



JOHNSTON INVESTMENT COUNSEL

TRUSTED FIDUCIARIES & FEE-ONLY ADVISORS

January, 2011

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

Five Hot Topics in 2011



Roth conversions, mortgages, and health-care reform were a few of the most talked about topics in 2010. Here's a look at five topics you're bound to hear about in 2011.

education and has drawn up a blueprint for overhauling the Elementary and Secondary Education Act. This Act (currently known as No Child Left Behind) is long overdue for reauthorization, and Congress will likely be debating it in 2011.

Social Security: saving the system

How to strengthen Social Security has been a political hot potato for many years, but calls for reform are growing louder as the time when program costs will permanently exceed tax revenues draws closer. The most recent annual report from the Social Security Board of Trustees projects that this will occur in 2015 (one year earlier than last year's report predicted) and notes that trust funds will be exhausted in 2037. Social Security is the most common source of income for retirees, and debate over how to save it will rage in 2011.

In addition, much attention is being focused on ways to make college more accessible and affordable. One initiative funded by the Bill and Melinda Gates Foundation awards grants to nonprofit and governmental institutions to develop effective online education opportunities. Currently the focus is on developing online courses and tools that can help more Americans attend college and prepare for careers, while saving students and schools money.

Energy: greener days ahead

"Going green" is a catchphrase that's likely to get even more press in 2011. One important green initiative currently pending in the Senate is the Homestar Act. This Act provides substantial rebates to homeowners who purchase and install energy-saving equipment or goods or who complete whole home retrofits.

Even the lowly lightbulb finally gets a makeover in 2011. The Federal Trade Commission is requiring that lightbulb packages carry labels that estimate yearly energy costs, the bulb's life span and light appearance, and brightness measured in lumens so that consumers can better compare new energy-efficient bulbs.

Wellness: saving lives and money

Look for employers to roll out, or expand, employee wellness programs this year in an effort to promote healthier living and curtail health insurance costs. The Health-Care Reform Act passed last year included funding for new wellness programs established by small employers, and makes it easier for all employers to offer substantial incentives to employees for participating. Also, new health insurance plans and many existing plans (including Medicare) must now fully cover preventive care services such as immunizations and screenings for certain health conditions.

Microlending: small loans count

Microlending--the practice of extending small loans to individuals and businesses who otherwise could not borrow money--has traditionally targeted entrepreneurs in developing countries. But as the credit crunch prevents many Americans from borrowing money through traditional channels, more are turning to microlending sites and companies to obtain funds. And more investors are offering to make microloans in return for the potential to earn somewhat higher returns than a savings account can offer. Until the economy improves, look for this trend to continue.

Microlending recently got a boost from the Small Business Jobs Act, passed in September, that expanded the Small Business Administration's microlending program. Funding for the program was increased, and business owners may now be able to borrow up to \$50,000 (previously, the limit was \$35,000) to use for working capital or other needs.

Education: expanding opportunities

Education-related debates will certainly heat up in 2011. The current administration is committed to reforming primary and secondary

In this issue:

Five Hot Topics in 2011

Estate Tax Update

New Adoption Assistance
Opportunities and
Requirements

Can I roll over my 401(k) plan
distribution to a Roth IRA?



Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.



Estate Tax Update

Once again, Congress waited until the eleventh hour to extend, patch, and reinstate old tax laws, and once again, they made most changes temporary (generally, for two years). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Act), signed into law on December 17, 2010, dramatically changes the federal transfer tax landscape. The biggest news: the estate and generation-skipping transfer (GST) taxes have been reinstated for 2010. And, to the delight of some and great disappointment of others, for 2010 through 2012, the estate tax exemption equivalent amount is increased to \$5 million (indexed for inflation in 2012), and the top estate tax rate is set at 35%. Here is a brief summary of all the changes.

