Johnston Investment Counsel

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Prepare Now for a Year-End Investment Review

Leaving Assets to Your Heirs: Income Tax Considerations

The Potential Pitfalls of DIY Estate Planning

What factors could negatively impact my credit report?

Prepare Now for a Year-End Investment Review

Getting organized for your year-end investment review with your financial professional may help make the review process more efficient. Here are some suggestions for making your meeting as productive as possible.

Decide what you want to know

One of the benefits of a yearly investment review is that it can help you monitor your investment portfolio. A key component of most discussions is a review of how your investments have performed over the last year. Performance can mean different things to different people, depending on their individual financial goals and needs. For example, an investor who's focused on long-term growth might define "performance" slightly differently than an investor whose primary concern isn't overall growth but trying to maintain a portfolio that has the potential to produce current income needed to pay ordinary living expenses.

Consider in advance what types of information are most important to you and why. You may want to check on not only your portfolio's absolute performance but also on how it fared compared to some sort of benchmark. For example, you might want to know whether any equity investments you held outperformed, matched, or underperformed a relevant index, or how your portfolio fared against a hypothetical benchmark asset allocation. (Remember that the performance of an unmanaged index is not indicative of the performance of any specific security, and indices are not available for direct investment. Also, asset allocation cannot guarantee a profit or eliminate the possibility of loss, including the loss of principal.)

Almost as important as knowing how your portfolio performed is understanding why it performed as it did. Was any overperformance or underperformance concentrated in a single asset class or a specific investment? If so, was that consistent with the asset's typical behavior over time? Or was last year's performance an anomaly that bears watching or taking action? Has any single investment grown so much that it now represents more of your portfolio than it should? If so, should you do a little profit-taking and redirect that money into something else?

Are any changes needed?

If your goals or concerns have changed over the last year, you'll need to make that clear during your meeting. Your portfolio probably needs to evolve over time as your circumstances change. Making sure you've communicated any life changes will make it easier to adjust your portfolio accordingly and measure its performance appropriately next year.

If a change to your portfolio is suggested based on last year's performance--either positive or negative--don't hesitate to ask why the change is being recommended and what you might reasonably expect in terms of performance and potential risk as a result of a shift. (However, when looking at potential returns, remember that past performance is no guarantee of future results.) Don't be reluctant to ask questions if you don't understand what's being presented to you; a little clarification now might help prevent misunderstandings and unrealistic expectations that could have a negative impact in the future.

Also, before making any change, find out how it might affect your investing costs, both immediate and ongoing. Again, a few questions now may help prevent surprises later.

Think about the coming year

Consider whether you would benefit next April from harvesting any investment losses before the end of the year. Selling a losing position could generate a capital loss that could potentially be used to offset either capital gains or up to $3,000 of ordinary income on your federal income tax return.

If you've amassed substantial assets, you could explore whether you might benefit from specialized assistance in dealing with issues such as taxes, estate planning, and asset protection. Finally, give feedback on the review process itself; it can help improve next year's session. *Note: All investing involves risk, including the potential loss of principal, and there can be no guarantee that any investing strategy will be successful.*

Leaving Assets to Your Heirs: Income Tax Considerations

An inheritance is generally worth only what your heirs get to keep after taxes are paid. Here we have focused primarily on federal income taxes. Depending on your circumstances, you may wish to also consider federal estate tax and state income, estate, and inheritance taxes.

Note: It is generally recommended that you designate IRA and other retirement plan beneficiaries, their shares, and any backup beneficiaries on the plan beneficiary form. This will help assure that retirement plan benefits pass as you wish at your death and that a beneficiary will be able to stretch distributions over his or her remaining life expectancy.

An inheritance is generally worth only what your heirs get to keep after taxes are paid. So when it comes to leaving a legacy, not all property is created equal--at least as far as federal income tax is concerned. When evaluating whom to leave property to and how much to leave to each person, you might want to consider how property will be taxed and the tax rates of your heirs.

Favorable tax treatment for heirs

Roth IRAs

Assets in a Roth IRA will accumulate income tax free and qualified distributions from a Roth IRA to your heirs after your death will be received income tax free. An heir will generally be required to take distributions from the Roth IRA over his or her remaining life expectancy. (Of course, your beneficiaries can always withdraw more than the required minimum amounts.) If your spouse is your beneficiary, your spouse can treat the Roth IRA as his or her own and delay distributions until after his or her death. So your heirs will be able to continue to grow the assets in the Roth IRA income tax free until after the assets are distributed; any growth occurring after funds are distributed may be taxed in the future.

