tax-deferred. (Some states do offer tax breaks for contributing.)
- Distributions used to pay the following expenses are income-tax-free for federal purposes and potentially also for state purposes, making the tax deferral a permanent savings:
  - Qualified postsecondary school expenses, such as tuition, mandatory fees, books, supplies, computer equipment, software, Internet service and, generally, room and board,
  - Elementary and secondary school tuition of up to $10,000 per year per student, and
  - Up to $10,000 of student loans per beneficiary.

WHAT'S NEW! Child and dependent care breaks expanded for 2021

The ARPA temporarily enhances some valuable credits and deductions for families:

Child tax credit. The ARPA raises the eligibility age to under age 18 at the end of 2021. It also increases the credit to $3,000 per child, and to $3,600 per child under age 6 at the end of 2021. However, the increased credit amount ($1,000 or $1,600) is subject to lower income phaseouts. Contact your tax advisor for details.

Under the ARPA, taxpayers can receive advance payments (generally by direct deposit) equaling 50% of the IRS's estimate of the taxpayer's 2021 child tax credit from July 2021 through December 2021.

Child and dependent care tax credit. For children under age 13 or other qualifying dependents, generally, a credit is available that equals 20% of the first $3,000 of qualified expenses for one child or 20% of up to $6,000 of such expenses for two or more children. So, the maximum credit is usually $600 for one child or $1,200 for two or more children.

For 2021, the ARPA increases the credit to 50% of up to $8,000 in qualified expenses for one child and up to $16,000 for two or more children — so the credit ultimately is worth up to $4,000 or $8,000. The credit is subject to an income-based phaseout beginning at household income levels exceeding $125,000, but not fully phasing out until $438,000.

Child and dependent care FSA. Under the ARPA, for 2021, you can contribute up to $10,500 (up from $5,000 for 2020) pretax to an employer-sponsored child and dependent care Flexible Spending Account. The plan pays or reimburses you for these expenses. You can't claim a tax credit for expenses reimbursed through an FSA.

- The plans usually offer high contribution limits, and there are no income limits for contributing.
- There's generally no beneficiary age limit for contributions or distributions.
- You can control the account, even after the child is of legal age.
- You can make tax-free rollovers to another qualifying family member.
- A special break for 529 plans allows you to front-load five years' worth of annual gift tax exclusions and make up to a $75,000 contribution (or $150,000 if you split the gift with your spouse) per beneficiary in 2021.

The biggest downside of 529 plans may be that your investment options — and when you can change them — are limited.

CHART 2 **2021 child and education breaks[1]: Are you subject to a phaseout?**

Tax break	Modified adjusted gross income phaseout range	
	Single / Head of household[2]	Married filing jointly
Child credit[3]	$ 200,000 – $ 240,000	$ 400,000 – $ 440,000
Adoption credit	$ 216,660 – $ 256,660	$ 216,660 – $ 256,660
ESA contribution	$ 95,000 – $ 110,000	$ 190,000 – $ 220,000
American Opportunity credit	$ 80,000 – $ 90,000	$ 160,000 – $ 180,000
Lifetime Learning credit	$ 80,000 – $ 90,000	$ 160,000 – $ 180,000
Student loan interest deduction	$ 70,000 – $ 85,000	$ 140,000 – $ 170,000

[1] Assumes one child or student. Amounts may vary for more than one child or student. Other rules and limits might reduce the break.

[2] These ranges also apply to married taxpayers filing separately, except that separate filers aren't eligible for the American Opportunity or Lifetime Learning credit or the student loan interest deduction.

[3] A lower income phaseout range applies to the additional child credit amount available under the ARPA. Contact your tax advisor for details.

ESAs

Coverdell Education Savings Accounts are similar to 529 savings plans in that contributions aren't deductible for federal purposes, but plan assets can grow tax-deferred and distributions used to pay qualified education expenses are income-tax-free. ESAs are worth considering if you'd like to have direct control over how your contributions are invested or you want to pay elementary or secondary school expenses in excess of $10,000 or that aren't tuition.

But the $2,000 contribution limit is low, and it's phased out based on income. (See Chart 2.) Also, contributions can generally be made only for beneficiaries under age 18. When the beneficiary turns age 30, the ESA generally must be distributed, and any earnings may be subject to tax and a 10% penalty.

Education credits

If you have children in college now or are currently in school yourself, you may be eligible for a credit:

American Opportunity credit. This tax break covers 100% of the first $2,000 of tuition and related expenses and 25% of the next $2,000 of expenses. The maximum credit, *per student*, is $2,500 per year for the first four years of post-secondary education.

Lifetime Learning credit. If you're paying postsecondary education expenses beyond the first four years, you may benefit from the Lifetime Learning credit (up to $2,000 *per tax return*).

Warning: Income-based phaseouts apply to these credits. (See Chart 2.) If your income is too high for you to qualify, your child might be eligible.

Student loan breaks

If you're paying off student loans, you may be able to deduct up to $2,500 of interest (per tax return). An income-based phaseout applies. (See Chart 2.)

New! If your employer pays some of your student loan debt, you may be eligible to exclude up to $5,250 from income. This break was created by the CARES Act and extended through 2025 by the CAA. Student loan interest payments for which the exclusion is allowable can't be deducted.

New! The ARPA requires the tax-free treatment of student loan debt forgiven between Dec. 31, 2020, and Jan. 1, 2026. (Forgiven debt typically is treated as taxable income.)

ABLE accounts

Achieving a Better Life Experience accounts offer a tax-advantaged way to fund qualified disability expenses for a beneficiary who became blind or disabled before age 26. For federal purposes, tax treatment is similar to that of Sec. 529 college savings plans.

