CHIEF INVESTMENT OFFICE

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Beginning of Year Tax Planning

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INTRODUCTION

Tax planning and tax decisions are not, and should not be, exclusive to the final weeks of the calendar year. Year end does offer an opportunity to assess one's tax situation with a nearly complete set of facts. But by then it may be too late to plan and make timely decisions.

Beginning-of-the-year tax planning should not be overlooked and in some instances may be even more important than year-end planning. As we begin a new year, we want to draw your attention to some important tax items that should be considered early in the year, not only because they have the potential to maximize savings and minimize taxes, but also because some are time-sensitive as well. The following is a non-exclusive list of items to be considered by taxpayers early in the year, some time-sensitive, some based on common sense.

TAX CONSIDERATIONS FOR THE BEGINNING OF THE YEAR

What if?

It is said that "an ounce of prevention is worth a pound of cure." Upfront tax planning can prevent unpleasant future surprises and, more importantly, potentially result in tax savings as well. An early-in-the-year assessment of projected income can lead to better and more informed decision making.

Rather than waiting for the end of the year, taxpayers should look at their prospective tax planning early in the year. If compensation or investment earnings have increased from the prior year, various tax benefits could be lost as income exceeds certain thresholds or phase-out ranges. For instance, an increase of $50,000 of investment income could cause the qualified business income deduction to be fully phased-out for some taxpayers. In such case, would it be better for investment income to be tax-exempt to preserve the deduction? Alternatively, consider whether increasing taxable interest income would result in a charitable gift being more tax-efficient by the charitable deduction offsetting ordinary income otherwise taxed at 37% versus long-term gains or dividends taxed at 20%. It may make sense to allocate investments to taxable bonds to generate a possible higher yield and gain greater tax efficiency from making a charitable gift.

Of course, a taxpayer could consider these tax decisions at year end, but by then the taxpayer would not be in a position to alter the character of income previously recognized during the year or rearrange investments to generate taxable or non-taxable income. Taxpayers could be well served by running a base-case, best-case, and worst-case financial and tax projection scenarios at the beginning of each tax year, with periodic updates throughout the year.

TIMING MATTERS

A host of tax decisions and elections are time-sensitive and must be considered within the first few months of the year, if not sooner. Some decisions have a retroactive effect and could affect taxes for the prior calendar year, and yet others are prospective in nature.

Trust/Estate Distribution Planning — One important tax planning decision must be made by early March. That decision allows a trustee to elect to treat trust distributions made during the first 65 days of the current tax year as distributions made during the immediately preceding tax year. This decision could save significant income taxes by pulling income away from a trust (which is subject to top ordinary and capital gains tax rates at income levels as low as about $13,000) and pushing that income into the hands of individual beneficiaries who may be in much lower tax brackets (the 2022 top income tax bracket for married taxpayers begins at approximately $650,000). While the trustee must make the distribution soon after year end, the election to treat the distribution as occurring in the preceding tax year is made on the trust's income tax return. An executor may make a similar election on the estate's income tax return during the first 65 days of the estate's current tax year.

Pass-Through Entity Taxes — Another important tax election relates to the new pass-through entity ("PTE") taxes enacted by many states within the last year or two. In many states, this is an optional tax that allows partnerships (including LLCs) or S-corporations to annually elect to pay state income tax on certain income at the entity level rather than at the partner or member level. Generally, if a partnership or S-corporation elects to pay an entity level tax, the partners, members, or shareholders of the electing entity which is subject to the tax may be eligible for a tax credit on their state income tax returns.

The rules for electing this treatment vary among states. New York, for instance, permits the annual PTE tax election to be made on or after January 1 but no later than March 15, for tax years beginning on or after January 1, 2022. New Jersey and California permit the PTE annual election to be made on an original, timely filed tax return, while North Carolina and Minnesota permit the PTE annual election to be made on the due date of the return, including extensions.

For those operating as a sole proprietorship or single member LLC, consideration should be given to incorporating as an S-corporation or adding another member to avail themselves of the benefits of state PTE rules.

Federal Elections: S-Corporations — For taxpayers who have converted a C-corporation into an S-corporation, the change in tax status will be recognized for federal tax purposes retroactive to the beginning of 2022 only if the taxpayer makes a timely election. That election must be made by March 15, 2022 (with limited exceptions), otherwise the S-corporation status will be prospective in nature.

