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Provenance Wealth Advisor

PROVENANCE

WEALTH ADVISORS

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

5100 Town Center Circle
Suite 430
Boca Raton, FL 33486
Telephone: (561) 361-2001
Fax: (561) 361-2005

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

Do your dependents qualify you for tax breaks?

Several IRS exemptions, deductions and credits are designed to ease the federal tax burden on people with children or other dependents. But before you start counting your tax savings, determine if you — and your dependents — qualify.

When in doubt

Can you count your unemployed brother-in-law as a dependent? How about your live-in niece? IRS rules say that both of the above could qualify as a dependent, under the right circumstances. For federal tax purposes, it all depends on whether that person is your "qualifying child" or, in some cases, a "qualifying relative."

In an effort to simplify the tax code and eliminate confusion, Congress established a uniform definition of "qualifying child" as part of the Working Families Tax Relief Act of 2004. The definition applies for purposes of several child-related tax benefits, such as:

- Dependency exemptions,
- The Child Tax credit,
- The Child and Dependent Care credit, and
- Head-of-household filing status.

In addition, the new definition relies on residency rather than requiring that you must have provided more than half of a dependent's support, as was the case in the previous definition.

More specifically, a qualifying child must meet four tests:

1. Relationship. The definition applies to your child (including one who's adopted or who's an eligible foster child), stepchild, brother, sister, stepbrother or stepsister. It also includes any of their descendants. So, for example, your grandchildren, nieces and nephews also qualify.

2. Age. A child must be under age 13 when the care was provided to qualify for the Child and Dependent Care credit, under age 17 (as of the end of the year) for the Child Tax credit and under age 19 (age 24 for a full-time student) for the other tax benefits. Except for the Child Tax credit, there's no age limit for a permanently disabled person.

3. Residence. The child must share your principal place of abode for more than half the year, which includes time spent away from home because of school, military service or illness.

4. Support. It's no longer necessary for you to provide more than half of a child's support. But the qualifying child generally can't provide more than half of his or her own support.

And under the new definition, the child must be a citizen or resident of the United States, Canada or Mexico to qualify. However, if the child files a joint return, he or she won't qualify. If more than one person claims a benefit with respect to the same child, the tax code specifies who's entitled to tax benefits.

If two or more people are eligible to claim the same child as a dependent, they can decide among themselves who will claim the tax benefits. In the event that more than one person actually claims those benefits, the following rules will be used to break the tie:

- An eligible parent's claim trumps all other claims.
- If each parent claims the child on a separate return, the tax benefits go to the parent who lives with the child longer or, if the child resides with each parent for the same amount of time, to the parent with the higher adjusted gross income (AGI).

- If neither parent claims the child, the tax benefits go to the claimant with the highest AGI.

If the parents are divorced, special rules allow the noncustodial parent to claim the child if the custodial parent consents and certain other requirements are met.

All in the qualifying family

What if you support someone who isn't a qualifying child? You still may be entitled to a dependency exemption and head-of-household status if that person is a "qualifying relative."

For each dependent you can legally claim, you receive a $3,650 personal exemption on your 2009 taxes. So, for example, if you're in the 25% tax bracket and have three dependents, worth $10,950 in personal exemptions, you could save $2,737 in taxes. Bear in mind that the personal reductions are reduced if your income exceeds certain limits.

To qualify as a dependent for federal tax purposes, your relative must:

- Have received more than half of his or her support from you for the year,
- Not file a joint income tax return,
- Be a citizen or resident of the United States, Canada or Mexico, and
- Be a member of your household the full year.

Relatives include all of the qualifying-child relationships, plus parents, stepparents, grandparents and other direct ancestors, nieces, nephews, aunts, uncles, and most in-laws. You can't claim someone as a qualifying relative whom someone else is entitled to claim as a qualifying child.

Not child's play

Extending help to a loved one could translate into tax breaks for you. Check with your tax advisor to determine if you can benefit. ■

Education savings

Making the most of your 529 plan

If you invest in a 529 college savings plan*, it's a good bet that volatile financial markets have left your account worth less today than last year at this time. If so, it's important to keep the losses in perspective.

You can't change the past, but you can make the most of the present situation. Depending on your investing time frame, you may be able to use market conditions to your advantage. You may also be eligible to take advantage of a unique tax opportunity.

Tax-free education savings

With a 529 plan, you invest after-tax dollars for a loved one — typically a child or grandchild. The money in the account accumulates tax free for college or other qualified postsecondary education expenses. Many states also offer a state income tax deduction for participating in their plan.

Investment options vary by state but generally consist of a variety of investments. In addition to equity and bond portfolios, many plans offer so-called target-date funds, whose asset allocation becomes progressively more conservative as your child or grandchild gets closer to college age. Keep in mind that using asset allocation as part of your investment strategy neither assures nor guarantees better performance and cannot protect against loss of principal because of changing market conditions.

