Wealth Planning Insights

Year-End Tax Planning in a Changing Tax Landscape

BESSEMER TRUST

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Highlights

- The House of Representatives has passed the Build Back Better Act (BBB), which contains several tax changes that target higher-income taxpayers to help pay for its wide-ranging measures. The Senate leadership plans to send its version of the bill back to the House before Christmas.
- Uncertainty over what tax changes will ultimately be enacted makes tax planning challenging in 2021. But meaningful tax planning is still possible.
- This Wealth Planning Insights focuses on the tax laws that are in effect for 2021 and provides income tax planning action steps and annual exclusion giving strategies to consider.

Year-end tax planning can be a complex undertaking in normal times. In large part, it requires a careful analysis of current and future tax laws and developing strategies based on the timing and amount of income, along with planned itemized deductions. With major tax legislation on the horizon and widespread uncertainty over what tax changes, if any, will ultimately be enacted, year-end planning in 2021 has become even more daunting.

The House of Representatives recently passed the Build Back Better Act (BBB), a wide-ranging piece of legislation containing significant investments in childcare, education, Medicare, affordable housing, and efforts to combat climate change. To help pay for these measures, several tax changes targeting higher-income taxpayers were included in the legislation (see Exhibit 1 on page 2). The Senate leadership plans to finish work on its version of BBB and send it back to the House before Christmas. It is important to note that House BBB tax provisions may be modified or fully eliminated by the Senate. At this point, there is no prudent approach to factor indeterminate 2022 tax changes into current-year planning. Action taken based on what might happen — without certainty of the end result — can be a risky proposition.

Nevertheless, taxpayers can still accomplish meaningful year-end tax planning by focusing on the tax laws that remain in effect for 2021, where the resulting tax treatment is free from doubt. The following discussion will focus on three main planning areas, followed by a checklist of annual income tax planning action steps and annual exclusion giving strategies to consider.

Charitable Planning

2021 presents a one-time window of opportunity for individuals considering a very large charitable gift. This year only, taxpayers can deduct up to 100% of their adjusted gross income (AGI) in charitable gifts. The normal limitations apply to gifts of long-term appreciated securities (LTAS) — 20% of AGI if given to a private foundation and 30% of AGI if given to a public charity. Further cash contributions can be deducted up to a combined maximum of 50% of AGI (60% of AGI if no contributions of LTAS). For the remainder of 2021, these amounts can be topped off up to 100% of AGI with cash gifts to public charities (excluding donor-advised funds).

Exhibit 1: House BBB Provisions Affecting Higher-Income Taxpayers

Surtax on higher-income taxpayers:
- 5% surtax on taxpayers with income over $10 million ($5 million for married taxpayers filing separately).
- Surtax increases to 8% on income over $25 million ($12.5 million for married taxpayers filing separately).
- For trusts and estates, 5% surtax applies at $200,000 income threshold.
- Trust and estate surtax increases to 8% on income over $500,000.

Net investment income tax expanded to nonpassive trade or business income:
- 3.8% tax would apply to taxpayers with income over $400,000 for single filers, $500,000 for married taxpayers filing jointly, and $250,000 for married taxpayers filing separately.

Section 1202 modified to remove 100% and 75% exclusion of gain on sale of qualified small business stock:
- Applies to individual taxpayers with income over $400,000.
- Also applies to trusts and estates (with no income threshold).
- 50% exclusion potential would be retained.
- Effective date — retroactive to September 13, 2021.

Restrictions on retirement plans for higher-income taxpayers:
- Further contributions prohibited if total value of all IRA and defined contribution accounts exceeds (or would exceed with additional contribution) $10 million as of end of prior tax year — effective January 1, 2029.
- This prohibition would apply to individuals with income over $400,000 (single and married filing separately) and $450,000 (married taxpayers filing jointly).
- Increased required minimum distributions (RMDs) for taxpayers with aggregate IRA and defined contribution plans in excess of $10 million — effective date January 1, 2029.
- RMDs from Roth IRAs would be required for certain taxpayers — effective January 1, 2029.
- Roth IRA conversions would be eliminated for taxpayers with income over $400,000 (single and married filing separately) and $450,000 (married taxpayers filing jointly) — effective January 1, 2032.
- So-called "back-door" Roth IRA conversions would be prohibited for all taxpayers

Effective date of January 1, 2022, unless otherwise noted.

Roth IRA Conversions

Although the House BBB legislation takes aim at taxpayers with very large retirement account balances (with a focus on Roth IRAs), we believe Roth IRAs remain a powerful wealth transfer planning tool. Conversions of traditional IRAs into Roth IRAs can provide significant economic benefits, especially for low- or no-cost conversions. Roth IRAs are not subject to income tax; distributions are also tax free, and there are no required minimum distributions (RMDs) for the account owner. Non-spouse beneficiaries must fully distribute the account within 10 years.

