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JOHNSTON INVESTMENT COUNSEL
TRUSTED FIDUCIARIES & FEE-ONLY ADVISORS

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Exceptions to the Early Distribution Penalty

Generally, taxable amounts you withdraw from an IRA, 403(b), or qualified retirement plan before age 59½ are subject to a federal 10% penalty tax (and possibly a state penalty tax, too) in addition to any federal (and possibly state) income tax due. SIMPLE IRAs are subject to a 25% penalty for premature distributions made during the first two years of participation. Fortunately, Section 72(t) of the Internal Revenue Code lists several exceptions to this premature distribution penalty tax.

Exceptions applicable to all plans

A qualified transfer or rollover from one retirement plan to another generally isn't subject to the penalty tax. Also, distributions made to your beneficiary or your estate after your death aren't subject to the early withdrawal penalty. Other exceptions include:

- Distributions not exceeding the amount of your tax-deductible unreimbursed medical expenses.
- Distributions made because of a qualifying disability.
- Amounts levied by the IRS directly from your qualified retirement plan. This exception doesn't apply if you withdraw funds from a plan to pay the IRS.
- Qualified reservist distributions pursuant to the Pension Protection Act of 2006.

Exceptions applicable only to IRAs

The 10% penalty doesn't apply if the distribution is made for you, your spouse, or your child or grandchild to pay qualified postsecondary education expenses, such as tuition, and room and board. If you're a first-time homebuyer, you can take pre-59½ IRA withdrawals if they're used to pay the costs of acquiring, constructing, or reconstructing your principal residence up to a $10,000 lifetime limit. You also can take penalty-free IRA distributions up to the cost of health insurance premiums you pay during a qualifying period of unemployment.

Exceptions for non-IRA retirement plans

Distributions made pursuant to a qualified domestic relations order (QDRO) are not subject to the penalty. Also, you can take penalty-free withdrawals from a qualified plan after separating from service with the employer maintaining the plan if your employment ends during or after the year you reach age 55. You may also be able to take qualifying distributions of dividends from your employer's employee stock option plan without penalty.

Substantially equal payments exception

An important exception that applies to all IRA and qualified retirement plans is the substantially equal periodic payments exception. To comply with this exception, you must withdraw funds from your retirement plan at least annually based on an IRS-approved distribution method. For qualified plans (but not IRAs), you also must have separated from service with the employer maintaining the plan.

There are three IRS-approved methods for calculating payments, but regardless of the method you choose, you generally can't change or alter the payments for five years or until you reach age 59½, whichever occurs later (although the IRS has held that owners can make a limited one-time switch between certain methods without incurring the penalty tax). Otherwise, if you modify the payments (e.g., by taking amounts smaller or larger than required distributions or none at all), you will be subject to the 10% premature distribution tax on the taxable portion of all pre-59½ distributions (unless another exception applies).

Federal Protection for Bank Deposits

Business coverage

The $250,000 limit does not necessarily apply to non-interest bearing deposit accounts, such as payroll processing accounts used by businesses. The FDIC's Temporary Liquidity Guarantee Program, scheduled to expire at the end of 2009, gives banks the option of offering unlimited protection for such accounts. Check with your bank to find out what it provides.

Credit union coverage

The National Credit Union Share Insurance Fund (NCUSIF) offers protection, backed by the full faith and credit of the U.S. Treasury, for credit union accounts. The limits are similar to those of the FDIC: $250,000 per individual account per institution.

In the wake of turbulence in the financial markets and recent legislation, it's worth reviewing the legal protections available for assets held by banks.

What's protected?

Bank deposits are protected by the Federal Deposit Insurance Corporation (FDIC), an independent agency backed by the full faith and credit of the U.S. government. FDIC insurance covers both demand deposits, such as checking, NOW, savings, and money market deposit accounts, and time deposits, such as certificates of deposit (CDs). It covers both principal and any interest accrued as of the date that an insured bank closes.

How safe is it?

According to the FDIC, no depositor has ever lost a penny of funds that were covered by FDIC insurance.

FDIC coverage does not include mutual funds, stocks, bonds, life insurance policies, annuities, or other securities, even if they were bought through an FDIC-insured bank. It also does not cover U.S. Treasury securities, though these are backed separately by the full faith and credit of the U.S. Treasury. Finally, the FDIC does not insure safe-deposit boxes, though if a bank were to fail, the FDIC would typically either arrange for transfer to another bank or notify you to retrieve the contents.