Gift Tax Returns — 2021 was an active year for estate planning. Many taxpayers were concerned about a potential imminent decrease in the federal estate and gift tax exemption, among other changes in the proposed Build Back Better Act. This concern accelerated significant gift/estate planning into 2021, which means many taxpayers will need to file a federal gift tax return by April 15, 2022. Taxpayers can request an automatic six-month extension of time to file a federal gift tax return in two ways, provided they take timely action. First, a taxpayer can request an automatic extension to file a gift tax return by also applying for an extension of time to file their federal income tax return. Second, if a taxpayer is not requesting an extension to file their income tax return, then a separate request to extend the time to file a gift tax return should be made on IRS Form 8892.

FUNDING RETIREMENT PLANS

Contributions to retirement accounts, such as a 401(k) or IRA, can be made throughout the calendar year, or in the case of an IRA even in the following tax year, if made on or before April 15 of such following year (the un-extended due date for filing a tax return). However, in a rising investment market, funding a retirement account early in the year has the benefit of permitting those funds to grow tax deferred for a longer period of time. A taxpayer who funds an IRA in January of 2022 rather than April of 2023, will enable those funds to potentially grow and compound for an extra 15 months. However, for an employer sponsored plan such as a 401(k), if your employer offers a match to your contributions, you will want to consider the implications of fully funding your account early in the year. In some instances, if your contributions stop, so will the company's match.

FEDERAL TAX LAWS — CONTINUED UNCERTAINTY

Congress attempted to pass a significant spending and tax bill (the Build Back Better ("BBB") Act) in late 2021, only to fail in the closing days of December. Some of the proposed tax changes would have taken away long-standing tax benefits. Other changes would have introduced new rules limiting taxpayer flexibility. All or portions of the previously proposed tax bill could be repurposed and used to offset the cost of future legislation, whether this year or in future years. Indeed, the Biden Administration will likely push to pass its spending priorities in separate initiatives or in a single, but smaller, version of its Build Back Better bill. While changes could be made on a retroactive basis, that is unlikely in our view. Taxpayers may therefore want to consider items in the crosshairs of Congress before they are reconsidered for passage in the new year. Here are a few items taxpayers should consider:

Qualified Small Business Stock (QSBS) — Congress attempted to significantly reduce the tax benefits associated with selling QSBS stock if an individual taxpayer earns more than $400,000. For a non-grantor trust selling QSBS stock, the tax benefit would be reduced regardless of the amount of trust income. To avoid the consequences of a possible resurrection of this provision, taxpayers should consider the sale of QSBS stock in the near term. If such a provision is enacted, there can be no certainty of its effective date. In our view it would likely be prospective from the date of introduction of new proposed legislation.

Wash-Sale Rules for Crypto-Currencies — Wash sale rules prohibit a taxpayer from realizing the tax benefits of selling certain property at a loss, if that property (or substantially similar property) is also purchased by the taxpayer (or certain other parities) within 30 days before or after the sale of the property resulting in a loss. Congress attempted to expand this rule to cover crypto-currencies beginning in 2022. Crypto-currencies are described as any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Treasury Secretary. Currently, taxpayers could sell all or some of their crypto-currencies, book a tax loss for 2022, and immediately repurchase identical positions. Given the approximately 20% decline in Bitcoin (as of January 24, 2022), taxpayers could consider the benefits of taking a tax loss that otherwise could not be taken if this proposal from the BBB Act is resurrected and passed in 2022.

Constructive Sales — Existing tax rules treat certain hedging and economic-risk-reduction strategies for certain previously owned financial assets as an actual sale for federal income tax purposes of those previously owned positions. These rules prevent taxpayers from locking in investment gains without realizing taxable gain. Proposed changes would include digital assets (crypto-currencies) in the constructive sale rules. Under the proposed BBB Act, the changes would apply to constructive sales after the date legislation is enacted and contracts entered into after the date of enactment. Assuming a continued prospective effective date, taxpayers would have an opportunity to lock in the value of appreciated crypto-currency gain without adverse tax consequences if done in a timely manner.

ROTH CONVERSIONS WITH AFTER-TAX DOLLARS

The Build Back Better Act would also have put an end to so-called back-door Roth conversions beginning in 2022. As written, the proposed legislation would have prohibited the conversion of any after-tax funds in an IRA or 401(k) from being converted into a Roth IRA or Roth 401(k) Account. That legislation did not pass, but there is a possibility the tax provisions could be used in subsequent legislation. It is unknown if subsequent legislation would restrict such Roth conversions on a retroactive basis, although this is unlikely in our view. Taxpayers, along with the advice of their tax accountants, may want to consider the merits of converting after-tax retirement plan dollars into Roth IRAs early in 2022, to take advantage of the current rules.

