Federal Tax Reduction Kit

A SPECIAL REPORT PREPARED EXCLUSIVELY BY THE EDITORS OF THE KIPLINGER TAX LETTER

FROM THE EDITOR IN CHIEF

DEAR CLIENT:

I'd like to welcome you as a new subscriber to *The Kiplinger Tax Letter*. The *Tax Letter* is published every other Friday for delivery to you by mail at the start of the following week. You also have access to each new issue as soon as it is published online at *www.KiplingerTax.com*. Our online version of the *Tax Letter* also includes links to primary source documents.

Tax planning is always complicated by the steady stream of changes coming from Washington. There were seven major tax measures in the 1980s, six during the 1990s and more than a dozen so far in the 21st century.

Much of the drive behind further efforts to overhaul the tax system, such as a flat tax or a national sales tax, come from those who want to simplify the tax law. Yet despite the talk about simplification, the 1997 tax law added a slew of new tax breaks to encourage saving for education and retirement. Myriad changes adopted in tax laws in the past few years have made the tax code even more complex.

You need to learn the new rules and how they relate to the old and to design and implement strategies that make financial and tax sense. Our *Federal Tax Reduction Kit* is a tool to assist you with that task. You can be confident that the time and effort you invest will pay off at tax time next year.

In the years ahead, *The Kiplinger Tax Letter* will cover the traps and opportunities in the ever-changing tax laws, how the Internal Revenue Service interprets them and what experts suggest you do to keep your tax bill as low as possible.

SINCERELY,

Knight Kiplinger

Knight A. Kiplinger
EDITOR IN CHIEF AND PUBLISHER

Table of Contents

Some Background on Taxes

WHAT YOU SHOULD KNOW

Although no one likes to pay taxes, we all have to deal with them in our business and personal lives. Because there is no way for us to escape taxes, our goal at *The Kiplinger Tax Letter* is to help you make dealing with them as painless as possible. And knowing the rules is the first step.

It's important to keep in mind that tax planning is something to think about ALL the time, not just when the filing deadline rolls around in April. It's a constant—something you should take into consideration whenever you make a business or personal financial decision.

Taxes Can Be Minimized

The amount you pay is not fixed. And it is not the same for everyone who receives the same amount of income. Minimizing your taxes requires using to your best advantage the laws, regulations, court decisions and rulings that are issued for your guidance. All are accepted—and even recommended—ways to help you pay your share, but not more than your share, of the federal tax bill.

Federal, state and local governments are your partners, whether you like it or not. They dip into your income, and they set the rules for doing so. What you can do is take full advantage of the legitimate outs and reliefs. Many are designed to ease your tax load. Others are the result of new interpretations of well-established laws.

This is where tax planning is important in your personal affairs and in your business. In any given year, you can make plans to pay more in taxes or to pay less, whichever is to your advantage. By knowing the rules, you can often treat taxes like most other expenses, adjusting them up or down.

Knowing the Basics is Key

Whether you are self-employed, a corporate manager or professional or a salaried executive, you should take tax consequences into account whenever you make a financial decision involving your company. The same philosophy should apply to your personal planning. Often, the success or failure of your business will hinge on taxes. We know of cases where business or personal transactions that would have been marginal have turned into bonanzas because advance thinking was given to achieving the best tax outcome.

Most people can't afford to employ a full-time tax adviser. Indeed, they may seek professional advice only once a year—at filing time. But throughout the year, they are faced with making decisions that will affect how much tax they owe for that year. To avoid making costly mistakes and to get the best out of your advisers, whether you use them full time or part time, you need to have your own working knowledge of taxes.

You don't have to know all of the technical sides of the tax laws, but you should have a basic knowledge to make prudent decisions, to know when you should seek advice and to evaluate the advice you receive. Remember that your finances are of most concern to YOU. It is your responsibility to be alert to all of the aspects of your financial affairs, including taxes.

Special Needs of Small Businesses

Small businesses are the ones most in need of guidance to take advantage of the rules and avoid overpaying their taxes. They cannot afford high-priced experts or elaborate accounting departments. In essence, tax planning becomes a do-it-yourself proposition for small businesses.

Heads of small firms can always know more about how to make the right decisions to keep taxes down and how to decide when experts are needed and when they are not. Our advice to small-business owners is to bone up on the basics and keep up with major changes.

Evolution of Tax Laws

Tax laws are always changing, often in major ways. Almost without exception, the result makes the laws more complex. As a result, you have to pay constant attention to tax policy to keep up to date and avoid paying more than the taxes you owe. Paying the least tax is vital in determining your personal income and to measure the profits from your business.

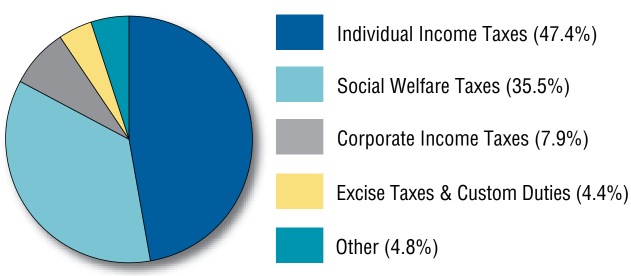
Taxes that are paid by individuals vary, even where income is about equal, where dependency exemptions are the same and where expenses are comparable. One reason is that federal tax law treats different types of income differently.

In other cases, it is due to a taxpayer's age or to other personal circumstances. But frequently the difference is due to how much a taxpayer knows he or she can do—what legal tax relief he or she is aware of to minimize the tax liability.

Chances are good that you aren't using all the breaks available to you. The following chapters will detail the major tax saving ideas you should know about.

SOURCES OF FEDERAL REVENUE

Estimates for 2012



Source: Office of Management and Budget

Our Job is to Help You

The Federal Tax Reduction Kit will give you the background you need to make the most of your business and personal tax status.

The Kiplinger Tax Letter as well as our Web site, *KiplingerTax.com*, will keep you abreast of changes by examining tax developments, taking them apart and analyzing them for you. To do this, our tax editors review every ruling and regulation that the Internal Revenue Service publishes. They also check the many Tax Court decisions that are handed down each day.

Tax legislation in Congress also receives close attention. The legislative course of each tax bill is closely followed from inception to the final outcome. You will get sound judgments on prospects for the modification and passage of tax legislation as it makes its way through the congressional labyrinth.

> Small businesses are the ones most in need of guidance to take advantage of the rules.

In addition, our editors consult the writings of other tax experts to help them evaluate the fine points.

Then we select the cream of the crop and write it up in an easy-to-read style. All of the complicated technical terminology and mumbo jumbo used by most experts in the tax profession is filtered out.

As a result, you receive sharply focused tax knowledge that is designed to save you time, trouble and money.

We will provide you with essential background that you need to form your tax policies and make your own tax decisions. You may decide that taxes are more important than other factors. That decision will be up to you. But you will know what the tax consequences will be, so you won't be unpleasantly surprised when the time comes each year to settle your tax bill with the IRS.

The Kiplinger Tax Letter covers a broad variety of subjects with tax applications. Naturally, not every item will apply to you—perhaps not even every issue. But during the term of your subscription, you'll find much useful material and many helpful ideas. Tax laws and their effects are always changing, and knowledge gained often pays back the cost of a subscription many times over.

Mark and Save Relevant Items

Clip and tuck them away for reference when you file your return, take a financial step or review your financial affairs. Share information in the *Tax Letter* with other people in your organization—those who help manage your business. You will be surprised at how often someone else will see an application to his or her area that you may have overlooked.

We're often asked why we publish in Washington. The answer is simple: Washington is where taxes are set—the place where Congress makes the laws, Treasury interprets them, the IRS administers them, the Tax Court judges them and the tax experts gravitate. We talk with officials to get their ideas, and we do it full time.

Then we tell you what we find out, with no ax to grind.

Tax Changes in 2012

ADDITIONAL TAX RELIEF AND INCENTIVES FOR BUSINESS TAKE EFFECT

The new year begins with one set of tax rules. It surely will end with a far different set. Lawmakers will have to find time during the year to deal with provisions that lapsed at the end of 2011. They have already addressed the two-percentage-point cut in the employee's share of Social Security payroll tax that was to expire after Feb., extending it for all of 2012.

We'll review changes that took effect Jan. 1. Start with provisions that lapsed after 2011. Lawmakers failed to extend many popular tax breaks, including write-offs for state sales taxes, college tuition and up to $250 of teachers' classroom supplies. The higher AMT exemptions and the AMT offset for personal tax credits such as tuition and dependent care were allowed to expire, as was the special provision allowing folks age 70½ or older to donate up to $100,000 a year from their IRAs directly to charity. In our view, all of these breaks will be reinstated for 2012, retroactive to Jan. 1. But with lawmakers tied up in knots in an election year, passage may be delayed until the end of the year. The $500 credit for energy efficient home improvements such as storm windows, biomass fuel stoves and water heaters has lapsed, and its return is in doubt. Solar credits aren't affected. Also on the endangered list: The limited write-off for mortgage insurance premiums.

Key business tax breaks also expired: 100% bonus first-year depreciation. It has been reduced to a 50% write-off for assets that are placed in service this year.

The higher ceilings on expensing are another casualty. Right now, businesses can expense only $139,000 of assets that are put in use in 2012, down from $500,000 last year. And the ability to claim expensing in lieu of depreciation phases out dollar for dollar once over $560,000 of assets are placed into service, down from $2 million in 2011. 15-year write-offs for restaurant renovations and tenant improvements also lapsed.

The R&D tax credit is no longer in effect, but Congress will revive it. The others stand a decent chance of being reinstated, but as with the expired breaks for individuals, Congress may not give the final word until after this year's elections.

Personal Taxes

This year's income tax brackets are a bit wider than those for 2011, because of an increase in inflation during the 12-month period ending last August that's used to figure the adjustments. The income tax rates for this year didn't change because the Bush tax cuts were extended through 2012.

The standard deductions for 2012 also increase by small amounts. Married couples can claim $11,900. If one spouse is age 65 or older…$13,050. If both are…$14,200. Singles can take $5,950. Those 65 and up can deduct $7,400. Heads of households can get $8,700 plus $1,450 more once they reach age 65. Blind people get $1,150 more ($1,450 if unmarried and not a surviving spouse).

Personal exemptions increase to $3,800 for filers and their dependents.

High-incomers don't lose any of their itemized deductions and personal exemptions, continuing a break for them that took effect in 2010.

Estate and Gift Taxes

Now turn to other tax changes for 2012 that are not going to be revised: The estate tax exemption for 2012 rises to $5,120,000, thanks to inflation. The rate stays at 35%. The annual gift tax exclusion remains at $13,000 per donee. It will increase to $14,000 per donee for 2013.

The special estate tax valuation of real estate is increasing as well. Up to $1,040,000 of farm or business real estate can receive discount valuation.

And more estate tax qualifies for an installment payment tax break. If a closely held business or businesses make up more than 35% of an estate, as much as $486,500 of tax can be deferred, and IRS will charge only 2% interest.

Trust Taxes

The income tax brackets for trusts and estates have changed slightly. Each of the five brackets starts at a higher level of income for 2012.

