



## Johnston Investment Counsel

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### December, 2013

It's December 31. Do You Know Where Your Money Is?

What's In Store for Health-Care Reform in 2014  
Gift Tax Strategies That Can Benefit Your Family  
What will happen to my digital assets if I die or become incapacitated?



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LIFE THE WAY YOU PLANNED IT.

## It's December 31. Do You Know Where Your Money Is?



December and January are the perfect months to look back at what you earned, saved, and spent during the past year, as W-2s, account statements, and other year-end financial summaries roll in. So before Punxsutawney Phil comes out of his burrow to predict when spring is coming, take some time to get your financial house in order.

### How much have you saved?

Whether you simply resolved last year to save more or you set a specific financial goal (for example, saving 15% of your income for retirement), it's time to find out how you did. Start by taking a look at your account balances. How much did you save for college or retirement? Were you able to increase your emergency fund? If you were saving for a large purchase, did you save as much as you expected? Challenge yourself in the new year to save a little bit more so that you can make steady financial progress.

### How did your investments perform?

Review any investment statements you've received. How have your investments performed in comparison to general market conditions, against industry benchmarks, and in relationship to your expectations and needs? Do you need to make any adjustments based on your own circumstances, your tolerance for risk, or because of market conditions?

### Did you reduce debt?

Tracking your spending is just as important as tracking your savings, but it's hard to do when you're caught up in an endless cycle of paying down your debt and then borrowing more money, over and over again. Fortunately, end of year mortgage statements, credit card statements, and vehicle financing statements will all spell out the amount of debt you still owe and how much you've really been able to pay off. You may even find that you're making more progress than you think. Keep these statements so that you have an easy way to track your

progress next year.

### Where did your employment taxes go?

If you're covered by Social Security, the W-2 you receive from your employer by the end of January will show how much you paid into the Social Security system via payroll taxes collected. If you're self-employed, you report and pay these taxes (called self-employment taxes) yourself. These taxes help fund future Social Security benefits, but many people have no idea what they can expect to receive from Social Security in the future. This year, get in the habit of checking your Social Security statement annually to find out how much you've been contributing to the Social Security system and what future benefits you might expect, based on current law. To access your statement, sign up for a *my Social Security* account at the Social Security Administration's website, [www.socialsecurity.gov](http://www.socialsecurity.gov).

### Has your financial outlook changed during the past year?

Once you've reviewed your account balances and financial statements, your next step is to look at your whole financial picture. Taking into account your income, your savings and investments, and your debt load, did your finances improve over the course of the year? If not, why not?

Then it's time to think about the changes you would like to make for next year. Start by considering the following questions:

- What are your greatest financial concerns?
- Do you need help or advice in certain areas?
- Are your financial goals the same as they were last year?
- Do you need to revise your budget now that you've reviewed what you've earned, saved, and spent?

Using what you've learned about your finances--good and bad--to set your course for next year can help you ensure that your financial position in the new year is stronger than ever.

# What's in Store for Health-Care Reform in 2014



## Increase in small business tax credit

The maximum tax credit available to qualifying small employers (no more than 25 full-time equivalent employees) that offer health insurance to their employees increases to 50% of the qualifying employer's premium costs (35% for tax-exempt employers) on January 1, 2014. This is an increase from the maximum credit of 35% (25% for tax-exempt employers) that began in 2010.

While the Affordable Care Act (ACA) became law in 2010, several of the more substantive provisions of the law don't take effect until 2014. Here's a review of some of the key parts of the ACA that are scheduled to begin in 2014.

## Individual mandate

The ACA imposes a shared responsibility mandate, which requires that most U.S. citizens and legal residents of all ages (including children and dependents) have minimum essential health coverage or pay a penalty tax, unless otherwise exempt. The monthly penalty is equal to the greater of a declared dollar amount (\$95 in 2014) or a percentage of the individual's gross income.

**Note:** The employer's mandate to provide coverage for employees was also scheduled to begin in 2014; however, the requirement will not be enforced until January 2015.

## State Exchanges

The ACA requires that each state establish state-based American Health Benefit Exchanges for individuals and Small Business Health Options Program (SHOP) Exchanges for small employers. The Department of Health and Human Services will establish Exchanges in states that do not create the Exchanges. The general purpose of these Exchanges is to provide a single resource in each state for consumers and small businesses to compare health plans, get answers to questions, and enroll in a health plan that is both cost effective and meets their health-care needs.

