

MARCH/APRIL 2009

Provenance Wealth Advisor



P R O V E N A N C E

W E A L T H A D V I S O R S

515 East Las Olas Boulevard
Fifteenth Floor
Fort Lauderdale, FL 33301
Telephone: (954) 712-8888
Fax: (954) 712-8900

200 South Biscayne Boulevard
Sixth Floor
Miami, Florida 33131
Telephone: (305) 379-8888
Fax: (305) 960-1243

Email: info@provwealth.com Website: www.provwealth.com

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Upside down

Cutting your taxes with capital losses

As volatile as the stock market has been, you've probably at least thought about selling some investments that have lost value. Using caution is especially important when you're considering selling at a loss. Why? Because you'll be locking in your losses but you may also be missing out should those securities bounce back after you sell.

In some situations, however, liquidating underperformers can make sense from a tax perspective. By selling holdings for less than you paid for them, you generate capital losses that can lower your income tax bill.

The short and long of it

Capital losses — as well as capital gains — come in two varieties: short- and long term (referring to securities held up to one year and longer than one year, respectively). Short-term gains are taxed the same as ordinary income, and long-term gains generally are currently taxed at a maximum income tax rate of 15%, subject to potential change.

Capital gains and losses are calculated on a net basis. Say, for example, you have \$5,000 worth of long-term gains this year and \$7,000 in long-term losses (for a net loss of \$2,000), as well as \$3,000 in short-term gains and \$5,000 in short-term losses (for another net loss of \$2,000). Under this scenario, you'd be left with a net capital loss of \$4,000.

You're allowed to use up to \$3,000 in capital losses each year to offset your ordinary taxable income (such as from salary and interest). (Married taxpayers filing separately can each use up to \$1,500 per year.) So, in the previous

example, you'd have \$3,000 to apply against your taxable income in the same tax year as the losses, as well as \$1,000 to carry over to future years.

Choose wisely

Bear in mind that it may be difficult to determine which securities to sell at a loss. Liquidating those that are down the most relative to your purchase price will give you the biggest tax benefit. But you'll also miss out on a potential recovery and the opportunity to add to your positions at favorable prices.

As you search for sale candidates, see if you own anything you really don't want to own anymore. For example, consider a stock in

Check your cost basis

To determine your capital losses, you need to keep track of your cost basis — the original price you paid for securities plus any commissions, reinvested capital gains or reinvested dividends.

When your entire investment in the security comes from a single purchase, this is a relatively straightforward calculation. But if you buy the same security at various intervals, or if you reinvested dividends or capital gains, the calculation can be more difficult. If this is the case, you can determine your cost basis by:

- Using the average purchase price,
- Choosing specific shares — a more detailed approach that provides maximum flexibility but that must be implemented when the shares are sold, or
- Using the “first-in, first-out” method, in which the first shares you purchased are considered to be the first shares you sold.

Each approach will provide a different tax impact, so be sure to get qualified advice about which is best for your situation.

which you've lost confidence because of a new management team, poor strategic choices or a changed business landscape. These types of disappointments may be prime opportunities to realize capital losses and turn your lemons into lemonade.

Watch the calendar

If you're selling securities at a loss that you still want to own, you may wish to buy them back again. But beware of one potential tax pitfall: The "wash-sale" rule states that you may not realize a capital loss on the sale of an investment if you buy a "substantially identical" one within 30 days before or after the sale.

A common way around this requirement is to swap one type of investment for a similar one. For example, you can sell shares in one mutual fund and buy shares in a comparable fund managed by another provider, or sell one company's stock and buy its competitor's. Such an approach can help you to realize a loss while

maintaining your exposure to the same investment type, if not the exact same holding.

You could also opt to buy back the investment you sold after 30 days have passed. Even though this approach will avoid the wash sale restrictions, there's another risk — if it performs well in the interim, you'll miss out on the appreciation. Alternatively, you can purchase more of the same security and then sell thirty days later. In this case, your exposure is that the price may decline further while you now own twice as many shares. There are some nuances to the wash sale rule, so be sure to consult with your tax advisor.

