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An economic and investment update

THE FINANCIAL INSIDER

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A Vacation Home: The Ultimate Hideaway

Are you dreaming of a mountain cabin or an ocean-front bungalow? Then you may want to know that a vacation home can offer some tax savings. If you choose to use the home solely for enjoyment or combine business and pleasure by renting the property part time, it is important to understand the tax laws for a second home.

As long as the combined debt secured by the vacation home and your principal residence does not exceed $1 million, you can deduct all of the interest paid on a mortgage used to buy a second home. This advantage is restricted to two homes. Should you purchase a third home, interest on that mortgage is not deductible. However, regardless of how many homes you have, you may be able to deduct all of the property tax paid.

One break enjoyed by homeowners—the right to immediately deduct points paid on a mortgage—applies only to a principal residence. Points paid on a loan for a second home must be deducted gradually, as the mortgage is paid off.

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Securing a Business Loan with Term Life

As a business owner, you have worked long and hard to build a successful company. Profit projections look promising, and your project is backed by a sound business plan. So, why is your banker reluctant to lend the funds necessary for expansion? If the success of your venture depends too heavily on *your* personal involvement, the bank could stand to lose a significant sum should something happen to you. **Life insurance** may help you get the funding you need.

A Life Insurance Strategy

Life insurance, an important component of many business arrangements, can help secure a business loan. Specifically, **term life insurance** is designed to help minimize financial risk for a specified period of time in the event of the insured's death. Your lender may require you to secure a loan if your company lacks collateral to back the loan or, as was previously mentioned, if the lender is concerned that your company relies primarily on the talents of one individual.

With a term policy on your life for the duration of the loan, the bank's security requirements may be satisfied. In addition, term life could benefit you by providing a safety net that would help protect your estate if things do not work out as anticipated.

Policy Assignments

By assigning your policy, you transfer your rights to all, or a portion, of the proceeds to

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Do You Know Your IRA Basis?

With the rising popularity of **Individual Retirement Accounts (IRAs)**, many people may have been making yearly contributions without giving much thought to exactly what will happen from a *tax standpoint* when they start taking money out of their traditional IRAs. This lack of concern is understandable, since many IRA contributors may be years away from retirement, and *contributions*, not withdrawals, are a primary focus.

When you begin taking distributions from a traditional IRA, a variety of tax issues arise. In general, your distributions are included in your gross income. Withdrawals made before the age of 59½ are subject to a 10% penalty, in addition to ordinary income tax. This process is relatively straightforward for those who have made only deductible contributions to their IRAs, but taxation is more complex for those who have made nondeductible contributions.

IRA Tax Basis

If all of your contributions to a traditional IRA were deductible, then you have no **basis** in your IRA, and your distributions are fully taxable. Basis represents the after-tax balance in your account. If you made nondeductible contributions to your IRA, the amount of your contributions equals your basis, and this money is not subject to tax upon distribution.

Deductible Contribution Limits

Prior to 1987, all wage earners could make a deductible contribution of up to $2,000 annually. But, the Tax Reform Act of 1986 (TRA '86) limits deductible contributions for employees who are active participants in qualified employer-sponsored retirement plans with **adjusted gross income (AGI)**—subject to certain modifications—exceeding specified amounts based on filing status ($56,000–$66,000 for single filers and $90,000–$110,000 for joint filers in 2011).

Nondeductible Contributions

While some people were aware that a nondeductible contribution was permitted without regard to active participation in a pension plan, many people who made such nondeductible contributions failed to account for them by filing Form 8606 with their annual tax returns. Form 8606 properly tracks nondeductible IRA contributions in both *current* and *prior* tax years, and it is the only official record of after-tax contributions (i.e., IRA basis).

Without having filed Form 8606 for years in which nondeductible contributions were made, a taxpayer will be exposed to double taxation of contributions when withdrawals are made. From the IRS's point of view, without the proper historical record, no distinction is made between contributions made with *before-* and *after*-tax dollars, and all withdrawals are subject to taxation. (In addition, there is a $50 penalty for failing to file Form 8606 for any year in which nondeductible contributions were made.)

Second, and perhaps just as concerning, is the matter of state taxation of IRA withdrawals. Many states do not permit deductions for IRA contributions and, consequently, provide for a tax-free "return of basis." This means that contributions are not taxed when withdrawn, but that part of the IRA account, consisting of accrued interest and dividends, is then taxed as received. However, this "return of basis" works only if the individual has kept accurate records and knows what his or her IRA basis is.

