

# Provenance Wealth Advisor



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**NEW DIVIDENDS AND  
CAPITAL GAINS TAX  
RATES CARRY FAR-  
REACHING IMPLICATIONS**

**COULD AN INSTALLMENT  
SALE OR SCIN BENEFIT  
YOUR ESTATE PLAN?**

**Small business incentives  
under the new tax law**

Revisit your account  
allocation strategy

Securities offered through Walnut Street Securities, Inc.\*

**MEMBER: BOSTON STOCK EXCHANGE, NASD & SIPC**

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# Planning for the New Dividend And Capital Gains Rates

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) made some relatively simple and straightforward changes to the tax rates for dividends and long-term capital gains. But as you devise your investment, tax and even business strategies, these differences carry far-ranging implications. Here are some actions to consider in light of JGTRRA's changes.

## Redefining Dividends

Dividends, which were previously taxed just like any other form of ordinary income, are now taxed at a maximum rate of 15% — retroactive for 2003 and continuing at least through 2008. First and foremost, this change means you need to know what is defined as a qualifying dividend as opposed to interest income or other earnings types.

Most dividends from common and preferred domestic and foreign stock typically are now eligible for the new rate. (Among other distinctions, preferred stock normally provides specific dividend payments, generally paid quarterly, and takes precedence over common stock for dividend payments and liquidation.) Mutual fund distributions, for funds whose gains aren't sheltered by losses built up during the last few years and thus are required to distribute income, also qualify. Their distributions are taxed either as dividends, which include short-term capital gains, or as long-term gain distributions. Either one should now generally be eligible for the lower rates.

But beware: Some corporate securities may look and act like preferred stock but technically are not. They are actually a form of corporate note or debenture and the income they pay is considered interest income to the recipient and deductible to the company. Also note that certain investments structured as partnerships, typically found in the oil and gas industry, don't qualify either — though they may create their own tax shelter by reporting taxable income that is less than the cash distributed. And if you're a real estate investor, keep in mind that income from real estate investment trusts (REITs) isn't eligible for the new rate.



## Recognizing the Limits

The new lower dividend rate clearly gives a small boost to dividend-paying stocks as an investment class for any account subject to tax at the individual level, including those in flow-through entities such as partnerships, limited liability companies (LLCs) and S corporations. But it has its limits — the rate naturally doesn't apply to IRAs and qualified retirement plans, something to consider when pondering allocations to these accounts. (For

## Do the New Tax Rates Affect Business Entity Choices?

The new dividend and long-term capital gains rates obviously matter to investors. But do they affect business owners choosing an entity type? Yes, somewhat. In recent years, the double tax on C corporation earnings or appreciation has led to a strong bias toward flow-through entities such as partnerships, limited liability companies (LLCs) and S corporations. The new rates heighten this partiality, because maximum individual rates are now reduced to the same 35% as the maximum corporate rate, eliminating one of the potential costs of a flow-through entity.

The potential double tax, either through dividends during a C corporation's life or capital gains on its sale, is now less. Still, as long as the double-taxation threat exists, the bias toward flow-through entities will remain. Nonetheless, some situations may arise in which advisors may be less hesitant to recommend a C corporation, at least for some portion of business activities, to perhaps take advantage of relaxed fringe benefit rules or lower tax rates on the first \$75,000 of corporate income.

more on this, see "Recent Wrinkles Change the Face of Account Allocation" on page 7.)

In addition, if you incur investment interest expense, you currently can deduct it only to the extent of your net investment income. That means, mirroring the rule already in place for long-term capital gains from investment property, you may now count dividends in your net investment income only if you elect to give up the favorable tax rate. Obtain professional advice before deciding which path to follow.

## Reviewing Capital Gains

JGTRRA also lessens the top tax rate on long-term capital gains — those held for more than one year — from 20% to 15%. The new rate is effective only for sales occurring on or after May 6, 2003, and the special long-term capital gains rates for collectibles (28%) and real estate depreciation recapture (25%) remain unchanged.

Although the new capital gains rate is merely a number revision and not a new definition like the dividend change, don't ignore its impact. Offsetting short-term gains with losses — particularly long-term losses — has always been good planning. And this remains true under JGTRRA. In fact, it will generally be a good idea this year to offset any pre-May 6 20% long-term gains with losses. Remember, though, that you must first use losses against gains of their own variety.

Another new factor: the greater difference between long- and short-term capital gains rates. At the highest rates, a 20 percentage point difference (35% vs. 15%) now exists. The previous difference was 18.6 percentage points, making it even more important to plan carefully to benefit as much as possible from the lower rates. For example, a like-kind exchange of property will defer long-term gain, but it will also reduce your depreciation deductions going forward. The strategy is still valuable, yet with its benefits reduced (particularly if little depreciation recapture is taxed at 25%), look closely at an exchange's costs and your projected net savings over the years.