The personal income tax brackets for 2012

MARRIEDS

IF TAXABLE INCOME IS	THE TAX IS
Not more than $17,400	10% of taxable income
Over $17,400 but not more than $70,700	$1,740.00 + 15% of excess over $17,400
Over $70.700 but not more than $142,700	$9,735.00 + 25% of excess over $70,700
Over $142,700 but not more than $217,450	$27,735.00 + 28% of excess over $142,700
Over $217,450 but not more than $388,350	$48,665.00 + 33% of excess over $217,450
Over $388,350	$105,062.00 + 35% of excess over $388,350

SINGLES

IF TAXABLE INCOME IS	THE TAX IS
Not more than $8,700	10% of taxable income
Over $8,700 but not more than $35,350	$870.00 + 15% of excess over $8,700
Over $35,350 but not more than $85,650	$4,867.50 + 25% of excess over $35,350
Over $85,650 but not more than $178,650	$17,442.50 + 28% of excess over $85,650
Over $178,650 but not more than $388,350	$43,482.50 + 33% of excess over $178,650
Over $388,350	$112,683.50 + 35% of excess over $388,350

HEADS OF HOUSEHOLD

IF TAXABLE INCOME IS	THE TAX IS
Not more than $12,400	10% of taxable income
Over $12,400 but not more than $47,350	$1,240.00 +15% of excess over $12,400
Over $47,350 but not more than $122,300	$6,482.50 + 25% of excess over $47,350
Over $122,300 but not more than $198,050	$25,220.00 + 28% of excess over $122,300
Over $198,050 but not more than $388,350	$46,430.00 + 33% of excess over $198,050
Over $388,350	$109,229.00 + 35% of excess over $388,350

The trust and estate tax brackets for 2012

IF INCOME OF AN ESTATE OR TRUST IS	THE INCOME TAX IS
Not more than $2,400	15% of taxable income
More than $2,400 but not exceeding $5,600	$360 + 25% of excess over $2,400
More than $5,600 but not exceeding $8,500	$1,160.00 + 28% of excess over $5,600
More than $8,500 but not exceeding $11,650	$1,972.00 + 33% of excess over $8,500
More than $11,650	$3,011.50 + 35% of excess over $11,650

Medicare

The basic Medicare Part B premium rises to $99.90 per month in 2012, up from $96.40 last year. However, this is a reduction for those seniors who first enrolled in 2010 or 2011. Their monthly premium last year was higher.

But the Part B premium is again much higher for upper-income seniors... if their modified adjusted gross incomes for 2010 exceeded $170,000 for couples or $85,000 for single persons. Modified AGI is AGI plus any tax-exempt interest, EE bond interest that's used for education and excluded foreign earned income.

And higher-income seniors also owe a surcharge on Part D premiums for coverage of their prescription drug costs. This table summarizes the impact:

FOR MARRIEDS:

IF YOUR 2010 MODIFIED AGI IS MORE THAN	BUT NOT OVER	YOUR 2012 MONTHLY PART B PREMIUM WILL BE	YOUR 2012 MONTHLY PART D SURCHARGE WILL BE
$170,000	$214,000	$139.90	$11.60
$214,000	$320,000	$199.80	$29.90
$320,000	$428,000	$259.70	$48.10
$428,000	—	$319.70	$66.40

FOR SINGLES:

IF YOUR 2010 MODIFIED AGI IS MORE THAN	BUT NOT OVER	YOUR 2012 MONTHLY PART B PREMIUM WILL BE	YOUR 2012 MONTHLY PART D SURCHARGE WILL BE
$85,000	$107,000	$139.90	$11.60
$107,000	$160,000	$199.80	$29.90
$160,000	$214,000	$259.70	$48.10
$214,000	—	$319.70	$66.40

Medicals

Annual caps on deductible payins to health savings accounts rise in 2012. The maximums are $6,250 for account owners with family medical coverage and $3,100 for single coverage. HSA owners born before 1958 can put in $1,000 more. The limitations on out-of-pocket expenses such as deductibles and copayments increase to $12,100 for those with family coverage and $6,050 for single coverage. Minimum policy deductibles remain at $2,400 for families and $1,200 for individuals.

The limits on deducting long-term-care premiums are a bit higher. Taxpayers who are age 71 or older can write off as much as $4,370 per person. Filers age 61 to 70... $3,500. Those who are 51 to 60 can deduct up to $1,310. Individuals age 41 to 50 can take $660. And people age 40 and younger...$350. Also, the limit for tax free payouts under such policies increases to $310 a day.

Social Security

The Social Security wage base rises to $110,100 in 2012, a $3,300 increase over 2011's figure and the first jump since 2009. And as we noted earlier, the employee Social Security tax rate will remain at 4.2% for the full year...6.2% on employers. The 1.45% Medicare rate on employees and employers hits all wages. Self-employeds will pay 13.3% on the first $110,100 of net profits... 2.9% above that.

Social Security benefits are going up 3.6% in 2012… the first hike since 2009.

The earnings limits are heading up, too. Individuals who turn 66 this year do not lose any benefits if they make $38,880 or less a year before they reach that age. Folks who are at least 62 but are not 66 by the end of 2012 can make up to $14,640 before they lose any benefits. There is no earnings cap once a beneficiary turns 66.

And the amount needed to qualify for coverage rises to $1,130 a quarter. So earning $4,520 anytime during 2012 will net the full four quarters of coverage.

The threshold for the nanny tax increases to $1,800 this year, a $100 boost.

Savings Plans

The maximum 401(k) contribution is $17,000 this year, a $500 increase over 2011. Individuals born before 1963 can put in as much as $22,500. The contribution limits apply to 403(b) and 457 plans as well. The ceiling on SIMPLEs stays at $11,500. Folks age 50 or older in 2012 can contribute an additional $2,500.

Employer payins to qualified plans can be based on up to $250,000 of pay.

The payin limitation for defined contribution plans increases to $50,000 in 2012. That's a $1,000 jump for Keogh plans, profit sharing plans and the like.

Anyone making over $115,000 is highly paid for plan discrimination testing.

The benefit limitation for pension plans increases to $200,000 this year.

The income ceilings on Roth IRA payins rise. Contributions phase out at AGIs of $173,000 to $183,000 for couples and $110,000 to $125,000 for singles.

The deduction phase outs for regular IRAs start at higher levels, ranging from $92,000 of AGI to $112,000 for couples and from $58,000 to $68,000 for singles. If only one spouse is covered by a plan, the phaseout zone for deducting a contribution for the uncovered spouse begins at $173,000 of AGI and finishes at $183,000.

There's no change in the payin ceilings for IRAs and Roth IRAs. The limits remain at $5,000, plus $1,000 more for people who were born in 1962 or before.

Adoption

The adoption credit can be taken on up to $12,650 of costs, down by $710. Congress allowed a temporary increase in the credit to expire after 2011. And if the credit is more than a filer's tax liability, the excess is no longer refundable. The full $12,650 credit is available for a special needs adoption, even if it cost less. The credit starts to dry up for filers with AGIs over $189,710 and ends at $229,710.

The exclusion for company-paid adoption aid also decreases to $12,650.

Business Taxes

The standard mileage allowance for business driving is 55.5¢ per mile in 2012, the same rate that was in effect for the final six months of 2011. The allowance is 23¢ a mile for travel for medical purposes and job-related moves, a 0.5¢ drop compared with the last six months of 2011. For charitable driving... 14¢.

More corporations need to file Schedule UTP to report uncertain tax positions to IRS. The $100-million asset threshold for filing is slashed to $50 million for 2012.

Many employers must report the value of health coverage on W-2s for 2012... those filing 250 or more W-2s for employees. Workers aren't taxed on these amounts.

Mutual funds have to report the basis of shares purchased after 2011.

The retention credit of up to $1,000 for hiring the unemployed is no more. Ditto for the tax credit for employing members of disadvantaged groups, except for unemployed veterans. But Congress will revive the full credit retroactively.

Two other tax incentives have bitten the dust: The first is the ethanol tax credit. The other is the 100% gain exclusion for investors who buy stock in a small company directly from the firm and sell more than five years later. The exclusion is now 50%.

Preparers

Preparers filing 11 or more individual returns must e-file them this year, down from 100 or more in 2011. Returns mailed by clients aren't counted, but clients must waive e-filing and preparers must retain a signed copy of the waiver.

Preparers of returns claiming the earned income credit have a new rule: They must submit Form 8867 or a similar due diligence checklist with the filed return. Note: The penalty for failing to comply with the checklist rule has increased to $500.

Fringe Benefits

U.S. taxpayers working abroad have a slightly larger exclusion...$95,100. But the caps on transit passes and commuter vans fall sharply this year to $125 a month…bad news for those who use public transportation to get to work. Meanwhile, the monthly limitation on tax free parking goes up to $240.

Education

The income caps are higher on tax free EE bonds used for education. The exclusion starts phasing out above $109,250 of AGI for married couples and $72,850 for singles. It ends when AGI hits $139,250 and $87,850, respectively.

The student loan interest deduction phases out at higher levels for couples, starting when their adjusted gross income exceeds $125,000 and ending at $155,000.

And the lifetime learning credit starts phasing out at higher income levels... from $52,000 to $62,000 of AGI for singles and $104,000 to $124,000 for couples.

As always, we'll report on all the tax changes Congress makes in 2012. With the two parties holding divergent views on taxes, it will be a very turbulent year.

Real Estate

MAKING THE RULES WORK TO YOUR ADVANTAGE

Most Americans own real estate, be it for personal, investment or business reasons. Whether the property is a house, vacant land or an office building, prudent tax planning can reduce the cost of buying, holding and selling.

Tax Advantages of Homeownership

Interest on up to $1 million of acquisition debt (a loan used to buy or build your home) is deductible for loans secured by a first or second home. That's a million total, not per home. A recreational vehicle or mobile home can qualify as a home for the regular income tax. Boats qualify, except when calculating the alternative minimum tax. Mortgages taken out before Oct. 14, 1987 get special treatment: Interest on them is fully deductible, even if it's more than $1 million.

Interest on up to $100,000 of home equity loans is deductible, regardless of how much the residence costs. The $100,000 ceiling applies to the total of all home equity loans, not $100,000 for each home.

Deductions for acquisition debt exceeding $1 million and home equity loans over $100,000 depend on how the funds are used. If the excess is for business or investment, the interest is deductible in most cases, provided that Internal Revenue Service tracing and other rules are satisfied. Interest on excess loans used for medical or education purposes is deductible only if the money was borrowed before Oct. 14, 1987, or if the $100,000 rule is used.

Refinancing a mortgage is OK unless the loan balance is increased as part of the refinancing. This rule applies to all mortgages, including those taken out before Oct. 14, 1987. Any extra funds from refinancing that aren't used to improve your home are not counted as acquisition debt and are subject to the $100,000 home equity cap.

Mortgage points are fully deductible in the year you paid them if you satisfy several rules. The points must be for the purchase or renovation of your primary home. They are not deductible if paid as part of a refinancing or if the loan is used for investment, tuition, etc.

The points must be paid by you or the seller, not taken out of the loan proceeds. You must have put down enough cash to cover the points. This includes any loan origination fee, if the fee is determined as a percentage of the loan.

If one of these rules is not fully satisfied, any deduction for points is spread over the life of the loan. Points paid when refinancing are deducted over the term of the loan.

