

Provenance Wealth Advisor



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Gifting Appreciated Assets to Succeeding Generations

Many high-net-worth individuals possess assets made up largely of appreciated investments such as personal residences, rental real estate, closely held businesses, and yes, even marketable securities. But, under current law, gifting appreciated assets to succeeding generations creates an often perplexing trade-off between estate planning and income tax planning. While estate planning for a high-net-worth individual might call for making gifts that use annual gift tax exclusions, lifetime exemptions and even discounting strategies (such as family limited partnerships [FLPs]), income tax planning might stand in the way. Let's take a closer look at this tricky situation.

The Conundrum

Much of the conflict here springs from the step-up in tax basis to fair market value that occurs at death under current law.* It has been a powerful incentive for taxpayers to hold on to appreciated assets rather than sell or gift

*So which is worth more,
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them to younger generations. Remember, in the case of a gift, your income tax basis does not “step up” but rather is “carried over” to the gift recipient. This means if, for example, you gift stock worth \$11,000 but for which you paid \$2,000, when the recipient sells the stock, he or she will have to pay tax on the difference between \$2,000 and the sale price, rather than between \$11,000 and the sale price. For this reason, the opportunity to permanently avoid paying federal and state income tax, even at a

lower long-term capital gains rate, has left many individuals committed to “standing pat” with their investments instead of giving them away — despite financial market risk that, in retrospect, may have posed a greater threat than taxes.

So which is worth more, the potential estate tax or income tax savings? And is there a mathematical solution to this conundrum? Perhaps. But even without considering potential tax law changes, the math is far too complicated to give a blanket answer.

The Numbers

Nevertheless, one should look at the numbers involved to get a clearer picture of the problem. Federal long-term maximum capital gains rates are now 15%, though in some states the combined effective rate may be as much as 20% to 25%. In the case of a recipient who sells the gifted asset on receiving it, a current tax will apply. Or, if you give an appreciated asset to a family member, who then might hold it for years to come, the tax will be deferred.

Indeed, the capital gains rate may well be lower if, for instance, a young grandchild age 14 or over with little income and living in a state with no tax intends to sell the assets someday. The capital gains rate may then be as low as 5%. And, of course, the overall tax rate will depend on the percentage of gain built into a particular asset.

For instance, if you own an asset worth \$10,000 that you bought for \$4,000, your gain would be only \$6,000 and your federal tax (at 15%) would be just \$900, or 9% of the asset's current value. In summary, the income

*Stepped up basis at death is limited in 2010 based upon current estate tax law.

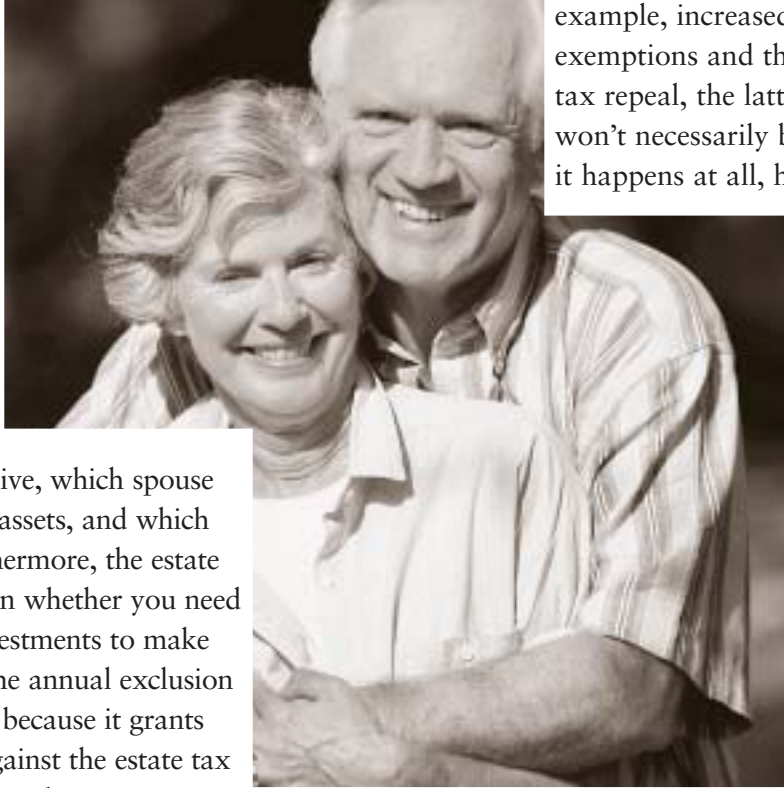
tax rate may run anywhere from some fraction of a 5% rate to as much as a 25% cost today.

