December 3, 2021

To our Clients and Friends,

As the end of the year is fast approaching, we should consider last-minute strategies that might help reduce your 2021 tax bill. This letter presents a few tax-saving ideas to get you started. As always, you can call on us to help you sort through the options and implement strategies that make sense for you.

Tax Planning for Individuals

Due to the enactment of legislation to offset the economic burden wrought by COVID-19, there is a lot to consider when reviewing year-end tax planning options. Pandemic-related tax breaks include an expanded dependent care assistance, payroll tax credits for self-employed individuals, substantial increases in the child tax credit and the earned income tax credit, $1,400 recovery rebates for many taxpayers, and an exclusion from income for certain student loan forgiveness, to name just a few.

The following are some of the considerations we should explore when discussing the tax breaks from which you may benefit, as well as the strategies we can employ to help minimize your taxable income and resulting federal tax liability.

2021 Recovery Rebate. Under American Rescue Plan (ARP) Act, passed in March, individuals with income under a certain level are entitled to a recovery rebate tax credit. These are direct payments (sometimes referred to as "stimulus checks") to individuals by the government.

Single individuals and joint filers are entitled to a payment of $1,400 for each eligible individual. An eligible individual is any individual other than (1) a nonresident alien, (2) a dependent of another taxpayer, and (3) an estate or trust. For these purposes, the term “dependent” includes not just children but qualifying relatives. The amount of the recovery rebate phases out for income over a certain level. The 2021 recovery rebate began phasing out starting at $75,000 of adjusted gross income (AGI) for an individual ($112,500 for heads of household and $150,000 in the case of a joint return or surviving spouse) and was completely phased out where an individual’s AGI is $80,000 ($120,000 for heads of household and $160,000 in the case of a joint return or surviving spouse).

The government began issuing the rebates based on 2019 income tax returns, or 2020 returns for individuals who filed their 2020 returns in time. The calculation for the correct amount of the rebate will be part of your 2021 tax return. If your 2021 tax return indicates a rebate larger than your stimulus check (because, for example, your income went down or you had another child), any additional amount will be claimed as a credit against your 2021 tax bill. On the flip side, if the 2021 rebate calculation shows an amount in excess of what you were entitled to, you do not have to repay that excess.

Filing Status. Your tax return filing status can impact the amount of taxes you pay. For example, if you qualify for head-of-household (HOH) filing status, you are entitled to a higher standard deduction and more favorable tax rates. To qualify as HOH, you must be unmarried or considered unmarried (i.e., legally separated or living apart from a spouse) and provide a home for certain other persons. If you are in such a situation, we need to review whether you qualify for HOH filing status.

If you are married, you'll either be filing your return using the married filing jointly or married filing separately filing status. Generally, married filing separately is not beneficial for tax purposes, but in some unique cases, such as when one party earns substantially less or when one party may be subject to IRS penalties for issues relating to tax reporting, it may be advantageous to file as married filing separately. Additionally, if one spouse was not a full-year U.S. Resident, an election is available to file a joint tax return where such joint filing status would otherwise not apply and this may help reduce a couple's tax liability.

Standard Deduction versus Itemized Deductions. The Tax Cuts and Jobs Act of 2017 (TCJA) substantially increased the standard deduction amounts, thus making itemized deductions less attractive for many individuals. For 2021, the standard deduction amounts are: $12,550 (single); $18,800 (head of household); $25,100 (married filing jointly); and $12,550 (married filing separately). An additional standard deduction amount of $1,350 applies for taxpayers who are 65 or older or blind. This additional amount is increased to $1,700 if the individual is also unmarried and not a surviving spouse. If the taxpayer is 65 or older and blind, the deduction is doubled.

If the total of your itemized deductions in 2021 will be close to your standard deduction amount, we should evaluate whether alternating between bunching itemized deductions into 2021 and taking the standard deduction in 2022 (or vice versa) could provide a net-tax benefit over the two-year period. For example, you might consider doubling up this year on your charitable contributions rather than spreading the contributions over a two-year period. If these contributions, along with your mortgage interest, medical expenses (discussed below), and state income and property taxes (subject to the $10,000 deduction limitation on such taxes that applies to both single individuals and married couples filing jointly; and the $5,000 limitation on such expenses for married filing separately returns), exceed your standard deduction, then itemizing such expenses this year and taking the standard deduction next year may be appropriate.

Medical Expenses, Health Savings Accounts, and Flexible Savings Accounts. As a result of the COVID-19 pandemic, a number of individuals have incurred more medical expenses than usual. For 2021, our-of-pocket medical expenses you have paid in 2021 are deductible as an itemized deduction to the extent they exceed 7.5 percent of your adjusted gross income. To be deductible, medical care expenses must be primarily to alleviate or prevent a physical or mental disability or illness. They don't include expenses that are merely beneficial to general health, such as vitamins or a vacation. Deductible expenses include not only hospitalization expenses, but also health insurance premiums and the amounts you pay for transportation to get medical care. Medical expenses also include amounts paid for qualified long-term care services and limited amounts paid for any qualified long-term care insurance contract. Depending on what your taxable income is expected to be in 2021 and 2022, and whether itemizing deductions would be advantageous for you in either year, you may want to accelerate any optional medical expenses into 2021 or defer them until 2022. The right approach depends on your income for each year, expected medical expenses, as well as your other itemized deductions.