Your time horizon

During the market's recent turmoil, stock investors suffered some of the biggest losses. But even relatively conservative fixed-income-oriented accounts have experienced large declines.

Declining asset values can be a serious concern if your loved one is close to college age and you expect to withdraw 529 plan funds soon. As a general rule, the shorter your time horizon, the more conservative your investment approach should be.

A more conservative approach may include moving part of your portfolio into lower-volatility investments. Doing so may help maintain what you have while other assets have the potential to grow. You also have the option to roll funds over into another 529 plan if your current plan doesn't offer the investment options you're looking for. For 2009 only, you may switch 529 plans twice in one year.

Keep in mind that, even if your child is about to start college, you won't need access to your entire savings immediately. If your daughter is a 17-year-old high school senior, for example, she'll have at least five years before she finishes college. That gives you time to remain invested and potentially make up some lost ground.

A healthy dose of perspective is even more important if your child is younger. If you're putting away funds for a toddler, now may not be the time to invest conservatively. You still have many years to wait out a further market downturn. There's no guarantee that your investments won't decline further. But maintaining too cautious an outlook can, in effect, lock in your current performance.

Potential tax benefits

If your 529 plan is now worth less than what you put into it, you may have a unique tax opportunity: to close your account, withdraw the balance free of federal taxes and penalties, and claim a loss on your income tax return.

This isn't the same as a capital loss. You'll need to report the amount as a miscellaneous itemized deduction. To be deductible, your 529 plan loss must exceed 2% of your adjusted gross income.

Note that this tax deduction may be capped for high-income individuals. Also, taking large miscellaneous deductions can increase your exposure to the alternative minimum tax — potentially eliminating the benefit you were hoping to realize by closing your account.

If you decide to close your 529 plan and open a new one, you'll have to wait more than 60 days. Why? The IRS may view the new account as a rollover and disallow the tax deduction.

Although this strategy can be beneficial, it's also complicated and relatively untested. So consult your tax advisor before you move forward.

Playing it safe

If your loved one is already in college or about to start, one smart strategy — particularly in volatile markets — is to put at least your next year's tuition in a highly secure investment vehicle, such as a certificate of deposit or a money-market fund. That can help protect you from sudden market turmoil.

But the younger your child or grandchild is, the more time you'll have to ride out market losses. Your financial advisor can help you assess market conditions and review your investment options. ■

Stimulus act expands 529 plan coverage

With a 529 plan, you can withdraw earnings tax free so long as you use them to pay qualified higher education expenses, such as tuition, textbooks, fees, supplies and equipment.

Thanks to the American Recovery and Reinvestment Act of 2009, you may now use plan earnings tax free to buy computers and computer technology, such as Internet access during the time you or other plan beneficiaries are enrolled in an eligible educational institution. Bear in mind that this benefit is in effect only for 2009 and 2010. (See http://finance.senate.gov/press/Bpress/2009press/prb021209.pdf for more information.)

*** Please contact your financial professional for more information on 529 plans and/or to obtain the appropriate disclosure statements and applicable prospectuses for the underlying investments of the 529 plans. Investors should consider the investment objectives, risks, charges and expenses of a portfolio carefully before investing or sending money. The disclosure statements and prospectuses contain this and other information about the investment options and their underlying investments and investors should read this material before investing or sending money.**

Planning ahead

Tips for a near-term retirement

Preparing to retire in an economic downturn can be challenging. If financial markets remain well below their highs, you may have a hard time building and maintaining the savings you'll need to realize your future goals.

Whether you've already retired or plan to do so soon, one question is likely foremost on your mind: "Will I have enough?" Here are a few tips to help you be able to answer "yes."

Keep your portfolio growing

As you near your retirement date, you want to make your portfolio more conservative — increasing your allocation to lower-volatility, income-generating securities. The more assets you have, the more conservative you can afford to be.

But in your desire to minimize investment risk, be careful not to invest too cautiously. Otherwise, you run an equally important risk that your savings won't grow quickly enough to keep pace with inflation.

> Every retirement plan involves two main components: how much income you'll have and how much you plan to spend.

Thanks in part to healthier lifestyles and improved medical care, retirements lasting several decades or more are now quite common. That's a positive trend, but it's also happening alongside the decline of company pensions. Increasingly, individuals are responsible for saving for their own retirements through contributions to 401(k) plans and IRAs, among other tax-advantaged investment vehicles.

Together, these trends — more time spent in retirement coupled with individual responsibility for retirement saving — mean it's more important than ever to keep your retirement assets growing for longer. That requires even conservative investors in or close to retirement to keep a portion of their portfolio in stocks throughout their later years.

Balance income and spending

Planning for retirement can be a complex undertaking. But every retirement plan — no matter how many moving parts — involves two main components: how much income you'll have and how much you plan to spend.

