Johnston Investment Counsel

Trusted Fiduciaries & Fee-Only Advisors

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1040 Tax Tips

You don't want to pay more in tax than you have to. That means taking advantage of every deduction and credit that you're entitled to. You also need to recognize potential opportunities to save. So here are a few things to keep in mind this filing season.

There's still time to contribute to an IRA

You generally have until the due date of your federal income tax return (April 18 this year) to make contributions to either a Roth IRA or a traditional IRA for the 2010 tax year. That means there's still time to set aside up to $5,000 ($6,000 if you're age 50 or older) in one of these retirement savings vehicles. It's worth considering, in part because contributing to an IRA can have an immediate tax benefit. That benefit comes in the form of a potential tax deduction--with a traditional IRA, if you're not covered by a 401(k) or another employer-sponsored retirement plan, you can generally deduct the full amount of your contribution. (If you're covered by an employer-sponsored retirement plan, whether or not you can deduct some or all of your traditional IRA contribution depends on your filing status and income.)

It's a little different with a Roth IRA; if you qualify to make contributions to a Roth IRA (whether you can contribute depends on your filing status and income), the contributions you make aren't deductible, so there's no effect on your 2010 taxes. Nevertheless, a Roth IRA may be worth considering because qualified Roth distributions are completely free from federal income tax.

Individuals with lower incomes may also be able to qualify for a tax credit of up to $1,000 when they contribute to a traditional or Roth IRA.

Decision time on 2010 Roth conversions

If you converted funds from a traditional IRA or an employer plan like a 401(k) to a Roth in 2010, you can report half the income that results from the conversion on your 2011 federal income tax return, and half on your 2012 federal income tax return. Good deal, right? Sure. But in some cases, you might be better off making an election to claim the entire amount on your 2010 return instead. This could be true if, for example, your 2010 taxable income is significantly lower than you think it will be in 2011 and 2012, or if you've got unusually high deductions for 2010.

Other considerations for 2010 returns

- For the first time in many years, itemized deductions and dependency exemptions will not be reduced for high-income individuals.
- If you claim a large number of dependency exemptions, deductible medical expenses, state and local taxes, or miscellaneous itemized deductions, you're more likely to be subject to the alternative minimum tax (AMT), essentially a parallel federal income tax system with its own rates and rules.
- If you purchased a new home in the first half of 2010, check to see if you meet the timing, purchase price, and income requirements to qualify for the first-time homebuyer tax credit, worth up to $8,000. Even if you weren't a first-time homebuyer, it's still possible to qualify for a tax credit of up to $6,500 if you maintained the same principal residence for five out of the eight years preceding the purchase, and meet all other requirements.
- If you made energy-efficient improvements to your home in 2010 (e.g., new windows, a new furnace), you might be entitled to a 30% tax credit, up to $1,500. Check the requirements closely, though, and note that if you claimed the full $1,500 credit in 2009 you can't claim the credit for 2010.

Legislation in late December extended a host of expiring tax credits, deductions, and provisions, so it could pay to take a little extra time to carefully review IRS instructions this year. And as always, if you have questions, discuss your situation with a tax professional.

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LIFE THE WAY YOU PLANNED IT.

Are We in a Bond Bubble?

Investors have been pouring money into bonds. Investment Company Institute statistics show that since January 2007, average net new money going into bond mutual funds each month has been roughly four times greater than net *outflows* from equity funds.* So does that mean we're in the bond market's equivalent of the late-1990s tech bubble?

What's been driving interest in bonds?

There are several reasons why bond funds have been attracting investor interest. First, in the wake of both the tech crash of 2000-2002 and the 2008 financial crisis, the Federal Reserve felt it needed to make credit more available by lowering interest rates. Over the last 10 years, the yield on the 10-year Treasury bond has fallen from 5% to well under 3% at the end of 2010.** And for the first time ever, 5-year Treasury Inflation-Protected Securities (TIPS) actually paid a negative yield when they were auctioned last October.*** Because bond prices rise as interest rates fall, that has increased bond prices generally.

As a result, bonds have outperformed stocks in recent years. For the last 20-year period, total returns from stocks and bonds have been equal: 8.2%.**** And during the decade between January 2000 and the end of 2009, bonds actually outperformed stocks; the S&P 500 saw a total return of -0.9%, while long-term government bonds returned 7.7%.**** That outperformance has lured investors who may have forgotten that past performance doesn't guarantee future results, and invest in an asset class based on its recent history rather than its prospects for the future.

