5 Tax-Smart Planning Ideas for 2021

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As 2021 ushers in renewed hope for the end of the pandemic, investors are understandably market weary from the past year. With the power shifting on Capitol Hill, we know that tax changes are looming, which may result in higher rates.

Here are five tax-smart planning ideas to help stay prepared for the road ahead:

1. Convert to a Roth IRA
2. Accelerate income tax deductions
3. Lower cost-basis strategies
4. Accelerate income
5. Leverage 401(k) contributions: To Roth or not

1. Convert to a Roth IRA

Problem: Tax rates are expected to go up.

Tax-Smart Strategy: Convert a traditional IRA to a Roth IRA.

Converting a traditional IRA to a Roth IRA creates a taxable event, but it may be worth consideration for a few reasons.

Converting now takes advantage of current rates and paves the way for future distributions to avoid being subject to higher tax rates.

Charitable contributions and other tax attributes could help mitigate the conversion tax liability.

Roth IRAs offer a slew of advantages:

- Tax-free compounding for growth.
- Roth distributions are not subject to net investment income tax.
- Distributions do not impact Social Security taxation or future Medicare premiums.

2. Accelerating income tax deductions

Problem: Itemized deduction limits may likely be ahead.

The Biden campaign tax plan provided that all itemized deductions be limited to 28%. The Pease Limitation[1] further restricts itemized deductions and might also be readopted.

Tax-Smart Strategy #1: Maximize lack of limits in 2021. Ahead of potential changes, accelerating deductions into the current year becomes even more important.

Here's an example of how it could work using charitable donations:

- A married taxpayer who files jointly has a standard deduction of $25,100.
- They typically make a $4,000 charitable donation each year and estimate their total itemized deductions will be below the standard deduction.
- By lumping five years of contributions ($20,000) into 2021, they exceed the standard deduction by $15,000, can itemize their deductions, and receive a tax benefit for their charitable contributions.

Moving future deductions up to 2021, before limits are imposed, could prove significant.

Tax-Smart Strategy #2: Consider donor-advised funds.

Taxpayers not wanting to make decisions about where $20,000 in charitable contributions would go in one year could consider a donor-advised fund, such as the SEI Giving Fund. This enables investors to open the fund and contribute cash or appreciated assets (in the example above, $20,000 worth) and get the deduction in 2021. Investors can decide later which charities will benefit from the donation.

[1] **Pease Limitation (code section 68):** Reduces most itemized deductions by 3% of adjusted gross income beyond a certain threshold. The combination of this and the 28% proposed benefit cap will make itemized deductions much less valuable for high-income taxpayers.

3. Lower cost-basis strategies

Problem: Future tax rates on capital gains could be significantly higher than today. Here's why:

- President Biden has discussed taxing capital gains as ordinary income, essentially doubling the current rate. As a candidate, he promised to increase the rate for individual long-term gains from 20% to his proposed top rate on ordinary income of 39.6%. That new rate for capital gains would apply only to taxpayers earning more than $1 million a year.[2]
- Those gains could also be subject to the 3.8% net investment income tax.
- Certain states have higher income tax rates than others.

> **Itemized deductions are first applied to reduce ordinary income and then applied to reduce other types of income, such as long-term capital gains.**

In high-income tax states, **tax rates on capital gains over $1 million could exceed 50%**. If these changes occur, we anticipate a tremendous amount of asset sales before they go into effect. We recommend getting ahead of those sales via two tax-smart techniques.

Tax-Smart Strategy #1: Harvest gains

For some, it might be worth selling highly appreciated assets now and locking in the current capital gains tax rate (the top long-term capital gain rate is 20%) in 2021. Harvesting gains now and holding losses to harvest later might make the most sense. When capital gains rates may be much higher, those tax losses could be more valuable in the future.

Tax-Smart Strategy #2: Set up charitable remainder trusts.

Setting up a charitable remainder trust (CRT) helps to systematically digest gains and distribute income over time. Here's how it could work:

- A CRT can distribute income over time. Total annual distributions can be kept below the $1 million threshold, which avoids the proposed top ordinary income tax rate of 39.6%.
- CRTs can be used as a location to gift stocks that have appreciated in value. Because CRTs are exempt from federal income tax, the trust can sell that stock later and not realize those gains.
- Long-term gains of the CRT can be distributed over time through taxable income to the beneficiary, spreading out the tax liability.

4. Accelerating income into the current year

Problem: The prospect of higher future tax rates creates a "sale" environment.

Tax-Smart Strategy: Proactively manage income today.

For income that taxpayers can control, it might make sense to accelerate tax-smart strategies forward to maximize the current rates. Some examples include:

1. Non-qualified stock options and non-qualified deferred compensation plans, which could be subject to both increased income taxes and increased payroll taxes
2. Net Unrealized Appreciation (NUA) rollout, which is subject to both ordinary tax rates and long-term capital gain rates
3. Deferring business expenses to future years to maintain higher current income level

Accurate tax projections are essential in understanding current vs. future impact of tax rates.

5. Leverage 401(k) contributions: To Roth or not

Problem: Uncertainty around future 401(k) tax advantages.

President Biden has proposed changing the 401(k) tax deduction to a tax credit[3] of 26%, effectively reducing the tax advantage of 401(k) contributions for high earners and increasing the tax advantages for middle- and low-income earners. The idea behind the change would be to equalize the tax benefit playing field, regardless of income level. The issue this may create will be the uncertainty around future marginal tax rates.

Tax-Smart Strategy: Consider a Roth 401(k).

Taxpayers may want to consider hedging their bets and start contributing to a Roth 401(k) when possible.

Future tax-free Roth distributions can help manage tax liabilities later when rates are higher.

The tax changes could also apply to 403(b) accounts and 457 accounts and create a sense of urgency for taxpayers

[2] https://www.forbes.com/sites/taxnotes/2021/02/16/biden-wants-to-reform-the-capital-gains-preference---it-will-be-hard/?sh=63bcc31578ad

[3] Source: "President Biden's Proposed Changes to 401(k) Plans," U.S. News & World Report, https: money.usnews.com, January 22, 2021.

in their 50s and older, with less time to meaningfully set up and fund Roth accounts.

Clients and prospects will be seeking advice on navigating the current and future tax environments. Proactive tax-smart management can have a significant impact on your ability to reach their long-term goals.

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