

2012 TAX PLANNING GUIDE



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YOU PROBABLY DO A LOT OF PLANNING in your everyday life. You plan vacations, meetings, even trips to the grocery store. But how much time do you spend on income-tax planning? If you're like most taxpayers, you probably devote very little time to mapping out strategies for reducing your tax obligation. That may be a costly mistake.

The 2012 Tax Planning Guide looks at how federal tax law affects you and presents a variety of strategies that can help you reduce your personal and business taxes. The planning opportunities mentioned may or may not be appropriate for your situation, so be sure to obtain professional advice before acting on any of the general information presented in this guide.

WHAT'S NEW?

- ▶ Unless the tax law is changed,* individual taxpayers can expect higher tax rates on ordinary income, capital gains, and qualified dividends after 2012. The top rate on ordinary income will be 39.6%, and the maximum rate on net capital gains generally will be 20%. Dividends will be treated as ordinary income.
- ▶ Higher income individuals will once again be subject to reductions in personal exemptions and itemized deductions after 2012. A new surtax on investment income and an additional Medicare tax on earnings are also slated to take effect in 2013.
- ▶ Contributions to a health flexible spending account (FSA) will be capped at \$2,500 annually, starting in 2013.
- ▶ The threshold for deducting unreimbursed medical expenses for taxpayers under age 65 rises from 7.5% of adjusted gross income (AGI) to 10% of AGI, starting in 2013.

* As we go to press, Congress is beginning discussions on deficit reduction and economic stimulus measures, some of which might impact 2012 and later taxes.



FOR INDIVIDUALS

LOOK AT YOUR TAX SITUATION

Your first planning step is to understand your personal tax situation. Take time to review your filing status, the number of exemptions you can claim, your marginal tax rate, and how the alternative minimum tax (AMT) may affect you.

FILING STATUS. The tax rate schedule you use depends on whether you qualify to file your return as: (1) married filing jointly (or a surviving spouse), (2) head of household, (3) single, or (4) married filing a separate return. The same six tax rates apply to each filing status, but the related brackets vary considerably, as you can see in the individual tax rate schedules on page 5.

Filing as a head-of-household taxpayer results in a lower income-tax liability than filing as a single taxpayer. Why? The tax brackets are more favorable. And there are certain other advantages associated with the head-of-household filing status, such as a larger standard deduction and less restrictive income limits on certain deductions and credits. Joint returns usually produce the lowest tax liability for married couples.

- ▶ However, filing separate returns may be to a married couple's advantage if, for example, one spouse has significant medical or miscellaneous expenses, which are subject to deduction floors based on adjusted gross income (AGI). More of the expenses may be deductible on a separate return filed by a spouse whose AGI is significantly lower than the couple's combined AGI.
- ▶ Don't overlook the possibility of filing as a head-of-household taxpayer if you are unmarried *and* you pay more than half the cost of keeping up a home for yourself and your child, grandchild, or another qualifying relative. Dependent parents don't necessarily have to live with you. For example, you might qualify as head of household if you support a parent living in a nursing home.





EXEMPTIONS. You may deduct personal exemptions for yourself, your spouse, and your dependents. Each exemption you're allowed trims \$3,800 from your taxable income in 2012. The exemption amount can change from year to year due to IRS inflation adjustments.

Do you have a child in college? Just because your student is not financially independent, don't automatically assume he or she still qualifies as your dependent. The tax law has some very specific requirements. For example, your child must be younger than 24 as of year-end, be enrolled as a full-time student for some part of at least five calendar months during the year, and live with you for more than half the year (treating temporary absences from home due to education, illness, military service, and certain other special circumstances as time spent living with you). Another requirement: Your child cannot provide more than half of his or her own support.

- ▶ Pay particular attention to the support test, especially if your child receives financial aid. Scholarship money is *excluded* from the support calculation. And, while support can come from loan proceeds, if your child is obligated to repay a student loan, the money is considered support *your child* provides.

► Sometimes it's better not to claim a dependency deduction for a child in college. This could be the case if you intend to chip in for your child's tuition but won't be able to claim an education credit (see page 17) for your expense because your income is too high. Assuming your child has enough taxable income, consider having your child pay the tuition (even if the money comes from you) and take the education credit. You'll have to pass up the exemption, but, dollar for dollar, the credit may save more taxes.

