



Johnston Investment Counsel

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Making the Most of Your 401(k) Plan

Looking Backward and Forward on Entitlement Programs

Understanding the New Medicare Tax on Unearned Income

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LIFE THE WAY YOU PLANNED IT.

Making the Most of Your 401(k) Plan



A 401(k) plan represents one of the most powerful retirement savings opportunities available today. If your employer offers a 401(k) plan and you're not participating in it, you should be.

Contribute as much as possible

The more you can save for retirement, the better your chances of enjoying a comfortable retirement. If you can, max out your contribution up to the legal limit (\$17,500 in 2013, \$23,000 if you're age 50 or older). If you need to free up money to do that, try to cut certain expenses. (Note: some plans limit the amount you can contribute.)

Why invest your retirement dollars in a 401(k) plan instead of somewhere else? One reason is that your pretax contributions lower your taxable income for the year. This means you save money in taxes immediately when you contribute to the plan--a big advantage if you're in a high tax bracket. For example, if you earn \$100,000 a year and contribute \$17,500 to a 401(k) plan, you'll only pay federal income taxes on \$82,500 instead of \$100,000.

Another reason is the power of tax-deferred growth. Any investment earnings compound year after year and aren't taxable as long as they remain in the plan. Over the long term, this gives you the opportunity to build a substantial sum in your employer's plan. (Your pretax contributions and any earnings will be taxed when paid to you from the plan.)

Consider Roth contributions

Your 401(k) plan may also allow you to make after-tax Roth contributions. Unlike pre-tax contributions, Roth contributions don't lower your current taxable income so there's no immediate tax savings. But because you've already paid taxes on those contributions, they're free from federal income taxes when paid from the plan. And if your distribution is "qualified" (that is, the distribution is made after you satisfy a five-year holding period, and after you reach age 59½, become disabled, or die)

any earnings are also tax free.

If your distribution isn't qualified, any earnings you receive are subject to income tax. A 10% early distribution penalty may also be imposed if you haven't reached age 59½ (unless an exception applies).

Capture the full employer match

Many employers will match all or part of your contributions. If you can't max out your 401(k) contributions, you should at least try to contribute as much as necessary to get the full employer match. Employer matching contributions are basically free money. By capturing the full benefit of your employer's match, you'll be surprised how much faster your balance grows. If you don't take advantage of your employer's generosity, you could be passing up a significant contribution towards your retirement.

Access funds if you must

Another beneficial feature that many 401(k) plans offer is the ability to borrow against your vested balance at a reasonable interest rate. You can use a plan loan to pay off high-interest debts or meet other large expenses, like the purchase of a car. You typically won't be taxed or penalized on amounts you borrow as long as the loan is repaid within five years. Immediate repayment may be required, however, if you leave your employer--if you can't repay the loan, you may be treated as having taken a taxable distribution from the plan.

And remember that when you take a loan from your 401(k) plan, the funds you borrow are generally removed from your plan account until you repay the loan, so you may miss out on the opportunity for additional tax-deferred investment earnings. So loans (and withdrawals if available) should be a last resort.

Evaluate your investment choices

Choose your investments carefully. The right investment mix could be one of your keys to a comfortable retirement. That's because over the long term, varying rates of return can make a big difference in the size of your 401(k) plan account.

Looking Backward and Forward on Entitlement Programs



An unsustainable path

The bipartisan Bowles/Simpson Deficit Reduction Commission stated that "our nation is on an unsustainable fiscal path" in regard to entitlement spending.

Last year's presidential election, along with the more recent fiscal cliff and debt ceiling negotiations, have put the spotlight on our nation's tax policy, deficit, and entitlement programs. For some, entitlement programs are necessary--a social compact for America in an era of longer life spans, the decline of employer-provided pensions and health insurance in retirement, and a widening gap between the haves and the have-nots. For others, the current level of entitlement spending is jeopardizing our country's fiscal health and creating an "entitlement lifestyle." No matter where you stand in the debate, do you know the basic facts on our country's largest entitlement programs?

Where the money goes

All entitlement spending isn't created equal. The "Big Three" of Social Security, Medicare, and Medicaid account for more than two-thirds of all federal entitlement spending. Social Security and Medicare are primarily age-based programs, whereas Medicaid is based on income level. According to the U.S. Bureau of Economic Analysis, in 2010, the federal government spent a total of \$2.2 trillion on entitlement programs, with the Big Three accounting for \$1.6 trillion of this total. The largest expenditure was for Social Security (\$690 billion), followed by Medicare (\$518 billion) and Medicaid (\$405 billion).



A history of growth

Alexis de Tocqueville, the famous French political thinker who traveled to the United States in the early 1830s and wrote about the uniqueness of our young nation's individual self-reliance in his famous book, *Democracy in America*, would likely be surprised to observe the growth in spending on entitlement programs that has occurred in the United States over the past 50 years. According to the Bureau of Economic Analysis, in 1960, U.S. government transfers to individuals totaled about \$24 billion in current dollars. By 2010, that figure was \$2.2 trillion, almost 100 times as much.

