



Financial Services

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CGI Financial Services
Ryan McLaughlin
171 Londonderry Turnpike
Hooksett, NH 03106
603.232.9317
rmclaughlin@cgifinancialservices.com
www.cgifinancialservices.com

*Securities offered
through L.M. Kohn &
Co., 9810
Montgomery Rd.,
Cincinnati OH 45242*

800-478-0788

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The Economics of Borrowing from Your 401(k)

When times are tough, that pool of dollars sitting in your 401(k) plan account may start to look attractive. But before you decide to take a plan loan, be sure you understand the financial impact. It's not as simple as you think.

The basics of borrowing

A 401(k) plan will usually let you borrow as much as 50% of your vested account balance, up to \$50,000. (Plans aren't required to let you borrow, and may impose various restrictions, so check with your plan administrator.) You pay the loan back, with interest, from your paycheck. Most plan loans carry a favorable interest rate, usually prime plus one or two percentage points. Generally, you have up to five years to repay your loan, longer if you use the loan to purchase your principal residence.

You pay the interest to yourself, but ...

When you make payments of principal and interest on the loan, the plan deposits those payments back into your individual plan account. This means that you're not only receiving back your loan principal, you're also paying the loan interest to yourself instead of to a financial institution. But the benefits of paying interest to yourself are somewhat illusory.

Here's why. To pay interest on a plan loan, you first need to earn money and pay income tax on those earnings. With what's left over after taxes, you pay the interest on your loan. When you later withdraw those dollars from the plan (at retirement, for example), they're taxed again because plan distributions are treated as taxable income. In effect, you're paying income tax twice on the funds you use to pay interest on the loan. (Note: Special tax rules apply to Roth 401(k) contributions.)

The opportunity cost

When you take a loan from your 401(k) plan, the funds you borrow are removed from your plan account until you repay the loan. While removed from your account, the funds aren't

continuing to grow tax deferred within the plan. So the economics of a plan loan depend in part on how much those borrowed funds would have earned if they were still inside the plan, compared to the amount of interest you're paying yourself. This is known as the opportunity cost of a plan loan, because you miss out on the opportunity for more tax-deferred investment earnings.

Other considerations

There are other factors to think about before borrowing from your 401(k) plan. If you take a loan, will you be able to afford to pay it back and continue to contribute to the plan at the same time? If not, borrowing may be a very bad idea in the long run, especially if you'll wind up losing your employer's matching contribution.

Also, if you terminate employment, your plan may require that your loan become immediately payable. If so, and you don't have the funds to pay it off, the outstanding balance will be treated as a taxable distribution to you, and if you're not yet 59½, a 10% early distribution penalty may also apply to your taxable balance.

Still, plan loans may make sense in certain cases (for example, to pay off high-interest credit card debt, or to purchase a home). But make sure you compare the cost of borrowing from your plan with other financing options, including loans from banks, credit unions, friends, and family. To do an adequate comparison, you should consider:

- Interest rates with each alternative
- Whether the interest will be tax deductible (for example, interest paid on home equity loans is usually deductible, but interest on plan loans usually isn't)
- The amount of investment earnings you may miss out on by removing funds from your 401(k) plan

Should a Destination Club Be Your Home Away from Home?

If you've thought about buying or building a vacation home, but have hesitated because you aren't sure that you want to limit yourself to a single location, there's an alternative you may want to consider: purchasing a membership in a destination club.

What are destination clubs?

Destination clubs are becoming increasingly popular. In return for a one-time membership fee and annual dues, destination club members are allowed to use a club's global network of luxurious properties for a certain amount of time each year, depending on their membership level. Club holdings are generally restricted to high-end properties--typically those with values of \$1.5 million to \$3 million. Accommodations are usually large, luxurious private homes, villas, and apartments that are located in travel hot spots such as cities and resort areas. They offer upscale amenities, and a host of personal services.

A destination club or a vacation home?

If you've ever fallen in love with a vacation spot, you know that there are some places worth going back to. You may be happy to own a home in a favorite locale and travel to it year after year. One of the main advantages of owning a vacation home is that you're in the driver's seat. You can use the property as often as you like, invite friends or family members to use it, or even rent it out. You can also customize your home and decorate it as you wish. But no matter how much you enjoy owning a vacation home, there's no escaping the fact that it's a big responsibility. You have to worry about maintaining it, and you must handle all expected--and unexpected--expenses.

