Johnston Investment Counsel

Trusted Fiduciaries & Fee-Only Advisors

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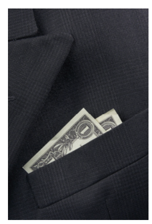
Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

How to Double the Power of Your Tax Refund

Filing your taxes may be a dreaded chore, but receiving your refund is a wonderful reward. What you do with a refund is up to you, but here are some ideas that may make your tax refund twice as valuable.

Double your savings

Perhaps you'd like to use your tax refund to start an education fund for your children or grandchildren, contribute to a retirement savings account for yourself, or save for a rainy day. A financial concept known as the rule of 72 can give you a rough estimate of how long it might take to double what you initially save. Simply divide 72 by the annual rate you hope that your money will earn. For example, if you expect an average annual rate of return of 6%, your invested tax refund may double in approximately 12 years. Of course, this is a hypothetical estimate, and doesn't account for taxes, inflation, or the actual return you may receive.



Split your refund in two

If you like to think of your tax refund as a well-deserved bonus, you may be less than enthusiastic about saving it or using it for something practical. If stashing it away in a savings account or using it to pay off bills sounds like no fun, go ahead and splurge on something for yourself. But remember, you don't necessarily have to spend it all. Instead, why not make the most of your tax refund by putting half of it toward something practical and spending the other half on something more fun?

The IRS has even made it easy for you to do this. When you file your income taxes and choose direct deposit for your refund, the IRS allows you to have it deposited among two or even three accounts. Qualified accounts include savings and checking accounts, and other accounts such as IRAs, Coverdell education savings accounts, health savings accounts, Archer MSAs, and TreasuryDirect online accounts. To split your refund, you'll need to fill out IRS Form 8888, *Direct Deposit of Refund to More Than One Account,* when you file your federal return.

Be twice as nice to others

Giving to charity has its own rewards, but Uncle Sam may reward you too by allowing you to deduct contributions made to a qualified charity from your taxes if you itemize. You can also help your favorite charity or nonprofit reap double rewards from your gift by finding out if it benefits from any matching gift programs. With a matching gift program, individuals, corporations, foundations, and employers offer to match gifts the charitable organization receives, usually dollar-for-dollar. Terms and conditions apply, so check with the charitable organization or with your employer's human resources department to find out more about available matching gift programs.

Make your refund do double duty

A great way to increase the value of this year's tax refund is to spend it on something that might offset your overall tax bill and potentially increase your tax refund next year. For example, this year you might want to consider spending your refund on improvements that will increase your home's energy efficiency because you may be eligible for a tax credit worth up to 30% of what you spend (capped at $1,500 for certain improvements). Qualifying improvements include certain high-efficiency heating and cooling systems, and water heaters, windows, doors, and insulation that meet strict energy-efficiency standards. You can find out more about this tax credit and other credits and deductions you may be entitled to by consulting IRS Publication 17, *Your Federal Income Tax*.

Got Stock? The Long and Short of Capital Gains

If you buy or sell shares of stock, you need to be familiar with the rules that govern the way capital gains are taxed. That's because the amount you owe in tax can depend on a number of factors, including the length of time you hold the shares and the federal income tax bracket you're in. Here are the basics.

Basis and holding period

"Basis" refers to your investment in the shares of stock you hold. Generally, your basis is the amount you paid for the stock, plus any commissions you paid to purchase the shares. (Note, however, that special rules apply if you received the stock as a gift or as part of an inheritance.) If you sell a share of stock and the sales price--less any commission--is more than your basis, you have a *gain*; if the amount you receive is less than your basis, you have a *loss*.

Your holding period is generally the length of time that you hold a share of stock before you sell or exchange it. If you hold a share of stock for a year or less before selling it, any gain you have is *short-term* capital gain. If you sell a share of stock after holding it for more than a year, any gain is *long-term* capital gain. Your holding period typically starts on the trade date the share is purchased, and ends on the trade date it's sold.

Short-term capital gain

Short-term capital gain is treated as ordinary income, just like interest on your savings account or wages from your employer. It's added in with all of your other income, and the amount of federal income tax you owe depends on the federal marginal income tax bracket you're in. For example, if you're in the top tax bracket in 2010, you'll pay tax on ordinary income at a maximum rate of 35%.

Long-term capital gain

If you sell shares of stock that you've held for more than a year, any gain is long-term capital gain, and special maximum tax rates apply. If you're in the 10% or the 15% marginal income tax bracket in 2010, you'll pay no federal income tax on long-term capital gains (a "0% tax rate" applies). So, for single individuals with taxable income of $34,000 or less ($68,000 for married individuals filing jointly), long-term capital gains are federal income tax-free in 2010.

