

# Nexus Financial Monthly

March 2010

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Hi everyone,

We hope you enjoyed the Olympics the last couple of weeks. It was exciting to watch all those talented athletes and to hear the background of many of their stories!

March is finally here and we hope to put the snowiest month ever behind us! Just keep thinking that spring is only a few weeks away!

We hope you enjoy some of these items of interest. Please let us know if you wish to get more information on a topic.

Take care and stay warm!

Dick, Dave, Lynn and Kathy

## **In this issue:**

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## The First-Time Homebuyer Tax Credit



Recent changes to the first-time homebuyer tax credit mean you might be able to benefit from the credit, even if you're not actually a first-time homebuyer. To take advantage of the credit, however, you have to act by May 1. Here are the basics as they apply to home purchases in 2010.

### **Qualifying for an \$8,000 credit**

If you, and your spouse if you're married, haven't owned a principal residence in 3 years, you may qualify for a credit worth 10% of the purchase price of a home, up to \$8,000 (\$4,000 if you're married and file a separate federal income tax return). The home has to be your principal residence, and must be purchased before May 1, 2010. If you enter into a written binding contract before May 1, 2010, you can still qualify for the credit if you close on the home before July 1, 2010.

### **Qualifying for a \$6,500 credit**

If you, and your spouse if you're married, have maintained the same principal residence for at least 5 consecutive years in the previous 8 years, you may qualify for a credit if you purchase a new principal residence. While the credit remains 10% of the purchase price of the new home, it's capped at \$6,500 (\$3,250 if you're married and file a separate federal income tax return). As with the \$8,000 credit, the home must be purchased before May 1, 2010 (or you must close on the home by July 1, 2010, after entering into a written binding contract before May 1, 2010).

### **Limitations**

There are several limitations that apply (the same limitations apply to both the \$8,000 credit and the \$6,500 credit):

- The credit is reduced if your modified

adjusted gross income (MAGI) exceeds \$125,000 and is completely eliminated if your MAGI reaches \$145,000. If you're married and file a joint return, the credit is reduced if your joint MAGI exceeds \$225,000 and is eliminated if your MAGI reaches \$245,000.

- You can't claim a credit if the purchase price of your principal residence exceeds \$800,000.
- You can't claim a credit if you're under age 18 at the time of purchase (unless you're married and your spouse is at least 18), or if you can be claimed by someone else as a dependent.
- You can't claim a credit if you purchase a principal residence from someone who is closely related to you or your spouse.
- You can't claim the credit if you're a non-resident alien.

### **Payback requirements**

Generally, if you qualify for the credit as a result of a 2010 home purchase, you won't have to worry about repaying the credit. There's one important exception, however: if the home ceases to be your principal residence in the 36 months following the purchase, you'll have to pay the credit back. (If you're married at the time of purchase, the home must remain the principal residence of *either* you *or* your spouse for the 36-month period.) If you have to pay back the credit, you'll do so on the tax return for the year in which the home ceased being your principal residence.

### **Treating a 2010 purchase as made in 2009**

If you purchase a qualifying principal residence in 2010, you can elect to treat the purchase as if it occurred on December 31, 2009, allowing you to claim the credit on your 2009 federal income tax return.





### Note on 529 plans

*Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

## 529 College Savings Plans vs. Roth IRAs

According to an article in *The Wall Street Journal* ("More Parents Are Becoming 529 Dropouts," November 11, 2009), after the 2008/09 market collapse, some investors--and financial advisors--have reduced their reliance on 529 plans. Some of this pullback can be attributed in part to a broader retreat from the stock market as a whole. But another part can be attributed to parents who have opted to trade the tax benefits of 529 plans for college savings vehicles that don't have a "must-be-used-for-college" restriction. And as parents seek to save for their own retirement too, one such vehicle is a Roth IRA. So, just how does a favorite of the college savings world, a 529 college savings plan, stack up to a favorite of the retirement savings world, a Roth IRA, as an education-funding vehicle?

### Tax benefits

Both 529 college savings plans and Roth IRAs offer federal tax-free earnings if certain conditions are met (and most states follow this tax treatment), but only 529 plans offer the possibility of a state tax deduction too.

For 529 plans, earnings are tax free at the federal level if the distribution is used to pay the beneficiary's qualified education expenses --a broad term that includes tuition, fees, room and board, books, and computers--at any accredited college in the United States or abroad. If the distribution is used for any other purpose, earnings are subject to income tax and a 10% federal penalty tax.