Note: *The Supreme Court has ruled that inherited IRAs are not retirement funds and do not qualify for a federal exemption under bankruptcy. Some states may provide some protection for inherited IRAs under bankruptcy. You may be able to provide some bankruptcy protection to an inherited IRA by placing the IRA in a trust for your heirs. If this is a concern of yours, you may wish to consult a legal professional.*

Appreciated capital assets

When you leave property to your heirs, they generally receive an initial income tax basis in the property equal to the property's fair market value (FMV) on the date of your death. This is often referred to as a "stepped-up basis," because basis is typically stepped up to FMV. However, basis can also be "stepped down" to FMV.

If your heirs sell the property with a stepped-up (or a stepped-down) basis immediately after your death for FMV, there should be no capital gain (or loss) to recognize since the sales price will equal the income tax basis. If they sell the property later for more than FMV, any appreciation after your death will generally be taxed at favorable long-term capital gain tax rates. If the appreciated assets are stocks, qualified dividends received by your heirs will also be taxed at favorable long-term capital gain tax rates.

Note: *If your heirs receive property from you that has depreciated in value, they will receive a basis stepped down to FMV and will not be able to claim any loss with respect to the depreciation before your death. You may want to consider selling depreciated property while you are alive so that you can claim the loss.*

Not as favorable tax treatment for heirs

Tax-deferred retirement accounts

Assets in a tax-deferred retirement account (including a traditional IRA or 401(k) plan) will accumulate income tax deferred within the account. However, distributions from the account will be subject to income tax at ordinary income tax rates when distributed to your heirs (if there were nondeductible contributions made to the account, the nondeductible contributions can be received income tax free). An heir will generally be required to take distributions from the tax-deferred retirement account over his or her remaining life expectancy. (Of course, your beneficiaries can always withdraw more than the required minimum amounts.) If your spouse is the beneficiary of the account, the rules may be more favorable. So your heirs will be able to defer taxation of the retirement account until distribution, but distributions will generally be fully subject to income tax at ordinary income tax rates.

Note: *Your heirs do not receive a stepped-up (or stepped-down) basis in your retirement accounts at your death.*

Even though distributions are taxable, your heirs will nevertheless generally appreciate receiving tax-deferred retirement accounts from you. After all, they do get to keep the amounts remaining after taxes are paid.

Toxic or underwater assets

Your heirs might not appreciate receiving property that is subject to a mortgage, lien, or other liability that exceeds the value of the property. In fact, an heir receiving such property may want to consider disclaiming the property.

Always nice to receive

Life insurance and cash

Life insurance proceeds received by your heirs will generally be received income tax free. Your heirs can generally invest life insurance proceeds and cash they receive in any way that they wish. When doing so, yours heirs can factor in how the property will be taxed to them in the future.

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The Potential Pitfalls of DIY Estate Planning

The one-size-fits-all, fill-in-the-blank forms that do-it-yourself estate planning sources provide may be attractive to some individuals because they cost a fraction of what attorneys typically charge. But is saving a few dollars worth the risk of doing things incorrectly?

Americans, by and large, are do-it-yourselfers. Books, websites, software programs, and even giant box stores exist solely to help ambitious Americans tackle all kinds of everyday challenges, from fixing leaky faucets to building backyard sheds. The same holds true for estate planning--there's certainly no dearth of information for those wanting to prepare their own wills and other important documents. However, do-it-yourselfers may want to exercise a bit of caution here.

Although do-it-yourself (DIY) estate planning can cost a fraction of what attorneys charge, depending on your personal situation, this may be a case of being penny-wise and pound-foolish.

Cheap, easy, and better than nothing

Proponents of DIY estate planning typically have two arguments:

1. **It's cheap and easy:** Creating a will and other estate planning documents on your own can cost far less than doing so with an attorney's assistance. You can find resources online and in the library that could help.
2. **It's better than nothing:** What happens if you die or become very ill without important estate planning documents? In that case, the state will make important decisions for you, such as how your property will be distributed, who will care for your minor children, and what medical care you'll receive if you are unable to make your wishes known.

