5 sneaky tax deductions

You've probably never heard of these write-offs, but they could save you a lot of money and make your April easier. Why send the IRS any more than you need to?

1. 'Depreciate' land

Depreciation is the deduction you take to expense and recover the cost of a business or investment asset. If that asset has a useful life of more than one year, normally the IRS requires you to write off the cost over that period. Depreciation, in theory, is the way you get to deduct your cost over the life of the asset.

The key words here are "life of the asset." Because land has an unlimited life, you don't qualify for expensing or depreciation. But that doesn't mean you can't suck some tax savings out of the land if you get creative.

Assume you have a piece of residential rental real estate. You know you can depreciate the cost of the building over 27.5 years. But how about the land? Here's what you do:

1. Set up an irrevocable trust with an independent trustee and your kids as beneficiaries.
2. Draft a deed that separates the land from the building. Gift the *land only* to the trust. You and your spouse each have an annual gift tax exclusion of $13,000 per child, plus a lifetime gift tax exclusion of $5 million each. That means no tax unless the value of the land is in excess of $10 million. In that case, call me -- you can afford my fees.
3. You now own a rental building on property owned by the trust. Legally, the trustee has a fiduciary obligation to offer you a choice: Either get the building off the land or pay a lease rental fee.

Assuming you have an IQ of at least two digits, you're going to pay some rent. But what are you really doing? You're now taking a deduction for the lease rental at your higher bracket while the income is taxed to your kids at their lower rates. You pocket the difference. If we're talking a rental of $1,000 a month and you're in the 28% bracket and the kids are in the 10% bracket, that's an annual family savings of $2,160. Be sure to watch out for the "kiddie" tax.

The same concept works with any land used for business or investment, such as farmland. If you don't have kids, how about parents in a lower tax bracket whom you want to help support?

That's how you "depreciate" land!

2. Make money on charitable contributions

Internal Revenue Code Section 280(A)(g) -- for those who want to look it up -- says you can rent out your house for up to 14 days in a calendar year and all the income comes to you tax-free. Go beyond the 14 days, and everything becomes taxable.

Now this is what you do:

1. Rent out your house to a qualified charity or church for a meeting once a month. Call a local hotel and get their rates for a conference room to establish a fair rental amount. Say that's $5,000 for the monthly use over the year. Since we have only 12 months, this monthly use will add up to less than 14 days out of the year, so all the rental income is tax-free.
2. In appreciation for all the good works the charity or church does, and *not* in exchange for the rental, you make a deductible contribution of $6,000. You're in the 25% bracket, so that saves you $1,500 in federal taxes.

What's the result? The charity spent $5,000 and got $6,000. It's up $1,000. You contributed $6,000 and got $5,000 in tax-free cash, plus another $1,500 in tax savings. You're up $500.

Isn't tax magic wonderful?

3. Expense it all, or depreciate 100%

If you're in business, this one's for you. There's a special exception to the general depreciation rules that allows you to deduct the cost of certain assets in a single year rather than over the life of the asset. Legal changes made in 2010 allow as much as $500,000 to be written off in a single year, for 2010 and 2011, falling to $125,000 (indexed for inflation) in 2012. This "election to expense" phases out based on a dollar amount of investment limitation ($2 million, dropping to $200,000 in 2012). Unfortunately, you can't use it to create deductible losses. It's limited to your net income before the deduction.

For qualified property that you depreciate rather than elect to expense, there's a new additional 100% bonus depreciation deduction. Qualified property includes only new assets with useful lives of 20 years or less, including furniture, machinery and other equipment, land improvements and farm buildings, placed in service after Sept. 8, 2010, and before Jan. 1, 2012. Then the bonus depreciation drops to 50% through Dec. 31, 2012.

This deduction is not limited by any investment cap and, unlike the election to expense, can generate net operating losses. If you're self-employed or own a business, this is a new opportunity to reduce your total tax liability.

4. **Take a remodeling credit**

For 2009 and 2010, Congress created an amazing tax credit of 30% of the cost of qualified energy efficiency improvements such as water heaters, furnaces, insulation, roofing, exterior windows and doors, and other items, limited to $1,500. Up to $5,000 in qualified improvements could cost as little as $3,500 after tax.

Didn't take advantage of it? A tax law change extended the credit through 2011, but at a much lower rate. The prior 30% credit has fallen to 10%, and the credit dollar ceiling has dropped from $1,500 to $500. There also are reduced caps for specific items. No more than $150 can be claimed for water heaters and furnaces, $200 for windows and $300 for biomass fuel stoves. Here's the real hurt: Credits claimed in prior years, including 2009 and 2010, will count against the $500 limit.

5. Make your estate-tax credit portable

Good news: Congress finally dealt with the estate tax and created a $5 million gift and estate tax exclusion. That means you can gift or bequeath not only an unlimited amount to a spouse, but an additional $5 million to non-spouse beneficiaries. Between husband and wife, a minimum of $10 million can go to the kids.

Better news: The credit that shields these assets from taxation is now portable. That means that any credit not used by the first spouse who dies can automatically be claimed by the surviving spouse upon the second death. If there were multiple spouses, only the last one counts.

There's a hitch though -- a major trap for the unwary. In order to have the credit carry forward, the IRS wants an estate tax return (Form 706) to be filed for the first to die, even if no tax is owed. It's a small price to pay.

Couples will no longer have to equalize their assets to maximize their credit. The change also means that special credit-shelter trusts no longer have to be drafted into wills in order to minimize taxes. They may be appropriate for other reasons, though, such as to protect the assets for the children from a potential successor spouse.

But beware: Unless Congress acts, the $5 million gift and estate tax exclusion falls to only $1 million after 2012.