INDIVIDUAL TAX RATE SCHEDULES

FILING STATUS	RATE (%)	TAXABLE INCOME (\$) BRACKETS
SINGLE 	10	0 – 8,700
	15	8,701 – 35,350
	25	35,351 – 85,650
	28	85,651 – 178,650
	33	178,651 – 388,350
	35	Over 388,350
HEAD OF HOUSEHOLD 	10	0 – 12,400
	15	12,401 – 47,350
	25	47,351 – 122,300
	28	122,301 – 198,050
	33	198,051 – 388,350
	35	Over 388,350
MARRIED Filing Jointly <i>(and surviving spouses)</i> 	10	0 – 17,400
	15	17,401 – 70,700
	25	70,701 – 142,700
	28	142,701 – 217,450
	33	217,451 – 388,350
MARRIED Filing Separately 	10	0 – 8,700
	15	8,701 – 35,350
	25	35,351 – 71,350
	28	71,351 – 108,725
	33	108,726 – 194,175
	35	Over 194,175

MARGINAL TAX RATE. Your marginal tax rate is essentially the rate you pay on your highest taxed income. You can use your marginal rate for tax planning purposes.

Example: Rob is a single taxpayer who expects to have taxable income of \$170,000 in 2012. Looking at the tax rate schedule, he sees that the first \$8,700 of his income will be taxed at 10%, the next \$26,650 at 15%, the next \$50,300 at 25%, and the last \$84,350 at 28%. Rob's marginal tax rate is 28%. Rob could have earned an additional \$8,650 of taxable income before jumping into the 33% bracket.

Knowing your marginal rate also allows you to estimate the tax benefit of deducting an additional expense. In the 33% bracket, for example, a \$2,000 deduction saves \$660 of income tax.

WILL YOU OWE AMT? The AMT system adds another layer of complexity to your tax planning. The number of taxpayers subject to AMT has been steadily increasing. Even if you haven't owed AMT before, you shouldn't overlook the possibility that you'll have to pay additional taxes because of the AMT.

Calculating your potential AMT liability is complicated. Your taxable income has to be recomputed under special rules. Many deductions aren't allowed, and certain otherwise nontaxable income has to be included in AMT income. If your AMT income is more than the AMT exemption amount for your filing status, you'll owe



AMT — in addition to your regular taxes. The AMT rates are 26% and 28%, and the AMT exemptions phase out at higher levels of income.

Here are some planning moves that could be helpful if you anticipate a potential AMT problem.

- ▶ Before investing in private activity municipal bonds, check their tax status. Although normally tax exempt for regular income-tax purposes, the interest on most private activity bonds has to be included in AMT income. Interest on private activity bonds originally issued (or, in certain cases, reissued) in 2009 and 2010 is an exception.
- ▶ It may be to your advantage to accelerate income into the current year if a projection shows you will be subject to AMT and your marginal tax rate for regular tax purposes is higher than the 28% maximum AMT rate. But take the time value of money into account before accelerating income, since you would pay taxes on the income sooner.
- ▶ Where an AMT liability is anticipated, you might also consider deferring late-year expenses that aren't deductible for AMT purposes to next year. Examples include investment fees and taxes.

TAXABLE OR NOT?

To plan for your taxes, you have to know what items must be included in your gross income. Most times, it's clear cut. But not always.

RENTAL PROPERTY. You don't have to include security deposits you receive from tenants in your rental income if you intend to return the money to the tenants when their leases expire. But if you end up not returning a deposit because a tenant breaches the lease agreement, the amount you keep is includable in your rental income that year.

PURCHASED INTEREST. If you buy a corporate bond between interest payment dates, the accrued interest will be added to your purchase price. When you receive the purchased interest amount from the bond issuer, it's not

considered taxable income. Instead, you treat the amount as a return of your capital investment by reducing your cost basis in the bond.

SCHOLARSHIPS. A scholarship may be tax free if the student receiving the aid is a “candidate for a degree” and the funds are used for tuition or for required course-related fees, books, supplies, and equipment. However, scholarship money spent for room, board, travel, and other expenses is taxable. And scholarships that are payments for past, present, or future teaching, research, or other services are also considered taxable income. In some cases, only part of a scholarship will be taxable and the rest will be tax free.

LIFE INSURANCE. With certain exceptions, life insurance death benefits are income-tax free to the beneficiary. Any increase in the cash value of permanent life insurance is generally tax deferred.

What happens from a tax perspective if you choose to access the cash value of a life insurance policy? The withdrawn amount won't be taxed if it's less than the amount you've paid into the policy. However, if the amount you withdraw is more than your cost — or if you surrender the policy for cash — you'll have to include the excess amount in your income. Taking a policy loan from a policy that isn't classified as a modified endowment contract generally does not result in taxable income.

SOCIAL SECURITY. It sometimes comes as a surprise to new retirees that their Social Security benefits could be taxable. Taxability depends on “provisional income” — defined as AGI with certain modifications plus tax-exempt interest plus half of the Social Security benefits received during the year.

Single retirees with provisional income between \$25,000 and \$34,000 and married couples with provisional income between \$32,000 and \$44,000 are taxed on up to 50% of their Social Security benefits. Up to 85% of your benefits will be taxable if your provisional income exceeds the top of the range.

► Taking certain steps to keep your provisional income low can help you minimize the tax hit on your benefits. For example, consider paying off debt with invested funds that are earning interest or dividend income. Or you might consider shifting some assets that you won't need in the short term to growth-oriented stocks that don't pay dividends. Of course, you'll want to carefully consider any such steps in the context of your overall financial planning.