Record Keeping

One way to determine your total deductible and nondeductible contributions is to examine your tax returns over the entire period of IRA funding. If your record keeping has been less than ideal, account trustees (insurance companies, banks, mutual fund companies, brokerage firms) may be able to help you reconstruct your total contributions over the years. However, be advised that such trustees may have no record of whether your contributions were deductible or nondeductible.

Consequently, if you find yourself in "IRA limbo" with respect to your IRA basis, you may want to enlist the help of a qualified tax professional. Going forward, it is important to keep careful records of your contributions, file the appropriate forms, and consult your tax professional. It would be a shame to have a "tax mishap" at the time of withdrawal undo some of the yearly benefits you've enjoyed from tax-deferred savings. $

A Vacation Home: The Ultimate Hideaway

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Personal Residence

Your vacation home is considered a personal residence even if you rent it for up to 14 days a year. In such a situation, you may retain the rent tax free without jeopardizing your mortgage interest and tax deductions. However, you may not deduct any rental-related expenses. If you rent out the house on a continual basis, things may become more complicated. Depending on the breakdown between personal and rental use, different rules apply.

If you buy primarily for pleasure but rent for 15 days or more, the rent you receive is taxable. Because the house is still considered a personal residence, you may deduct all of the interest and property tax. You may also be able to deduct other rental-related expenses, including the cost of utilities, repairs, and insurance attributable to the time the house is rented. In some cases, you may be able to deduct depreciation. When the house is considered a personal residence, rental deductions cannot exceed the amount of rental income you report. In other words, your second home cannot produce a tax loss to shelter other income. In most cases, the interest and taxes assigned to the rental use of the house, plus the operating expenses, more than offset rental income, thus limiting your ability to write off depreciation.

Rental Property

Now, consider your tax situation if you buy a property primarily as an investment and limit your personal use of the property to 14 days a year (or 10% of the number of rental days, whichever is greater). Because the house is a rental property according to the Internal Revenue Service (IRS), your deductions can exceed the amount you receive in rental income.

If your rental income does not cover the cost of renting the house, you may be able to claim a taxable loss. Rental losses are classified as passive and can be deducted only against passive income, such as another rental property that realizes a gain. If you do not have passive income to shelter, the losses have no immediate value; however, unused losses can be used in the future when you have passive income.

There's an exception to this rule, however, that permits taxpayers with adjusted gross income (AGI) under $100,000 ($50,000 if married filing separately) to deduct up to $25,000 ($12,500 if married filing separately) of passive losses against other kinds of income, including salaries. To qualify, you must actively manage the property. The $25,000 allowance is gradually phased out for taxpayers whose AGI is between $100,000 and $150,000.

If your vacation home is considered a rental property, the mortgage interest attributable to the time the premises are rented is a business deduction. The remainder cannot be deducted as home mortgage interest since the house doesn't qualify as a personal residence.

These tax laws also apply to apartments, condominiums, mobile homes, or boats with basic living accommodations. Generally, this means the property must include a sleeping space, bathroom, and cooking facilities. If you are considering the purchase of a vacation home, keep in mind that, from a tax perspective, that mountain cabin or ocean-front bungalow may be the ultimate dream home. $

Pursuant to IRS Circular 230, we are providing you with the following notification: The information contained in this article is not intended to (and cannot) be used by anyone to avoid IRS penalties. This article does not support the promotion and marketing of any particular product. You should seek advice based on your particular circumstances from an independent tax advisor.

The Role of Estate Executor

When you write a will, you have the opportunity to appoint an **estate executor**. An executor is entrusted first with the responsibility to protect the deceased's property until all debts and taxes have been paid, and then to ensure that the remaining assets are transferred according to the will. This responsibility is both an honor and a burden. While the law does not require that an executor be a legal or financial expert, the job may require honesty, impartiality, and diligence. Executors have a number of duties, the complexity of which depends upon the deceased's financial and personal circumstances.

Specific duties of the executor include the following:

- Determining what the individual owns
- Paying any bills and claims against the estate, including funeral costs
- Paying all estate and inheritance taxes
- Collecting any money due on the estate
- Handling other estate assets, such as insurance or trusts
- Overseeing the investment of assets in the estate
- Distributing assets and property according to the will
- Settling the estate with the probate court

Determining Estate Assets

As a part of his or her duties, the executor first needs to determine what assets comprise the estate, such as property, pensions, savings, benefits from employers, and other insurance proceeds. To help facilitate this process, a letter of instruction and/or a list of assets may be included with the will. In the absence of such instructions, it is the executor's job to explore all available channels to locate all distributable assets.