Under the TCJA, through 2025, 529 plan funds can be rolled over to an ABLE account without penalty if the ABLE account is owned by the beneficiary of the 529 plan or a member of the beneficiary's family. Such rolled-over amounts count toward the ABLE account annual rollover and contribution limit ($15,000 for 2021).

Factoring taxes into your investment planning

For at least the first three quarters of 2021, the stock market has generally been on an upward trend. But economic, political and pandemic uncertainty could cause volatility to resume. Such uncertainty also makes tax planning for investments challenging. There are many other factors to evaluate before deciding whether to sell or hold an investment, such as investment goals, time horizon, risk tolerance, factors related to the investment itself, fees and charges that apply to buying and selling securities, and your need for cash. But taxes are still important to consider.

Capital gains tax and timing

Although time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. Your marginal long-term capital gains rate can be as much as 20 percentage points lower than your ordinary-income tax rate.

The long-term gains rate applies to investments held for more than 12 months. The rate varies depending on your income and the type of assets. (See Chart 3.) Under the TCJA, current rates are scheduled to be in effect through 2025. Lawmakers could, however, make changes to the rates sooner. Be aware that taxing long-term gains of the highest-income taxpayers at their ordinary-income rate has been proposed, though a smaller increase may be more likely.

Holding on to an investment until you've owned it more than one year may help substantially cut tax on any gain. But be sure to look at your specific situation, and keep an eye out for possible tax law changes.

Being tax-smart with losses

Losses aren't truly losses until they're realized — that is, generally until you sell the investment for less than what you paid for it. So while it's distressing to see an account statement that shows a large loss, the loss won't affect your current tax situation as long as you still own the investment.

Realized capital losses are netted against realized capital gains to determine capital gains tax liability. If net losses exceed net gains, you can deduct only $3,000 ($1,500 for married taxpayers filing separately) of losses per year against ordinary income (such as wages, self-employment and business income, interest, dividends, and taxable retirement plan distributions). But you can carry forward excess losses until death.

If you don't have enough gains to absorb losses, you could be left with losses in excess of the annual ordinary-income deduction limit. So think twice before selling an investment at a loss. After all, if you hold on to the investment, it may recover the lost value. In fact, a buy-and-hold strategy works well for many long-term investors because it can minimize the effects of market volatility.

Of course, an investment might continue to lose value. That's one reason why tax considerations shouldn't be the primary driver of investment decisions. If you're ready to divest yourself of a poorly performing stock because, for example, you don't think its performance will improve or your investment objective or risk tolerance has changed, don't hesitate solely for tax reasons.

Plus, building up losses for future use could be beneficial. This may be especially true if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future gains, or if tax rates increase.

CHART 3 What's the maximum 2021 capital gains tax rate?

Type of gain	Rate[1]
Short-term (assets held 12 months or less)	Taxpayer's ordinary-income tax rate
Long-term (assets held more than 12 months)	15%
Some key exceptions	
Long-term gain of certain higher-income taxpayers	20%[2]
Most long-term gain that would be taxed at 10% or 12% based on the taxpayer's ordinary-income rate	0%
Long-term gain on collectibles, such as artwork and antiques	28%
Long-term gain attributable to certain recapture of prior depreciation on real property	25%

[1] In addition, the 3.8% net investment income tax (NIIT) applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds $200,000 (singles and heads of households), $250,000 (married filing jointly) or $125,000 (married filing separately).

[2] The 20% rate applies only to those with taxable income exceeding $445,850 (singles), $473,750 (heads of households), $501,600 (joint filers) or $250,800 (separate filers).

Mutual funds

Mutual funds with high turnover rates can create income that's taxed at ordinary-income rates. Choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

Also pay attention to earnings reinvestments. Unless you or your investment advisor increases your basis accordingly, you may report more gain than required when you sell the fund. Brokerage firms are required to track (and report to the IRS) your cost basis in mutual funds acquired in recent years.

Finally, beware of buying equity mutual fund shares late in the year. See Case Study 1 to learn why.

Income investments

Some types of investments produce income in the form of dividends or interest. Here are some tax consequences to consider:

Dividend-producing investments. Qualified dividends are taxed at the favorable long-term capital gains tax rate rather than at your higher ordinary-income tax rate. But if long-term gains of the highest-income taxpayers begin being taxed at their ordinary-income rate, as has been proposed, this would likely also apply to the taxation of qualified dividends of these taxpayers.

Interest-producing investments. Interest income generally is taxed at ordinary-income rates. So stocks that pay qualified dividends may be more attractive taxwise than other income investments, such as CDs and taxable bonds. But also consider nontax issues, such as investment risk, rate of return and diversification.

Bonds. These also produce interest income, but the tax treatment varies:

- Interest on U.S. government bonds is taxable on federal returns but exempt by federal law on state and local returns.
- Interest on state and local government bonds is excludable on federal returns. If the bonds were issued in your home state, interest also may be excludable on your state return.
- Tax-exempt interest from certain private-activity municipal bonds can trigger or increase the alternative minimum tax (AMT), but the AMT now occurs much more rarely.
- Corporate bond interest is taxable for federal *and* state purposes.
- Bonds (except U.S. savings bonds) with original issue discount build up "interest" as they rise toward maturity. You're generally considered to earn a portion of that interest annually — even though the bonds don't pay this interest annually — and you must pay tax on it.

CASE STUDY 1

Year-end mutual fund capital gains distributions can lead to tax surprises

Selena purchases 200 shares of an equity mutual fund on December 1 at $100 per share, for a total investment of $20,000. The next week, the fund makes a capital gains distribution of $15 per share.

Selena ends up with capital gains of $3,000, reportable on her tax return for the year of the distribution. It doesn't matter whether the actual value of the shares has increased or even decreased since Selena purchased them, or whether she reinvests the proceeds back into the same fund.

