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Why You Need a Power of Attorney and Medical Directive

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LIFE THE WAY YOU PLANNED IT.

Why You Need a Power of Attorney and Medical Directive



It's late at night and you're waiting for your husband to arrive home from a business trip. Suddenly the phone rings and the voice on the other end informs you that your husband was in a terrible car accident and

has been rushed to the hospital. You arrive to find several doctors awaiting permission to operate on your unconscious husband. They ask if he has a medical directive that authorizes someone, preferably you, to make health-care decisions on your husband's behalf.

A few days pass and your husband survives the accident, but he's going to be laid up for several weeks or months. Household bills need to be paid, but the primary source of income is your husband's business and you're not named on any of the business bank accounts. The bank representative asks whether your husband has a durable power of attorney naming you as his agent for financial matters.

These are everyday examples that highlight the importance of a medical directive and a durable power of attorney. Without these documents in place, you and your family could face personal and financial disaster.

What is a medical directive?

A medical directive lets others know what medical treatment you would want, and allows someone to make medical decisions for you, in the event you can't express your wishes yourself. There are two basic types of advanced medical directives--a durable power of attorney for health care and a living will--which generally vary by state. So be sure your documents comply with the laws of your state of residence.

A durable power of attorney for health care (known as a health-care proxy in some states) allows you to appoint a representative (health-care agent) to make medical decisions for you if you are unable to do so yourself. You can appoint almost anyone as your agent (as long as they are of legal age, usually age 18 or older). You decide how much power your representative will or won't have.

A living will allows you to approve or decline certain types of medical care, even if you will die as a result of that choice. In most states, living wills take effect only under certain circumstances, such as terminal injury or illness. Typically, a living will can be used to decline medical treatment that "serves only to postpone the moment of death." In those states that do not authorize living wills, you may still want to have one to serve as an expression of your wishes.

What is a durable power of attorney?

A durable power of attorney (DPOA) can help protect your property in the event you become physically unable or mentally incompetent to handle financial matters. If no one is ready to look after your financial affairs, your property may be wasted, abused, or lost. A DPOA allows you to authorize someone else to act on your behalf, so he or she can do things like pay everyday expenses, collect benefits, watch over your investments, and file taxes.

A DPOA may be effective immediately (this may be appropriate if you face a serious operation or illness), or it may only become effective upon the occurrence of an event, such as your incapacity (sometimes referred to as a springing power of attorney).

Caution: A springing power of attorney is not permitted in some states, so you'll want to check with an attorney for its availability in your state.

Additional things to consider

When creating either a DPOA or medical directive such as a durable power of attorney for health care (HPOA), it is important that you choose an appropriate agent. While you may select the same person to serve as agent in both documents, you are not compelled to do so. And be sure the person you select as agent is aware of that fact. Also, let them know where you keep these documents (you may want to give a copy of your HPOA to your agent and primary care physician as well).

Once you have these documents, review them periodically to be sure they still accomplish what you intend them to do.

Estate Planning and Income Tax Basis



Income tax basis can be important when deciding whether to make gifts now or transfer property at your death. When you make a gift of property, the recipient generally receives your basis in the property. When you transfer property at your death, the recipient generally receives a basis equal to the fair market value of the property. The difference can substantially affect the amount of taxable gain when the recipient sells the property.

Income tax basis can be important when deciding whether to make gifts now or transfer property at your death. This is because the income tax basis of the person receiving the property depends on whether the transfer is by gift or at death. This, in turn, affects the amount of taxable gain subject to income tax when the person sells the property.

What is income tax basis?

Income tax basis is the base figure you use when determining whether you have recognized capital gain or loss on the sale of property for income tax purposes. (Gain or loss on the sale of property equals the difference between your adjusted tax basis and the amount you realize upon the sale of the property.) When you purchase property, your basis is generally equal to the purchase price. However, there may be some adjustments made to basis.

What is the income tax basis for property you receive by gift?

When you receive a gift, you generally take the donor's basis in the property. (This is often referred to as a "carryover" or "transferred" basis.) The carried-over basis is increased--but not above fair market value (FMV)--by any gift tax paid that is attributable to appreciation in value of the gift (appreciation is equal to the excess of FMV over the donor's basis in the gift immediately before the gift). However, for purpose of determining loss on a subsequent sale, the carried-over basis cannot exceed the FMV of the property at the time of the gift.

Example: Say your father gives you stock worth \$1,000. He purchased the stock for \$500. Assume the gift incurs no gift tax. Your basis in the stock, for the purpose of determining gain on the sale of the stock, is \$500. If you sold the stock for \$1,000, you would have gain of \$500 (\$1,000 received minus \$500 basis).

