



## 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

## Mid-Year Planning: Accounting for New Tax Rules



The American Taxpayer Relief Act of 2012 (ATRA), passed in early January, permanently extended a host of expiring tax provisions. It also largely set the rules for tax planning for 2013 and beyond. As you take stock of your tax situation this year, here are a few new wrinkles to keep in mind.

qualifying dividends.

And keep in mind that a new Medicare contribution tax now applies to some or all of the net investment income of individuals with more than \$200,000 in modified adjusted gross income (\$250,000 for married couples filing a joint federal income tax return, and \$125,000 for married individuals filing separate returns). The Medicare contribution tax is 3.8%, and is in addition to other taxes that apply.

### New top tax rate

The six tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) that applied for the last several years have been made permanent for most individuals. That's really good news, since it removes a great deal of uncertainty going forward (it's always easier to plan when you know what the tax rates will be the following year).

But higher-income individuals and families will have to contend with a new top federal income tax bracket starting this year, paying tax on a portion of their income at a rate of 39.6%. The new 39.6% rate applies to individuals with taxable income exceeding \$400,000; married individuals filing joint federal income tax returns with taxable income exceeding \$450,000; married individuals filing separate returns with taxable income exceeding \$225,000; and individuals filing as head of household with taxable income exceeding \$425,000.

### Higher rates on investment income for some

Most individuals won't see any change in the rate at which they're paying tax on long-term capital gains and qualifying dividends. If you're in the 10% or 15% marginal income tax bracket, a special 0% rate will generally apply. If you are in the 25%, 28%, 33%, or 35% tax brackets, a 15% maximum rate will generally apply.

If you're in the new top 39.6% tax bracket, though, it's going to be a little different starting this year--that's because in 2013 a new maximum rate of 20% will generally apply to some or all of your long-term capital gains and

### Other considerations

- This year, if your adjusted gross income (AGI) is greater than \$250,000 (\$300,000 if you're married and file a joint return, \$150,000 if married filing separately, and \$275,000 if you file as head of household), your personal and dependency exemptions will be phased out in part or in full. Similarly, your itemized deductions may be limited.
- If you itemize deductions, note that the AGI threshold for deducting qualified medical expenses on Schedule A increased this year from 7.5% to 10% for most individuals. If you or your spouse will be 65 or older by the end of the year, though, the 7.5% threshold will continue to apply for 2013.
- The rules allowing qualified charitable distributions from IRAs were extended through 2013. This popular provision allows individuals age 70½ or older to make qualified charitable distributions of up to \$100,000 from an IRA directly to a qualified charity; the charitable distributions are excluded from income and count toward satisfying any required minimum distributions for the year.

### Make time to plan

It's never easy to set aside the time to analyze your current tax situation and project how you'll be affected by recent changes. But it's important to do so while you still have time to implement a plan and take action. This year, it's particularly important to consider all of your options if your income level brings you within range of one or more of the new provisions targeting higher-income individuals.

### July 2013

Mid-Year Planning: Accounting for New Tax Rules  
Coordinating Social Security Benefits with Other Retirement Assets

Portability of Applicable Exclusion Amount between Spouses

I just bought a vacation home. Do I need to purchase a specific type of insurance?



Johnston Investment Counsel  
LIFE THE WAY YOU PLANNED IT.



### Special rules for government pensions

*If your pension is from a job where you did not pay Social Security taxes (such as certain government jobs), two special provisions may apply. If you're entitled to receive a government pension as well as Social Security spousal retirement or survivor's benefits based on your spouse's (or former spouse's) earnings, the government pension offset (GPO) may apply. Under this provision, your spousal or survivor's benefit may be reduced by two-thirds of your government pension (some exceptions apply).*

*The windfall elimination provision (WEP) affects how your Social Security retirement or disability benefit is figured if you receive a pension from work not covered by Social Security. The formula used to figure your benefit is modified, resulting in a lower Social Security benefit.*

## Coordinating Social Security Benefits with Other Retirement Assets

Social Security provides retirement income you can't outlive. And, in addition to your own benefit, your spouse may be eligible to receive benefits based on your earnings record in the form of spousal benefits and survivor's benefits. So, it's easy to see why, with all of these potential benefit options, Social Security is an important source of retirement income. But, according to the Social Security Administration, only about 40% of an average worker's preretirement income is replaced by Social Security (Source: SSA Publication No. 05-10035, July 2012). When trying to figure out how you'll meet your retirement income needs, you'll probably have to coordinate your Social Security benefits with other retirement income sources such as pensions, qualified retirement accounts (e.g., 401(k), IRA), and other personal savings.

### Factors to consider

How you incorporate Social Security benefits into your total retirement income plan may depend on a number of factors, including whether you're married, your health and life expectancy, whether you (or your spouse) will work during retirement, the amount of your Social Security benefit (and that of your spouse, if applicable), other sources of retirement income (e.g., pension), how much retirement savings you have, and, of course, your retirement income needs of you and your spouse, including the income need of your spouse after your death.