Some assets, such as art collections, real estate, and furniture or household goods, may then need to be valued. The executor may hire appraisers to assess the value of such items. Once valued, the executor is responsible for distributing property to the heirs. Property can pass directly, or instead, it may be sold, and the proceeds, divided among the heirs accordingly.

A Few Finer Points

Is it valid? It is the executor's duty to notify all creditors, anyone named in the will, and anyone else who stands to inherit part of the estate. All potential beneficiaries then have a chance to protest if they believe the will is invalid. In most states, a surviving spouse is allowed to challenge a will if he or she is awarded less than a certain percentage of the estate. If there are no protestations, the probate court then issues "letters testamentary," documents that empower the executor to carry out the required duties.

What are the formalities? The executor transfers the decedent's bank accounts into estate accounts, and other assets can be transferred from the decedent's name to the executor's name. A "will construction proceeding" may be required if all parties agree that a will is valid, but disagree upon its meaning.

What about insurance? Insurance benefits are generally paid promptly once the executor submits an insurance claim form with the original policy and a copy of the death certificate.

What about bills? It is important that all bills are paid before the distribution of any assets begins. The executor needs to keep accurate records of joint property, even if it escapes probate by passing directly to the other owner, because all property, regardless of ownership, affects estate tax bills.

What about liability? The executor generally works with the lawyer for the estate until the estate is settled. Until that time, however, the executor is responsible for keeping the estate in order, protecting tangible assets, and investing the estate's funds prudently. If these responsibilities are not upheld, he or she may be liable to the beneficiaries.

Alternate or Successor Executor

For complicated estates, the probate process may take years. Therefore, you may wish to

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Guardianship for Your Children

Selecting a guardian for your children is an extremely personal and important decision. While you certainly want to choose a trustworthy individual, you also need to choose someone who understands the serious commitment involved in guardianship.

A Look at the Issues

If a potential guardian does not have children already, suddenly having children may require a significant change in lifestyle. On the other hand, those who do have children will need to integrate your children into their family. Regardless of the guardian, it is difficult to know how well children will adjust to their new family. Suppose the guardian is a friend rather than a relative. Will your family members make the situation difficult by second-guessing the decisions of the guardian?

Assuming guardianship of someone else's children is also a major financial responsibility. Too often, the respective parties avoid addressing some important financial issues, such as the following:

- Will the guardian be willing and able to assume full financial responsibility for raising your children? Will the guardian require financial provisions to be made in your will? For instance, will you designate the guardian as the beneficiary of your **life insurance policies** should both you and your spouse die?
- Is there sufficient life insurance to help pay for the cost of raising your children, including higher education expenses?
- If assets are to be placed in **trust** for the benefit of your children, how will the trust be administered? Will the guardian have a role in controlling the trust assets?

Finalizing a Commitment

Even if you have chosen a guardian, your decision is not binding until a court formally appoints the guardian. Generally, a court will not force unwilling people to serve as guardians, even if they have previously agreed and were named as guardians in the deceased parents' will.

When selecting a guardian, be sure to discuss these important issues. Everyone can benefit from an open and honest airing of expectations. You may feel assured, knowing a caring individual will raise your children in a loving, supportive environment. The guardian may better understand the financial responsibility he or she is being asked to assume. And, most importantly, your children can be cared for by prepared and willing guardians. $

The Role of Estate Executor

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appoint an alternate or "successor" executor in case the original executor is unable or unwilling to serve. In a family with children from more than one marriage, an individual may choose to designate co-executors. For a large or complicated estate, an individual may wish to appoint a personal representative and a professional representative or institution, such as an attorney or a bank. Should the estate become deadlocked among co-executors, a third party advisor, such as a professional accountant, may be consulted, subject to court authority.

Make an Informed Choice

Now that you are aware of an executor's specific duties, you can make an informed choice about an executor for your estate. Choose an individual whom you trust to help ensure that your final wishes are fulfilled and your family benefits from your years of hard work. Once your decision has been made, be sure to work closely with your designated executor, so that he or she can fully understand and appreciate your wishes. $

Business Ownership: What Structure Is Best?