How much is insured?

The Emergency Economic Stabilization Act of 2008 temporarily increased the amounts that are FDIC insured at an individual bank or savings and loan. The legislation states that the increase in standard coverage is effective through December 31, 2009, though there has been widespread discussion of making the increased limits permanent.

The previous limit of $100,000 per individual per bank was increased to $250,000. The $250,000 limit applies to single-owner accounts, such as those held in one person's name, those established for another individual (e.g., an UTMA or escrow account), sole-proprietor ("DBA") accounts, and accounts established for the estate of a deceased person.

You can't increase your protection just by opening multiple accounts in your name at the same bank (for example, splitting money between a checking and a savings account, or opening accounts at more than one branch).

What if I have more than $250,000?

The simplest approach is to have accounts at more than one bank. However, your coverage at an individual bank depends on how accounts are owned; different types of accounts are insured separately. You can exceed the $250,000 limit as long as the deposits represent different categories of ownership. For example, a joint account qualifies for up to $250,000 of coverage for each person named as a joint owner. That coverage is in addition to the $250,000 maximum coverage for each person's aggregated single-owner accounts at that bank. For example, a married couple with three accounts at one bank--they each have $250,000 in an individual account, and they also have $200,000 in a joint account--would qualify for insurance on the entire $700,000.

The limit on the amount protected in one or more retirement accounts at one bank also is $250,000; this is separate from the $250,000 coverage of individual accounts. (Remember, however, that FDIC insurance applies only to deposit accounts, not to any securities held in an IRA or other retirement account.) An online calculator at the FDIC website, www.fdic.gov, can help you estimate the total coverage on your deposit accounts.

Additional safety nets

In some states, a state-chartered savings bank is required to have additional insurance to cover any losses beyond the FDIC limits. Some banks also may participate in the Certificate of Deposit Account Registry Service (CDARS), which enables a bank to spread large CD deposits among multiple banks while keeping the amount at each individual bank within FDIC limits. Paying attention to your bank balances and account ownership can help protect you in a worst case scenario.

Rethinking Your Retirement Game Plan

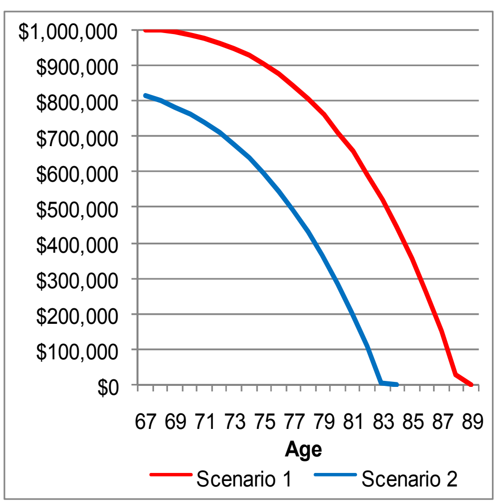
Periodic market downturns may result in significant investment losses, particularly within retirement accounts. If you are faced with this situation, you may have to reconsider when, or even if, you can retire.

The effects of a decline

Historically, the stock market has had its ups and downs. How any substantial market change impacts your retirement outlook may depend on how close you are to retirement. If you plan on working and contributing to your retirement savings for many more years, you may have time to recoup losses to your accounts due to poor investment performance. But if you're closing in on retirement or you're already there, a dip in your savings may affect how much you can safely withdraw and how long your savings can last.

To demonstrate, assume you and your spouse have $1 million in retirement savings, expect an annual average rate of return of 7%, and estimate that you presently need $100,000 annual retirement income for both of you to live comfortably, of which $30,000 will come from Social Security. Presuming withdrawals increase by 3% each year to offset the effects of inflation, your savings will last about 22 years, as shown in the chart below (scenario 1).

However, a decrease of 14% in the value of your savings in one year shortens the duration of your savings by over 4 years (scenario 2). (This example is hypothetical and does not reflect a specific investment or strategy.)



What are your options?