You may also want to consider health saving accounts (HSAs) if you don't already have one. These are tax-advantaged accounts which help individuals who have high-deductible health plans. If you are eligible to set up such an account, you can deduct the amount you contribute to the account in computing adjusted gross income. These contributions are deductible whether you itemize deductions or not. Distributions from an HSA are tax free to the extent they are used to pay for qualified medical expenses (i.e., medical, dental, and vision expenses). For 2021, the annual contribution limits are $3,600 for an individual with self-only coverage and $7,200 for an individual with family coverage.

In addition, if you are not already doing so and your employer offers a Flexible Spending Account (FSA), consider setting aside some of your earnings tax free in such an account so you can pay medical and dental bills with pre-tax money. The maximum amount that the IRS will allow to be set aside for 2021 limit is $2,750. Since you don't pay taxes on this money, you'll save an amount equal to the taxes you would have paid on the money you set aside. FSA funds can be used to pay deductibles and copayments, but not for insurance premiums. You can also spend FSA funds on prescription medications, as well as over-the-counter medicines, generally with a doctor's prescription. Reimbursements for insulin are allowed without a prescription. And finally, FSAs may also be used to cover costs of medical equipment like crutches, supplies like bandages, and diagnostic devices like blood sugar test kits.

Charitable Contributions. While the tax benefits of making charitable contributions and taking an itemized deduction for such contributions were tamped down as a result of the increases made to the standard deduction amounts, a law passed at the end of 2020 modified the charitable contribution rules for 2021 tax returns. As a result, eligible individuals can claim an above-the-line deduction of up to $300 ($600 in the case of a joint return) for qualified charitable contributions made during 2021. An eligible individual is an individual who does not elect to itemize deductions. Thus, absent this provision, anyone taking the standard deduction would be ineligible to take a charitable contribution deduction. A qualified charitable contribution is a cash contribution paid in 2021 to an eligible charitable organization. Contributions of noncash property, such as securities, are not qualified contributions.

In addition, if you are itemizing your deductions and have substantial charitable contributions, the new rules modified the percentage limitation rules that could otherwise limit your charitable contribution deduction. As a result, for charitable contributions made during 2021, any qualified contribution is allowed as a deduction to the extent that the aggregate of such contributions does not exceed the excess of your charitable contribution base over the amount of all other charitable contributions. Excess contributions are eligible for a five-year carryover.

As in prior years, you can reap a larger tax benefit by donating appreciated assets, such as stock, to a charity. Generally, the higher the appreciated value of an asset, the bigger the potential value of the tax benefit. Donating appreciated assets not only entitles you to a charitable contribution deduction but also helps you avoid the capital gains tax that would otherwise be due if you sold your stock. For example, if you own stock with a fair market value of $1,000 that was purchased for $250 and your capital gains tax rate is 15%, the capital gains tax you would owe if you sold that stock is $113 ($750 gain x 15%). If you donate that stock instead of selling it, and are in the 24% tax bracket, your ordinary income deduction is worth $240 ($1,000 FMV x 24% tax rate). You also save the $113 in capital gains tax that you would otherwise pay if you sold the stock; that amount goes to the charity. Thus, the after-tax cost of the gift of appreciated stock is $647 ($1,000 - $240 - $113) compared to the after-tax cost of a donation of $1,000 cash which would be $760 ($1,000 - $240). However, it's important to also keep in mind that tax deductions for contributions of appreciated long-term capital gain property may be limited to a certain percentage of your adjusted gross income depending on the amount of the deduction.

Finally, if you have an individual retirement account and are 70 1/2 years old and older, you are eligible to make a charitable contribution directly from your IRA. This is more advantageous than taking a distribution and making a donation to the charity that may or may not be deductible as an itemized deduction. If your itemized deductions, including the contribution, are less than your standard deduction, then you receive no tax benefit from taking a taxable distribution and donating that distribution. By making the donation directly from your IRA to a charity, you eliminate having the IRA distribution included in your income. This in turn reduces your adjusted gross income (AGI). And because various tax-related items, such as the medical expense deduction or the taxability of social security income or the 3.8% net investment income tax, are calculated based on your AGI, a reduced AGI can potentially increase your medical expense deduction, reduce the tax on social security income, and reduce any net investment income tax.

Expenses Incurred While Working from Home. Although more people have been working from home this year due to the pandemic, related expenses are not deductible if you are an employee. However, if you are self-employed and worked from home during the year, tax deductions are still available. Thus, if you have been working from home as an independent contractor, we should discuss what expenses you have incurred that might offset that taxable income.

Mortgage Interest Deduction. If you sold your principal residence during the year and acquired a new principal residence, the deduction for any interest on your acquisition indebtedness (i.e., your mortgage) could be limited. The interest deduction on mortgages of more than $750,000 obtained after December 14, 2017, is limited to the portion of the interest allocable to $750,000 ($375,000 in the case of married taxpayers filing separately). If you have a mortgage on a principal residence acquired before December 15, 2017, the mortgage interest limitation applies to mortgages of $1,000,000 ($500,000 in the case of married taxpayers filing separately) or less. However, if you operate a business from your home, an allocable portion of your mortgage interest is not subject to these limitations.

Interest on Home Equity Indebtedness. You can potentially deduct interest paid on home equity indebtedness, but only if you used the debt to buy, build, or substantially improve your home. Thus, for example, interest on a home equity loan used to build an addition to your existing home is typically deductible, while interest on the same loan used to pay personal expenses, such as credit card debt, is not.

Sale of a Home. If you sold your home this year, up to $250,000 ($500,000 for married filing jointly) of the gain on the sale is excludible from income. However, this amount is reduced if part of your home was rented out or used for business purposes. Generally, a loss on the sale of a home is not deductible. But again, if you rented part of your home or otherwise used it for business, the loss attributable to that portion of the home is deductible.

