



THE PERSONAL PLANNER

Personal Financial Planning Tips for Today and the Rest of Your Life

September 2010

Heling Associates Inc.

Bruce R. Heling, CFP(R)
CPA

PO Box 1385
Brookfield, WI 53008-1385
262-821-1008
bheling@helingassociates.com
<http://HelingAssociates.com>

Meteorological summer is giving way to fall and what a great summer it's been. If only the dry weather and stormy weather didn't come in such terrifying streaks. That goes for the equity markets, too, which seem to be on a month by month roller coaster ride of impressive proportions. After being down in May and June, and up in July, equity markets were down again in August. For no apparent reason, however, they seem to have rebounded significantly on the first trading day of September. It's been a challenging start for our new portfolio risk control strategy. It is simply not intended to deal with this kind of short term gyrations. I'm considering some strategy modifications to deal with this unusual situation... more on that in the monthly bulletin. In the mean time, let's hope for a more "temperate" Fall.

Bruce Heling, CFP CPA
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Year-End Tax Planning--Special Concerns for 2010



Year-end tax planning is as much about 2011 as it is about 2010. Often, there's a real opportunity for year-end tax savings when you can predict that you'll be paying taxes at a lower rate in one year than in the other. For example, under the right circumstances, deferring a year-end bonus or potentially accelerating deductions into the current year can pay off in a big way. Of course, to effectively plan, it helps to have a good idea of what next year's tax rates will be. Unfortunately, as 2010 draws to a close, 2011 brings some uncertainty in that regard.

Will there be higher tax rates in 2011?

Currently, there are six marginal federal income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%. These brackets--the result of 2001 tax legislation--expire at the end of 2010. As things stand now, in 2011 the 10% bracket disappears, and the remaining brackets return to their pre-2001 levels: 15%, 28%, 31%, 36%, and 39.6%. Though it would take action by Congress, the president has indicated that he would like to permanently extend the 2010 rates for individuals earning less than \$200,000 and married couples earning less than \$250,000 (these dollar benchmarks would be reduced by an amount that reflected the standard deduction and exemption amounts), but allow the two highest brackets to return to 36% and 39.6% for higher earners.

What about long-term capital gains?

Currently, long-term capital gain is generally taxed at a maximum rate of 15%. If you're in the 10% or 15% marginal income tax bracket in 2010, though, a special 0% rate applies (in other words, you owe no tax on any long-term capital gain). The same rates apply to qualified dividends received in 2010.

These rates also expire at the end of the year. The maximum rate on long-term capital gain in 2011 will generally increase to 20%, with a 10% rate applying to individuals in the lowest tax bracket (special rules would apply to qualifying

property held for five years or more). Qualifying dividends will be taxed as ordinary income. The president has proposed to permanently extend the 0% and 15% rates, with a new 20% rate applying to high-income individuals (those in the 36% and 39.6% tax brackets). Again, though, that all depends on what Congress does in the next few months.

Other considerations

- **2010 Roth IRA conversions:** A special rule applies to Roth IRA conversions in 2010 that allows you to postpone paying federal income tax on the income that results from the conversion. Instead of including the taxable income that results from the conversion on your 2010 federal income tax return (still an option if you so choose), you can report half the income on your 2011 return and half on your 2012 return. Whether a Roth conversion makes sense for you depends on your individual circumstances, including your marginal income tax rate in 2011 and 2012.
- **Alternative minimum tax (AMT):** In a now-familiar pattern, legislation that temporarily increased AMT exemption amounts, forestalling a dramatic increase in the number of individuals ensnared by the tax expired at the end of 2009. Congress is likely to act, but the specifics are uncertain.
- **Required minimum distributions (RMDs):** The requirement to take minimum distributions from IRAs and defined contribution plans was temporarily suspended for 2009; minimum distribution requirements are once again in effect for 2010.
- **Pending legislation:** Legislation is pending to extend some popular provisions that had expired, including the ability to deduct state and local sales tax in lieu of income tax on Schedule A, the additional standard deduction for state and local real property tax, and the above-the-line deduction for qualified tuition and related expenses. And additional legislation is likely, too, so stay up-to-date.

In-Service Withdrawals from 401(k) Plans

You're probably familiar with the rules for putting money into a 401(k) plan. But are you familiar with the rules for taking your money out?

All 401(k) plans are not the same

Federal law specifies the withdrawal options that a 401(k) plan can offer. But your plan can be stricter than the law allows (i.e., offer fewer withdrawal options), and may even provide that you can't take any money out until you reach normal retirement age (usually 65). However, many plans are more flexible.