Current status

Let's look at our two main entitlement

programs--Social Security and Medicare.

Social Security. Created in 1935, Social Security is a "pay-as-you-go" system, meaning that payments to current retirees come primarily from payments into the system by current wage earners in the form of a 12.4% Social Security payroll tax (6.2% each from employee and employer). These payroll taxes are put into two Social Security Trust Funds, which also earn interest. According to projections by the Social Security Administration, the trust funds will continue to show net growth until 2022, after which, without increases in the payroll tax or cuts in benefits, fund assets are projected to decrease each year until they are fully depleted in 2033. At that time, it's estimated that payroll taxes would only be able to cover approximately 75% of program obligations.

Medicare. Created in 1965, Medicare is a national health insurance program available to all Americans age 65 and older, regardless of income or medical history. It consists of Part A (hospital care) and Part B (outpatient care)--which together make up "traditional" Medicare; Part C (Medicare Advantage, which is private insurance partly paid by the government); and Part D (outpatient prescription drugs through private plans only). Medicare Part A is primarily funded by a 2.9% Medicare payroll tax (1.45% each from employee and employer), which in 2013 is increased by 0.9% for employees with incomes above \$200,000 (single filers) or \$250,000 (married filing jointly). In addition, starting in 2013, a new 3.8% Medicare contribution tax on the net investment income of high-earning taxpayers will take effect.

Looking ahead, Medicare and Medicaid are expected to face the most serious financial challenges, due primarily to increasing enrollment. The Congressional Budget Office, in its report *Budget and Economic Outlook: Fiscal Years 2012 to 2022*, predicts that federal spending on Medicare will exceed \$1 trillion by 2022, while federal spending on Medicaid will reach \$605 billion (state spending for Medicaid is also expected to increase). According to the CBO, reining in the costs of Medicare and Medicaid over the coming years will be the central long-term challenge in setting federal fiscal policy.

Reform

There has been little national consensus by policymakers on how to deal with rising entitlement costs. At some point, though, reform is inevitable. That's why it's a good idea to make sure your financial plan offers enough flexibility to accommodate an uncertain future.



Understanding the New Medicare Tax on Unearned Income



Health-care reform legislation passed in 2010 included a new additional 0.9% Medicare tax on wages, compensation, and self-employment income over certain thresholds. This new tax also took effect on January 1, 2013. The 0.9% tax does not apply to income subject to the NIIT. So while you may be subject to both taxes, the taxes do not apply to the same types of income.

Health-care reform legislation enacted in 2010 included a new 3.8% Medicare tax on the unearned income of certain high-income individuals. The new tax, known as the unearned income Medicare contribution tax, or the net investment income tax (NIIT), took effect on January 1, 2013.

Who must pay the new tax?

The NIIT applies to individuals who have "net investment income," and who have modified adjusted gross income (MAGI) that exceeds certain levels (see the chart below). (Estates and trusts are also subject to the new law, although slightly different rules apply). In general, nonresident aliens are not subject to the new tax.

Filing Status	MAGI over ...
Single/Head of household	\$200,000
Married filing jointly/ Qualifying widow(er)	\$250,000
Married filing separately	\$125,000

What is MAGI?

For most taxpayers, MAGI is simply adjusted gross income (AGI), increased by the amount of any foreign earned income exclusion.

AGI is your gross income (e.g., wages, salaries, tips, interest, dividends, business income or loss, capital gains or losses, IRA and retirement plan distributions, rental and royalty income, farm income and loss, unemployment compensation, alimony, taxable Social Security benefits), reduced by certain "above-the-line" deductions (see page one of IRS Form 1040 for a complete list of adjustments).

Note that AGI (and therefore MAGI) is determined *before* taking into account any standard or itemized deductions or personal exemptions. Note also that deductible contributions to IRAs and pretax contributions to employer retirement plans will lower your MAGI.

What is investment income?

In general, investment income includes interest, dividends, rental and royalty income, taxable nonqualified annuity income, certain passive business income, and capital gains--for example, gains (to the extent not otherwise offset by losses) from the sale of stocks, bonds, and mutual funds; capital gains distributions from mutual funds; gains from the sale of interests in partnerships and S corporations (to

the extent you were a passive owner), and gains from the sale of investment real estate (including gains from the sale of a second home that's not a primary residence).

Gains from the sale of a primary residence may also be subject to the tax, but only to the extent the gain exceeds the amount you can exclude from gross income for regular income tax purposes. For example, the first \$250,000 (\$500,000 in the case of a married couple) of gain recognized on the sale of a principal residence is generally excluded for regular income tax purposes, and is therefore also excluded from the NIIT.