Why? The distribution itself is a taxable event. If capital gains distributions from the mutual fund are reinvested in the fund, the distribution itself doesn't change Selena's value in the fund. It simply increases the number of shares she owns, yet now at a lower per-share value.

3.8% NIIT

Taxpayers with modified adjusted gross income (MAGI) over $200,000 ($250,000 if married filing jointly and $125,000 if married filing separately) may owe the net investment income tax. The NIIT equals 3.8% of the lesser of your net investment income or the amount by which your MAGI exceeds the applicable threshold. Net investment income can include capital gains, dividends, interest, passive business income, rental income and other investment-related income (but not business or self-rental income from an active trade or business). Be aware that broadening the NIIT has been proposed.

Many of the strategies that can help you save or defer income tax on your investments can also help you avoid or defer NIIT liability. And because the threshold for the NIIT is based on MAGI, strategies that reduce your MAGI could also help you avoid or reduce NIIT liability.

How businesses can maximize their tax savings

This year some businesses are thriving while others are still struggling to recover from the pandemic and resulting economic crisis. Whatever your business's situation, taking full advantage of available tax breaks — including temporary relief in response to the crisis — is critical. And changes under the TCJA still demand attention, too.

Business structure

Income taxation and owner liability are the main factors that differentiate business structures. Many owners choose entities that combine pass-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations.

The TCJA significantly changed the tax consequences of business structure. The now-flat corporate rate (21%) is substantially lower than the top individual rate (37%), providing sizable tax benefits to C corporations and mitigating the impact of double taxation on owners. But, the TCJA also introduced a powerful deduction for owners of pass-through entities. (See below.)

Depending on your situation, a structure change may sound like a good idea. But keep in mind that increases to both the corporate rate and the top individual rate have been proposed. Even if there are no tax increases, a change could have unwelcome tax consequences. Consult your tax advisor if you'd like to explore whether a structure change could benefit you.

199A deduction for pass-through businesses

Through 2025, the TCJA provides the Section 199A deduction for sole proprietorships and owners of pass-through entities. The deduction generally equals 20% of qualified business income (QBI), not to exceed 20% of taxable income. QBI is generally defined as the net amount of qualified items of income, gain, deduction and loss that are connected with the conduct of a U.S. business.

Additional limits begin to apply if 2021 taxable income exceeds the applicable threshold — $164,900 or, if married filing jointly, $329,800 ($164,925 if married filing separately). The limits fully apply when 2021 taxable income exceeds $214,900 and $429,800 ($214,925), respectively.

One such limit is that the 199A deduction generally can't exceed the greater of the owner's share of:

- 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or
- The sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

Another is that the 199A deduction generally isn't available for income from "specified service businesses." Examples include businesses that provide investment-type services and most professional practices (other than engineering and architecture).

Be aware that additional income-based limits on the 199A deduction have been proposed.

Projecting income

Projecting your business's income for this year and next can allow you to time income and deductions to your advantage. It's generally — but not always — better to defer tax, so consider:

Deferring income to next year. If your business uses the cash method of accounting, you can defer billing for products or services at year end. If you use the accrual method, you can delay shipping products or delivering services.

Accelerating deductible expenses into the current year. If you're a cash-basis taxpayer, you may pay business expenses by Dec. 31, so you can deduct them this year rather than next. Both cash- and accrual-basis taxpayers can charge expenses on a credit card and deduct them in the year charged, regardless of when the credit card bill is paid.

Warning: Don't let tax considerations get in the way of sound business decisions. For example, the negative impact on your cash flow or customers may not be worth the tax benefit.

CHART 4 2021 income tax differences based on business structure

Pass-through entity or sole proprietorship	C corporation
One level of taxation: The business's income passes through to the owner(s).	Two levels of taxation: The business is taxed on income, and then shareholders are taxed on any dividends they receive.
Losses flow through to the owner(s).	Losses remain at the corporate level.
The top individual tax rate is 37%, but, for eligible taxpayers, up to 20% of qualified business income is deductible.	The flat corporate tax rate is 21%, and the top rate on qualified dividends is 20%.

Taking the opposite approach. If your business is a pass-through entity and it's likely you'll be in a higher tax bracket next year, accelerating income and deferring deductible expenses may save you more tax over the two-year period.

Depreciation

For assets with a useful life of more than one year, you generally must depreciate the cost over a period of years. In most cases, the Modified Accelerated Cost Recovery System (MACRS) will be preferable to other methods because you'll get larger deductions in the early years of an asset's life.

But if you make more than 40% of the year's asset purchases in the last quarter, you could be subject to the typically less favorable midquarter convention. Careful planning can help you maximize depreciation deductions in the year of purchase.

Other depreciation-related breaks and strategies may be available:

Section 179 expensing election. This allows you to currently deduct the cost of purchasing eligible new or used assets, such as equipment, furniture, off-the-shelf computer software, qualified improvement property, certain depreciable tangible personal property used predominantly to furnish lodging, and the following improvements to nonresidential real property: roofs, HVAC equipment, fire protection and alarm systems, and security systems.

For qualifying property placed in service in 2021, the expensing limit is $1.05 million. The break begins to phase out dollar for dollar when asset acquisitions for the year exceed $2.62 million.

Bonus depreciation. This additional first-year depreciation is available for qualified assets, which include new tangible property with a recovery period of 20 years or less (such as office furniture and equipment), off-the-shelf computer software, and water utility property.

Under the TCJA, through Dec. 31, 2026, the definition has been expanded to include used property and qualified film, television and live theatrical productions. For qualified assets placed in service through Dec. 31, 2022, bonus depreciation is 100%. For 2023 through 2026, bonus depreciation is scheduled to be gradually reduced. For certain property with longer production periods, these reductions are delayed by one year.

