



## Johnston Investment Counsel

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## Expecting a Large Inheritance? Don't Count on It



Banking on a substantial inheritance from your parents or other relatives? Well don't break out the champagne glasses just yet. A variety of factors has transformed what once had been a reasonable

expectation of some inherited wealth to a concern that parents will have enough money to provide for their well-being in their later years.

### Longevity

First and foremost, we're living longer. According to the Social Security life expectancy tables, men and women who have reached age 65 can expect to live into their 80s. It is not uncommon for individuals to live 25 years or longer in retirement.

Living longer means paying for living expenses over a longer period of time. This sometimes results in stretching savings past their breaking point. Children of older parents often find themselves worrying about whether they will have to provide financial support for their aging parents.

### Rising health-care costs

Another consequence of living longer is the likelihood of spending more on medical care as we age. And health-care costs are rising at a rate that outpaces inflation. While Medicare covers some of these expenses, it doesn't cover all of them. Also, there are co-payments, deductibles, and premium costs for Medicare Parts B and D as well as Medigap insurance. Out-of-pocket medical expenses paid over a longer period of time can deplete savings.

### Investment risk

Fewer retirees are able to rely on employer pensions for income. Accordingly, many seniors are depending on stock market returns from their investments to finance their retirement income needs while exposing their savings to the risk of loss due to market volatility.

Coupled with the prospect of reduced savings due to market risk is the fact that most retirement savings are invested in qualified

plans such as 401(k) accounts and IRAs. Withdrawals from these accounts are typically taxable as ordinary income, further reducing their net value to the account holder, meaning more has to be withdrawn to cover any tax owed.

### I'm spending my kid's inheritance

Preserving and protecting assets for the primary purpose of passing that wealth on to subsequent generations is not as important a goal as it once was, and for many retirees, it's not a goal at all. We often see members of the older generation passing wealth to their children and grandchildren during their lives by providing a down payment for a home or helping with college expenses, for example.

On the other hand, the decline of employer pensions, increasing cost-of-living expenses, and dwindling savings often force retirees to rely on assets that otherwise may have been earmarked for inheritance. Life insurance policies may be cashed in or sold, and home equity might be accessed through loans or reverse mortgages.

### What does all this mean for you?

While you may have expected or hoped for an inheritance from your parents, instead you may find yourself having to help provide for their financial support. It's best to prepare for this possibility by talking to your parents about the provisions they've made for the future. Find out whether they have adequate income and savings. Have they prepared for the potential of long-term care expenses? Gaining as much information as possible about your parents' finances may help you prepare for their future needs as well as your own.

Not getting the inheritance you may have anticipated means you'll probably have to rely on your own savings for your retirement. So save as much as you can, or you may find yourself relying on your children for your financial support in your later years.

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*In these challenging economic time, you may be considering taking a withdrawal from your traditional IRA. While you're allowed to withdraw funds from your IRAs at any time, for any reason, the question is, should you?*



*Technically, there are three IRS-approved methods for calculating SEPPs--the RMD (required minimum distribution) method, the fixed amortization method, and the fixed annuitization method. The rules for calculating your SEPPs can be found in IRS Notice 89-25 and Revenue Ruling 2002-62.*

## The "SEPP" Exception to the IRA Premature Distribution Tax

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### Why you should think twice

Taxable distributions you receive from your IRA before age 59½ are generally referred to as premature distributions, or early withdrawals. To discourage early withdrawals, they're subject to a 10% federal penalty tax (and possibly a state penalty tax) *in addition to* any federal and state income taxes. This 10% penalty tax is commonly referred to as the premature distribution tax.

However, not all distributions before age 59½ are subject to the federal penalty tax. For example, the penalty tax doesn't apply if you have a qualifying disability, or if you use the money to pay certain medical, college, or first-time homebuyer expenses.

### The SEPP exception to the penalty tax

But one of the most important (and often overlooked) exceptions, from a retirement income perspective, involves taking a series of "substantially equal periodic payments" (SEPPs) from your IRA. This exception from the federal penalty tax is important because it's available to anyone, regardless of age, and the funds can be used for any purpose.