Discharge of Qualified Principal Residence Indebtedness. If you had any qualified principal residence indebtedness which was discharged in 2021, it is not includible in gross income.

Deductions for Mortgage Insurance Premiums: You may be entitled to treat amounts paid during the year for any qualified mortgage insurance as deductible qualified residence interest if the insurance was obtained in connection with acquisition debt for a qualified residence.

Deductions for Excess Business Losses. The ARP allows taxpayers other than corporations to deduct excess farm losses and excess business losses through 2027. An excess business loss for the tax year is the excess of aggregate deductions attributable to your trades or businesses over the sum of your aggregate gross income or gain plus a threshold amount. The threshold amount for 2021 is $262,000 or $524,000 for joint returns.

Qualified Business Income Passthrough Tax Break. Under the qualified business income tax break, a 20% deduction is allowed for qualified business income from sole proprietorships, S corporations, partnerships, and LLCs taxed as partnerships. If you qualify for the deduction, which is available to both itemizers and nonitemizers, it is taken on your individual tax return as a reduction to taxable income. This tax break is subject to some complicated restrictions and limitations, but the rules that apply to individuals with taxable income at or below $164,900 ($329,800 for joint filers; $164,925 for married individuals filing separately) are simpler and more permissive than the ones that apply to individuals with taxable income above those thresholds.

Child Tax Credit. The ARP significantly increased the child tax credit (CTC) available in 2021. The CTC was increased from $2,000 to $3,000 or, for children under 6, to $3,600. The age of a child for which the credit is available was raised from 16 to 17. Further, the refundable amount of the 2021 CTC equals the entire credit amount, rather being based on an earned income formula. Under modified phase-out rules, the modified adjusted gross income threshold which determines if an individual qualifies for the CTC was reduced to $150,000 in the case of a joint return or surviving spouse, $112,500 in the case of a head of household, and $75,000 in any other case. This special phase-out reduction is limited to the lesser of the applicable credit increase amount (i.e., either $1,000 or $1,600) or 5% of the applicable phase-out threshold range.

Taxpayers with refundable child tax credits may be eligible to receive advance payments of the credit.

Earned Income Credit. The ARP also expanded eligibility for the earned income tax credit (EITC) in 2021 and increased the amount of the credit available. For 2021, the minimum age to claim the so-called "childless EITC" for workers without qualifying children (i.e., dependent children who live with the taxpayer for more than half the year) is reduced from 25 to 19 (except for certain full-time students) and the upper age limit for the childless EITC is eliminated. In addition, the childless EITC amount has been increased so that the maximum EITC for 2021 for a childless individual is now $1,502.

The ARP also repealed a provision which prohibited an otherwise EITC-eligible taxpayer with qualifying children from claiming the childless EITC if he or she could not claim the EITC with respect to qualifying children due to failure to meet child identification requirements (including a valid SSN for qualifying children). This prohibition no longer applies.

Finally, the ARP increased to $10,000 the amount of investment income a person could have and still qualify for the EITC. In addition, taxpayers can compute their EITC amount for 2021 by substituting their 2019 earned income for their 2021 earned income, if 2021 earned income is less than 2019 earned income.

Dependent Care Assistance Tax Benefits. The ARP provided a number of favorable changes to tax benefits relating to dependent care assistance, including: (1) making the child and dependent care tax credit (CDCTC) refundable; (2) increasing the amount of expenses eligible for the CDCTC; (3) increasing the maximum rate of the CDCTC; (4) increasing the applicable percentage of expenses eligible for the CDCTC; and (5) increasing the exclusion from income for employer-provided dependent care assistance.

Generally, you may be eligible for a nonrefundable CDCTC for up to 35% of the expenses paid to someone to care for your child or your dependent so that you can work or look for work. For 2021, the dependent care credit is refundable for an individual who lives in the United States for more than one-half of the tax year. Under the ARP, the amount of child and dependent care expenses that are eligible for the credit was increased to $8,000 for one qualifying individual and $16,000 for two or more qualifying individuals. The maximum credit rate also goes up from 35 to 50% and a phaseout thresholds begin at $125,000 of adjusted gross income (i.e., household income). At $125,000, the credit percentage begins to phase out, and plateaus at 20%. This 20-percent credit rate phases out for taxpayers whose adjusted gross income is in excess of $400,000. In addition, the amount of employer-provided dependent care assistance that may be excluded from income has been increased from $5,000 to $10,500 (from $2,500 to $5,250 in the case of a separate return filed by a married individual) for 2021.

Premium Tax Credit. A health insurance subsidy is available through a premium assistance credit for eligible individuals and families who purchase health insurance through insurance Exchanges offered under the Patient Protection and Affordable Care Act (PPACA). The premium assistance credit is refundable and payable in advance directly to the insurer on the Exchange. Individuals with incomes exceeding 400% of the poverty level are normally not eligible for these subsidies. However, the ARP eliminated that provision for tax years beginning in 2021 or 2022 and allows anyone to qualify for the subsidy. In addition, the provision limits the percentage of a person's income paid for health insurance under a PPACA plan to 8.5% of income.