New! Qualified improvement property is now eligible for bonus depreciation. (See Case Study 2.)

Warning: Under the TCJA, in some cases a business may not be eligible for bonus depreciation. Contact your tax advisor for details.

CASE STUDY 2: Reaping the benefits of bonus depreciation on QIP investments

Taylor owns a specialty housewares store and, with Americans spending more on their homes during the pandemic, business remained surprisingly good in 2020 and has been picking up in 2021. So the retailer is considering making some improvements to the store this year.

Taylor is wondering what tax breaks would be available. Store improvements made in 2018 didn't provide much of a tax benefit due to a technical error in the TCJA.

The TCJA classified qualified retail-improvement, restaurant and leasehold-improvement property as qualified improvement property (QIP). Congress intended QIP placed in service after 2017 to have a 15-year MACRS recovery period and, in turn, qualify for 100% bonus depreciation. (See "Bonus depreciation" below.) But, the statutory language didn't define QIP as 15-year property, so QIP defaulted to a 39-year recovery period, making it ineligible for bonus depreciation.

Taylor consults a tax advisor, who shares some good news: The CARES Act included a technical correction to fix the QIP drafting error. Retailers like Taylor as well as other businesses that have made qualified improvements during the past three years can claim an immediate tax refund for the bonus depreciation they missed. Businesses investing in QIP in 2021 and beyond also can claim bonus depreciation going forward, according to the phaseout schedule.

So, not only can Taylor's 2021 store improvements potentially qualify for 100% bonus depreciation, but the retailer's tax advisor can file an amended tax return for 2018 and Taylor can receive a refund for bonus depreciation related to the 2018 store improvements.

Vehicle-related depreciation

Vehicle purchases may be eligible for Sec. 179 expensing, and buying a large truck or SUV can maximize the deduction. The normal Sec. 179 expensing limit (see above) generally applies to vehicles with a gross vehicle weight rating of more than 14,000 pounds. A $26,200 limit applies to vehicles (typically SUVs) rated at more than 6,000 pounds, but no more than 14,000 pounds.

Even if you prefer to buy a smaller vehicle, you can still potentially enjoy a valuable first-year deduction. Vehicles rated at 6,000 pounds or less are subject to the passenger vehicle limits; contact your tax advisor for details.

If you use a vehicle for business and personal purposes, the associated expenses, including depreciation, must be allocated between deductible business use and nondeductible personal use. ***Warning:*** If business use is 50% or less, you won't be able to use Sec. 179 expensing or the accelerated regular MACRS; you'll have to use the straight-line method.

Meals, entertainment and transportation

The TCJA changed some of the rules related to meal, entertainment and transportation expenses. Here's a closer look at what's deductible and what's not:

Meals. Under the TCJA, business-related meal expenses, including those incurred while traveling on business, remain 50% deductible.

But, the TCJA expanded the 50% disallowance rule to meals provided via an on-premises cafeteria or otherwise on the employer's premises for the convenience of the employer. (Such meals used to be 100% deductible.)

New! The CAA generally increases the deduction to 100% for food and beverages provided by a restaurant in 2021 or 2022.

Entertainment. Under the TCJA, these expenses are no longer deductible.

Transportation. Employer deductions for providing commuting transportation (such as hiring a car service) aren't allowed under the TCJA, unless the transportation is necessary for the employee's safety. The TCJA also eliminated employer deductions for qualified employee transportation fringe benefits (for example, parking allowances, mass transit passes and van pooling). But, those benefits are still tax-free to recipient employees. Transportation expenses for business travel are still 100% deductible, provided they meet the applicable rules.

Employee benefits

Offering a variety of benefits not only can help you attract and retain the best employees, but also may save tax because you generally can deduct your contributions:

Qualified deferred compensation plans. These include pension, profit-sharing, SEP and 401(k) plans, as well as SIMPLEs. (For information on the benefits to employees, see page 12.) Certain small employers may also be eligible for a tax credit when setting up a retirement plan.

HSAs, FSAs and HRAs. If you provide employees with a qualified high-deductible health plan (HDHP), you can also offer them Health Savings Accounts. (See page 3.) Regardless of the type of health insurance you provide, you can offer Flexible Spending Accounts for health care. (See page 3. You can also offer FSAs for child and dependent care. See page 4.)

A Health Reimbursement Account reimburses an employee for medical expenses up to a maximum dollar amount. Unlike an HSA, no HDHP is required. Unlike an FSA (other than when an exception applies), any unused portion can be carried forward to the next year. But only the employer can contribute to an HRA.

Fringe benefits. Certain fringe benefits aren't included in employee income, yet the employer can still deduct the portion, if any, that it pays and typically also avoid payroll taxes. Examples are employee discounts, group term-life insurance (up to $50,000 per person) and health insurance.

Warning: You might be penalized for not offering health insurance. The Affordable Care Act can in some cases impose a penalty on "large" employers if they don't offer full-time employees "minimum essential coverage" or if the coverage offered is "unaffordable" or doesn't provide "minimum value."

WHAT'S NEW!

Some COVID-19 tax relief still available for employers in 2021

To help employers retain their workforces and provide paid leave during the pandemic, legislation signed into law in 2020 offered some tax relief. Much of this relief has been extended into 2021 and, in some cases, it's been expanded. Keep in mind that additional rules and limits apply, and there could be more changes to these breaks. Check with your tax advisor for the latest information.

Employee retention credit. The CARES Act created this credit for employers whose operations were fully or partially suspended because of a COVID-19-related governmental shutdown order or whose gross receipts dropped more than 50% compared to the same quarter in the previous year (until gross receipts exceed 80% of gross receipts in the earlier quarter).