Exchanges may only offer qualified health plans that cover essential benefits, limit out-of-pocket costs, and provide coverage based on four levels of cost sharing--bronze, silver, gold, and platinum. Also, tax credits and cost-sharing subsidies will be available to U.S. citizens and legal immigrants who buy health insurance through the health Exchanges.

## Insurers must provide guaranteed issue and renewability of coverage

All individual and group plans must issue insurance to all applicants regardless of health status, medical condition, or prior medical expenses. Insurers must renew coverage for applicants even if their health status has changed. Grandfathered individual plans are exempt from these requirements. Grandfathered plans are those that were in existence prior to the enactment of the ACA (March 2010) and have not been significantly altered in subsequent years.

In the past, insurers used pre-existing medical condition provisions to deny coverage for care

related to the condition (pre-existing condition policy exclusion), increased the premium to cover the condition, or denied coverage altogether. Beginning January 1, 2014, the ACA prohibits insurers in group markets and individual markets (with the exception of grandfathered individual plans) from imposing pre-existing condition exclusions.

In keeping with the guaranteed availability of coverage, insurers may not charge individuals and small employers higher premiums based on health status or gender. Premiums may vary only based on family size, geography, age, and tobacco use.

## Essential health benefits

All nongrandfathered small group and individual health plans must offer a package of essential health benefits from 10 benefit categories. The categories include ambulatory patient services, emergency services, hospitalization, laboratory services, maternity and newborn care, mental health and substance abuse treatment, prescription drugs, rehabilitative services and devices, preventive and wellness services, and pediatric services, including dental and vision.

## Other policy provisions

The ACA also imposes several requirements and eliminates other provisions commonly found in insurance policies:

- Group and individual policies (including grandfathered plans) may not impose waiting periods longer than 90 days before coverage becomes effective.
- Annual deductible for small group (fewer than 50 full-time equivalent employees) health plans (excluding grandfathered plans) must not exceed \$2,000 per insured and \$4,000 per family. These amounts are indexed to increase in subsequent years.
- The most you'll pay annually for out-of-pocket expenses (deductibles, coinsurance, and co-pays) for all individual and group health plans (excluding grandfathered plans) cannot exceed the maximum out-of-pocket limits for health savings accounts (\$6,350 for individual/\$12,700 for family in 2014).
- All group health plans and nongrandfathered individual health plans can no longer impose annual or lifetime dollar limits on essential health benefits.



## Gift Tax Strategies That Can Benefit Your Family



**Now may be a great time to make gifts that take advantage of the current large gift tax applicable exclusion amount, low gift tax rates, depressed property values, and low interest rates.**

**Be aware, however, that if you make a gift to a person who is two or more generations younger than you, such as a grandchild, generation-skipping transfer (GST) tax may also apply. In general, annual exclusions, qualified transfers, and an exemption equal to the applicable exclusion amount are also available for GST tax purposes and the same 40% tax rate applies.**

Today's large gift tax applicable exclusion amount, low gift tax rates, depressed property values, and low interest rates create a favorable environment for making certain gifts.

### Federal gift tax basics

**Annual exclusion.** Each year, you can give a certain amount (\$14,000 in 2013 and 2014) to as many individuals as you like gift tax free.

**Qualified transfers exclusion.** You can give an unlimited amount on behalf of any individuals for tuition or medical expenses gift tax free. You must pay the amount directly to the educational or medical care provider.

**Applicable exclusion amount.** Gifts can also be sheltered by the applicable exclusion amount, which can protect gifts of up to \$5,340,000 (in 2014, \$5,250,000 in 2013). The dollar limit applies to all taxable gifts you make during your lifetime and to your estate at your death for federal estate tax purposes.

### Basic planning

Generally, the first gifts you should consider making are annual exclusion and qualified transfer gifts. You can make annual exclusion gifts to anyone for any purpose. The annual exclusion is lost in any year in which you do not use it. While you can make unlimited gifts using the exclusion for qualified transfers, the gifts must be for educational and medical purposes.

