



JOHNSTON INVESTMENT COUNSEL

TRUSTED FIDUCIARIES & FEE-ONLY ADVISORS

April, 2011

Johnston Investment Counsel

Gregory A. Johnston, CFA,
CFP, QPFC, AIF
President & Chief
Investment Officer
331 Fulton
Suite 429
Peoria, IL 61602
309-674-3330
309-685-6957
gjohnston@jicinvest.com
www.jicinvest.com

Saving for Retirement and a Child's Education at the Same Time

You want to retire comfortably when the time comes. You also want to help your child go to college. So how do you juggle the two?

Know what your financial needs are

The first step is to determine what your financial needs are for each goal. Answering the following questions can help you get started:

For retirement:

- How many years until you retire?
- Does your company offer an employer-sponsored retirement plan or a pension plan? Do you participate? If so, what's your balance? Can you estimate what your balance will be when you retire?
- How much do you expect to receive in Social Security benefits?
- What kind of lifestyle do you hope to have in retirement? For example, do you want to travel extensively, or will you be happy to stay in one place and live more simply?
- Do you or your spouse expect to work part-time in retirement?

For college:

- How many years away is college?
- Will your child attend a public or private college? What's the expected cost?
- Do you have more than one child?
- Does your child have any special skills that could lead to a scholarship?
- Do you expect your child to qualify for financial aid?

Figure out what you can afford to put aside each month

After you know what your financial needs are, the next step is to determine what you can afford to put aside each month. To do so, you'll need to prepare a detailed family budget that lists all of your income and expenses. Once you've come up with a dollar amount, you'll

need to decide how to divvy up your funds.

Retirement takes priority

Though college is certainly an important goal, you should probably focus on your retirement if you have limited funds. With generous corporate pensions mostly a thing of the past, the burden is primarily on you to fund your retirement. But if you wait until your child is in college to start saving, you'll miss out on years of tax-deferred growth and compounding of your money. Remember, your child can always attend college by taking out loans (or maybe even with scholarships), but there's no such thing as a retirement loan!



Help! I can't meet both goals

If the numbers say that you can't afford to educate your child or retire with the lifestyle you expected, you'll have to make some sacrifices. Here are some things you can consider.

Defer retirement: The longer you work, the more money you'll earn and the later you'll need to dip into your retirement savings. Or, consider working part-time during retirement.

Make changes to your lifestyle now or in retirement: You might be able to adjust your spending habits now, or you may consider cutting back in retirement.

Increase your earnings now: Consider increasing your hours at your current job, finding a new job with better pay, taking a second job, or having a previously stay-at-home spouse return to the workforce.

Invest more aggressively: But remember that aggressive investments mean a greater risk of loss.

Send your child to a less expensive school: Don't feel guilty--a lesser-known liberal arts college or a state university may provide your child with a similar quality education at a far lower cost.

In this issue:

Saving for Retirement and a Child's Education

Rising Interest Rates: The Downside of Economic Recovery

A/B and A/B/C Trusts

Can I make charitable contributions from my IRA?



Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Rising Interest Rates: The Downside of Economic Recovery

Over the last several years, investors have grown accustomed to historically low interest rates. Ever since the Federal Reserve Board's target fed funds rate--the rate at which banks lend to one another--hit a high above 19% in mid-1981, the long-term direction of rates has been downward. In the last decade, the Fed's data* shows the target rate has never been much higher than 6%. And since December 2008, the Fed has kept it at a previously unheard-of level between 0.25% and zero to try to ensure that credit would be available to promote economic recovery.

Because bond prices typically rise when interest rates fall, that decline in yields has produced a bull market in bonds over the last decade. But what happens when the trend reverses? Even if they continue to remain relatively stable for a while, ultra-low interest rates have nowhere to go but up. When the economic recovery begins to show signs of strength, at some point the Federal Reserve Board will begin to raise the target rate again. When that happens, bond prices also will begin to reverse their long-term direction.

Here are some factors to consider in anticipation of a future with rising interest rates.

Bond maturities: when short is sweet

When interest rates rise, longer-term bonds typically feel the impact the most. In an extended period of rising interest rates, bond buyers become reluctant to tie up their money for longer periods because they foresee higher yields in the future; the later the bond's maturity date, the greater the risk that its yield will eventually be superseded by that of newer bonds. As demand drops and yields increase to attract purchasers, prices fall.

There are various ways to manage that impact. If you own individual bonds, you always have the option of holding them to maturity; in that case, you would suffer no loss of principal unless the borrower defaults. Bond investments also can be laddered. This involves buying a portfolio of bonds with varying maturities; for example, a five-bond portfolio might be structured so that one of the five matures each year for the next five years. As each bond matures, it can be reinvested in an instrument that carries a higher yield. Laddering also can be used with certificates of deposit (CDs).

If you own a bond fund, you can check the average maturity of the fund's holdings, or the fund's average duration, which takes into account the value of interest payments and will generally be shorter than the average maturity.

The longer a fund's duration, the more sensitive it may be to interest rate changes.

