Capital Financial Advisors of New York
7 Corporate Drive
Clifton Park, NY 12065
518-280-0030
paul.corr@cfany.com
www.cfany.com

Paul J. Corr, CPA/PFS, CFP®
Walton A. Williams, CPA/PFS
Kerry G. Mayo, CFP®
Julie Sciandra, MBA

Spring 2013

Capital Advice

Capital Financial Advisors of New York, LLC

Are Muni Bonds Still a Good Investment?

Over the years we have found good value in taxable and tax-exempt municipal bonds. They generate good income for all of our clients. Of course, with all of the headlines about municipal bonds, it is easy to worry about their safety.

Municipal bonds have received a lot of attention recently because of some widely publicized bankruptcy filings by local governments. Economic problems, lower investment returns, and cuts in federal aid have led to an increase in the number of local governments filing under Chapter 9 of the U.S. bankruptcy code. The bankrupt governments include the single largest U.S. municipal bankruptcy on record, Stockton, CA (one of three municipalities in the state to file for bankruptcy in a single month). Very recently, Detroit's potential bankruptcy has stolen the headlines.

Despite the increased pace of filings, municipal bankruptcies are still extremely rare.The Municipal Securities Rulemaking Board estimates that there are more than 80,000 different government agencies that have issued municipal bonds. According to Governing.com, a total of 33 municipalities have filed for Chapter 9 bankruptcy protection since 2010. All but seven of these were filed by utility authorities and other narrowly-defined special districts, and three of these seven filings have already been dismissed.

Municipal bond defaults are very rare for a couple of reasons. Municipalities have taxing power giving them the ability to raise needed revenue. Municipalities also do everything they can to avoid a default because if a municipality does default, it will be extremely difficult for it to borrow in the future. While corporations may go out of business, municipalities usually exist in perpetuity and almost always need to borrow to fund activities.

So, are municipal bonds still a good investment? That depends on your situation; it also depends on the “story” behind the bond. Bond prices generally have benefited greatly over the last few years from low interest rates, and municipal bonds have been no exception. Also, income from municipal bonds is often exempt from federal income taxes; that has enhanced their after-tax return relative to corporate bonds or U.S. Treasuries, especially since Treasury yields are at historically low levels.

Some tax-exempt municipal bonds, known as private activity bonds, may be subject to the alternative minimum tax. However, with the recent federal tax legislation, the tax advantages of tax-exempt municipal bonds become even more valuable for those in the higher income tax brackets. If investors in higher tax brackets adjust their portfolios to try to minimize their tax bite, increased demand for municipal bond might have a positive effect on prices.

Not all municipal bonds are created equal; and therefore digging a bit deeper to more fully understand the bond's story can go a long way to understanding the true value. The safest municipal bonds are “general obligation” bonds. Municipalities, by law, must repay this type of bond and may raise taxes to do so. The other main type of municipal bond is “revenue bonds” which are backed by a particular revenue stream of some kind. Bonds backed by revenue from essential services, such as water and sewer revenue, are typically the safest. There are also revenue bonds that can be considered general obligation bonds due to the strength of their indentures.

Lastly, understanding the interplay of the underlying credit ratings of both the bond issuance itself, as well as that of any insurance agency backing the bond can go a long way to truly understanding the risk-reward trade-off. Our primary focus is always on the quality of the bonds that we buy.

Finally, remember that low interest rates won't last forever. Because bond prices move in the opposite direction from interest rates, when rates do begin to go up, the increase likely will affect the value of all of your bond holdings, including municipals.

Looking Backward and Forward on Entitlement Programs

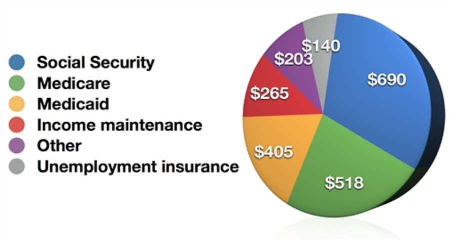
An unsustainable path

The bipartisan Bowles/Simpson Deficit Reduction Commission stated that "our nation is on an unsustainable fiscal path" in regard to entitlement spending.

Last year's presidential election, along with the more recent fiscal cliff and debt ceiling negotiations, have put the spotlight on our nation's tax policy, deficit, and entitlement programs. For some, entitlement programs are necessary--a social compact for America in an era of longer life spans, the decline of employer-provided pensions and health insurance in retirement, and a widening gap between the haves and the have-nots. For others, the current level of entitlement spending is jeopardizing our country's fiscal health and creating an "entitlement lifestyle." No matter where you stand in the debate, do you know the basic facts on our country's largest entitlement programs?

Where the money goes

All entitlement spending isn't created equal. The "Big Three" of Social Security, Medicare, and Medicaid account for more than two-thirds of all federal entitlement spending. Social Security and Medicare are primarily age-based programs, whereas Medicaid is based on income level. According to the U.S. Bureau of Economic Analysis, in 2010, the federal government spent a total of $2.2 trillion on entitlement programs, with the Big Three accounting for $1.6 trillion of this total. The largest expenditure was for Social Security ($690 billion), followed by Medicare ($518 billion) and Medicaid ($405 billion).