For 2010

For 2010, the federal gift tax is unchanged by the 2010 Tax Act. The gift tax remains in force with an exemption equivalent amount (called the "applicable exclusion amount") of \$1 million and a top tax rate of 35% (also, remember that if you file as single, you can exclude gifts of up to \$13,000 per recipient, or if you're married and file jointly, you can exclude gifts of up to \$26,000 per recipient).

The estate tax has been reinstated for 2010, with a "basic" exclusion amount (the name has been changed from the "applicable" exclusion amount) of \$5 million. That translates into a tax credit of \$1,730,800. The top estate tax rate is 35%.

The 2010 Tax Act gives estates of decedents dying after December 31, 2009, and before January 1, 2011, the option to elect to apply (1) the reinstated estate tax with a step-up (or step-down) in basis, or (2) no estate tax with a modified carryover basis. The modified carryover basis allows an increase in basis of \$1.3 million, plus an additional \$3 million for property that passes to a surviving spouse.

The GST tax (a separate tax on assets transferred to grandchildren and lower generations) has also been reinstated, but at a rate of zero percent.

Note: *The 2010 Tax Act provides an extension of sorts to pay estate taxes for decedents dying after December 31, 2009, and before the date of enactment of the 2010 Tax Act. The due date for filing an estate tax return, paying estate taxes, or disclaiming an interest in property passing to a beneficiary from a decedent's estate is nine months after the date of enactment of the 2010 Tax Act.*

Note: *IRS Form 8939 is necessary to allocate the \$1.3 million basis adjustment allowed for any heirs and the additional \$3 million basis adjustment allowed for surviving spouses of decedents who die in 2010. Originally, the form was due on the same date as the decedent's final income tax return (April 18, 2011). The 2010 Tax Act also extends this deadline to nine months after the Act becomes effective.*

For 2011 and 2012

For 2011 and 2012, the gift tax is reunited with the estate tax. There is a lifetime basic exclusion amount of \$5 million (which will be indexed for inflation in 2012). The top tax rate is 35% (for taxable gifts/estates in excess of \$500,000).

The basic exclusion amount is portable (new in 2011). That means a surviving spouse can use that portion of the exclusion that was left unused by a deceased spouse. This "deceased spousal unused exclusion amount" (DSUEA) is available only from the estate of a spouse who dies in 2011 or 2012. For gift tax purposes, the DSUEA is available for an unlimited number of deceased spouses. But there can be only one DSUEA at a time. For gift tax purposes, the DSUEA is determined on the last day of the year using the DSUEA of the last deceased spouse as of such date. For estate tax purposes, however, the DSUEA is available only from the last deceased spouse as of the date of death of the surviving spouse. Thus, the DSUEA can change if the surviving spouse remarries, and is then widowed for a second time.

Note: *An election is required on the estate of the first spouse to die in order to preserve the ability of the surviving spouse's estate to use the DSUEA.*

The GST tax rate for transfers made after 2010 is equal to the highest estate tax rate in effect for the year. The GST exemption for 2011 is \$5 million, which will be indexed for inflation for 2012.

Note: *The GST tax exemption is not portable.*

For 2013 and beyond

If there is no further legislation, the changes described above will sunset after 2012. The transfer tax rules that were in effect in 2000 will apply for 2013 and beyond. That means a gift and estate tax exemption equivalent amount of \$1 million and a top tax rate of 55%.

For 2010 through 2012, there is an estate tax exemption equivalent amount of \$5 million (indexed for inflation in 2012), and the top estate tax rate is 35%.

You can also make federal tax-free gifts by paying for someone else's medical expenses or college tuition. Payments must be made directly to the medical care provider or educational institution, and other requirements may apply.

New Adoption Assistance Opportunities and Requirements

Congratulations! You've adopted a child. Your family is growing, and so are your expenses. Fortunately, the federal government offers some financial assistance.

If you adopt a child, you may be able to claim a tax credit for qualifying expenses you paid. Further, certain amounts reimbursed by your employer for qualifying adoption expenses may be excludable from your gross income.

