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It is better to ask some of the questions than to know all the answers.

- James Thurber

In this issue:

CAVANAUGH
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Quarterly Newsletter - Q4 2010

News and Anouncements

Sean's Corner

With November elections around the corner, there are some significant changes that Congress will need to address before year end. Specifically, the Bush tax cuts of 2001 and 2003 are set to expire on January 1st of 2011. If the tax cuts aren't extened, marginal tax brackets will rise for all income levels. The Obama administration is pushing to extend the cuts for individual earners with incomes under $200,000 and families with incomes under $250,000. In addition, the Estate Tax will reset to $1 million at a rate of 55% for estates over that amount. Currently, in 2009, there is no estate tax. Capital gains rates are currently at 15% and bound to go higher. Taxes on qualified dividends from stocks are currently 15% and could go as high as 39.6% at the Federal level. Once the new legislation has been passed to address these issues, we will let you know in our next quarterly newsletter or in person at your next bi-annual review.

On July 21st, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (FIN-REG 2010) into law. This is the most sweeping financial legislation since the Great Depression. This legislation institutes new mortage lending rules intended to provide more borrower protection. In addition, the law provides for the creation of the Consumer Financial Protection Bureau. This new government entity will serve as a watch dog, governing all financial institutions that offer consumer financial products. The temporary increase in FDIC insurance on bank deposites from $100,000 to $250,000 has been made permanent. To conform to the new FIN-REG legislation, U.S. banks will be required to reduce leverage and proprietary trading. The recent Basel III accord would impose new capital requirements on the world's banks in an effort to avert future financial meltdowns.

Sean's Corner (continued)

On a personal note, my family and I had a great time on our recent vacation. It was great to recharge my batteries. Our oldest daughter is off to college for her second year and the other kids are back in school and longing for Summer.

RMDs

In November, we will be contacting all clients who have not taken their required minimum distributions for 2010. Should you have any year end tax questions or other questions, please don't hesitate to give us a call.

Educational Workshops

We recieved some great feedback at our most recent workshop on "Estate Planning". This was held at the Brigantine in La Mesa. Thank you to those who attended. We will be conducting 3 to 4 education workshops next year and are interested to know what topics you would like to see covered. Please call us or send suggestions to nick.hanna@raymondjames.com.

Family and Friends

If you have any family or friends who might benefit from recieving our newsletter, please have them call or sign up on our website at www.cavanaughfinancial.com.

Holiday Schedule

The office will be closed on November 25-26 for Thanksgiving and on December 24 for Christmas.

They're Baaack: RMDs for 2010

Required minimum distributions, often referred to as RMDs, are amounts the federal government requires you to withdraw annually from traditional IRAs and employer-sponsored retirement plans after you reach age 70½ (or, in some cases, after you retire). RMDs are also required if you inherit an IRA (traditional or Roth) or employer plan account. You can always withdraw more than the minimum amount from your IRA or plan in any year, but if you withdraw less than the required minimum, you'll be subject to a federal penalty tax equal to 50% of the shortfall.

In response to deteriorating economic conditions in 2008, Congress (as part of the Worker, Retiree, and Employer Recovery Act of 2008, or "WRERA") waived RMDs from IRAs and defined contribution employer plans for the 2009 calendar year. This allowed individuals to avoid having to deplete retirement plan assets while the value of those assets was suddenly depressed. But RMDs are back for 2010. Here's how the rules apply.

IRA owners and employer plan participants

If you turned 70½ before 2009, your RMD for the 2009 calendar year, which was due by December 31, 2009, was waived. You must now resume taking RMDs. Your next RMD (based on your December 31, 2009, account balance) must be taken no later than December 31, 2010.

If you turned 70½ in 2009, your first RMD (for the 2009 calendar year) was due by April 1, 2010. This RMD was waived. You must now take your first RMD (for the 2010 calendar year, based on your account value as of December 31, 2009) no later than December 31, 2010. You'll need to take your second RMD from the account (for the 2011 calendar year) no later than December 31, 2011.

If you turned 70½ in 2010, your RMDs are not impacted by the 2009 waiver at all. Your first RMD (for the 2010 calendar year) is due by April 1, 2011, and is based on the value of your account on December 31, 2009. You'll need to take a second RMD from the account no later than December 31, 2011.

Inherited accounts

In general, if you inherit an IRA (traditional or Roth) or employer-plan account, you must begin taking RMDs over your life expectancy ("life expectancy" rule) starting with the year following the year of the account owner's death. Alternatively, you may elect, or your plan may require, that you withdraw the entire account by December 31 of the calendar year containing the 5th anniversary of the account owner's death ("five-year" rule).

