



# Parker Financial Services, LLC

## Helping Biz Owners & Professionals Retire On Time

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## Downsizing Your Home: Moving Out, Moving On



If your children have finally flown the coop and retirement is fast approaching, you may be thinking about downsizing your home. Moving to a less expensive home can help free up cash for your retirement years, but before you start packing, you have some decisions to make.

### **Paying cash or financing your new home**

If you've carried a mortgage for many years, you may be thinking about paying cash for your new home now that you can afford to do so. Owning a home free and clear rather than making mortgage payments is a good financial move for many retirees, but is it the right move for you?

One factor in your decision is whether you'll have a large enough cash reserve. If you tie up most of your cash in a new home, will you still have the financial flexibility to handle the unexpected expenses that will inevitably crop up?

Alternatively, you might decide to invest the proceeds from the sale of your home, but consider whether you'll come out ahead if you do so. The lower mortgage interest rates are, the more attractive investing your money may be. However, if you decide to carry a mortgage and you're still working, try to make large enough mortgage payments to pay off your loan by your anticipated retirement date.

### **Worrying about taxes**

Have you owned your current home for many years? If so, you might need a refresher course on the tax implications of a home sale. A decade ago, your age and whether you would be rolling over home sale proceeds to a new home were two factors that played a part in determining whether you'd pay tax on your home sale gain. But tax laws have changed.

Today, regardless of your age or whether you're purchasing a new residence, you may be able to exclude up to \$250,000 of gain on the sale of your home, \$500,000 if you're married filing jointly. You can generally use this exemption only once every two years, and to qualify, you must have owned and used your home as your principal residence for at least two out of the five years before the sale. A tax professional can help you assess the tax implications of selling your home.

### **Sorting out your prized possessions**

Downsizing inevitably means sorting through a lifetime of cherished possessions. It's hard to decide what to keep and what to give away, but you may save a lot on moving and storage costs if you sort out your stuff before you relocate. Here are some tips:

- Obtain a layout of your new home and take accurate measurements. This will help you determine which pieces of furniture you'll have room for, and how much storage space you'll have.
- Make a list of your possessions, then come up with a timetable for moving. Avoid hasty decisions by allowing plenty of time to sort and pack your things.
- Have older or potentially valuable possessions appraised before you discard them. Those dusty vinyl LPs may look like trash to you, but a collector may be willing to pay top dollar for them. And don't forget about donating unwanted items to charity.
- Ask family members for input when you're sorting out your things. Consider passing on items to family members now, while you can enjoy seeing them put to good use.

Though it's hard to empty your nest of the things you love, remember the upside: At the end of this process, you'll be ready to move on to a new phase in your life.



### **The bond seesaw**

*Why do bond prices tend to go up when interest rates go down, and vice versa?*

*Because whenever interest rates are falling, bonds that are issued today will typically pay a lower interest rate than a similar bond that was issued when rates were higher. That means that older bonds with higher coupons are more valuable to investors, who are willing to pay a higher price to get that greater income stream. The opposite is true when interest rates are rising.*

## **Rate Changes and Your Portfolio: Awaiting with Interest**

Over the last two years, we've grown used to rising interest rates. Ever since mid-2004, the Federal Reserve Board has regularly increased the federal funds target rate. However, that pace has begun to moderate. It's not necessarily safe to assume that interest rates will be flat or drop, but it's no longer a given that they'll automatically go up, either. What does this mean when it comes to your portfolio?

### **Balance bond yields and values**

As interest rates rose, you may have noticed that the prices of any bonds you own probably dropped. That's because bond prices tend to move in the opposite direction of interest rates; when rates go up, prices go down, and vice versa. More stable interest rates should also translate into more stable bond prices.

If you own short-term bonds, U.S. Treasury bills, or a short-term bond mutual fund, you might talk with your financial professional about whether the current interest-rate outlook represents an opportunity to diversify into intermediate or longer-term maturities that offer a higher yield.

However, be aware that if interest rates continue to rise, longer-term bonds will feel the impact on prices more than short-term bonds will. A drop in value could eliminate the advantage of any increased yield. Also, you'll need to think about the yield curve: the difference between the yield on short-term securities and the yield on long-term securities. Is the difference great enough to compensate you for the additional risk of a longer-term security?

### **Take stock of your situation**

Whenever interest rates begin to flatten out, it's usually because the Fed believes the economy has begun to slow. That has implications for the stock portion of your portfolio.

Consider how you've balanced your stock portfolio. Think about whether you own stocks that might be especially sensitive to a slowing economy and possible cutbacks in spending by consumers. Will people be traveling as much? Will they be buying new homes, cars, or appliances? Conversely, are there companies or industries that you think will do well given the current economic and interest rate environment? Are there companies whose products or services are relatively insensitive to interest rates, whose prospects depend

more on their own execution, or that might actually benefit if the economy were to slow?

Another area to consider is dividend yields. If income is your primary investment focus, is the dividend rate from your stocks competitive with bond yields? Has your tax situation changed? If so, does your new status have any implications for your preference for capital gains, dividends, or interest payments?

### **Remember the rest of the world**

Interest rates also can affect the strength of the dollar compared to other currencies. If the dollar weakens, that could favor U.S. companies that do much of their business overseas. It also might mean it's time to reexamine the balance between your U.S. and international holdings. However, be careful; in some cases, stock mutual funds devote part of their holdings to foreign companies. That could mean that the portion of your portfolio that's in foreign investments might be larger than you realize.



