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Spring 2012

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Capital Advice

Capital Financial Advisors of New York, LLC

Market-Moving Indicators for Monitoring Europe

If you've struggled to make sense of the ongoing European debt debacle, you're not alone. It's difficult even to keep track of all the pieces of this financial Rube Goldberg puzzle, let alone understand how they can influence one another.

Though new aspects of the situation seem to crop up every month, here are some of the most common factors that either reflect or affect sentiment about what's happening in Europe. Knowing about them might help you understand why markets react to a seemingly obscure headline. After all, one of the few things that almost everyone seems to agree on is that the situation isn't likely to be solved overnight.

Take an interest in interest rates

Interest rates on sovereign debt are perhaps the most closely watched indicator. When demand for a country's bonds is low because investors are concerned about the possibility that they might not be repaid in full and on time, that country must offer a higher interest rate in order to borrow money to finance its day-to-day operations.

Interest rates become particularly worrisome when they reach or exceed 7%. That's the level that prompted Greece, Ireland, and Portugal to seek bailouts from their European peers, and it's widely seen as unsustainable. When a country must pay that much simply to service its debt, investors become concerned that high borrowing costs will make a country's financial situation even worse.

Watch credit ratings

Troubled European countries are struggling to deal with a devilish Catch-22. In many cases, unsustainable debt burdens have led to stringent austerity measures; however, such measures also can hamper economic growth, which reduces tax revenue and can potentially increase deficits. Higher deficits can lead to a lower credit rating that in turn can mean higher borrowing costs, bringing on the problems discussed above and potentially launching a new downward economic cycle. Thus, a downgrade to a country's credit rating tends to raise concerns.

However, investor reaction also can be unpredictable. For example, Standard & Poor's January downgrade of nine sovereign nations and the European Financial Stability Fund was largely met with a shrug by investors. There's been so much pessimism about Europe for so long that in some cases, markets may already have priced in much of the bad news.

Monitor credit default swap costs

A credit default swap (CDS) is a form of insurance against the possibility that a bond issuer might default or fail to make a payment on its obligations. Bondholders buy a CDS from a financial institution or insurance company that promises to reimburse the bondholder for any losses sustained in the event of a default. The cost of that insurance is seen as a proxy for the perceived risk involved in investing in a particular country's bonds. The higher the cost of a CDS on, say, Italian sovereign debt, the greater the anxiety about whether the bond issuer will default and the CDS issuer will have to pay.

Follow the money

To prevent credit markets from seizing up, the European Central Bank late last year provided almost €500 billion in three-year loans to European banks, making it easier for them to refinance their debt. The level of borrowing at the ECB is seen as one indicator of how banks are being affected by their holdings of sovereign debt. The greater the need to borrow from the ECB, the greater the banks' perceived level of vulnerability.

Bailouts: Nein nein nein?

U.S. voters aren't the only ones who are sensitive about bailouts; so are Germans. As Europe's most powerful economy and the one with the best credit rating, Germany is the tentpole upon which European financial stability hangs. However, by the end of 2011, the German economy had begun to slow. Any indications that economic pressure could threaten Germany's ability and willingness to remain strong in its support of the eurozone can spook anxious investors.

See disclaimer on final page

Inheriting an IRA--What You Need to Know

The rules governing inherited IRAs can be complicated. If you inherit an IRA from someone who isn't your spouse, your options are fairly limited. If you inherit an IRA from your spouse, you have many more options.

The rules governing inherited IRAs can be complicated. Here are the major issues to consider.

Transferring inherited IRA assets

If you inherit a traditional or Roth IRA from someone who isn't your spouse, your options are fairly limited. You can't roll the proceeds over to your own IRA, treat the IRA as your own, or make any additional contributions to the IRA. What you can do is transfer the assets to a different IRA provider, as long as the registration of the account continues to reflect that the IRA is an inherited IRA, and not your own.

If you inherit an IRA from your spouse, however, you have additional options. You can roll over all or part of the IRA proceeds to your own IRA (or to a qualified plan). If you roll the proceeds over to your own IRA (an existing one, or one you establish just for this purpose) the rules that apply to IRA owners, not beneficiaries, will apply from that point on. If you're the sole beneficiary, you can also generally treat the inherited IRA as your own by simply retitling the IRA in your name.

But you aren't required to assume ownership of an IRA you inherit from your spouse. You can, instead, continue to maintain the inherited IRA as a beneficiary. You might want to do this if, for example, you inherit a traditional IRA and you'll need to use the funds before you turn 59½ (distributions from inherited IRAs aren't subject to the 10% early distribution penalty but distributions from IRAs you own are subject to the penalty, unless an exception applies).

A spouse beneficiary can also convert all or part of an inherited traditional IRA to a Roth IRA (you'll generally have to pay income tax on the amount converted). This option is not available to nonspouse beneficiaries.

Required minimum distributions

Nonspouse beneficiary: Federal law requires that you begin taking distributions (called required minimum distributions, or RMDs) from an inherited IRA (traditional or Roth) after the IRA owner dies.

