Johnston Investment Counsel

TRUSTED FIDUCIARIES & FEE-ONLY ADVISORS

September, 2010

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

In this issue:

Medicare Annual Enrollment Season Is Here

If you're currently enrolled in Medicare, you've probably begun receiving information about your coverage. That's because the annual enrollment period for Medicare runs from November 15 through December 31. During this period, you can make changes to your Medicare coverage that will be effective on January 1, 2011. Even if you like the Medicare coverage you already have, it's a good time to explore your options, especially if your health or financial circumstances have changed.

Reviewing your Medicare plan

Your Medicare plan sends you two important documents every year. The first, called the Evidence of Coverage, gives you information about what your plan covers, and its cost. The second, called the Annual Notice of Change, lists changes to your plan for the upcoming year (these will take effect in January). You can use these documents to evaluate your current plan and decide if you need different coverage. If you haven't already gotten one, you should soon receive a copy of Medicare & You 2011, the official government Medicare handbook. It contains detailed information about Medicare that should help you decide if your current plan is right for you.

Here are a few points to consider as you review your coverage:

- Will your current plan cover all the services you need and the health-care providers you need to see next year?
- Does your current plan cost more or less than other options? Make sure you consider premiums, deductibles, and other out-of-pocket costs you pay such as co-payments or coinsurance costs, and determine if any of these costs are changing.
- Do you need to join a Medicare drug plan? When comparing plans, consider the cost of drugs under each plan, and make sure the drugs you take will still be covered next year.

What's new?

This year, it's especially important to carefully review your coverage, because legislation passed in 2010 will affect your Medicare coverage next year. Some costs and coverages will be different. For example, starting in 2011, if you're enrolled in original Medicare, you'll be entitled to a free annual physical and wellness plan, and other preventive care services will be fully covered. If you have a Medicare prescription drug plan, and you have prescription costs high enough to put you into the coverage gap known as "the donut hole," you'll receive a 50% discount on brand-name drugs and a small discount on generic drugs.

Medicare Advantage plans will be affected too. The open enrollment period that used to be available each year from January 1 through March 31 is changing; starting next year, this period will run from January 1 through February 15. If you're enrolled in a Medicare Advantage plan, the only option you'll have during this period is to disenroll from your plan and switch back to original Medicare (formerly you could switch to a different Medicare Advantage plan during this time). However, if you return to original Medicare and lose drug coverage provided by your Medicare Advantage plan, you'll also be able to enroll in a Medicare prescription drug plan.

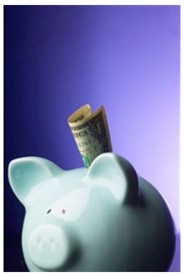
What if you want to keep your current plan?

If you're happy with your current coverage, you don't need to switch plans. You can keep the plan you have if it still meets your needs.

If you have any questions or concerns about your coverage or need help comparing your options, call 1-800-Medicare. Or, you can find a tool on the official Medicare website, www.medicare.gov, that compares Medicare plans, Medigap plans, and Medicare prescription drug plans available in your area.

Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

In-Service Withdrawals from 401(k) Plans



Remember that your 401(k) account is there for your retirement. Using it before then should be a last resort only.

You're probably familiar with the rules for putting money into a 401(k) plan. But are you familiar with the rules for taking your money out?

All 401(k) plans are not the same

Federal law specifies the withdrawal options that a 401(k) plan can offer. But your plan can be stricter than the law allows (i.e., offer fewer withdrawal options), and may even provide that you can't take any money out until you reach normal retirement age (usually 65). However, many plans are more flexible.

Withdrawing your own contributions

If your plan allows, you can withdraw your own pretax and Roth contributions (and in some cases, any investment earnings on them) for one of the following reasons:

- You terminate employment
- You attain age 59½
- You become disabled
- You incur a hardship

Hardship withdrawals are permitted only if you have an immediate and heavy financial need, and only in an amount necessary to meet that need. In most plans, you must need the money to (1) purchase a principal residence or repair a principal residence damaged by an unexpected event (e.g., a hurricane), (2) prevent eviction or foreclosure, (3) pay medical bills, (4) pay certain funeral expenses, (5) pay certain education expenses, and (6) pay income tax and/or penalties due on the hardship withdrawal itself. In addition, you generally must have already utilized all other available distributions and nontaxable loans under all plans maintained by your employer. But think carefully before making a hardship withdrawal--in most plans your employer must suspend your participation in the plan for at least six months after the withdrawal, and you could lose valuable employer matching contributions.

