ABELES
AND
HOFFMAN
P.C.
CERTIFIED PUBLIC ACCOUNTANTS
AND BUSINESS CONSULTANTS

9666 Olive Boulevard
Suite 625
Saint Louis, Missouri 63132
(314) 991-4770
(314) 991-4254 Fax
www.ahcpa.com
Integrity. Insight. Solutions.

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To Our Clients and Friends:

Another challenging year has just passed. While the COVID-19 crisis has lessened, international events have led to supply chain issues and inflationary prices. Since income may not rise at the same rate as expenses, saving on income taxes can help keep you in the black. There is still uncertainty over whether any pieces of President Biden's tax plan will be implemented. If legislation does occur, there could be higher tax rates for both individual and corporate taxpayers. The results of the midterm elections will most likely have an effect on whether this legislation moves forward. As always, we are monitoring these developments and will alert you as soon as any legislation is signed into law. For now, it's a good time to get a handle on what your 2022 income might look like so that, if legislation is passed, we will be able to project how it affects you.

Here are some ideas to think about over the summer.

Consider Adjusting Your Tax Withholding or Estimated Payments

No taxpayer likes to be surprised with a large tax bill (or a smaller-than-anticipated refund) come tax filing season. In many cases, this occurs because individuals didn't adjust their tax withholding or estimated payments to account for changes in income. Fortunately, there's still time to make sure the right amount of federal income tax is being withheld or prepaid for 2022.

IRS Form W-4 is used to tell your employer how much tax to withhold from each paycheck. If you haven't reviewed your withholding recently, you should consider using the IRS's "Tax Withholding Estimator," available at **www.irs.gov/individuals/tax-withholding-estimator**. However, keep in mind that the calculator isn't perfect. If you want more precise results, we would be happy to put together a 2022 tax projection for you.

If you pay estimated tax payments throughout the year (if you're self-employed, for example), we can take a closer look at your tax situation for 2022 to make sure you're not underpaying or overpaying.

Take Advantage of Lower Tax Rates on Investment Income

Income from an investment held for more than one year is generally taxed at preferential capital gains rates. Those rates are 0%, 15%, and 20% for most investments. [Higher-income individuals may be subject to an additional 3.8% Net Investment Income Tax (NIIT).] The rate that applies is determined by your taxable income. For example, the 0% rate applies if your 2022 taxable income doesn't exceed $83,350 (for joint filers), $55,800 (for heads of household), or $41,675 (for other individuals). The 20% rate doesn't kick in until your taxable income exceeds $517,200 (for joint filers), $488,500 (for heads of household), $258,600 (for married filing separately), or $459,750 (for other individuals).

If your taxable income hovers around these threshold amounts, there are ways to reduce your income to take advantage of a lower capital gains rate. For example, you could make deductible IRA contributions or reduce taxable wages by deferring bonuses or contributing to employer retirement plans. If you're over the age of 70½, making contributions to a qualified charity with a direct distribution from your IRA also is a good way to lower income. If you own a business and use the cash method of accounting, you can wait until the end of the year to send out some client invoices. That way, you won't receive payments until early 2023. Also, you can postpone taxable income by accelerating some deductible expenses this year. If possible, you should get your income low enough to qualify for the 0% rate. But, if you are subject to a higher tax rate next year, strategies that defer tax, like delaying billing, can push income into a higher bracket. Hopefully, we will know more before year end.

If your income is too high to benefit from the 0% rate, consider gifting investments (like appreciated stock or mutual fund shares) to children, grandchildren, or other loved ones. If these individuals will be in the 0% or 15% capital gains tax bracket when they later sell the investments, any gain will be taxed at the lower rates, as long as you and your loved one owned the investments for more than one year. This strategy has two risks, however. First, there are gift tax consequences if you transfer assets worth over $16,000 during 2022 to a single recipient ($32,000 if married and each spouse makes an equitable gift). Second, all children under age 18 and most children age 18 or age 19–23 who are full-time students are subject to the "Kiddie Tax" rules. Kiddie Tax rates are tied to the parent's tax bracket. The Kiddie Tax limits the opportunity for parents to take advantage of the 0% capital gains rate by gifting appreciated property to their children, including college age children.

