

Ten Gifting Traps You Should Avoid

Lifetime gifting can be a powerful estate planning tool. Transferring property during your life, instead of at your death, has many advantages. Making lifetime gifts can be desirable for personal reasons (e.g., to help your children or other family members) or for financial reasons (e.g., saving taxes). No matter what your reasons for starting a gifting program, there are a few gifting traps you should be aware of.

1. The kiddie tax rules

Beware of the kiddie tax rules when transferring income-producing property to your children. Investment income over \$1,800 (for 2008) will be taxed at your marginal income tax rate, not your child's.

The kiddie tax rules apply to children who are: (1) under age 18, (2) age 18 with earned income that doesn't exceed one-half of their support, and (3) ages 19 to 23 who are full-time students with earned income that doesn't exceed one-half of their support.

2. Gifts of retained interests or powers

Be careful when making gifts of property in which you retain some financial interest (e.g., a life estate, right of reversion, or right of revocation) or powers (e.g., the power of appointment). This property may be includible in your estate for estate tax purposes.

For example, say you transfer ownership of your home to your son on the condition that you're allowed to continue living in the home for the rest of your life. You have retained a financial interest in the home, and this interest may be includible in your estate for estate tax purposes.

3. Income taxation of gifts made to a trust

Some types of trusts are taxpaying entities, which are taxed at more compressed income tax rates than individual taxpayers. If you'll be using such a trust, be sure to consider the consequences of paying income tax on trust income at higher income tax rates.

4. Delays in making a gift of life insurance

Do not delay making a gift of a life insurance policy on your life. A transfer of an insurance policy by gift within three years of death results in the proceeds being includible in your estate for estate tax purposes.

5. Delays in planning your estate to meet percentage tests

Do not delay removing certain nonbusiness assets to help your estate meet the percentage tests to qualify for Section 303 (redemption of stock), Section 2032A (special use valuation), or Section 6166 (installment payout of taxes) tax treatment. This technique will work only if the gift is made more than three years prior to your death.

6. Payments for tuition or medical care made to the donee

Payments you make for tuition or medical care on behalf of another are exempt from federal gift tax. However, to qualify, you must make the gifts directly to the educational or medical institution--do not make such payments to the donee.

7. Overlooking gift splitting

For 2008, you can give \$12,000 per donee federal gift tax free under the annual gift tax exclusion. There is also a gift-splitting privilege for spouses who qualify that can double the exclusion.

8. "Reverse" gifting if death is imminent

Reverse gifting is a technique where a healthy individual transfers low-basis assets to a dying individual. If the decedent lives for more than one year from the date of the transfer, the basis gets stepped up to fair market value. However, the basis will not get stepped up if the decedent dies within a year of receiving the gift, and should this happen, you may end up needlessly paying gift tax and/or using up your \$1 million gift tax applicable exclusion amount.

9. Overlooking the benefit of taxable lifetime gifts

Don't assume that lifetime gifts and transfers made at death result in the same tax effect. Paying gift tax on taxable lifetime gifts can result in an overall tax savings because the tax you pay is also removed from your estate.

10. Selecting property that does not attain your tax-savings objectives

There are some types of property that you should avoid giving if you want to enjoy tax savings, such as property that has depreciated in value or is likely to depreciate.

Ask the Experts



I have a home office—can I still exclude gain when I sell my home?

You're generally eligible to exclude from income up to \$250,000 (\$500,000 if married filing jointly) of the capital gain that results from the sale of your home if:

- You have owned and lived in the home as your primary residence for at least two out of the five years preceding the sale (special rules apply to certain individuals, including members of the U.S. Armed Forces)
- You have not sold a principal residence and excluded some or all of the resulting gain in the prior two years

Even if you fail to meet these tests, you may be able to claim a partial exclusion if the primary reason for selling your house is a change in place of employment, health, or certain unforeseen circumstances.

The fact that you use a portion of your home for business purposes (in this case, your home office) adds a couple of wrinkles.

First, when you sell your home, any capital gain that's attributable to depreciation deductions allowed or allowable for the business use of your home after May 6, 1997, can't be excluded.