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Demographics also have played a role. Many aging baby boomers who became accustomed to investing much of their IRAs and 401(k)s in stocks are beginning to realize that their time horizon for retirement isn't as long as it used to be, and that they should consider allocating an increasing percentage of their retirement portfolios to income-producing assets. The financial crisis also sent many frightened investors scurrying to put their money anywhere besides stocks.

Finally, diminished dividends from stocks have encouraged many investors to look elsewhere for income. During the tech boom, companies preferred to reinvest in growth or buy back stock rather than increase dividends, and according to Standard and Poor's, 2009 was the worst year on record for dividend payments. Though there has been some reversal of that trend in recent months, stingy dividends helped make bonds and their income more attractive.

What to watch out for

No investing trend lasts forever without interruption. Here are some factors that could affect bond prices:

- Signs that inflation is picking up: Higher inflation means fixed income payments will have less purchasing power in the future, diminishing bonds' appeal as income vehicles.
- Fed reversal on interest rates: As the economy recovers, the Federal Reserve will need to withdraw the support it has given the bond markets. As it gradually rachets up interest rates, bonds will begin to reverse their pattern of the last decade. Depending on the pace of the Fed action, that reversal could be swift. Rising interest rates typically mean falling bond prices, and longer-term bonds often feel the most impact because bond buyers are reluctant to tie up their money long-term if a better rate lies ahead.
- Lack of overseas interest in U.S. debt: Foreign buyers have been large purchasers of U.S. government debt. If foreign buyers show signs of turning away from U.S. debt, it could send shivers through the bond markets.
- Muni bond troubles: Some experts worry that defaults by cash-strapped state and local governments could become a problem.

However, balance those factors against the possibility of further sovereign debt problems abroad. Several European nations are still struggling to deal with their debt problems; another bout of global jitters like the one in spring 2009 could remind investors that the United States has never defaulted on its debt. Also, if the potential for deflation that the Fed is so concerned about turns into an actual decline in wages and prices, that could be a positive for bonds, since the income they pay would be more valuable as prices fall. Either way, now is an especially good time to keep an eye on your bond investments.

*Average of monthly net new cash flows from January 2007 through September 2010 as reported in Investment Company Institute's "Long-Term Mutual Fund Flows Historical Data" as of Nov. 20, 2010.

**Source: U.S. Treasury historical data on daily Treasury yield curve rates.

***Source: "Record Setting Auction Data," www.treasurydirect.gov.

****10- and 20-year returns based on data on the Standard and Poor's 500 and long-term government bonds from *Ibbotson SBBI 2010*.

Retirement Plan and IRA Limits for 2011

Many retirement plan and IRA limits are indexed for inflation each year. Some of the key numbers for 2011 are discussed below.

Elective deferrals

If you're lucky enough to be eligible to participate in a 401(k), 403(b), 457(b), or SAR-SEP plan, you can make elective deferrals of up to $16,500 in 2011, unchanged from 2010. If you're age 50 or older, you also can make a catch-up contribution of up to $5,500 to these plans in 2011 (also unchanged from 2010). (Special catch-up limits apply to certain participants in 403(b) and 457(b) plans.)

If your 401(k) or 403(b) plan allows Roth contributions, your total elective contributions, pretax and Roth, can't exceed $16,500 ($22,000 with catch-up contributions). You can split your contribution any way you wish. For example, you can make $9,500 of Roth contributions and $7,000 of pretax 401(k) contributions. It's up to you.

If you participate in a SIMPLE IRA or SIMPLE 401(k) plan, you can contribute up to $11,500 in 2011 (unchanged from 2010). If you're age 50 or older, the maximum catch-up contribution to a SIMPLE IRA or SIMPLE 401(k) plan in 2011 is $2,500 (unchanged from 2010).

IRA limits remain the same for 2011

The amount you can contribute to a traditional or Roth IRA remains at $5,000 (or 100% of your earned income, if less) for 2011, and the maximum catch-up contribution for those age 50 or older remains at $1,000. You can contribute to an IRA in addition to an employer-sponsored retirement plan. But if you (or your spouse) participate in an employer-sponsored plan, your ability to deduct traditional IRA contributions may be limited, depending on your income. Roth contributions are also subject to income limits.

Contribution limits: 2011 tax year*		
Plan type	Annual dollar limit	Catch-up limit
401(k), 403(b), govt. 457(b) plans	$16,500	$5,500
SIMPLE plans	$11,500	$2,500
Traditional and Roth IRAs	$5,000	$1,000

*Contributions can't exceed 100% of your income. Special catch-up rules apply to 403(b) and governmental 457(b) plans.

Some other key numbers for 2011

For 2011, the maximum amount of compensation your employer can take into account when calculating contributions and benefits in qualified plans (and certain other plans) is $245,000 (unchanged from 2010).