Employers whose workforces exceeded 100 employees could claim the credit for employees who'd been furloughed or had their hours reduced because of the reasons noted. If an employer had 100 or fewer employees, it could qualify for the credit regardless of whether there had been furloughs or hour reductions.

The credit equaled 50% of up to a ceiling of $10,000 in *annual* compensation, including health care benefits, paid to an eligible employee after March 12, 2020, through Dec. 31, 2020.

The CAA extended the credit through June 30, 2021, and for those quarters increased the credit to 70% of compensation and the ceiling to $10,000 *per quarter*. It also reduced the gross receipts threshold to a 20% drop, and increased the threshold for a "large" employer to more than 500 employees. The ARPA extended the expanded credit through Dec. 31, 2021, but ending it sooner has been proposed. Check with your tax advisor for the latest information.

Paid leave credit. The Families First Coronavirus Response Act generally required employers with fewer than 500 employees to provide paid leave in certain COVID-19-related situations in 2020. Covered employers generally could take a federal payroll tax credit for 100% of the qualified sick and family leave wages they pay each quarter, up to $511 per day for leave taken for the employee's own illness or quarantine and $200 for leave taken to care for others. The ARPA extended the credit through Sept. 30, 2021.

Warning: Payroll tax deferral available in 2020 has *not* been extended to 2021. Under the CARES Act, the first half of any deferred 2020 employer share (6.2% of wages) of Social Security tax is due by Dec. 31, 2021, and the second half is due by Dec. 31, 2022. Under the CAA, any 2020 employee share (also 6.2% of wages) of Social Security tax deferred under the Aug. 8, 2020, presidential memorandum must be withheld from employee pay and paid on a prorated basis over 2021.

Tax credits

Tax credits reduce tax liability dollar for dollar, making them particularly beneficial:

Research credit. This credit gives businesses an incentive to increase their investments in research. Certain start-ups (in general, those with less than $5 million in gross receipts) can, alternatively, use the credit against their payroll tax. While the credit is complicated to compute, the tax savings can prove significant.

Work Opportunity credit. This credit is designed to encourage hiring from various disadvantaged groups, such as certain veterans, ex-felons, the long-term unemployed and food stamp recipients. The maximum credit is generally $2,400 per hire but can be higher in some cases — up to $9,600 for certain veterans, for example. ***New!*** The CAA has extended this credit through Dec. 31, 2025.

New Markets credit. This gives investors who make "qualified equity investments" in certain low-income communities a 39% credit over a seven-year period. ***New!*** The CAA has extended this credit through Dec. 31, 2025.

Family and medical leave credit. The TCJA created a tax credit for qualifying employers that begin providing paid family and medical leave to their employees. The credit is equal to a minimum of 12.5% of the employee's wages paid during that leave (up to 12 weeks per year) and can be as much as 25% of wages paid. ***New!*** The CAA has extended this credit through Dec. 31, 2025.

Additional rules and limits apply to these credits, and expiring credits might be extended. Other credits may also be available to you. Check with your tax advisor for more information.

WHAT'S NEW!

Interest-expense and loss deductions return to pre-CARES Act rules

The CARES Act temporarily eased TCJA rules for certain deductions, but the relief hasn't been extended to 2021:

Interest expense deduction. Generally, under the TCJA, interest paid or accrued by a business is deductible only up to 30% of adjusted taxable income (ATI). Taxpayers with average annual gross receipts of $25 million or less for the three previous tax years generally are exempt from the limitation. Some other taxpayers are also exempt — check with your tax advisor for more information.

The CARES Act generally increased the interest expense deduction limit to 50% of ATI for the 2019 and 2020 tax years.

The TCJA's 30% deduction limit and other rules return for 2021.

Loss deductions. A loss occurs when a business's expenses and other deductions for the year exceed its revenue:

1. **Net operating losses (NOLs).** The TCJA generally reduces the amount of taxable income that can be offset with NOL deductions from 100% to 80%. It also generally prohibits NOLs from being carried back to an earlier tax year — but allows them to be carried forward indefinitely (as opposed to the previous 20-year limit).

   Under the CARES Act, taxpayers could carry back NOLs arising in 2018 through 2020 tax years to the previous five tax years. The CARES Act also allowed taxpayers to potentially claim an NOL deduction equal to 100% of taxable income for prior-year NOLs carried forward into tax years beginning before 2021.

   The TCJA's 80% of taxable income deduction limit and prohibition of carrybacks generally return for NOLs arising in 2021 or later.

2. **Pass-through entity "excess" business losses.** Through 2025, the TCJA applies a limit to deductions for current-year business losses incurred by non-corporate taxpayers: Such losses generally can't offset more than $250,000 ($500,000 for married couples filing jointly) of income from other sources, such as salary, self-employment income, interest, dividends and capital gains. (The limit is annually adjusted for inflation.) "Excess" losses are carried forward to later tax years and can then be deducted under the NOL rules.

   The CARES Act temporarily lifted the limit, allowing taxpayers to deduct 100% of business losses arising in 2018, 2019 and 2020.

   Not only does the deduction limit return for 2021, but the ARPA has extended it through 2026. Making it permanent but with some changes has been proposed.

The self-employed

If you're self-employed, you have to pay both the employee and employer portions of employment taxes on self-employment income. The employer portion is deductible "above the line," which means you don't have to itemize to claim the deduction.

In addition, you can deduct 100% of health insurance costs for yourself, and for a spouse and children, too. This above-the-line deduction is limited to net self-employment income. You also can take an above-the-line deduction for contributions to a retirement plan (see page 12) and, if eligible, an HSA (see page 3) for yourself.

If your home office is your principal place of business (or used substantially and regularly to conduct business) and that's the only use of the space, you probably can deduct home office expenses from your self-employment income.

