MARCH/APRIL 2005

Provenance Wealth Advisor

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PROVENANCE
WEALTH ADVISORS

515 East Las Olas Boulevard
Fifteenth Floor
Fort Lauderdale, FL 33301-2281
Telephone: (954) 712-8888
Fax: (954) 712-8900

200 South Biscayne Boulevard
Sixth Floor
Miami, Florida 33131-5310
Telephone: (305) 379-8888
Fax: (305) 960-1243

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

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How much life insurance do you need?

Family obligations, lifestyle and other factors determine coverage

You know you probably need life insurance, but you may be unsure about the amount of coverage or the type of policy required to adequately protect your loved ones. Unfortunately, your insurance needs can't be calculated with a simple formula. And they will change over time. Nevertheless, your responsibilities, financial situation and certain life events can help you determine how much insurance you need.

Key factors determine coverage

Key factors that may necessitate coverage or indicate the need to update coverage include the following:

Family matters. When you marry and have children, your insurance needs grow since you want to make sure your family will be provided for should something happen to you. Also consider other dependents, such as elderly relatives, when calculating your insurance requirements.

As your children approach college, you may need to increase your coverage if funds haven't already been set aside. This ensures that they would be able to finish their education without your salary. When your children leave the nest and become financially self-sufficient, your need for insurance may decrease. But life insurance can be a way to provide an inheritance for them.

Liabilities. The liabilities you have incurred are also a big part of the insurance picture. Every dollar of debt is that much more insurance needed. For example, the larger your mortgage, the greater your insurance need.

Also keep in mind the potential for future estate tax liability. Unless there is further congressional action, the estate tax reductions and repeal are only temporary. Without sufficient liquid assets such as insurance proceeds to pay taxes, your family could be forced to sell assets they'd prefer to keep.

Lifestyle. Your earnings have probably increased since you initially bought life insurance, and your family spending has adjusted accordingly. To ensure that your family will be able to live in the manner to which it has become accustomed, you may need to increase your insurance coverage.

While family spending may decrease upon the death of a family member and certain assets might even be sold, some expenses may increase. Child care costs, for example, could go up if a stay-at-home spouse goes back to work.

Remember, too, that your current projected spending will rise over time due to inflation. An initial annual budget of $100,000 multiplied by a 2.5% annual rate of inflation is equal to $164,000 in 20 years.

Retirement. What changes in your financial future do you project between now and when you expect to retire? For example, you may be 50 and currently need a large amount of insurance. But you may also plan to work for 10 more years — during which

Two types of insurance: Term and permanent

Life insurance policies come in many varieties, but the first and most important distinction is between *term* and *permanent* (often called whole life or cash value) insurance.

When you buy a term policy, you buy coverage for a specific period of time. If you die during that term, your beneficiaries receive a death benefit equal to the face amount of the policy. Term policy premiums are generally lower than permanent policy premiums and can remain constant year-to-year for a certain period of years. When your policy's term ends, it has no cash value. If, at that time, you need new coverage, your premiums likely will go up because of your age. If you have health problems, you could even be uninsurable.

Permanent insurance is generally more expensive, but your payments accumulate and your policy grows in value over time. This means you can borrow or withdraw cash and even use the value of your policy to fund your retirement or children's education. You won't have to worry about future uninsurability, because this coverage is permanent.

time you will be able to build up substantial retirement savings.

As you enter retirement, you may decide to use your permanent policy for living expenses by borrowing or withdrawing a portion of its accumulated cash value. (Loans and withdrawals of cash values accumulate interest and ultimately affect the amount of the policy's death benefit.)

Cover all the bases

There are many variables to consider when planning your life insurance needs. Your family obligations, lifestyle and retirement plans may indicate an increased need for coverage at different times in your life. So it's important to reevaluate your insurance occasionally to ensure that you've covered all the bases. ■

Solo 401(k)s allow the self-employed to save more for retirement

401(k) plans have become extremely popular with employers and employees over the past 20 years. That's because they allow companies and participants to control the amounts they contribute annually, contributions are pretax, and account funds can grow tax-deferred for retirement.

But until recently, 401(k)s didn't make sense for many self-employed individuals and owners of incorporated businesses with no other employees. They provided no more control or contributions than profit-sharing, Keogh and Simplified Employee Pension (SEP) plans for these individuals.

Beginning in 2002, contribution limits for 401(k)s increased. As a result, the solo 401(k) plan (also known as the individual 401(k), small business owner 401(k) and uni-k) provide the self-employed with new opportunities to maximize their retirement savings.

Make bigger contributions

The key difference with the updated 401(k) is that participants can now contribute as much as 100% of their compensation, compared with 25% in the past. In addition, the maximum contribution limit has gone up to $14,000 in 2005, with an additional "catch up" contribution of $4,000 for those who reach age 50 during the year.

These changes are particularly important for those whose self-employment income is not extremely large. For example, a 40-year-old self-employed individual with net earnings of $28,000 in 2005 could contribute up to $14,000 to a solo 401(k). By contrast, a regular profit-sharing plan contribution for the same individual would be limited to 25% of compensation or $5,600.