When a traditional IRA is converted into a Roth, the amount converted must be included in taxable income. Taxpayers can reduce or fully offset this related tax in certain scenarios:

- Many taxpayers have suspended passive losses from various investments, including real estate. When these investments are disposed of, the suspended losses are triggered and can be used to offset ordinary income, such as income related to a Roth conversion.
- Large charitable contributions can also offset some or all of the income from a Roth conversion. As noted above, in 2021 a deduction up to 100% of AGI is allowed; coupling a large cash contribution with a Roth IRA conversion can produce compelling long-term results.

Self-Employed Retirement Plans

High-income taxpayers often earn self-employment income from various sources, such as consulting or director's fees. They may overlook the tax benefits afforded by self-employed retirement plans. Many plans, such as the solo 401(k), are quite generous. Based on the amount of self-employment income earned, taxpayers can make a tax-deductible contribution of up to $58,000 in 2021. This provides an immediate tax benefit and allows for further tax-deferred growth of plan assets for many years, until distributions are required in retirement. In effect, the government is paying you to move money from a taxable account into a tax-advantaged account. (Note that, unlike most plans that allow contributions to be made in the following year, a portion of the solo 401(k) contribution must be made prior to year-end.)

Annual Income Tax Planning Action Steps

Action Step	Income Tax Benefit
Consider selling investments to realize losses.	Losses reduce current-year capital gains.
Fund a self-employed retirement plan (must have self-employment income).	Current-year income tax deduction; tax deferred growth of plan assets.
Use long-term appreciated securities for charitable contributions.	Current-year full fair market value deduction up to 30% of adjusted gross income (AGI) — income tax liability on appreciation amount is eliminated.
Fund a so-called "back-door" Roth IRA (must have earned income). Can also fund for spouse with no earned income.	Up to $7,000 per year ($14,000 if married). No RMDs. Roth income and distributions are excluded from taxable income. Not effective for individuals who own a traditional IRA.
Front load several years of charitable giving with a donor-advised fund, such as the Bessemer Giving Fund.	Tax deduction for full amount in current year; grants to charity can be spread over multiple years in the future.
Make a qualified charitable distribution (QCD) from an IRA if 70½ or older.	Can satisfy RMD; will reduce AGI such that limitations on tax benefits tied to AGI levels may not apply.

In addition to annual income tax planning, we recommend Bessemer clients take advantage of annual exclusion giving. For 2021, every individual is entitled to give $15,000 ($30,000 for a married couple) to any number of individuals. These annual exclusion gifts do not reduce the remaining lifetime exemption.

The table below summarizes annual exclusion giving strategies that we recommend clients consider to advance their estate planning goals.

Common Annual Exclusion Giving Strategies

- In all cases, amounts transferred and future growth are excluded from taxable estate.
- Annual exclusion giving should be coordinated with the overall estate plan.
- Many strategies provide a combination of income tax and estate tax benefits.

Strategy	Income Tax Treatment	Notes
Make direct cash gifts.	Recipient pays tax on income earned on transferred assets.	Recipient has immediate control of assets.
Fund 529 plans for children or grandchildren. Consider front loading five years.	Income and qualified distributions are tax free. State income tax deduction may be available.	Account owner has control of account and assets. Can be used to pay education expenses beyond tuition, such as room and board.
Fund a Roth IRA or so-called "back-door" Roth IRA for children or grandchildren with earned income.	Income and qualified distributions are excluded from tax; no RMDs.	Recipient will have full control of assets.
Fund a GST non-exempt trust to benefit children. Consider structuring as a grantor trust.	Trust income is subject to tax. If structured as a grantor trust, tax is payable by the trust creator.	Trustee maintains control over assets.
Fund a GST exempt trust to benefit future generations. Consider structuring as a grantor trust.	Trust income is subject to tax. If structured as a grantor trust, tax is payable by the trust creator.	Trustee maintains control over assets. Use of GST exemption required in most cases.
Fund a life insurance trust.	Life insurance proceeds are free from income and estate tax.	Trustee maintains control over policy and assets.
Make direct payments of tuition and medical expenses for children or grandchildren.	Not treated as taxable gifts and do not count toward annual exclusion giving.	Educational expenses beyond tuition do not qualify but can be funded from a 529 account.

We hope you find this summary to be helpful in considering year-end tax planning for 2021. We are monitoring the progress of legislation in Washington closely and will keep you informed of any meaningful developments.

Please contact your client advisor or one of our senior tax consultants if you have any questions or would like to discuss further.

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