These points are valid: For those who cannot afford to pay an attorney, DIY may be an economical alternative. For others, a poorly drafted will may be better than no will at all, especially when naming a guardian for minor children is involved. But there are several risks to DIY estate planning, including the risk that your wishes will not be carried out exactly as you intend.

Basic is not always ideal

Although DIY sources can typically handle the needs of simple estates, they generally are not appropriate for even the most common complexities such as children from a prior marriage, children with special needs, property that has appreciated in value resulting in capital gains, and estates that are large enough to be subject to estate taxes (typically those worth more than $5,340,000 in 2014). Also, DIY sources generally fail to take advantage of sophisticated estate planning strategies because they usually can't account for an individual's unique circumstances.

Further, you may make an error by failing to understand the instructions or by following the instructions incorrectly.

The result is that the documents you create could be invalid, ineffective, or contain legal language having consequences you never intended. You might not know if that is the case during your lifetime, but at your death your loved ones will find out and may suffer the lasting consequences of your mistakes.

You may benefit from legal advice

DIY sources provide forms but not legal advice. In fact, these sources clearly state that they are not a substitute for an attorney, and that they are prohibited from providing any kind of legal advice.

Estate planning involves a lot more than producing documents. It's impossible to know, without a legal education and years of experience, what the appropriate legal solution is to your particular situation and what planning opportunities are available. The actual documents produced are simply tools to put into effect a plan that is specifically tailored to your circumstances and goals.

Estate planning laws change

Laws are not static. They constantly change because of new case law and legislation, especially when it comes to estate taxes. Attorneys keep up with these changes. DIY websites, makers of software, and other sources may not do as good a job at keeping current and up-to-date.

Fixing mistakes can be costly and time-consuming

As previously stated, working with an attorney to create your estate planning documents can be very expensive, costing anywhere from several hundred to several thousands of dollars, depending on the complexity of your estate. But these costs are minor compared to the costs and frustrations that your loved ones may experience if there are serious errors in your DIY estate plan. Many more thousands of dollars and many hours with attorneys may have to be spent to undo what was done wrong. Before embarking on a DIY estate plan, consider these risks very carefully.

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What factors could negatively impact my credit report?

Having a good credit report is important when it comes to personal finance, because most lenders use credit reports to evaluate the creditworthiness of a potential borrower. Borrowers with good credit are presumed to be more creditworthy and may find it easier to obtain a loan, often at a lower interest rate.

A number of factors could negatively impact your credit report, including:

- *A history of late payments.* Your credit report provides information to lenders regarding your payment history over the previous 12 to 24 months. For the most part, a lender may assume that you can be trusted to make timely monthly debt payments in the future if you have done so in the past. Consequently, if you have a history of late payments and/or unpaid debts, a lender may consider you to be a high credit risk and turn you down for a loan.
- *Too many credit inquiries.* Each time you apply for credit, the lender will request a copy of your credit history. The lender's request then appears as an inquiry on your credit report. Too many inquiries in a short amount of time could be viewed negatively by a potential lender, since it may indicate that the borrower has a history of being turned down for loans or has access to too much credit.
- *Not enough good credit.* You may have good credit, but not enough of it. As a result, you may need to build up more of your credit history before a lender deems you worthy to take on any additional debt.
- *Uncorrected errors on your report.* Uncorrected errors on a credit report could make it difficult for a lender to accurately evaluate creditworthiness, and could result in a loan denial. If you have errors on your credit report, it's important to take steps to correct your report, even if it doesn't contain derogatory information.

Finally, if you are ever turned down for a loan, there is a way to find out the reason behind it. Under federal law, you are entitled to a free copy of your credit report as long as you request it within 60 days of receiving notice of a company's adverse action against you. For more information, visit the Federal Trade Commission's website.

I'm looking to buy a home. What are some common mortgage mistakes to avoid?

Navigating the complex world of mortgages can be difficult. As a result, it's easy to make mistakes when applying for a mortgage loan.