Spouse beneficiary: If you roll the inherited IRA over to your own IRA, or treat it as your own, then the RMD rules apply to you the same way they apply to any IRA owner--you'll generally need to begin taking RMDs from a traditional IRA after you turn 70½; no lifetime RMDs are required at all from a Roth IRA. If you don't roll the IRA assets over or treat the IRA as your own, then the same rules described above for nonspouse beneficiaries generally apply to you, except that you can defer receiving distributions until your spouse would have turned 70½.

Note: *In both cases, if the IRA owner died after turning 70½ and didn't take a required distribution for the year of death, you'll need to make sure to take that distribution by December 31 of the year of death in order to avoid a 50% penalty.*

Taxation of inherited Roth IRAs

Qualified distributions to a beneficiary from an inherited Roth IRA are free from federal income taxes. To be qualified, the distribution must be made after a five-year holding period. The five-year period begins on January 1 of the year the deceased IRA owner first established *any* Roth IRA, and ends after five full calendar years. If you take a distribution from an inherited Roth IRA before this five-year period ends, any earnings you receive will be nonqualified, and will be subject to federal income taxes (earnings generally come out last).

For example, you inherit a Roth IRA from your father on January 1, 2013. Your father established this IRA in June 2012. Your father also established a separate Roth IRA, which you did not inherit, in December 2008. Distributions you receive from the Roth IRA will be qualified, and tax free, because the five-year holding period (January 1, 2008, to December 31, 2012) has been satisfied.

If you're a spouse beneficiary, and you roll the inherited Roth IRA over to your own Roth IRA or treat the inherited IRA as your own, then you'll be eligible to take tax-free distributions only after *you* reach age 59½, become disabled, or have qualifying first-time homebuyer expenses. You'll also need to satisfy the five-year holding period, but a special rule applies. The five-year period for all of your Roth IRAs--including the inherited IRA--will be deemed to have started on January 1 of the year either you or your spouse first established *any* Roth IRA.

Speak to a financial professional if ...

- You're sharing the inherited IRA with other beneficiaries. This can impact when and how you must begin receiving RMDs from the IRA.
- You don't want or need the IRA funds. You may be able to disclaim the IRA and have it pass to another beneficiary. This must be done in accordance with strict IRA rules.
- Any estate taxes were paid that are attributable to the inherited IRA. You may be entitled to an income tax deduction equal to the estate taxes paid.

Of Taxes Past, Present, and Future

Qualified charitable distributions

A popular provision allowing individuals age 70½ or older to make qualified charitable distributions of up to $100,000 from an IRA directly to a qualified charity expired at the end of 2011. These charitable distributions were excluded from income, and counted towards satisfying any required minimum distributions that you would have had to take from your IRA for the year.

Return of the "marriage penalty"?

Tax changes that were originally made to address a perceived "marriage penalty" expire at the end of 2012. If you're married and file a joint return with your spouse, you'll see the effect in the form of a reduced 2013 standard deduction amount, as well as in lower 2013 tax bracket thresholds in the tax rate tables (i.e., couples move into higher rate brackets at lower levels of income).

With the 2011 tax filing season behind us, much attention is being paid to the expiring "Bush tax cuts"--the reduced federal income tax rates, and benefits, that will expire at the end of 2012 unless additional legislation is passed. In fact, though, several important federal income tax provisions already expired at the end of 2011. Here's a quick rundown of where things stand today.

What's already expired?

A series of temporary legislative "patches" over the last several years has prevented a dramatic increase in the number of individuals subject to the alternative minimum tax (AMT)--essentially a parallel federal income tax system with its own rates and rules. The last such patch expired at the end of 2011. Unless new legislation is passed, your odds of being caught in the AMT net greatly increase in 2012, because AMT exemption amounts will be significantly lower, and you won't be able to offset the AMT with most nonrefundable personal tax credits.

Other provisions that have already expired:

- *Bonus depreciation and IRC Section 179 expense limits*-- If you're a small business owner or self-employed individual, you were allowed a first-year depreciation deduction of 100% of the cost of qualifying property acquired and placed in service during 2011; this "bonus" depreciation drops to 50% for property acquired and placed in service during 2012, and disappears altogether in 2013. For 2011, the maximum amount that you could expense under IRC Section 179 was $500,000; in 2012, the maximum is $139,000; and in 2013, the maximum will be $25,000.
- *State and local sales tax*-- If you itemize your deductions, 2011 was the last tax year for which you could elect to deduct state and local general sales tax in lieu of state and local income tax.
- *Education deductions*-- The above-the-line deduction (maximum $4,000 deduction) for qualified higher education expenses, and the above-the-line deduction for up to $250 of out-of-pocket classroom expenses paid by education professionals both expired at the end of 2011.

What's expiring at the end of 2012?