For those who aren't in the lowest two federal income tax brackets (i.e., those in the 25%, 28%, 33%, and 35% brackets), a 15% maximum tax rate generally applies to long-term capital gains. There are limited cases, however, when individuals in the higher tax brackets can still benefit from the 0% tax rate.

For example, a retired couple with taxable income of $60,000 would be in the 15% marginal income tax bracket in 2010 if they file jointly (the bracket covers married couples with taxable income less than or equal to $68,000). The couple sells stock, resulting in a long-term capital gain of $40,000. This increases their taxable income to $100,000, placing them in the 25% marginal income tax bracket. In this situation, they would pay no federal tax on the first $8,000 of long-term capital gain, and the maximum 15% rate would apply to the remaining $32,000 in gain.

Offsetting gains with losses

Any capital losses that you may have realized during the year can offset some or all of your capital gain. If your losses offset all capital gains, any excess capital loss can be applied against up to $3,000 of ordinary income ($1,500 for married individuals who file separately), and any unused capital loss can be carried forward to future years.

Big exception: retirement plans, IRAs

All of this assumes your stock is not being held in a tax-advantaged retirement account like a 401(k) plan or IRA. Special tax rules apply to investments, including stock, held within these plans. If you sell shares of stock within one of these plans, there's no immediate tax consequence. Instead, you'll generally pay federal income tax when you take withdrawals from the plan, and any income will be considered ordinary income--even if the earnings are attributable to capital gains. (Certain Roth retirement plans and Roth IRAs provide for tax-free treatment of qualified withdrawals.)

Uncertainty in 2011

The special federal income tax rates that currently apply to long-term capital gains expire at the end of 2010. Absent new legislation, in 2011, individuals in the 15% tax bracket (under current law the 10% bracket disappears in 2011) will pay tax on long-term capital gain at a rate of 10%. For everyone else, a 20% rate will generally apply. Special rules (and slightly lower rates) will apply for qualifying property held five years or more.

Small business stock

Special rules apply to qualified small business stock. Generally, a portion of any gain realized upon the sale of qualified small business stock held for more than 5 years can be excluded from income. The portion of the gain that is not excluded from income is generally taxed at a maximum rate of 28%. For additional information, see IRS Publication 550.

Special Needs Trusts

A special needs trust (SNT), sometimes referred to as a supplemental needs trust, is a trust that is established to benefit a disabled person, or a person who has special needs, while still allowing such persons to qualify for and receive governmental health-care benefits.

Background

Some government programs aimed at assisting the disabled, such as Medicaid and Supplemental Social Security Income (SSI), are needs based. That means that if the disabled individual has access to more than a specified level of resources (generally $2,000), he or she will not be eligible to receive such benefits. In 1993, Congress officially approved the use of SNTs to maximize the use of all available resources, both private and governmental, to provide more fully for the needs of the disabled.

For persons of limited means, government programs may constitute the primary, if not the only, source of funding for their current and future needs. However, government assistance is also available to families who have resources available to meet their loved one's basic needs. These families may be fortunate enough to be able to use their personal resources to provide for non-basic needs as well. With an SNT, the disabled person is able to first tap into any government benefits to which he or she is entitled, and then can spend personal resources as a secondary source for additional support and comfort.

Types of SNTs

There are three types of SNTs: a self-settled or first-party SNT, a pooled SNT, and a third-party SNT.

Self-settled or first-party SNT

A self-settled or first-party SNT is created for the sole benefit of a disabled person who is under age 65. The trust must be established by the disabled person's parent, grandparent, guardian, or by the court, but it cannot be created by the disabled person. However, the disabled person can fund the trust. For example, the disabled person could fund the trust with money that has been inherited or received in settlement of a lawsuit, or as a result of a divorce.

As previously stated, in order to qualify for Medicaid or SSI, the person who is enrolling must have a limited amount of income and resources. Generally, Medicaid and SSI will look back 36 or 60 months to see if assets have been transferred to someone else in order to qualify for benefits, and if so, a penalty is imposed. The penalty will be that the person who is enrolling won't be able to receive benefits for a certain amount of time. Transferring assets to an SNT, however, does not trigger these look-back provisions.

The other benefit of this SNT, of course, is that assets in the trust will not be countable as resources for eligibility purposes.