For Roth IRAs, earnings are tax free at the federal level if the distribution is "qualified." A distribution is qualified if a five-year holding period requirement is met *and* one of the following conditions is met: (1) you are at least age 59½; or the distribution is made (2) due to a qualifying disability; (3) to pay certain first-time homebuyer expenses; or (4) by your beneficiary after your death.

If you are younger than age 59½ and you have a taxable distribution, you will also pay a premature distribution tax (also called an early withdrawal penalty) equal to 10% of the earnings portion of the distribution. But there are exceptions to this penalty, and one is if the money withdrawn is used to pay your child's qualified higher education expenses.

Bottom line: if you withdraw money before age 59½ to pay your child's college expenses, you'll generally owe income tax on the earnings, but not an early withdrawal penalty.

However, you may not end up owing income tax on the earnings, because Roth IRA distributions generally aren't taxed as earnings until the principal has been fully withdrawn. (By contrast, a distribution from a 529 plan is considered part principal and part earnings.)

### Financial aid

There is an important difference here. Under federal financial aid rules, 529 plans are counted as a parent asset (if the parent is the account owner), and 5.6% of all parent assets are deemed available for college costs. By contrast, the federal aid methodology doesn't count retirement assets in determining aid eligibility. So a Roth IRA won't impact the amount of federal aid your child may be eligible for. However, although Uncle Sam doesn't count retirement assets, colleges typically do when awarding their own institutional aid.

### Investment choices

Roth IRAs have the edge here--you can choose from a wide range of investments to fund your Roth IRA, and you can buy and sell investments whenever you like. But with a 529 plan, you are limited to the investment options offered by the plan. If you're unhappy with the investment performance of the options you've chosen, most plans let you change the investment options for your future contributions at any time, but for existing contributions, you can only change investment options once per year (twice per year in 2009 only). In 2008 and 2009, this restriction proved costly for many 529 account owners: having reached their limit on investment changes for the year, they were unable to make further changes in response to deteriorating market conditions.

### Lump-sum contributions and eligibility

If you have a lump sum to contribute, 529 plans allow individuals to gift up to \$65,000 in 2010 (\$130,000 for married couples) and avoid gift tax if certain conditions are met. By contrast, Roth IRAs have a contribution limit in 2010 of \$5,000 (\$6,000 for individuals age 50 or older). And your ability to contribute to a Roth IRA depends on your income level. But anyone can contribute to a 529 plan--there are no restrictions based on income.

### Bottom line

Whether a Roth IRA or a 529 college savings plan is best for your college savings depends on your personal circumstances and the factors discussed here.

## 10 Financial Terms Everyone Should Know

Understanding financial matters can be difficult because of the jargon used. Becoming familiar with these ten financial terms may help make your financial picture clearer.

### 1. Time value of money

The time value of money is the concept that money on hand today is worth more than the same amount of money in the future because the money today can be invested to earn interest. *Why is it important?* Understanding that money today is worth more than the same amount in the future can help you evaluate and compare investments that offer returns at different times.

### 2. Market volatility

Market volatility measures the rate at which the price of a security moves up and down. If the price of a security historically changes rapidly over a short period of time, its volatility is high. Conversely, if the price of a security rarely changes, its volatility is low. *Why is it important?* Understanding volatility can help you evaluate whether a particular investment is suited to your investing style and risk tolerance.

### 3. Inflation

Inflation reflects any overall upward movement in the price of goods and services in the economy. *Why is it important?* Because inflation generally pushes the cost of goods and services higher, any estimate of how much you'll need in the future—for example, how much you'll need to save for retirement—should take into account the potential impact of inflation.

### 4. Asset allocation

This strategy means spreading investments over a variety of asset categories, such as equities, cash, bonds, etc. *Why is it important?* How you allocate your assets depends on a number of factors, including your risk tolerance and your desired return. Diversifying your investments over asset classes can potentially help you manage risk and volatility.

### 5. Net worth

Net worth is what your total holdings are worth after subtracting all of your financial obligations. *Why is it important?* Your net worth will probably fund most of your retirement years. Therefore, the faster and bigger your net worth grows, the earlier and more comfortably

you will be able to retire. Once retired, preserving your net worth to last through your retirement years is your goal.

### 6. Five C's of credit

These are character, capacity, capital, collateral, and conditions. They're the primary elements lenders evaluate to determine whether to make you a loan. *Why is it important?* With a better understanding of how your banker is going to view and assess your creditworthiness, you will be better prepared to deliver appropriate information to obtain the loan you want or get a better interest rate.