Rising rates and other assets

Higher interest rates often are an attempt to prevent rising prices. When prices go up, purchasing power goes down, including the purchasing power of a bond's fixed interest payments. That can make bonds less attractive to buyers. However, not all investments are hurt by higher prices. For example, commodities such as oil and wheat typically do well in inflationary periods; in fact, increases in commodity prices are often what trigger a bout of inflation. If you're primarily interested in the overall value of your portfolio rather than a regular income stream, your financial professional can help you explore whether you should consider diversifying into asset classes that tend to benefit from inflation and that might help counteract the potential impact of falling bond prices.

Though bonds are affected most directly, equities aren't necessarily immune to rate increases. Though many companies borrowed money in recent years to take advantage of low rates and postpone the need to issue bonds for some time, those that haven't may see their borrowing costs increase, which could affect their bottom lines. Even those that squirreled away cash could be hit when they return to the bond markets eventually. Also, if interest rates rise to a level that's competitive with the return on stocks, that could reduce investor demand for equities.

Higher rates aren't all bad news

For those who've been diligent about saving, or who have kept a substantial portion of their investments in cash, higher rates could be a boon. Savings accounts, CDs, and money market funds are all likely to do better at providing income than they have in recent years. The downside, of course, is that if higher rates are accompanied by inflation, such cash alternatives might not keep pace with rising prices. And bear in mind that a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1 per share, it is possible to lose money investing in a money market fund.

**Source: Federal Reserve Statistical Release Historical Data for Fed funds rate weekly since 1954.*



Bonds don't respond uniformly to interest rate changes. The differences, or spreads, between the yields of various types of debt, such as corporate, government, emerging market, and municipal debt, can mean that some bonds are under- or overvalued compared to others. Don't forget that the total return on bonds is a combination of yield and price return. Financial professionals have many ways to adjust a bond portfolio to help you cope with rising rates.

A/B and A/B/C Trusts

If you're married, a combination of trusts, often referred to as A/B, A/B/C, or A/B/Q trusts, may be useful for estate planning purposes. The combination of trusts can sometimes be used to minimize total estate tax for two spouses, and can provide nontax benefits as well.

A federal estate tax overview

- An unlimited marital deduction is generally available for transfers of wealth between you and your spouse.
- Currently, an estate of \$5 million can be sheltered by a \$5 million basic exclusion amount and a tax rate of 35% applies to any excess. Any unused portion of the basic exclusion of a deceased spouse is portable and can be transferred to a surviving spouse. The \$5 million amount will be indexed for inflation in 2012.
- Absent further legislation, in 2013, the amount that can be sheltered is reduced to \$1 million, the top estate tax rate increases to 55%, and the basic exclusion amount is no longer portable.

The A, or power of appointment marital, trust

The A trust is structured to qualify for the marital deduction. You give your surviving spouse a right to all of the trust's income for life and the power to appoint who receives the trust property at your spouse's death. You would typically fund the A trust (together with a Q trust, if desired) with the amount of your estate in excess of the applicable exclusion amount.

The B, or bypass credit shelter, trust

You would typically fund the B trust with an amount equal to the applicable exclusion amount, or credit shelter amount. You can give your spouse interests in the B trust, but generally none that would cause the trust to be includable in your spouse's estate for estate tax purposes (thus, the B trust bypasses your spouse's estate). You can name the persons who will receive trust income or other distributions from the trust. You can also provide that, at your spouse's death, the trust will continue for the benefit of, or be distributed to, your children or other beneficiaries. Or, you could give your spouse a limited power to appoint property among a limited class of beneficiaries, such as your children from your current marriage.

The C, Q, or QTIP marital, trust

The C or Q trust, typically a QTIP trust, is also structured to qualify for the marital deduction.

You give your surviving spouse a right to all of the trust's income for your spouse's life.

However, you retain for yourself the right to designate who receives the property at your spouse's death. This can be useful when you have children from a prior marriage who you would like to benefit after your spouse's death. You would typically fund the C trust (together with an A trust, if desired) with the amount of your estate in excess of the applicable exclusion amount.

Everything to spouse versus A/B trusts

Because the exclusion amount is higher and portable in 2011 and 2012, some couples may think they do not need A/B or A/B/C trusts. Everything could be left to the surviving spouse who uses both spouses' exclusions. However, there are still tax advantages to using this basic planning strategy as shown in the following example.

Example: John is married to Mary and has an estate of \$10 million. Assume a \$5 million basic exclusion amount that is indexed and portable and a top estate tax rate of 35%. John leaves \$10 million to Mary at his death. The transfer qualifies for the marital deduction, no estate tax is due, and John's unused \$5 million exclusion is transferred to Mary. Everything (except the unused exclusion) doubles in value. Mary's estate of \$20 million is partially sheltered by Mary's applicable exclusion amount of \$5 million (\$10 million basic exclusion plus John's unused \$5 million exclusion). After estate taxes of \$1,750,000 are paid, \$18,250,000 remains for John and Mary's children.

