

# Get your clients ready for tax season



Offer advice on moves that will help avoid surprises in April.

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**T**he American Rescue Plan Act (ARPA), P.L. 117-2, introduced many new tax changes when it was enacted in March. Some retroactively affected 2020 returns, and many more will affect this year's returns, so now is the time to get your practice and your clients ready for next year's tax filing season. A little due diligence now can pay dividends in April.

Getting clients ready for tax season includes making sure they are in the best position by year end. Here are some tips for advising clients on moves to make now.

### ARPA TAX CHANGES

In addition to moving this year's return filing and payment deadline to May 17, a number of tax provisions were enacted to help individuals deal with the COVID-19 pandemic and its economic disruption.

#### Economic impact payments

ARPA enacted a new round of economic impact payments that were sent to qualifying individuals in 2021. Just like 2020's two rounds of stimulus payments, the economic impact payments were set up as advance payments of a recovery rebate credit. ARPA created a new Sec. 6428B that provides individuals with a \$1,400 recovery rebate credit (\$2,800 for married taxpayers filing jointly) plus \$1,400 for each dependent (as defined in Sec. 152) for 2021, including college students and qualifying relatives who are claimed as dependents.

For single taxpayers, the credit and corresponding payment begin to phase out at an adjusted gross income (AGI) of \$75,000, and the credit is completely phased out for single taxpayers with an AGI over \$80,000. For married taxpayers who file jointly, the phaseout begins at an AGI of \$150,000 and the credit ends at AGI of \$160,000. And for heads of household, the phaseout begins at an AGI of \$112,500 and is complete at AGI of \$120,000.

Although millions of payments were sent out by the IRS, starting in April and continuing through the summer, there are undoubtedly eligible individuals who did not receive a payment. Practitioners should confirm with clients whether they were eligible and whether they received a payment in 2021 (and whether they received all that they were eligible to receive). Eligible taxpayers who did not receive a payment can claim a recovery rebate credit on their 2021 tax returns.

#### Child tax credit

ARPA expanded the Sec. 24 child tax credit and provid-

ed for advance payments of the credit. Under ARPA, the credit is fully refundable for 2021, and 17-year-olds are eligible as qualifying children.

ARPA increased the amount of the credit to \$3,000 per child (\$3,600 for children under 6). The increased credit amount phases out for taxpayers with incomes over \$150,000 for married taxpayers filing jointly, \$112,500 for heads of household, and \$75,000 for others, reducing the expanded portion of the credit by \$50 for each \$1,000 of income over those limits.

Taxpayers generally have to reconcile the advance payment amount they receive in 2021 with the actual credit amount on their tax return and increase their tax by the excess of the advance payment amount over the actual credit allowed. But taxpayers whose modified AGI for the tax year does not exceed 200% of the applicable income threshold (\$60,000 for married taxpayers filing jointly) will have the increase for an excess advance payment reduced by a safe harbor amount of \$2,000 per child.

#### Earned income tax credit

ARPA made several changes to the Sec. 32 earned income tax credit. It introduced special rules for individuals with no children: For 2021, the applicable minimum age is decreased to 19, except for students (24) and qualified former foster youth or homeless youth (18). The maximum age was eliminated.

Other changes include that the credit's phaseout percentage was increased to 15.3%, and the phaseout amounts were increased; the credit is now allowed for certain separated spouses; the threshold for disqualifying investment income was raised from \$2,200 to \$10,000; and, temporarily, taxpayers are allowed to use their 2019 income instead of 2021 income in figuring the credit amount.

#### Child and dependent care credit

ARPA made various changes to the Sec. 21 child and dependent care credit, effective for 2021 only, including making it refundable. In 2021, the credit is worth 50% of eligible expenses, up to a limit based on income, making the credit worth up to \$4,000 for one qualifying individual and up to \$8,000 for two or more. Credit reduction starts at household income levels over \$125,000. For households with income over \$400,000, the credit can be reduced below 20%.

ARPA also increased the exclusion for employer-provided dependent care assistance to \$10,500 for 2021.

#### Family and sick leave credits

ARPA codified the credits for sick and family leave originally enacted by the Families First Coronavirus

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Response Act (FFCRA), P.L. 116-127, as Secs. 3131 (credit for paid sick leave), 3132 (credit for paid family leave), and 3133 (special rule related to tax on employers). The credits were extended to Sept. 30, 2021. These fully refundable credits against payroll taxes compensate employers and self-employed people for coronavirus-related paid sick leave and family and medical leave.

The act increased the limit on the credit for paid family leave to \$12,000.

The number of days a self-employed individual can take into account in calculating the qualified family leave equivalent amount for self-employed individuals increases from 50 to 60.

The paid leave credits are now allowed for leave that is due to a COVID-19 vaccination.