After December 31, 2012, we're scheduled to go from six federal tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) to five (15%, 28%, 31%, 36%, and 39.6%). The rates that apply to long-term capital gains and dividends will change as well. Currently, long-term capital gains are generally taxed at a maximum rate of 15%. And, if you're in the 10% or 15% marginal income tax bracket, a special 0% rate generally applies. Starting in 2013, however, the maximum rate on long-term capital gains will generally increase to 20%, with a 10% rate applying to those in the lowest (15%) tax bracket (though slightly lower rates might apply to qualifying property held for five or more years). And while the current lower long-term capital gain rates now apply to qualifying dividends, starting in 2013, dividends will be taxed at ordinary income tax rates.

Other provisions expiring at the end of the year:

- *2% payroll tax reduction*-- The recently extended 2% reduction in the Social Security portion of the Federal Insurance Contributions Act (FICA) payroll tax expires at the end of 2012.
- *Itemized deductions and personal exemptions*-- Beginning in 2013, itemized deductions and personal and dependency exemptions will once again be phased out for individuals with high adjusted gross incomes (AGIs).
- *Tax credits and deductions*-- The earned income tax credit, the child tax credit, and the American Opportunity (Hope) tax credit revert to old, lower limits and (less generous) rules of application. Also gone in 2013 is the ability to deduct interest on student loans after the first 60 months of repayment.

New Medicare taxes in 2013

New Medicare taxes created by the health-care reform legislation passed in 2010 take effect in just a few short months. Beginning in 2013, the hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--increases by 0.9% for high-wage individuals. Also beginning in 2013, a new 3.8% Medicare contribution tax is imposed on the unearned income of high-income individuals.

Who is affected? The 0.9% payroll tax increase affects those with wages exceeding $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately). The 3.8% contribution tax on unearned income generally applies to the net investment income of individuals with modified adjusted gross income that exceeds $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

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What is personal liability insurance and do I have it?

Personal liability insurance protects your assets if you injure another person or damage someone else's property. It's also known as third-party insurance because it protects you if a third party files a claim against you. Personal liability insurance can be purchased as part of a package policy (such as a homeowners or automobile insurance policy) or as a separate policy (such as a personal umbrella liability policy).

Today, lawsuits are everywhere. What if your dog bites a neighbor? What would happen if someone slips and falls on your front walk? While you may not be able to avoid all accidents, you can transfer some of the financial risk of the resulting loss to an insurance company by buying personal liability insurance.

How much liability coverage do you need? Probably more than you think you do. Because there's no optimum amount that applies to everyone, how much personal liability coverage you need depends partly on your tolerance for risk. Can you afford to pay the cost of a claim out of pocket or would even a small claim threaten your finances? If you already have liability coverage, take a look at your current policy. Determine whether your liability limits are high enough, or if there are any coverage gaps you'd like to fill.

If you own a homeowners or automobile insurance policy or another type of property insurance (e.g., mobile home insurance or renters insurance), you have basic personal liability coverage. These policies will protect you against many liability claims. Your insurance company will defend or settle claims and lawsuits brought against you and pay the sum owed for covered damages (bodily injury or property damage), up to the liability limits of the policy. If you want greater liability coverage limits or if you want broader coverage that includes more types of claims, consider buying a personal umbrella liability policy.

No personal liability insurance policy will protect you against every loss you might face. Generally, personal liability policies don't cover claims stemming from your business or profession, claims resulting from an act intended to cause injury or damage, and damage to property owned by you.

What is umbrella insurance and why do I need it?

Umbrella liability insurance (ULI) provides additional liability coverage in excess of the liability coverage provided by other insurance policies, such as homeowners, renters, and auto insurance. By providing liability protection above and beyond these basic coverages, ULI can protect you against the catastrophic losses that can occur if you are sued. Although ULI can be purchased as a separate policy, your insurer will require that you have basic liability coverage (i.e., homeowners/renters insurance, auto insurance, or both) before you can purchase an umbrella liability policy.

A typical umbrella liability policy provides protection, up to the coverage limits specified in the policy, for vehicle-related liabilities above your basic auto policy; for claims of bodily injuries or property damage caused by you or members of your household; for incidents that occur on or off your property; for non-business-related personal injury claims, such as slander, libel, wrongful eviction, and false arrest; and for legal defense costs for a covered loss, including lawyers' fees and associated court costs.

Policy exclusions vary from one insurer to another, but typically, basic umbrella liability insurance doesn't cover intentional damage caused by you or a member of your family or household; damages arising out of business or professional pursuits; liability that you accept under the terms of a contract or agreement; liability related to the ownership, maintenance, and use of aircraft, nontraditional watercraft (e.g., jet skis), and most recreational vehicles; damage to property owned, used, or maintained by you; damage covered under a workers' compensation policy; and liability arising as a result of war or insurrection.

How much liability insurance do you need? A large judgment against you could easily wipe out your assets and put your future earnings in jeopardy. That's why you should also consider factors such as how often you have guests in your home, whether you operate a home-based business, how much you drive, whether you have teenage drivers in your home, and whether your lifestyle gives the impression that you have "deep pockets." Your insurance professional can help you determine how much coverage you need.

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