Withdrawing employer contributions

Getting employer dollars out of a 401(k) plan can be even more challenging. Many plans won't let you withdraw employer contributions at all before you terminate employment. But some plans are more flexible, and let you withdraw at least some vested employer contributions before then. "Vested" means that you own the contributions and they can't be forfeited for any reason. In general, a 401(k) plan can let you withdraw vested matching or profit-sharing contributions if:

- You become disabled
- You incur a hardship
- You attain a specified age
- You participate in the plan for at least five years, or
- The employer contribution has been in the account for a minimum of two years

Taxation

Your own pretax contributions, company contributions, and investment earnings are taxable when withdrawn from the plan. If you've made any after-tax contributions, they'll be nontaxable when withdrawn. Each withdrawal is deemed to carry out a pro-rata portion of taxable and nontaxable dollars. Any Roth contributions, and investment earnings on them, are treated separately: if your distribution is qualified, then your withdrawal will be entirely free from federal income taxes. If your withdrawal is nonqualified, then each withdrawal will be deemed to carry out a pro-rata amount of your nontaxable Roth contributions and taxable investment earnings. And keep in mind that taxable distributions made prior to age 59½ are generally subject to a 10% premature distribution tax in addition to any income tax due, unless an exception applies.

Plan loans

Many 401(k) plans allow you to borrow money from your own account. A loan may be attractive if you don't qualify for a withdrawal, or you don't want to incur the taxes and penalties that may apply to a withdrawal.

In general, you can borrow up to one half of your vested account balance (including your contributions, your employer's contributions, and earnings), but not more than $50,000.

You can borrow the funds for up to five years (longer if the loan is to purchase your principal residence). In most cases you repay the loan through payroll deduction, with principal and interest flowing back into your account. But keep in mind that when you borrow, the unpaid principal of your loan is no longer in your 401(k) account working for you.

Be informed

You should become familiar with the terms of your employer's 401(k) plan to understand your particular withdrawal rights. A good place to start is the plan's summary plan description (SPD). Your employer will give you a copy of the SPD within 90 days after you join the plan.

Year-End Investment Planning Is More Challenging in 2010

If you don't normally review your investments at the end of each year, 2010 might be a good time to start. And if year-end investment planning is already part of your routine, you might want to pay special attention this year. Why? Because significant changes in the tax code that are scheduled to go into effect in 2011 could substantially alter the taxation of your portfolio next year. That could in turn affect your investment strategy. And since many expect additional changes that will affect next year's tax landscape, it's even more important than usual to think about whether your portfolio needs fine-tuning.

Begin planning before December 31

If you plan to sell a profitable investment at some point, you'll want to assess whether you should sell before the end of the year. That's especially true if you're in a low tax bracket or you have investments that have appreciated substantially. Investors in the 10% and 15% tax brackets currently owe no capital gains taxes on long-term capital gains. That is scheduled to change in 2011, when the long-term capital gains rate at this level is scheduled to increase from 0 to 10%. If you're in the 25% bracket or higher this year, you'll also need to think about this issue, though the scheduled increase from the current 15% to 20% isn't quite as dramatic as the leap from 0 to 10% that those in the lower income brackets will face. (Special, slightly lower rates for investments held for more than five years will apply beginning in 2011.)

Also, the tax brackets themselves are scheduled to change next year (see sidebar). If you plan to harvest a tax loss and think you may be in a higher tax bracket next year, it might make sense to first determine whether the loss would be more valuable later. Though tax considerations shouldn't be the sole factor in a decision to buy or sell, they shouldn't be ignored, either--especially this year.

Complicating your decisions, of course, is the uncertainty about whether the scheduled changes will undergo further revision before the end of the year. One possibility is to have a game plan based on the current scenario, and adjust it as warranted. It may seem like a burden, but for those in higher tax brackets, the extra effort could pay off come tax time.

Think about your overall tax burden

If you converted an IRA to a Roth IRA this year or are thinking about doing so before the end of the year, you may need to take that into account when deciding whether to book capital gains in 2010. That's because you're able to report the taxable ordinary income from the conversion on either your 2010 return or in the 2011 and 2012 tax years (half of the income in each year). Your decision about when you will account for the taxable income that results from a Roth conversion may affect your decision about the timing of investment sales, or vice versa. If you choose to report the income resulting from your Roth conversion on your 2010 return, consider whether it makes sense to realize sizable capital gains this year. If you feel it's to your advantage to sell assets and pay the capital gains tax in 2010, you may want to consider opting to postpone payment of the taxes owed on the Roth conversion until 2011 and 2012. That would mean the total taxes owed would be spread over three years rather than one (though as noted above, your future tax bracket also should be factored into the calculation).