Here are some common mortgage mistakes you should try to avoid:

- *Taking on a mortgage that is too big for you to handle.* The mortgage you are qualified or preapproved for isn't necessarily how much you can afford. Be sure to examine your budget and lifestyle to make sure that your mortgage payment--including any extras, such as mortgage insurance--is within your means.
- *Neglecting to read the fine print.* Before you sign any paperwork, make sure that you fully understand the terms of your mortgage loan and the costs associated with it. For example, are you are applying for an adjustable-rate mortgage? If so, it's important to be aware of how and when the interest rate for the loan will adjust.
- *Overlooking your credit.* A positive credit history may not only make it easier to obtain a mortgage loan, but potentially could also result in a lender offering you a lower interest rate. Be sure to review your credit report and check it for inaccuracies. You may have to take the necessary steps to improve your credit history, such as paying your monthly bills on time and limiting credit inquiries on your credit report (which are made every time you apply for new credit).
- *Putting down too little.* While it is possible to obtain a mortgage with a minimal down payment, a larger down payment may help you get more attractive mortgage terms. In addition to requiring private mortgage insurance, lenders generally offer lower loan limits and higher interest rates to borrowers who have a down payment of less than 20% of a home's purchase price.
- *Forgetting to shop around.* Be sure to shop around among various lenders and compare the types of loans offered, along with the costs and rates associated with those loans. Consider each lender's customer service reputation as well.

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The Newest Largest IPO In History

Last fall it was Twitter. Before that, it was Facebook. Now it's Alibaba, the huge Chinese e-commerce company that just became the largest tech IPO in history, after raising $21.8 billion in its initial public offering on September 18.

As it turns out, Facebook and Twitter turned out to be decent investments at their IPO price. Post-IPO buyers purchased Twitter shares at roughly $45 a share, and over the nearly 12 months since, the stock has climbed to around $50--an 11% return that is below what the market as a whole has delivered, but above the negative returns most investors experience in the first year after a public offering. Facebook has done better, starting life at $38 a share in May of 2012, following a very bumpy path that saw investors deeply under water for months, and then recovering so that shares are now trading around $75.

Will Alibaba continue the streak? Amid all the hype, one voice to listen to is veteran emerging markets analyst/manager Mark Mobius, of Franklin Templeton Investments. Mobius acknowledges that Alibaba has some interesting fundamentals--including a return on equity of 24%, operating margins of 26% and revenue of $1.02 billion, making it by far the biggest e-commerce engine in China.

But he also notes that the company has an unusual corporate structure that could lead to problems for investors down the road. He warns that the company's ownership team controls the board of directors, which means that if shareholders are concerned about the direction of the company, well, there isn't much shareholders could do about it.

What, exactly, did investors buy in this IPO? In most cases, IPO investors are purchasing direct ownership shares of the company. But Alibaba is listed as a variable interest entity, which creates a somewhat more complicated ownership structure. The bottom line is that shareholders, in this public offering, are actually buying a stake in a company registered in the Cayman Islands, which has a contract to share in Alibaba's profits. If shareholders ever became concerned about Alibaba's management decisions, they would have to go to a Chinese court to get redress. It is hard to imagine a positive outcome for American investors.

Along this line, it is interesting to note that the original plan was for Alibaba to go public on the Hong Kong stock exchange, but the Hong Kong regulators declined to allow it, citing concerns about (you guessed it) the ownership structure and fairness to Hong Kong investors.

Providing For Pets

This summer, the entertainment world lost one of its most prominent and popular figures: Joan Rivers. When her estate planning documents were unveiled, it became clear that she was a careful planner of her legacy--and also a devoted pet owner. One of the most interesting details of her estate plan was the careful provisions Rivers made for her pets.

Rivers left the bulk of her estate to her daughter Melissa and her grandson Cooper--an estimated $150 million in total value. The two rescue dogs who shared her New York residence, and two other dogs who lived at her home in California, were beneficiaries of pet trusts, which included an undisclosed amount of money set aside for their ongoing care, and carefully written provisions that described the standard of living that Rivers expected them to receive for the remainder of their lives.

Traditional pet trusts are honored in most U.S. states, as are statutory pet trusts, which are simpler. In a traditional trust, the owner lists the duties and responsibilities of the designated new owner of the pets, while the statutory trusts incorporate basic default provisions that give caregivers broad discretion to use their judgment to care for the animals. Typical provisions include the type of food the animal enjoys, taking the dog for daily walks, plus regular veterinary visits and care if the pet becomes ill or injured. The most important provision in your pet trust, according to the American Society for the Prevention of Cruelty to Animals, is to select a person who loves animals and, ideally, loves your pets.