Time Investment Gains and Losses

Under the current rules, the 2022 federal income tax rates on long-term capital gains are 0%, 15%, and 20% for most categories of long-term gain. As mentioned earlier, the maximum 20% rate affects singles with 2022 taxable income (including long-term gains) above $459,750, married joint-filing couples with income above $517,200, heads of households with income above $488,500, and married individuals who file separate returns with income above $258,600. Higher-income individuals also may be hit with the 3.8% NIIT, which can result in an effective marginal federal rate of up to 23.8% (20% + 3.8%) on long-term gains. Under President Biden's proposed tax plan, the rate on long-term gains would increase to 39.6% for taxpayers making over $1 million, which, when combined with the NIIT, would result in a marginal rate on long-term gains of up to 43.4% (39.6% + 3.8%).

Until we know exactly where the capital gains rates will fall in 2023, the best strategy at the moment is to be prepared. If rates increase, as the President's plan indicates, it might make sense to sell winners before year end and hold on to losers until January. At this point, it's just too early to make any decisions. However, we should be mindful of what's coming and have a plan in place to time your transactions to result in the best possible outcome.

As you evaluate investments held in your taxable brokerage accounts, be mindful of your holding period. For most taxpayers, the federal income tax rate on long-term capital gains (gains on assets held for over a year) is still much lower than the rate on short-term gains. This should remain true in many cases even if the long-term capital gains rates increase in 2023. Under the proposed plan, only taxpayers making over $1 million will be affected. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling to qualify for the lower long-term capital gains tax rate.

Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year end also can be a tax-smart idea. Any capital losses taken before year end will offset capital gains from other sales this year, including high-taxed short-term gains from securities owned for one year or less. Under the current rules, the maximum rate on short-term gains is 37%, and the 3.8% NIIT may apply too, which can result in an effective marginal rate on short-term gains of up to 40.8% (37% + 3.8%). Future tax legislation could increase the maximum rate on short-term gains, but it could still be significantly higher than the rate on long-term gains for taxpayers making less than $1 million. Whatever happens, you won't have to worry about paying a high rate on short-term gains if they can be sheltered with capital losses.

If capital losses for this year exceed capital gains, you will have a net capital loss for 2022. You can use that net capital loss to shelter up to $3,000 of this year's higher-taxed ordinary income from salaries, bonuses, self-employment, and so forth ($1,500 if you're married and file separately). Any excess net capital loss will be carried forward to 2023.

Selling enough loser securities to create a net capital loss that exceeds what you can use this year also might make sense. You can carry forward the excess capital loss to 2023 and beyond and use it to shelter both higher-taxed short-term gains and long-term gains recognized in those years. Recent declines in securities markets have prompted some investors to begin "loss harvesting" early.

Check Your Deduction Strategy

It's generally best to itemize your deductions if you have significant qualifying personal expenses. However, don't rule out the standard deduction. For 2022, joint filers can enjoy a standard deduction of $25,900. The standard deduction for heads of household is $19,400, and single taxpayers (including married taxpayers filing separately) can claim a standard deduction of $12,950.

Unfortunately, tax reform passed in 2017 suspended or limited many of the itemized deductions. Although there have been talks of possible legislation that might repeal or relax some of these limitations, we don't necessarily expect changes for 2022. The most discussed limitation at the moment is the cap on the deduction for state and local taxes, which is currently $10,000 ($5,000 if married filing separately). Nothing has been passed yet, so the $10,000 limitation continues to apply.

Taxpayers who have itemized deductions just under (or just over) the standard deduction should consider bunching state and local taxes into alternating years by paying two years' worth of taxes in a single calendar year. However, the effect of the $10,000 cap must be considered.

In addition to bunching state and local taxes, consider bunching charitable contributions. In many instances, this can be accomplished through a donor-advised fund. Also known as *charitable gift funds* or *philanthropic funds*, donor-advised funds allow donors to make a charitable contribution to a specific public charity or community foundation that uses the assets to establish a separate fund. Taxpayers can claim the charitable tax deduction in the year they fund the donor-advised fund and schedule grants over the next two years or other multiyear periods. If you have questions or want more information on donor-advised funds, please give us a call.