INCENTIVE STOCK OPTIONS

Exercising incentive stock options early in the year can provide tax benefits and flexibility not otherwise available for late-year exercises. Incentive Stock Options (ISOs) have special tax benefits which can result in long-term capital gains treatment if you exercise your options and then hold the underlying stock for more than one year. While the exercise of ISOs is not a taxable event for regular federal income tax purposes, the gain upon exercise is considered income for Alternative Minimum Tax purposes. If the underlying shares are sold within one year of exercise, then it results in a disqualifying disposition, and options are treated as non-qualified stock options: the gain at the date of exercise is taxable as compensation income (and there is no resulting AMT income).

Exercising ISOs early in the year provides significant flexibility because it gives you almost a full year to determine if the resulting shares should be sold: If the stock prices goes up, a taxpayer should continue to hold the underlying stock to attain long-term capital gain treatment; however, if the stock price goes down the taxpayer should consider disposing of the shares (in the same calendar year as the exercise) to negate the AMT income and turn the tax treatment into non-qualified options.

For example, assume an incentive stock option is exercised on January 20, 2022 with a strike price of $10 and the underlying stock is valued at $25. If the stock is then held for over a year, there will be no ordinary income tax due on the $15 difference between the $10 strike price and the $25 stock value at the time of exercise. A future sale of the stock at a price above the $10 strike will result in a long-term capital gain. For the purpose of calculating the potential AMT, the $15 will be considered income for 2022 regardless of what happens to the price of the stock for the remainder of 2022 if the stock continues to be held by the taxpayer through year end.

Now assume that 11 months after exercising the option (December 20, 2022) the share price declines to $10 and, without expecting a near term recovery of the share price, the taxpayer decides to sell the shares thereby disqualifying the option from the special tax treatment permitted for ISOs. For ordinary income tax purposes, this would result in taxable income being due based on the difference between the strike price and the lower of the price on the date of exercise or the price on the date of sale of the shares. In this case, with the sale price equal to the $10 strike price, there would be no ordinary income tax due.

However, for AMT remember that the tax would be calculated and due for the calendar year of the option exercise. If the disqualifying disposition occurs in 2022 (the same calendar year as the ISO exercise) there would not be any AMT income resulting from the exercise. However, if the taxpayer delayed the sale by two weeks and the disqualifying disposition occurs in 2023, the taxpayer would have already calculated their AMT due for 2022 based on the difference between the strike and the exercise price. A sale occurring in 2023 would not change that. This could leave the taxpayer with a large AMT liability bill for 2022 based on the $25 price at the time of exercise, despite the current $10 stock price. The bottom line is that exercising earlier in the year would give the taxpayer more time to decide whether to disqualify shares acquired through an ISO exercise prior to year-end and avoid a potential 2022 AMT liability based on a higher price if the stock price declines.

ESTATE PLANNING

Annual exclusion gifts. Like contributions to retirement plans, there are benefits to making annual exclusion gifts early in the tax year. A gift early in the year gives the recipient more time to invest the funds, which will hopefully appreciate in the recipient's hands, rather than in the donor's estate. For 2022, the annual exclusion is $16,000.

Exemption gifts. While there has been much talk about the possibility of the estate, gift and GST exemption going down, it has steadily been going up each year due to the inflation adjustment. In 2021, the exemption was $11,700,000. In 2022, the exemption went up to $12,060,000 – an increase of $360,000, or $720,000 for a couple. Just as with annual exclusion gifts, a gift of the full amount of the exemption gives the recipient more time to invest the funds, which will result in a greater amount of property removed from the donor's estate. In fact, there is an even greater incentive to make an exemption gift early in the year. This is because of the possibility that the exemption amount may go down, even before the scheduled reduction in 2026. By making a full exemption gift now, it would presumably lock-in not only appreciation, but also the full exemption amount as well.

Taxable gifts. When gifts exceed the annual exclusion amount and the lifetime exemption amount, it could result in the payment of gift taxes. Those gifts have an effective federal tax rate of 28.6%, if the donor survives for three years after the gift is made, otherwise the effective rate jumps to 40%. The earlier such a taxable gift is made, the more likely the donor will survive the three years and the less likely the gift will be taxed at 40%.