### **Consider your asset allocation**

This might also be a good time to reexamine how your assets are divided among various types of investments. If you're concerned about stability, you could increase the amount you've invested in bonds or cash. If you feel confident that you can ride out any volatility and are more focused on long-term growth, you might keep an eye on stocks you'd like to buy, especially if they're available at bargain prices. It's a good idea to periodically revisit your asset allocation. The end of the year, combined with a possible shift in the Fed's outlook, could provide an opportune time to take a broad look at your portfolio.

If you decide changes are needed, you can make gradual alterations by:

- Adjusting only a portion of your bond or stock holdings
- Shifting allocations over a period of time, using dollar-cost averaging
- Directing only new money into assets that may benefit from current interest rates

## Business or Hobby--Proving You Mean Business

Do you have a hobby--an activity you do simply because you love doing it--that also earns you income? That income, as you probably already know, must be reported on your annual income tax return. What you may not know is that sometimes a hobby can be more than just a hobby--it can be a business. On the flip side, however, a legitimate business suffering losses may be classified as merely a hobby, a disadvantage for tax purposes.

### The bright side

According to the IRS, a hobby is an activity pursued for pure enjoyment, regardless of the cost, while a business is a for-profit activity; any enjoyment you get from the business is irrelevant. Profit motive is the key difference. Since determining profit motive can be highly subjective, the IRS uses this rule of thumb: Profit motive is presumed if you earn net income (income minus expenses) in three out of five consecutive years (although the IRS can still rebut this presumption).

If your income-producing activity qualifies as a business, you're entitled to deduct qualified business expenses, such as the home office expenses and depreciation, even if they exceed the income produced by your hobby business. In other words, you can use hobby business losses to offset income from other sources.

These tax rules can be a great advantage if you want to turn your hobby into a business. But these same rules sometimes work against taxpayers who are trying to get a new business off the ground.

### The dark side

Just as steady net income is evidence of a bona fide business, reporting a net loss in three out of five years is evidence of a not-for-profit hobby. Although there is no presumption, this is a red flag that may result in closer scrutiny by the IRS or even trigger an audit.

If an activity is classified as a hobby, expenses can only be used to offset income generated by that activity; losses are not allowed. Further, hobby expenses, together with other miscellaneous expenses, must equal more than 2% of your adjusted gross income before they can be deducted.

This can be a huge disadvantage to young businesses, which normally incur losses in their first years of existence. Fortunately, you can still convince the IRS that you mean

business and intend to make a profit.

### The gray area

The IRS will look at the following nine factors to determine whether you have a profit motive:

1. Whether you run the activity in a business-like manner
2. How much time and effort you put into making a profit
3. Whether you depend on the activity for your livelihood
4. Whether your losses were sustained due to circumstances beyond your control
5. Whether you changed your operating methods to improve profitability
6. Whether you or your advisors have the knowledge needed to carry on a successful business
7. Whether you successfully made a profit in similar activities in the past
8. Whether the activity makes a profit in some years, and how much
9. Whether you can expect to make a profit in the future from the appreciation of assets used in the activity

### Practically speaking

What are some practical things you can do to make sure your activity is classified as a business and not just a hobby? Here are a few:

- Have a business name, and put it on stationery, business cards, and invoices
- File a DBA (doing business as) form with your local city/town or county, or incorporate
- Have a separate business phone/fax line
- Open a separate business bank account, and get a separate credit card
- Keep receipts, along with a good set of books and records
- Prepare a business plan
- Get expert advice

See IRS Publication 535, *Business Expenses*, and consult your tax professional for more information.

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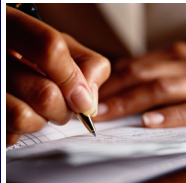
### ***Buying time to prove your business is profitable***

*By filing IRS Form 5213, Election to Postpone Determination as to Whether the Presumption Applies That an Activity is Engaged in for Profit, you can elect to have the IRS wait until five years are up before examining the profitability of your business.*



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## Ask the Experts



### How does an UGMA/UTMA custodial account work?

An UGMA/UTMA custodial account is a special type of account that allows a minor child to legally hold money or other property, such as stock or real estate, that the child would not otherwise be able to hold in his or her own name. It's governed by a particular state's Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). Most states have enacted an UTMA because it allows for more types of property to be held in the account, and the account can remain open longer than with an UGMA.

A custodial account can easily be opened at a bank or other financial institution using a common form. Central to the operation of a custodial account is the custodian, who is responsible for contributing money or property to the account, managing these assets, and withdrawing from the account when necessary. Typically, the custodian is the parent, but it's possible for another person or even a bank (for a fee) to act as the custodian.

Custodial accounts have several unique features. Any money or property placed in the account is considered an irrevocable gift to the child. (Gifts qualify for the federal annual gift tax exclusion, which means you can gift \$12,000 per year to the account without incurring gift tax.) Withdrawals from the account can only be made for the child's benefit.

Any income earned by assets in the account is taxed to the child under the "kiddie tax" rules--for children under age 18, the first \$850 of investment income is tax exempt, the next \$850 of investment income is taxed at the child's rate (usually 10%), and anything over \$1,700 is taxed at the parent's rate. For children 18 and older, the first \$850 of investment income is tax exempt, and anything over \$850 is taxed at the child's rate.

When the child reaches the relevant age (generally 21 or 25 for UTMA accounts, and 18 for UGMA accounts) the custodianship ends and the child receives sole control of all the assets in the account.