JOHNSTON INVESTMENT COUNSEL
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August, 2009

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Social Security: What Does the Future Hold?

Each year, the Social Security and Medicare trustees issue a report on the financial health of these two programs. The news hasn't been good. According to this year's report, in 2016, Social Security will begin paying out more money than it takes in, and will be able to pay promised benefits only until 2037; afterwards, the trust fund reserves will be exhausted and payroll tax income will be enough to finance only 76% of scheduled benefits until 2083.

Social Security reform has been a political hot potato, but that may be about to change. The decline of the financial markets has led to renewed focus on the importance of Social Security income to retirees, and on the need to address the growing burden that Social Security is placing on the federal budget.

> ***You can find the annual trustees report on the Social Security Administration's website, www.socialsecurity.gov.***

Proposals to stabilize Social Security

Despite fears that Social Security will not be around for future generations, there have been no calls to eliminate Social Security, and the focus is on making the program sustainable. In fact, President Obama has repeatedly expressed his commitment to preserving Social Security. To help accomplish this, he favors a Social Security payroll tax on earnings above $250,000 (currently no Social Security payroll tax is assessed on earnings above a certain maximum, $106,800 in 2009). Many other potential solutions have also been suggested. For example, the Social Security Solvency Act of 2009, introduced in the Senate in February, proposes accelerating by five years the gradual increase in full retirement age to 67, and modifying the benefit calculation to reduce benefit growth. This year's trustees report mentions immediately increasing the payroll tax or reducing benefits as additional options.

The near future

The Congressional Budget Office (CBO) is projecting that for the first time since 1975, when cost-of-living adjustments (COLA) were first payable, Social Security beneficiaries will not receive an automatic increase next year (or for 2011), due to low inflation. According to the CBO, the absence of COLA will also affect the maximum earnings that are taxable for Social Security, because under the Social Security Act, the earnings maximum can only increase when COLA is payable. Therefore, the CBO is projecting that this year's earnings base of $106,800 will remain the same for the next two years.

Medicare beneficiaries will be affected too. By law, for individuals who have their Medicare Part B premiums withheld from their Social Security checks, premiums cannot rise more than COLA increases for Social Security. Consequently, no annual COLA means that standard Medicare premiums will remain at their current level of $96.40 per month for approximately 75% of Medicare beneficiaries. However, certain beneficiaries (those who do not have their premiums deducted directly from Social Security and those with higher incomes who pay higher income-related premiums) do not have this protection, and will see their premiums rise, perhaps substantially.

Stay informed

Most Americans rely on Social Security for at least a portion of their retirement income, but to ensure that Social Security will be able to pay promised benefits for many years to come, it's clear that the program must change. It's a good idea to follow the news to learn about legislative developments and model various income scenarios when developing your own retirement plan.

Refinancing Your Mortgage: Is It Worthwhile?

The Home Affordable Refinance program allows the refinancing of certain Fannie Mae or Freddie Mac mortgages so long as the new mortgage doesn't exceed 105% of your home's current market value. Additionally, if your existing mortgage payment doesn't include private mortgage insurance (PMI), you won't be required to buy it when refinancing.

Other considerations:

- *The interest you pay on a no-cash-out mortgage refinancing is tax deductible only to the extent as was the interest on your original mortgage.*
- *Refinancing may allow you to switch to a different type of mortgage (e.g., from an ARM to a fixed-rate mortgage) and/or a shorter mortgage term.*

Mortgage rates on 15- and 30-year fixed mortgages are at all-time lows. So, is now a good time to refinance your existing mortgage? That depends on several factors.

The first, of course, will be your loan-to-value ratio. In no-cash-out refinancing (where the amount of your new loan doesn't exceed the balance of your existing loan, plus points and closing costs, if applicable), you may be able to borrow as much as 95% of your home's value. However, if the value of your home has fallen below the amount of your existing mortgage balance, you may be unable to refinance at all, except through the American Recovery and Reinvestment Act of 2009's Home Affordable Refinance program (see sidebar). But let's assume your loan-to-value ratio is still "above water"--that is, the value of your home is still greater than your mortgage balance.

If you refinance your mortgage to a lower interest rate, you may save a substantial amount on your monthly mortgage payment--which will give you more money to put toward your savings goals or reducing your other expenses. This is one of the main reasons people consider refinancing their mortgages. But what other factors do you need to consider?

How much will it cost?

The cost of refinancing can include both points you pay and other expenses (called "closing costs") related to refinancing.

One point equals 1% of the amount to be financed. So, if the refinancing costs will include an up-front charge of 0.5 points and you're refinancing $200,000, you will incur a charge of $1,000 (special tax treatment applies to points).

Closing costs typically include an application fee, attorney's fee, appraisal fee, credit report fee, loan origination fee (which can be 1% or more of the amount you refinance), title search fee, and title insurance. These costs can vary from state to state. Get a "good faith estimate" from each potential lender and compare both closing costs and interest rates.

