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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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GRATs and IDITs allow you to give *and* receive

Different types of trusts can serve different purposes, but many help you pass wealth on to future generations while minimizing estate taxes and negative repercussions of probate. Two types of trusts, the grantor retained annuity trust (GRAT) and the intentionally defective irrevocable trust (IDIT), are particularly appropriate if you wish to derive some income from assets you expect will appreciate significantly and leave the remainder to your beneficiaries.

GRATs provide income stream

A GRAT is a trust in which the grantor (the person setting up the trust) transfers cash or property for the ultimate benefit of others — typically children or grandchildren. But a GRAT differs from some other trusts because it has an annuity component; the grantor receives a stream of payments from the trust for a specific period.

When you set up a GRAT, you choose an annuity period (usually between two and 20 years) and specify the frequency of payments (typically quarterly or annually) and what fixed dollar amount or percentage of the trust's value you will receive each year. If you're using the percentage method to determine the payment amount, the rate is applied to the initial value you contribute, or, in the case of the similar grantor retained unitrust, the trust's value in the year of the payment. After the designated period elapses, any remaining assets are left to the trust's beneficiaries, either to be distributed immediately or to remain in trust according to its terms.

Gift depends on asset appreciation

The value of the gift to your beneficiaries for gift tax purposes is determined at the time you fund the trust, based on the trust terms and the monthly-adjusted federal discount (Section 7520) rate. How much ultimately does get left to them may be more or less than this, depending on how the investments perform. If, for example, you establish the trust so that only excess appreciation above the Sec. 7520 rate is left, the taxable gift — and thus the gift tax — could be minimal or zero. This means that over the term of the annuity you get back all of your principal plus interest.

Because investment performance determines how much will end up passing gift-tax free to your beneficiaries, the best assets to transfer to a GRAT are those you reasonably expect to appreciate at a higher rate than the Sec. 7520 rate. These may include stocks, real estate or interests in a closely held business. In fact, interests in young businesses poised for explosive growth can be excellent GRAT assets. If, on the other hand, you contribute assets that don't appreciate enough, the trust may have to return them to you over the years, leaving little for your beneficiaries.

While GRATs offer many advantages, they're not for everyone. They make the most sense for individuals with large estates who are financially prepared to part with important assets and, eventually, the income stream they provide. It's also worth noting that, if you die before an annuity period ends, the assets in the trust will be included in your taxable estate. GRATs, therefore, are best for individuals who are very likely to outlive the trust's term.

IDITs provide slightly different structure

Benefits similar to that of a GRAT can be achieved by establishing an IDIT. Both IDITs and GRATs are ideal for transferring assets to high-income beneficiaries because

the grantor retains ownership of trust assets for income tax purposes.

When you create an IDIT, you sell assets to it in exchange for an interest-bearing installment note from the trust. You don't recognize a gain or loss on the sale and aren't required to pay tax on interest payments you receive from the installment note. You do, however, owe taxes on the trust's income.

After the sale, any appreciation on the property sold to the IDIT in excess of the amount of interest payable on the installment note will end up in the hands of the trust — and ultimately the loved ones you name as beneficiaries — without you incurring gift taxes. While the structure looks different, the concept is the same as a GRAT: Appreciation above a market rate is transferred gift-tax free. As with GRATs, it's important to fund the trust with assets that are likely to appreciate significantly during the term of the note.

Complicated trusts require assistance

While they can help you minimize estate and gift taxes, GRATs and IDITs are complicated estate planning tools. Before you decide you want to establish one of these types of trusts, talk with your financial professional and your legal and tax advisors. ■

How interest rates affect GRATs and IDITs

The calculation that determines the value of a grantor retained annuity trust (GRAT) or the amounts to be paid on a sale to an intentionally defective irrevocable trust (IDIT) are based on market interest rates. Because the rate is fixed at the time of the initial transfer of assets, it matters whether market rates are high or low.

GRATs and IDITs work most efficiently when interest rates are relatively low at the time they are created. For example, a GRAT annuity fixed at 5% is treated as being worth more when long-term interest rates are at 4%, and it is above market, than when the market rate is 6%, and the same 5% return is considered below market. When the retained annuity interest (the amount you keep) in a GRAT is worth more, the remainder interest (the amount that goes to your beneficiaries) is therefore worth less and the gift tax cost of funding the trust is lower.

Shop around for tax breaks

You may benefit from the new sales tax deduction

The itemized sales tax deduction is back — at least for now. Individual taxpayers who itemize deductions on their federal income tax return are allowed to claim a sales tax deduction, but only as an alternative to deducting state and local income taxes.

