



Financial Foresights

Practical Insights For Your Financial Goals

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Hi Everyone,

I hope you enjoy this month's edition of my newsletter. If you have any year-end tax planning questions, please feel free to call me.

Have a great holiday season!

Dave

In this issue:

Year-End Gifting Tax Tips

Capital Gains: A
Double-Edged Sword at Tax
Time

Income in Retirement

Ask the Experts

Year-End Gifting Tax Tips

As the holiday season and the close of the year quickly approach, you may be planning to make gifts to family, friends, and charities. You can be generous to yourself, too, by making those gifts in a way that maximizes your tax benefits. Here are some tips for tax-wise giving.



Giving to family and friends

Gifts to family and friends may be subject to federal gift tax (and perhaps state gift tax), and gifts to grandchildren may also be subject to generation-skipping transfer tax (GSTT). However:

- Gifts to spouses are gift tax free.
- Currently, you can give tax free up to \$12,000 per recipient (\$24,000 if the gift is from both you and your spouse) under the annual gift tax exclusion. Gifts over that amount are tax free to the extent of your \$1 million lifetime gift tax exemption (\$2 million lifetime GSTT exemption).
- If you fund a 529 plan for your child or grandchild, you can contribute up to five years' worth of gifts at once; that's \$60,000 per child or \$120,000 if you and your spouse make the gift.
- You can make unlimited tax-free gifts if you directly pay medical bills or college tuition on behalf of a recipient.

Giving to charity

Donations to charity are completely gift tax free and are also generally deductible for income tax purposes, subject to the usual limitations. However:

- Only donations to "qualified" organizations are tax deductible. IRS Publication 78, available online and at many public libraries, lists most organizations that are

qualified to receive deductible contributions, or you can ask the organization for a copy of its tax-exempt status determination letter. In addition, churches, synagogues, temples, mosques, and government agencies are eligible to receive deductible donations.

- Avoid giving cash, and keep records (receipts, canceled checks) of all your donations, regardless of the amount. Although the value of your time serving as a volunteer is not deductible, out-of-pocket expenses (including transportation costs) directly related to your volunteer service to a charity are usually deductible.
- You must obtain a "qualified appraisal" for donations of property worth over \$5,000 (other than cash and publicly traded securities), and you must attach an appraisal summary (IRS Form 8283) to your tax return.
- Donated clothing and household items must be in good condition. You may claim a deduction of more than \$500 for any single item, regardless of its condition, if you include a qualified appraisal with your return.
- For 2007, an IRA owner age 70½ or older can directly transfer income tax free up to \$100,000 per year to an eligible charitable organization. You can take advantage of this provision regardless of whether you itemize your deductions.
- Consider donating appreciated securities that you've held for more than a year. You'll generally get a full fair market value deduction and avoid capital gains tax, too.
- Consider grouping donations and making gifts in alternate years to create a larger deduction and opportunity to itemize.

Capital Gains: A Double-Edged Sword at Tax Time

It's no fun to look at your mutual fund statement and realize that you've had losses for the year. It's even more painful if you discover that, in addition to suffering a paper loss, you owe taxes on the fund's distribution of capital gains. It's a question that puzzles a lot of investors: How can you owe taxes on an investment that has lost money?

The answer has to do with the difference between your profit when you sell fund shares, and the fund's profit when it sells individual securities. As a fund buys and sells securities during the year, it will typically have some gains and some losses. At the end of the year, losses are subtracted from gains to determine the fund's shareholder distribution. The fund also may use losses from previous years to help offset gains.

By law, gains and/or income must be distributed each year; typically, those distributions occur around the end of the year and are taxable (unless the fund is held in a tax-advantaged account such as an IRA). Even if a fund is down at the end of that year, it may still have capital gains from earlier sales of securities.

Example: In 2002, Harry's stock fund bought 10,000 shares of XYZ Corporation for \$33 a share. By the end of last year, the share price had reached \$50, helping to push up the net asset value (NAV) the fund reported on its year-end statement to shareholders. This year, XYZ's price drops to \$43. The fund's manager, concerned that XYZ might fall still further, sells the shares for a \$100,000 profit. However, other shares held by the fund drop in value, and Harry's end-of-year statement now shows a lower balance compared to the year before. Because the fund did not sell shares to realize losses, it must still pass its \$100,000 XYZ profit on to shareholders as capital gains distributions.