Be careful about lenders that advertise "no points, no closing costs" refinancing deals. Often these plans simply roll the closing costs into the amount to be refinanced, or come at a higher interest rate.

How long will it take to recoup the costs?

To determine your break-even point (the point at which you'll begin to save money after paying fees and closing costs), divide the amount of your monthly mortgage payment savings due to refinancing into the cost of refinancing; the result is your break-even point, expressed in months.

Example: *If you're saving $100 per month on your refinanced monthly mortgage payment, and your refinancing costs totaled $3,700, your break-even point is in 37 months.*

It makes sense to refinance if you're certain that you'll be able to recoup your refinancing costs while you're still living in your home. Ideally, you should recover your costs in one year or less.

A matter of term

In many cases, refinancing may mean taking out a mortgage with a new term equal to the *original* term of your refinanced mortgage, not equal to the *remainder* of the term on that mortgage. Depending on when you refinance, this can make a significant difference in the amount of interest you'll pay overall.

Example: *You have a $200,000 30-year fixed mortgage at 6%, with a monthly payment of $1,199. After 6 years, you have paid $69,131 in interest on that mortgage. At that point, you refinance your remaining principal balance of $182,796 for a new 30-year fixed mortgage at 5% with a monthly payment of $981. Over the life of that new mortgage, you will pay $170,468 in interest. So, your total interest payment will be $239,599 ($69,131 + $170,468). If you had stayed with your old mortgage at 6%, you would have paid a total of $231,676 in interest. Instead, by refinancing when you did, you'll pay an extra $7,923 ($239,599 - $231,676) in total mortgage interest.*

Because of this, you may want to consider applying the monthly mortgage payment savings after refinancing toward additional principal payments. By doing so, you can reduce both the term of your mortgage and the total interest you'll pay.

Crunch the numbers first

In many cases, refinancing looks attractive in the short term because your monthly mortgage payment will be lower--and that can be important to your monthly budget. But will it really save you money to refinance, both in the short run and in the long run? That depends on many factors. Look at them all before you make your decision.

Estate Planning Opportunities in a Down Market

A down market can mean tough times, but it can also present unique opportunities to minimize property transfer (gift and estate) taxes. While owning assets that are losing value might seem like a bad thing, it may actually be a great time to reduce your taxable estate by gifting those assets to beneficiaries. That's because current low asset values and interest rates enable you to make gifts at a lower gift tax cost. And, if and when the market rebounds, those assets will be growing in your beneficiary's estate and not in yours. Here are a few gift-giving techniques that take advantage of today's economic climate.

Note: *This article discusses federal tax rules only. Individual states impose their own property transfer taxes using rules that may be different from the federal rules.*

Basic gifting

Each year, you can make gifts of up to $13,000 to anyone you want, to as many people as you want, tax free under the annual gift tax exclusion. You can give away twice that amount if both you and your spouse make the gifts together (this is called gift splitting). And, you can give away an unlimited amount if you pay tuition or medical bills on behalf of another person (just be sure to make these payments directly to the school or health-care provider).

Family loans

You can lend money to your children at the current IRS minimum interest rate (known as the AFR, which changes monthly), and then potentially forgive an amount equal to the gift tax exclusion each year. (The gift tax exclusion amount is adjusted for inflation; $13,000 is the figure for 2009.)

Grantor retained annuity trust (GRAT)

A GRAT is an irrevocable trust with a specified term (e.g., 10 years) into which you gift assets that you expect will greatly increase in value in the future. You receive annuity payments during the trust term, and at the end, your beneficiaries receive any remaining property.

The transfer of assets to the GRAT is a taxable gift to the trust beneficiaries. The value of the gift for tax purposes is determined based on the current IRS rate (known as the 7520 rate, which also changes monthly).

Tax savings are achieved because the annuity payments are calculated to result in a gift tax value of zero. It's anticipated, however, that the actual interest earned will be higher than the 7520 rate, leaving a substantial value in the GRAT at the end of the term. This remaining value is passed on to your beneficiaries tax free.

Intentionally defective grantor trust (IDGT)

An IDGT is an irrevocable trust that has a purposeful flaw (i.e., you retain some control over the trust) so that you, and not the trust entity, pays the income taxes on trust income (thus, an IDGT is ideal when you want to transfer income-producing assets). Even though you retain some control over the trust, IDGT assets will generally not be included in your taxable estate at your death.

You sell assets to the IDGT in return for an installment note, with interest calculated based on the current AFR. There is no gift tax because it is a "sale" (except for an initial gift that "seeds" the trust). However, because you and the trust entity are considered the same taxpayer, no gain is recognized on the sale, and interest you receive under the note is not considered taxable income.

Tax savings are achieved because, hopefully, the value leaving your estate via the sale will exceed the value returned to your estate via the note. You also reduce your estate by paying the income taxes on IDGT income.