Education-Related Deductions and Credits. Certain education-related tax deductions, credits, and exclusions from income may apply for 2021. Tax-free distributions from a qualified tuition program, also referred to as a Section 529 plan, of up to $10,000 are allowed for qualified higher education expenses. Qualified higher education expenses for this purpose include tuition expenses in connection with a designated beneficiary's enrollment or attendance at an elementary or secondary public, private, or religious school, i.e., kindergarten through grade 12. It also includes expenses for fees, books, supplies, and equipment required for the participation in certain apprenticeship programs and qualified education loan repayments in limited amounts. A special rule allows tax-free distributions to a sibling of a designated beneficiary (i.e., a brother, sister, stepbrother, or stepsister). As a result, a 529 account holder can make a student loan distribution to a sibling of the designated beneficiary without changing the designated beneficiary of the account.

In addition, if your modified adjusted gross income level is below certain thresholds, the following are also available for 2021: an American Opportunity Tax Credit of up to $2,500 per year for each eligible student; a Lifetime Learning credit of up to $2,000 for tuition and fees paid for the enrollment or attendance of yourself, your spouse, or your dependents for courses of instruction at an eligible educational institution; an exclusion from income for education savings bond interest received; and a deduction from gross income for student loan interest of up to $2,500. In addition, under the ARP, certain discharges of student loans occurring in years 2021 through 2025 are excludible from income.

Credit for Sick Leave for Self-Employed Individuals. As a result of the COVID-19 pandemic, special income tax credits were enacted for self-employed individuals. If you are considered an eligible self-employed individual, you may qualify for an income tax credit for a qualified sick leave equivalent amount. You are an eligible self-employed individual if you regularly carry on any trade or business and would be entitled to receive paid leave during the tax year under the Emergency Paid Sick Leave Act added by the Families First Act. The calculation of the qualified sick leave equivalent amount is quite complicated but is generally equal to the number of days during the tax year that you could not perform services for which you would have been entitled to sick leave, multiplied by the lesser of two amounts: (1) $511, or (2) 100% of your average daily self-employment income. The number of days taken into account in determining the qualified sick leave equivalent amount may not generally exceed 10 days. Your average daily self-employment income under this provision is an amount equal to the net earnings from self-employment for the year divided by 260. In addition, if you have appropriate documentation, the credit is refundable.

Credit for Family Leave for Certain Self-Employed Individuals. Another coronavirus-related income tax credit that may be available to you is a credit for a qualified family leave equivalent amount with respect to wages paid before October 1, 2021. The qualified family leave equivalent amount is an amount equal to the number of days (up to 50) during the tax year that you could not perform services for which you would be entitled, if you were employed by an employer, to paid leave under the Emergency Family and Medical Leave Expansion Act, multiplied by the lesser of two amounts: (1) 67% of your average daily self-employment income for the tax year, or (2) $200. Your average daily self-employment income under the provision is an amount equal to your net earnings from self-employment for the year divided by 260. This credit is also refundable.

Retirement Planning. If you can afford to do so, investing the maximum amount allowable in a qualified retirement plan will yield a large tax benefit. If your employer has a 401(k) plan and you are under age 50, you can defer up to $19,500 of income into that plan for 2021. Catch-up contributions of $6,500 are allowed if you are 50 or over. If you have a SIMPLE 401(k), the maximum pre-tax contribution for 2021 is $13,500. That amount increases to $16,500 if you are 50 or older. The maximum IRA deductible contribution for 2021 is $6,000 and that amount increases to $7,000 if you are 50 or over.

Life Events. Life events can have a significant impact on your tax liability. For example, if your filing status last year was Head of Household or Surviving Spouse and your filing status for 2021 is Single, then your tax rate will go up. If you married or divorced during the year and changed your name, you need to notify the Social Security Administration (SSA). Similarly, the SSA should be notified if you have a dependent whose name has been changed. A mismatch between the name shown on the tax return and the SSA records can cause problems in the processing of tax returns and may even delay tax refunds. Let us know if you have been impacted by a life event, such as a birth or death in your family, the loss of a job or a change in jobs, or if you retired during the year. All of these can affect your tax situation.

Tax Planning for Businesses

As COVID-19 has continued to impact businesses, Congress passed the Consolidated Appropriations Act, 2021 (CAA 2021) at the end of last December along with the ARP in March as previously mentioned. A major highlight in CAA 2021 is a provision allowing businesses to fully deduct expenses paid with the proceeds of a forgiven Paycheck Protection Program loan, effectively overriding earlier guidance. The ARP followed up by extending and modifying certain refundable payroll tax credits for both businesses and self-employed individuals, which are discussed in depth below. As a result of this latter change, the IRS has revised Form 941-X to allow businesses to correct COVID-19 related employment tax credits reported on Form 941 earlier in the year. Reviewing your payroll tax returns to ensure that your business took full advantage of these credits, and filing any amended returns that may be necessary, should be one of your top year-end tax planning priorities.

Section 179 Expensing and Depreciation Deductions. Depending on what the income of your business looks like for 2021, there are two "go-to" deductions that generally take priority when trying to reduce income for tax purposes: the Section 179 deduction, where your business can elect to deduct the entire cost of certain property acquired and placed in service during the year, and the bonus depreciation deduction, where 100% of the cost of business property may be expensed. Under the Section 179 expensing option, your business can immediately expense the cost of up to $1,050,000 of "Section 179" property placed in service in 2021. This amount is reduced dollar for dollar (but not below zero) by the amount by which the cost of the Section 179 property placed in service during the year exceeds $2,620,000.

The bonus depreciation rules apply unless the business specifically elects out of those rules. An election out might be preferable where a business expects a tax loss for the year and the bonus depreciation would just increase that loss or where it might be advantageous to push depreciation deductions into future years. For example, where the owner of a pass-thru entity to whom these deductions would flow expects to be in a higher tax bracket in future years, such deductions might be of more use in those future years. If applying both the Section 179 deduction and the bonus depreciation deduction to an asset, the Section 179 deduction applies first.