Similarly, the actual estate tax cost will also vary according to your situation. Factors affecting it include how long you and your spouse live, which spouse owns the appreciated assets, and which of you dies first. Furthermore, the estate tax cost will depend on whether you need to use appreciated investments to make gifts that qualify for the annual exclusion (a powerful tax saver, because it grants you 100% leverage against the estate tax and is lost forever if you don't use it) or to make gifts that use the lifetime exemption (a less powerful option, because such gifts remove only future appreciation from your estate).

If you use a discounting strategy (such as an FLP) to leverage the lifetime exemptions, your gift's power will be greater no matter whether you use the annual exclusion gifts or the lifetime exemption. At the same time, estate tax savings will depend on the size of your overall estate (not today, but at death) as well as the rates and exemptions that estate tax law will then include (if it still exists).

The Bottom Line

Thus, the bottom line is a trade-off: A potential federal and state income tax that could range from very small to 25% versus a potential estate tax that could range from zero to 49% in 2003 — the timing of either tax being unknown. And if that sounds like difficult math, one also can't ignore the potential for future tax law changes. For



example, increased estate tax exemptions and the potential estate tax repeal, the latter of which won't necessarily be permanent if it happens at all, have already been

on the horizon for the past few years. And though getting much less publicity, a companion provision (for 2010) would place a cap on the step-up-in-basis amount at death that a taxpayer could use.

So potential estate tax repeal might suggest you shouldn't forgo income tax savings to pursue estate tax savings, which themselves may prove unnecessary. Then again, potential limits on the step-up-in-basis rule might similarly imply that holding assets with that "step up" as a goal may prove illusory.

The Road Ahead

If any clear conclusion exists, it's that you shouldn't necessarily place tax factors (income or estate) center stage in your planning process. Evaluate your own tax situation carefully and with a professional's guidance. But don't lose sight of other, perhaps equally important factors — such as long-term investment and family goals — as you evaluate gifting strategies. Please call us; we can help you better navigate the road ahead by putting these uncertainties into perspective and assisting you in developing or adjusting your gifting strategy. ■

Buy-Sell Agreements: A Risk Management Essential

Buy-sell agreements are critically important to a company's survival in the face of disaster or even the most long-foreseen ownership change. Unfortunately, owners often neglect to develop them early in a company's existence, and they become more difficult to settle as time goes on. Thus, you should create a buy-sell agreement as soon after starting a new business as possible. Or, if your company is already well-established, you need to immediately set aside time to create this risk management essential.

4 Key Elements

For any business entity, whether a corporation, partnership or limited liability company (LLC), buy-sell agreements serve a variety of purposes. For starters, they allow you to set the price and sale terms for departing owners while also determining who the company will — and won't — admit as a new owner. Plus, they can provide a ready market for the shares in the case of an owner's death or another ownership-change event. Here are four typically key elements of a buy-sell agreement:

1. Triggering events. Many people think of an owner's death as the primary triggering event, but it's certainly not the only one. Others may include disability, traditional retirement, divorce or bankruptcy, conviction of a crime or loss of a professional license, or owner disagreement. In short, you need to include any triggering event that would cause an owner to give up ownership or jeopardize his or her ability to own or even work for a company.

2. Obligation to buy. Also set forth in your buy-sell agreement the circumstances under which the business entity or remaining owners may buy a departing owner's share or stipulate a right of first refusal (without obligation) to buy the share. A business being obligated to buy a departing owner's interest is known as a "redemption agreement." If other owners are the ones who must buy, it's called a "cross-purchase agreement." Redemptions are more common in larger organizations, because they're less cumbersome — particularly if the agreement



is funded by life insurance. (For more on this, see "Life Insurance: A Potential Funding Vehicle" on page 5.) The cross-purchase option is more flexible, because acquisitions of the departing owner's interest needn't be proportional to existing ownership.