Now assume that the stock is only worth \$200 at the time of the gift and you sell it for \$200. Your basis in the stock, for purpose of determining gain on the sale of the stock, is still \$500; but your basis for purpose of determining loss is \$200. You do not pay tax on the sale of the stock. You do not recognize a loss either. In this case, your father should have sold the stock (and recognized the loss of \$300--his basis of \$500 minus \$200 received) and then transferred the sales proceeds to you as a gift. (You are not permitted to transfer losses.)

What is the income tax basis for property you inherit?

When you inherit property, you generally

receive an initial basis in property equal to the property's FMV. The FMV is established on the date of death or on an alternate valuation date six months after death. This is often referred to as a "stepped-up basis," since basis is typically stepped up to FMV. However, basis can also be "stepped down" to FMV.

Example: Say your mother leaves you stock worth \$1,000 at her death. She purchased the stock for \$500. Your basis in the stock is a stepped-up basis of \$1,000. If you sold the stock for \$1,000, you would have no gain (\$1,000 received minus \$1,000 basis).

Now assume that the stock is only worth \$200 at the time of your mother's death. Your basis in the stock is a stepped-down basis of \$200. If you sold the stock for more than \$200, you would have gain.

Make gift now or transfer at death?

As the following example shows, income tax basis can be important when deciding whether to make gifts now or transfer property at your death.

Example: You purchased land for \$25,000. It is now worth \$250,000. You give the property to your child (assume the gift incurs no gift tax), who then has a tax basis of \$25,000. If your child sells the land for \$250,000, your child would have taxable gain of \$225,000 (\$250,000 sales proceeds minus \$25,000 basis).

If, instead, you kept the land and transferred it to your child at your death when the land is worth \$250,000, your child would have a tax basis of \$250,000. If your child sells the land for \$250,000, your child would have no taxable gain (\$250,000 sales proceeds minus \$250,000 basis).

In addition to income tax basis, you might consider the following questions:

- Will making gifts reduce your combined gift and estate taxes? For example, future appreciation on gifted property is removed from your gross estate for federal estate tax purposes.
- Does the recipient need a gift now or can it wait? How long would a recipient have to wait until your death?
- What are the marginal income tax rates of you and the recipient?
- Do you have other property or cash that you could give?
- Can you afford to make a gift now?





With a grantor retained annuity trust (GRAT), you receive a fixed dollar amount that does not change even if the value of the trust property (corpus) increases or decreases. Some other types of trusts are a grantor retained unitrust (GRUT) and a rolling or cascading GRAT. A GRUT allows you to retain the right to receive a fixed percentage of the trust corpus (determined annually), while a rolling or cascading GRAT is a technique that involves creating a series of short-term GRATs (typically two or three years) with each successive GRAT being funded by the annuity payments from the previous ones. This technique can minimize the risk of the grantor dying during the GRAT term, and can also minimize interest rate risk.

All in the Family: Transferring a Business to Your Children

You've spent years building a family business that's a source of pride and income for both you and your family, and now you may be thinking of handing over the reins to your children. If so, consider that transferring your business interest to your children may have income, gift, and estate tax consequences. Careful planning can help prevent the need to sell some (or all) of the business assets to pay those taxes.

Some common strategies for minimizing taxes are discussed briefly below. Remember, however, that none of these strategies are without drawbacks. Before you act, consult a tax professional as well as your estate planning attorney.

Giftng or bequeathing your interest outright

If you don't need continued income from the business and you don't want to retain some control, you can simply give the business to your children outright. For example, you can begin a systematic program of making annual gifts to your children in amounts that equal the annual gift tax exclusion (\$14,000 per year per recipient in 2013). By transferring your interest in this manner, you may be able to transfer all or a significant portion of the business free from federal gift tax (although these transfers may still be subject to state gift tax). The disadvantage here is the amount of time that may be needed to transfer your entire interest.

If you can wait and transfer your business at your death, Section 6166 of the Internal Revenue Code allows any estate taxes incurred because of the inclusion of your family business in your estate to be deferred for 5 years (with interest-only payments for the first 4 years), and then paid in annual installments of interest and principal over a period of up to 10 years. This will allow your beneficiaries more time to raise sufficient funds to pay the taxes or obtain more favorable interest rates if they need to borrow the money. Be aware that the business must exceed 35% of your gross estate and other requirements must be met.

Selling your interest outright

If you need income from your business, you can sell your business interest (for full fair market value) to your children. This will avoid gift and estate taxes, but you may owe capital gains tax.

Using a buy-sell agreement

If you want to sell your business interest to your children but retain control over the business for a period of time, consider using a buy-sell agreement. This is a legal contract that states

that the sale will happen when a specific event occurs, such as your retirement, disability, divorce, or death. When the triggering event occurs, the children will be obligated to buy your interest from you or your estate. The price and sale terms will have been predetermined by the contract. Remember, however, that you will be bound under a buy-sell agreement: you won't be able to sell or give your business to anyone except the buyers named in the agreement (unless they consent).