SEPPs are amounts that are calculated to exhaust the funds in your IRA over your lifetime (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. To avoid the 10% penalty, you must calculate your lifetime payments using one of three IRS-approved distribution methods, and take at least one distribution annually.

### Calculating your payment

If you have more than one IRA, you can take SEPPs from just one of your IRAs or you can aggregate two or more of your IRAs and calculate the SEPPs from the total balance. It's up to you. But you can't use only a portion of an IRA to calculate your SEPPs.

You can also use tax-free trustee-to-trustee transfers (or rollovers) to ensure that the IRA(s) that will be the source of your periodic payments contain the exact amount necessary to generate the payment amount you want based on the IRS formulas. This makes the

SEPP exception a very important and flexible retirement income planning tool.

### Modifying your payments

Even though your payments must be calculated as though they'll be paid over your lifetime (or over you and your beneficiary's lifetimes), you don't actually have to take distributions for that long. You can change, or stop, your SEPPs after payments from your IRA have been made for at least five years, or after you reach age 59½, whichever is later.

But be careful--if you "modify" the payments before the required waiting period ends, the IRS will apply the 10% penalty tax (plus interest) to all taxable payments you received before age 59½ (unless the modification was due to your death or disability).

For example, assume Mary began taking SEPPs from her traditional IRA account three years ago, when she was 43 years old (using one of the three IRS-approved methods). Mary does not take a distribution this year. Because Mary's payment stream has been modified before she turned 59½, the 10% penalty (plus interest) will now apply retroactively to the taxable portion of all her previous distributions.

The five-year period begins on the date of your first withdrawal, so you can't make any changes before the fifth anniversary of that withdrawal. This is true even if you turn age 59½ in the meantime.

For example, assume John began taking SEPPs from his traditional IRA (using an IRS-approved method) on December 1, 2009, and that he also took payments on December 1 of 2010, 2011, and 2012. John turned 59½ on December 2, 2012. Even though John is over age 59½, he must take one more payment by December 1, 2013. Otherwise, he'll be subject to the 10% penalty on the taxable portion of the distributions he took before he turned age 59½.

**Caution:** *To ensure that your distributions will qualify for the SEPP exception to the premature distribution tax, be sure to get professional advice. The calculation of SEPPs can be complicated, and the tax penalties involved in the event of an error can be significant.*

Also, if your state imposes a penalty tax on early withdrawals, be sure to determine whether any similar exemption from the state tax is available to you.



## Why a GRAT Can Be GREAT



**A GRAT that is structured so that the annuity payments to you are high enough to result in a gift valued at zero is known as a "zeroed out" GRAT. With this type of GRAT, since there is no gift, no gift tax is due and no applicable exclusion amount is used.**

If you have property that's rapidly appreciating or generating high earnings, and you're ready to pass it down to your children or other heirs but want to continue receiving income from the property for a period of years, a GRAT, which stands for grantor retained annuity trust, may be a great strategy for you. The goal of a GRAT is to transfer property with minimal gift tax consequences.

A GRAT is an irrevocable trust into which you make a onetime transfer of property, and from which you receive a fixed amount each year for a specified number of years (the annuity period). At the end of the annuity period, the property remaining in the trust (the remainder interest) is distributed to the beneficiaries you've named in the trust document.

### Potential tax benefits of a GRAT

A transfer of property to an irrevocable trust is a taxable gift. The value of the gift on which gift tax is imposed is generally its fair market value. However, because you retain an interest in a GRAT, the value of the transfer is discounted; gift tax is imposed only on the remainder interest (and any gift tax due may be sheltered by your applicable exclusion amount).

This taxable value is calculated using an interest rate provided by the IRS (known as the discount rate or Section 7520 rate), which is based on current interest rates and changes monthly. This interest rate assumes the GRAT property will earn a certain rate of return during the annuity period. Any actual return that exceeds the assumed return passes to the remainder beneficiaries free from gift and estate tax. Investment performance, therefore, is central to this strategy.