In addition to the 401(k) component, a self-employed individual or small business owner can also make a profit-sharing contribution. The combination of both will allow the maximum contribution.

If your self-employment income is $100,000 in 2005, you can make a 401(k) salary deferral contribution of $14,000, plus another 20% of the $86,000 balance, or $17,200. This total of $31,200 is far greater than the $20,000 available with just a traditional profit-sharing, Keogh or SEP plan. (Note that, for a self-employed person, compensation is measured by net income after the retirement plan contribution.)

The solo 401(k) boasts a few other advantages over other types of plans. Participants can borrow up to 50% of the account balance, up to a maximum of $50,000. But keep in mind that you must repay the loan with level payments made at least quarterly based on a market rate of interest, and the interest paid may not be deductible. You can also purchase life insurance within the plan account — a feature not available with IRAs and many other plans.

Not everyone benefits

At the highest income levels, the new solo 401(k) doesn't offer any great advantage. Those with net self-employment income of more than $210,000, or salary from a corporation of at least $168,000, would be able to contribute an overall maximum of $42,000 (not including catch-up contributions) with a SEP, Keogh or straightforward profit-sharing plan — and this limit wouldn't increase with the addition of a solo 401(k).

Individuals who are employees of larger companies but have some separate consulting income, director fees or other non-W-2 income may find the solo 401(k) a useful retirement savings tool.

Realize, however, that you can't create your own plan based on self-employment income if you are also a majority (more than 50%) owner of another business that has other employees. In that case, you're considered an owner of what is known as a "controlled group" of businesses and are responsible for providing similar coverage to the employees of each business.

Because the solo 401(k) counts as a qualified retirement plan, you can't both contribute to one and make deductible IRA contributions if your adjusted gross income exceeds certain amounts. The phaseout ranges are $50,000 to $60,000 for most single filers and $70,000 to $80,000 for joint filers.

A better plan

The solo 401(k) plan presents an exciting new opportunity for many sole proprietors and small business owners to create a retirement plan that will allow increased contributions. This may be exactly the vehicle they need to fund their retirement in the most tax-advantageous way. ■

Give your home away

Donate your residence to charity and realize valuable tax benefits

If you intend to leave a substantial amount to charity upon your death, donating your home now could make good financial sense — especially if it's highly appreciated. That's because transferring your personal residence to charity during your lifetime provides income tax and other benefits that a transfer at death does not.

Save income and capital gains taxes

When you donate your home, you receive an income tax deduction for a charitable contribution in the year you make the gift. If the value of the property is sizable, you probably won't be able to use the entire deduction in one year, but can claim the excess on returns over the next five years. A deductible donation isn't limited to your primary residence; it can also include vacation or second homes, as long as they are not being used as rental properties.

If your home has appreciated significantly, this also might help you avoid capital gains taxes. Generally, the first $250,000 of capital gains ($500,000 on a joint return) on a sale of a principal residence is exempt from capital gains tax. But if the appreciation on your home exceeds these limits, your tax savings may be significant.

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Even homeowners with mortgages can exercise this option. If your residence has a mortgage, you may be able to ask the charity to pay it off as part of the deal. Your gift would be the net value less the mortgage. Or you can ask the charity to buy the property for a bargain price. Say your house is worth $500,000, but you only want to give away $300,000. The charity may be willing to buy your house for $200,000.

Even if you're making the donation during your lifetime, you are still likely to accomplish important estate planning objectives. This major charitable gift will reduce the size of your taxable estate. What's more, your heirs won't have the headache of selling the property after your death.

Continue to live in your home

If you aren't ready to give up living in your home, you can donate the property with a "retained life estate." You and your spouse retain the right to reside in the property for the remainder of your lives. The charity takes possession of the property only after the death of the donor, donor's spouse or other specified beneficiaries.

Keep in mind that, if you retain the right to live in your house, your tax deduction will be less than the residence's full fair market value. You are, in effect, transferring a "remainder interest" in the property to charity — one that begins after the end of your family's interest in the property.

The amount of the deduction for a remainder interest in the residence is its fair market value multiplied by the remainder interest factor at the time of the donation. The remainder factor is based on a monthly adjusted government interest rate known as Section 7520, combined with government tables for life expectancy. When interest rates are low, the remainder interest left to charity is valued higher, and therefore the income tax deduction is greater.

Here's how it might apply: A 72-year-old widow has lived in her home for 30 years and has no plans to move. To receive a tax benefit without altering her lifestyle, she donates her home to charity while retaining the right to live there for life. At the time of the donation in September 2004, the home's fair market value is $250,000 and the remainder factor is 59.504%. The donation, therefore, provides an income tax deduction of $148,760.