Whatever your age, it pays to think about how taxes fit into retirement planning

Which type of plan should you invest in? When should you start taking distributions? What are the tax consequences? Whether you're just starting to think about retirement planning, are retired already, or are somewhere in between, addressing the relevant questions will help ensure your golden years are truly golden.

401(k)s and other employer plans

Contributing to a traditional employer-sponsored defined contribution plan is usually a good first step:

- Contributions are typically pretax, reducing your taxable income.
- Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions.
- Your employer may match some or all of your contributions.

Chart 5 shows the 2021 employee contribution limits. Because of tax-deferred compounding, increasing your contributions sooner rather than later can have a significant impact on the size of your nest egg at retirement. Employees age 50 or older can also make "catch-up" contributions. If your employer offers a match, *at minimum* contribute the amount necessary to get the maximum match so you don't miss out on that "free" money.

More tax-deferred options

In certain situations, other tax-deferred saving options may be available:

You're a business owner or self-employed. You may be able to set up a plan that allows you to make much larger contributions than you could make to an employer-sponsored plan as an employee. You might not have to make 2021 contributions, or even set up the plan, before year end.

Your employer doesn't offer a retirement plan. Consider a traditional IRA. You can likely deduct your contributions, though your deduction may be limited if your spouse participates in an employer-sponsored plan. You can make 2021 contributions until the 2021 income-tax-return-filing deadline for individuals, *not* including extensions. (See Chart 5 for the annual contribution limits.)

Roth alternatives

A potential downside of tax-deferred saving is that you'll have to pay taxes when you make withdrawals at retirement. Roth plans, however, allow tax-free distributions; the tradeoff is that your contributions don't reduce your current-year taxable income:

Roth IRAs. An income-based phaseout may reduce or eliminate your ability to contribute. But estate planning advantages are an added benefit: Unlike other retirement plans, Roth IRAs don't require you to take distributions during your lifetime, so you can let the entire balance grow tax-free for the benefit of your heirs.

Roth conversions. If you have a traditional IRA, a partial or full conversion to a Roth IRA can allow you to turn tax-*deferred* future growth into tax-*free* growth and take advantage of a Roth IRA's estate planning benefits. The converted amount is taxable in the year of the conversion. Discuss with your tax advisor whether a conversion makes sense for you.

"Back door" Roth IRA contributions. If your income is too high to make Roth IRA contributions and you don't have a traditional IRA, consider setting up a traditional account and making a nondeductible contribution to it. You can then immediately convert the contributed amount to a Roth account with minimal tax impact. But be aware that eliminating this option for higher-income taxpayers has been proposed.

Roth 401(k), Roth 403(b) and Roth 457 plans. Employers may offer one of these in addition to the traditional, tax-deferred version. No income-based phaseout applies, so even high-income taxpayers can contribute.

Early withdrawals

Early withdrawals from retirement plans should be a last resort. With a few exceptions, distributions before

CHART 5 Retirement plan contribution limits for 2021

	Regular contribution	Catch-up contribution[1]
Traditional and Roth IRAs	$ 6,000	$1,000
401(k)s, 403(b)s, 457s and SARSEPs[2]	$19,500	$6,500
SIMPLEs	$13,500	$3,000

[1] For taxpayers age 50 or older by the end of the tax year.

[2] Includes Roth versions where applicable.

Note: *Other factors may further limit your maximum contribution.*

age 59½ are subject to a 10% penalty on top of any income tax that ordinarily would be due on a withdrawal. Additionally, you'll lose the potential tax-deferred future growth on the withdrawn amount.

If you must make an early withdrawal and you have a Roth account, consider withdrawing from that. You can withdraw up to your contribution amount without incurring taxes or penalties.

Another option: If your employer-sponsored plan allows it, take a plan loan. You'll have to pay it back with interest and make regular principal payments, but you won't be subject to current taxes or penalties. (You can't borrow from an IRA.)

Early distribution rules also become important if you change jobs or retire. It's usually best to request a direct rollover from your old plan to your new plan or IRA. If you receive a lump sum payout, you'll need to make an indirect rollover within 60 days to avoid tax and potential penalties.

RMDs

Historically, after reaching age 70½, taxpayers have had to begin taking annual required minimum distributions from their IRAs (except Roth IRAs) and, generally, from any defined contribution plans. However, the age has increased to 72 for taxpayers who didn't turn age 70½ before Jan. 1, 2020 (that is, who were born after June 30, 1949).

If you don't comply with RMD rules, you can owe a penalty equal to 50% of the amount you should have withdrawn but didn't. You can avoid the RMD rule for a non-IRA Roth plan by rolling the funds into a Roth IRA.

Warning: The RMD waiver available in 2020 hasn't been extended to 2021.

Waiting as long as possible to take distributions generally is advantageous because of tax-deferred compounding. But a distribution (or larger distribution) in a year your tax bracket is low may save tax. Be sure, however, to consider the lost future tax-deferred growth and, if applicable, whether the distribution could: 1) cause Social Security payments to become taxable, 2) increase income-based Medicare premiums and prescription drug charges, or 3) affect tax breaks with income-based limits.

If you've inherited a retirement plan, consult your tax advisor about the distribution rules that apply to you.

Warning: The time period for distributions has been reduced to 10 years for beneficiaries — other than surviving spouses and certain others — inheriting plans after Dec. 31, 2019.

WHAT'S NEW!

Taking advantage of tax breaks on COVID-19 distributions

In response to the COVID-19 crisis, the CARES Act waived the 10% early withdrawal penalty — along with providing additional tax advantages that taxpayers age 59½ and older can also benefit from — on COVID-19-related distributions up to $100,000. These generally were 2020 withdrawals made by someone who had been (or whose family had been) infected with COVID-19 or who had been economically harmed by the virus.