A history of growth

Alexis de Tocqueville, the famous French political thinker who traveled to the United States in the early 1830s and wrote about the uniqueness of our young nation's individual self-reliance in his famous book, *Democracy in America,* would likely be surprised to observe the growth in spending on entitlement programs that has occurred in the United States over the past 50 years. According to the Bureau of Economic Analysis, in 1960, U.S. government transfers to individuals totaled about $24 billion in current dollars. By 2010, that figure was $2.2 trillion, almost 100 times as much.

Current status

Let's look at our two main entitlement programs--Social Security and Medicare.

Social Security. Created in 1935, Social Security is a "pay-as-you-go" system, meaning that payments to current retirees come primarily from payments into the system by current wage earners in the form of a 12.4% Social Security payroll tax (6.2% each from employee and employer). These payroll taxes are put into two Social Security Trust Funds, which also earn interest. According to projections by the Social Security Administration, the trust funds will continue to show net growth until 2022, after which, without increases in the payroll tax or cuts in benefits, fund assets are projected to decrease each year until they are fully depleted in 2033. At that time, it's estimated that payroll taxes would only be able to cover approximately 75% of program obligations.

Medicare. Created in 1965, Medicare is a national health insurance program available to all Americans age 65 and older, regardless of income or medical history. It consists of Part A (hospital care) and Part B (outpatient care)--which together make up "traditional" Medicare; Part C (Medicare Advantage, which is private insurance partly paid by the government); and Part D (outpatient prescription drugs through private plans only). Medicare Part A is primarily funded by a 2.9% Medicare payroll tax (1.45% each from employee and employer), which in 2013 is increased by 0.9% for employees with incomes above $200,000 (single filers) or $250,000 (married filing jointly). In addition, starting in 2013, a new 3.8% Medicare contribution tax on the net investment income of high-earning taxpayers will take effect.

Looking ahead, Medicare and Medicaid are expected to face the most serious financial challenges, due primarily to increasing enrollment. The Congressional Budget Office, in its report *Budget and Economic Outlook: Fiscal Years 2012 to 2022,* predicts that federal spending on Medicare will exceed $1 trillion by 2022, while federal spending on Medicaid will reach $605 billion (state spending for Medicaid is also expected to increase). According to the CBO, reining in the costs of Medicare and Medicaid over the coming years will be the central long-term challenge in setting federal fiscal policy.

Reform

There has been little national consensus by policymakers on how to deal with rising entitlement costs. At some point, though, reform is inevitable. That's why it's a good idea to make sure your financial plan offers enough flexibility to accommodate an uncertain future.

Understanding the New Medicare Tax on Unearned Income

Health-care reform legislation passed in 2010 included a new additional 0.9% Medicare tax on wages, compensation, and self-employment income over certain thresholds. This new tax also took effect on January 1, 2013. The 0.9% tax does not apply to income subject to the NIIT. So while you may be subject to both taxes, the taxes do not apply to the same types of income.

Health-care reform legislation enacted in 2010 included a new 3.8% Medicare tax on the unearned income of certain high-income individuals. The new tax, known as the unearned income Medicare contribution tax, or the net investment income tax (NIIT), took effect on January 1, 2013.

Who must pay the new tax?

The NIIT applies to individuals who have "net investment income," and who have modified adjusted gross income (MAGI) that exceeds certain levels (see the chart below). (Estates and trusts are also subject to the new law, although slightly different rules apply). In general, nonresident aliens are not subject to the new tax.

Filing Status	MAGI over ...
Single/Head of household	$200,000
Married filing jointly/ Qualifying widow(er)	$250,000
Married filing separately	$125,000

What is MAGI?

For most taxpayers, MAGI is simply adjusted gross income (AGI), increased by the amount of any foreign earned income exclusion.

AGI is your gross income (e.g., wages, salaries, tips, interest, dividends, business income or loss, capital gains or losses, IRA and retirement plan distributions, rental and royalty income, farm income and loss, unemployment compensation, alimony, taxable Social Security benefits), reduced by certain "above-the-line" deductions (see page one of IRS Form 1040 for a complete list of adjustments).

Note that AGI (and therefore MAGI) is determined *before* taking into account any standard or itemized deductions or personal exemptions. Note also that deductible contributions to IRAs and pretax contributions to employer retirement plans will lower your MAGI.

What is investment income?

In general, investment income includes interest, dividends, rental and royalty income, taxable nonqualified annuity income, certain passive business income, and capital gains--for example, gains (to the extent not otherwise offset by losses) from the sale of stocks, bonds, and mutual funds; capital gains distributions from mutual funds; gains from the sale of interests in partnerships and S corporations (to the extent you were a passive owner), and gains from the sale of investment real estate (including gains from the sale of a second home that's not a primary residence).

Gains from the sale of a primary residence may also be subject to the tax, but only to the extent the gain exceeds the amount you can exclude from gross income for regular income tax purposes. For example, the first $250,000 ($500,000 in the case of a married couple) of gain recognized on the sale of a principal residence is generally excluded for regular income tax purposes, and is therefore also excluded from the NIIT.