The sales tax deduction was originally repealed by Congress in 1986 as a tax simplification measure but was signed back into law on Oct. 22, 2004. It took effect retroactively for all of 2004, and is available for 2005 as well.

Who benefits

The new law gives all federal taxpayers who itemize the option to deduct their state and local sales taxes instead

of state and local income taxes. Indeed, some taxpayers who previously claimed the standard deduction will find that they now can save tax by itemizing. But for taxpayers in most states, annual state income taxes will still likely be greater than the amount of sales tax they pay over the course of a year.

The biggest beneficiaries of the sales tax deduction are residents of the seven states that don't have any income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Officials in these states have spent years lobbying to restore the tax break, arguing that it is unfair for taxpayers to be deprived of a tax deduction simply because their states have chosen to tax consumption rather than income.

But the new deduction will also be important for residents of states like Tennessee — which taxes only interest and dividends — and those who live in states where sales tax rates are significantly higher than income tax rates. Or it may save you taxes if your income is only partially subject to state income tax because it includes retirement plan distributions, Social Security benefits or U.S. government bond interest. Finally, the deduction may be beneficial if you frequently cross borders to shop in neighboring states.

How to calculate your deduction

Taxpayers have two options for calculating their sales tax deduction. You can deduct the sales tax you actually paid during the year based on the amounts shown on your receipts. Or you can deduct an estimate based on IRS tables, posted on the IRS Web site (www.irs.gov) or available through your tax preparer.

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If the actual amount of your receipts exceeds the amount shown on the tables, you can save taxes by using the actual amount. But be careful to closely examine your receipts. You may be paying different sales tax rates in different parts of the same state and for different types of items. Taxpayers who, unaware of the new deduction, failed to save sales receipts throughout the year can rely on the tables.

Sales tax paid on large-ticket items such as motor vehicles, boats, airplanes, jewelry, and home construction, remodeling or refurnishing may be deducted in addition to the table amount. If you live in a state with an income tax, only these kinds of large purchases are likely to cause your sales tax to exceed your income tax.

If both amounts are roughly similar, you may benefit by shifting state income tax payments between years. For example, you might pay your fourth-quarter 2005 estimated state tax payment after, rather than before, the year ends.

You should also consider the tax consequences when deciding whether to make a large purchase this year or next. And keep in mind that, just like the deduction for state and local income taxes, the sales tax deduction cannot be used for alternative minimum tax (AMT) purposes. This means that you will lose some or all of the benefit of the deduction if you end up paying the AMT instead of the regular tax.

What you can do to save

It's possible the sales tax deduction will be extended beyond 2005 or even become a permanent deduction. Congress is likely to consider the issue again before it expires. In the meantime, talk to your tax advisor to determine if the sales tax option might benefit you and whether you should begin keeping records that will help maximize your deduction. ■

Planning for a special needs child's future

Typical estate planning considerations won't apply — or at least may be overridden by other goals and concerns — if a family member is a special needs individual. If you have a disabled child or other loved one who is or might be unable to support him- or herself, you need to plan now for his or her financial future.

Getting governmental assistance

The disabled often have many needs, including medical care, supervision and special education or job training. Managing these needs can be overwhelmingly expensive, even for wealthy families. Once they turn 18, most children no longer qualify for coverage under their parents' health insurance policies. At that point, most families apply for state and federal governmental assistance but still find it necessary to supplement public benefits with their own funds.

To qualify for federal Supplemental Security Income (SSI) and state Medicaid programs, disabled people must have less than $2,000 of property in their own name. There are also limits on how much income they can earn. State rules vary, but all impose limits on the amount disabled individuals can earn each month and still receive benefits.

Creating a special needs trust

In addition to obtaining government benefits, family members of a disabled individual can ensure their loved one's support by setting up a special needs trust. You can establish and fund this type of trust during your lifetime with such assets as cash, real estate and investments. Or you can fund it upon your death, as a beneficiary of your will or with a particular asset such as a life insurance policy or retirement plan account.

Note that there are some ways you cannot fund a special needs trust. This includes any direct transfers to the individual that would qualify for the $11,000 annual gift tax exclusion. While gifts to a trust normally can qualify for this exclusion through a temporary right of withdrawal known as a Crummey power, special needs trusts are excluded.

To avoid conflicts with government assistance income and property rules, the provisions of a special needs trust must be carefully worded. The idea is to create a trust that supplements, rather than replaces, public benefits. Therefore, its language needs to specify that the funds are not to be used for basics such as food, clothing,

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shelter and medical expenses. What the trust can cover is "enhancements," including medical benefits not covered by Medicaid, vacations, and such items as computers and telephone and cable TV service.