HOME SALE PROFIT. Homeowners who sell their principal residence may exclude up to \$250,000 (\$500,000 if married filing jointly) of capital gain from income. The capital gain exclusion is available only once every two years, and you must have owned and used the home as your principal residence for at least two of the five years immediately before the sale. A partial exclusion is available if you fail to meet the requirements due to a change in employment, health problems, or certain other unforeseen circumstances.

YOUR INVESTMENT TRANSACTIONS

It can pay to watch the calendar when you're contemplating a potential sale of an appreciated security. Your net capital gain will be taxed at a maximum rate of 15% in 2012 if you've held the investment for more than one year (long term). In contrast, short-term gains (on investments held one year or less) are taxed at ordinary tax rates as high as 35% in 2012.



Example: Delores bought 1,000 shares of stock for \$75,000 11 months ago. Her shares are currently worth \$95,000. If she sells them now, her \$20,000 capital gain will be taxed at ordinary rates as high as 35% — a tax of as much as \$7,000. But, if she holds the shares until the more-than-one-year holding period has passed and sells them for the same \$95,000, her tax on the \$20,000 gain will be no more than \$3,000 (15%). By waiting, Delores could save \$4,000 of tax.

Since you risk a price decline by holding an investment, you shouldn't let tax considerations take priority over your better judgment.

CAPITAL LOSSES. Nobody likes investment losses, but they can help you at tax time. You can use capital losses to offset capital gains on other investment transactions plus an additional \$3,000 of ordinary income annually (\$1,500 if you are married filing separately). Capital losses that aren't deductible because of these limitations may be carried forward for deduction in future tax years, subject to the same restrictions.

KNOW YOUR BASIS. To figure your capital gain or loss on the sale of an investment, you have to know your “adjusted basis” in the investment. Your basis in securities you purchase is generally equal to your cost.

- ▶ The basis of inherited securities is usually their market value on the date of death (or an alternate valuation date, generally six months later). Due to this basis “step-up” rule, price appreciation that occurred while the deceased person owned the shares escapes capital gains tax.
- ▶ That said, you should exercise caution if you're selling securities you inherited from someone who died in 2010. The estate's executor or personal representative may have elected to apply “modified carryover basis” rules to certain estate property. Should that be the case, it's possible your basis in the inherited securities will be lower than their date-of-death value — and that would increase your taxable capital gain.

CAPTURE A LOW DIVIDEND RATE. Through 2012, you'll generally pay tax on qualified dividends at a maximum rate of 15%. Qualified dividends are tax free if, absent the tax break, they'd be subject to ordinary income tax at a 10% or 15% rate. For dividends paid on stock to be considered qualified, you must have held the stock for a minimum period (generally, for more than 60 days during the 121-day period beginning 60 days before the stock's ex-dividend date). Other requirements apply.

NEW SURTAX. Keep in mind that a new surtax on investment income is slated to take effect in 2013. The surtax, referred to as the "unearned income Medicare contribution" tax, will be imposed at a rate of 3.8% on the *lesser* of (1) net investment income for the year or (2) the amount by which modified AGI exceeds: \$200,000 (single and head of household), \$250,000 (married filing jointly), or \$125,000 (married filing separately).



Example: Calvin is a head-of-household taxpayer with modified AGI of \$230,000. Of that amount, \$100,000 is net investment income. His liability for the unearned income Medicare contribution tax is \$1,140 — 3.8% of \$30,000, the amount of his modified AGI in excess of \$200,000.

► The definition of net investment income for surtax purposes includes gross income from interest, dividends, annuities, royalties, rents, net

capital gain from disposing of property, and income earned from passive trade or business activities. It does *not* include tax-exempt municipal bond interest or distributions from qualified retirement plans and individual retirement accounts (IRAs). However, since taxable distributions from your retirement accounts increase your AGI, you'll still need to take them into consideration when you are determining your potential exposure to the surtax.

LOOK AT AFTER-TAX RETURNS. If you are choosing between tax-exempt municipal bonds and comparable bonds that pay taxable interest, you can use your marginal tax rate to determine the taxable yield you'd need to match a given tax-exempt yield.

COMPARING YIELDS

TO MATCH THE TAX-EXEMPT YIELD BELOW	IN THIS TAX BRACKET			
	25%	28%	33%	35%
YOU NEED TO EARN A TAXABLE YIELD OF:				
3.5%	4.7%	4.9%	5.2%	5.4%
4.0%	5.3%	5.6%	6.0%	6.2%
4.5%	6.0%	6.3%	6.7%	6.9%
5.0%	6.7%	6.9%	7.5%	7.7%
5.5%	7.3%	7.6%	8.2%	8.5%
6.0%	8.0%	8.3%	9.0%	9.2%
6.5%	8.7%	9.0%	9.7%	10.0%

TAX DIVERSIFICATION. Although it does not guarantee a profit or protect against loss, most investors recognize the importance of diversification as a basic risk-management strategy. The concept can also be useful in tax planning. By spreading money among accounts that are treated differently for tax purposes, you may have greater flexibility to manage your taxes and potentially enhance your after-tax returns in what could be a changing tax landscape in the years ahead.