On the income side, consider all of the individual assets you'll have available — from annual IRA and 401(k) withdrawals to an employer pension, if you're lucky enough to have one. Also, review your Social Security benefits statement, which will provide you with an estimate of the annual income you can expect from the government.

The other half of the retirement equation is determining your likely monthly expenses. In part, these will depend on your plans for retirement. If you expect to spend your time engaged with exotic travel and fine dining, your expenses will probably be relatively high. If you're content to stay closer to home visiting family and friends, your retirement could be less costly.

Create a budget to determine whether your annual expenses will be in line with your annual income. When budgeting, be sure to include a generous allowance for health care costs, which are rising fast and likely to be one of your biggest retirement expenses.

If you haven't already, line up health coverage through a private insurance provider or, if you're age 65 or older, Medicare. Also consider long-term care insurance, which, while expensive, may be much cheaper than nursing home care down the road.

2009 retirement contribution limits

You can contribute the lesser of 100% of your compensation or the amounts below to your retirement plans this year. Note that individuals 50 and older can put aside even more for retirement through "catch-up" contributions. Also bear in mind that for future years these amounts will be indexed for inflation.

	Under age 50	Over age 50
Traditional/Roth IRA (combined)	$5,000	$6,000
401(k), 403(b), or 457 plans	$16,500	$22,000

Close the gap

You're within several years of retirement, have done the math and have determined you haven't saved enough. What now?

First, make sure to take full advantage of all the retirement savings options available to you. If you're age 50 or older, you're eligible to make special "catch-up" contributions to your retirement accounts. (See "2009 retirement contribution limits" above.) This catch-up provision helps you make up for lost time and put more funds away on a tax-advantaged basis.

If that's still not enough, consider working a few extra years. Doing so can provide multiple advantages, including additional income; access to employer benefits such as health insurance and retirement plan contributions; and increased Social Security income when you do retire. If you're ready for a life change, consider a second career that lets you continue earning an income while pursuing a new line of work.

Get planning help

If you haven't already, be sure to work on your retirement plan with your financial advisor. He or she can help you refine and prioritize your goals, evaluate your progress, and develop strategies for achieving your retirement goals. ■

SIX

Consider taxes *before* you hire household help

When you hire someone to work in your home, you become an employer. Thus, you have specific tax obligations, such as withholding and paying Social Security and Medicare (FICA) taxes and possibly federal and state unemployment insurance. So before you say, "You're hired," make sure you understand your tax obligations — and the penalties for not meeting them.

Who's considered a household employee?

A household employee is someone you hire to work in your home caring for your children, cleaning your house, cooking meals, gardening or providing similar domestic services. But not everyone who works in your home is an employee.

For example, some workers are classified as independent contractors. These self-employed individuals typically provide their own tools, set their own hours, offer their services to the general public and are responsible for their own taxes. To avoid the risk of misclassifying employees, however, it's wise to assume that a worker is an employee unless your tax advisor tells you otherwise.

When do I pay employment taxes?

You're required to fulfill certain state and federal tax obligations for any person you pay $1,700 or more annually (in 2009) to do work in or around your house. (The threshold is adjusted annually for inflation.)

In addition, you're required to *pay* the employer's half of FICA (Social Security and Medicare) taxes (7.65% of cash wages) and to *withhold* the employee's half. For employees who earn $1,000 or more in a calendar quarter, you must also pay federal unemployment taxes (FUTA) equal to 6.2% of the first $7,000 in cash wages. And depending on your resident state, you may be required to make state unemployment contributions, but you'll receive a FUTA credit for those contributions, up to 5.4% of wages.

You don't have to withhold federal (and, in most cases, state) income taxes, unless you and your employees agree to a withholding arrangement. But regardless of whether you withhold income taxes, you're required to report employees' wages on Form W-2.

Are there exceptions?

You aren't required to pay employment taxes on wages you pay to your spouse, your child under age 21, your parent (unless an exception is met) or an employee who is under age 18 at any time during the year, providing that performing household work isn't the employee's principal occupation. If the employee is a student, providing household work isn't considered his or her principal occupation.

How do I make tax payments?

Pay any federal employment and withholding taxes by attaching Schedule H to your Form 1040. You may have to pay state taxes separately and more frequently. Keep in mind that this may increase your own tax liability at filing, though the Schedule H tax isn't subject to estimated tax penalties.

If you owe FICA or FUTA taxes or if you withhold income tax from your employee's wages, you need an employer identification number (EIN). Visit the IRS Web site at www.irs.gov for more information.

Comply with IRS rules

If you fail to pay employment taxes on household help you may be subject to criminal and civil sanctions. And because there is no statute of limitations on the failure to report and remit federal payroll taxes, you can be audited by the IRS at any time and be required to pay back taxes, penalties and interest charges. To avoid this outcome, consult with your tax advisor to ensure you comply with all IRS rules. ■