Increased dollar amounts for 2010

If your employer has an adoption assistance plan, for each adoption you can exclude from income up to \$13,170 (in 2010) of adoption assistance paid by your employer or paid by you through salary reduction. For adoption expenses paid by you and for which this exclusion is not available, a tax credit is available for up to \$13,170 of adoption expenses per adoption. The \$13,170 amount is subject to phaseout and is reduced if you have modified adjusted gross income (MAGI) above \$182,520 and is fully phased out if you have MAGI of \$222,520 (in 2010). If you adopt a child with special needs, the \$13,170 amount (subject to phaseout) is available regardless of the amount of actual adoption expenses. The dollar limit is for aggregate expenses for all years with respect to an adoption. (Same rules and limits--adjusted for inflation--apply to adoptions in 2011.)

When to claim adoption expenses

Domestic adoptions: You generally claim the exclusion for qualified adoption expenses in the year your employer pays the qualifying expenses. For qualified adoption expenses you paid in a year before the adoption is final, you claim the credit in the year after you paid the expenses. You claim the credit for qualified adoption expenses you paid in the adoption year or a later year in the year you paid the expenses.

Foreign adoptions: You claim the exclusion or the credit for qualified adoption expenses you (or your employer) paid in a year before the adoption is final in the year the adoption is final. You claim the exclusion or the credit for qualified adoption expenses you (or your employer) paid in the adoption year or a later year in the year the expenses are paid.

Example: Veronica adopts a child in a domestic adoption that is final in 2010. Veronica paid qualified adoption expenses of \$1,000 in 2008, \$5,000 in 2010, and \$2,000 in 2011. Veronica can claim a credit for \$1,000 of qualified adoption expenses in 2009, \$5,000 in 2010, and \$2,000 in 2011.

Refundable credit in 2010

Starting in 2010, the adoption expenses credit is refundable. That is, if the credit exceeds the amount of income tax otherwise due, the excess is refundable to you.

Credits carried over to 2010

The adoption expenses credit was not refundable prior to 2010. As a result, you may have a credit from a prior year carried over to 2010. Such a credit is refundable in 2010. Furthermore, a credit carried over to 2010 is not subject to the phaseout income limitations in 2010.

Example: John and Mary adopted a child in 2009. They paid \$10,000 of qualified adoption expenses and claimed a \$10,000 adoption expense credit for 2009. Their income tax liability was \$6,000 before the adoption expense credit, so they could use only \$6,000 of the credit in 2009. John and Mary can carry forward \$4,000 of adoption expense credit from 2009.

In 2010, John and Mary's income tax liability before the adoption expense credit is \$3,000. John and Mary can offset their income tax liability with \$3,000 of the adoption expenses credit and receive a refund of the remaining \$1,000 of credit in 2010.

Substantiating the adoption

Starting with your 2010 tax return, you must substantiate the adoption or attempted adoption in order to claim the adoption expenses exclusion or credit. For a domestic or foreign adoption that has been finalized in the United States, you must attach a copy of an adoption order or decree to your federal income tax return. For a domestic adoption that is not final, you can use an adoption taxpayer identification number or attach various documents to your federal income tax return. If you claim adoption expenses under the special provision for a child with special needs, you must attach a copy of the state determination of special needs.

You must file paperwork

If you claim the adoption expenses exclusion or credit, you must send in a printed-out income tax form along with any substantiation documents--even if you file electronically.

Form 8839

For 2010, you claim the adoption expenses exclusion and credit on IRS Form 8839, Qualified Adoption Expenses.

There may be substantial tax benefits for your adoption expenses, but you will need to substantiate the adoption and file paperwork.



State adoption assistance programs may be available, but reimbursed expenses do not qualify for the federal adoption expenses credit.



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

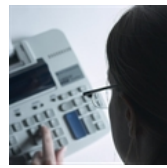
Forefield Inc. does not provide legal, tax, or investment advice. All content provided by Forefield is protected by copyright. Forefield is not responsible for any modifications made to its materials, or for the accuracy of information provided by other sources.