SAVING FOR RETIREMENT

Making wise use of any tax-favored accounts you're eligible for can help you meet your retirement savings goals.

CONTRIBUTE TO YOUR EMPLOYER'S PLAN. You can save for your retirement *and* postpone paying taxes on money you invest pretax in a 401(k) or other tax-deferred retirement savings plan. Income taxes won't be due until you receive plan benefits. The maximum 401(k) salary deferral is \$17,000 in 2012 (\$22,500 if you're eligible to make catch-up contributions). Other plan limits may apply.

Your 401(k) account's investment earnings — interest, dividends, and capital gains — are also tax deferred. You won't pay tax on them until you withdraw money from the plan. With no taxes taken out, your savings can potentially grow and compound more rapidly.

IRAS. For 2012, contributions to individual retirement accounts — traditional and Roth combined — can be as much as \$5,000 (\$6,000 if you are age 50 or older). Your contributions to a traditional IRA will be fully tax deductible if you (and your spouse, if you're married) do not actively participate in an employer-sponsored retirement plan. With active plan participation, the availability of a deduction for a traditional IRA contribution depends on your modified AGI.

In 2012, a plan participant's deduction for an IRA contribution is phased out with modified AGI of \$58,000-\$68,000 for single and head-of-household filers, \$92,000-\$112,000 for joint filers, and \$0-\$10,000 for a married person filing separately. The phaseout range for a married person who does not participate in an employer's plan but whose spouse does participate in a plan is \$173,000 to \$183,000 of joint AGI.



► Generally, you aren't allowed to make IRA contributions that exceed your earned income. However, as a married person filing jointly, you can contribute to an IRA even if you don't have earnings yourself, assuming combined IRA contributions for you and your spouse don't exceed the taxable earnings on your joint return.

SHOULD YOU CHOOSE A ROTH? Roth IRAs and Roth accounts in 401(k), 403(b), and 457(b) governmental plans also offer tax-deferred earnings. Even better, investors can avoid taxes on Roth investment earnings *permanently* by not taking withdrawals until a five-year period has elapsed and they've reached age 59½ (or in other limited circumstances). Their potential for tax-free growth makes Roth accounts a powerful planning tool. However, contributing to a Roth account provides no upfront tax benefit.

Annual contributions to a Roth IRA are restricted for high earners. For 2012, the allowable Roth IRA contribution is phased out with modified AGI between \$110,000 and \$125,000 (single or head of household); \$173,000 and \$183,000 (married filing jointly); and \$0 and \$10,000 (married filing separately).

These income limitations do not apply to Roth conversions. You may convert a traditional IRA to a Roth IRA regardless of income. Similarly, some employer plans allow participants to convert eligible distributions from regular pretax accounts to Roth accounts within the plan. Since a Roth conversion triggers income taxes on all previously untaxed conversion amounts, the decision to convert should be made carefully.



► If you make a nondeductible Roth IRA contribution and later realize you need the deduction that a contribution to a traditional IRA provides, you can change your mind and turn that Roth IRA contribution into a traditional IRA contribution by “recharacterizing” the contribution. Certain time limits and other requirements apply.

► Similarly, if you determine that a Roth conversion you made earlier in the year wasn’t a tax-wise decision — which could happen, for example, if the IRA’s value has dropped since the conversion, and you’ll have to pay tax on value that you no longer have — you can undo the Roth conversion by recharacterizing the transaction, thus changing the account back into a traditional IRA. Again, certain time limits and requirements apply.



TAX-FREE ROLLOVERS. If you are going to receive a taxable distribution from a 401(k) or other tax-favored plan, consider rolling the money over into an IRA or a new employer’s plan, if available, to avoid income taxes on the distribution. Most non-annuity distributions are eligible for rollover.

► You can avoid mandatory 20% tax withholding on a retirement plan payout you want to roll over by arranging for a direct trustee-to-trustee transfer of your funds.

► In addition to income taxes, a 10% early distribution penalty may apply to a distribution you

take before age 59½ and don't roll over. You will not, however, owe a penalty on a qualified plan distribution you receive because you have separated from service if you are 55 or older by year-end. The penalty also doesn't apply in certain other circumstances, so review your alternatives carefully if you expect to receive a distribution.

REQUIRED MINIMUM DISTRIBUTIONS. After you reach age 70½, you generally must begin taking required minimum distributions (RMDs) from tax-favored employer plans and traditional IRAs. The amount of each RMD is figured using an IRS life-expectancy-based table. Roth IRAs are an exception: There's no requirement to withdraw minimum amounts from your Roth IRA during your lifetime. However, Roth IRA beneficiaries do have to take RMDs.