If you are in the market for a vehicle, the purchase of a sport utility vehicle weighing more than 6,000 pounds, can trigger a bigger deduction than if a smaller vehicle is purchased. This is because vehicles that weigh 6,000 pounds or less are considered listed property and the related first-year deduction is limited to $18,200 for cars, trucks and vans acquired and placed in service in 2021. For vehicles weighing more than 6,000 pounds, however, up to $26,200 of the cost of the vehicle can be immediately expensed.

If you leased a passenger automobile in 2021 with a value of more than $51,000, the deduction available for that lease expense is reduced. In such cases, the lessee must include in gross income an amount determined by a formula the IRS issues each year.

Energy Efficient Building Deduction. Please let me know if your business made any energy-efficient improvements to a building during the year, such as installing property that is part of (1) an interior lighting system, (2) heating, cooling, ventilation, and hot water systems, or (3) the building envelope. If so, an energy efficient building deduction, which was made permanent in the CAA 2021, may be available.

Payroll Tax Credits Available. Refundable payroll tax credits are available for businesses with under 500 employers that offered paid sick or family leave through September 30, 2021 (i.e., qualified leave wages), to employees who took leave due to COVID-19. In addition, an employee retention credit may be available for all four quarters of 2021 for businesses that were impacted by COVID-19 but kept employees on the payroll.

Generally, employers claim these payroll tax credits on either Form 941, Employer's Quarterly Federal Tax Return, or Form 7200, Advance Payment of Employer Credits Due to COVID-19. Because of the numerous changes to the dates these credits apply, the IRS recently made significant revisions to Form 941-X to allow for correcting COVID-19 related employment tax credits reported on Form 941. Thus, you need to review the Forms 941 or any Forms 7200, Advance Payment of Employer Credits Due to COVID-19, filed for your business to ensure that all payroll tax credits for which your business is eligible have been claimed.

For the first three quarters of 2021, employers are eligible for tax credits for wages paid for up to 80 hours of paid sick leave in an amount equal to either: (1) the employee's regular wage, capped at $511/day, up to a total of $5,110 if the employee was sick or quarantining, awaiting the results of a COVID test, obtaining or recovering from a vaccine; or (2) two-thirds of the employee's regular wage, capped at $200/day, up to a total of $2,000, if the employee was taking time to care for someone quarantining or to provide care due to COVID-19 school or child care provider closures. In addition, employers may receive tax credits for up to 12 weeks of paid family leave provided to employees who are unable to work for any of the reasons listed above. These credits are equal to two-thirds of an employee's regular wages, capped at $200/day up to a total of $12,000.

Additionally, the payroll tax credits are also available to self-employed individuals, who will recoup these credits by filing Form 1040 or Form 7202, Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals.

Your business may be eligible for an employee retention tax credit (ERTC) if your business either (1) had their operations fully or partially suspended under government orders in 2021, or (2) experienced a decline in gross receipts for a quarter in 2021 of 20% or more compared to the same quarter in 2019 (i.e., a "significant decline in gross receipts"). However, if the business did not exist as of the beginning of the same calendar quarter in calendar year 2019, then the same calendar quarter in 2020 is used. The ERTC generally equals 70% of the first $10,000 in wages, including certain health plan expenses, per employee in each quarter of 2021. For the third and fourth quarters of 2021, the credit amount is increased to $50,000 per quarter if the business is a "recovery startup business." A recovery startup business is any business which (1) began carrying on any trade or business after February 15, 2020, (2) for which the average annual gross receipts for the three-tax year period ending with the tax year which precedes such quarter does not exceed $1,000,000, and (3) with respect to such quarter, the operation of the trade or business is not subject to a government-ordered suspension or a significant decline in gross receipts.

The IRS has issued guidance which says that, because of the interaction of certain Internal Revenue Code provisions, wages paid to majority owners, their spouses, and children generally are not qualified wages for purposes of the ERTC. This interpretation appeared to run contrary to the intent of Congress when it enacted the ERTC legislation. If your business is in this situation, you'll need to consider the potential avenues available for claiming, or postponing the claiming of, this credit.

Expenses Paid with Paycheck Protection Program Loan Funds. If your businesses received a loan through the Paycheck Protection Program (PPP), which ended on June 30, 2021, and has not yet received forgiveness of that loan, a simplified loan forgiveness application has been issued for PPP loans of $150,000 or less. A forgiven PPP loan is not includible in income, and no deduction will be denied, no tax attribute will be reduced, and no basis increase will be denied by reason of the exclusion from gross income of a forgiven PPP loan. In addition, PPP loan recipients that did not deduct certain otherwise deductible expenses paid or incurred in 2020 based on guidance available at that time can elect to deduct these expenses on their 2021 tax return rather than by filing an amended return or administrative adjustment request. Thus, if you received a PPP loan, you'll need to consider its impact on your 2021 tax return.

Importance of Employee Benefits. The employment landscape has changed significantly since the beginning of the COVID pandemic. Many businesses are facing a worker shortage and are reevaluating what it will take to get employees in the door. If your business is not already doing so, it may reap substantial tax benefits, as well as non-tax benefits, by offering a retirement plan and/or other fringe benefits to employees. Businesses that offer such benefits have a better chance of attracting and retaining talented workers which, in turn, reduces the costs of searching for and training new employees. Contributions made to retirement plans on behalf of employees are deductible and your business may be eligible for a tax credit for setting up a qualified plan.