A variation on the special needs trust, the OBRA '93 trust, allows the disabled person to self-fund a trust, perhaps with proceeds from a personal injury or medical malpractice lawsuit. These trusts, however, include a payback provision that gives the government the right to be reimbursed after the death of the disabled individual for expenditures made on his or her behalf.

Careful navigation required

Both the creation and operation of special needs trusts require careful planning and attention. But the reward is knowing your child or other loved one will have assistance with their supplemental needs, even after you're gone. ■

Make a distribution plan

Preserve your retirement account and transfer more to your heirs

If you have sufficient income from other sources, you may wish to forgo taking distributions from your traditional IRA or employer-sponsored retirement plan as long as possible. This can delay income tax and increase the amount you leave your heirs. Tax law, however, mandates minimum withdrawals after age 70½ in most cases. But by planning ahead, you can preserve your retirement account balance and minimize income taxes.

Calculate required distributions

Under rules adopted in 2002, nearly all retirement plan participants now calculate their required minimum distribution (RMD) by reference to the same IRS table. This table specifies what amount must be distributed annually based on the plan's previous year-end value and the number of years you and your beneficiary are likely to live. The table automatically assumes that your beneficiary is 10 years younger than you, but if your spouse is the sole beneficiary and is more than 10 years younger, you can use his or her actual age — resulting in a lower RMD.

Required distributions normally must begin when you reach age 70½. If you decide to postpone distributions for one more tax year, you must double up the following year, taking the first year's distribution by April 1, and the second by Dec. 31. Doubling up, however, may not be a good idea if it could push you into a higher tax bracket or cause you to be subject to deduction limits that apply based on adjusted gross income.

If you fail to take your RMD, the IRS can impose a penalty of 50% of the shortfall — or the difference between the amount, if any, you took and the amount you should have taken. That penalty, however, may be waived if the error was due to "reasonable cause": for example, your advisor provided you with incorrect information, and you are taking steps to remedy the error.

Note that RMD rules don't all apply to Roth IRAs. In fact, you are not required to take any Roth IRA distributions during your lifetime. And while qualified plan accounts are generally subject to the same RMD rules as IRAs, you can delay distributions if you are still employed by the plan sponsor and don't own more than 5% of the company sponsoring the plan.

Understand post-death distributions

If distributions begin during your lifetime, after your death your beneficiary must continue to receive at least the same amount with the same frequency. But if you die before distributions have begun, your beneficiaries have a couple of choices.

They can take a lump sum distribution at any time within five years after your death. Alternatively, if the beneficiaries begin taking distributions within a year following your death, they can spread the distributions out over their lifetimes. As a result, it may make sense to leave some or all of your retirement plans directly, or through certain types of trusts, to children or grandchildren. Because such decisions involve income tax and estate tax issues, it is important to seek advice that considers your overall estate planning objectives.

If your beneficiary is your spouse, distributions don't have to begin until you would have reached age 70½. Or your spouse can roll over your retirement plan into his or her own IRA. Look at which alternative will allow distributions to be spread out the most.

Take advantage of the rules

Assuming the funds aren't needed sooner, taking maximum advantage of these rules can spread out and substantially delay income taxes on distributions. This may allow you to grow more tax-deferred and leave a greater amount to your loved ones. ■

Wealth management 101: Passive vs. active investing

In recent years, a variety of investment vehicles have sprung up that allow you to invest "passively" in the market. Instead of trying to beat the market or reduce the risk inherent in it through asset selection, you ride the market — for better or worse.

You can invest passively through index mutual funds, or with I-shares, which trade differently but perform similarly to index funds. The best known passive investments are S&P 500 index funds that invest in all 500 stocks, in the same proportion as the index. Some index funds track other market indexes, such as the international MSCI EAFE index — which includes stocks from 20 different countries — and the Lehman Brothers Aggregate Bond index.

Index funds are relatively easy for investment companies to manage because they require little research or trading. Therefore, their fees are generally much lower than those of actively managed funds. These investments are usually tax-efficient too, because there is little portfolio turnover. (As with all equity and fixed-income investments, however, index funds can be risky and their holdings can possibly decline in value.)

Active investing also features advantages and disadvantages. Using your own or your investment manager's research, you may be able to select securities that outperform major indexes and the general market. And if you own a large number of securities, your fees may be comparable to those of a passively managed portfolio.

By holding stocks long enough to avoid short-term capital gains taxes or investing in low-turnover mutual funds, you may also be able to achieve tax efficiency. Your investment expertise and ability to choose investments that, over time, outperform the market after expenses will determine whether the rewards of active management outweigh the risks.

So should you follow a passive or active strategy? It may depend on how you're investing, whether your assets are in taxable or tax-deferred accounts, and whether you manage them yourself or rely on advisors.

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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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