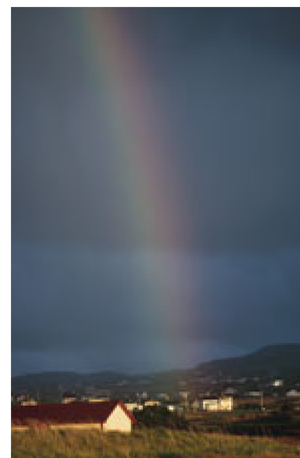
Charitable lead trust (CLT)

A CLT is an irrevocable trust with both charitable and noncharitable beneficiaries. It's called a lead trust because it is the charity that is entitled to the first or lead interest from the trust property. After the specified term, the remaining trust property passes to you or another named noncharitable beneficiary.

At the time assets are placed into the CLT, you receive a current gift tax deduction equal to the present value of the income stream that will be going to the charity. The interest rate used is based on the current 7520 rate. The lower the interest rate, the higher the deduction. As with a GRAT or IDGT, it is hoped that the CLT assets will appreciate beyond the 7520 rate, allowing the excess to pass tax free.

Conclusion

These gifting strategies, and others, can turn this economic downturn into a mixed blessing.



A down market can mean tough times, but it can also present unique opportunities to minimize property transfer (gift and estate) taxes. While owning assets that are losing value might seem like a bad thing, it may actually be a great time to reduce your taxable estate by gifting those assets to beneficiaries.

Estate planning tools that are generally less attractive when interest rates are low:

- *Qualified personal residence trust (QPRT)*
- *Charitable remainder annuity trust (CRAT)*

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Ask the Experts

Can creditors reach my 401(k) plan account?

The extent to which your 401(k) plan account is protected from the claims of your creditors depends on two things: (1) whether your plan is covered by the Employee Retirement Income Security Act of 1974 (ERISA), and (2) the type of claim (in bankruptcy or outside of bankruptcy).

Most 401(k) plans are covered by ERISA. ERISA contains an "anti-assignment" rule that provides broad protection from creditors' claims. This anti-assignment rule applies whether you've declared bankruptcy or not--no bankruptcy or judgment creditor can reach your 401(k) plan account, if the plan is governed by ERISA. (There are several important exceptions to ERISA's anti-assignment rule. For example, the IRS may be able to levy against your 401(k) plan account for failure to pay your taxes. And a court can issue a qualified domestic relations order (QDRO) that will require the plan to pay all or part of your plan benefit to your former spouse.)

But again, this broad protection applies only if your 401(k) plan is governed by ERISA. Some plans are not. For example, a plan that covers only a business owner, or the owner and his or her spouse (i.e., an "individual 401(k)" plan), isn't covered by ERISA. Plans sponsored by governmental entities and certain churches aren't governed by ERISA either.

If you participate in one of these plans, you won't be able to rely on ERISA at all for protection from your creditors. What happens then? Your 401(k) plan account will still be fully protected from your creditors if you declare bankruptcy, as a matter of federal law. But whether you'll be protected from creditor claims outside of bankruptcy will depend on the laws of your particular state. While most states provide at least some protection for retirement accounts, some do not. You'll need to consult a qualified attorney to determine how the laws of your state apply to your particular situation.

Can creditors reach my IRA assets?

Traditional and Roth IRAs generally aren't subject to ERISA (we'll discuss SEPs and SIMPLE IRAs later). Therefore, they don't qualify for the broad protection from creditors that ERISA typically provides. However, even though ERISA doesn't apply, federal law still provides protection for up to $1,095,000 (in 2009) of your aggregate traditional and Roth IRA assets if you declare bankruptcy.

If you've rolled any funds over from a 401(k) or 403(b) plan (or another qualified plan) to your IRA, then those assets, and any earnings on them, aren't subject to the $1,095,000 cap, and are fully protected. (You may want to consider setting up a separate IRA to hold rollover funds so that you can more easily identify the amount eligible for full protection if you declare bankruptcy.)

But, with IRAs, federal law governs only bankruptcy claims. Whether you'll have protection from your creditors outside of bankruptcy will depend on the laws of your particular state.

Different rules apply to SEP IRA and SIMPLE IRA plans. SEP and SIMPLE IRAs are fully protected from your bankruptcy creditors under federal law--the $1,095,000 limit doesn't apply. But whether or not your SEP/SIMPLE IRA has protection from your creditors outside of bankruptcy may depend on whether your plan is governed by ERISA (because it covers one or more common law employees).

If your SEP/SIMPLE IRA plan isn't subject to ERISA, whether you'll have protection from your creditors outside of bankruptcy will likely depend on the laws of your particular state.

But if your SEP/SIMPLE IRA is governed by ERISA, whether you'll have protection under state law from creditors outside of bankruptcy is not clear. These plans are not covered by the part of ERISA that protects assets from creditors generally. But they *are* subject to the part of ERISA that preempts state laws. So state laws that may have provided protection for your SEP or SIMPLE IRA account from nonbankruptcy creditors may not be available.

These rules are obviously quite complicated. Be sure to consult a qualified attorney if creditor protection is important to you.