Consider the tax status of dividends

Qualifying dividends are scheduled once again to be taxed next year as ordinary income, as they were before 2003, rather than at long-term capital gains rates, which are typically lower. If you'll be in the 15% tax bracket, that represents an increase of 15%. And if you'll be in the 28% tax bracket or higher next year, the change in the tax status of dividend payments could also have an impact; the higher your tax bracket in 2011, the greater the impact.

Don't forget the usual suspects

In addition to staying on top of the tax issues that complicate this year's investment planning efforts, there are some tasks that are useful every year. A portfolio review can tell you whether it's time to adjust your holdings to maintain an appropriate asset allocation. Also, if you have losses, you may be able to harvest those losing positions to offset some or all of any capital gains. Be sure to consider how long you've owned the asset; assets held a year or less generate short-term capital gains and are taxed as ordinary income.

If you're selling an investment but intend to repurchase it later, be careful not to buy within 30 days before or after a sale of the same security. Doing so would constitute a violation of the "wash sale" rule, and the tax loss would be disallowed. Finally, if you're considering the purchase of a mutual fund outside of a tax-advantaged account, find out when the fund will distribute dividends or capital gains, and consider postponing action until after that date to avoid owing tax on that distribution.

Federal tax brackets for ordinary income are scheduled to change in 2011 as follows:

10% becomes 15%

15% remains 15%

25% becomes 28%

28% becomes 31%

33% becomes 36%

35% becomes 39.6%

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

Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Ask the Experts

Will the new health-care law affect my Medicare drug plan?

Yes, it might. Many Medicare Part D beneficiaries have had to pay for prescriptions out-of-pocket after reaching a gap in their annual coverage, referred to as the "donut hole." Currently, if you're a Medicare Part D beneficiary, you may pay up to an additional $3,610, out-of-pocket, for medicines after reaching an initial threshold of $2,830 in total prescription drug costs (including Part D payments, beneficiary co-pays, and deductibles). But, in 2010, if you fall in the coverage gap, you will receive a $250 rebate.

Starting in 2011, you will receive a 50% discount on the cost of brand-name drugs in the coverage gap. Additionally, a reduction in coinsurance for generic drugs in the coverage gap will be phased in, starting in 2011, and a similar reduction in coinsurance for brand-name drugs begins in 2013. By 2020, a combination of federal subsidies and a reduction in co-payments will reduce your total out-of-pocket costs for medications in the donut hole to 25%.

Another change affecting Medicare Part D beneficiaries relates to full-benefit dual-eligible beneficiaries (individuals eligible for both Medicaid and Medicare). Dual-eligible beneficiaries receiving institutional care, such as in a nursing home facility, do not owe any co-payments for prescriptions covered by Part D. However, dual-eligible beneficiaries receiving long-term care services at home or in a day-care community setting are subject to such co-payments. Beginning in 2012, the new legislation removes this imbalance; individuals receiving services at home or in a community setting will no longer be subject to co-payments.

Also, beginning in 2011, the time period during which Part D and Medicare Advantage beneficiaries can make changes to their coverage is extended and runs from October 15 through December 7. This extension should provide more time for beneficiaries to consider their options while ensuring that any benefit changes are properly incorporated into the plan for the following year.

Does the new health-care reform law affect health spending accounts?

Yes. The new health-care reform legislation impacts flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs), health savings accounts (HSAs), and Archer medical savings accounts (MSAs).

Over-the-counter medications. Beginning in 2011, FSAs and HRAs will not be able to make reimbursements for the cost of over-the-counter medications, and HSA and Archer MSA distributions used to pay for the cost of over-the-counter medications will not be made on a tax-free basis. However, insulin and over-the-counter medications prescribed by a physician will still be reimbursable on a tax-favored basis by these plans. You may want to stock up on your over-the-counter drugs to take advantage of the available reimbursement before the end of this year.

Tax increase on nonqualified distributions. Generally, distributions from HSAs and Archer MSAs for qualified medical expenses are received income-tax free. Plan distributions for other than qualified medical expenses are subject to ordinary income tax plus a penalty tax. In the case of HSAs, the penalty is 10%, and for Archer MSAs the penalty is 15%. However, the health-care reform legislation increases the tax penalty for both of these plans to 20%, beginning in 2011.

FSA contribution limit. If you participate in an FSA as part of a cafeteria plan, beginning in 2013, the annual amount available for reimbursement for qualified medical expenses is limited to $2,500 (this figure will be adjusted for inflation in subsequent years). This reduction does not apply to health FSAs that aren't part of a cafeteria plan.

If these changes will affect you, and you or a family member needs substantial dental work such as orthodontia, or corrective vision surgery, you might want to plan for and address these needs prior to 2013. And remember, FSAs are subject to the "use it or lose it" rule, meaning that any pretax money in your plan that is not used by the end of the plan year is forfeited.