If you took an eligible 2020 distribution, consider these tax-deferral options:

Recontribute the distributions. Normally once you've taken a retirement plan distribution, you have only 60 days to return it to the plan. But the CARES Act created an exception for eligible COVID-19 distributions: They may be recontributed over the three-year period starting the day after the withdrawal.

If you can afford to do so, this is likely the best option. You can avoid current tax liability, and the funds can return to growing tax deferred, building up your retirement nest egg. Depending on when you recontribute, you may have to initially pay some tax and then file an amended return after the recontribution to get that tax back.

Spread out the income tax payments. Generally, tax on distributions is due by the filing deadline for the year the distribution was taken. But under the CARES Act, you can spread out the reporting of eligible COVID-19 distributions over 2020, 2021 and 2022.

If you can't afford to recontribute the distribution, this option might be beneficial — though if your 2020 tax bracket is lower than usual, you may be better off reporting the entire distribution on your 2020 return. Also, you still have the option to return some or all of the distribution up until the end of the three-year period; you'll just need to file one or more amended returns to get the tax refunded.

The rules are complex, so be sure to consult your tax advisor.

IRA donations to charity

Taxpayers age 70½ or older are allowed to make direct contributions from their IRA to qualified charitable organizations up to $100,000 per tax year. A charitable deduction can't be claimed for the contributions. But the amounts aren't included in taxable income and can be used to satisfy an IRA owner's RMD. A direct contribution might be tax-smart if you won't benefit from the charitable deduction. (See "What's new!" on page 3.)

Today's tax savings opportunities may not be available tomorrow

Because the TCJA has put estate, gift and generation-skipping transfer (GST) tax exemptions at record-high levels, far fewer taxpayers are worrying about these taxes. But the high exemptions are only temporary, and proposed tax law changes could also increase taxes when assets are transferred. So whether or not you'd be subject to estate taxes under the current exemptions, it's a good idea to consider whether you can seize opportunities to potentially lock in tax savings today.

Estate tax

While the TCJA keeps the estate tax rate at 40%, it has doubled the exemption base amount from $5 million to $10 million. The inflation-adjusted amount for 2021 is $11.7 million. (See Chart 6.)

Without further legislation, the estate tax exemption will return to an inflation-adjusted $5 million in 2026. So taxpayers with estates in the roughly $6 million to $12 million range (twice that for married couples), whose estates would escape estate taxes if they were to die while the doubled exemption is in effect, still need to keep potential post-2025 estate tax liability in mind. Plus, it's possible the exemption could be reduced sooner.

Gift tax

The gift tax continues to follow the estate tax, so the gift tax exemption also has increased under the TCJA. (See Chart 6.) Any gift tax exemption used during your lifetime reduces the estate tax exemption available at death. Using up some of your exemption during your lifetime can be tax-smart, especially if your estate exceeds roughly $6 million (twice that if you're married). (See Case Study 3.)

Under the "annual exclusion," you also can exclude certain gifts of up to $15,000 per recipient in 2021 ($30,000 if your spouse elects to split the gift with you or you're giving joint or community property) without depleting any of your gift and estate tax exemption.

Warning: Each year you need to use your annual exclusion by Dec. 31. The exclusion doesn't carry over from year to year. For example, if you didn't make an annual exclusion gift to your granddaughter last year, you can't add $15,000 to your 2021 exclusion to make a $30,000 tax-free gift to her this year.

GST tax

The GST tax generally applies to transfers (both during your lifetime and at death) made to people more than one generation below you, such as your grandchildren. This is in addition to any gift or estate tax due. The GST tax exemption also has increased under the TCJA. (See Chart 6.)

The GST tax exemption can be a valuable tax-saving tool for taxpayers with large estates whose children also have — or may eventually have — large estates. With proper planning, they can use the exemption to make transfers to grandchildren and avoid any tax at their children's generation.

State taxes

Even before the TCJA, some states imposed estate tax at a lower threshold than the federal government did. Now the differences in some states are even more dramatic. To avoid unexpected tax liability or other unintended consequences, consult a tax advisor familiar with the law of your particular state.

Exemption portability

If part (or all) of one spouse's estate tax exemption is unused at that spouse's death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining exemption. This exemption "portability" provides flexibility at the first spouse's death, but it has some limits. Portability is available only from the most recently deceased spouse, doesn't apply to the GST tax exemption and isn't recognized by many states.

And portability doesn't protect future growth on assets from estate tax like applying the exemption to a credit shelter (or bypass) trust does. Such a trust also offers creditor and remarriage protection, GST tax planning, and possible state estate tax benefits.

So married couples should still consider these trusts — and consider transferring assets to each other as necessary to fully fund them at the first death. Transfers to a spouse (during life or at death) aren't subject to gift or estate tax as long as the recipient spouse is a U.S. citizen.

CHART 6 2021 transfer tax exemptions and rates

	Estate tax	Gift tax	GST tax
Exemption	$11.7 million[1]	$11.7 million	$11.7 million
Rate	40%	40%	40%

[1] Less any gift tax exemption already used during life.

Tax-smart giving

Giving away assets now will help reduce the size of your taxable estate. Here are some strategies for tax-smart giving:

Choose gifts wisely. Consider both estate and income tax consequences and the economic aspects of any gifts you'd like to make:

- To minimize *estate tax*, gift property with the greatest future appreciation potential.
- To minimize *your beneficiary's income tax*, gift property that hasn't appreciated significantly while you've owned it.
- To minimize *your own income tax*, don't gift property that's declined in value. Instead, consider selling the property so you can take the tax loss and then gifting the sale proceeds.

Warning: It's been proposed that, when appreciated assets are transferred, gains beyond a specific limit be included in the taxable income of the giver (or of the estate in the case of a bequest). It appears unlikely this will be included in any final legislation this year, but it's worth keeping in mind in case it's proposed again in the future.