If you're fortunate, even a significant decrease in savings may not impact your retirement income dramatically. You may have other sources of fixed income such as company-sponsored pensions, so you won't need to rely on your savings to provide much of your income. Or you may be able to offset the effect of diminished savings by spending less -- forgoing that planned cruise, putting off buying that new car, or making smaller gifts to children and grandchildren, for example. But if you rely on your savings for most of your retirement income, considerable investment losses of the magnitude recently experienced can require major lifestyle changes. Here are a few ideas to help you cope with the erosion of your retirement savings.

Continue working

You may have to delay the retirement party a little longer. Postponing retirement lets you continue to add to your retirement savings, which can offset losses caused by poor investment performance. Also, working allows you to delay withdrawing from your savings. That could allow more time for your retirement accounts to recover from investment-related losses.

Delay taking Social Security

Social Security may be the only source of fixed income you'll have in retirement. If you delay applying for benefits until your full retirement age, you can get as much as 30% more in monthly payments compared to taking benefits early. And, for each year you defer benefits past your full retirement age (between 65 and 67, depending on when you were born) to age 70, your benefit is increased by 8%. That could mean an additional $500 or more in your benefit check each month--and that doesn't include annual cost of living increases.

Consider fixed income investments

Investments such as single premium immediate annuities (SPIAs) provide an income for the rest of your life, or for the combined lives of you and your spouse. However, while the income is dependable (subject to the claims-paying ability of the annuity issuer), you generally don't have access to the money you paid for the SPIA and you may not be able to change the amount of income payments or their duration once you've started.

By 2016, the number of working people over age 65 is expected to increase by 80%.

Source: U.S. Bureau of Labor Statistics

If you delay your Social Security benefit, don't forget to sign up for Medicare at age 65.

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Ask the Experts

Can I get an estimate of my child's financial aid eligibility before we officially apply for aid?

Yes. Last year, the U.S. Department of Education launched an online financial aid tool to help families better prepare for the cost of college. Called the FAFSA4caster, it's modeled on the government's official aid application, the FAFSA (Free Application for Federal Student Aid). The tool examines a family's financial data and estimates how much aid a student might expect to get. To use the tool, visit www.fafsa4caster.ed.gov.

To complete the FAFSA4caster, gather the following information for you and your child:

- Social Security numbers
- Federal tax information or tax returns, including W-2 information
- Information on savings, investments, and business and farm assets
- Records of any untaxed income (such as Social Security or welfare benefits)

To get as accurate an estimate as possible, you should answer all the questions on the tool, even if you have to estimate or guess.

Using the FAFSA4caster isn't exactly a quick process, but when you're ready to apply officially for federal aid, the FAFSA4caster will automatically transfer all of your data (that's password protected and saved securely) to your online FAFSA application, saving you the hassle of keying in all your information again. And, if your financial circumstances change, you'll get the opportunity to update any answers on the FAFSA that you originally submitted on the FAFSA4caster.

By providing an advance estimate of federal aid eligibility, the FAFSA4caster can help you forecast how much money you and/or your child may need to come up with to meet college costs--information that can also come in handy in the college selection process. By having an idea of the numbers ahead of time, you can help minimize unwelcome surprises.

When does my child need to submit financial aid applications?

The FAFSA is the federal government's financial aid application. It should be submitted as soon as possible after January 1 of your child's senior year in high school (and after every January 1 in any year your child is seeking aid). Several financial aid programs operate on a first-come, first-served basis, so getting your child's application in early increases his or her chances of securing aid.

Your FAFSA relies on the previous year's tax information. For example, a FAFSA filed in early 2009 would rely on information from your 2008 tax return. Because most parents have not yet completed their federal income tax return in January, one option is to complete an estimated tax return, which can then be used to complete the FAFSA, a practice the federal government considers acceptable.

You can fill out the FAFSA on paper or online at www.fafsa.ed.gov. A paper version takes about four to six weeks to process; the online version takes only one week. The better route is the online application. Not only is the processing faster, but the form notifies you of inputting errors and does the math as you go along. Plus, if you've previously filled out the FAFSA4caster, the government's online financial aid tool, the online FAFSA will be automatically populated with your data.

Along with the FAFSA, some colleges require you to submit one or more additional financial aid forms to determine your child's eligibility for the college's own grants, loans, and scholarships. These colleges may have their own forms, or, more commonly, they require you to complete the College Board's PROFILE application. The PROFILE application can be submitted in the fall, before the FAFSA, but it's a good idea to check with individual colleges regarding their submission rules. Go to profileonline.collegeboard.com to file the PROFILE online.