Investment income does not include wages, unemployment compensation, operating income from a nonpassive business, interest on tax exempt bonds, veterans benefits, or distributions from IRAs and most retirement plans (e.g., 401(k)s, profit-sharing plans, defined benefit plans, ESOPs, 403(b) plans, SIMPLE plans, SEPs, and 457(b) plans).

Net investment income is your investment income reduced by certain expenses properly allocable to the income--for example, investment advisory and brokerage fees, investment interest expenses, expenses related to rental and royalty income, and state and local income taxes.

How is the tax calculated?

The tax is equal to 3.8% of the lesser of (a) your net investment income, or (b) your MAGI in excess of the statutory dollar amount that applies to you based on your tax filing status. So, effectively, you'll be subject to the additional 3.8% tax only if your MAGI exceeds the dollar thresholds listed in the chart above.

Example: *Sybil, who is single, has wages of $180,000 and $15,000 of dividends and capital gains. Sybil's MAGI is $195,000, which is less than the $200,000 statutory threshold. Sybil is not subject to the NIIT.*

Example: *Mary and Matthew have $180,000 of wages. They also received $90,000 from a passive partnership interest, which is considered net investment income. Their MAGI is $270,000, which exceeds the threshold for married taxpayers filing jointly by $20,000. The NIIT is based on the lesser of $20,000 (the amount by which their MAGI exceeds the $250,000 threshold) or $90,000 (their net investment income). Mary and Matthew owe NIIT of $760 ($20,000 x 3.8%).*

Note: *The NIIT is subject to the estimated tax rules. You may need to adjust your income tax withholding or estimated payments to avoid underpayment penalties.*

Capital Financial Advisors of New York
7 Corporate Drive
Clifton Park, NY 12065
518-280-0030
paul.corr@cfany.com
www.cfany.com

IMPORTANT DISCLOSURES

Broadridge Investor Communication Solutions, Inc. does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable—we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

I already have health insurance. Will I have to change my plan because of the new health-care reform law?

For the most part, no. The Patient Protection and Affordable Care Act (ACA) does not require you to change insurance plans, as long as your plan, whether issued privately or through your employer, meets certain minimum requirements. In fact, the ACA may add benefits to your existing plan that you have not had before.

Your present insurance plan may be considered a grandfathered plan under the ACA if your plan has been continually in existence since March 23, 2010 (the date of enactment of the ACA), and has not significantly cut or reduced benefits, raised co-insurance charges, significantly raised co-payments or deductibles, and your employer contribution toward the cost of the plan hasn't significantly decreased. However, if a grandfathered plan significantly reduces your benefits, decreases the annual dollar limit of coverage, or increases your out-of-pocket spending above what it was on March 23, 2010, then the plan will lose its grandfathered status.

Some provisions of the ACA apply to all plans, including grandfathered plans. These provisions include:

- No lifetime limits on the dollar cost of coverage provided by the plan
- Coverage can't be rescinded or cancelled due to illness or medical condition
- Coverage must be extended to adult dependents up to age 26

The ACA doesn't apply to all types of insurance. For example, the law doesn't apply to property and casualty insurance such as automobile insurance, homeowners insurance, and umbrella liability coverage. The ACA also doesn't affect life, accident, disability, and workers' compensation insurance. Nor does the law apply to long-term care insurance, nursing home insurance, and home health-care plans, as long as they're sold as stand-alone plans and are not part of a health plan. Medicare supplement insurance (Medigap) is generally not covered by the ACA if it's sold as a separate plan and not as part of a health insurance policy.

What are health Exchanges and do I have to buy health insurance through them?

A health insurance Exchange is essentially a one-stop health insurance marketplace. Exchanges are not issuers of health insurance. Rather, they contract with insurance companies who then make their insurance coverage available for examination and purchase through the Exchange. In essence, Exchanges are designed to bring buyers and sellers of health insurance together, with the goal of increasing access to affordable coverage.

The Patient Protection and Affordable Care Act does not require that anyone buy coverage through an Exchange. However, beginning in 2014, each state will have one Exchange for individuals and one for small businesses (or they may combine them). States have the option of running their own state-based Exchange or partnering with the federal government to operate a federally facilitated Exchange. States not making a choice default to a federally run Exchange.

Through an Exchange, you can compare private health plans based on coverage options, deductibles, and cost; get direct answers to questions about coverage options and eligibility for tax credits, cost-sharing reductions, or subsidies; and obtain information on a provider's claims payment policies and practices, denied claims history, and payment policy for out-of-network benefits.

Policies sold through an Exchange must meet certain requirements. Exchange policies can't impose lifetime limits on the dollar value of coverage, nor may plans place annual limits on the dollar value of coverage. Insurance must also be "guaranteed renewable" and can only be cancelled in cases of fraud. And Exchanges can only offer qualified health plans that cover essential benefits.

In order to be eligible to participate in an individual Exchange:

- You must be a U.S. citizen, national, or noncitizen lawfully present in the United States
- You cannot be incarcerated
- You must meet applicable state residency standards