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

Winter 2013

High-Yield Bonds: The Pros and Cons

Life Insurance Tax Traps for the Unwary

Real-life Financial Tips for Different Generations

I refinanced my mortgage loan last year. Can I deduct any of the costs associated with refinancing the loan?

Capital Advice

Capital Financial Advisors of New York, LLC

High-Yield Bonds: The Pros and Cons

Interest rates at historically low levels are great for those looking to refinance a mortgage or borrow money to start a business. However, people who rely on their investments for income have sought out a variety of alternatives to rock-bottom yields on U.S. Treasuries, including high-yield bonds. If you're considering investing in high-yield bonds--sometimes called "junk bonds"--yield shouldn't be the only factor in your decision.

What are high-yield bonds?

High-yield bonds are corporate bonds considered less than investment grade (a rating of BB or lower from Standard & Poor's or Fitch, Ba or lower from Moody's). A bond can fail to achieve investment-grade status for many reasons. A company may be in a turnaround situation; high-yield bonds have frequently been used as a way to finance large-scale leveraged buyouts, such as that of RJR Nabisco in the 1980s. Or the company might already have substantial debt on the books, or have a risky or untested business model. Whatever the reason, there is greater uncertainty about the company's ability to repay its debt.

The advantages

So why would an investor be willing to face those risks? In a word, yield. The more uncertainty about an issuer's ability to repay its debt, the higher the interest rate investors typically demand from its bonds. As of early November 2012, one benchmark index of high-yield bonds was yielding almost 4% more than a comparable index of corporate bonds, and almost 5% more than a 10-year Treasury.*

Because a junk bond's yield is often more dependent on the quality of the issuer than on other factors, it can sometimes be less affected by interest rate changes than investment-grade yields. That difference can provide an additional level of diversification for a bond portfolio (though diversification alone cannot guarantee a profit or protect against potential loss). You can provide still another level of diversification by investing in a variety of high-yield bonds from different issuers in different industries.

Don't forget that even high-yield bonds typically have precedence over common stocks in the event of a bankruptcy; that increases the odds that you would receive at least part of your original investment if the issuer went under.

Factors to consider

Not surprisingly, default rates on high-yield bonds tend to be lower when the economy is robust; renewed recession could mean more defaults by companies already on shaky ground. Also, remember that selling any bond before it matures could mean a loss of principal. While interest rates are expected to remain low for another couple of years, bond values generally are likely to fall when rates begin to rise. A credit rating downgrade of your high-yield bond also would likely reduce its market value. Finally, recent investor interest has boosted prices of high-yield bonds generally; consider getting expert help in deciding whether high-yield, investment-grade debt, or dividend-paying equities represent a better investment at current valuations.

If you're a long-term investor, there's another factor to consider. Bonds can have a call provision that lets the issuer redeem the bond before it matures. The lower current interest rates are, the more likely they are to trigger call provisions on bonds with a higher rate. If you rely on the interest from a high-yield bond and it gets called, you'll be faced with the challenge of replacing that income.

Also, individual high-yield bonds can sometimes be less liquid than investment-grade bonds, so you might have some difficulty selling the bond at your asking price. And during periods of global uncertainty, high-yield bond values can drop as investors flock to less risky investments generally. As with any investment, make sure you're being compensated for the level of risk you're willing to take.

*Data based on yields reported for Merrill Lynch High Yield Constrained Index, Barclays Capital U.S. Corporate Bond Index, and daily Treasury yield curve rates as of November 7, 2012.

See disclaimer on final page

Life Insurance Tax Traps for the Unwary

If you take a loan against your cash value, the death benefit available to your survivors will be reduced by the amount of the loan. In addition, policy loans may reduce available cash value and can cause your policy to lapse. Finally, you could face tax consequences if you surrender the policy with an outstanding loan against it.

Life insurance has been recognized as a useful way to provide for your heirs and loved ones when you die. Lawmakers have long recognized the social significance of life insurance as a source of funds for widowed spouses and children, and have offered liberal tax benefits as an incentive to those who put their hard-earned dollars into life insurance policies. However, there are a number of situations that can easily lead to unintended and adverse tax consequences. Here are some of the life insurance tax traps you may want to avoid.

Policy loans

One area fraught with unintended tax ramifications involves life insurance policy loans. A number of different scenarios involving policy loans can result in unplanned taxes, but one of the most common situations arises when a policy is surrendered (cancelled) or lapses with an outstanding policy loan.

Generally, if a policy is surrendered or lapses while a loan is still outstanding, the loan balance becomes taxable to the policyowner as ordinary income to the extent the cash value exceeds the owner's basis (net premiums paid less any tax-free distributions received) in the policy--it's as if cash from the policy is distributed to pay off the loan.