The hallmark of a destination club, on the other hand, is flexibility. Joining a destination club allows you to travel to many different places and stay in homes spacious enough to accommodate your family and friends, without the hassles of owning vacation property.

Comparing costs

To compare a destination club membership financially with the purchase of a second home, you have to consider the upfront and ongoing costs of each. Some costs may be similar. For example, maybe you're considering a destination club with a one-time membership fee of \$300,000 and annual dues of \$25,000. Alternatively, you could buy a comparable property, let's say one that's worth \$1.5 million. If you opt to finance the home,

your \$300,000 (20%) down payment would be equivalent to the destination club's membership fee, and the amount you'll spend annually on home maintenance and utility costs could be equivalent to the destination club's annual dues. (Of course, financing the remaining \$1.2 million of the home's purchase price will also mean making significant monthly payments.)

Costs can vary widely, however. Initial membership fees for a destination club typically range from \$100,000 to \$1 million or more, and annual fees typically range from \$10,000 to \$75,000 or more. Home ownership costs may include mortgage expenses, taxes, insurance, utilities, and maintenance (which may be offset somewhat by any rental income you receive).

Another variable to account for is what you'll get for your money. Destination club memberships entitle you to a certain number of days of use annually, whereas you can use a vacation home as much as you'd like. You'll also need to take into account home values. For example, joining a destination club may entitle you to stay in a home worth much more than one you could afford to buy (and will also give you access to personal concierge services), but it depends on the specifics.

As a vacation home owner, you can decide when to sell your property, and you'll benefit from any appreciation in value. Destination clubs, on the other hand, are frank about the fact that becoming a member should be viewed mainly as a lifestyle decision, rather than as an investment decision, although some do allow you to benefit directly or indirectly from any appreciation in the club's property values. Most destination clubs also have provisions that enable you to "cash out" your membership at your request. For example, you may be allowed to cash out your membership for a specified percentage of the membership fee being charged at the time (generally 80% to 100%). If that's the case, you might benefit if you cash out at a time when the club's holdings have risen in value and membership fees are higher than when you joined.

Do your homework

When you join a destination club you're committing a substantial amount of money. So, make sure that the club is financially sound. Get information about the club's finances, and carefully read materials and contracts before you sign on the dotted line.



Destination clubs vs. residence clubs

With a residence club, you're generally buying a share in a specific property. Destination clubs, while similar in many respects, offer memberships that tend to be more flexible, and are not tied to any specific property.



Annuity Maximization: A Strategy to Leave More to Your Heirs

What if you're living comfortably in retirement and find that you don't need a deferred annuity you bought years ago? Instead, you want to leave it to your heirs at your death. What you may not know is that transferring your deferred annuity at death may subject it to both estate and income taxes. A strategy that can minimize the impact of these taxes is called annuity maximization using permanent life insurance.



Some background

When you die, the portion of the annuity death benefit received by your beneficiaries (either in a lump sum or as periodic payments) that exceeds your investment in the annuity is includible as taxable income to your beneficiaries.

In addition, the full accumulation value of your deferred annuity is includible in your gross estate at your death. If your estate is large enough to owe federal and/or state estate taxes, your deferred annuity will be subject to those taxes as well.

The combination of estate and income taxes can erode a significant portion of your annuity's value. The result is that your beneficiaries may receive an annuity worth much less than you anticipate.

How annuity maximization works

Here's the basic way this strategy works: you exchange your deferred annuity for a single premium immediate annuity (SPIA) that provides an income stream to you for the rest of your life. You then obtain permanent life insurance with you as the insured, and use the SPIA distributions to pay the insurance premiums. At your death, the SPIA payments stop and the insurance proceeds are paid to your beneficiaries.

Alternatively, if you prefer to retain the deferred annuity instead of converting it to an SPIA, you may be able to take penalty-free withdrawals from your deferred annuity, which also can be used to pay the insurance premiums. However, annuities vary as to penalty-free withdrawal availability, so for complete

details, be sure to check with the annuity issuer, or review your annuity contract or prospectus.

Caution: *Annuity distributions before age 59½ may be subject to a 10% federal tax penalty. Annuity guarantees are based on the claims-paying ability of the annuity issuer.*

The annuity maximization strategy may pose some income tax issues for you. SPIA payments and annuity withdrawals may be taxable to you. A portion of each SPIA payment you receive is subject to income taxes and a portion is considered a nontaxable return of premium. Conversely, withdrawals from your deferred annuity (for annuities issued after 1982) are taxed as income first, meaning the entire withdrawal is includible as income until all of the annuity's earnings are withdrawn, after which withdrawals of principal are not includible as income.