If you refinanced a loan you previously refinanced, you can deduct all the points left on the prior loan. But if you refinanced with the same lender, IRS says that you must take the deduction for the remaining points over the term of the new loan.

Property tax deductions are another a big advantage of homeownership. The deduction for a home that's being sold must be divided between the buyer and seller, even if the full tax is paid by only one of you. When you are buying a home, ask if the assessed value of the property is frozen under local law. If it isn't, you'll probably face higher property taxes when there's a reassessment following the sale. Note that to claim this write-off, you must itemize deductions. A special break for nonitemizers lapsed after 2009.

Other tax issues to consider include capital gains rules. Marrieds can exclude gains of up to $500,000 from capital gains taxes. Singles can exclude up to $250,000.

To get the exclusion, you must have owned and used the house as your primary home for two years during the five years before you sell it. Even if only one spouse owns the home, both must live there for two years to get the full $500,000 exclusion. If only one lived there for two years, only $250,000 of gain is tax free. This break can not be used more than once in two years. And if a main home was acquired in a like-kind exchange and the home is sold within five years of the exchange, no gain can be excluded.

There's an exception for a quick sale due to a job change, illness or an unforeseen circumstance, such as a divorce. The exclusion is prorated based on the time lived in the home if you sell for any of those reasons. So, a single person who lived in a home for a year before being transferred to work out of state can exclude up to $125,000 of gain.

A vacation or rental home can qualify if you make it your main home for two years after you leave your principal residence. The same is true for a boat. But a new law limits your exclusion if you turn a vacation or rental home into your main residence after 2008. A portion of the gain on a later sale will be taxed, based on the ratio of the time after 2008 that the home was used as a second home or a rental home to the total time you owned the house. The rest of the gain is eligible for the home-sale exclusion.

It's still vital to keep records on your home. If you rent out the house, you'll need your records to compute depreciation. You will have to prove your gain if the property appreciates and the gain exceeds $500,000. Remember, deferred gain from prior homes counts toward the $500,000 or $250,000. And surviving spouses who sell are limited to only $250,000. They may need records to prove their gain.

Here's what you need: the original cost of the property, plus what you spent on permanent improvements, such as additions, fences, shades, carpets, fitted drapes, shelves, storm windows and central air-conditioning. These expenses boost your home's cost basis and reduce your gain.

Divorced and separated spouses can use the exclusion, too, even if only one has lived in the home for two of the five years before the sale. If either meets the two-of-five-year rule and one is living there as a result of a court decree, each can exclude up to $250,000 when the house is sold.

Surviving spouses have a special rule. The cost of homes bought since 1976 is increased to reflect half the appreciation when the spouse died. The increase is 100% if the couple lived in a community property state, or elsewhere if bought before 1977 and the decedent put up all of the money to buy the home. They also can claim the full $500,000 gain exclusion if the home is sold within two years of the spouse's death.

Using part of your residence for business may get you a deduction. If you pay rent, part may be deductible. If you're the owner, you may get depreciation. Deductions for operating a business in your residence are allowed only for the portion that is used solely and regularly as your primary place of business or when your home office is used for seeing clients, customers or patients. But it need not be exclusive use if inventory or samples are stored there. If you are an employee, you must show that use of your home is for your employer's convenience, not just yours. Home-office deductions will be allowed even if clients or others are not there or if it is not the main place for managerial or administrative functions.

Maintenance and depreciation are deductible only up to the amount of business income that's generated from your home. In computing that amount, you must subtract any interest and taxes that are related to the property. But there is relief when you sell the home. The gain on your home office qualifies for the home-sale exclusion, even though the space was not used as a residence. However, any depreciation after May 6, 1997 is recaptured and taxed at a maximum rate of 25%.

Renting out your house can convert it into a business asset, which may let you claim deductions for maintenance and depreciation. You can rent the home you used to live in or buy another to rent. If you rent to a relative, the rent must be fair and paid from your relative's funds, not your own. And it must be your tenant's home—you can't live there.

Renting out rooms in your home doesn't yield big tax savings. Depreciation and maintenance are deductible only up to the rental income, and only after deducting interest and taxes on the rental portion.

Vacation homes can provide you with some tax deductions, but deductions are limited when your personal use of the rental home exceeds certain limits. Maintenance and depreciation are deductible only to the extent that rental income exceeds the real estate taxes and mortgage interest allocable to the rental.

This rule is triggered if personal use exceeds 14 days and 10% of the home's rental time. When personal use is less, you can get a full write-off for depreciation and maintenance unless the IRS proves that you are not engaged in a profit-making venture. The definition of "personal use" is tricky. The IRS counts days rented to relatives as personal use by the owner even if a fair rent is paid. But days spent repairing or cleaning the place do not count.

Interest on a vacation home is fully deductible if it is used as a second home. If it's strictly a rental property, the losses can be deducted from other income in some situations, as we'll discuss later in this section.

Rent can be tax free if you rent your home for fewer than 15 days during the year. Keep this in mind if your area attracts visitors for sports playoffs, or other special happenings. But you cannot deduct depreciation or upkeep.

Tax credit recapture.

First-time home buyers who purchased their residences in 2008 were entitled to a tax credit of as much as $7,500. But the credit was actually an interest-free loan from the government. Starting in 2010, the credit is recaptured ratably over 15 years, so filers who claimed the maximum credit must report $500 in extra tax each year. Any remaining credit is recaptured when the home is sold. Filers who got the credit on houses bought after 2008 avoid any recapture unless the home is sold within three years of purchase.

Investment Real Estate

The tax code has many provisions affecting the use of investment real estate as a tax shelter.

Depreciation is calculated using rules that change frequently. For residential buildings, the rule is straight-line depreciation for 27 years and six months. For nonresidential property, it's 39 years. That's the time over which you can write down the value of the property based on your purchase price. Some special buildings—greenhouses, and gas stations, for example—get a shorter period.

Depreciation isn't all gravy, however. When you sell, depreciation you have claimed is recaptured and taxed at a top rate of 25%. And depreciation on a home used for business is exempted from the $500,000 or $250,000 capital gain exclusion, if traced to periods after May 6, 1997. This is so even if the home was not used for business in the year it was sold.

Tax credits also are available for some buildings. Renovations of old buildings and restorations of historic structures and sites qualify for the credit. Credits equal 20% on historic sites and 10% on buildings first used before 1936.

Trusts for children have lost some appeal. Putting business real estate into such a trust is an arrangement that has been used to build nest eggs. The child receives rent from a building that's used by a family firm, which deducts the payments. But current tax rules treat such income for a child under 19 (or 24 in the case of dependent full-time students) as income to the parent, which means it is taxed at the parent's rate. It is also taxed to the parent if put in a trust and likely to become the parent's again, whatever the child's age.

Owning real estate used by a business is another arrangement that has lost favor. In the past, stockholders who owned buildings profited from renting them to the firm. This enabled the shareowners to claim depreciation and other deductions. They usually netted losses that offset other income. But the extent to which you can deduct such losses is now limited.

The passive-loss rule is a wild card in real estate investing. A passive loss is a loss from an investment in which the owner is not involved in the operation of the business that is generating the loss. Such losses usually cannot offset income from salary or other investments.

Most passive losses are from two sources. One involves limited partnerships. All limited partners are passive, no matter what the size of the company or what it does. The other involves most rental real estate—homes, apartments and office buildings.

Many closely held corporations are nicked by the ban on writing off passive losses. Professional corporations—doctors, CPAs, etc.—are hit too, as are owners of S firms, unless they can show they are active in the business.

Real estate qualifies for two special exceptions from the restrictions on offsetting passive losses against other income. The first is that an owner of rental property may deduct rental losses of up to $25,000 from other income. But there is a catch that affects many taxpayers: This break dwindles and disappears completely as income rises. The phaseout starts when adjusted gross income tops $100,000. It disappears entirely when adjusted gross income exceeds $150,000.

To qualify for the $25,000 offset, you must also actively manage the real estate, which can be done through agents you direct. For rehabilitation tax credits, the phase-out range on adjusted gross income is higher. The $25,000 deduction phases out between $200,000 and $250,000. For low-income-housing investments, there is no phaseout for higher-incomers. And personal involvement by the owner isn't required for the credit.

Passive losses can offset all corporate operating income, whatever the size of the firm or ownership structure. However, passive losses cannot offset corporate income from dividends, interest, royalties, capital gains, etc., of most personal service corporations or of closely held corporations where fewer than six people directly or indirectly own more than 50% of the stock.

> Rent can be tax free if you rent your home for fewer than 15 days during the year. But you cannot deduct depreciation or upkeep.

When the real estate is sold, unused passive losses can be utilized to offset capital gains.

The second exception to the passive-loss rules applies to real estate professionals. They are exempted from these limits and can deduct their losses from rental real estate in full. To qualify as a real estate professional, you must satisfy a couple of requirements. You must spend more than one-half of your working hours AND at least 750 hours per year materially involved in real estate as a developer, broker, landlord and the like.

Other real estate tax angles that you may need to know about include:

- Interest deductions on rental real estate are limited by the rules on passive losses.

- Like-kind property exchanges postpone taxes on some business or investment real estate. You may be able to work out a tax-free exchange even if your seller doesn't want your realty in return. You must use a qualified intermediary to hold the proceeds from the sale of your property. You must identify replacement property within 45 days of the sale and acquire it within 180 days. Follow the rules carefully.

Things to be wary of as a real estate investor:

- You may be taxed as a dealer if you buy and sell properties too often. If you sell property on the installment basis, the IRS might not let you report gains as payments are received, the method that is available to nondealers taking back notes of $5 million or less.

- Too much tax-exempt income may catch the IRS' attention. The IRS may trim your interest deductions if your tax-exempt securities exceed 2% of the total assets in your investment portfolio and business.

- Excessive rental income could cause a forfeiture of special tax treatment by S corporations. Or it could draw a personal holding company tax.

- Too much depreciation can force you to pay the alternative minimum tax, which limits your deductions.

Estate Tax Aspects of Real Estate

Large real estate holdings may leave an estate cash poor and force your heirs to sell property in order to pay estate taxes. Jointly owned property that is taxed to an estate might also pose payment problems. It can lead to the sale of assets that were destined to go to other heirs and, as a result, would shortchange them. But the good news is that appreciated assets escape income tax, even if estate tax is owed to the IRS.

Having a vacation home in another state can cause problems. Each state can tax your estate based on the fact that you lived there. That can be a big problem if your vacation spot is in a state with a high estate tax.

Including real estate in your portfolio makes good sense. As a general rule, real estate in a well-situated locale appreciates in value, sometimes in fits and starts, but in a general uptrend over the long term.

Setting Up Your Business

THE TAX ANGLES

How your business is organized makes all the difference in how it is treated under the law for tax and benefit purposes. Whether the business should be incorporated is the big question, especially in view of ever-changing federal laws and regulations affecting incorporated businesses.

This chapter outlines the key points that you should weigh—the advantages that incorporation of a company brings plus the pitfalls that can be avoided.

Small firms often fail to incorporate because earnings are taxed twice—once to the corporation and again as dividends to stockholders.