3. Valuation provider and method. Typically, a buy-sell agreement mandates that an independent and qualified business appraiser perform a valuation. Moreover, it should state guidelines for the appraiser, such as using fair market value. Fair market value is the price at which a willing seller would sell and a willing buyer would buy, each with reasonable knowledge of the relevant facts and without compulsion to sell or buy, respectively. It

Life Insurance: A Potential Funding Vehicle

Among a company's funding options for a buy-sell agreement, life insurance stands out as a potential choice. When an owner dies, the coverage provides an immediate cash infusion to allow a lump-sum payout with no damage to the business. Life insurance proceeds generally are income tax-free to the beneficiary — whether an individual, business entity or separate entity. The only exception is the “transfer for value” rule, which asserts that proceeds will be taxable if a company transfers a corporate-owned policy to someone other than the insured or the insured's partner for valuable consideration.

The other side of the income tax equation, the trade-off, is that life insurance premiums for corporate-owned policies are not tax-deductible — even though a company is paying them to accomplish a business purpose. Because shareholders typically expect and hope that a company's value will rise over time, look for insurance flexible enough to follow a value increase by allowing additional future coverage regardless of changes in the insured individuals' medical histories.

In the case of a cross-purchase agreement (see “Obligation to buy” on page 4), each owner will bear the life insurance costs as a nondeductible expense. Premium costs will vary — sometimes dramatically — by policy, depending on owners' respective ages, insurance ratings and ownership percentages. A policy generally can pay such insurance as additional compensation to each owner, “grossed up” because the premiums aren't deductible.

For example, it would take \$1,800 of gross compensation (if income taxes and payroll taxes are 45%) to equal a \$1,000 insurance cost. So beware that a 90% owner might end up paying most of his own eventual buyout's cost if the business covers the insurance premiums. Ultimately, when creating a buy-sell agreement, you must evaluate carefully whether it's really “fair” for the company to cover the entire cost.

generally includes a discount for being a minority interest and for lack of marketability. Although this discount is favorable for estate tax purposes, it may mean the departing owner (or his or her family) gets a reduced value. Remember that you and your fellow owners must choose a valuation method at a time when no one yet knows who will be the first to depart.

4. Buyout terms. Also address these in your buy-sell agreement. Which buy-out terms will apply usually depends on the applicable triggering event. For example, because life insurance can cover it, death typically prompts a lump-sum cash payment. An agreement will generally provide for payment of other buyouts over a period of years, so as to not create too large a burden on the business when an owner departs. An agreement might provide for a

discounted price if the triggering event is within the owner's control, such as commission of a crime or loss of a license. But a discounted price probably wouldn't apply to events such as divorce or bankruptcy, because authorities would likely view doing so as a “fraudulent transfer” purposefully designed to keep value low.

Many Difficult Issues

Without question, you face many difficult issues when crafting a buy-sell agreement. Nevertheless, the far greater peril is not facing the issues mentioned here, and others, either early in your company's existence or at some point well before an ownership change occurs. For help better understanding — or conducting — this critical task, please call us. ■

Taking Early Withdrawals From Retirement Plans

Are you thinking of withdrawing funds early from your qualified plan, such as a traditional or Roth IRA, profit-sharing plan, or pension plan? Generally, you should do so only as a last resort because, in most cases, you will be subject to income tax — plus a 10% penalty if you take distributions before age 59½.

Of course, many reasons exist for dipping into retirement accounts. For example, you may have retired at a young age and most of your assets are in qualified plans, or a financial crisis has struck your family — such as a long layoff or illness, business failure, or divorce. But even in circumstances like these, you may want to borrow rather than withdraw assets. Let's look at the consequences of early qualified plan distributions as well as how you can avoid or reduce potential income taxes and penalties.

Know the Rules

Keep in mind that distributions are subject to federal income tax — at ordinary income rates — except for qualified Roth IRA distributions, and qualified plan rollovers and nondeductible contributions.

Even if you die, your beneficiaries must still pay income tax on the distributions (except on distributions from Roth IRAs that have been open for at least five years). The step-up in basis

that applies to other investments has no effect on inherited IRAs or qualified plan accounts. But make sure you check to see whether your state also taxes these distributions.

Note the Exceptions

Although the income tax bite on early withdrawals may hit your wallet hard, the additional 10% penalty tax is onerous because you cannot offset it — even with other losses — and because it could be avoided simply by waiting until age 59½. Fortunately, you can steer clear of the consequence if:

- Distributions are obtained after terminating employment with the plan sponsor in or after the year you reach age 55,
- Distributions are received after death or permanent disability,
- Distributions are used to pay medical or qualified higher education expenses for you, your spouse or your dependent children,
- You receive qualified domestic relations order (QDRO) divorce payments from an ex-spouse's plan, or
- You incur first-time homebuyer's expenses, up to \$10,000. (But you must have owned no home in the last two years.)