PAYING FOR HIGHER EDUCATION

Are you setting aside money for college or is someone in your family attending college now? If so, the tax incentives discussed in this section may be helpful to you.

SAVING FOR COLLEGE. Section 529 prepaid tuition and college savings plans are tax-advantaged plans designed for college savers. With these plans, investment earnings accumulate on a tax-deferred basis, and plan distributions to pay the account beneficiary's qualified higher education expenses are tax free. There are no income limits on contributions. You aren't restricted to investing in your own state's plan. However, certain plan benefits may not be available unless you meet specific requirements, such as state residency. A particular plan also may have restrictions on the timing and use of plan distributions. *Before investing in a 529 plan, consider the investment objectives, risks, and expenses associated with municipal fund securities. The issuer's official statement contains more information about municipal fund securities, and you should read it carefully before investing.*

A Coverdell education savings account (ESA) is another tax-advantaged option to consider. Annual ESA contributions are limited to \$2,000 per designated beneficiary and

generally may not be made after the beneficiary turns 18. (After 2012, the annual contribution limit is scheduled to drop to \$500.) The maximum ESA contribution is phased out with modified AGI of \$95,000-\$110,000 (\$190,000-\$220,000 for married taxpayers filing jointly).

EDUCATION CREDITS. There are two tax credits for the payment of higher education expenses. The American Opportunity Tax Credit is allowed for qualified tuition and related expenses paid for each of a student's first four years of college. The maximum credit is \$2,500 (100% of the first \$2,000 of expenses and 25% of the next \$2,000 of expenses). It's phased out with modified AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing jointly).

The Lifetime Learning Credit can be particularly beneficial if you are paying graduate school tuition and related expenses for yourself, your spouse, or your child, since those expenses don't qualify for the American Opportunity Tax Credit. The maximum credit of \$2,000 per taxpayer return (20% of up to \$10,000 of expenses) phases out with modified AGI between \$52,000 and \$62,000 (\$104,000 and \$124,000 for married taxpayers filing jointly) for 2012.



STUDENT LOAN INTEREST. Up to \$2,500 of interest paid on qualified higher education loans is deductible "above the line" in 2012, meaning you don't have to itemize to claim the deduction. The deduction is phased

out for unmarried taxpayers with modified AGI between \$60,000 and \$75,000. The income phaseout range is between \$125,000 and \$155,000 of modified AGI for married persons filing jointly.

MAXIMIZING DEDUCTIONS AND CREDITS

To determine your taxable income, you deduct a standard deduction or your itemized deductions from your AGI. Tax credits reduce your tax liability dollar for dollar and, in some cases, are refundable if a taxpayer does not have a large enough tax liability to absorb the credit.

DEDUCTION TIMING. Certain categories of itemized deductions are limited by income-based “floors.” For example, you may deduct unreimbursed medical expenses only to the extent your total expenses exceed a floor amount equal to 7.5% of your AGI. And expenses that qualify as a miscellaneous itemized deduction — such as unreimbursed employee business expenses and various investment-related expenses — are deductible only to the extent they, in aggregate, exceed 2% of your AGI.

- ▶ Deciding whether to pay certain medical and miscellaneous expenses this year or next can help you make the most of your deductions. For instance, “bunching” expenses in a single year, to the extent possible, can be a helpful strategy.
- ▶ The hurdle for deducting medical expenses generally will be higher starting in 2013 when the 7.5%-of-AGI floor is slated to increase to 10% of AGI. The exception: You can continue using the 7.5%-of-AGI floor to figure your medical deduction through 2016 if either you or your spouse is age 65 or over.
- ▶ The unreimbursed expenses of a job search, such as employment agency fees, résumé preparation costs, and travel for interviews, may be deductible as a miscellaneous itemized deduction. However, you cannot deduct job search expenses if you’re looking for your first job, if there was a substantial break in time between your last job and the start of your search for a new one, or if you’re switching careers.

TAXES. You may be able to increase your deduction for state and local taxes by paying your final quarterly state income-tax estimate before year-end. You could also increase the amount of state income-tax withholding from your pay for the last few months of the year — especially if you think you’ll owe more than has already been withheld.

- ▶ Avoid accelerating tax payments if you think you may be subject to AMT (see page 6), since you are not allowed to deduct taxes in computing AMT income. Instead, save the expense for 2013 when AMT may not apply to you. But be sure your payments are sufficient to avoid under-payment penalties.

CHARITABLE CONTRIBUTIONS. Qualifying donations of either cash or property are tax deductible, within limits. Be sure to get the appropriate substantiation from the charity for tax-deduction purposes.