In addition, as a business owner you, and your spouse, can take advantage of a retirement plan yourselves. By adding your spouse as an employee and paying a salary up to the maximum amount that can be deferred into a retirement plan you could realize significant tax savings. For example, if your spouse is 50 or older, a salary of $26,000 could all go into a 401(k), leaving him or her with a retirement account but no current year taxable income.

Because health insurance is a much sought-after employee benefit, you might consider setting up a high deductible health plan paired with a health savings account (HSA). The benefits to your business would include savings on health insurance premiums that would otherwise be paid to traditional health insurance companies and having employee wage contributions to the plan not being counted as wages. Thus, neither your business nor the employee would be subject to FICA taxes on the payroll contributions. As for the employee, he or she can reap a tax deduction for funds contributed to the HSA. Because there is no use-it-or-lose-it policy, the funds can grow tax free and be used in retirement.

Another employee benefit worth considering is the establishment of a flexible spending account (FSA) for healthcare and dependent-care expenses. An FSA allows employees to be reimbursed for medical and dependent-care expenses and is usually funded through voluntary salary reduction agreements with the employer. The maximum amount that can be set aside in a health-care FSA for 2021 is $2,750. The maximum amount that may be set aside for a dependent care FSA is $5,250 for a single filer and $10,500 for joint filers. Your business would have the option of making or not making contributions to the FSAs. Some of the tax benefits of an FSA include the fact that contributions made by the business can be excluded from the employee's gross income and thus no employment or federal income taxes are deducted from the contributions. Also, payments by the FSA to the employee are tax free if used for qualified expenses, and the FSA can be used to pay qualified expenses even if the employer or employee haven't yet placed the funds in the account. Also, while FSAs previously had a modified use-it-or-lose-it policy, meaning employees could carryover over a limited amount of unspent funds if the FSA plan allowed it, CAA 2021 temporarily allows a "full" carryover of unspent funds.

Qualified Business Income Deduction. If you are conducting your business as a sole proprietorship, a partner in a partnership, a member in an LLC taxed as a partnership, or as a shareholder in an S corporation, the qualified business income (QBI) deduction under Code Sec. 199A can significantly help reduce taxable income. The QBI deduction allows eligible taxpayers to deduct up to 20% of their QBI, plus 20% of qualified real estate investment trust dividends and qualified publicly traded partnership income. A W-2 wage limitation amount may apply to limit the amount of the deduction. The W-2 wage limitation amount must be calculated for taxpayers with a taxable income that exceeds a statutorily defined amount (i.e., the threshold amount). For any tax year beginning in 2021, the threshold amount is $329,800 for married filing joint returns, $164,925 for married filing separately, and $164,900 for all other returns.

Since the QBI deduction reduces your taxable income, and is not used in computing adjusted gross income, it does not affect limitations based on adjusted gross income such as the medical expense deduction or the calculation of social security income that is includible in income. The QBI deduction does not apply to a "specified service trade or business," which is defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. Engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

Rental Real Estate. If you incurred losses in a real estate business, we need to determine whether the losses were incurred in a passive activity or not, as passive activity losses are only deductible against passive activity income. However, a deduction of up to $25,000 ($12,500 if married filing separately) may be allowed against nonpassive income to the extent you or your spouse actively participated in the rental real estate activities. However, the deduction is subject to a phaseout for individuals with modified adjusted gross income above $100,000 (or $50,000 if married filing separately).

Rental real estate enterprises operated by individuals and owners of passthrough entities may also qualify for the QBI deduction if certain criteria are met. For example, to qualify for the QBI deduction, your rental business activity must be considerable, regular, and continuous in scope. In determining whether this criteria is met, relevant factors include, but are not limited to, the following:

(1) the type of rented property (commercial real property versus residential property);

(2) the number of properties rented;

(3) an agent's day-to-day involvement;

(4) the types and significance of any ancillary services provided under a lease; and

(5) the terms of a lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

A rental real estate activity will be treated as a business eligible for the QBI deduction if certain safe harbor requirements are satisfied, such as:

(1) separate books and records are maintained to reflect the income and expenses for each rental real estate enterprise;

(2) for rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise (with slightly less stringent requirements for rental real estate enterprises that have been in existence for at least four years);

(3) contemporaneous records have been maintained, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services; and

(4) certain compliance requirements are met.

Thus, to qualify for the QBI deduction with respect to rental real estate, it's important to determine if the safe harbor conditions are met. Alternatively, even if the safe harbor conditions are not met, there may be certain actions we can take to ensure that your real estate business falls within the "trade or business" guidelines for taking the deduction.

Meal and Entertainment Expenses. Generally, the business deduction allowable for food or beverage expenses is limited to 50% of the amount spent. However, CAA 2021 enacted a more lenient rule for expenses relating to food and beverages purchased from restaurants in 2021 and 2022. Under that rule, a 100% deduction is allowed, providing the expense is properly documented. As part of that documentation, the business purpose of the meal must be provided. The term "restaurant" in this case means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises. It does not include a business that primarily sells pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk.

Electing the De Minimis Safe Harbor Deduction. If your business has not already done so, and is eligible, you should explore making an election to apply the IRS's de minimis safe harbor rules to any amounts paid to acquire or produce tangible property to the extent such amounts are deductible for financial accounting purposes. If your business has an applicable financial statement (AFS), it can use the safe harbor to deduct amounts paid for tangible property up to $5,000 per invoice or item (as substantiated by invoice). If your business doesn't have an AFS, it can use the safe harbor to deduct amounts up to $2,500 per invoice or item (as substantiated by invoice).