One disadvantage, however, is that upon the disabled individual's death, any money or assets remaining in the trust must be used to reimburse the government for Medicaid benefits extended to the individual during his/her lifetime.

Pooled SNT

A pooled SNT is a trust that is managed by a nonprofit organization. Funds are pooled for investment purposes, but separate subaccounts are maintained for each disabled beneficiary. A pooled SNT works in the same way as a self-settled or first-party SNT. However, with a pooled SNT, the disabled individual can create the account for himself or herself.

Further, any funds remaining in the account upon the individual's death can be used to pay back Medicaid, or they can remain in the pooled SNT to help others in the pool, depending on state law.

Third-party SNT

A third-party SNT is a trust created by a disabled person's parent or other third party, but this type of SNT has no payback requirement. The person establishing the trust must not have a duty to support the disabled child, so the child must be age 21 or older, depending on your state's laws. There is no requirement that the disabled person be under the age of 65. However, transfers to a third-party SNT may or may not trigger the Medicaid or SSI penalty period. Again, it depends on your state's laws.

Conclusion

An SNT requires careful drafting and administration to avoid disqualification for government benefits. Be sure to consult a specialist.

In 1993, Congress officially approved the use of SNTs to maximize the use of all available resources, both private and governmental, to provide more fully for the needs of the disabled.

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Ask the Experts

What's an exchange-traded fund?

Like a mutual fund, an exchange-traded fund (ETF) pools money from investors to buy a group of securities. Though diversification alone can't guarantee a profit or protect against potential loss, such an investment helps you spread your risk over many individual securities.

Most ETFs are passively managed. Instead of having a portfolio manager who uses his or her judgment to select specific stocks, bonds, or other securities to buy and sell, ETFs try to approximate the performance of a specific index, which can be either broad-based or narrowly focused. In this, they are somewhat similar to an index mutual fund.

However, there are some substantial differences between mutual funds and ETFs. Perhaps the biggest is the ability to trade ETFs throughout the day. Mutual funds are priced once a day after the market closes. If you buy or sell after that, you'll receive the next day's closing price. By contrast, ETFs are priced throughout the day. Also, they can be bought on margin or sold short; in other words, they can be traded just like stocks. As a result, investors may use ETFs to actively trade a particular sector or industry.

ETFs typically have no minimum investment requirements or redemption fees for brief holding periods. And because most ETFs are based on an index, the administrative costs can be relatively low. However, ETFs must be purchased through a broker. Since you'll pay a brokerage commission with every transaction, ETFs may not be well-suited to a systematic investing program such as dollar cost averaging--transaction costs could quickly eat up any cost efficiencies.

Because the differences between one ETF and another can be dramatic, you should carefully consider a fund's investment objectives, risks, charges, and expenses, which are included in the prospectus available from the fund. Read it carefully before investing.

How can I use exchange-traded funds?

There are many ways an exchange-traded fund (ETF) can be used to help round out or supplement an existing investment portfolio.

Investing in a sector rather than an individual stock. An ETF allows you to invest in an industry or sector without relying on the fate of an individual company. If you have broad-based stock funds, you can give more weight to a particular sector by also investing in an ETF that focuses on a relevant index.

Minimizing taxes. ETFs can be relatively tax-efficient. Because a passively managed ETF trades relatively infrequently, it typically distributes few capital gains during the year. That means you won't incur the same tax liability as if you received significant capital gains. However, make sure you consider just how an ETF's returns will be taxed. Depending on how the fund is organized and what it invests in, returns could be taxed as short-term capital gains, ordinary income, or even as collectibles, all of which are generally taxed at higher rates than long-term capital gains.

Staying invested after selling stock for a tax loss. If you have sold a large stock position to realize a capital loss for tax purposes, but still believe that industry as a whole will soon experience a big short-term move, you can use an ETF to try to take advantage of that volatility. If you buy the same stock within 30 days, the tax-loss deduction will be disallowed. However, buying an ETF based on a relevant index as a proxy for that investment until you are able to buy the stock again allows you to preserve the tax deduction on the stock loss while staying invested in that industry.

Limiting losses. With an ETF, you can set a stop-loss limit on your shares. A stop-loss order instructs your broker to sell your position if the shares fall to a certain price. If the ETF's price falls, you've minimized your losses. If its price rises over time, you can increase the stop-loss figure accordingly. This strategy lets you pursue potential gains while setting a limit on the amount you can lose.

Be sure to carefully consider a fund's investment objectives, risks, charges, and expenses, which are included in the prospectus available from the fund. Read it carefully before investing.