For older taxpayers (over age 70½) who won't itemize in 2022 but still want to make contributions, a Qualified Charitable Distribution (QCD) from an IRA is a great way to give to charity. Making a direct contribution from the IRA to the charitable organization has the added value of not increasing the taxpayer's Adjusted Gross Income (AGI), which can decrease the amount of Social Security benefits that is taxable, as well as affecting other favorable tax provisions that phase out based on AGI. Please note that a QCD will count towards the taxpayer's required minimum distribution.

Virtual Currency

Virtual currency (also known as *cryptocurrency*), such as Bitcoin, has been increasing in popularity. Virtual currency may be used to pay for goods or services or held for investment. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency. For federal tax purposes, virtual currency is treated as property. As such, it can be classified as business property, investment property, or personal property. General tax principles applicable to property transactions apply to transactions using virtual currency.

Basis in virtual currency is the Fair Market Value (FMV) of the currency on the date it is received. If you receive virtual currency as payment for services, it is considered taxable income and will be subject to both income and Social Security taxes. Also, using virtual currency to obtain cash or purchase goods is a recognizable transaction. If the FMV of property you receive for the virtual currency exceeds your adjusted basis in the currency, you will have a taxable gain. A loss will occur if the FMV is less than your basis. The character of the gain or loss depends on whether the virtual currency is considered your capital asset.

One strategy to reduce your 2022 tax liability on virtual currency transactions is to use the Highest-in, First-out (HIFO) accounting method. To use this method, you will need to specifically identify which units you are transferring in the transaction. You also will need to keep detailed records of all virtual currency purchases to substantiate your basis on sale. If you do not keep detailed records, the IRS will default to the First-in, First-out (FIFO) method, which may result in a larger gain in 2022. Fortunately, since virtual currency is considered property and not stock, the wash sale rules do not apply, making it possible to harvest losses on some of your units and then repurchase the same units immediately. (Note there have been legislative proposals to apply the wash sale rules to cryptocurrency, but none have passed to date).

Planning for Businesses

If you own a business, consider the following strategies to minimize your tax bill for 2022.

Section 179 Expense and Bonus Depreciation. If your business plans to purchase new or used machinery or equipment prior to year end, you may be able to expense the entire cost in 2022. Under Section 179, taxpayers can elect to expense up to $1,080,000 of qualified purchases, subject to taxable income limitations. Alternatively, your business can take advantage of 100% first-year bonus depreciation. Unlike the Section 179 deduction, claiming 100% bonus depreciation is not limited to taxable income, although another limitation could apply. Many factors can influence this decision, including current and future tax rates. With the possibility of higher rates in 2023, the best choice may be to wait and

see if you are going to be subject to a higher tax rate before you acquire assets, if it is feasible to hold off. Also, under current law, 100% bonus depreciation is scheduled to be reduced to 80% for property placed in service in 2023. If you're thinking of acquiring business property between now and the end of the year, we can help you navigate that decision. Please keep in mind we never want tax savings to be the only factor in the decision of when to acquire assets.

Cost Segregation of Real Estate. Business and individual taxpayers that acquire nonresidential real property or residential rental property have and opportunity to reduce the depreciable lives on assets which are building components. Certain assets may qualify for shorter lives and recovery periods under current depreciation. The reduction of the asset lives provides accelerated deductions to offset income.

Many taxpayers mistakenly include the cost of such components in the depreciable basis of the building and the cost is recovered over a longer depreciation period. A nonresidential real property is depreciated over a 39-year life and a residential rental property is depreciated over 27.5-years. Certain building components may qualify for a reduced recovery period over 5-years, 7-years, or 15-years.

Some examples of building components include: parking lots, sidewalks, curbs, roads, fences, storm sewers, landscaping, signage, lighting, security and fire protection systems, removable partitions, removable carpeting and wall tiling, furniture, counters, appliances and machinery (including machinery foundations) unrelated to the operation and maintenance of the building, and the portion of electrical wiring and plumbing properly allocable to machinery and equipment that is unrelated to the operation and maintenance of the building.

