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Hello-

We hope you had a pleasant summer and are enjoying the change of seasons. As the winter months approach and outdoor activities cease, it may be advantageous to redirect your focus toward year-end tax planning. Although the outcome of pending tax legislation is uncertain, it is clear that significant changes are likely. Planning now can help you capitalize on available opportunities and avoid potential pitfalls that may await. Please contact us with any questions or concerns, or use our website at [www.smithmayerliddle.com](http://www.smithmayerliddle.com) as a helpful resource.

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# INVESTING PERSPECTIVES

4th Quarter 2010

## 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.

## 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.*

## Avoiding Probate: Is It Worth It?

When you die, your estate goes through a process that manages, settles, and distributes your property according to the terms of your will. This process is governed by state law and is called probate. Probate proceedings fall under the jurisdiction of the probate court (also called the Surrogate's, Orphans', or Chancery court) of the state in which you are domiciled at the time of your death. This court oversees probate of your personal property and any real estate that is located in that state. If you own property located in a state other than the state in which you are domiciled at the time of your death, a separate "ancillary" probate proceeding may need to be initiated in the other state.

**Note:** "Domicile" is a legal term meaning the state where you intend to make your permanent home. It does not refer to a summer home or a temporary residence.

Items that are subject to probate are known as probate assets. Probate assets generally consist of any property that you own individually at the time of your death that passes to your beneficiaries according to the terms of your will. Nonprobate assets include all property that passes outside of your will. Examples of nonprobate assets include property that is owned jointly with right of survivorship (e.g., a jointly held bank account) and property that is owned as tenants-by-the-entirety (i.e., real property owned jointly by a husband and wife). Another example is property that passes to designated beneficiaries by operation of law, such as proceeds of life insurance and retirement benefits.

### Why avoid probate?

Most wills have to be probated. The rules vary from state to state, but in some states, smaller estates are exempt from probate, or they may qualify for an expedited process.

**Probate can be slow.** Depending on where your executor probates your estate and the size of your probate estate, the probate process can take as little as three months or as long as three years. Three years can be a long time to wait for needed income. It can take even longer if the estate is a complicated one or if any of the heirs are contesting the will.

**Probate can be costly.** Probate costs usually include court costs (filing fees, etc.), publication costs for legal notices, attorney's fees, executor's fees, bond premiums, and appraisal fees. Court costs and attorney's fees can vary

from state to state. Typically, the larger the estate, the greater the probate costs. However, if a smaller estate has complex issues associated with its administration or with distribution of its assets (e.g., if the decedent owned property in several states), probate can be quite costly.

**Probate is a public process.** Wills and any other documents submitted for probate become part of the public record, something to consider if you or your family members have privacy concerns.

### Why choose to go through probate?

For most estates, there's usually little reason to avoid probate. The actual time and costs involved are often modest, and it just doesn't make sense to plan around it. And, there are actually a couple of benefits from probate. Because the court supervises the process, you have some assurance that your wishes will be abided by, and, if a family squabble should arise, the court can help settle the matter. Further, probate offers some protection against creditors. As part of the probate process, creditors are notified to make their claims against the estate in a timely manner. If they do not, it becomes much more difficult for them to make their claims later on.

In addition, some states require that your will be probated before the beneficiaries under your will can exercise certain rights. Among the rights that may otherwise be limited are the right of your surviving spouse to waive his or her share under the will and elect a statutory share instead, the right of your surviving spouse to use your residence during his or her remaining life, the right of your surviving spouse to set aside certain property, and the right of your surviving spouse to a family allowance.

### How to avoid probate

An estate plan can be designed to limit the assets that pass through probate or to avoid probate altogether. The major ways property is passed outside of probate are by owning property jointly with rights of survivorship; by ensuring that beneficiary designation forms are completed for those types of assets that allow them, such as IRAs, retirement plans, and life insurance; by putting property in a trust; and by making lifetime gifts.

See your financial professional or attorney for more information.

### Why avoid probate?

- It can be slow; getting needed assets into the hands of your heirs may be delayed
- It can be costly, especially if an estate is large or complex, or ancillary probate is needed
- It is public; documents that you wish to remain private can be accessed by the public



### How to avoid probate

- Own assets jointly with rights of survivorship
- Own assets that pass by beneficiary designation, such as life insurance and retirement plans
- Use a trust
- Gift assets during your lifetime



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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.