The limitation on the overall number of days taken into account for paid sick leave reset after March 31, 2021.

The credits were expanded to allow 501(c)(1) governmental organizations to take them.

### Employee retention credit

ARPA codified the employee retention credit in new Sec. 3134 and extended it through the end of 2021. The employee retention credit was originally enacted in the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, and it allows eligible employers to claim a credit for paying qualified wages to employees.

As this report went to press, Congress was considering legislation that would eliminate the credit after Sept. 30, 2021.

### Premium tax credit

ARPA expanded the Sec. 36B premium tax credit for 2021 and 2022 by changing the applicable percentage amounts in Sec. 36B(b)(3)(A). A special rule was added that treats a taxpayer who has received, or has been approved to receive, unemployment compensation for any week beginning during 2021 as an applicable taxpayer.

### COBRA continuation coverage

ARPA contained a provision to provide premium assistance for COBRA health care continuation benefits to affected employees and other beneficiaries and provide a corresponding tax credit to employers. ARPA provides for a temporary 100% reduction in COBRA premiums for individuals and their families who elect COBRA continuation coverage due to a loss in group health coverage as a result of a reduction in work hours or involuntary termination of their employment. ARPA also provides an extended COBRA election period. The employer, insurer, or multiemployer plan to which the COBRA continuation premiums are payable can then claim a refundable tax



credit against its share of Medicare taxes (Sec. 6432, added by ARPA).

Under Sec. 139l, the premium assistance is excluded from an individual's gross income.

### WITHHOLDING AND ESTIMATED TAXES

It is important to confirm a client's expected net income for 2021. This includes determining whether any net investment income will be subject to the net investment income tax, to ensure the appropriate amount of tax has been paid for the year. It also includes other nonwage income for which clients may not have had withholding or been making estimated tax payments.

For taxpayers who expect to owe at least \$1,000 in tax, the required tax payment to avoid underpayment of tax penalties is the lesser of 90% of the tax shown on the current year's return or 100% of the tax shown on the prior year's return. However, if an individual's gross income for the preceding year was more than \$150,000 (\$75,000 if the filing status for the current year is married filing separately), 110% is substituted for 100% in determining the amount of tax that must be paid by Jan. 15, 2022, to avoid penalties.

In calculating the tax due for 2021, the top tax rate remains the same as in 2020 — 37%. If it looks as if a client's income tax withholdings will not be enough come Jan. 15, have the client file a new Form W-4, *Employee's Withholding Certificate*, with his or her employer to increase the withholding through the end of the year. Income tax withholdings are considered paid equally throughout the year, even if they are bunched near the end of the year. On the other hand, if it appears the client will have overpaid his or her taxes for the year, suggest filing a Form W-4 to decrease



withholding and get a refund upfront, rather than giving the IRS an interest-free loan.

### ALTERNATIVE MINIMUM TAX

Practitioners should watch out for clients who may be newly subject to the alternative minimum tax (AMT). For example, clients with increased income this year, and facing a corresponding increase in state taxes, may run afoul of the AMT if they live in high-income-tax states. State and local income taxes are not deductible for AMT purposes. Personal exemptions are also disallowed in calculating the AMT, so an increase in a client's personal exemptions could also create an AMT issue.

Clients who exercised incentive stock options (ISOs) during the year may also run into AMT trouble. When a client exercises ISOs (and does not sell the stock received in the same tax year), the client will have no ISO income for regular tax purposes but must include the spread between the option price and the purchase price in his or her income for AMT purposes — which often subjects the taxpayer to the AMT. However, AMT paid because of the exercise of ISOs generates an AMT minimum tax credit that the client may be able to use to offset regular tax when he or she later sells the shares and recognizes the income for regular tax purposes.

### MARITAL STATUS

Be sure clients who are getting married or divorced understand that their year-end marital status will affect the tax return because any taxpayer who marries or divorces during the year is treated as having had his or her Dec. 31 marital status all year.

### YEAR-END GIFTS

Now is a good time to evaluate whether clients should be making year-end gifts. A year-end gift of appreciated property can move taxable gain to family members in a lower tax bracket. Also, a client can make gifts to any number of donees before year end, and, as long as each gift is no more than \$15,000, the gifts will not be taxable or count against the donor's unified estate and gift tax exemption. Married clients can make joint gifts of up to \$30,000 to each donee under these rules. Remind clients that they must make any gifts by Dec. 31 for the gifts to count as being made in 2021 and that a gift made by check generally will not count as a 2021 gift for gift tax purposes if it is not cashed or deposited by the donee in 2021.