Using a grantor retained annuity trust (GRAT)

A GRAT is a trust into which you transfer your business interest, and from which you receive income for a period of time. The value of the gift is determined using the IRS's current interest rate (published monthly by the IRS). The trust must terminate at a specified time (e.g., 10 years). You receive annuity payments during the term of the trust, and at the end, your children will receive the business. If the business has appreciated beyond the IRS's interest rate, the excess can pass tax free. Be aware, however, that if you die during the GRAT term, your entire business interest will be included in your gross estate for federal estate tax purposes. You will have failed to transfer your business interest and lost the tax advantages of the GRAT. Plus, you will have incurred the costs of creating and maintaining the GRAT for nothing. For these reasons, be sure to structure your GRAT carefully.

Creating a family limited partnership (FLP)

An FLP is a type of business entity. First, you establish a partnership with both general and limited partnership interests. Then, you transfer the business to this partnership. You retain the general partnership interest for yourself, allowing you to maintain control over the day-to-day operation of the business. Over time, you gift the limited partnership interests to your children, leveraging your lifetime gift tax exemption and the annual gift tax exclusion. You also save taxes because the value of the gifts may be eligible for valuation discounts, such as the minority interest and lack of marketability discounts.



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Will interest rates rise this year?

The Fed hasn't yet raised its target interest rate from less than 0.25%, and it has promised not to do so before unemployment reaches

roughly 6.5%, which it doesn't expect to happen until next year. However, some interest rates have already begun to go up. For example, according to Freddie Mac, the average interest rate on a 30-year fixed-rate mortgage shot above 4% last June for the first time since late 2011, hitting its highest level in almost 2 years. In the same month, the yield on the 10-year Treasury bond went above 2.5% for the first time since August 2011.

Why are interest rates rising even though the Fed's target rate hasn't? Because bond investors are concerned that higher interest rates in the future will hurt the value of bonds that pay today's lower rates. Immediately after the Fed's June announcement, investors began pulling money out of bond mutual funds in droves, reversing a multiyear trend. If there's less demand for bonds, yields have to rise to attract investors.

Aside from bonds, why are investors concerned about a possible Fed rate hike? Bonds aren't

the only financial asset that can be affected by potential future interest rate changes. Dividend-paying stocks with hefty yields have benefitted in recent years; more competitive bond yields could start to reverse that dynamic. Shares of preferred stock typically behave much like those of bonds, since their dividend payments also are fixed; their values could be affected as well.

Also, higher mortgage rates could potentially slow the housing market recovery, though historically they remain at relatively low levels. And if a Fed rate increase were to bring on higher interest rates abroad, that could create even more problems in countries already struggling with sovereign debt--problems that have provoked global market volatility in the past.

The Fed has said any hikes in its target rate will occur only if the economy seems strong enough. If higher rates seem likely to halt the recovery, the Fed could postpone a rate hike even longer. It also will take other measures before raising rates. Even though the timing and size of any Fed action is uncertain, it's best to be aware of its potential impact.



What is asset allocation?

Each type of investment has specific strengths and weaknesses that enable it to play a specific role in your overall investing strategy.

Some investments may offer growth potential. Others may provide regular income or relative safety, or simply serve as a temporary place to park your money. And some investments may even serve to fill more than one role. Because you likely have multiple needs and desires, you probably need some combination of investment types, or asset classes.

Balancing how much of each asset class should be included in your portfolio is a critical task. That balance between growth, income, and safety is called your asset allocation, and it can help you manage the level and types of risks you face.

The combination of investments you choose can be as important as your specific investments. Your mix of various asset classes, such as stocks, bonds, and cash alternatives, generally accounts for most of the ups and downs of your portfolio's returns.

Ideally, your portfolio should have an overall combination of investments that minimizes the

risk you take in trying to achieve a targeted rate of return. This often means balancing more conservative investments against others that are designed to provide a higher potential return but that also involve more risk. However, asset allocation doesn't guarantee a profit or eliminate the possibility of investment losses.

Someone living on a fixed income, whose priority is having a regular stream of money coming in, will probably need a very different asset allocation than a young, well-to-do working professional whose priority is saving for a retirement that's 30 years away. Even if two people are the same age and have similar incomes, they may have very different needs and goals, and your asset allocation should be tailored to your unique circumstances.

And remember, even if your asset allocation was right for you when you chose it, it may not be right for you now. It should change as your circumstances do and as new ways to invest are introduced. A piece of clothing you wore 10 years ago may not fit now; you just might need to update your asset allocation, too.



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