You and your spouse can split gifts that either of you make. Doing so allows you and your spouse to effectively use each other's annual exclusions and applicable exclusion amount. For example, if you have 2 children, you and your spouse could make annual exclusion gifts totaling \$56,000 to your children (2 spouses x 2 children x \$14,000). If you make gifts of \$56,000 for 10 years, you will have transferred \$560,000 to your children free from gift tax.

Next, consider gifts that are sheltered by the applicable exclusion amount. But, remember that use of the applicable exclusion amount during life reduces the amount available for estate tax purposes at your death.

If you are likely to have a very large taxable estate at your death that could not be sheltered by the applicable exclusion amount, it might even make sense to make gifts that cause you to pay gift tax. For example, let's assume any additional transfer you make would be subject to the current top gift or estate tax rate of 40% and you make a taxable gift of \$1 million to your child on which you pay \$400,000 of gift tax. If you instead retained the \$1,400,000 until death, \$560,000 of estate tax would be due (\$1,400,000 x 40%), and only \$840,000 of the

\$1,400,000 would remain for your child. By making the taxable gift and paying gift taxes that reduced your taxable estate, you reduced taxes by \$160,000 while increasing the amount transferred to your child by the same \$160,000.

### Gift considerations

If you have property whose value is depressed, now may be a good time to make a gift of it. The gift tax value of a gift is its fair market value, and a lower value means a smaller gift for gift tax purposes. However, you generally should not make gifts of property that would produce an income tax loss if sold (basis in excess of sales price). The person receiving the property would have a carryover basis and would not be able to claim the loss. In these cases, instead consider selling the property, claiming the loss, and making a gift of the sales proceeds.

Future appreciation on gifted property is removed from your gross estate for federal estate tax purposes. However, while property included in your estate generally receives a basis stepped up (or stepped down) to fair market value when you die, lifetime gifts do not. Therefore, you may wish to balance the gift tax advantage of a gift with carryover basis and income tax on gain if the property is sold against the income tax advantage of a stepped-up basis and estate tax (if any) if you retain the property until your death.

In the current low interest rate environment, you may wish to consider a grantor retained annuity trust (GRAT). In a GRAT, you transfer property to a trust, but retain a right to annuity payments for a term of years. After the trust term ends, the remaining trust property passes to your beneficiaries, such as family members. The value of the gift of a remainder interest is discounted for gift tax purposes to reflect that it will be received in the future. Also, if you survive the trust term, the trust property is not included in your gross estate for estate tax purposes. Any appreciation in the trust property that is greater than the IRS interest rate used to value the gift escapes gift and estate taxation. The lower the IRS interest rate, the more effective this technique generally is.

In the current low interest rate environment, you may also wish to consider a low-interest loan to family members. You are generally required to provide for adequate interest on the loan, or interest will be deemed for gift tax purposes. However, with the current low interest rates, you can provide loans at a very low rate and family members can effectively keep any earnings in excess of the interest they are required to pay you.



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## What will happen to my digital assets if I die or become incapacitated?

In today's digital age, many individuals live at least a part of their life online. Whether you share your life with others through e-mail, Facebook posts, and tweets, or simply have a number of online, password protected accounts, you'll want to make plans for the disposition of all of your digital assets in the event of your death or incapacity.

Unfortunately, the laws governing digital assets are not well settled. Only a small number of states have estate laws that specifically cover digital assets, and those laws are relatively new and untested. As a result, you should consult an estate planning attorney for information on how digital assets are handled in your particular state.

For the most part, websites, blogs, and registered domain names are transferable under standard property and copyright laws. However, certain online accounts (e.g., e-mail, social media accounts) may not be transferrable, depending on the site's terms of service. Terms of service vary widely from site to site. Some sites will allow a person with the appropriate legal authority to access your

accounts upon your death. Others will put your accounts in a "memorial state" or permanently delete your account upon proper notification of your death.

The most important step you can take to protect your digital assets is to include them in your estate plan, just as you would your physical assets. Your first step should be to identify and inventory all of your digital assets. Make a list of where your assets are located and how they are accessed (e.g., username and password). Next, indicate what you wish to happen to your digital assets (e.g., transfer to an heir or terminate) and who will be responsible for carrying out those wishes (e.g., an executor). Be sure to refer to this inventory in your will (but keep it separate since your will eventually becomes public information).