- ▶ Donating appreciated stock you’ve held longer than one year can accomplish two things: You’ll generally secure an immediate income-tax deduction equal to the full value of the stock, and you’ll avoid the taxable capital gain you would have realized if you’d sold the stock first and donated the proceeds.
- ▶ On the other hand, if your securities have declined in value, consider selling them first and

contributing the proceeds to charity. This strategy would give you a deductible capital loss (within limits) *and* a deduction for your cash contribution.

► If you're a volunteer, don't overlook a potential deduction for any out-of-pocket expenses you may incur while volunteering, such as the cost of hosting a fundraiser or using your car for charitable activities.

HSA CONTRIBUTIONS. A health savings account (HSA) is a tax-favored account used to pay out-of-pocket medical expenses. To qualify for an HSA, you must be covered under an eligible high-deductible health plan, either personally or through your employer. Additional health coverage is generally prohibited, although there are certain exceptions.

For 2012, a person with self-only coverage may deduct up to \$3,100 of HSA contributions (or contribute pretax under an employer's cafeteria plan). With family coverage, the 2012 contribution limit is \$6,250. Earnings on HSA investments accumulate on a tax-deferred basis, and HSA withdrawals used to pay qualified medical expenses are tax free.

Any HSA withdrawals you don't use for qualified expenses would be taxable, and a 20% penalty also may apply. However, you don't have to worry about a "use it or lose it" rule, as you do with a flexible spending account. Any unspent funds in your HSA can simply accumulate in the account for future use.



FOR BUSINESSES



DIFFERENT BUSINESS FORMS

How you legally organize your business can have significant tax consequences. The table summarizes the tax characteristics of several business entities.

TAX CHARACTERISTICS OF BUSINESS ENTITIES

ENTITY	TAX ON ENTITY?	DOUBLE TAXATION?
C Corporation	Yes	Yes
S Corporation	No*	No*
Partnership	No	No
Limited Liability Company	No*	No*

* Some exceptions apply.

YOU AND YOUR CORPORATION

If your company is a closely held C corporation, the tax information in this section may be useful to you.

FRINGE BENEFITS. As a shareholder/employee, you can receive a variety of nontaxable fringe benefits. For example, consider having the company pay for your life insurance coverage (up to \$50,000 on a group term policy), medical benefits, and disability insurance. The costs will be deductible if all requirements are met.

CORPORATE TAX RATES

TAXABLE INCOME	RATE
Up to \$50,000	15%
\$50,001 – \$75,000	25%
\$75,001 – \$100,000	34%
\$100,001 – \$335,000	39%
\$335,001 – \$10 million	34%
Over \$10 million – \$15 million	35%
Over \$15 million – \$18,333,333	38%
Over \$18,333,333	35%
ALTERNATIVE MINIMUM TAX	20%
The corporate AMT exemption of \$40,000 is phased out with alternative minimum taxable income between \$150,000 and \$310,000.	

COMPENSATION. Your corporation may deduct your compensation as a business expense if it is reasonable in amount. Distributing profits as salaries and bonuses can help minimize taxable corporate income, although you and other recipients will be taxed individually on the compensation you receive. Many companies annually review salaries and bonuses as part of their year-end planning.

LEASING PROPERTY TO YOUR COMPANY. Leasing business property or equipment to the company is another way to draw out earnings on a tax-deductible basis. Your corporation deducts the rent expense; you declare the rent as income. To protect the deduction, be sure to execute a formal written lease and have documentation establishing that the rent charged is reasonable.

LOANS. Fully document any loan you take from your corporation and be sure the terms are reasonable. These precautions are necessary so that the IRS will not later attempt to recharacterize the loan as a dividend — which would be taxable income to you and nondeductible by the corporation.

CORPORATE AMT. Like individuals, larger corporations also have to plan for possible alternative minimum taxes. While S corporations pass AMT items through to individual shareholders, regular C corporations pay any AMT that applies at the corporate level.

Certain small corporations are *exempt* from the AMT. The exemption applies if average annual gross receipts for all three-year periods beginning after 1993 and ending before the current year are \$7.5 million or less (\$5 million or less for the corporation's first three-year period).

TIPS FOR S CORPORATIONS

You may have structured your company as an S corporation so that income will be taxed to you and other shareholders individually. Operating as an S corporation can raise some unique issues.

PRESERVING AN S ELECTION. Be careful to limit the number of shareholders to no more than 100. (A husband and wife are treated as one shareholder, as are certain other related individuals.) And keep in mind that an S corporation can't have a nonresident alien or corporate shareholder. (Exception: An S corporation may be wholly owned by another S corporation.) All shareholders generally must be individuals, estates, certain trusts, or tax-exempt 501(c)(3) charitable organizations. However, a partnership may hold S corporation stock as a nominee for an eligible shareholder.

Unlike a regular C corporation, an S corporation may have only one class of stock. Generally, a corporation is treated as having only one class of stock if all outstanding shares of the corporation's stock confer identical rights to distribution and liquidation proceeds.