A factor to consider is that Social Security has a "built-in" protection against longevity risk. Benefits increase each year you delay starting benefits through age 69 (benefits do not increase past age 70), so the later you start receiving benefits, the greater the benefit amount. In addition, Social Security benefits are inflation-protected, and may increase with annual cost-of-living adjustments based on increases in the Consumer Price Index.

How much you may pay in income tax may also factor into your retirement income plan. For example, distributions from tax-qualified accounts (e.g., 401(k)s, IRAs, but not including Roth IRAs) are generally taxed as ordinary income. Up to 85% of your Social Security benefits may also be taxed, depending on your modified adjusted gross income and tax filing status. Tax issues are complex, so you should talk to a tax advisor to understand your options and the tax consequences.

### Pensions

If you're lucky enough to have a traditional employer pension available, that's another

reliable source of income. You'll want to be sure that you effectively coordinate your Social Security benefit with pension income. Your pension may increase in value based on your age and years of employment, but it may not include cost-of-living adjustments (COLAs). As mentioned earlier, Social Security not only increases the longer you delay taking benefits, but it may increase with COLAs.

If your pension benefit increases past the age at which you retire, you might consider waiting to take your pension (either single or joint and survivor with your spouse) in order to maximize your pension benefit amount. Depending on your income needs, you could start Social Security benefits earlier to provide income. Or, if you've already reached your maximum pension benefit, you could start your pension first, and defer Social Security in order to receive an increased monthly benefit later. Your decision depends on your individual situation, including your pension benefit amount and whether it increases in value after you retire, and the pension options that are available to you (e.g., single life, qualified joint and survivor). You can get an explanation of your pension options prior to retirement from your pension plan, including the relative values of any optional forms of benefit available to you.

### Personal savings

Prior to retirement, when it came to personal savings, your focus was probably on accumulation--building as large a nest egg as possible. As you transition into retirement, that focus changes. Rather than concentrating on accumulation, you're going to need to look at your personal savings in terms of distribution and income potential. Your savings potentially can provide a source of income to help you bridge any gap between the time you begin retirement (if you've stopped working) and the time you wait to begin taking Social Security benefits.

One option you might consider, depending on the amount of retirement savings you have and your income needs, is taking some of your savings and purchasing an immediate annuity, which will provide a guaranteed (based on the claims-paying ability of the annuity issuer) income stream. In this way, your remaining savings may have a chance to increase in value, while delaying Social Security benefits increases your annual benefit as well.

Incorporating Social Security into your retirement income plan involves several other important factors. Talk to your financial professional for help in developing the best plan for you.





*Portability allows a surviving spouse to use the unused applicable exclusion amount of the spouse who dies first to shelter property from federal gift and estate taxes. Portability of the exclusion between spouses would seem to make estate planning easier for many estates, but that may not always be the case.*

*Now that portability and the increased exclusion, which had been scheduled to expire in 2013, have been made permanent, it is probably a good time to review your estate plan and documents.*

## Portability of Applicable Exclusion Amount between Spouses

Transfers of property during life or at death are generally subject to federal gift or estate taxes. However, each taxpayer has an amount of property that can be sheltered from federal gift and estate taxes by the unified credit, called the "applicable exclusion amount."

Prior to 2011, each spouse was entitled to his or her own applicable exclusion amount, and any amount that a spouse did not use would be lost; so special planning was often used to insure neither spouse's exclusion was wasted.

In 2011 and later, the estate of the first spouse to die can elect to transfer any applicable exclusion amount that is not used to the surviving spouse. This is known as "portability." The applicable exclusion amount is redefined as equal to the sum of the basic exclusion amount of the surviving spouse and the unused applicable exclusion amount of the predeceased spouse, and the basic exclusion amount is equal to \$5 million as indexed for inflation each year (\$5,250,000 in 2013).

Now that portability and the increased exclusion, which had been scheduled to expire in 2013, have been made permanent, it is probably a good time to review your estate plan and documents. Portability of the exclusion between spouses and an increase in the basic exclusion amount should make estate planning easier for many estates.

### Simple planning with portability

If you're planning today, you could transfer everything to your spouse at your death, and your estate can elect to transfer your unused applicable exclusion amount to your surviving spouse. Your spouse will then have an applicable exclusion amount equal to the sum of his or her own basic exclusion amount and your unused applicable exclusion amount, which your spouse can use for gift or estate tax purposes. For example, if you transfer your \$5,250,000 unused applicable exclusion to your surviving spouse, who also has a \$5,250,000 basic exclusion amount, your spouse then has a \$10,500,000 applicable exclusion amount in 2013 to shelter property from gift and estate tax. Such simple planning might be very practical for some married couples, especially where the spouses' combined estates are expected to be less than their combined applicable exclusion amounts.

### Potential need for more complex planning

There are a number of reasons why such simple planning with portability may not always produce the desired or best results. These might include (among others):

- You have family members or individuals other than your spouse who you would like to benefit prior to the death of your spouse.
- You have grandchildren or later generations who you would like to benefit. The \$5,250,000 (in 2013) generation-skipping transfer (GST) tax exemption is not portable between spouses.
- State exclusion amounts may be different than the federal applicable exclusion amount and may not be portable between spouses.
- The unused exclusion is not adjusted for inflation after the first spouse's death, and may not fully protect appreciating property from estate tax in the surviving spouse's estate.