Vehicle-Related Deductions and Substantiation Requirements. If your business has incurred vehicle or transportation-related expenses, you need to ensure that any amount taken as a deduction is properly substantiated. When the IRS selects a business return for an audit, it tends to focus on vehicle expenses and disallow them if they are not properly substantiated. Thus, for such expenses, it's important that the records relating to any such expenses include the following for each vehicle used in the business:

(1) the amount of each separate expense with respect to the vehicle (e.g., the cost of purchase or lease, the cost of repairs and maintenance, etc.);

(2) the amount of mileage for each business or investment use and the total miles for the tax period;

(3) the date of the expenditure; and

(4) the business purpose for the expenditure.

The following are considered adequate for substantiating such expenses:

(1) records such as a notebook, diary, log, statement of expense, or trip sheets; and

(2) documentary evidence such as receipts, canceled checks, bills, or similar evidence.

Records are considered adequate to substantiate the element of a vehicle expense only if they are prepared or maintained in such a manner that each recording of an element of the expense is made at or near the time the expense is incurred.

Increasing Basis in Pass-thru Entities. If you are a partner in a partnership or a shareholder in an S corporation, and you expect the entity to pass through a loss for the year, it's important to determine if you have enough basis to absorb the loss. If not, then we should review actions that can be taken before the end of the entity's tax year to increase your basis. Generally, increasing basis in an entity is done by contributing or loaning money to the entity.

S Corporation Shareholder Salaries. If you are doing work for an S corporation, it's important to ensure that you are being paid an amount that is commensurate with your workload. The IRS scrutinizes S corporations which distribute profits instead of paying compensation subject to employment taxes. Failing to pay arm's length salaries can lead not only to the assessment of tax deficiencies, but also penalties and interest on those deficiencies as well. The key to establishing reasonable compensation is being able to show that the compensation paid for the type of you did during the year is similar to what other corporations would pay for similar work. In such cases, you need to document the factors that support the amount paid.

Also, because there are stringent requirements for who may be an S corporation shareholder, if the number of shareholders have changed or increased during the year, you should review the residency or citizenship status of the S corporation's shareholders and S corporation stock beneficiaries (including contingent and residuary beneficiaries).

California Taxes

California Conformity and Nonconformity. As California maintains a separate set of tax and compliance laws, any year-end tax moves should be considered in light of California conformity or nonconformity to the federal income tax code.

Paycheck Protection Program (PPP) for California. On September 9, 2020, California Assembly Bill (AB) 1577 (Coronavirus Aid, Relief, and Economic Security (CARES) Act Conformity) was enacted which allowed an income exclusion for tax years beginning on or after January 1, 2020, for forgiven PPP loans. On April 29, 2021, California AB 80 (Consolidated Appropriations Act (CAA) Conformity) was enacted which allowed the additional income exclusion for second draw PPP loans and Economic Injury Disaster Loan (EIDL) advance grants and allowed the deduction of expenses, basis adjustments, and tax attribution adjustments for qualifying taxpayers, for years beginning on or after January 1, 2019. The American Rescue Plan (ARP) Act (Public Law 117-2), enacted on March 11, 2021, expanded the PPP to include certain nonprofit entities and certain internet publishing organizations. California law did not conform to the expansion of PPP eligibility under the ARP Act. The Paycheck Protection Program Extension Act (PPPEA) (Public Law 117-6), enacted on March 30, 2021, extended the covered period of the PPP from March 31, 2021, through June 30, 2021. California law did not conform to the extension under the PPPEA and does not allow an exclusion from income for PPP loans forgiven after March 31, 2021.

For California purposes, forgiven PPP loans are excluded from gross income unless forgiven under the PPPEA. In order to qualify for expense deductions, basis adjustments, and lack of reduction of tax attributes related to California AB 80, your business cannot be publicly traded and must meet the 25% gross receipts reduction qualifications. If the forgiven loan relates to an EIDL Grant or Targeted EIDL Advance, you are not required to meet these qualifications to deduct expenses.

In order to meet the 25% gross receipts reduction qualifications, a business is required to have experienced at least a 25% drop in gross receipts in the first second or third quarter of 2020, or the fourth quarter if a PPP loan application was submitted on or after January 1, 2021, compared to the same quarter in 2019. Note that only a gross receipts reduction in one quarter in 2020 must meet this 25% threshold to qualify for the PPP loan expense deduction.

California Tax Rates. California voters have passed several propositions over the years that have led to significant changes in California taxpayers' overall tax burden. Proposition 30, a Sales and Income Tax Increase Initiative, was passed by California voters in 2012 increasing both income and sales taxes. The passage of Proposition 55 in 2016 extended the personal income tax increases enacted by Proposition 30 through 2030. The following table summarizes California individual income tax rate increases under Proposition 30/55 effective for 2021:

10.3% (1% increase) on income of:	$312,687–$375,221 for single/MFS; $425,252–$510,303 for HOH; and $625,373–$750,442 for MFJ.
11.3% (2% increase) on income of:	$375,222–$625,369 for single/MFS; $510,304–$850,503 for HOH; and $750,443–$1,250,738 for MFJ.
12.3% (3% increase) on income of:	More than $625,369 for single/MFS; More than $850,503 for HOH; and More than $1,250,738 for MFJ.

Income in excess of $1 million is also subject to the 1% mental health surcharge, in accordance with Proposition 63 passed by California voters in 2004.