SHAREHOLDER COMPENSATION. If you work in the business, the company should pay you reasonable compensation for the services you provide. The IRS is



on guard against S corporation shareholders who take distributions from their companies but pay themselves little or no salary in an attempt to avoid employment taxes.

LOSSES. As an S corporation shareholder, you can deduct losses allocated to you by the corporation only to the extent you have sufficient “adjusted basis” in your stock and any loans you have made to the corporation. If you expect your company to show a loss in 2012, you should check to make sure you will be able to deduct it. If not, you might consider advancing money to the company to increase your basis.

IF YOU'RE SELF-EMPLOYED

As a self-employed individual, your net earnings are potentially subject to both regular income taxes and self-employment taxes. Several strategies can help you minimize the tax burden on your business earnings.

BUSINESS OR PERSONAL? Be careful about record-keeping so that your business and personal expenses can be easily segregated. In most cases, business expenses will be easy to identify as such. In other situations, however, the correct classification won't be as readily apparent.

- ▶ You can deduct interest paid on a home equity line of credit as a business expense to the extent the borrowed funds are used for business purposes.
- ▶ The cost of ad space in a program for a charity's fundraising event may be deductible as business advertising rather than as a charitable contribution.





HIRING YOUR CHILD. Consider paying your child reasonable wages for doing legitimate work for your business. You'll be able to deduct the wages from your business income. The wages will represent income to your child, but up to \$5,950 (in 2012) can be shielded from tax by your child's standard deduction. Any earnings over \$5,950 will be taxed at your child's rate — which is probably much lower than yours. Wages you pay your child will be exempt from FICA taxes until your child turns age 18, assuming your business is unincorporated.

HAVE A RETIREMENT PLAN. You can put away money for retirement and cut your current tax bill by making tax-deductible contributions to a tax-favored retirement plan.

- ▶ If you have no employees (or employ only your spouse), a solo 401(k) plan can be a good choice since it typically allows a larger contribution than most other types of plans.
- ▶ The Simplified Employee Pension (SEP) plan is another popular option. A SEP utilizes IRAs and is relatively easy to set up and administer. Plan contributions are discretionary, but you must contribute for all of your eligible employees in any year you contribute to your own SEP account.
- ▶ A SIMPLE IRA allows your eligible employees (and you) to contribute on a tax-favored basis. Your business must make tax-deductible employer contributions as well.

Various contribution and tax law limits apply to these plans. We can provide more information.

HOME OFFICE. If you operate your business from home, look into the requirements for deducting expenses related to using your home for business purposes. Deductions for an office in the home are generally available only if the space is used regularly and *exclusively* for business. Potentially deductible expenses include utilities, homeowners insurance, trash removal, cleaning services, and building depreciation. Since many of these expenses relate to the entire home, the business portion of an expense is usually estimated using square footage.

Example: Mary Beth's home office occupies 10% of her home's total square footage. Last year, Mary Beth's home heating bills totaled \$1,500. She may deduct \$150 (10%) of that amount as a business expense, assuming she meets the tax law's requirements for a home office deduction.



Home office deductions can save you taxes currently. But keep in mind that any capital gain you may realize when you sell your home that is attributable to depreciation for business use of your home (after May 6, 1997) will potentially be taxable. Currently, a 25% maximum rate applies to such gain.

HEALTH INSURANCE. As a self-employed person, you may be eligible to deduct 100% of health and dental insurance costs for yourself, your spouse, your dependents, and qualifying children who haven't reached age 27 as of

the end of the tax year. Your annual deduction can't be more than your earned income from the trade or business for which you establish the health coverage. The deduction is not available for any month in which you're eligible to participate in a subsidized health plan maintained by an employer of you, your spouse, your dependent, or your under-age-27 child.

DEDUCTING THE COST OF ASSET PURCHASES

The tax law contains substantial incentives designed to encourage business investment in equipment, machinery, and other fixed assets.

BONUS DEPRECIATION. Your business may make an election to write off 50% of the cost of new machinery, equipment, or other qualified property placed in service during calendar year 2012. This 50% first-year depreciation "bonus" is allowed for both regular tax and AMT purposes, and it reduces the property's basis for purposes of figuring regular depreciation deductions.

SECTION 179 EXPENSING. Making a Section 179 election to "expense" (deduct) the cost of qualifying assets in the year your business first places them in service is another alternative to claiming regular depreciation deductions. The Section 179 election may be as much as \$139,000 for the 2012 tax year. There's a dollar-for-dollar reduction in the limit as the cost of all Section 179 property placed in service during the tax year exceeds \$560,000. You cannot expense more than the amount of your taxable income from active trades or businesses.

- ▶ If you operate a sideline business but also are employed elsewhere, your salary as an employee can be taken into account as taxable income for expensing purposes. So don't rule out the possibility of claiming a Section 179 deduction for equipment purchases simply because your business shows little or no profit for the year.