A taxpayer may engage a specialist to conduct a cost segregation study to identify the separately depreciable components and their depreciable basis. Ideally, a cost segregation study should be conducted prior to the time that a building is placed into service (i.e., when it is under construction or at the time of purchase). However, a cost segregation study can be completed after a building is placed in service. Even if a detailed cost segregation study is impractical, taxpayers should carefully consider whether there are any obvious land improvements and personal property components of a building that can be separately depreciated over a shorter recovery life.

Retirement Plan Contributions. Setting up a qualified retirement plan for your business allows you to make deductible contributions for 2022 while allowing the earnings in the plan to build up without taxation until the funds are withdrawn. Selecting the best qualified retirement plan will depend on the facts and circumstances of your business, including your level of income and whether you have employees. Types of available plans include defined benefit, defined contribution, one-person 401(k), Simplified Employee Pension (SEP), and SIMPLE IRAs. Each type of plan has advantages and disadvantages that we will gladly discuss with you to determine which plan is the right fit for your business.

There are limits on the amount that may be contributed to a plan, depending on the type of plan. Defined contribution plans and SEPs have a maximum contribution amount of $61,000 for 2022, while one-person 401(k) plans are limited to $20,500 for elective deferrals made by the employee and $61,000 for combined employee/employer contributions, and SIMPLE IRAs are generally limited to $14,000. If you are age 50 or older, you also can make additional catch-up contributions of $6,500 for a one-person 401(k) plan or $3,000 for a SIMPLE IRA. Defined benefit plans can't provide an annual benefit that exceeds the lesser of $245,000 or 100% of compensation for the three highest years.

One benefit of making contributions to a qualified retirement plan is that the contribution may not need to be paid by the end of 2022. The employer portion of the contributions can sometimes be paid as late as 10/16/23.

In addition to making current year deductions, you may be eligible for two tax credits. A small employer who starts a new retirement plan is eligible for a nonrefundable income tax credit of up to the greater of (1) $500 per year or (2) the lesser of $250 per eligible employee or $5,000 for the administrative and retirement-education expenses of adopting a new qualified defined benefit or defined contribution plan, a SIMPLE IRA plan, an annuity plan under 403(a), or a SEP. A second tax credit exists for small employers who include an auto-enrollment feature in a qualified plan. Eligible employers that include an Eligible Automatic Contribution Arrangement (EACA) in a qualified plan can claim an annual credit of $500 for up to three tax years. The credit also is available to employers who convert an existing plan to an automatic enrollment design.

Employing Family Members. Employing family members can be a useful strategy to reduce overall tax liability. If the family member is a bona fide employee, the taxpayer can deduct the wages and benefits, including medical benefits, paid to the employee on Schedule C or F as a business expense, thus reducing the proprietor's self-employment tax

liability. In addition, wages paid to your child under the age of 18 are not subject to federal employment taxes, will be deductible at your marginal tax rate, are taxable at the child's marginal tax rate, and can be offset by up to $12,950 (your child's maximum standard deduction). However, your family member must be a bona fide employee, and basic business practices, such as keeping time reports, filing payroll returns, and basing pay on the actual work performed, should be followed.

Business Meal Expenses. Normally, business meal expenses are limited to a deduction of 50% of the total costs. However, for 2022, food and beverages provided by a restaurant are allowed a 100% deduction. Taxpayers who use the per diem method may treat the entire meal portion of the per diem rate paid or incurred in 2022 as being attributable to food or beverages provided by a restaurant, making the meal per diem 100% deductible. As such, you may want to move any business meals originally planned for early 2023 into late 2022 in order to obtain the higher deduction.

Please Contact Us

We hope you found some ideas in this letter that might be useful. If there is anything here that piqued your interest, please let us know. The goal of this letter is to get you thinking about tax planning ideas and potential moves we can make to help maximize cash flow prior to the end of the year. We are continuously monitoring future developments and will do our best to keep you informed of the latest tax law changes. Please don't hesitate to contact us if you want more details about any of the topics discussed or just have questions or concerns.

Very Truly Yours,

Abalos and Hoffman, P.C.