Good news, bad news

Owing taxes on distributions from a fund that's down is especially likely in years when a fund experiences substantial redemptions. If your fellow investors in a mutual fund have been pulling money out, the manager might have had to sell securities in order to meet those redemption demands. High market volatility also could mean a greater than usual level of capital gains distributions by funds with managers who traded actively, either to try to lock in gains or avoid further losses.

Some capital gains distributions this year may be affected by what happened in 2000-2002. Many funds that suffered during the bear market could use those losses in subsequent years to offset any capital gains and minimize that year's taxable distribution. However, many funds have now used up their losses from the down years, leaving their managers with fewer leftover losses to offset any current gains from selling individual securities.

Tax factors to consider in fund selection

One way to minimize such problems is to consider a fund's tax efficiency in advance. Taxes shouldn't be the single deciding factor in any investment decision. However, when assessing the capital gains impact of a potential purchase, consider the following points:

- Some mutual funds tend to be more susceptible to the capital-gains dilemma than others. For example, funds with a high turnover ratio buy and sell more often and may generate more capital gains distributions.
- Some actively managed funds are designed specifically to be tax efficient, taking capital gains into account when making trading decisions.
- A fund's long-term capital gains will be taxed at a more favorable rate than its short-term gains.
- Bond funds can experience capital gains and losses from the sale of individual bonds.
- Each mutual fund must report its after-tax return in its prospectus.

In the small consolation department ...

If you are squeezed by both a loss in your fund's value and a capital gains distribution this year, remind yourself that at least the maximum tax rate on long-term capital gains and qualified dividends is 15% until January 1, 2011 (less if you're in the 15% or 10% tax bracket).

You also may be able to offset capital gains from one mutual fund by taking a capital loss on another investment. A financial professional can help you assess the potential tax impact of a given mutual fund, as well as the best way to manage any capital gains liability.



Owing taxes on distributions from a fund that's down is especially likely in years when a fund has substantial redemptions by shareholders.

Income in Retirement

You've worked hard your whole life, anticipating the day you could finally retire and enjoy your golden years. Well, that day has arrived. There's still work to be done, however--you'll need to carefully manage your assets so that your retirement savings will last as long as you need them to.

Review your portfolio regularly

It's commonly said that retirees should value the safety of their principal above all else. For this reason, some people shift their investment portfolio to fixed-income investments, such as bonds and money market accounts, as they approach retirement. The problem with this

approach is that if returns don't keep up with inflation, an investment portfolio may not enjoy the growth



needed to fund today's longer retirements.

So while there are good reasons to invest more conservatively as you grow older, consider maintaining at least a portion of your portfolio in growth investments.

Choosing a sustainable withdrawal rate

A key factor in determining whether your assets will last for your entire lifetime is the rate at which you withdraw funds. The more you withdraw, the greater the likelihood you'll exhaust your resources too soon. On the other hand, if you withdraw too little, you may not enjoy your retirement as much as you could. It's vital that you estimate an appropriate withdrawal rate for your circumstances, and determine whether you should adjust your lifestyle and/or estate plan.

An appropriate withdrawal rate depends on many factors, including the value of your current assets, your expected rate of return, your life expectancy, your risk tolerance, inflation, your expenses, and whether you want some assets left over for your heirs.

Studies have tackled this issue, resulting in the creation of tables and calculators that can provide you with a range of rates that have some probability of success. A financial planning professional can help you with this.

Which assets to draw from first?

Most retirees have assets in accounts that are taxable (e.g., CDs, mutual funds), tax deferred (e.g., traditional IRAs), and tax free (e.g., Roth IRAs). Given a choice, which type of account should you withdraw from first? The answer is--it depends.

For retirees who don't care about leaving an estate to beneficiaries, the answer is simple in theory: withdraw money from taxable accounts first, then tax-deferred accounts, and lastly, tax-free accounts. By using your tax-favored accounts last, and avoiding taxes as long as possible, you'll keep more of your retirement dollars working for you.