The trust document will often name a trustee who will oversee the level of care, and a different person will be named as the actual caregiver. In all cases, the trusts terminate upon the death of the last surviving animal beneficiary, and the owner should choose who will receive those residual assets.

Some states have different laws that require different arrangements. Idaho allows for the creation of a purpose trust, and Wisconsin's statute provides for an "honorary trust" arrangement. There are no pet trust provisions on the legal books in Kentucky, Louisiana, Minnesota and Mississippi, but pet owners living there can create a living trust for their pets or put a provision in their will which specifies the care for pets. A popular (and relatively simple) alternative is to set aside an amount of money in the will to go to the selected caregiver, with a request that the money be used on behalf of the pet's ongoing care.

It should be noted that a pet trust is not designed to pass on great amounts of wealth into the total net worth of the animal kingdom. The poster child of an extravagant settlement is Leona Helmsley's bequest of $12 million to her White Maltese, instantly putting the dog, named "trouble," into the ranks of America's one-percenters. Rather than confer a financial legacy on an animal, the goal should be to ease any financial burdens the successor owner might incur when caring properly for your loved animals for the remainder of their lives, including food and veterinary bills.

How long should you plan for the funding to last? Cats and dogs typically live 10-14 years, but some cats have lived to age 30, and some dogs can survive to see their 24th birthday. Interestingly, estate planners are starting to see some pet trusts extend out for rather lengthy periods of time, as owners buy pets that have longer lifespans. For example, if an elderly person has a Macaw parrot as a companion, the animal could easily outlive several successor owners, with a lifespan of 80-100 years. Horse owners should plan for a life expectancy of 25-30 years, and, since horses tend to be expensive to care for, the trust will almost certainly require greater levels of funding. On the extreme end, if you know anyone who happens to have a cuddly

Galapagos giant tortoise contentedly roaming their backyard, let them know that their pet trust would need to be set up for an average 190-year lifespan.

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Secession Movement?

Scotland has voted--for now--to remain a part of the United Kingdom, a move which avoids such huge and thorny decisions as: how much of Britain's national debt would belong to the newly-independent Scottish nation? Would Scotland have to create its own army and navy, or enter into a contract with the UK for mutual defense? What currency would Scottish citizens use--the euro, the pound or some new currency that hasn't been created yet? Would other countries have to set up embassies in the new nation, and would the country have to create its own embassies around the world? And the most interesting question of all: if Scotland leaves the UK, would Northern Ireland and / or Wales follow?

The vote has put the spotlight on a lot of other separatist initiatives around the world. Prominent among these are the French-speaking citizens of Quebec in Canada, the citizens of Spain's Catalonia, Uighurs and Tibetans in China, the Flemish in Belgium, the Istrian Italians in Croatia, the Moravians in the Czech Republic and many others.

Nor is the concept totally foreign to the U.S. Texas Governor Rick Perry started his own separatist movement by publicly talked about the possibility that his state could exit the U.S., and a Texas secession petition garnered 125,000 signatures in 2012. Its backers hope to make Texas what it was for ten years in the 1800s--a sovereign nation.

In case you were wondering, the Scottish nation would have been the world's 42nd largest, behind Finland and ahead of Israel, and secession would have knocked the UK's GDP down a rung from 6th to 7th in the world, behind Brazil. An independent Quebec's GDP would rank 33rd among the world's nations, behind Colombia, comfortably ahead of Denmark. The sovereign nation of Texas would instantly become the world's 12th largest economy, larger than Mexico or Spain. The state's 27 million people would qualify Texas as the world's 44th most populous, behind Venezuela and ahead of Ghana.

Constitutional experts note that, unlike Quebec and Scotland, Texas doesn't actually have the right to vote itself out of its national affiliation. Polls show that 80% of Texas voters prefer to remain American, just as Scottish voters have preferred to remain English and, so far, the Quebecois and Catalonians have voted to stay in their respective countries. But as these votes become increasingly common, it's possible that the world is entering a new era where secession initiatives are becoming more thinkable. Thirty or 50 years from now, the global map--and perhaps the American one as well--might look very different than it does today

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