### CONVERT ORDINARY INCOME TO QUALIFIED DIVIDEND INCOME

Clients should consider shifting investments from ones where the income is taxed at ordinary rates, such as

bonds, to stocks that pay dividends. If the dividend income is qualifying (received from a domestic corporation or qualified foreign corporation and the taxpayer held the stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date), the income will be taxed at capital gains rates. (Note that some dividends are not qualified dividends, even if they are reported in box 1b of Form 1099-DIV, *Dividends and Distributions*; these include capital gain distributions, dividends paid on deposits with financial institutions, and certain other dividends.)

### POSTPONING INCOME AND ACCELERATING DEDUCTIONS

Usually, it makes sense for clients to defer income into later years and to accelerate deductions into the current year. This strategy can help the client lower taxes this year and can also help the client avoid crossing the threshold at which he or she is subject to the net investment income tax or subject to losing all or part of certain deductions, such as the dependency exemption.

Clients who have money to donate but do not know which charity they want to contribute to can consider donating the money to a donor-advised fund. The client can then take the deduction in the current year while deciding which charities to parcel the donation out to over the next couple of years.

Here are various strategies that can help postpone income or accelerate deductions into 2021:

#### Minimize tax on Social Security benefits

When a Social Security recipient's modified AGI (MAGI) plus 50% of his or her Social Security benefits exceeds certain base amounts, the benefits can be taxable. The MAGI thresholds are \$25,000 for single individuals, \$32,000 for married taxpayers filing a joint return, and zero for married individuals filing separately. Clients whose income is close to these thresholds should consider deferring income to avoid taxes on the Social Security benefits.

#### Defer a bonus

If the client's employer will cooperate, consider asking the employer to put off paying any 2021 bonus until early in 2022.

#### Prepay certain expenses using a credit card

Contributions to charity and deductible medical expenses are deductible when charged to the client's credit card rather than when the client pays the credit card bill (Rev. Rul. 78-38; Rev. Rul. 78-39). Such expenses charged in December will be deductible in 2021, even though the credit card bill is not paid until 2022. ►

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### Dispose of passive activities to take advantage of suspended passive losses

Losses from a passive activity that cannot be realized in a particular tax year because of the passive loss limitations are suspended and carried forward until they can be used. Clients who are carrying suspended passive losses might want to dispose of the passive activity before the end of the year to take advantage of those suspended losses. When the passive activity is disposed of, the losses from the year of disposition, including carried-over losses that exceed passive income for the year, are no longer treated as passive losses.

### Make Sec. 179 and bonus depreciation expenditures

Clients can elect to deduct currently the costs of certain tangible property used in the client's business rather than depreciate the costs over a period of years. Under Sec. 179, for property placed in service in 2021, the maximum amount that can be expensed is \$1,050,000, and the deduction is phased out when qualifying property placed in service during the year exceeds \$2,620,000. Under Sec. 168(k) (bonus depreciation), 100% of the cost of eligible property placed in service in 2021 can be deducted. (This percentage will decrease to 80% in 2023, 60% in 2024, 40% in 2025, and 20% in 2026.)

### Realize stock losses to offset gains

Clients who own appreciated investments but have realized capital losses in 2020 should consider selling the appreciated investments. Clients need to be aware that long-term capital losses first offset long-term capital gains and that short-term capital losses first offset short-term capital gains.

### Check phaseout thresholds

Finally, practitioners should help clients see if they are nearing the phaseout thresholds for various tax benefits and help them keep their income below the threshold if possible. Common tax benefits with income-level phaseouts include contributions to Coverdell education savings accounts, the deduction for interest on qualified education loans, the lifetime learning and American opportunity credits, the child tax credit, and traditional and Roth IRAs.

## ACCELERATING INCOME AND POSTPONING DEDUCTIONS

Postponing income and accelerating deductions is not always the right strategy. If a client expects a substantial increase in income or anticipates using a less-favorable tax filing status in future years, accelerating income into the current year may be an appropriate strategy to lessen the client's tax bill next year. This can be accom-



plished by moving up planned retirement distributions (assuming the 10% additional tax does not apply), selling gain-generating assets, billing clients in advance, or deferring deductions (e.g., delaying the purchase of business property that will generate Sec. 179 deductions and depreciation) to the following year.

## RETIREMENT PLANNING

### Start a retirement plan

Clients who are eligible to contribute to an IRA or 401(k) plan or to start a Keogh plan (if self-employed), but who do not currently have such a retirement savings vehicle, should consider setting one up to take advantage of deductible contributions for 2021.

### Maximize contributions to retirement plans

Making contributions from pretax income is always a good strategy, but it can be especially beneficial if it brings the client's income down into a lower tax bracket.

## ESTATE PLANNING

The increased estate tax exemption (\$11,700,000 for estates of decedents dying in 2021) and portability of the unused exemption of the first spouse to die means that for many clients, estate planning has become less important. Now is a good time to revisit estate plans made under the old rules to see if they should be revised to reflect the new rules. ■