California Safe-Harbor Estimates for AGI over $1 Million. In order to avoid late payment penalties and interest, California taxpayers with current year adjusted gross income equal to or greater than $1 million/$500,000 MFS must figure and pay estimated tax based on at least 90% of their current year tax.

Taxation of Marijuana or Hemp, including Cannabis Resin. Regulation and taxation of marijuana or hemp, including cannabis resin, are vastly different for Federal and California purposes. If you have or are considering entering into a business venture which includes the sale of marijuana or hemp, including cannabis resin, please contact us to discuss.

Franchise Tax Board Website Access. The California Franchise Tax Board (FTB) allows tax preparers to view certain client information on their website (MyFTB) with authorization. This allows tax preparers the ability to access and verify California estimated tax, extension, and other payments, California wages and withholding, and 1099s issued by the State of California. It also allows the filing of California Power of Attorney forms. Please note that filing Power of Attorney forms with the California Franchise Tax Board may be initiated by our firm as a precautionary measure, primarily for those clients who have received or have the potential to receive substantial correspondence from the California Franchise Tax Board. Due to the FTB's concerns over taxpayer privacy, a multi-step process has been implemented by the FTB for preparers to view **new client** information on MyFTB. First, the preparer will request limited access, at which point the FTB will send a letter to the client requesting that they contact the FTB if they do not want to provide limited access to the preparer. The preparer will then request full access, at which point the FTB will send a second letter to the client with an authorization code that must be used to grant full access within a specified period. Client account access typically expires 13 months from the date added or renewed and will be added or renewed by our firm unless you instruct us otherwise. If you receive correspondence from the FTB or our office regarding our access to MyFTB, we strongly advise that you act on it immediately.

Estate Planning and Annual Gifting

Whittling your estate down by making annual gifts continues to be a tax-smart strategy. If you have some favorite relatives or unrelated persons, you can give each of them up to $15,000 this year without utilizing any of your lifetime exclusion. So can your spouse. These gifts will reduce your estate tax exposure without any adverse gift tax effects. Making multiple gifts over multiple years can dramatically reduce your exposure to the estate tax. The sooner you start an annual gifting program, the better. In addition, you can pay for tuition, dental and medical expenses on behalf of anyone without utilizing any of the annual gift exclusion of $15,000 so long as the payments are made directly to the providers of those services. If you simply reimburse the people who you are benefiting, those reimbursements are subject to the $15,000 annual gift exclusion - please note that most tuition deductions are available only to the taxpayer who claims the related student as a dependent. For 2022 the annual gift tax exclusion is also $16,000.

Under the Tax Cuts and Jobs Act of 2017 (TCJA), beginning after December 31, 2017, the unified federal gift and estate tax exemption is doubled from $5 million (adjusted for inflation after 2011) to $10 million, which will also be indexed for inflation, and the federal estate tax rate will remain at 40%. As a result of the TCJA, the 2021 exclusion amount (lifetime exclusion) is $11.7 million and the 2022 exclusion amount is $12,060,000. The unified federal gift and estate tax exemption is scheduled to revert to $5 million (adjusted for inflation after 2011) after December 31, 2025. Taxpayers and taxpayers' estates that take advantage of the increased unified federal gift and estate tax exemption will not be adversely affected by the post-2025 decrease in the unified federal gift and estate tax exemption. For those with large estates, gifting or transferring a portion of their assets out of their estate prior to January 1, 2026, utilizing their lifetime exclusion, may save considerable estate taxes.

It is uncertain, what, if any changes current tax legislation being considered by Congress will have on the 2022 exclusion amount or future exclusion amounts. Due to this uncertainty, consideration should be given to utilizing the entire 2021 exclusion amount of $11.7 million prior to January 1, 2022.

Form 1099-Misc and 1099-NEC Reporting Requirements

The PATH Act, P.L. 114-113, Div. Q, sec. 201, accelerated the due date for filing Form 1099 that includes nonemployee compensation (NEC) from February 28 to January 31 and eliminated the automatic 30-day extension for forms that include NEC. You now must use Form 1099-NEC to report nonemployee compensation. You should review your records and ensure you have all the information necessary to file your Forms 1099-MISC and 1099-NEC properly and accurately for 2021. This includes obtaining the correct payee name, address and tax identification number by having a completed W-9, Request for Taxpayer Identification Number on file. Remember, if a sole proprietor provides you their social security number, make sure to report their individual name, not the business name on the 1099. Some of the important reminders concerning Forms 1099-MISC and 1099-NEC are listed below:

- Form 1099-NEC reporting is due to the Department of Treasury on or before January 31, 2022 if you file on paper or if you e-file.

- Form 1099-MISC reporting is due to the Department of Treasury by January 31, 2022 if you file on paper or if you e-file.
- Payments made to attorneys, even if incorporated, must always be reported on a Form 1099.

Keep in mind that reporting late or incorrect information can lead to additional IRS correspondence and penalties.

Conclusion

Through careful planning, it's possible your 2021 tax liability can still be significantly reduced, but don't delay. The longer you wait, the less likely it is that you'll be able to achieve a meaningful reduction. The ideas discussed in this letter are a good way to get you started with year-end planning, but they're no substitute for personalized professional assistance. Keep in mind that California has its own unique set of rules to consider and, as such, many of the strategies employed to reduce Federal taxes may not be applicable to California income taxes. In addition, it is unclear what, if any, tax legislation may be coming.

Please don't hesitate to call us with questions or for additional strategies on reducing your tax bill. We'd be glad to set up a planning meeting or assist you in any other way that we can.

Very truly yours,

Butterfield + Co. CPAs, Inc.

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