



# The Mint Edition

from Yerba Buena Financial Partners, LLC

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YBFP empowers its select clientele to make informed decisions regarding building, protecting, and distributing wealth by providing conflict-free independent management advice, comprehensive education, and service of the highest caliber.

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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.**

## Buy Term and Invest the Difference Isn't Always the Best Strategy

When it comes to life insurance, we've all heard the debate over whether to buy cash value life insurance, or buy term insurance and invest the difference. While cash value life insurance provides a cash accumulation account, it typically costs a great deal more than a similar amount of term insurance. The "buy term and invest the difference" strategy involves using the amount you'd spend on cash value life insurance to buy a less expensive term policy for the same death benefit and investing the difference on your own.

### Why "buy term and invest the difference"?

There are several reasons proponents consider this strategy instead of cash value life insurance:

- Your need for life insurance protection is often temporary (e.g., replacing income during working years, paying off a mortgage or other debt), so there may be no need for permanent cash value life insurance
- You have a greater variety of investment options to better meet your risk tolerance and savings goals
- By selecting your own investments, you have the potential of earning greater returns than may be provided by cash value life insurance
- You may have greater access to your savings, depending on the types of investment vehicles you choose
- You may be able to invest within tax-advantaged accounts such as IRAs, Roth IRAs, and tax-deferred annuities

### Why cash value might be the better choice

*Is your life insurance need permanent?* Your need for life insurance may not be temporary. For example, you may want to leave a monetary gift to children or grandchildren, provide estate liquidity for taxes and other expenses including memorial and burial costs, or make a charitable bequest. You could use your savings to meet these goals, but what if you haven't accumulated enough? You may not be able to meet your financial goals at death, or you could fail to secure your surviving family members' financial future.

#### *Will your term policy keep up with inflation?*

Most term policies are purchased for a specific period of time, such as 20 years. Generally, the death benefit remains level for the entire term. However, rising inflation may actually eat

away at your death benefit, diminishing its value over time. Most cash value life insurance affords the opportunity to increase the death benefit in the future. For example, dividends from whole life insurance can be used to buy more death benefit (though dividends are not guaranteed), and some universal life policies allow excess cash accumulations to increase the death benefit.

*How much savings will you have?* Depending on your investment choices, you may not know how much your savings will be worth at a given point in the future. Recent stock market downturns exemplify how quickly portfolios and investment accounts can be reduced. If you haven't accumulated the amount of savings you anticipated and your term life insurance runs out, you may be forced to continue your term coverage. But your premium cost for term can increase significantly, simply because you're older. And if your health has deteriorated, it may cost you substantially more to renew your coverage, or you might not qualify for coverage at any price. Even if your policy is guaranteed renewable (i.e., the company has to renew your coverage regardless of your health), your premiums can still increase if the insurer does so for the entire class of policyholders, including you.

The advantage of many cash value policies is that you can usually predict the policy's death benefit and cash value throughout the life of the contract. Most cash value policies have a minimum or guaranteed death benefit that will remain in effect as long as premiums are paid (subject to the claims-paying ability of the insurer). And your premiums typically won't increase under any circumstances. Also, many types of cash value policies pay a minimum interest on the cash accumulation account. And some whole life policies may even pay a dividend that can be added to your cash value.

*Will you invest the difference?* If the buy term and invest the difference strategy is going to work, you have to "invest the difference." If you don't have the discipline to follow the course, you probably won't reach your accumulation goal. Cash value life insurance offers "forced savings," so it may be a good choice for individuals who are unable to save on their own.



***In many states, the cash value of a life insurance policy is protected, at least in part, from claims of your creditors, providing a potential asset protection advantage over some other investment vehicles.***





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## Ask the Experts



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

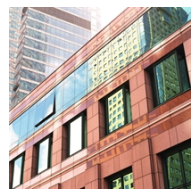
Yes, it might. Many Medicare Part D beneficiaries have had to pay for prescriptions

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.