Assume instead that John leaves \$5 million to Mary in an A trust and \$5 million in a B trust for Mary and their children. No estate tax is due. Everything doubles in value. Mary's estate of \$10 million is sheltered by Mary's basic exclusion amount of \$10 million. No estate tax is due. The entire \$20 million (the \$10 million B trust plus Mary's \$10 million estate) remains for John and Mary's children. By using the A/B trusts, estate tax has been reduced by \$1,750,000, and the tax savings go to John and Mary's children.

Other trust benefits

The use of trusts can also provide other benefits, such as control over who receives your property and when, investment management of trust property for trust beneficiaries, avoidance of probate, and asset protection. To learn more, consult an estate planning professional.

A combination of marital and credit shelter trusts can be used to minimize estate tax on your estates, and can provide nontax benefits as well.

Even with a large and portable federal estate tax exclusion, there are still tax advantages to using A/B trusts.





Johnston Investment Counsel

Gregory A. Johnston, CFA,
CFP, QPFC, AIF
President & Chief
Investment Officer
331 Fulton
Suite 429
Peoria, IL 61602
309-674-3330
309-685-6957
gjohnston@jicinvest.com
www.jicinvest.com

Forefield Inc. does not provide legal, tax, or investment advice. All content provided by Forefield is protected by copyright. Forefield is not responsible for any modifications made to its materials, or for the accuracy of information provided by other sources.

Prepared by Forefield Inc,
Copyright 2011

Ask the Experts



Can I make charitable contributions from my IRA?

Yes, if you qualify. The law authorizing "qualified charitable distributions," or QCDs, has recently been extended through 2011.

You simply direct your IRA trustee to make a distribution directly from your IRA (other than a SEP or SIMPLE) to a qualified charity. You must be 70½ or older, and the distribution must be one that would otherwise be taxable to you. You can exclude up to \$100,000 of QCDs from your gross income in 2011. If you file a joint return, your spouse (if 70½ or older) can exclude an additional \$100,000 of QCDs in 2011. But you can't also deduct QCDs as a charitable contribution on your federal income tax return--that would be double dipping.

QCDs count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to take from your IRA in 2011, just as if you had received an actual distribution from the plan. However, distributions that you actually receive from your IRA (including RMDs) that you subsequently transfer to a charity cannot qualify as QCDs.

For example, assume that your RMD for 2011

is \$25,000. In June 2011, you make a \$15,000 QCD to Qualified Charity A. You exclude the \$15,000 of QCDs from your 2011 gross income. Your \$15,000 QCD satisfies \$15,000 of your \$25,000 RMD. You'll need to withdraw another \$10,000 (or make an additional QCD) by December 31, 2011, to avoid a penalty.

You could instead take a distribution from your IRA and then donate the proceeds to a charity yourself, but this would be a bit more cumbersome, and possibly more expensive. You'd include the distribution in gross income and then take a corresponding income tax deduction for the charitable contribution. But the additional tax from the distribution may be more than the charitable deduction, due to IRS limits. QCDs avoid all this by providing an exclusion from income for the amount paid directly from your IRA to the charity--you don't report the IRS distribution in your gross income, and you don't take a deduction for the QCD. The exclusion from gross income for QCDs also provides a tax-effective way for taxpayers who don't itemize deductions to make charitable contributions.



Can I name a charity as beneficiary of my IRA?

Yes, you can name a charity as beneficiary of your IRA, but be sure to understand the advantages and disadvantages.

Generally, if you name a spouse, child, or other individual as beneficiary of a traditional IRA, they must pay federal income tax on any distribution they receive from the IRA after your death. By contrast, if you name a charity as beneficiary, the charity will not have to pay any income tax on distributions from the IRA after your death (provided that the charity qualifies as a tax-exempt charitable organization under federal law), a significant tax advantage.

After your death, distributions of your assets to a charity generally qualify for an estate tax charitable deduction. In other words, if a charity is your sole IRA beneficiary, the full value of your IRA will be deducted from your taxable estate for purposes of determining the federal estate tax (if any) that is due. This can also be a significant advantage if you expect the value of your taxable estate to be at or above the federal exclusion amount (\$5 million for 2011).

Of course, there are also nontax implications. If you name a charity as sole beneficiary of your IRA, when you die your family members and other loved ones will obviously not receive any benefit from those IRA assets. If you would like to leave some of your assets to your loved ones and some assets to charity, consider leaving your taxable retirement funds to charity and other assets to your loved ones. This may offer the most tax-efficient solution, since the charity will not have to pay any tax on the retirement funds. If the retirement funds are a major portion of your assets, you might consider leaving those funds to a charitable remainder trust. Under this type of trust, the trust receives the funds free from income tax at your death, then pays a lifetime income to individuals of your choice. When those individuals die, the remaining trust assets pass to the charity. Finally, another option is to name the charity and one or more individuals as co-beneficiaries.

The issues discussed here are complex. Be sure to consult an estate planning attorney for further guidance.