But double taxation may be a bigger fear than is warranted. Key variables include how much income you earn from your business and how much from other sources, the type of income involved and your tax bracket and those of your co-owners. Congress has also lightened the double-taxation penalty a bit by lowering the tax rate on dividends. The maximum rate on them is now 15% through 2012.

Tax Rules for Corporations

There are both tax advantages and disadvantages to being a corporation. Chief among the advantages is the fact that profits aren't taxed to shareholders until the profits are paid to them. But there's a disadvantage in that, unlike partnerships, corporations are taxed on their own income.

A tax rate of 35% is the maximum that corporations have to pay. The top rate applies to income in excess of $10 million. The corporate tax begins at 15% on the first $50,000. It increases to 25% between $50,000 and $75,000. And there is a 34% rate on income between $75,000 and $10 million. Once income tops $100,000, an additional tax soaks up what the lower rates save. The tax on the first $200,000 of income is $61,250.

Some types of businesses pay a flat 35% on all income. They are personal service corporations in accounting, actuarial science, architecture, consulting, engineering, health, law and the performing arts.

Comparing personal tax rates with corporate taxes comes into play when deciding whether to incorporate. For individuals with $200,000 of taxable income after deductions, singles will pay about $50,500 in tax, and marrieds, approximately $43,800. Personal tax brackets are automatically adjusted each year for inflation. These tax levels may make it less attractive to form a business as a regular corporation, rather than a partnership, an S corporation or a hybrid known as a limited liability company, or LLC.

An accumulated earnings tax also scares some owners away from the corporate form of business. The IRS imposes a penalty of 15% on excess earnings that are left in a corporation, so-called retained earnings. The first $250,000 of retained earnings is usually exempt from the accumulated earnings tax. (The exemption is only $150,000 for personal service corporations—doctors, accountants, architects, etc.) The penalty is in addition to the regular corporate income tax of up to 35%.

But there are ways to avoid the accumulated earnings tax. It will not be applied to corporations that can prove they need the money to expand, to replace aging assets or for other foreseeable needs. The best defense is to have bona fide plans for using the money. A vague intent won't pass muster with the IRS.

A minimum tax that large corporations are required to pay is something that you should take into consideration when deciding whether to incorporate, especially if your firm has lots of income or fast write-offs. Corporations pay the minimum tax if calculating the tax results in a higher tax liability than they would pay using normal calculations. To figure the minimum tax, you add back some exclusions and deductions to income.

The minimum tax rate for corporations is a flat 20%. Deductions, exclusions and credits also figure into calculating the minimum tax. Adjusted earnings is the key item in the corporate minimum tax. If the corporation's earnings and profits are larger than its taxable income for minimum tax purposes, 75% of that excess is added back to its income for alternative minimum tax purposes.

Small corporations normally won't face an alternative minimum tax for 2012 if their average gross income for all three-year periods from 2006 through 2011 was less than $7.5 million.

Some corporations are required to reduce some of their deductions by 20%, including mining exploration and development costs, pollution control facilities, bad-debt reserves and interest deductions tied to tax-exempt organizations and banks.

Tax-preferred dividends can be issued only by corporations. Dividends paid out of current or accumulated profits are taxed to shareholders at no more than 15%, a rate that compares very favorably with the 35% maximum rate on salary. In some cases, the tax savings to shareholders will exceed the extra tax the corporation pays by distributing a nondeductible dividend.

> When small corporations go bust, the owners have a special tax break: They are allowed to deduct up to $100,000 from other income.

The type of income earned by corporations doesn't matter. Capital gains and tax-exempt interest are mixed together and taxed as dividends (ordinary income) when the company pays out earnings.

Dividends also get favored tax treatment when the dividends are received by corporations. Seventy percent of payouts from U.S. companies are tax free to those receiving the dividend if the recipient owns less than 20% of the firm that makes the payment. This makes the top tax on dividends paid to corporations 11.7%. But there are limits on how much income firms can have from interest, dividends and the like before the IRS slaps on a 15% personal holding company tax. Proprietors and partners cannot exclude any taxable dividends.

Capital gains treatment of corporations and unincorporated firms differs, and for some that might mean that a noncorporate form is preferable. Capital gains tax rates on unincorporated businesses are the same as those for individuals. Therefore the tax burden on a net long-term capital gain generally is 15%.

Corporations usually pay a flat rate of 35% on net gains. Those earning less than $75,000 pay 15% or 25% on their gains. But capital gains paid to stockholders as dividends are taxed at 15%.

Salaries can significantly reduce the taxable income of corporations. In fact they can eat up ALL the profits as long as they are not so high that the IRS concludes they are unreasonable. If that's the case, the Revenue Service will slash the deduction.

Also look at the owners' tax brackets before paying them more, especially if the owners do not need the income and the company can make good use of the cash. Paying a tax-preferred dividend may make more sense.

Corporations have advantages on other expenses. They can deduct reasonable pay to owners who are employees, even if the firm takes a loss.

Fringe benefits are a big tax advantage for corporations, although Congress has been trimming that advantage, a trend that we believe will probably accelerate over the next decade or two. Corporations no longer enjoy an exclusive break on the cost of medical benefits. For many years, they have been able to deduct 100% of medical expenses, including insurance, for owner-employees. Now self-employeds also get to take that deduction.

There is a difference in the treatment of group-term life insurance. It is not available as a tax deduction for a sole proprietor or a partner. But corporate plans with limits for key employees are OK.

Partnerships and Sole Proprietorships

The main alternatives to incorporating are partnerships and sole proprietorships. In these, the owners are taxed on any income the business has, even when they leave the money in the company to use for expansion or for other needs.

Partnerships have the option of operating on a fiscal year. But most that do must keep a revolving fund on deposit with the IRS. The amount fluctuates with profitability and depends on when the firm's fiscal year ends. Partnership income is taxed to owners in the year in which the firm's tax year ends.

Partnerships have more leeway on some expenses than corporations. A partner who puts up assets can take the depreciation if the other partners agree. A partner who has to travel can claim travel costs.

Partners can deduct losses from their business on their personal tax returns. Normally, shareholders cannot. This gives an advantage to new ventures operating in the red. And it allows active owners to use the firm's losses to offset other income they may have. The amount of loss that they can deduct is limited by the amount they have invested in the firm, their share of the company's debts and, for inactive owners, their net income from other limited business interests they have.

> Businesses often change their legal form to meet their changing needs. Smart business owners review their form early and often.

Some income goes to partners. For example, a partnership's capital gain or loss is taxed to the partners as a gain or loss. Tax-exempt interest remains exempt. Also, interest, dividends and passive income retain their tax status.

Social security taxes are about equal for incorporated and nonincorporated businesses. Self-employeds now pay the same total rate levied on employers and employees. But self-employeds get a deduction for half their self-employment tax, or SECA, in calculating their income tax. They can also deduct 7.65% of their net earnings when figuring the SECA tax. Corporations with a loss still have to pay FICA (Social Security and Medicare tax), but self-employeds don't pay SECA if they lose money. And proprietors don't pay FICA or FUTA (federal unemployment tax) if they employ their children and the children are under 18. But corporations employing the owners' children do have to pay FICA and FUTA on them.

S Corporations

There is a compromise between incorporated and unincorporated firms: S corporations. The S corporation is named for the part of the tax law that contains its rules. S status is especially appealing if a firm has losses that owners can use on their own returns, which is very common in the early years of a firm's existence.

No corporate income tax is levied on S corporations, even though in reality they are corporations. Income or loss is taxed to the owners as though they were partners.

But losses are deductible only up to the amount invested in the company, which includes stock and loans made to the firm. And, as is true of partnerships, S firm losses exceeding the owners' investment can be used in later years, equal to the amount of additional capital, including loans, from the owners. Also, only active owners can use losses to offset salaries, dividends, etc.

Other differences distinguishing S corporations:

- They can have no more than 100 shareowners. But family members who own stock count as one owner, even when the stock is owned separately.
- S status lasts until it's revoked by a majority of owners.
- It is limited to one class of stock, but voting rights can vary.
- Unlike regular corporations, S firms are not subject to the accumulated earnings tax.
- Salaries should be paid to owner-employees as a precaution should S status be lost. Salary deductions reduce corporate tax.
- The IRS can slap payroll taxes on S corporation dividends when the salary taken is too low.
- The firm may have to maintain a deposit with the IRS if it uses a fiscal tax year.

■ Corporations with retained earnings that become an S corporation pay a 35% tax to the extent that more than 25% of their income is from dividends, interest, etc. And they must pay a tax on any appreciated assets sold during their first 10 years as an S corporation.

Note that pension and profit-sharing rules are the same as for other corporations. While S status offers many advantages, the IRS is quick to spot errors that let it void S status and slap a corporate income tax on a business.

Limited Liability Companies

In these companies, all owners have limited liability. They are taxed like partnerships, but without the complex rules and restrictions that S corporations face. LLCs can be established in all 50 states.

Family Corporations

The IRS allows family partnerships and corporations to shift income to children or others in lower tax brackets, unless salaries of shareowners working in the company are too low.

Related Companies

Corporations under common control have pitfalls to keep in mind. They don't get to use the lower rates on the first $75,000 of income EACH earns. They must figure their tax on combined income. The rules are complicated and should be consulted whenever 80% of a corporation is owned by fewer than six people, some of whom own stock in other small companies. And companies with common control are subject to reallocations of income and expenses if the IRS doesn't like their way of apportioning them.

Other Issues to Consider

There are issues unrelated to taxes to think about regarding the form of a business. They include owners' liability, licensing, usury laws and managerial convenience. These often dictate the choice, regardless of taxes. Ask your attorney.

Incorporating can be tricky for small businesses, which often start unincorporated and later incorporate after becoming established and successful. The switch can be tax free or taxable, depending on how it is handled.

A tax-free move requires that each owner of an unincorporated business use the same cost for company shares that the owner had for the assets turned over.

A taxable move may be better in some cases, such as when the firm's property has appreciated in value. The owners will then sell it to a corporation and pay tax on their gain, with the firm's depreciation based on its cost.

Unincorporated owners may have to pay tax on past deductions or credits.

When small corporations go belly up, owners can claim a special tax break: Section 1244 stock. It lets the owners deduct up to $100,000 of their loss on such stock from other income. Otherwise, the loss would be a capital loss that is subject to a $3,000 annual net-loss limit.

Changing a Firm's Legal Status

Businesses often change their form to meet their changing needs. For example, a split of operating divisions may be advantageous for management of the enterprise. Or the ownership arrangement may need to be altered for estate-planning reasons.

Smart business owners review their form of business early and often just to be sure that they are not overlooking anything. Such reviews are necessary given the frequency of changes in tax rules.

For example, the 1976 tax law tightened up on many of the partnership rules. Revisions in 1978 made scads of changes affecting businesses. The 1981 law reduced the top personal tax rate from 70% to 50%. In 1983, a slew of easings for S corporations went into effect. In 1984, changes altered many ways of taxing business. In 1986, reforms scrambled the tax principles that had long guided choices on the form of business.

In 1987, 1988 and 1989, there were still more changes. In 1993, Congress increased rates on individuals and corporations. In 1997, it eased the minimum tax and taxes on capital gains and cut the estate tax on family-owned businesses. And in 2001 and 2003, lawmakers lowered individual tax rates and taxed dividends at capital gains rates.