Small business owners have unique financial, tax, and liability concerns, which can be addressed by their form of business ownership. In particular, your choice of business structure determines your tax treatment and your liability risk. As your company grows or ownership changes hands, reassessing your initial choices can be appropriate.

This article explores the characteristics of five basic business entities: sole proprietorships, partnerships, C corporations, S corporations, and limited liability companies (LLCs).

Sole Proprietorships

Many small businesses start out as sole proprietorships, but owners need to be aware of the personal liability risk. One individual owns a sole proprietorship and typically runs the business. Sole proprietors own all assets and profits, and income is subject to individual income tax, as well as self-employment tax. The sole proprietor assumes personal liability for all aspects of the business, including debt and legal action taken against the business.

Partnerships

Two or more people own a partnership, and there are several types, including general partnerships, limited partnerships, family limited partnerships, and limited liability partnerships. A legal agreement generally specifies how profits will be shared, delineates the management responsibilities, and provides guidance for resolving disputes and dissolving the partnership. General partners face unlimited personal liability, whereas limited partners assume liability no greater than the capital they contributed.

Tax treatment is similar to that of sole proprietorships. The partnership entity is not taxed; however, partners are subject to income tax on their compensation, plus self-employment tax, if applicable. Losses also pass through to partners, and restrictions on deductibility apply. Because of this "pass-through" taxation, partnerships avoid the double taxation that corporations may face.

C Corporations

Shareholders own a corporation, which is considered by law to be a unique entity separate from those who own and run it. The corporation pays corporate taxes, and the shareholders pay tax on the income they receive as dividends. This double taxation can be a disadvantage, particularly for owners who are not in a position to reinvest a significant portion of profits back into their business.

One advantage to this structure for businesses is the protection it offers from personal liability. Owners are personally shielded from debt liability and lawsuits against the company; only the amount of their investment is at risk.

S Corporations

S corporations, which limit ownership to 100 shareholders, share characteristics of C corporations and partnerships. This form of **pass-through entity** generally does not pay corporate income tax and permits the shareholder to treat company earnings and profits as distributions. This income depends on the shareholder's percentage of ownership and passes through directly to his or her personal tax return, thereby avoiding double taxation and self-employment tax. Shareholders may also deduct losses, limited to their basis in the business. State tax treatment may vary.

As with C corporations, shareholders are protected from personal liability. Only their investment in the company is at risk.

Limited Liability Companies

A limited liability company (LLC) provides the limited liability benefits of a corporation and the tax efficiencies and operational flexibility of a partnership. Members of an LLC are protected from personal liability, risking only their investment in the company. Most states require LLCs to have at least two members, but there is no maximum limit.

LLCs can be taxed in a variety of different ways. "Check-the-box" regulations enacted in 1997 simplified the taxation of LLCs. Unless it chooses to be treated as a corporation for tax purposes, an LLC with two or more members will be treated as a partnership, while a single-member LLC will be treated as a sole proprietorship. If treated as a partnership, the LLC's profits and losses pass through to the members, who then pay the tax on their individual income tax returns.

As you can see, each business structure has its advantages and disadvantages. Your choice affects the taxes you pay and your personal liability risk, so it is important to choose the right entity for your business. $

Exploring the Leasing Option

Automobile leasing has grown in popularity over the past several years, but many people still hesitate to enter into a lease. This may be because there are so many factors to consider that it seems easier to buy a vehicle. Under the right circumstances, however, leasing an automobile can save you considerable money, and even taxes. No one can tell you which option is better without knowing your particular situation, but these factors may impact your decision.

How Does Leasing Work?

When you lease an automobile, you only pay for the portion of it that you use, or the amount by which it depreciates. Many people hesitate because, at the end of the lease, they don't own anything. But, that's exactly why lease payments are lower than loan payments. You're not buying the leftover value in the car—you're buying only what you use.

A lease payment consists of a depreciation charge and a finance charge. The finance charge is much like the interest you would pay on a car loan. The depreciation charge is determined by dividing the value of the car that you use by the number of months in the lease. Without considering the tax effects, the short-term cost of leasing compared to buying is about the same. This assumes that you sell your car after the loan is paid off for its full market value. But as you well know, this is often not the case, especially if the car is used as a trade-in. If you are apt to keep your car for 10 years, then buying may be your best option. What about the tax effects? Ultimately, the *tax cost* of leasing versus buying may be about the same. However, the timing of when you get the deductions can be greatly impacted by your decision.