Withdrawing your own contributions

If your plan allows, you can withdraw your own pretax and Roth contributions (and in some cases, any investment earnings on them) for one of the following reasons:

- You terminate employment
- You attain age 59½
- You become disabled
- You incur a hardship

Hardship withdrawals are permitted only if you have an immediate and heavy financial need, and only in an amount necessary to meet that need. In most plans, you must need the money to (1) purchase a principal residence or repair a principal residence damaged by an unexpected event (e.g., a hurricane), (2) prevent eviction or foreclosure, (3) pay medical bills, (4) pay certain funeral expenses, (5) pay certain education expenses, and (6) pay income tax and/or penalties due on the hardship withdrawal itself. In addition, you generally must have already utilized all other available distributions and nontaxable loans under all plans maintained by your employer. But think carefully before making a hardship withdrawal--in most plans your employer must suspend your participation in the plan for at least six months after the withdrawal, and you could lose valuable employer matching contributions.

Withdrawing employer contributions

Getting employer dollars out of a 401(k) plan can be even more challenging. Many plans won't let you withdraw employer contributions at all before you terminate employment. But some plans are more flexible, and let you withdraw at least some vested employer contributions before then. "Vested" means that you own the contributions and they can't be forfeited for any reason. In general, a 401(k) plan can let you withdraw vested matching or profit-sharing contributions if:

- You become disabled
- You incur a hardship
- You attain a specified age
- You participate in the plan for at least five years, or
- The employer contribution has been in the account for a minimum of two years

Taxation

Your own pretax contributions, company contributions, and investment earnings are taxable when withdrawn from the plan. If you've made any after-tax contributions, they'll be nontaxable when withdrawn. Each withdrawal is deemed to carry out a pro-rata portion of taxable and nontaxable dollars. Any Roth contributions, and investment earnings on them, are treated separately: if your distribution is qualified, then your withdrawal will be entirely free from federal income taxes. If your withdrawal is nonqualified, then each withdrawal will be deemed to carry out a pro-rata amount of your nontaxable Roth contributions and taxable investment earnings. And keep in mind that taxable distributions made prior to age 59½ are generally subject to a 10% premature distribution tax in addition to any income tax due, unless an exception applies.

Plan loans

Many 401(k) plans allow you to borrow money from your own account. A loan may be attractive if you don't qualify for a withdrawal, or you don't want to incur the taxes and penalties that may apply to a withdrawal.

In general, you can borrow up to one half of your vested account balance (including your contributions, your employer's contributions, and earnings), but not more than \$50,000.

You can borrow the funds for up to five years (longer if the loan is to purchase your principal residence). In most cases you repay the loan through payroll deduction, with principal and interest flowing back into your account. But keep in mind that when you borrow, the unpaid principal of your loan is no longer in your 401(k) account working for you.

Be informed

You should become familiar with the terms of your employer's 401(k) plan to understand your particular withdrawal rights. A good place to start is the plan's summary plan description (SPD). Your employer will give you a copy of the SPD within 90 days after you join the plan.

Remember that your 401(k) account is there for your retirement. Using it before then should be a last resort only.

How Will Financial Reform Affect You?

In response to an outcry for reform, on July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. Much of the legislation centers on new regulations affecting how Wall Street functions, including the infusion of new powers in the Federal Reserve, and new government authority to shut down large financial companies on the brink of failure.

Nevertheless, while the bulk of the legislation is aimed at Wall Street, most consumers want to know how the law will affect them. Here are some of the provisions that may directly affect consumers like you.

Revised mortgage lending practices

The legislation institutes new mortgage lending rules intended to provide more borrower protection. For instance, lenders will have to follow defined standards to verify whether, based on income, credit history, and other data, a borrower has a reasonable ability to repay a loan including associated taxes and insurance. And if the lender doesn't adhere to this "ability to repay" standard, or if the mortgage has excessive fees or abusive terms, the borrower may raise those factors as a defense to foreclosure without regard to any statute of limitations.

Lenders also must retain at least a 5% interest in loans they make that don't meet certain standards, so that a lender will be less inclined to make a loan to a borrower who can't afford it; the law is also designed to prevent a lender from selling the loan and passing all of the risk of default onto the secondary mortgage buyer.

While these rules may limit the size of the mortgage you qualify for, they're intended to prevent you from being steered into a loan that's not suitable for you. Lenders can no longer provide mortgage originators and loan officers with financial incentives such as higher commissions for directing potential borrowers to mortgages with higher interest rates. And lenders can't coerce or encourage an appraiser to make a faulty appraisal of a property's value so the borrower may obtain a loan more easily.

Making the entire process of obtaining a loan more transparent is a key goal of financial reform. For instance, loan originators of residential mortgages must disclose any conflicts of interest and compare costs

and benefits of a mortgage offered to a potential borrower. Prepayment penalties on balloon loans and adjustable-rate mortgages (ARMS) are banned and must be disclosed on other loans. If you have a hybrid ARM, the lender must give you at least six months notice in advance of any change in the interest rate. And if you're unable to make your mortgage payments as a result of losing your job or because of a medical condition, you may now qualify for up to \$50,000 in assistance loaned through HUD's existing Emergency Mortgage Assistance Fund.

Lenders are prohibited from refinancing an existing mortgage unless the new mortgage offers a net benefit to the borrower, and borrowers are entitled to a copy of the lender's appraisal of the property no later than three days prior to the closing.