As this pattern of tax legislation shows, there is no end to the modification of federal tax code. Business is always an easier target than individuals for lawmakers to hit when raising revenue. That's more than enough reason to stay abreast of developments for business planning, whatever form you operate your business in.

Fringe Benefits

FINDING THE BEST OPTIONS

You can reap tax benefits and minimize costs by knowing how fringe benefits are treated under the tax code. The basic rule is this: Fringe benefits are taxable compensation. But there are exceptions in the Internal Revenue Code to encourage businesses and individuals to do things that lawmakers deem to be good public policy.

As a result, some fringe benefits are exempt from tax, if certain rules are satisfied. Other benefits are tax deferred, with no income tax due until a later date. Or they are taxed at lower rates, such as capital gains on an employer's stock.

Even fully taxed fringe benefits have a plus side: The tax that employees pay is less than what the cost would be if they had to pay for the benefits on their own.

Usually, all employees must be eligible for a benefit for it to escape taxation. Some benefit plans cannot cover sole proprietors or partners, which is one reason many businesses incorporate. Most benefits also have limits on what can be paid to owner-employees and others.

Employers' products and services qualify for breaks, within limits. They include:

Price discounts. These are tax free if they are available equally to all employees and if the products are part of the business line in which the employees work. The discount cannot exceed the firm's gross profit. On services, the discount may not exceed 20% of the price that customers pay (lower commissions for employees of a broker, for example). Spouses, children and retirees also can be offered the breaks.

Free services, such as rooms for hotel employees or trips for airline workers, are allowed. They must be available on an equal basis to all employees. Otherwise, high-paid staffers are taxed on the value of benefits they get. Reciprocity agreements with others in the same line of business are allowed.

Transportation and commuting benefits are popular, including the following:

Company cars. The cost of providing a company car is taxable to the extent the car is available for personal use, except demonstrators for full-time salespeople.

There are three ways to value company cars used by employees for personal business. An annual lease value can

be figured from IRS tables. Rank-and-file employees can be assessed $1.50 each way for commuting. Or they can be charged 55.5 cents per mile for every mile of personal use, if the cost of the employer's car is less than $15,900 to buy.

Transit passes and tokens can be sold to employees at discounts of up to $125 a month. Or employees can be given cash up to $125, tax free.

Parking is tax free if worth up to $240 per month, even if the benefit is limited to high-paid employees. Anything above $240 per month is taxable income. The entire value of free parking is taxed to partners, 2% shareholders of S corporations and independent contractors. Employees can be offered the option of taking cash instead of parking, but they will be taxed on the money.

Bicycle commuters. Employers can reimburse up to $20 per month tax free for their employees' costs of pedaling to work in months when the bike is used for a major part of the commute. This includes the cost of the bike, repairs and storage costs. But they can't receive any other tax-free commuting perk, such as parking or transit passes.

Leasing a "luxury" car triggers a tax. Those who use a car for business have income that's imputed if the vehicle is valued at more than $18,500 and was first leased in 2012.

Company planes have special rules. Personal use is taxed unless employees on business occupy half of the seats. The same rule applies if spouses or children use the plane. Airline employees are not taxed if they fly space available.

Chauffeur and bodyguard services are taxable unless they are needed for the firm's convenience, which is the case when there's legitimate concern about an employee's safety.

Meals and entertainment are big benefits and have complex rules spelling out when they are taxable and when they are not.

Supper money is tax free for employees who occasionally work late. But the IRS takes a dim view of habitual supper-money payments and will tax them.

Meals and lodging are tax free if provided on the firm's premises and for the employer's convenience, such as on-site meals for restaurant servers. They are 100% deductible by the employer, too. Farmers who incorporate can deduct the value of their meals and lodgings if they must live on the farm in the corporation's residence and if 24-hour oversight is needed to run the operation.

Company cafeterias are tax free if open to wide classes of employees, not just top executives, officers, owner-employees and high-paids. Also, any revenue generated must be used to cover operating expenses.

Executive dining rooms are tax free if eating on the premises is for the convenience of the employer or if the employee also could take a tax deduction for the cost of the meal as a valid business expense.

Parties and picnics are tax free when a company sponsors them on an occasional basis.

Club memberships are taxable unless the business use predominates. But the employer can treat the payment of dues as compensation to the employee.

Entertainment allowances are not taxable if they are used for business.

Education benefits

can be considered taxable if the courses are not related to the employee's job.

Tuition paid for job-related courses is tax free to employees and fully deductible by the employer. There is no limit on the amount. To be job related, a course must improve skills used on the current job. Classes to meet minimum requirements for a job or qualify for a new line of work, such as getting an MBA degree, usually are not job related.

Non-job-related courses, including undergraduate and graduate courses, are tax-free up to $5,250. Several requirements for the $5,250 exclusion must be met, including having a written reimbursement plan. And there's a cap of 5% of total tuition payments per year to 5% of the owners of the company or to their relatives.

Tuition breaks for teachers' children are tax free unless heavily tilted toward high-paids. This break does not cover graduate school tuition.

Health benefits subsidized by the employer are highly valued by most employees. The employer may pay all or a portion of the tab for health insurance or let employees pay some or all of it. It usually costs employees less to pay a group rate offered through their employer than to pay for coverage on their own.

Benefits are not taxable, except in some self-insured arrangements. Nor are the premiums that employers pay. But reimbursements to officers and owner-employees are taxed in self-insured plans that do not cover a large share of a firm's employees. Arrangements with insurance companies to handle employee medical claims and charge the employer accordingly are classified as self-insured plans.

Firms must offer continuation of medical coverage to employees who quit, retire or are disabled, and their families. But costs can be passed on to them in part.

The reimbursement costs of required annual physicals are tax free, even if exams are required only for top executives.

Proprietors and partners may deduct 100% of the premiums paid for coverage for themselves and their families, thus treating them just like corporations. The same is true for owner-employees of S companies. They no longer have to hire a spouse as an employee and offer family medical coverage to take the full deduction for insurance.

Health savings accounts (HSAs) are another health insurance option now available to businesses and individuals. HSAs can be set up only by folks who have policies with high deductibles. The minimum allowable deductible is $2,400 for family coverage and $1,200 for self-only coverage. HSAs must also limit copayments on covered benefits to $12,100 a year for marrieds and family coverage and $6,050 for individual coverage.

HSAs are tapped to pay what basic coverage would have paid. Disability, dental, vision and long-term-care insurance are permitted. Seniors covered by Medicare can't have HSAs. Nor can persons who can be claimed as someone's dependent.

Write-offs for contributions by individuals to their HSAs are no longer limited to the deductible on the associated insurance policy. Annual payins are $6,250 for family coverage and $3,100 for self-only coverage. Participants born before 1958 can put in an extra $1,000 for 2012. The deduction can be claimed by both itemizers and nonitemizers. Contributions can be funded through salary reduction.

Income earned within an HSA is not taxed to the HSA owner. Withdrawals are not taxed if used to pay for medical treatment of someone covered by the plan.

Payouts for other purposes are taxed and hit with a 20% penalty, unless made on or after reaching age 65 or because of death or disability. Unused amounts in HSA accounts are carried over to the following year. Individuals with medical savings accounts can roll them over tax free into HSAs.

Payins to HSAs are fully deductible by employers that make them on behalf of employees who do not have basic medical insurance protection. Contributions that are made by employers are tax free to the employees. Employers that offer HSAs must do so for all of their eligible workers.

HSA plans are worth checking into, especially by healthy folks, who can benefit from the tax-free compounding of their unused HSA payins.

Group-term life insurance is another popular benefit that employers can provide. The first $50,000 of insurance is tax free. Premiums for the amount above $50,000 are hit by income and Social Security taxes. But the tax paid is far less than what employees would pay for similar individual coverage. Policies must cover 70% or more of the staff, or only 15% of insureds can be top executives. Policies must be convertible if an employee quits, but employers need not offer any break on price. Policies given only to key employees are fully taxed to those employees. Retirees can be covered by company policies.

Companies that employ fewer than 10 workers have special rules: They must cover ALL full-time workers. Coverage must be a uniform percentage of pay or be based on tables that satisfy IRS rules. Physicals cannot be required, although employees can be required to fill out a medical questionnaire.

Group permanent insurance costs more, but it gives more to employees. An employee is taxed on employer-paid premiums that build up the cash value. But if changing jobs, the employee can buy the policy from his or her employer and pay future premiums.

Split-dollar coverage is a low-tax way to insure key people. Employers and employees split premiums and benefits. The company pays for and gets the cash value, and the worker's heirs get the balance. The employee pays for the term insurance portion and is taxed on the part that the employer pays. The IRS has been keeping a close eye on split-dollar policies and is cracking down on abuses in this area.

Long-term-care coverage can be provided by employers for their workers tax free, just like company paid health insurance, for up to $310 a day. Above that amount, the benefit is taxable income.

Disability and sick pay can also provide some valuable tax breaks. Employees aren't taxed on insurance paid by their employers, be it a group insurance policy or individual policies for key employees. Benefits are taxed unless the employee pays the premiums. Some low-paids under 65 and permanently disabled can get a tax credit to ease their burden a bit. Social Security tax is due on the first six months of sick pay.

Adoption assistance is tax free up to $12,650 if used for lawyer's fees, court costs, adoption fees and travel, including meals and lodging. Assistance is available for foreign adoptions, too. The break phases out for employees with adjusted gross income of more than $189,710, and it disappears entirely at $229,710. Employees can claim a tax credit for adoption expenses that are not covered by employers.

Cafeteria plans let employees take cash or pick from a list of tax-free benefits, including health insurance. Other benefits that can be offered that way are group-term life, dependent care, 401(k) payins and longer vacations, but not parking, tuition, long-term care or employer-provided meals. In effect, employees can tailor fringe benefit packages to their needs. For example, they can buy extra health insurance or skimp on that and fulfill other needs.

Flexible spending accounts are a narrow variety of cafeteria plan. Employees agree to reduce their pay, with the reduction put into accounts that they can tap for medical and dependent care expenses during the year. Employees pay less income tax because the expenses are paid with pretax dollars. Employers save, too: They pay less in Social Security and Medicare taxes because employee salaries are reduced.

There is one risk worth noting: A "use it or lose it" rule applies. Employees forfeit any money left unspent in accounts at year end. But if the firm has amended the plan to follow a recent IRS easing, March 15 of the following year becomes the cut-off date to clean out remaining funds.

Tax-qualified retirement plans are another key area for fringe benefits. Qualified plans offer three tax breaks that make them attractive: deductible payins, tax-free income buildup and low tax payouts.

Firms have three options: pension plans, profit sharing and 401(k)s. Their plans can be used to give workers a stake in the firm by giving them stock or options to purchase stock in the company. Or they can be used to encourage employees to save.

Annual contributions by employers are required with pension plans. They are not required with profit-sharing plans because contributions obviously depend on whether there are any profits to share.

Retirement payouts are specified under pension plans, often based on a percentage of pay for the final year or series of years of employment. Profit-sharing and stock purchase plans don't promise a specific benefit. Employees get the current worth of the company contributions to the plan. Most pension plans are insured by a government agency, but profit-sharing plans are not.