If privacy issues surrounding your digital assets are a real concern, a number of online websites securely store all of your digital asset information and allow you to leave legacy instructions for a designated beneficiary or executor. The costs of these types of services vary, depending upon the services offered.



## What can I do to protect my username and password information from computer hackers?

At one time, computer hackers were viewed as a few rogue individuals who mainly worked alone. Today, many hackers are part of highly sophisticated networks that carry out well-organized cyber attacks. Unfortunately, these online security breaches can result in your username and password information being compromised.

Whenever you enter your personal information online, you'll want to make sure that you create a strong password to protect that information. Some tips for creating a strong password include:

- Avoid creating simple passwords that have a connection to your personal identity (e.g., date of birth, address) or that can be found in the dictionary
- Create a password that uses a nonsense word/random alphanumeric combination or an arbitrary, easy to remember phrase with mixed-up character types (e.g., upper/lower case, punctuation)
- Don't use the same password for multiple websites

- Use an online tool that allows you to test the strength of a password

If you have trouble keeping track of all of your password information or if you want an extra level of password protection, you may want to use some type of password management software. There are a variety of password managers on the market. Password managers typically work by using high-level encryption methods to store all of your online usernames and passwords on one secure server, using a single master password.

There are a few things you should consider when choosing a password manager. First, if you plan on needing your password information for use on various devices (e.g., tablet, smartphone), you will want to choose a password manager that has mobility features. In addition, some password managers offer added benefits such as web form fillers, which can come in handy if you do a lot of online shopping. Other features to look for include automatic log in and password generator capability.



## Expiring Taxes: How You Probably WON'T Be Affected

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The last day of 2013 is scheduled to be the last day for an estimated 57 different tax deductions-- unless Congress extends some or all of them. All of these deductions will be available for 2013 tax return that you file by April 15, 2014. But as it stands now, these deductions won't be available next year, creating a stealth tax increase in 2014.

How will this impact you? Only a few of the 57 are likely relevant to you at all, unless you qualify for the American Samoa Economic Development Credit, the "special expensing" rules for film and television production, the mine rescue team training credit or special three-year depreciation for your race horses that happen to be two years or younger.

You probably do, however, claim deductions for state and local taxes, which expire at the end of the year, and people with kids and/or grandkids in college might miss the above-the-line deduction for tuition and related educational expenses. Many Americans will be at least slightly affected by the loss of the deduction for mortgage insurance premiums, and some retired Americans over age 70 1/2 will be distressed to learn that they can no longer make tax-free distributions of up to \$100,000 from an IRA account to their favorite charity. School teachers will lose their classroom expense deductions of up to \$250 for unreimbursed expenses.

And thousands of homeowners whose homes are listing below what they paid for them will lose a provision that lets them exclude from their taxable income any reduction in their mortgage obligation (through debt modification or a short sale) up to a maximum of \$2 million. Other expiring tax breaks that may affect some people:

- Enhanced tax breaks for people who donate property (or easements on their property) to the Nature Conservancy or a local land trust.
- Tax credits for the purchase of 2- or 3-wheeled electric vehicles and a separate credit of \$7,500 for those who buy certain 4-wheeled electric vehicles like the Ford Focus Electric and the Nissan Leaf.
- A maximum \$500 tax credit for making certain energy-efficiency improvements in your home (like adding insulation), plus other credits for constructing new energy-efficient homes and a credit for energy-efficient appliances.

The biggest expiring corporate tax break is the research and development tax credit. At the end of the year, companies will also lose the additional first-year depreciation for 50% of the basis of qualified property.

In the past, Congress has allowed tax provisions to expire and then, retroactively, extended them for another year or two. Many tax observers believe this will almost certainly happen with the state/local tax deduction and corporate R&D tax credits, and quite possibly for the tuition tax credit as well.

So when you read about the 57 expiring provisions, and you are not in the biodiesel fuel business or planning to claim the electricity production credit for building a renewable power plant, or actively mining coal on Indian lands, you shouldn't get too excited. Chances are you aren't going to get hammered on next year's taxes -- and Congress may even get around to extending the provisions that you really care about.