Investment income does not include wages, unemployment compensation, operating income from a nonpassive business, interest on tax exempt bonds, veterans benefits, or distributions from IRAs and most retirement plans (e.g., 401(k)s, profit-sharing plans, defined benefit plans, ESOPs, 403(b) plans, SIMPLE plans, SEPs, and 457(b) plans).

Net investment income is your investment income reduced by certain expenses properly allocable to the income--for example, investment advisory and brokerage fees, investment interest expenses, expenses related to rental and royalty income, and state and local income taxes.

How is the tax calculated?

The tax is equal to 3.8% of the lesser of (a) your net investment income, or (b) your MAGI in excess of the statutory dollar amount that applies to you based on your tax filing status. So, effectively, you'll be subject to the additional 3.8% tax only if your MAGI exceeds the dollar thresholds listed in the chart above.

Example: Sybil, who is single, has wages of \$180,000 and \$15,000 of dividends and capital gains. Sybil's MAGI is \$195,000, which is less than the \$200,000 statutory threshold. Sybil is not subject to the NIIT.

Example: Mary and Matthew have \$180,000 of wages. They also received \$90,000 from a passive partnership interest, which is considered net investment income. Their MAGI is \$270,000, which exceeds the threshold for married taxpayers filing jointly by \$20,000. The NIIT is based on the lesser of \$20,000 (the amount by which their MAGI exceeds the \$250,000 threshold) or \$90,000 (their net investment income). Mary and Matthew owe NIIT of \$760 (\$20,000 x 3.8%).

Note: The NIIT is subject to the estimated tax rules. You may need to adjust your income tax withholding or estimated payments to avoid underpayment penalties.



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I don't think I'll be able to file my tax return by April 15. Is there any way to file my return at a later date?

If you don't file your federal income tax return on time, you could be subject to a failure-to-file penalty.

Fortunately, you can file for and obtain an automatic six-month extension by using [IRS Form 4868](#).

You must file for an extension by the original due date for your return. Individuals whose due date for filing a return is April 15 would then have until October 15 to file their return.

It is important to note, however, that in most cases this six-month extension is an extension to file your tax return and not an extension to pay any federal income tax that is due.

You should estimate and pay any federal income tax that is due by the original due date of the return without regard to the extension. Any taxes that are not paid by the regular due date will be subject to interest, and possibly penalties.

There are a couple of instances, however, where the IRS allows both an extension to file a tax return and an extension to pay any federal income tax due:

- If you are a U.S. citizen or resident and, on the due date of your federal income tax return, you either: (1) live outside the U.S. or Puerto Rico (with your main place of business or post of duty outside the U.S. or Puerto Rico as well), or (2) are in the military or naval service outside the U.S. or Puerto Rico, you may be allowed an automatic two-month extension of time to both file your federal income tax return and pay any federal income tax due. Interest will be assessed on any unpaid taxes due as of the regular due date.
- If you serve in a combat zone (or qualified hazardous duty area), your due date for both filing a federal income tax return and paying federal income tax is automatically extended by at least 180 days from the last day you are in a combat zone or the last day of qualified hospitalization for injury related to service in a combat zone. No penalties or interest will be assessed for failing to file a return or to pay federal income tax during this extension period.



After filing my tax return, I found out that I'll be getting a large refund this year. What should I do with it?

It's easy to get excited at tax time when you find out you'll be getting a refund from the IRS--especially if it's a large

sum of money. The prospect of taking your family on a dream vacation, purchasing that 60-inch LCD television you've had your eye on, or going on a shopping spree at the mall all seem like great ways to spend the money. But what about doing something a bit more practical with your refund, such as putting it towards improving your overall financial picture?

While it may not seem as exciting as a vacation to a tropical island, consider putting your refund in a tax savings vehicle such as a retirement or education savings plan. To make it even easier for you, the IRS allows direct deposit of refunds into a variety of accounts, including IRAs and Coverdell education savings accounts.

Another option is to pay down any existing debt you may have, especially if it is in the form of credit card balances that carry high interest rates. Paying off any outstanding balances will reduce the interest you pay each month in addition to the total interest you'd pay over the

long term--freeing up money to work for you in more beneficial ways, such as saving and investing.

You may also consider putting your refund towards increasing your cash reserve. It's a good idea to have at least three to six months' worth of living expenses in your cash reserve. Without adequate savings, a period of unemployment or an unexpected illness could be financially devastating.

Keep in mind that a refund is essentially an interest-free loan from you to the IRS. If you find that you always end up receiving an income tax refund, it may be time to adjust your withholding. When determining the correct withholding amount, your objective should be to have just enough withheld to prevent you from incurring penalties when your tax return is due.

Finally, to avoid any surprises at tax time (either in the form of a refund or tax bill due), it's a good idea to periodically check your withholding, especially when your lifestyle or employment circumstances change. Visit www.irs.gov for more information.



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