Who gets coverage is similar under pensions and profit-sharing plans. There are limits on favoring owners, officers and high-paids. Company payins can be tied to pay. But they must cover most workers, including those in other companies that are owned by the same people. If most of the plan benefits go to top employees, faster vesting is required.

> Cafeteria plans let employees take cash or pick from a list of tax-free benefits, including health insurance.

401(k) plans are a growing retirement option for companies, replacing older alternatives in which employers put up most of the money. Salaries or bonuses are diverted into an account and invested in any or all of the investments on a menu (usually a choice of mutual funds) selected by the plan. Employees choose which options to invest in and can shift savings from one option to another.

Payins are free of income tax, but Social Security and Medicare taxes apply. Employees can contribute as much as $17,000 of annual pay—$22,500 if they were born before 1963. Employers can match employee payins, adding incentive to participate.

Payins by high-paids—those who make more than $115,000 a year or own more than 5% of the company or are related to someone who does—are capped. The amount high-paids can set aside depends on the level of participation of others in the plan. High-paids can put in up to 125% of the percentage of pay that those making less than $115,000 contribute. Or up to 2% of pay more than lower-paids contribute, so long as that isn't more than twice what lower-paids set aside. For simplicity, companies can use the prior year's percentages for lower-paids. Any excess deferrals must be returned as taxable income to high-paids.

Rank-and-file participation is vital for a successful 401(k), although nondiscrimination rules have been eased a bit since 401(k)s started. Contributions by high-paids needn't be tied to what others do if the employer matches at least the first 3% of pay plus one-half of the next 2% that lower-paids put in. Or firms can put in 3% for all employees making less than $115,000.

Tax-exempt organizations can have 401(k)s, but state and local governments cannot.

Small businesses have an option when it comes to setting up tax-qualified retirement plans. They can simply adopt a master or prototype plan approved by the IRS. There are many options. They are offered by life insurers, mutual funds, banks, benefit advisers and others. Be sure that the sponsor will amend your plan to keep current with rules and regulations as they change. That's a chore that small businesses are ill equipped to do on their own.

To qualify, firms must have 100 or fewer employees. The plans are called SIMPLEs, which stands for Savings Incentive Match Plans for Employees. SIMPLEs require a match from employees paid $5,000 or more in 2010, 2011 and 2012. The match cannot be more than the smaller of 3% of pay or what the employee puts in. SIMPLEs can be set up as individual retirement account (IRA) arrangements or 401(k) plans.

In SIMPLE plans, employee contributions are capped at $11,500 per year. Employees who are 50 or older in 2012 can contribute an extra $2,500. Unlike 401(k)s, payins of high-paids don't depend on what lower-paids contribute.

Payouts from retirement plans involve their own set of rules. Payouts start at retirement for most employees. Workers can retire and delay payouts until April 1 of the year they reach 70 and a half. At that age, they must begin to take them. Distributions also must begin by April 1 of the year after the participant turns 70 and a half for those owning more than 5% of the company, even if they continue to work beyond age 70 and a half.

Annuities are one option. They can be designed to make payments for a set period of years, the life of the beneficiary or the life of his or her survivor. But the spouse must consent to waive survivor benefits.

A lump-sum payment is another option. Income tax can be delayed by making a rollover to an IRA. Then payouts are taxed as they are made from the IRA. But distributions must start by April 1 of the year after the participant is 70 and a half, even if the person is still on the job.

Special averaging is available for those born before 1936. They can use 10-year averaging and a 15% rate on pre-1974 earnings appreciation. But folks over age 59 and a half can no longer use five-year averaging on lump-sum payouts.

Employer stock may be subject to capital gains rates on payouts. When shares are sold, the appreciation can be taxed at only a 15% rate if the sale results in a long-term capital gain. However, that break is lost if the stock is rolled into an IRA. Beware of penalties that the tax code imposes for early distributions. They apply when payouts are received too early—generally 10% on what is paid before age 59 and a half unless paid out as an annuity or because of a disability.

Plans for nonprofits include more than 401(k)s. Employees can also get 403(b) annuities, which many teachers have. The maximum payin in 2011 is $17,000—$22,500 for those born before 1963.

There are many types of deferred-pay plans that are often used to reward key employees even though they do not qualify for special tax treatment. They can defer tax on current pay or provide retirement benefits that are in excess of the limits placed on qualified plans. The employee isn't taxed until the benefits are paid, and the company gets no deduction until then. But if current assets are set aside to fund the future benefit, the employee is taxed right away, unless the company's creditors have a right to grab the set-aside assets.

Stock option plans that companies do not get to deduct can involve actual receipt of company stock. Or they can give employees stock appreciation rights, which represent stock, with actual payment in cash tied to an increase in the value of the stock. Performance shares are a variation. Their payoff is tied to achieving fixed performance objectives. When the company meets the performance standards, the executive is rewarded with stock.

Other fringe benefits may or may not be taxable.

- Vacation facilities are taxable, even if they are available to all employees.

- Company athletic facilities on company premises are not taxed when all employees can use them.

- Day care is tax free up to $5,000 a year when it's offered to everyone in the company.

- Help with retirement planning is tax free for employees if the employer sponsors a retirement plan. Such help may also include financial counseling.

- Low-interest loans can be tricky. Employees are deemed to have received income generally equal to the interest they don't pay. They may get offsetting deductions for phantom interest paid to the employer, depending on whether the loan is for investment, business or a home mortgage. The tax impact on employers must be weighted, too. Income that employees could earn with loan proceeds might generate taxable income for employers.

- Gifts are not taxed if they are inexpensive and are given for holidays, birthdays, etc.

- Achievement awards are tax free if they're given for length of service or reaching safety goals. The awards must be tangible personal property, not cash, and must not cost the employer more than $400—or $1,600 for awards made under a written plan that does not favor high-paids.

The Future of Fringe Benefits

Part of the debate in Washington over the role of government, deficits, tax cuts and reform involves fringe benefits.

Tax cuts remain a major inducement from Congress to encourage private actions, and fringe benefits are no exception. In 1996, for example, SIMPLEs and tax breaks for long-term care and adoptions were enacted. And starting in 2004, Health Savings Accounts were allowed.

Incentives are often a substitute for programs the government cannot afford. Thus, breaks for long-term care will ease some of the burden facing Medicare as baby boomers age. Favorable treatment for benefits is a tax cut in disguise for employees and employers in a position to use them.

Reducing the number of tax benefits could save federal revenue that could be used to reduce tax rates. That is at the heart of the discussion about a flat tax and tax simplification.

How this unfolds will affect all of us in our personal lives and in our businesses. We will keep you ahead of the pack on these and many other developments in *The Kiplinger Tax Letter.*

Children as Tax Shelters

TAX SAVING FOR EDUCATION

YOUNG CHILDREN provided good tax shelters for many years. But tax law revisions in recent years have drastically limited our options. The dreaded "kiddie tax" now applies until the tax year the child turns age 19, or 24 in the case of dependent full-time students. The tax disappeared at age 18 before. We'll explain all the rules in this section.

A child cannot claim his or her own personal exemption if at least one parent can claim the child, even if neither parent actually does use the exemption. But up to $5,950 of income is not taxed if earned by the child.

Investment income received by a child is another matter. Before the year in which a child outgrows the kiddie tax, a complex set of rules applies.

If the child does not work, $950 of investment income is tax-free. The next $950 of investment income is taxed at a rate of 10%—$95 tax on the first $1,900.

If the child works and earns more than $950 but less than $5,650, $300 of investment income is tax free, the next $1,600 (other than from tax-exempts) is taxed at the child's rate, and his or her earned income completely escapes tax. If the child earns between $5,650 and $5,950, the $300 tax-free amount falls to zero while unearned income taxed at the child's rate rises to $1,900.

Investment income that is more than $1,900 is taxed as if received it was by the parent with whom the child lives, or by the parent with the larger income if the parents file separate tax returns. If a parent has two or more children receiving more than $1,900 from their investments, their income is combined and the tax the parent will pay is computed first on the total and then apportioned among THOSE children.

The source of the child's assets, whether it be grandparents, a trust, or some other source, does not matter: It is taxed at the parent's rate.

The rules change in the year that a child escapes the kiddie tax. When that occurs, the investment income is no longer treated as though the parents had received it. Then his or her investment income is taxed at the same rates that apply to other taxpayers: 10% on the first $8,700 of taxable income; 15% from there up to $35,350. The 25%, 28%,

33% and 35% tax rates also apply if a child's income is high enough.

The $950 limit on tax-free investment income remains in effect until the child becomes self-supporting. For that reason, it may be advantageous to delay selling appreciated assets owned by a child or to delay trust payouts to the year when the child is 19 or older, or if later, is no longer a full-time student.

Investment Options

There are many ways to minimize a child's taxable income:

- Tax-exempt municipal bonds. Consider ones that are subject to the minimum tax. They often yield the most.

- EE savings bonds. Children need not pay tax on the income until the bonds are cashed in, which can be in a year when the kiddie tax rules no longer apply. A bonus: no state tax.

- Life insurance. Earnings are not taxed until withdrawn. And loans aren't taxable.

- Single-premium annuities. They also defer tax. But loans are taxable.

- Growth stocks that pay low dividends. They can be sold after the child outgrows the kiddie tax. The gain will escape tax if the seller is below the threshold of the 25% income tax bracket.

- Nonleveraged equipment-leasing partnerships. These are for youngsters who are about to escape the reach of the kiddie tax. Their first payouts are return of capital. Later ones are counted as income.

- Treasury bills. If you buy bills that mature in the year the child outgrows the kiddie tax, the income isn't taxed until then.

- For children not subject to the kiddie tax, high-yield investments may be the best option.

Ways to Save for College

Putting funds aside early makes sense when saving for college. Congress has beefed up ways to help.

Coverdell education savings accounts are much more tax advantaged than they used to be. Up to $2,000 a year can be put into accounts for children under 18, a significant increase from the paltry $500 that was allowed before 2002. While there is no tax deduction for the payin, withdrawals are tax free if used for education, including K-12 schooling. Even parochial school is now covered. Funds not cleaned out by the time the child reaches age 30 will be taxed as income to the beneficiary.

Income restrictions on payins to Coverdell accounts include a twist. It is the income of the contributor that the

Internal Revenue Service looks at, and the contributor need not be a parent. A contributor whose adjusted gross income (AGI) is less than $95,000—$190,000 if married—can make a full payin. But above those amounts, the $2,000 scales down. Thus, if the parents are over the income limit, the grandparents can step in and make the full contribution.

Custodial accounts and trusts can also be used to shift assets to children to build college nest eggs at the lowest total tax cost to a family.

Assets in custodial accounts belong to the child at age 18. They are easy to set up: Forms just need to be signed with a stockbroker or a bank. If the parent provides the funds, it is better to name someone else as custodian because if the parent dies, the IRS will tax the account as part of the parent's estate.

Trusts provide more flexibility, but they also need an attorney to draft them to ensure that they fully comply with current laws. Trusts let parents control funds for a while after age 18. And control can go on much longer when trusts are established with gifts that do NOT qualify for the $13,000 that donors can give free of gift tax. Many donors use part of their $5 million gift tax exemption instead and pay no tax.