The maximum annual benefit you can receive from a defined benefit pension plan is limited to $195,000 in 2011 (unchanged from 2010).

And the maximum amount that can be allocated to your account in a defined contribution plan (for example, a 401(k) plan or profit-sharing plan) in 2011 is $49,000 (also unchanged from 2010), plus age-50 catch-up contributions. (This includes both your contributions and your employer's contributions. Special rules apply if your employer sponsors more than one retirement plan.)

Income phaseout range for determining deductibility of traditional IRA contributions in 2011	
1. Covered by an employer plan	
Single/head of household	$56,000-$66,000 (same for 2010)
Married filing jointly	$90,000-$110,000 ($89,000-$109,000 for 2010)
Married filing separately	$0-$10,000
2. Not covered by an employer plan, but filing joint return with a spouse who is covered	$169,000-$179,000 ($167,000-$177,000 for 2010)
Income phaseout range for determining ability to fund Roth IRA in 2011	
Single/head of household	$107,000-$122,000 ($105,000-$120,000 for 2010)
Married filing jointly	$169,000-$179,000 ($167,000-$177,000 for 2010)
Married filing separately	$0-$10,000

Many retirement plan and IRA limits are indexed for inflation each year. Most of the limits for 2011 are unchanged from 2010.

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Ask the Experts

Understanding the math of recovering from losses

Everyone knows the stock market has its ups and downs, but just what's involved in recovering from a serious down? If you lose 10% one year but your portfolio returns 10% the next year, are you even again?

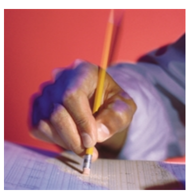
The short answer: no. The math of recovering from a loss isn't quite that symmetrical. You have to gain more than you lost to recoup all your losses. To understand why, let's look at a hypothetical example. Say you have a $50,000 portfolio. In Year 1, you suffer a 10% loss and are down $5,000. That leaves your portfolio worth only $45,000.

In Year 2, the market rebounds and your portfolio rises by 10%. However, that 10% increase is based on a $45,000 portfolio, not $50,000. That means the 10% return adds only $4,500 to your portfolio, not $5,000, leaving you still $500 down from where you started. You would actually have to earn a return of a little over 11% to get back to your original $50,000.

The bigger the loss, the bigger that rebound needs to be to get you even. For example, if that $50,000 portfolio had taken a 40% hit, as many did in 2008, you'd need almost a 67% increase to offset that $20,000 loss and get back to the original $50,000. That could take several years even if stocks perform well.

The challenge is compounded by investor psychology. Adjusting your asset allocation to aim for a higher return is one way to try to recoup losses faster. However, many investors find it difficult to take on additional risk after having watched their investments take a hit. And there's no guarantee that more risk will necessarily produce the desired result--at least not within the desired time frame.

The lopsided nature of recovery from market losses underscores why risk management is such a key component of successful portfolio management. Being realistic about the level of risk your portfolio involves and how much time you have to come back from potential downturns may help increase both your emotional and financial resilience.



Are you sabotaging your own portfolio?

Individual investors' returns typically fall short of those for the stock market as a whole. Why? Because their returns are affected by their own behavior. Many studies have shown that individual investors tend to buy and sell at the wrong times. When the market goes down, they panic and sell. When the market rebounds, many gun-shy investors are reluctant to invest again and postpone getting back into the market. As they watch prices rise, they get increasingly anxious about missing out on those returns. However, by the time these investors are comfortable with buying again, prices often have risen to the point that they're almost ready to turn down again.

That kind of behavior can be costly over the long term. Dalbar's *Quantitative Analysis of Investor Behavior for 2010* compared the performance of the average mutual fund investor between 1990 and 2009 (as measured by fund inflows and outflows tracked by the Investment Company Institute) to that of the average index fund based on the S&P 500.* The company found that returns for the average investor trailed the S&P over that 20-year period by 5.6% because of investor behavior. Though there's no guarantee that the patterns of the past will continue in the future, previous studies also reached the same conclusion: that investors often earn less than a mutual fund's reported returns because of their own behavior.

How can you prevent self-inflicted portfolio sabotage? A disciplined approach to investing helps. Some techniques that can give you a framework for decisions that aren't based solely on emotion include establishing a target price based on fundamentals, dedicating specific pools of money to specific goals with defined time horizons, and rebalancing investments periodically. Also, understand your true risk tolerance. Knowing the type and level of risk involved in each of your investments and understanding how each has behaved relative to the overall market can help you stand firm despite losses.

*Based on the average return for all funds listed in Lipper's U.S. Diversified Equity fund category.