Grantor trust proposal. For a period of time during 2021, taxpayers and the estate planning community were confronted with a proposal that would have adversely affected "grantor trusts" (a trust whose income or capital gain, or both, are taxed to the grantor regardless of distributions). This proposal has been jettisoned from recent tax bills, but it could come back.

Two popular tax benefits of grantor trusts are (1) payment of income tax by the grantor as a tax-free gift to the trust and (2) tax-free transactions between the grantor and grantor trust. The proposal would have (i) required the value of grantor trusts to be included in the deceased owner's estate and (ii) treated most distributions to beneficiaries from grantor trusts as a taxable gift.

The proposal would eliminate the first benefit because although the grantor could still pay the grantor trust's income tax, the payments would benefit a trust which would either be includible in the grantor's estate or subject to gift tax. With respect to the second benefit, the proposal provides that in the case of any transfer of property between the grantor and the grantor trust, the transaction would be treated as a taxable event. This would therefore eliminate the second benefit, as well.

While we believe that it is unlikely that such a provision would resurface in the near term, it may, nonetheless, be prudent to explore the benefits of swapping low-basis assets held by a grantor trust with high-basis assets held by the grantor, if the trust agreement authorizes the grantor to make such swaps. This could provide the grantor with low-basis assets that then could be used for gifting to charitable recipients; alternatively, the grantor could hold on to those assets to achieve a step-up in basis on death and eliminate the embedded capital gain. Taxpayers should be aware that if low-basis assets held by the grantor trust at the time of the swap are expected to appreciate at a rate greater than the assets swapped by the grantor, an "early swap" could result in a larger taxable estate due to the subsequent appreciation.

NEW ACTUARIAL TABLES

The IRS maintains a series of actuarial tables used to calculate required distributions from retirement plans based on owner and beneficiary life expectancies. These tables are used for owners of retirement plans who are age 72 or older, and for beneficiaries who have inherited retirement plans and are permitted to take distributions based on their life expectancy. For required minimum distributions beginning in 2022, the IRS has published updated tables to reflect longer life expectancies. These changes will generally result in smaller required distributions versus the old tables.

For example, an account owner who is turning age 75 in 2022 and has an IRA balance of $1,000,000 as of December 31, 2021 would be required to take a distribution of $40,650, based on a life expectancy factor of 24.6 from the new tables. Using the old tables, that distribution would have been $43,668, based on a life expectancy factor of 22.9.

Individuals who rely on their required minimum distribution to fund spending during the year may need additional cash distributions to make up any shortfall. In some instances it could make sense to draw this additional cash from taxable investment accounts, leaving more in retirement accounts to accumulate tax-deferred. However, this could require raising additional cash in one's taxable investment accounts, which could also have income tax consequences.

For beneficiaries of inherited retirement accounts who are permitted to take life-expectancy-based distributions (i.e., most beneficiaries who inherited accounts prior to 2020, and certain eligible designated beneficiaries who inherited accounts from 2020 on), there will also be changes to their minimum distributions. For these beneficiaries, their initial life expectancy payout factor was based on their age in the year after the original owner's year of death, and then reduced by 1 for each subsequent year.

For example, a beneficiary who inherited an IRA, and turned 50 in the year following the owner's death, would use a divisor of 34.2 for the first distribution, and reduce that by 1 each year. Assuming 5 years have passed since the first distribution, the 2022 divisor would be 29.2 using the old tables. Under the new table, this beneficiary's divisor at age 50 would have been 36.2. The beneficiary may now recalculate their current divisor using the 36.2 age 50 divisor from the new table and then adjust for the number of years that have passed. For 2022 the new divisor in this example would be 31.2.

By reducing the required distribution, more assets will remain in the IRA to grow tax-deferred over the beneficiary's lifetime. Beneficiaries should ensure that their 2022 distribution reflects this change if their goal is to keep assets in the inherited account as long as possible.

CONCLUSION

Tax planning and tax decisions are not, and should not be, exclusive to the final weeks of the calendar year.

Beginning–of-the-year tax planning should not be overlooked and in some instances may be even more important than year-end planning. Potential tax legislation as part of a slimmed down Build Back Better bill could close some tax planning opportunities on a prospective basis. Taking action before such changes should be considered by some taxpayers. Absent any changes in tax law, other opportunities exist to change tax consequences on a retroactive basis, but are generally elective in nature and time sensitive to early in the calendar year. Tax planning is always a year-round endeavor, with particular emphasis on not only year-end planning but on beginning-of-year planning, too.

— National Wealth Strategies, Chief Investment Office

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