Your choice requires a lot of care, planning and thought. If a child rejects college, the money belongs to him or her anyway. That could give a youngster a big chunk of money at precisely the wrong time.

There's a pitfall in paying tuition with trust income. If a trust pays for items your state says are parental support obligations, the IRS will tax the payments as income to the parent. State laws are changing to include tuition as a support item. This issue arises in divorce actions when one parent wants his or her ex-to-be to pay a child's tuition. What counts is the state law in effect when the trust makes payment, NOT the law when the trust was set up. If you created such a trust a while back, check to see whether your state now makes college a parental obligation.

To dodge this problem, pay trust income to the child for a few years before it is needed to pay tuition and have the child pay the tuition. That's then treated as the child's money. Remember, until the year the child is not subject to the kiddie tax, the money is taxed as if earned by the parents.

Credit for College Tuition. For 2009 through 2012, Congress replaced the Hope Credit with a souped-up tax credit for education called the American Opportunity Tax Credit. The new credit is 100% of the first $2,000 of qualified tuition and related expenses and 25% of the next $2,000, for a maximum of $2,500 per student. This break is allowed for the four years of college, not just the first two that the Hope credit covered. The cost of books also is eligible for this credit.

The new credit begins to phase out at $80,000 for single filers and $160,000 for couples. It disappears completely at $90,000 of AGI for singles and $180,000 for married filers. If the credit is more than your income tax liability, 40% of it is refundable. Also, the full credit is allowed against the minimum tax.

The lifetime learning credit can still be used for most courses at any time, including much later in life, if you satisfy all of the rules. Again, income limits can be an obstacle. The credit equals 20% of up to $10,000 of expenses, for a maximum tax break of $2,000. It applies to courses taken to learn or improve job skills or simply to expand your knowledge, but not to courses related to hobbies, games, etc.

A student can claim these credits instead of the parents, but only if the parents forgo claiming any dependency exemption for the student. And it does not matter whether the parents or the child pay the tuition. This is an exception to the general rule that the parents who pay tuition get to take the credit.

A deduction for college expenses is capped at $4,000 for 2012 for itemizers and nonitemizers alike. But there are limits based on income. The full deduction can't be used by singles whose adjusted gross income is more than $65,000 or by marrieds whose AGI is more than $130,000. The deduction will help some taxpayers whose incomes are too high to claim education credits.

New college savings plans are catching on in all 50 states. They are a twist on the prepaid tuition plans that started in the 1980s and are similar to individual retirement accounts (IRAs) to pay for college.

The plans, not the depositors, control investments, and they typically offer a blend of mutual funds designed to tailor risk to the amount of time remaining before the student goes to college.

Payouts from these plans are tax free if they are used to pay for education. Many states provide additional tax breaks by allowing parents to deduct payins on their state tax returns. Accounts can be transferred to a sibling or, in some cases, to the child of a relative, provided the child for whom the account was established decides not to attend college.

Savings bonds are another fairly new approach to tax-free education financing. When bonds are used to pay for college, the accumulated interest paid on the bonds escapes income tax if the adjusted gross income of the parents does not exceed certain limits. In 2012, the break begins to disappear as AGI exceeds $109,250 for couples, $72,850 for singles. These phaseouts apply to EE bonds bought after 1989.

The phaseouts are indexed to inflation, so they increase every year. Income in the year of redemption is what counts, not AGI in the year the bonds are bought. So you can fall into a trap if your children are young and your income is increasing. But note: EEs can be cashed in tax free if the funds are placed into Coverdell accounts or state college savings plans.

IRAs can be tapped early for tuition costs without being hit with the 10% penalty for payouts before age 59 and a half if the proceeds are used for the IRA's owner or the owner's spouse, children or grandchildren. But income tax is still due on any amount taken from the IRA.

Interest on some education loans is deductible up to a maximum of $2,500 in 2012. These deductions are available to all taxpayers, whether or not they itemize, if under the AGI cap of $120,000 for couples and $60,000 for singles. Deductions phase out completely at $150,000 for married and $75,000 for singles.

Scholarships and fellowships are tax free in most instances. But the aid is not tax free if a student is required to teach, do research or provide other services.

Tuition discounts can be tax free for employees of a school or college, whether for the employee, a spouse or a child. However, such discounts cannot be limited to a class of employees deemed high-paid.

Employer-paid education qualifies for a tax break, too. If courses aren't job related, tuition and books up to $5,250 a year are fully tax-free for undergraduate and graduate-level courses. If courses are job related, there's no cap on how much can be paid tax free. But courses cannot be part of a program to qualify for a new career.

Education expenses are partially deductible by employees who itemize if the expenses are job related and are not reimbursed.

Some forgiven student loans are not considered income. Loans must be made by certain government agencies or tax-exempt organizations. And they must require that the student perform a public-service job for a predetermined period.

A nontax aspect of college funding should be kept in mind. Putting assets in a child's name for tax reasons may backfire when financial aid rules are applied. Those rules change frequently, making early planning chancy at best.

Planning Your Estate

MINIMIZING THE TAX BITE

THE FEDERAL ESTATE TAX has been given a brief reprise. Lawmakers reinstated it retroactively to Jan. 1, 2010 with a $5 million exemption and a 35% rate, and gave it life through Dec. 31, 2012. The exemption for 2012 is $5,120,000, thanks to inflation. After 2012, the exemption is still scheduled to fall back to $1 million, with a 55% maximum rate. We think Congress will prevent that from happening. Nevertheless, proper estate planning will still be required, even if you won't owe any federal estate tax.

Planning Remains Essential

Beware of misconceptions that recent changes in the federal estate tax law have caused regarding estate planning. For example, many people believe the higher amounts that can be passed on tax free to their heirs eliminate the need for estate planning. In fact, however, MORE planning may be needed. The estate tax changes also mean that many wills need to be rewritten, especially those that have trusts for nonspousal heirs.

Some say that it no longer pays to make gifts. That's wrong. For many taxpayers, there are still advantages to giving. There may be fewer advantages than years ago, but there are still enough to avoid having taxable property left in your estate at death.

Don't assume that joint ownership takes care of things. And don't assume that you have too little property to be concerned. Such attitudes can end up costing you and your heirs money and headaches.

For one thing, joint ownership does not necessarily trump the estate tax. For another, your estate is probably much larger than you realize.

An up-to-date will is important. If you don't have a will, your state's laws say who inherits what.

In many cases, the inheritance rules of a state can take assets in your estate away from a surviving spouse and give them to relatives who otherwise wouldn't have gotten anything. A will can ensure that your wishes are met—that your spouse will inherit the full amount if your estate is small, for example.

State law may require that young children who inherit property when there is no will have court-appointed guardians to oversee the assets. Such guardians may need the court's approval to spend the money on the children.

Don't count on joint ownership as a substitute for a will. Sure, it transfers ownership of the property at death, but it can also create complications. The survivor will eventually need a will unless the inherited assets are again put in joint names, which limits any opportunity to make changes.

Wills can be altered easily by adopting a codicil or a new will. On the contrary, joint ownership cannot be changed unless all of the owners agree to the new ownership structure.

The simultaneous deaths of husband and wife joint owners without wills can cause an estate to be inherited by persons the couple might not want to have it. The estate tax also may be higher and may result in two levies instead of one. And the control of assets may be tied up. One of the owners may disagree about a sale, for example, or may be incapacitated or too young to sign a binding contract.

A survivor may be left with plenty of assets but lack the expertise for managing them, especially if the assets include an interest in a business, securities or real estate. Leaving them in a trust, with a bank or attorney or friend as trustee, is a better way to make sure that a survivor is properly provided for.

Joint ownership can also complicate a divorce. A husband and wife who own everything jointly can get into a hassle if they split up.

Keep in mind that property left to a joint owner can just as easily be passed on in a will.

Begin by taking inventory of what you own, including the location of property and what it is worth. The federal estate tax is based on the value of this property at your death.

Add up everything: Cash. Savings and checking accounts. Certificates of deposit. Stocks. Mutual funds. Bonds, including tax-exempts. Jewelry. Cars. Boats. Stamps, coins and other collectibles. Real estate, including your primary residence, vacation home and rental property. Your company plus any interests you have in other firms. Mortgages and notes you hold. Retirement plan benefits. And amounts that you expect to inherit from others.

Treatment of property varies when computing estate taxes.

For jointly owned property of spouses, half the value is included in the estate of the first spouse to die. It does not matter whose funds were used to buy the property or that the survivor automatically inherits it. And the full value is counted in the survivor's estate, which could result in a bigger estate tax when the second spouse dies.

IRS now recognizes an exception for pre-1977 joint tenancies for married couples. In that case, the amount included in an estate depends on the percentage of the purchase price that was paid by the decedent. Other joint property is taxed to the estate in direct proportion to the owner's part of it. For example, a 25% interest means that 25% is in the estate.

Life insurance is taxed in your estate if you own it at death, can name new beneficiaries, borrow against policies or take out the cash value. Even insurance you give away can come back—if the person you give it to dies and leaves it to you. Group insurance may be included, too.

Pensions and individual retirement accounts (IRAs) are taxable, except for pensions where the distribution method was fixed before 1985.

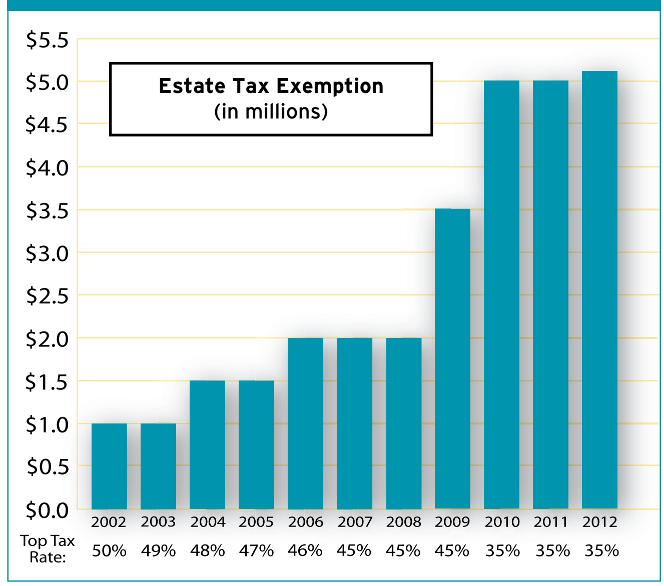
Large gifts that exceed $13,000 a year and are not given to charities are counted as well.

Property partly given away is taxed in your estate if you retain the right to use it. Examples include a residence that you give to your children but still use rent free. And stock that you give away but keep voting rights in, if in a firm you control. Also business interests in which you keep an ownership interest.

Property of others over which you have rights, such as a power under another's will to name who gets part of that estate, is taxable. If you can name yourself, your estate or your creditors, it counts as part of your estate. That includes assets you give a child but retain the right to control.

Add all these up to determine the potential value of your estate. Then take into consideration the effect of future inflation on what you will be worth. For example, if your assets are worth $1 million today and appreciate at 6% a year, they will be worth $1,503,000 in seven years and $2,012,000 after 12 years.