### 7. Sustainable withdrawal rate

Sustainable withdrawal rate is the maximum percentage that you can withdraw from an investment portfolio each year to provide income that will last, with reasonable certainty, as long as you need it. *Why is it important?* Your retirement lifestyle will depend not only on your assets and investment choices, but also on how quickly you draw down your retirement portfolio.

### 8. Tax deferral

Tax deferral refers to the opportunity to pay income taxes in the future for investment interest and appreciation earned in the current year. *Why is it important?* Tax-deferred vehicles like IRAs and annuities produce earnings that are not taxed until withdrawn. This allows those earnings to compound, further adding to potential investment growth.

### 9. Risk/return trade-off

This concept holds that, in order to achieve a higher personal investment return, you must be willing to accept greater risk. *Why is it important?* When considering your investments, the goal is investing to get the greatest return for the level of risk you're willing to take, or to minimize the risk involved in trying for a given return.

### 10. Annuity

An annuity is a contract where you pay money to an insurance company in return for the insurer's promise to pay it back, with interest, in the future. *Why is it important?* You can supplement other retirement savings with tax-deferred annuity funds, and you can add to your retirement income with payments from your annuity for a fixed period of time or for the rest of your life.



### Ten more terms to look up

- Equity
- Gross Domestic Product
- Working capital
- Recession
- Triple net lease
- Net income
- Roth IRA
- Earned income
- Debt/equity ratio
- P/E ratio



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## Ask the Experts



### How do I unwind my QPRT?

Given the state of the economy, it's not uncommon for real estate that has been transferred to a qualified personal residence trust (QPRT) to have experienced less than anticipated appreciation or even depreciation. Consequently, one of the purposes of the QPRT--removing future appreciation from an estate--may go unachieved. Some grantors in this position may be inclined to "unwind" (undo) the QPRT. That, however, may not be the best option.

If you unwind the QPRT, you will have wasted any payment of federal gift tax or gift tax exemption that you may have used on the original transaction.

For example, say you transferred your primary residence valued at \$500,000 to a QPRT with a 20-year term when you were 40 years old and the Section 7520 rate was 4%. You made a gift of approximately \$205,000, and you either paid gift tax on that amount or you used

up \$205,000 of your \$1 million gift tax exemption. Either way, you will have squandered that amount because you won't get that back when you unwind the QPRT.

You may be better off keeping the QPRT. Even if there will be zero appreciation in the property, you might still enjoy some tax savings if you let the QPRT continue. That's because when the IRS values the gift, it assumes there will be no appreciation in the property; *plus*, it gives you a discount because there's a chance you may die during the trust term. So, if you outlive the trust term, you will still enjoy the benefit of that discount.

Not only that, but when the QPRT terminates, you will have to pay the remainder beneficiaries fair market rent. These payments will reduce your estate even further.

That said, if you still want to unwind the QPRT, your best option may be to invalidate the QPRT by ceasing to use your home as a primary residence (a requirement for a valid QPRT). How? Sell the home or rent it out.

### My QPRT has terminated. What do I do now?



If the grantor outlives the term of a QPRT, the residence passes to the remainder beneficiaries. At this time, several things need to happen. Here's a quick checklist:

- **Transfer title of residence:** The trustee of the QPRT must transfer ownership of the residence from the name of the trust into the names of the remainder beneficiaries. This is done by recording a new deed in the registry where the property is located.
- **Pay fair market rent:** If you want to continue to live in the residence full-time, or if you want to use it periodically, such as for vacations, you'll have to pay fair market rent to the remainder beneficiaries. This will help to further reduce the value of your estate federal gift tax free, or without using any more of your \$1 million lifetime gift tax exemption, because the rent payments won't be considered gifts. Note that it's important to execute a written lease.
- **Shift payment of expenses for the property to the remainder beneficiaries:** During the term of the trust, the grantor typically continues to pay the expenses for upkeep of the home, such as maintenance, taxes, and repairs. When the QPRT terminates and ownership shifts to the remainder beneficiaries, so does the obligation to pay those expenses. Note that the income tax deduction for real estate taxes shifts as well.
- **Do not repurchase the residence:** An IRS ruling prohibits the grantor, the grantor's spouse, and any entity benefiting the grantor or the grantor's spouse from repurchasing the residence either during the trust term or afterwards.