**Tip:** The current low Section 7520 rates are very beneficial for GRATs.

### ... and the catch

The catch to this strategy is that you must outlive the annuity period. If you die before the annuity period expires, the value of the property in the trust on the date of your death will be included in your estate for estate tax purposes. This, however, merely puts you in the same position you would have been in had you not used the GRAT (except for the costs to create and maintain the trust).

**Tip:** In order to reduce the risk that the grantor will not outlive the annuity period, annuity periods as short as two years are often used. Sometimes a series of these short-term GRATs are used.

**Note:** It may be advisable for the remainder beneficiaries to buy life insurance on your life

(the life of the grantor) so that funds will be available to pay the estate taxes in case the GRAT property is included in your estate due to your early death.

### The risk

The key to this strategy is investment performance. If the trust property does not outperform the discount rate, there will be no excess return, and no tax savings will be achieved.

### ... and other drawbacks

Gifts of present interests qualify for the annual gift tax exclusion. But, because the gift to the remainder beneficiaries is a future interest, not a present interest, transfers to a GRAT do not qualify for the annual exclusion.

Additionally, a GRAT is generally not appropriate for making gifts to grandchildren or other skip persons (persons who are more than one generation below you). That is because there are rules that prevent you from allocating your generation-skipping transfer (GST) tax exemption until the annuity period expires. Because you cannot effectively leverage your GST tax exemption, a GRAT should not be used for generation-skipping transfer tax planning.

Finally, property transferred by reason of your death will receive a step-up (or step-down) in income tax cost basis (i.e., the property's value will generally be increased to its fair market value on the date of your death); property that is transferred during your lifetime by gift does not receive a step-up in basis. Losing the step-up in basis may mean significant capital gains taxes for the remainder beneficiaries.

### Other considerations

Some property that may be appropriate for a GRAT includes:

- High-yield or high-growth investment portfolio
- Commercial rental property
- Closely held stock
- Family limited partnership (FLP) interests
- Any property with appreciation potential, such as real property, precious metals, and artwork

A GRAT is usually considered a grantor-type trust for income tax purposes. All income, gains, deductions, and losses flow through to you on your personal income tax return. The GRAT document must be precisely drafted for the property to receive GRAT tax treatment. You should consult an experienced estate planning attorney if you are considering this strategy.





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## How can my child get a better financial aid package?

If your child is accepted at a college, he or she will get a financial aid award letter that contains: (1) the college's cost of attendance (COA) (this figure is different for every college); (2) your expected family contribution (EFC), which is calculated from the federal government's aid application (this figure is constant); and (3) the specific types and amount of aid being offered. The difference between the college's COA and your EFC equals your child's financial need. The college's financial aid administrator will attempt to meet this need by offering aid that includes a mix of loans, grants, scholarships, and work-study.

Let's assume you and your child are comparing financial aid awards from several colleges. Is it possible to request a more favorable aid package? The answer is yes. Financial aid administrators have the authority to exercise "professional judgment" to reduce the loan portion of an aid award and increase the grant, scholarship, and/or work-study component. Your chances of prevailing are best in two situations:

(1) You have a special circumstance that affects your ability to pay. Examples include a recent job loss, high medical bills, or some other factor that puts above-average constraints on your income.

(2) Your child has been accepted at two competing colleges, and one has offered a more generous aid package. Many colleges don't mind losing an applicant to a more (or less) selective college, but they generally don't like to lose an applicant to a direct competitor.

Even if neither of these situations applies, you can still contact the college's aid administrator. In any case, the best approach is to send a polite business letter, with a follow-up telephone call or meeting. Explain in positive terms how much your child wants to attend that college and highlight your child's accomplishments. Your success will likely depend on whether your child will help the college meet its enrollment goals, and the amount of discretionary aid the college has available.



**I THINK I FINALLY UNDERSTAND THE MEANING OF HIGHER EDUCATION.**



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