In practice, however, your choices, to some extent, may be directed by tax rules. Retirement accounts, with the exception of Roth IRAs, have minimum annual withdrawal requirements. In general, your first withdrawal must be made by April 1 of the year following the year you turn age 70½, with subsequent distributions due each December 31. Failure to do so can result in a 50% excise tax imposed on the amount by which the required minimum distribution exceeds the distribution you actually take.

For retirees who intend to leave assets to beneficiaries, the analysis is more complicated. You need to coordinate your retirement planning with your estate plan. For example, if you have appreciated or rapidly appreciating assets, it may be more advantageous for you to withdraw from tax-deferred and tax-free accounts first. This is because these accounts will not receive a step-up in basis at your death, as many of your other assets will.

However, this may not always be the best strategy. For example, if you intend to leave your entire estate to your spouse, it may make sense to withdraw from taxable accounts first. This is because spouses are given preferential tax treatment with regard to retirement plans. A surviving spouse can roll over retirement plan funds to his or her own IRA or retirement plan, or, in some cases, may continue the deceased spouse's plan as his or her own. The funds in the plan continue to grow tax deferred, and distributions need not begin until the spouse's own required beginning date.

By planning carefully, investing wisely, and spending thoughtfully, you can increase the likelihood that your retirement will be a financially secure one.

While there are good reasons to invest more conservatively as you grow older, consider maintaining at least a portion of your portfolio in growth investments.



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Ask the Experts



How convenient are credit card convenience checks?

If you have a credit card account, you've no doubt seen them: blank checks that may be used to make purchases, obtain cash, or transfer higher-interest balances. As it turns out, these checks are often more convenient to your creditor (for making a profit) and to thieves (for going on a spending spree at your expense) than they are to you.

When you use the checks, your creditor makes a greater profit than when you use your card. That's because:

- The interest rate on convenience check usage is often higher than the rate charged on card purchases
- The creditor may charge a substantial fee for using the check (up to 5% of the check amount, with no cap)
- There may be no grace period on purchases made with these checks; interest accrues from the moment you write one
- Your creditor may apply your payments

first to balances (such as card purchases) with a lower interest rate

What's more, if you purchase defective merchandise with your credit card and you have no luck returning it to the seller, you may contact your credit card company for relief. If you use a convenience check to make the purchase, however, these protections may not apply.

Convenience checks are a favorite target of mailbox thieves. Unlike unsolicited credit card offers, you can't "opt out" of receiving them. Since you never know when the credit card company will send them, you can't report them missing when they don't arrive. Most creditors don't require a call to activate them, and merchants often don't verify signatures on convenience checks. To make matters worse, the regulations that limit your liability to \$50 for use of a lost or stolen credit card do not apply to convenience checks.

So, the bottom line: It may be best to "inconvenience" yourself by using your credit card instead.

Should I pay off my credit card debt with home equity financing?

Your credit card balances have gotten pretty steep, and the interest charges seem to be going through the roof. Meanwhile, you've built up substantial equity in the roof over your head (your home). Wouldn't it make sense, then, to take an equity loan to pay off your credit card debt?

Well, maybe. Home equity financing (which may be set up as either a loan or a line of credit) does have certain advantages over unsecured personal debt, including:

- Favorable interest rates
- Low monthly payments (due in part to longer terms)
- Tax-deductible interest (if you itemize your deductions on your federal income tax returns)

But equity financing also has drawbacks:

- You may have to pay closing costs and other fees
- Longer repayment terms can lead to high total interest charges

- Since your home is the collateral that secures the financing, you run the risk of foreclosure if you can't make your payments

If you do repay your credit card debt with equity financing, here are some tips that may help you make the most of that decision:

- Shop around. In an effort to attract your business, a lender may absorb or waive some or all of the costs of obtaining the financing.
- If possible, make monthly payments at least equal to what you were paying on your credit card debt. At the lower interest rate, you'll apply more to the principal and repay the debt faster (and at a lower total interest cost, too).
- Remove the temptation to "dig the hole again." If you don't cut up the credit cards, at least try to use them sparingly and pay them off every month.