- Per the WRERA, if you inherited an IRA or employer account, and you were using the life expectancy payout rule, then your RMD for the 2009 calendar year was waived. You must take an RMD for the 2010 calendar year no later than December 31, 2010.
- If you inherited an IRA or employer account, and you were using the five-year rule for RMDs, you ignore 2009 when determining when your five-year period ends. So, for example, if your original five-year deadline was December 31, 2009, you ignore 2009 and you now have until December 31, 2010, to complete withdrawals from the account. Similarly, if your original five-year deadline was December 31, 2013, your new deadline, ignoring 2009, is December 31, 2014.
- If you inherited an employer plan account, you may have been given the right to elect whether to use the five-year rule or the lifetime expectancy payout rule for taking RMDs. This election is generally required no later than December 31 of the year following the year of the account owner's death. Per IRS Notice 2009-82, if your deadline for making the election was December 31, 2009, you now have until December 31, 2010, to make that election.
- If you inherited an employer account from someone other than your spouse, and the five-year rule applies to your benefit, you generally have until December 31 of the year following the year of the account owner's death to make a direct rollover of the account to an inherited IRA, and use the lifetime expectancy payout rule for distributions from the IRA. If the account owner died in 2008, you generally would have needed to complete your rollover by December 31, 2009. Per Notice 2009-82, you have until December 31, 2010, to complete the rollover.

As you can see, the 2009 waiver significantly complicates the RMD landscape for 2010. If you're taking RMDs from an IRA or employer-sponsored retirement plan, you may want to consider reviewing your situation with your financial professional.

As you can see, the 2009 waiver significantly complicates the RMD landscape for 2010. If you're taking RMDs from an IRA or employer-sponsored retirement plan, you may want to consider reviewing your situation with your financial professional.

Health-Care Reform Creates Small Business Tax Credit

Beginning this year, if you're a small business employer, you may be able to take advantage of the small business tax credit provided by the new health-care reform legislation. To be eligible for the tax credit, you must be a qualified small business employer who contributes at least 50% of the premium cost of a qualifying health plan (health insurance coverage purchased from a licensed insurance company).

Qualified small business employer

To be a qualified small business employer, you must employ fewer than 25 full-time equivalent employees (FTEs) during the taxable year, and your employees must have annual full-time equivalent wages that average less than $50,000 (indexed to the Consumer Price Index for Urban Consumers beginning in 2014). The full amount of the credit is available only if you have 10 or fewer FTEs whose average annual full-time equivalent wages is not more than $25,000 (also indexed to the Consumer Price Index for Urban Consumers beginning in 2014).

Full-time equivalent employees

Calculate your FTEs by totaling all hours worked by all your employees during the tax year, and dividing the result by 2080. For purposes of the calculation, the maximum number of hours that can be attributed to an individual employee is 2080.

Average full-time equivalent wages

To determine annual full-time equivalent wages, divide the total wages paid for the year, divided by the number of FTEs, rounding the result down to the nearest $1,000. Hours and wages paid for seasonal employees aren't included unless they worked more than 120 days during the taxable year.

Maximum credit

The full credit for years 2010 through 2013 is equal to 35% of the lesser of (1) the amount of contributions you made on behalf of employees during the taxable year for qualifying health coverage, and (2) the amount of contributions that you would have made during the taxable year if each employee had enrolled in coverage with a small business benchmark premium.

The benchmark premium is the average total premium cost in the small group market for employer-sponsored coverage in your state. The premium and the benchmark premium vary based on the type of coverage provided to your employees.

Beginning in 2014, the maximum credit is equal to 50%, determined in the same manner as in years prior to 2014. However, the credit is only available if you purchase employee health insurance coverage through a state Exchange. The credit is available for a maximum coverage period of two consecutive years, beginning with the first year in which you offer one or more qualified plans to your employees through an exchange.

Sliding scale tax credit

The tax credit is reduced if you have more than 10 FTEs and/or if the average annual wages exceed $25,000.

If you have more than 10 FTEs, the credit reduction is determined by multiplying the amount of the maximum credit by the number of FTEs exceeding 10, then dividing this total by 15.

If your average annual wages exceeds $25,000, the credit reduction is calculated by multiplying the maximum credit amount by the average annual wages in excess of $25,000, then dividing this total by $25,000.

If you have more than 10 FTEs and average annual wages in excess of $25,000, the credit reduction is the sum of the total of the two reductions.

Example: *In 2011, you have 11 FTEs with average annual wages of $30,000, and your premium cost for the year is $100,000. To determine the reduced credit:*

1. *Maximum credit before reduction: (35% x $100,000) = $35,000*
2. *Credit reduction for FTEs exceeding 10: ($35,000 x 1/15) = $2,333*
3. *Wages exceeding $25,000: ($35,000 x $5,000/$25,000) = $7,000*
4. *Total credit reduction: ($2,333 + $7,000) = $9,333*
5. *Total credit in 2011: $25,667 ($35,000 - $9,333)*

Tax-exempt organizations

The tax credit is also available if you are a 501(c) organization exempt under IRC Section 501(a). However, the credit percentage for 2010, 2011, 2012, and 2013 is 25% (rather than 35%), and the credit percentage for taxable years beginning in years 2014 and later is 35% (rather than 50%). You can only apply the tax credit against your liability for payroll taxes.

Self-employed individuals, including partners and sole proprietors, 2% shareholders of S corporations, and 5% owners of an employer, are not treated as employees for purposes of this credit. Sole proprietorships are not entitled to the credit by virtue of employing family members, and these individuals are not taken into account in determining the number of FTEs or average full-time equivalent wages.

By 2014, employers with fewer than 100 employees may be able to compare and purchase qualified employee health insurance plans at competitive prices through state-based Small Business Health Options Program (SHOP) Exchanges.

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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.