Why annuity maximization works

Instead of getting the deferred annuity at your death, your beneficiaries receive the life insurance proceeds, income tax free. And you can effectively remove the value of the deferred annuity from your estate by converting it to a SPIA. Since the SPIA payments cease at your death, the SPIA is not included as an asset of your estate.

In addition, the life insurance can escape estate taxes if the policy is not part of your estate at death. To achieve this goal, you can't own the policy; it must be owned by another (e.g., your child or an irrevocable life insurance trust). You then make gifts to the policy owner equal to the annual insurance premium. However, gifts may be subject to both federal and state gift taxes, so you should consult your tax professional before making such gifts.

The bottom line

If you own an annuity that you want to transfer to your heirs at your death, a significant portion of its value may be lost to estate and income taxes. Annuity maximization is a strategy that lets you replace part or all of a taxable asset (your deferred annuity) with an asset (permanent life insurance) that may be subject to neither income nor estate taxes at your death. This approach may effectively allow you to increase the amount you pass on to your beneficiaries.

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Ask the Experts



Will the current credit crunch impact my child's ability to get a student loan for college?

It's hard to say whether the credit crunch will prevent students from obtaining the financing they need to pay for college. According to the College Board, last year students and their families borrowed nearly \$60 billion in federal loans and \$17 billion in private loans for college. In order to understand the current student lending market, some background is helpful.

Federal student loans. Under the Federal Family Education Loan Program (FFELP), private lenders receive subsidies from the federal government to issue federal student loans at reduced interest rates. But last year, Congress slashed subsidies to FFELP lenders. This, coupled with tightening credit and near paralysis in the secondary debt markets, created the perfect storm--a student lending market in potential turmoil due to the unwillingness and/or inability of some private lenders (to date more than 50) to make, package, and sell federal student loans.

The problem was big enough to attract the attention of the federal government--legislation passed in May allows the Department of Education to buy billions of dollars in federal student loans from private lenders to keep money flowing into the widely used FFELP. The consensus is that there will be enough federal student loan money--Stafford, Perkins, and PLUS Loans--in the FFELP to go around for the 2008/09 academic year.

Private student loans. Over the past decade, the use of private student loans to finance college has soared as federal student loans fail to keep up with rising costs. This year, college students in need of private loans are expected to face higher interest rates and more stringent credit checks. Unfortunately, this means that some students who qualified for a loan last year may not this year, or they may have to pay a higher interest rate. The federal government has not proposed buying private student loans, so lenders will be on their own to raise the necessary capital.

What is a Parent PLUS Loan?



A Parent PLUS Loan is a federal student loan available to parents with good credit histories who want to help pay for their dependent child's undergraduate education. (A similar Graduate PLUS Loan is available to graduate students.) Under the program, parents can

borrow up to the full cost of their child's college education each year, less any financial aid received. For example, if college costs \$30,000 this year and a student receives \$10,000 in financial aid, parents would potentially be eligible for a \$20,000 PLUS Loan. To qualify, students must be attending an eligible school at least half time.

PLUS Loans aren't based on financial need; parents need only pass a credit check. Under new federal legislation passed in May, parents who are delinquent up to 180 days on their home mortgage or medical debt will still be considered creditworthy to borrow under the program.

The interest rate on all PLUS Loans issued on or after July 1, 2006, is capped at 8.5%. (For PLUS Loans issued before this date, the interest rate is variable, adjusted each July, and capped at 9%.)

Interest begins accruing upon the first loan disbursement, but thanks to the recent legislation, parents have the option to defer repayment of the loan for up to six months after their child leaves school. Previously, repayment was required to begin within 60 days of the last loan disbursement for that year.

PLUS Loans can be made either by private lenders who participate in the Federal Family Education Loan Program (FFELP), or directly by the federal government under the William D. Ford Federal Direct Loan Program. The federal government recently took steps to pump liquidity into the FFELP market due to turmoil in the general credit markets, so fund availability isn't expected to be a problem.

CGI Financial Services
Ryan McLaughlin
171 Londonderry Turnpike
Hooksett, NH 03106
603.232.9317
mclaughlin@cgifinancialservices.com
www.cgifinancialservices.com

Securities offered through L.M.
Kohn & Co., Member
FINRA/SIPC 9810 Montgomery
Rd, Cincinnati OH 45242 (800)
478-0788

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