Prepared by Forefield Inc,
Copyright 2011



Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Ask the Experts



Can I roll over my traditional 401(k) plan distribution to a Roth IRA?

In general, yes, but there are some important exceptions. You cannot roll over required minimum distributions (RMDs).

You also cannot roll over hardship distributions from your 401(k) plan, or certain periodic payments you receive from the plan. Most other distributions are eligible for rollover.

A rollover of regular 401(k) assets to a Roth IRA is similar to a conversion of a traditional IRA to a Roth IRA (and it's often referred to as a conversion). You'll need to pay taxes on the amount you roll over to the Roth IRA, except to the extent your distribution includes your own after-tax contributions (you receive those back tax free). But a special rule applies to rollovers in 2010 only--you can elect either to pay all of the conversion taxes in 2010, or instead include half of the resulting income from the conversion on your 2011 federal tax return, and the other half on your 2012 tax return.

Your rollover can be either direct (the 401(k) plan transfers the funds directly to your Roth IRA for you) or indirect (the plan distributes the funds to you, and then you roll the funds over to

the IRA within 60 days). A direct rollover is almost always the best way to transfer the funds. If you choose to make an indirect rollover, you run the risk of missing the 60-day deadline. More importantly, the plan will be required to withhold 20% of the taxable portion of your distribution for federal income taxes. If you want to roll over the full amount of your distribution, you'll need to come up with other funds to make up for the 20% that was withheld (you'll get credit for those withheld funds when you file your income tax return).

Qualified distributions from your Roth IRA will be tax free. To be qualified, your distribution must satisfy a five-year holding period *and* must be made after you reach age 59½, become disabled, or have qualifying first-time homebuyer expenses (up to \$10,000 lifetime). The five-year holding period begins on January 1 of the year you first opened *any* Roth IRA (either by a regular contribution, rollover, or conversion).

(Note: special rules apply if you inherit a 401(k) plan account or IRA.)



Can I roll over my Roth 401(k) plan distribution to a Roth IRA?

Yes. You can roll your Roth 401(k) plan distribution over to a Roth IRA. Your rollover can be direct (the plan transfers the assets to the Roth IRA on your behalf) or indirect (you receive the distribution and then roll it over to the Roth IRA yourself within 60 days). Your rollover will be tax free regardless of whether your distribution from the Roth 401(k) plan is qualified or nonqualified.

But whether your Roth 401(k) plan distribution is qualified or nonqualified is important for determining the taxation of future distributions from the Roth IRA. A distribution from a Roth 401(k) plan is qualified if you satisfy a five-year holding period *and* the distribution is made after you attain age 59½, become disabled, or have qualifying first-time homebuyer expenses (up to \$10,000 lifetime). The five-year holding period begins on January 1 of the year you first started participating in that particular employer's Roth 401(k) plan.

If you receive a qualified distribution from your Roth 401(k) plan and roll it over to your Roth IRA, the entire amount rolled over is treated as

a nontaxable contribution to the Roth IRA. You can withdraw this amount tax free from the Roth IRA at any time. Only additional earnings will be subject to the Roth IRA's five-year holding period.

But if you receive a nonqualified distribution from your Roth 401(k) account and roll it over to a Roth IRA, only an amount equal to your contributions to the Roth 401(k) plan, not the investment earnings, are treated as a nontaxable contribution to the Roth IRA. The investment earnings rolled over, along with any additional investment earnings, will be subject to the Roth IRA's five-year holding period.

IRS regulations provide that separate five-year holding periods apply to Roth 401(k) accounts and Roth IRAs. That is, you don't get to carry over your Roth 401(k) holding period to your Roth IRA. Your Roth IRA five-year holding period begins on January 1 of the year you first establish *any* Roth (by regular contribution, rollover, or conversion). (Special rules apply to inherited Roth IRAs.)