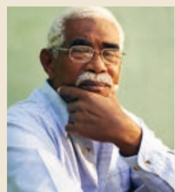
Plan gifts to grandchildren carefully. Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts to a grandchild that don't qualify for the exclusion to be tax-free, you generally must apply both your GST tax exemption and your gift tax exemption.

Pay tuition and medical expenses. You may pay these expenses without the payment being treated as a taxable gift to the student or patient, as long as the payment is made directly to the provider.

Make gifts to charity. Donations to qualified charities aren't subject to gift tax. They may also be eligible for an income tax deduction. (See "What's new!" on page 3.)

CASE STUDY 3

2021 might be a good year to make "taxable" gifts



Louis has an estate of $12 million. In 2021, he has already made $15,000 annual exclusion gifts to each of his chosen beneficiaries. With future inflation adjustments, the exemption might be enough to protect his entire estate.

But he's in good health and believes he'll live beyond 2025. He also thinks that the exemption might be reduced sooner. So he's concerned about having substantial estate tax exposure, especially considering that his assets likely will continue to appreciate.

His tax advisor suggests that he make some gifts beyond the annual exclusion this year. Louis uses $6 million of his gift tax exemption to make additional "taxable" gifts. Therefore, his estate can't use that amount as an exemption. But he protects at least $6 million from gift and estate tax, even if the exemption drops below $6 million during his lifetime.

He also removes the future appreciation from his estate. If the assets, say, double in value before Louis's death, the gift will essentially have removed $12 million from his estate. This amount escapes the estate tax.

He does, however, need to keep in mind his beneficiaries' income tax. Gifted assets don't receive the "step-up" in basis that bequeathed assets do. This means that, if beneficiaries sell the assets, their taxable capital gains will be determined based on Louis's basis in the assets. So their capital gains tax could be higher than if they inherited the assets. But there also have been proposals to change the rules regarding when gains on transferred appreciated assets are taxed. See the warning under "Choose gifts wisely" at left.

Gift interests in your business. If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts for lack of control and marketability. For example, you could gift an ownership interest worth up to $20,000 (on a controlling basis) tax-free, assuming a combined discount of 25%. That's because the discounted value of the gift wouldn't exceed the $15,000 annual exclusion.

Gift interests in an FLP. Another way to benefit from valuation discounts is to set up a family limited partnership. You fund the FLP with assets such as public or private stock and real estate, and then gift limited partnership interests. But be aware that eliminating discounts for interests in entities holding nonbusiness assets has been proposed. ***Warning:*** The IRS may challenge valuation discounts, and it scrutinizes FLPs. So obtain a professional valuation and set up and operate an FLP properly.

Trusts

Trusts can provide a way to transfer assets and potentially enjoy tax savings while preserving some control over what happens to the transferred assets. For those with large estates, funding trusts now, while the gift tax exemption is high, may be particularly tax-smart. Here are some types of trusts to consider:

A qualified personal residence trust (QPRT). It allows you to give your home to your children today — removing it from your taxable estate at a reduced gift tax cost (provided you survive the trust's term) — while you retain the right to live in it for a specified period.

A grantor-retained annuity trust (GRAT). It works on the same principle as a QPRT, but allows you to transfer other assets; you receive payments back from the trust for a specified period.

A GST — or "dynasty" — trust. It can help you leverage both your gift and GST tax exemptions. And it can be an excellent way to potentially lock in the currently high exemptions while removing future appreciation from your estate.

CHART 7 2021 individual income tax rate schedules

Tax rate	Regular tax brackets			
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
10%	$ 0 – $ 9,950	$ 0 – $ 14,200	$ 0 – $ 19,900	$ 0 – $ 9,950
12%	$ 9,951 – $ 40,525	$ 14,201 – $ 54,200	$ 19,901 – $ 81,050	$ 9,951 – $ 40,525
22%	$ 40,526 – $ 86,375	$ 54,201 – $ 86,350	$ 81,051 – $ 172,750	$ 40,526 – $ 86,375
24%	$ 86,376 – $ 164,925	$ 86,351 – $ 164,900	$ 172,751 – $ 329,850	$ 86,376 – $ 164,925
32%	$ 164,926 – $ 209,425	$ 164,901 – $ 209,400	$ 329,851 – $ 418,850	$ 164,926 – $ 209,425
35%	$ 209,426 – $ 523,600	$ 209,401 – $ 523,600	$ 418,851 – $ 628,300	$ 209,426 – $ 314,150
37%	Over $ 523,600	Over $ 523,600	Over $ 628,300	Over $ 314,150
Tax rate	**AMT brackets**			
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
26%	$ 0 – $ 199,900	$ 0 – $ 199,900	$ 0 – $ 199,900	$ 0 – $ 99,950
28%	Over $ 199,900	Over $ 199,900	Over $ 199,900	Over $ 99,950
	AMT exemptions			
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
Amount	$ 73,600	$ 73,600	$ 114,600	$ 57,300
Phaseout[1]	$ 523,600 – $ 818,000	$ 523,600 – $ 818,000	$ 1,047,200 – $ 1,505,600	$ 523,600 – $ 752,800

[1] This is the AMT income range over which the exemption phases out; only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

Note: *Consult your tax advisor for AMT rates and exemptions for children subject to the "kiddie tax" and for estates and trusts.*

CHART 8 2021 corporate income tax rates

Tax rate	Type of corporation
21%	C corporation
21%	Personal service corporation

CHART 9 2021 estate and trust income tax rate schedule

Tax rate	Tax brackets
10%	$ 0 – $ 2,650
24%	$ 2,651 – $ 9,550
35%	$ 9,551 – $ 13,050
37%	Over $ 13,050

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