Another exception: If you receive substantially equal periodic payments, the IRS may not penalize you. The periodic payments exception is a catchall because you may qualify regardless of your distributions' purpose. It generally works well for individuals close to retirement age because you must carefully adhere to a schedule of payments made at least annually and for at least five years, and until you reach age 59½. On the downside, it is typically ineffective for those with large one-time expenditures.

Remember, if you break from the prescribed amounts before the period ends, you will be subject to penalty on all prior payments.

Consider the Bottom Line

The bottom line is, in some instances, you may have to take preretirement distributions from your qualified plans — it may be your only choice. But, if possible, borrow funds from them instead.

And either way, please call us; we'll help you determine whether you can avoid paying the penalty on early withdrawals and whether you should explore other options. ■

3 Ways To Better Use Your 401(k), 403(b) or 457 Plan

The 401(k) plan has become an important part of both our culture and millions of Americans' financial pictures. So much so, in fact, that **Time** magazine listed its creation as one of the "80 Days that Changed the World." But many 401(k) plan participants (or those of its counterpart for tax-exempt organizations, the 403(b) plan, or for government bodies, the 457 plan) continue to underuse their accounts. And, during recent times, the accounts themselves have become notorious for their poor investment performance. Here are three ways you can better understand — and therefore better use — your 401(k), 403(b) or 457 plan:

1. Learn how the plan works. For starters, obtain a copy of the written summary plan description, which explains the account. In addition, attend any staff meetings your employer offers about your plan and its investment choices. Also, if available, one-on-one guidance can prove particularly useful in clarifying any misunderstandings or misconceptions about your account.

2. Recognize the significance of employer matching. If your employer matches your contributions up to some salary percentage, make sure you fully grasp the value in this. Whether the match is dollar-for-dollar or something less — for example, 50% of contributions up to 6% of compensation — get acquainted with the advantages of this generous compensation. To that end, perhaps suggest to your employer that it organize a brief seminar to demonstrate how matching works. Such an event would bolster your knowledge while also promoting plan participation among your co-workers.

3. Invest your funds prudently. This means not putting too much into your employer's stock, if that's an option, and generally diversifying your portfolio by allocating investments among the various alternatives. In addition, review your choices regularly and rebalance your portfolio as appropriate. Above all, don't stop contributing to your plan just because of market fears. Rather, adjust your investment style as necessary to fit your risk parameters. Doing so may call for a bit of professional guidance.



Seated left to right: John F. Young, Richard A. Berkowitz, Barry M. Brant
Back row left to right: Lee Hediger, Jeffrey M. Mutnik, Tom Young, Eric Zeitlin, Todd Moll,
Terrence A. Schultz, Randi K. Grant, Richard A. Pollack, Kenneth J. Strauss, Gary E. Rosenthal.

“We believe in a comprehensive financial perspective.

*We provide our clients with an integrated approach to income, estate, business and investment planning.
Upon completion of a comprehensive plan, we proactively implement the plan to achieve the desired outcome.”*

Provenance Wealth Advisors, an affiliate of Berkowitz Dick Pollack & Brant, Certified Public Accountants, LLP is a registered representative of Nathan & Lewis Securities, Inc. The Directors of Provenance Wealth Advisors are Investment Advisor Representatives with extensive experience in design, development, and implementation of sophisticated financial plans. We have both the expertise and the experience required to develop creative solutions for the complex issues faced in today's constantly changing financial landscape.

Our clients consist of successful business owners, CEOs and entrepreneurs who often have the fundamentals of good planning in place, but lack the time, expertise, and most importantly the right team of advisors to create and implement comprehensive planning strategies.

Our experience tells us that having the work “done” does not necessarily mean “done right.” Rarely, very rarely, does it mean, “done best.” Our approach revolves around planning according to your established objectives, and to make sure your plan is properly implemented without infringement on your lifestyle.

Our Services Include:

- Comprehensive Financial Planning
- Estate Planning
- Insurance Planning
- Income Planning
- Investment Planning & Counseling
- Retirement and Distribution Planning
- Business Valuations and Succession
- Gift and Charitable Contribution Planning
- Employee Benefit Planning



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