Avoid complications

Donating your home may be the perfect way to benefit your favorite charity and realize significant tax benefits. But the process can be complicated, so consult your advisors before making a major gift of this nature. ■

Restricted stock is all the rage — for a reason

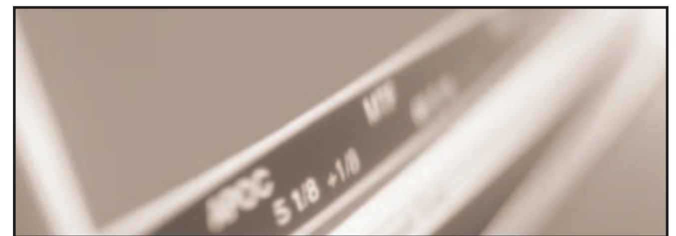
Just a few years ago, stock options were all the rage and virtually every publicly traded company seemed to be granting options to its key executives. Today, the stock option program is disappearing — more often than not replaced by grants of restricted stock. That's not necessarily a bad thing: Restricted stock is a less leveraged investment that offers somewhat more straightforward tax treatment.

Option flaws

One of the main reasons stock options lost favor is because wild fluctuations in the stock market exposed their prime weakness: the extreme leverage they create. Options are generally granted at current market prices and, when stock prices increased dramatically in the late 1990s, options exploded in value.

When prices later plummeted, many yet unexercised options or unsold stock became virtually worthless. Around the same time, public companies came under fire for their accounting treatment and the overall cost of their options programs.

Meanwhile, option holders wrestled with the complicated issues of when to exercise, when to sell and whether to forgo favorable tax treatment for a less risky approach to their holdings. To obtain the best tax result, you must hold a qualified incentive stock option for at least one year,



and then hold the stock for a minimum of one more year after exercising the option.

Even if you do so, a large adjustment for alternative minimum tax (AMT) purposes is created in the year you exercise. The AMT tax can be recovered as a credit in subsequent years, but it may take time.

Many option holders have made unfortunate decisions by failing to exercise or holding stock too long after exercising their options. Worse, some have lost their jobs when companies faltered and have seen the value of their options disappear after already paying taxes for exercising them.

Fewer bumps with restricted stock

Restricted stock — stock which can't be sold for a specified period of time — is, by comparison, much tamer. Unlike options, stocks don't have the same extreme financial leverage or complicated tax treatment. The amount of shares granted will typically be far smaller than with options, because the stock has a more substantial value per share when granted.

Indeed, even if the stock price drops by 25%, owners still hold a valuable asset. On the other hand, there is much less upside potential. Also, you may be required to forfeit the stock if you leave the company before the time restrictions have lifted.

If you make a Section 83(b) election within 30 days, stock grants are taxable immediately as compensation and subject to withholding taxes. If you don't elect to do this, you won't be taxed until the restriction period has ended — perhaps years later.

It may seem preferable to be taxed later rather than sooner, but you will be taxed later based on the value of the stock at the time the restrictions lapse. So an 83(b) election may save significant taxes in the case of privately held companies near their startup phase and likely to explode in value.

Even so, it generally makes sense to wait. With an 83(b) election, you risk paying tax on stock you may never see or that may decline in value before the restrictions are lifted. You may also have trouble finding the cash to pay these taxes when all you have is stock that can't be sold.

Plan around your stock

Tax and wealth management planning for restricted stock is crucial. You may have the opportunity to make transfers for estate planning purposes before the stock vests and while its value is relatively low.

Or you may want to plan the rest of your investment portfolio around this one, often large, stock position. To balance your restricted stock position, you may, for example, require a larger allocation to bonds or other equity market sectors. ■

Wealth management 101: Rebalance your investment portfolio regularly

If your investment portfolio can guarantee you anything, it's that it won't remain static over time. So, even after you've established a well-diversified portfolio that meets your financial goals and risk parameters, your work isn't done. Over time, you'll need to rebalance it even if you simply want to maintain your original asset allocation.

Say your portfolio started with 50% in stocks and 50% in bonds, and that, after a year, your stock holdings have doubled in value but your bonds have made no gains. Your allocation is now two-thirds stocks and one-third bonds, even though you've changed nothing.

You can rebalance your portfolio by selling securities from the category that has performed better — in this case, stocks — and reinvesting the money in the category that has not performed as well.

Note that it is relative performance measured between the categories that matters. The same rebalancing principle holds true if, for example, one category has declined in value by 30%, while another has declined by only 5%.

Rebalancing can be done not only in the general categories of stocks, bonds and cash, but also in their subcategories. This may include, for example, allocations among small-, mid- and large-cap stocks, international and U.S. stocks, and different industry sectors.

But before you rebalance, be aware of the potential pitfalls. By selling from the best-performing categories, you may generate taxable capital gains. And if you rebalance too quickly, you may lose out on investment returns because you aren't allowing the best-performing areas to fully run their course.

If you rebalance only annually, however, you likely can minimize these risks and costs. Typically, segments of the market that underperform for a period will eventually recover their relative losses, and rebalancing can ultimately enhance your long-term returns.

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WEALTH ADVISORS

BERKOWITZ DICK POLLACK & BRANT

CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS, LLP

515 East Las Olas Boulevard, Fifteenth Floor, Ft. Lauderdale, Florida 33301-2281
Telephone: 954-712-8888 • Fax: 954-712-8900

200 South Biscayne Boulevard, Sixth Floor, Miami, Florida 33131-5310
Telephone: 305-379-8888 • Fax: 305-960-1243

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