Second, if your home office is separate from the residential portion of your home (for example, a home office that's located in a converted, detached garage), any gain from the sale of the property typically has to be allocated between the business part of the property and the part used as a home. The gain that is allocated to the business portion (the separate office) can't be excluded. This can get complicated, though, so it's worth discussing your situation with a tax professional.

For more information, see IRS Publication 523, *Selling Your Home*.

Do I qualify for the first-time homebuyer tax credit?

If you purchase a principal residence after April 8, 2008, and before July 1, 2009, and you qualify as a first-time homebuyer, you may be eligible for a refundable tax credit of up to \$7,500.

To qualify as a first-time homebuyer, you (and your spouse, if you are married) cannot have had an ownership interest in a principal residence in the United States for the 3-year period immediately preceding the purchase. In addition, you have to meet certain income requirements. If your modified adjusted gross income for the year in which you purchase the home is \$95,000 (\$170,000 for joint filers) or more, you don't qualify; if your modified adjusted gross income is between \$75,000 and \$95,000 (\$150,000 and \$170,000 for joint filers), the amount of credit that you're eligible for is reduced.

The credit is calculated as a percentage of the purchase price of the home. You're generally entitled to a credit of 10% of the purchase price, up to the \$7,500 cap. If you're married and file a separate return, the maximum credit is \$3,750.

If you purchase the home in 2008, you'll claim the credit on your 2008 federal income tax return. If you purchase the home after December 31, 2008, and before July 1, 2009, you can claim the credit on your 2009 return, or you can elect to treat the purchase as if it took place on December 31, 2008 (allowing you to claim the credit on your 2008 return).

The twist with this credit, though, is that it has to be repaid in equal installments over 15 years, making the credit more like an interest-free loan from the government. If you claim the credit on your 2008 federal income tax return, the 15-year repayment period begins with your 2010 federal income tax return. If you claim the credit on your 2009 return, the first year of repayment is 2011.

There are several special rules that apply, including acceleration of repayments if you sell the home, or if the home ceases to be the principal residence of you or your spouse.

A Consumer Debt Repayment Strategy

Okay, maybe you're not drowning in consumer debt, but the water level is just too high and seems to be getting deeper. The interest charges are steep, and you know that if you start falling behind in your payments, the late fees will just add insult to injury and make your balances even higher. You'd like to get out of the situation you're in before you get soaked. What's the best way to go about it?

First, plug the hole

Are you still using credit? If so, attempting to get out of debt while you're still incurring more of it is like trying to bail out a boat that's still leaking.

Review your expenses and compare them to your income. If you're spending more than you're earning, you're probably using credit, even if only for the occasional "emergency." In order to bail out of debt, you'll first have to plug the leaks in your budget.

As you go about making your budget more seaworthy, look for ways to reduce your expenses to the point where you create a cash surplus. You can then use this surplus to accelerate your debt repayment. This is a key element to any strategy that accelerates repayment of consumer debt.

Line up your ducks

List all your unsecured debts (don't include your mortgage, student loan, and/or car loan); rank them from the one with the highest interest rate charged to the lowest. Hopefully, you're current with all of them (including the unlisted ones); if not, first direct any surplus to getting current.

Once all your debts are current, make the minimum payment on all of them and direct any surplus toward increasing the payment against the debt with the highest interest rate. As the minimum payments required on all your debts start to go down (as happens with credit cards), don't pay less on your total debt. Instead, make the minimum payments on all of them and keep shifting the "extra" to increasing the payment on the debt with the highest interest rate.



Take your best shot

Once that debt with the highest interest rate is paid off, add the amount of the payment you were making toward it to what you're paying on the debt with the next highest interest rate. Once again, as the minimum payment requirements on other debts with lower interest rates

decline further, put the "extra" created toward this highest-interest debt.

Because the amount you pay toward each debt increases in size as you move down the list of your debts, this repayment strategy is often referred to as snowballing.

An alternative approach

Some snowballing methods recommend that you pay off your debts starting with the smallest balance first, regardless of its interest rate, and also apply to this debt any surplus, while keeping your payments the same each month on all of the rest of your debts (regardless of their decreasing minimum requirements). While this approach offers the psychological satisfaction of paying off smaller debts quickly and paying extra against the principal on all your debts, it may not save you as much in total interest charges as the approach outlined above.

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