Example: *You own a life insurance policy into which you paid premiums of $100,000 (your basis); the policy cash value is $200,000; and there is an outstanding policy loan of $150,000. You surrender the policy for $50,000 cash (the difference between your cash value and loan balance). However, much to your surprise, you'll have to include $100,000 as ordinary income for the tax year in which you surrender the policy ($150,000 loan balance + $50,000 cash - $100,000 premiums).*

Modified endowment contract (MEC)

Since 1988, if the total premiums paid during the first seven years of the policy exceed a maximum amount based on the death benefit, then the policy becomes a MEC. The tax-free treatment of the death benefit and the tax-deferred cash accumulation are generally the same for MEC and non-MEC life insurance, although the tax consequences for pre-death withdrawals are different.

For non-MEC policies, partial and full surrenders are taxed on a first-in, first-out basis, meaning cash value withdrawals are considered first coming from your investment in the policy (i.e., your premiums) then from any gain in the cash value (i.e., interest/earnings). Generally, policy loans from non-MECs are not subject to income tax.

But any withdrawals (including loans and partial or full surrenders) taken from the cash value of a MEC are treated as coming from earnings first and are taxed as ordinary income to the extent the policy's cash value exceeds your basis. In addition, if the policyowner is under age 59½, a 10% tax penalty may be assessed on the amount withdrawn from a MEC that's includible as income unless an exception applies.

Example: *You purchased a cash value life insurance policy with a single premium of $100,000, making the policy a MEC. The policy cash value has grown to $150,000. If you take out a loan of $75,000 against the cash value, you will have to include $50,000 of the loan amount as ordinary income ($50,000 of the total amount borrowed represents gain in the policy).*

Estate planning

Generally, the life insurance death benefit is includible in the estate of the policyowner and may be subject to federal and/or state estate tax. Often, attempts to remove the policy from the owner's estate create problems. A quick solution has the owner transferring ownership of the policy to another person or an irrevocable life insurance trust (ILIT), in an attempt to remove the policy from the estate. However, if an insured owns a policy on his or her own life and gives the policy to another person, trust, or entity and then dies within three years of the transfer, the death benefit will be included in the estate of the insured/transferor, subject to possible estate tax.

Issues may arise when the policyowner, insured, and beneficiary are three different parties. If the insured is the first to die, the policy proceeds are considered a gift from the owner to the beneficiary, subject to potential gift tax. Generally, the owner and insured should be the same, or the owner and beneficiary should be the same party.

Unintended ownership issues may result if the insurance policyowner and insured are different parties, and the owner is the first to die. If the policy owner did not name a successor owner, then the policy will be subject to probate, including possible creditors' claims and unnecessary costs. To avoid this scenario, the owner should name a successor owner.

Real-life Financial Tips for Different Generations

Do you remember The Game of Life®? In Milton Bradley's popular board game, players progress through life stages making decisions that affect their prosperity. Like those players, today's generations face financial decisions with lasting effects. Here are some tips for staying focused despite life's ups and downs.

Generation Z (teens to early 20s):

Accustomed to instant gratification, the "Digital Generation" may need to recognize that financial success takes diligence and patience. Consider sharing the following advice with the Gen Zers in your life:

Live within your means. Your first paycheck provides the chance to learn valuable lessons, such as creating a budget and spending less than you earn.

Build a saving habit. You have one powerful advantage over other generations--time. Why not make saving automatic and direct a part of your paycheck into a savings or investment account?

Understand credit and credit reports. A good credit history helps you get a car loan and a mortgage, but a bad one can ruin your borrowing chances for years. Reviewing your credit report regularly can help you manage your finances and protect your identity.

Generation Y (20s and early 30s):

In this group, you could be juggling your first "real" job, college loans, marriage, a first home, and young children. Three points for you:

Risk management isn't just for companies. Save 6 to 12 months' worth of living expenses in a savings account for unexpected emergencies. Review your insurance, and at a minimum, have health and property coverage. Also consider disability insurance, which helps pay the bills during a health crisis.

Start saving for retirement ... Like Generation Z, time is your strongest ally. Participate in a retirement savings plan at work, if offered, and if your employer offers a match (free money!), contribute enough to get all of it. If you don't have a plan at work, open an individual retirement account (IRA) and invest what you can (up to annual limits).

... And your children's college. In 18 years, a four-year degree could cost as much as several hundred thousand dollars. Give your children a head start by saving now.

Generation X (30s and 40s):

Home ownership, older children, a career in full swing--if you're in this group, your finances may take a back seat to life's daily demands. To help stay focused, consider the following:

Retirement savings trump college savings. Don't risk your future to pay for your children's entire education. There's no financial aid office in retirement.

Don't neglect your health. Are you experiencing new aches and pains? At this age, medical issues can begin to surface, demanding time, energy, and financial resources. Take care of yourself, and before an emergency arises, review your health and disability coverage.