► Monitor the Section 179 dollar limit carefully if you own interests in several businesses. It applies per taxpayer return. Thus, expensing amounts you elect as a sole proprietor must be added to any allocations from partnerships, limited liability companies, and/or S corporations.

CATEGORIZING EXPENDITURES. The depreciation period for commercial buildings and their structural components is generally 39 years. Depreciation periods are usually substantially shorter for equipment, furniture, fixtures, and other assets classified as tangible personal property. If you plan to buy or construct a new business facility, properly segregating your costs will allow you to write them off as quickly as possible.



MORE PLANNING POINTERS

Here are some additional tips that may save your business tax dollars.

BUSINESS BAD DEBTS. Look into claiming a bad debt deduction on your business tax return if you're unable to collect money a customer or client owes you. You must be able to show that the debt is partly or totally worthless. Note, however, that a business generally may not claim a bad debt deduction if it uses the cash method of accounting for tax purposes, since the related revenue typically would not have been recognized yet.

EMPLOYEE BUSINESS EXPENSES. Do you reimburse your employees for travel, entertainment, and other business expenses? Using an “accountable plan” reimbursement method that meets IRS requirements can save payroll taxes. With an accountable plan, employees provide an adequate accounting of their expenses (some type of log plus receipts or other substantiation) to the employer and return any excess reimbursement or expense allowance within a reasonable period. Expense reimbursements under an accountable plan are not treated as wages.

HEALTH INSURANCE CREDIT. An eligible small business — generally one that has no more than 25 full-time equivalent employees and pays average annual wages of \$50,000 or less — can take a tax credit for the cost of providing health care coverage to its employees. The maximum credit is 35% of qualifying premium expenses.

- ▶ Your business can qualify for the maximum credit if it has 10 or fewer full-time equivalent employees and average annual wages of \$25,000 or less. Over those limits, the credit is reduced on a sliding scale.
- ▶ Owners, partners, family members of owners or partners, and seasonal workers generally aren't counted when figuring the number of full-time equivalent employees or their average annual wages.

DOMESTIC PRODUCTION ACTIVITIES. Manufacturers, construction contractors, software companies, engineering and architectural firms, and other businesses involved in U.S. production activities may be eligible to deduct 9% of their qualified production activities income or, if less, 9% of their taxable income (determined without regard to the deduction). The deduction is limited to 50% of W-2 wages allocable to domestic production gross receipts.



ESTATE- AND GIFT-TAX UPDATE



TAX RATES. For 2012, the highest federal gift- and estate-tax rate is 35%. Unless there is a law change, the highest rate will rise to 55% for taxable transfers made after 2012.

EXEMPTION AMOUNT. For 2012, every individual is entitled to a unified credit that offsets gift and estate tax on up to \$5,120,000 of cumulative lifetime gifts and transfers at death. The exemption amount is slated to drop to \$1 million after 2012. The representative of a deceased spouse's estate may elect to transfer any exemption amount the estate doesn't use to the surviving spouse. This election opportunity will not be available after 2012, unless lawmakers extend the provision or make it permanent.

GIFT-TAX ANNUAL EXCLUSION. You can make annual gifts of up to \$13,000 per recipient to as many individuals as you wish without triggering gift tax or using up any of your unified credit. Splitting gifts with your spouse doubles the annual limit to \$26,000 per recipient. The IRS adjusts the annual exclusion amount periodically for inflation.

- ▶ Federal gift tax also does not apply to tuition you pay directly to a qualifying educational organization for someone else (your grandchild,

for example) or to payments you make directly to a medical care provider as payment for someone else's medical care. Payments for medical insurance are eligible for this exclusion. These exclusions are available to you *in addition* to the gift-tax annual exclusion described above.

GST TAX. An additional federal transfer tax can come into play when you transfer property to your grandchildren or other individuals more than a generation younger than you. When it applies, the generation-skipping transfer (GST) tax is levied in addition to any gift or estate tax on the transfer. The GST-tax rate is equal to the highest federal gift- and estate-tax rate, 35% in 2012.

A GST-tax exemption gives you the ability to transfer up to \$5,120,000 of assets to your grandchildren or others free of GST tax. Like the gift- and estate-tax exemption, the GST-tax exemption is scheduled to be reduced after 2012.



TAX RATES AND EXEMPTION AMOUNTS

	TOP RATE		EXEMPTION AMOUNT	
	2012	2013	2012	2013
Estate and Gift Tax	35%	55%	\$5,120,000	\$1 million
GST Tax	35%	55%	\$5,120,000	\$1 million*

* As indexed for inflation after 1997.



WE CAN HELP

When it comes to keeping your taxes at a minimum, planning is everything. We hope you can take advantage of some of the strategies discussed in this *2012 Tax Planning Guide* to lower your tax burden. Please let us know if you would like planning assistance or more information.

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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