Only part of the story

Tax losses provide a valuable tax-management tool, but it's just one of many considerations to keep in mind when selling securities. Your tax and investment advisors can be a big help as you determine which purchases and sales will best help you pursue your financial goals. ■

Should you put your trust in a living trust?

The last thing you want is for your assets to end up in the wrong hands after your death. So taking steps now to ensure they'll be properly distributed to your heirs is paramount. There are estate planning tools to help carry out your wishes, one of which is a living trust.

How it works

When you establish a living trust — also known as a revocable trust — you transfer ownership of some or all of your assets to the trust. Typically, you name yourself as trustee; but you can name another person, such as a friend, family member or professional advisor, or even name an institution, such as a bank or trust company. (Professional trustee fees will apply if you appoint a professional advisor, bank or trust company.) If you name someone other than yourself, you can require that you be consulted before your trustee buys or sells assets. And if you're not

satisfied with how your trustee is performing, you can modify his or her powers, name a new trustee, or revoke the trust altogether.

Even if you name yourself as trustee, you'll need to name a successor trustee to take over on your incapacity or death. A living trust becomes irrevocable after you die, and the trust assets are distributed according to your wishes, which are expressed in the trust document. For example, you may wish to have your assets distributed immediately; distributed gradually over time or at specific ages; or given on special occasions, such as a birthday, anniversary, wedding or graduation.

3 benefits

A living trust offers three key estate planning benefits:

1. **A means to bypass the probate process.** Because of the required notifications and court

proceedings, probate can be time consuming and costly for your loved ones. In addition, it's a public process, so anyone can learn of your family's financial affairs, which you may feel violates your privacy. Plus it can increase the chance that someone will challenge how you've chosen to distribute your assets.

Assets held by the trust before your death will avoid probate. This can be especially beneficial if you own real estate or other property in more than one state, because it prevents your estate from having to go through multiple probate proceedings.

2. A blueprint for handling your affairs. In addition to specifying how your assets are distributed after your death, a living trust can specify how and by whom you'd like your assets to be managed should you become incapacitated. You can even include specific details about your care, such as what nursing home or long-term care facility you want to live in or if you'd prefer to be cared for in your home.

3. Separation of marital assets. Living trusts can be particularly useful for married couples in community property states who had a substantial amount of property or assets before the marriage. The trust can help keep those assets separate from those that would be considered community property.

3 limitations

Even though living trusts offer important benefits, keep in mind that there are limitations, too, such as:

1. No income tax savings. During your life, all the income, deductions and credits attributable to the trust flow through to your return as the trust owner for federal income tax purposes.

2. No estate tax savings. A living trust doesn't reduce estate taxes because trust assets are included in your taxable estate when you die. You can work with your estate planning advisor, however, to incorporate tax-saving measures into your estate plan, such as charitable bequests and a credit shelter trust.

3. No protection from creditor claims. A living trust typically doesn't protect assets from your creditors because you're still in control of the trust assets. It also doesn't protect assets if you are sued.

In addition, be sure you transfer current and future assets to the trust as they are required; otherwise your planning could be wasted, and the assets left out would be subject to probate, which could undermine your reason for establishing the trust in the first place. A pour-over will can specify that assets you didn't transfer to your living trust during your life should be transferred to it after your death, but this won't help with probate.

Weigh all sides

A living trust can help ensure a smooth transfer of your assets to your loved ones and that your wishes for providing for their financial security are carried out. But it's not for everyone. Consult with your estate planning professional to help determine if a living trust is right for you. ■

Risk vs. reward

The potential benefits — and pitfalls — of emerging markets investing

International stocks turned in strong gains for much of the 2000s — until a steep decline in 2008 — with a large part of that strength coming from the growth of emerging markets. And even though emerging markets have a reputation

for volatility and risk — a reputation that has been well earned amid the market's downturn — they also offer strong growth potential and diversification benefits. Both are big reasons why emerging markets stocks can be a vital part of many investors' portfolios.