### Use of A/B trust arrangement

Prior to 2011, many married couples with estates that were greater than the applicable exclusion amount would set up an A/B (or A/B/C) trust arrangement. In general, the first spouse to die would transfer an amount equal to the applicable exclusion amount to the "B" or credit shelter bypass trust. The B trust could benefit the surviving spouse and their children, but the B trust would be designed to bypass the surviving spouse's estate. The balance of the estate would be transferred to the surviving spouse, either outright or using an "A" marital trust, and qualify for the marital deduction. In some cases, a "C", "Q", or QTIP marital trust was also used if the first spouse to die wanted to control who received the marital trust property at the second spouse's death. The A/B trust arrangement typically assured that there would be no estate tax at the first spouse's death and that neither spouse's applicable exclusion amount was wasted.

An A/B trust arrangement may still be useful, even with the availability of portability. For example, the B trust can be used to provide for family members or individuals other than your spouse (and even your spouse) prior to the death of your spouse. You could also allocate your GST tax exemption or state exclusion to the B trust. Also, appreciation of property after the transfer to the B trust should not be subject to estate tax at your spouse's death. The A trust could use your spouse's applicable exclusion amount, GST tax exemption, and state exclusion.

The use of trusts can also provide other benefits, such as control over who receives your property and when, investment management of trust property for trust beneficiaries, avoidance of probate, and asset protection.



## 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](mailto:gjohnston@jicinvest.com)

[www.jicinvest.com](http://www.jicinvest.com)

### IMPORTANT DISCLOSURES

Broadridge Investor Communication Solutions, Inc. does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable—we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.



## I just bought a vacation home. Do I need to purchase a specific type of insurance?

Insuring a vacation home is different from insuring a primary residence. As a result, you'll want to purchase insurance that is specifically geared to provide coverage for this type of property.

When insuring a vacation home, the type and cost of coverage will vary, depending upon the insurance company and the state in which your vacation home is located.

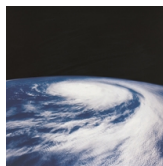
Most insurers offer at least some type of insurance that is specifically designed for second/vacation homes. Coverage under these types of policies can range from standard coverage that protects against certain named perils, to more comprehensive coverage that protects against all perils unless specifically excluded in a policy.

Keep in mind that, depending on what is covered under the policy, you may need to obtain additional protection (e.g., property or liability coverage) through either an endorsement or separate policy. In addition, if your vacation home is located in an area that is susceptible to flood damage—which is not covered under a standard vacation home

policy—you'll want to look into obtaining separate coverage for that peril as well.

Due to some of the unique circumstances surrounding vacation homes (e.g., high-risk location, not being occupied for long periods of time), vacation home insurance premiums are usually much higher than those for a primary residence. However, you may be able to save money by insuring your vacation home with the same company that provides coverage for your primary residence (some insurers may require this). In addition, you may be eligible for other discounts, such as those offered for newly built homes, nonsmokers, and homes that have a security system installed. Policy discounts will vary by state and insurer.

Because of the vast array of vacation home insurance products on the market, you'll want to be sure to shop around for the best coverage and rates. You may also want to contact the state department of insurance where your vacation home is located for additional information on the coverage and rate options that may be available.



## Will my homeowners insurance policy cover hurricane damage?

It depends. While the types of coverage offered by standard homeowners insurance policies vary, windstorms are one of the basic perils that most standard homeowners insurance policies will cover. This means your policy should compensate you for loss/damage to your home that results from a hurricane or other windstorm (e.g., broken windows, torn roof, damage from fallen trees).

Keep in mind that if you live in an area of the country that is prone to hurricanes (e.g., the coastal region of Florida), an insurance company may exclude coverage for hurricane damage from a standard homeowners insurance policy. And even if an insurance company does provide coverage, homeowners insurance policies in states that are at a high risk for hurricanes often contain a separate, higher deductible for hurricane damage.

If you find that your current policy doesn't provide coverage for hurricane damage, you have a few options. First, check with your insurance company and ask if you can add windstorm coverage to your existing policy by purchasing an endorsement (an optional

coverage that gets attached to your policy). Another option is to shop around and see if another company will sell you a homeowners policy that includes windstorm damage as a standard covered peril. You may also want to check to see whether your state administers windstorm insurance plans that pick up where regular homeowners policies leave off. If you live in one of these states, you may be able to purchase a separate windstorm policy to provide you with coverage for hurricane damage.

Finally, keep in mind that hurricanes are often accompanied by flooding. In many cases, flooding can cause far more damage to a home and other property than high winds. Unfortunately, though, neither standard homeowners insurance nor a separate windstorm policy will cover flood damage. If you want this type of protection, you'll need to purchase a separate flood insurance policy. The National Flood Insurance Program offers flood insurance through the federal government and some private insurers.



Johnston Investment Counsel  
LIFE THE WAY YOU PLANNED IT.