THE ELASTIC EXCLUSION



Now calculate your debts. Figure an amount for your funeral, executor's fee and other estate expenses. Estimate 8%-12% of your estate for those purposes. Add to that any mortgages that you owe. Subtract the amount from your assets and the result is your potential taxable estate BEFORE any estate planning.

Up to $5,120,000 of that amount is free from federal estate taxes in 2012. If your estate is worth less than this amount and you are confident that it will remain in that category, you can skip down to the income tax angles of estate planning covered later in this section.

The estate and gift tax rates reach a maximum of 35% on transfers of more than $5,120,000. An estate of $6 million will owe $308,000 to the Internal Revenue Service. The tax on an estate that is worth $10 million is $1,708,000, which is quite a hefty bill.

Reducing the Tax Bite

There are several ways you can reduce the estate tax. They include giving away property that is most likely to appreciate in value. The value at the time you make the gift has an effect on you estate tax, but appreciation AFTER the gift is made has no effect.

You can also give away other assets to take advantage of the rule that allows you to make annual gifts of up to $13,000 to as many people as you wish without eating into the $5,120,000 million that you can transfer tax free by gift or at death. If your spouse agrees, you can give $26,000 per recipient, even if the asset is entirely owned by only one of you.

In addition, tuition or medical bills you pay directly for a third party avoid the gift tax.

You can freeze the estate tax value of your business by setting the price in a buyout agreement with co-owners. The rules are relatively complex; you'll need the help of experts.

Another way to cut the tax bite is to arrange to have enough farmland and business real estate to qualify your estate for special valuation rules that permit you to trim up to $1,040,000 from the value of your estate. Heirs have to stay active in the enterprise for 10 years after our death. There are other requirements, too.

The estate tax exemption is now portable between spouses, so that any unused exemption passes to the surviving spouse and can be used by the survivor to shelter the tax on lifetime gifts or transfers at death. For example, if a husband dies and leaves $3 million to the kids and the rest to his spouse, the surviving spouse is able to use the $2.12 million unused exemption, giving her a $7.24 million estate and gift tax exemption. This new rule is only for estates of people dying in 2011 and 2012, as the law now reads. But we expect Congress to eventually make the provision permanent. It eliminates the need to have spouses set up trusts in their wills solely to save estate taxes.

Setting up deductions for your estate can also shave your taxes. One way is to donate to charity. Charitable bequests are fully deductible from an estate. They can be made in a variety of ways, including as a gift or as a remainder interest after your spouse benefits from the property during his or her life.

Consider making lifetime donations instead of waiting until death. By making lifetime donations, you get an income tax deduction as well as saving on estate taxes. You can even keep receiving the income or use of the property during your life.

You can leave property to your spouse under the marital deduction. There is no limit on the deduction for transfers to a spouse, for gifts and for bequests. Note, however, that isn't always true if the surviving spouse is not a U.S. citizen. If that is the case, the assets must be placed in a special trust administered by a U.S. trustee.

The marital deduction must meet some special requirements. Anything the spouse gets outright is OK, including joint assets, insurance, etc. Everything else, such as a trust, is also acceptable, provided only the survivor gets income for life or lifetime use of the property. Others may not benefit during the survivor's life.

The survivor does not have any right to name heirs at his or her death. This lets the first spouse to die protect his or her children from a previous marriage. The provision is also useful for childless couples, when, for example, the husband wants to be sure that his blood relatives get his property or the wife, hers, if she dies first.

Other Aspects of Estate Planning

There are other things you should consider in your estate planning.

Income tax angles of estate planning are often overlooked. For example, when donees sell property that they receive as a gift, they generally measure their profit or loss the same way that the donor would have had the donor sold the asset instead—by using the donor's cost of the property as their cost.

But when heirs get around to selling the property they inherit, their gain or loss depends on the asset's value at the time of death—not on what the property originally cost the decedent. So appreciation during the decedent's life escapes income tax.

Community property state residents have an edge in that surviving spouses can use the value at death for the entire amount of assets that they owned as community property. But survivors elsewhere cannot. They can use the value at death for only half of each of their jointly held assets.

The same is also true for joint ownership arrangements set up before 1977 by spouses in noncommunity-property states. Survivors who paid nothing can use the value at the time of their spouses' death as their cost.

Use of a carryover basis made a brief return in 2010. After Congress revived the estate tax retroactively in late 2010, it gave estates of people dying in 2010 the option of using a $5 million exemption with heirs receiving date-of-death value for inherited assets, or no estate tax and a partial carryover basis scheme. If the no-estate-tax option was elected, heirs get to add up to $1.3 million to the tax basis of inherited assets, and surviving spouses can add on an additional $3 million. Beyond that, heirs will have to use the decedent's tax basis for the assets they inherit. The executor of the estate will make the allocations of basis to the heirs and report the amounts to the IRS.

There is another way to save on income taxes, even though the donor gets no deduction for the value of the gifts beyond deductions for contributions to charity. Income from property given away is taxed to the donee, unless the donee is your child and is under 19 or is under 24 and doesn't provide over half of his or her support. For the child, the tax will be the same as you would pay on investment income above $1,900. But on the first $1,900, the child's rate applies. This provision applies to donors with smaller holdings as well as to others.

Nearly any asset can be given away: stocks, bonds, art, coins, real estate, life insurance policies, etc. But it is important to carefully consider which assets to give and when to give them.

First decide whether you will need the assets to produce income in the future, such as in your retirement or for your spouse's security. Then decide what to give, taking into consideration whether the value of the assets will rise. That will affect the income tax consequences later, when donees or heirs sell the assets.

Remember that gifts make it possible for you to transfer more property tax free. Gifts of as much as $13,000 each year are in addition to what you can transfer by gift or bequest. And that is $13,000 for each donee. If your spouse agrees, the limit is $26,000, even if only one of you owns the assets that are being donated.

Direct payments of tuition and medical expenses also can be made tax free, as we noted earlier. They can be made in addition to the $13,000 each year without counting against the $5,120,000 million that you can transfer tax free by lifetime gifts or at death.

Planning takes time and effort. Often experts are needed: lawyers, accountants, trust officers and the like. But the place to begin is with you. You have to set your own goals and take into consideration your heirs—their ages, needs, their abilities to handle inherited assets and so on. These factors will change with shifts in your circumstances and responsibilities, so you will want to revise your plans from time to time.

> Remember that gifts make it possible to transfer more property tax free. For 2012, you can give up to $13,000 tax free for each donee.

Estate tax laws also change. They have been revised 14 times in the last 36 years. And Congress will have to revise the laws yet again very soon, since the higher estate and gift tax exemptions are set to lapse again after 2012.

We will be watching closely as these and other issues unfold, and we will be providing you with timely updates in regular issues of *The Kiplinger Tax Letter* as well as online at *KiplingerTax.com*.

The most successful businesspeople and investors don't have a secret. They're just well prepared.

NEW! **ENHANCED DIGITAL EDITION NOW INCLUDED**
You get 52 weekly issues delivered by mail — plus the digital edition enhanced with extra forecasts that appear only on the Web, an online library of past issues, and more.

The Kiplinger Letter gives you accurate forecasts and a reliable outlook on what's ahead for business, the economy and your investments. And when you know what comes next, you can plan ahead to profit from it. Get *The Kiplinger Letter* today, and plan to profit.

RISK-FREE 100% MONEY-BACK GUARANTEE If you are ever dissatisfied for any reason, simply cancel at any time during your active subscription and request a 100% refund of the price you paid for your current subscription term. No questions asked.

12 FREE GIFTS, FREE SPECIAL REPORT with subscription.

- 12 monthly issues of ***Kiplinger's Personal Finance Adviser***
- ***10 Trends That Will Change the Way You Do Business.***

The Kiplinger Letter **12 FREE GIFTS • FREE SPECIAL REPORT • 58% SAVINGS**

☑ **YES!** Send my free Special Report, *10 Trends That Will Change the Way You Do Business,* and start my subscription for one year/52 weekly issues of ***The Kiplinger Letter*** for just $49. I save 58% off the regular rate of $117. Also send me 12 monthly issues of *Kiplinger's Personal Finance Adviser,* FREE!

Name ______________________________
please print

Address ______________________________

City ____________ State ______ Zip ______

Mail to: The Kiplinger Letter, P.O. Box 5106, Harlan, IA 51593-2606

FOR CREDIT CARD ORDERS CALL TOLL FREE
1-866-201-3824
OR ORDER ONLINE AT **www.kiplinger.com/go/klsubscribe** J2KLAD1

The Kiplinger Tax Letter

1100 13th Street NW / Suite 750 / Washington DC 20005-4051

TL12FTRB1

Other Kiplinger Publications

The Kiplinger Letter

Make more profitable decisions for your business and investments. You get Kiplinger's renowned outlook for business, the economy and key industries, early alerts on legislation and regulation that will affect your livelihood, forecasts on interest rates, inflation, employment, foreign competition and overseas markets and much more. You can receive the latest issue by mail and/or get free online access to the weekly *Letter* as soon as it is published every Friday afternoon. At Kiplingerbiz.com, you can take part in our subscribers-only forum and pose questions directly to *Letter* editors. One year of weekly issues, $117.

The Kiplinger Tax Letter

Help for taxpayers and tax professionals who want to cut taxes to the legal minimum for themselves, their clients or their businesses. Take advantage of new tax laws to claim all the benefits you can, avoid tax traps and audits, and seize the latest tax-slashing opportunities we uncover in recent IRS regulations, rulings and court decisions. Service includes access to the online edition available immediately upon publication every other week, with links to valuable tax-related legal decisions, regulation and much more — including an easily searchable archive of hundreds of past issues — at no extra cost. 26 biweekly issues, $147.

Kiplinger's Retirement Report

Authoritative help to plan for and enjoy a financially secure, worry-free retirement. *Retirement Report* reveals the best strategies for retirement investing and estate planning, how to protect your nest egg, get the best health care, choose a top retirement location, secure the best housing and more. 12 monthly issues, $59.95.

Kiplinger's Personal Finance magazine

The first magazine of personal finance. *Kiplinger's* provides trusted and authoritative information and guidance on investing, managing and spending your money. Carefully researched articles written in the unbiased and straightforward style for which Kiplinger is known. 12 monthly issues, $23.95.

The Kiplinger Agriculture Letter

What's ahead for agriculture and agribusiness. Timely forecasts of government commodity, farm and conservation programs and policies, plus the outlook for crops, prices, farm income and more. Alerts on promising new research developments, revealing how you can make or save money in food or livestock production and processing. Subscription includes access to the online edition with helpful links, plus immediate access to our archive of past issues at no extra cost. 26 biweekly issues, $137.

kiplinger.com
(m.kiplinger.com on your mobile device)

Kiplinger.com is your gateway to reliable personal finance, business and economic advice and guidance from the acknowledged leader in the field. Includes stock quotes, business forecasts, retirement advice, financial calculators, selections from *Kiplinger's Personal Finance* magazine, and much more. You can visit the business portion of our website by clicking the Your Business tab on the homepage or by going directly to Kiplingerbiz.com. This area includes timely business forecasts and economic outlooks and analysis of breaking news. In addition, subscribers to any of the Kiplinger *Letters* can access a library of past issues, pose questions to — and get answers directly from — Kiplinger editors, interact with other subscribers, and more.