Consumer protection provisions

The law provides for regulation of consumer financial products under the auspices of a single agency: the Consumer Financial Protection Bureau. This government entity will serve as a consumer protection watchdog, able to write rules for consumer protections governing all financial institutions--banks and other institutions offering consumer financial services or products. This agency will also regulate the private student loan industry while giving students access to information about private student loans.

Increase in FDIC account protection

During the financial crisis, the Federal Deposit Insurance Corporation (FDIC) temporarily increased the amount it will insure on deposit accounts in FDIC-insured banks from \$100,000 to \$250,000. The law makes the \$250,000 limit permanent. For example, you and your spouse can each have separate deposit accounts as well as a single joint account and qualify for up to \$1 million worth of total FDIC protection.

Another change is your ability to get your credit score for free if you were turned down for credit, housing, or a job based, in part, on your credit score. You can also get your credit score if your credit card company changes your credit terms based on a negative credit score. The free look at your credit score isn't available if you don't have a negative credit experience, however.



The new law offers a reward to whistle-blowers with information that leads to monetary sanctions of more than \$1 million. Whistle-blowers will receive 10% to 30% of the amount collected from the offender.



Heling Associates Inc.
Bruce R. Heling, CFP(R)
CPA

PO Box 1385
Brookfield, WI 53008-1385
262-821-1008
bheling@helingassociates.com
<http://HelingAssociates.com>

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Ask the Experts



Will the new health-care law affect my Medicare drug plan?

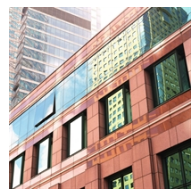
Yes, it might. Many Medicare Part D beneficiaries have had to pay for prescriptions

out-of-pocket after reaching a gap in their annual coverage, referred to as the "donut hole." Currently, if you're a Medicare Part D beneficiary, you may pay up to an additional \$3,610, out-of-pocket, for medicines after reaching an initial threshold of \$2,830 in total prescription drug costs (including Part D payments, beneficiary co-pays, and deductibles). But, in 2010, if you fall in the coverage gap, you will receive a \$250 rebate.

Starting in 2011, you will receive a 50% discount on the cost of brand-name drugs in the coverage gap. Additionally, a reduction in coinsurance for generic drugs in the coverage gap will be phased in, starting in 2011, and a similar reduction in coinsurance for brand-name drugs begins in 2013. By 2020, a combination of federal subsidies and a reduction in co-payments will reduce your total out-of-pocket costs for medications in the donut hole to 25%.

Another change affecting Medicare Part D beneficiaries relates to full-benefit dual-eligible beneficiaries (individuals eligible for both Medicaid and Medicare). Dual-eligible beneficiaries receiving institutional care, such as in a nursing home facility, do not owe any co-payments for prescriptions covered by Part D. However, dual-eligible beneficiaries receiving long-term care services at home or in a day-care community setting are subject to such co-payments. Beginning in 2012, the new legislation removes this imbalance; individuals receiving services at home or in a community setting will no longer be subject to co-payments.

Also, beginning in 2011, the time period during which Part D and Medicare Advantage beneficiaries can make changes to their coverage is extended and runs from October 15 through December 7. This extension should provide more time for beneficiaries to consider their options while ensuring that any benefit changes are properly incorporated into the plan for the following year.



Does the new health-care reform law affect health spending accounts?

Yes. The new health-care reform legislation impacts flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs), health savings accounts (HSAs), and Archer medical savings accounts (MSAs).

Over-the-counter medications. Beginning in 2011, FSAs and HRAs will not be able to make reimbursements for the cost of over-the-counter medications, and HSA and Archer MSA distributions used to pay for the cost of over-the-counter medications will not be made on a tax-free basis. However, insulin and over-the-counter medications prescribed by a physician will still be reimbursable on a tax-favored basis by these plans. You may want to stock up on your over-the-counter drugs to take advantage of the available reimbursement before the end of this year.

Tax increase on nonqualified distributions. Generally, distributions from HSAs and Archer MSAs for qualified medical expenses are received income-tax free. Plan distributions

for other than qualified medical expenses are subject to ordinary income tax plus a penalty tax. In the case of HSAs, the penalty is 10%, and for Archer MSAs the penalty is 15%. However, the health-care reform legislation increases the tax penalty for both of these plans to 20%, beginning in 2011.

FSA contribution limit. If you participate in an FSA as part of a cafeteria plan, beginning in 2013, the annual amount available for reimbursement for qualified medical expenses is limited to \$2,500 (this figure will be adjusted for inflation in subsequent years). This reduction does not apply to health FSAs that aren't part of a cafeteria plan.

If these changes will affect you, and you or a family member needs substantial dental work such as orthodontia, or corrective vision surgery, you might want to plan for and address these needs prior to 2013. And remember, FSAs are subject to the "use it or lose it" rule, meaning that any pretax money in your plan that is not used by the end of the plan year is forfeited.