But keep in mind that there is no assurance that such an investment strategy will protect against market risk. Past performance does not guarantee future results. Investment return will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data.



Not just China and India

Generally speaking, emerging markets are countries with rapidly growing economies that are “emerging” onto the world stage. The two most well-known are China and India. Both realized tremendous economic expansion and stock price growth before being caught up in the global market plunge. But these are only two of dozens of emerging markets spread throughout the world, from Southeast Asia to Eastern Europe, Latin America to the Middle East.

Many of these emerging markets are quickly catching up to their developed market counterparts. China, for example, is now the world's fourth-largest economy, just behind Germany, and is widely predicted to take the top spot within several decades.

A variety of factors have been driving emerging markets' growth, such as:

- An increasingly affluent middle class wanting access to consumer goods and luxury products,
- Greater demand for better nutrition, and
- Improved local infrastructure.

In addition, some natural-resource-rich emerging markets such as Russia and many Middle Eastern countries have benefited disproportionately from the global boom in commodity prices — a trend that itself has been

helped by robust demand from fast-growing emerging countries.

Why take the risk?

Investors look to emerging markets for two primary benefits:

1. Appreciation potential. Markets in the early stages of their economic development can grow faster because they're smaller and, therefore, have more room to expand. The risk, of course, is that economic or political conditions can change and the markets may fail to live up to investors' expectations.

As a corollary, think of the difference between Microsoft circa 1989 and the company today. Twenty years ago, it was still a relatively small, successful but aspiring software maker. Early investors bet on Microsoft's future but accepted the risk that it could be overwhelmed by larger competitors.

Similarly, emerging markets offer greater growth prospects than their larger, developed counterparts. But they're also more vulnerable to sudden price drops if the market and economic backdrop takes an unanticipated turn for the worse. Just as there was no guarantee that Microsoft would succeed, some emerging markets may not perform as well as investors hope.

2. Diversification. Historically, emerging stock markets have been only somewhat loosely correlated to developed markets — making them a valuable diversifier for a U.S.- or Europe-centered stock portfolio. But it's important to remember that using diversification as part of your investment strategy neither assures nor guarantees better performance and cannot protect against loss of principal due to changing market conditions.

That said, the global economy is becoming increasingly interconnected. As economic ties increase between the developed and developing worlds, that correlation should increase. For now, however, the correlation remains far from perfect, meaning that emerging markets can continue to provide these important diversification benefits.

A little goes a long way

Because of their volatility and risk, it's wise to limit your exposure to emerging markets stocks.

In fact, you may already be more exposed to this asset class than you realize.

Many internationally oriented mutual funds* already have sizable emerging markets positions. Check your fund's Web site or shareholder report to see what you already own before investing further in emerging markets.

It's also prudent to avoid excessive exposure to any individual country. Emerging markets can be more susceptible to political turmoil, currency fluctuations, adverse regulatory changes and other risks. By investing across a

variety of emerging countries, you can reduce the potential impact of these negative events. Many investors find a broadly diversified mutual fund a convenient way to gain broad exposure to this asset class.

Your circumstances

Because of emerging markets' risks and volatility, you're generally best served by not investing funds you plan to use in the near term. If, however, you're a relatively risk-tolerant investor with a long time horizon, you may find that emerging markets stocks have an important role to play in a diversified portfolio. ■

*** Mutual funds are sold by prospectus. Investors should carefully read the prospectus before investing. They also should carefully consider information contained in the prospectus, including investment objectives, risks, and charges and expenses, before investing. For this and other information, request a prospectus from your financial professionals. Past performance does not guarantee future results. Investment return will fluctuate so that an investor's shares when redeemed may be worth more or less than their original cost. Current performance may be lower or higher than the performance data.**

Property swap

Defer capital gains taxes with a like-kind exchange

If you're planning to sell highly appreciated business or investment property, you're likely bracing yourself to pay taxes on the capital gain. But brace yourself for some good news instead: A like-kind exchange may allow you to trade your property for another one that better suits your needs and defer payment of capital gains taxes that might otherwise be due on the sale of the assets.

What is a like-kind exchange?