### The Housing Affordability Window

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Mortgage rates are still low but trending upward. Banks are offering 30-year mortgages at a national average rate of 4.35%, up from 3.81% in May. Housing prices are still low by historical standards, but are also rising. Home prices have risen an average of 10% over the last 12 months. Wages for American workers are going up slower than the inflation rate. Mix these three numbers together, and you have a decline in the affordability of homes in the U.S.

The National Association of Realtors (NAR) issued its most recent update to the U.S. Home Affordability Index a few days ago: the index fell from 178.1 earlier in the year to 160.8 -- which is about where it was in the third quarter of 2009. However, to put that into perspective, this compares favorably with the average level of the index (134) since the NAR began tracking it in 1986. So, while home affordability may no longer be at its peak, the current market remains unusually accessible -- at least by historical standards.

The problem with these numbers is that different markets have different housing dynamics. Homes can be affordable in one region and outside the reach of most residents in others. Examples of affordability include Syracuse, NY (median home price: \$92,000, compared with a median income of \$65,800), Indianapolis, IN (\$93,000; \$65,100), Cleveland, OH (median listing price: \$63,729), Flint, MI (\$84,437) and Sioux City, IA (\$97,969).

At the other end of the spectrum, consider the San Francisco bay area, where the median home costs \$779,000 and the median income of local residents is \$101,200--a 7:1 ratio. Los Angeles (median home price: \$425,000 vs. median income of \$61,900), New York (\$464,000 vs. \$66,000 median income), and the Silicon Valley (\$625,000 vs. \$101,300) also tend to fall into the less-affordable-market category.

Regardless of where you live, however, people are likely to look back at this period when interest rates were still relatively low and homes were more attractively priced. Eventually, this window of opportunity will be closed as housing recovers and interest rates rise. It's hard to predict the future, but the trends suggest that our current affordability index level won't last forever.



### High Yields, Scary Prospects

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Investors are starving for yield. But reaching for yield is not always the best strategy. Bond investors should first be concerned with the return of their principal before the return on their principal. For example, there are federal and state tax-free municipal bonds yielding 10% -- five times the yield of government bonds. Legal? Of course it's legal. These bonds are issued by the self-governing American territory known as Puerto Rico.

Investors lost between 50% and 70% of their investments in the past five months, proving once again that high returns are pretty much always joined at the hip with high risk. But the Puerto Rican bond story is interesting for other reasons as well. The island territory has long been a favorite of professional muni bond investors because its securities have offered persistently high yields and because those yields are exempt not just from federal taxes, but from state taxes in all 50 states as well. To get that state tax exemption anywhere else, you have to invest in the qualifying municipal bonds issued in the state you pay taxes in.

Demand for these bonds got so high that Puerto Rico became, in effect, a major exporter of municipal bond debt. Moody's Investor Services estimates that the territory now has between \$52 billion and \$70 billion in outstanding paper, making it--astonishingly--the third-largest issuer behind the states of California and New York. But the most jaw-dropping statistic is its ratio of state debt to personal income--which is a pretty good measure of a municipality's capacity to pay back its debt obligations. The average debt to income figure for all U.S. states is 3.4%. In Illinois, which is routinely cited as the state teetering closest to the edge of bankruptcy, that figure is just over 5%. For Puerto Rico, the comparable number is 89%.

What are the chances that Puerto Rican bondholders, including high-yield municipal bond funds, will get fully compensated for their investments? The territory's 13% unemployment rate and 41% rate of participation in the labor force does not inspire optimism; nor does the fact that the territory's pension fund is only 7% funded. But unlike a city (think: Detroit), Puerto Rico cannot declare bankruptcy. Nobody knows exactly what will happen if (or when) the island doesn't have the money to make its next round of interest payments.

Even some prudent investors may feel the impact of a potential downgrade, restructuring or default. Because Puerto Rican bonds don't trigger state taxes, some state-specific muni bond funds have quietly loaded up on them to boost their yields and look more competitive compared with their stodgier peers. Regulators are concerned that investors were not informed of this aggressive investment tactic, and had no idea that a chunk of their nest egg was being shipped down into the Caribbean equivalent of Greece.

Puerto Rican bond yields may be sky-high. Returns could be another story.