Claiming Tax Deductions on Leases

Because you do not own a car that you lease, you are not allowed to depreciate it. You can, however, deduct at least some of the cost of operating a car leased primarily for business purposes. Keep in mind that you are only allowed to deduct the business portion of the costs of a lease if the car is also used for personal purposes, such as commuting.

You have two options for figuring your deductible expense on a business vehicle that is leased for more than 30 days: the standard mileage rate allowance or actual expenses method. The standard mileage rate allowance is easier to calculate, but it may provide less tax relief than the actual expenses method if you do not drive a lot of miles or if your car is relatively expensive.

The standard mileage allowance is a cents-per-mile allowance that takes the place of deductions for lease payments; vehicle registration fees; and the expenditures on gas, oil, insurance, maintenance, and repairs. The standard mileage allowance rate for business use of a car—leased or owned—is 51 cents a mile in 2011. To figure out your deduction, simply multiply the rate by the number of miles driven.

The actual expenses method generally allows you to deduct all out-of-pocket expenses for operating your car for business, from lease payments to repair costs. If the car you have leased has fair market value in excess of the luxury vehicle threshold according to the IRS, your deduction is reduced by a so-called "inclusion amount," which is added to your gross income. This additional sum brings your deduction roughly in line with the depreciation you would have been able to claim as the car's owner.

Inclusion amount tables in IRS Publication 463 can help you determine the inclusion amount that applies in your case. Because the inclusion amounts increase from year to year in the course of a lease, you may want to consider taking out a lease with a term of no more than two years.

Any advance payments on the lease must be deducted over the entire lease period. If you take out a lease with an option to buy, you can deduct the payments if the arrangement is set up as a lease. If, however, the arrangement amounts to a purchase agreement, the payments are not deductible.

Leases—Hidden Traps

Despite the limits on deductions for luxury vehicles, the available tax breaks for business

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Securing a Business Loan with Term Life

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the bank. The extent to which these rights are transferable depends on the assignment provisions in the policy, the intention of the parties as expressed in the assignment form, and the actual circumstances of the assignment. There are two common types of insurance policy assignments:

- **Absolute assignments—**These normally assign *every* policy right the policyholder possessed prior to the assignment. Once the transaction is complete, the policyholder will have no further financial interest in the policy.
- **Collateral assignments—**These are more *limited* types of transfers. They can protect the lender by using the policy as security for repayment. When the loan is fully repaid, the bank releases its interest in the policy.

Generally, life insurance policies can be freely assigned, unless some limitation is specified in the contract. To fully protect the assignee, the insurance company must be notified in writing that the assignment has been made, typically on forms provided by the carrier for this purpose. It is also important to notify the insurer if future assignments are made and/or terminated.

Benefits after the Loan Is Repaid

Term life offers benefits even after the loan has been repaid. At that point, you could convert the policy to **permanent life insurance** to be used for a number of other business purposes. These may include funding a **buy-sell agreement** or a **deferred compensation plan**. If you have no further need for the insurance, you could simply decide to let the term policy lapse.

To succeed in the long run, small businesses need to take advantage of their opportunities for growth. A term policy can be an economical way of obtaining a business loan by providing a safety net that secures repayment for a lender in the event of your death. $

Exploring the Leasing Option

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owners are generous enough to make leasing an attractive alternative to buying—especially if you want to change cars frequently. Before you sign on the dotted line, consider the potential pitfalls involved in leasing:

Mileage limits: All leases have mileage limits, usually 12,000 or 15,000 miles. If it's probable that you'll rack up more miles, you could face costly penalties. Try to negotiate the mileage limit up in exchange for higher lease payments. Or, buy the car.

Open-end leases: In an open-end lease, the residual value is re-determined at the end of the lease. If the residual value is lower than initially projected, you have to make up the difference. Closed-end leases avoid this problem, but your payments may be higher.

Early termination: When leasing, be sure to keep the car for the entire lease period. Penalties for early termination are severe and are usually difficult to get out of. If you're not sure how long you'll keep the car, consider a shorter lease term or purchase it.

While laws require dealers to disclose more information on leases, key information can be buried in the fine print or omitted completely, like the interest rate that you are being charged. Be sure you completely understand the terms before signing on the dotted line. Leasing your next automobile can either make a lot of sense, or it can be a big mistake. Your tax professional can help you consider all of the factors and make the right choice. $

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