Create a will, if you don't already have one. This important document can help ensure your children are cared for and your assets are distributed according to your wishes. Medical directives should also be established now.

Baby boomers (50s and 60s):

If you're in this age group, you may have both adult children and elderly parents who need assistance, as well as an impending or current retirement. Pointers for you include:

Shift your retirement savings into high gear. People over 50 benefit from higher savings limits on 401(k)s and IRAs. Strive for the maximum.

Visit a financial professional. When should you tap Social Security and your retirement savings? How should you invest your assets to potentially provide a lifetime of income? A financial professional can be a critical coach at this time of your life.

Investigate long-term care insurance. These policies help protect your family's assets from the potentially devastating effects of long-term care. The older you get, the more expensive these policies can be.

Retirees:

The Game of Life ends when players reach retirement, but not so in real life--you still have years ahead of you. Consider the following:

Review the basics. Whether you plan to travel to exotic locales or play board games with your grandchildren, a key to happiness is living within your means. Develop a realistic budget and don't exceed your spending limits.

Manage your income stream. A financial professional can help you choose vehicles and determine an investment strategy to help ensure you don't outlive your assets.

Plan for your family's well-being. A properly crafted estate plan can help you ensure that your wishes are carried out--for both your and your family's peace of mind.

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 refinanced my mortgage loan last year. Can I deduct any of the costs associated with refinancing the loan?

Now more than ever, homeowners are taking advantage of historically low interest rates and refinancing their mortgage loans. Did you pay points to your lender when you refinanced your loan? If so, you may be able to deduct them.

Points are costs that a lender charges when you take out a mortgage loan or refinance an existing mortgage loan on your home. One point equals 1% of the loan amount borrowed (e.g., 2 points on a $300,000 loan equals $6,000).

In order for points to be deductible, they must have been charged by your lender as up-front interest in return for a lower interest rate on your loan. If the points were charged for services provided by the lender in preparing or processing the loan, then the points are not deductible.

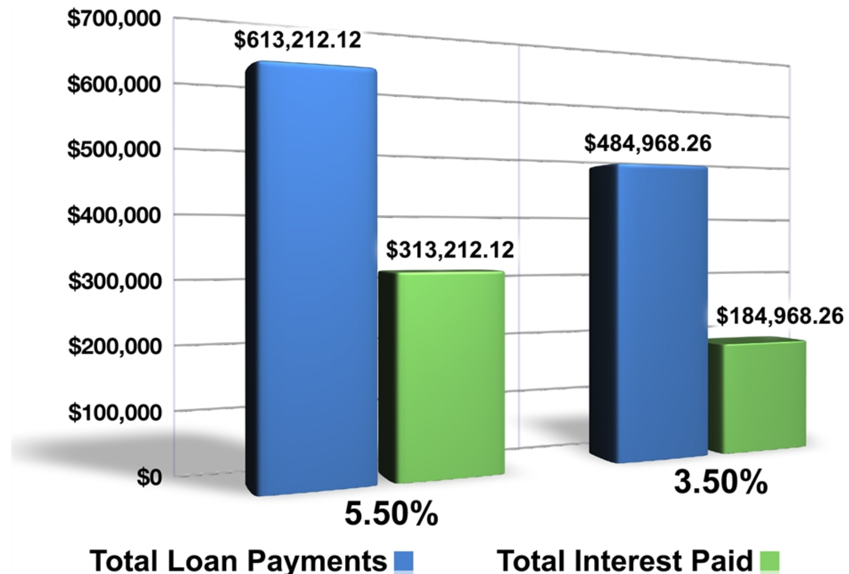
When deducting points, keep in mind that unlike points paid on a loan used to purchase a home, points paid on a refinanced loan usually cannot be deducted in the year that you paid them. Instead, the points may need to be amortized over the life of the loan.

For example, assume that you refinanced to a $300,000/30-year mortgage loan and paid $6,000 in points. You would be able to deduct 1/30 of those points each year over the 30-year loan period, or $200 per year.

The one exception to the amortization rule is if part of your refinanced loan is used to make improvements to your primary residence. In that case, you may be able to deduct the portion of the points that is allocable to the home improvements in the year that the points are paid. In addition, if you choose to refinance again or sell your home in the future, you can generally claim the entire unamortized deduction that remains. For more information on the deductibility of points, you can refer to IRS Publication 936.

As for other costs you may have incurred from refinancing, such as recording, title search, appraisal, and attorney's fees, they are not deductible. Furthermore, unlike costs associated with a home purchase, costs associated with a refinance cannot be added into the cost basis (value) of your home for income tax purposes.

The Potential Benefits of Refinancing Your Mortgage



This is a hypothetical example and does not reflect all of the costs that may be associated with refinancing. Actual results may vary.

Prepared by Broadridge Investor Communication Solutions, Inc. Copyright 2013