A like-kind exchange — also known as a Section 1031 exchange — lets you defer all or part of the gain you'd otherwise recognize on the sale of real or personal property used in a trade or business or held for investment by instead exchanging it for property of a "like kind," assuming the values of the exchanged properties are comparable. Any net cash you receive or debt you're relieved of in the transaction must be recognized as taxable gain.

You must intend to use the replacement property for business or investment purposes until you sell it. Keep in mind that a reasonable amount of actual business or investment use can help you avoid an IRS challenge. Two years is a common rule of thumb, but if you swap properties with a related party — such as a family member or another business that you control — both properties must be used for business or investment purposes for two years. If either party disposes of their property within that time, the like-kind exchange then becomes taxable.

Additionally, certain types of business and investment property are excluded from like-kind exchanges, such as inventory, stock and other securities, partnership interests, and trust certificates.

What does "like-kind" mean?

For personal (non-real-estate) property, "like kind" means property in the same asset or

product class. For example, you can exchange a backhoe for a bulldozer, but you can't exchange it for a computer server.

For real estate, on the other hand, virtually any property type is eligible, so long as it's used for business or investment purposes. For example, you can exchange a parking garage for an apartment building. You can't, however, trade (or trade for) a personal residence unless your use of it will be as a rental or investment property. In addition, you can't exchange U.S. property for foreign property.

Are there other options?

The tax law allows "deferred exchanges" in which you sell (or relinquish) property to one party and then acquire replacement property from another. To qualify for tax deferral, you must identify up to three potential replacement properties within 45 days after you sell the property you're relinquishing and complete the transaction within 180 days after the sale.

Also, you cannot gain control of the sale proceeds. Instead, you must engage a "qualified intermediary" — such as a bank or title company — to sell the property, hold the proceeds and then use them to purchase replacement property.

If you find an ideal replacement property and need to move quickly to acquire it, a reverse exchange allows you to purchase the replacement property first and then sell one or more relinquished properties later.

Are there additional benefits?

If you hold a property for the rest of your life, you may be able to eliminate capital gains taxes permanently. Your heirs likely will receive a stepped-up basis in the property equal to its fair market value when you die, thereby avoiding income tax on any previous appreciation in value. (Note that under current law the step-up rules are scheduled to be tightened in 2010 with the estate tax repeal but to revert to current law in 2011, when the estate tax is scheduled to be reinstated. Check with your tax and estate planning advisors for the latest information.)



What are the risks?

This article provides a brief overview of like-kind exchanges by explaining in general terms their basic structure. But bear in mind that every exchange must follow more detailed rules and document full compliance. Variables in facts and failures of nonexchanging parties to follow instructions can result in complications in even well-planned exchanges.

In addition, it's important to understand a few specific risks of like-kind exchanges, including:

Potential for property value loss. Like-kind exchanges are subject to fluctuations in value because of changes in occupancy rates and economic factors.

Illiquid nature of the investment. Like-kind exchanges may have long-term holding periods and limited liquidity, thus affecting an investor's ability to access his or her investment.

Associated fees and expenses. Like-kind exchanges have unique fees and expenses that could affect cash flow and investment returns.

Every like-kind exchange should have a tax attorney preparing the documents and guiding compliance.

Is a like-kind exchange right for you?

A like-kind exchange may enable you to meet your property goals without having to pay a hefty tax bill. But structuring an exchange can be complicated, and the IRS imposes strict requirements that you must follow to complete a successful exchange. Your tax advisor can help you determine if a like-kind exchange is right for you and help you properly structure it. ■

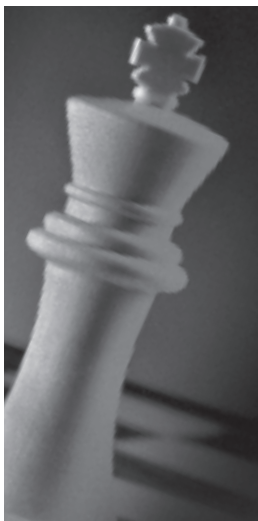
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