## Re-examining Your Choices

The new dividend and capital gains rates received much publicity before and after JGTRRA became law. And deservedly so — these changes definitely alter the tax and investment landscape. For help re-examining your choices, please call us. ■

# Consider Installment Sales And SCINs for Your Estate

Installment sales are a good way to transfer closely held business interests or real estate within your family, because they can help provide you with an ongoing income stream and reduce your estate taxes. And your loved ones buying the note will receive competitive interest rates — currently the lowest in years. But as we discuss installment sales, let's also explore another option: self-canceling installment notes (SCINs).

## Get the Appreciation Out

Generally, family business owners may prefer installment sales to outright gifts because they can retain the property's current value and pass future appreciation out of their estates when transferring business ownership or other assets to relatives. Plus, owners can spread the tax bill over time, because they will receive payments over a set period of years.

**The income tax impact:** You must recognize capital gains each year you receive principal payments on the note. But if you (the seller) should die before the buyer pays it off, the IRS will include the note in your estate. The note is valued at the fair market value (FMV) at the date of your death.

Fortunately, you can avoid capital gains tax by selling all or part of your family business to an intentionally defective grantor trust (IDGT), which is a separate legal entity. Essentially the IRS treats you as having sold the property to yourself for income

tax purposes while also making a completed transfer for estate tax purposes.

This strategy also may work for other assets you expect to increase in value, including real estate or securities, because you pay no taxes on the transferred assets' future income. The trust's grantor pays the income tax on the property's future income and appreciation, while the trust beneficiaries get the real financial benefit without paying income taxes. Paying the income tax for the beneficiaries is really an additional gift, but it doesn't count as one for gift tax purposes.



The end result? You have an

income-tax-neutral transaction that replaces an asset from your estate with a note. If all goes as planned, the value of the property sold will increase at a greater rate than the interest the trust pays — getting the excess appreciation out of your estate and minimizing estate taxes.

Keep in mind that family members (the buyers) can pay an interest rate that matches the minimum required by the government's applicable federal rate — currently lower than it has been for many years. You must charge a minimum interest rate in line with the applicable federal rate; the government rate varies by transaction type and the note period.

## Look Deeper to SCINs

Instead of creating a traditional installment sale, you could use a variation of it — the SCIN. It also calls for principal and interest payments (or just interest) over a period of years. But if the buyer fails to pay the note in full before you die, the SCIN is automatically canceled, requiring no further payments. To get a zero value for the note, you must properly design the SCIN by including the self-cancellation at death feature as well as increasing either the purchase price or interest rate or both to reflect this risk.

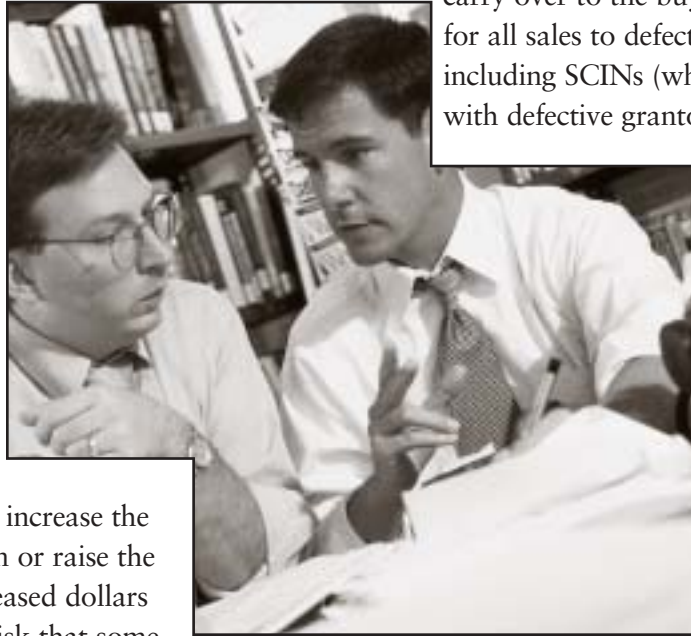
Let's look at an example. If you sold an asset valued at \$1 million and the required minimum interest rate was 4%, you could (for example) increase the purchase price to \$1.2 million or raise the interest rate to 5%. The increased dollars to be paid should offset the risk that some of the money may in fact never be paid because of death. Even after this adjustment, the IRS may still challenge the SCIN if you (the seller) suffered from an illness at the time of the transaction and died shortly after or if the note term exceeded your actuarial life expectancy.

Family business owners can take advantage of this strategy because the courts have upheld SCINs in familial cases. By properly structuring and valuing SCINs in IDGTs, you can avoid income tax, remove assets from your estate and receive a specified return for the rest of your life.

## Consider the Drawbacks

Although SCINs have some desirable advantages, they also have disadvantages. For one,

you receive no step-up in basis for assets sold to an IDGT, because the IRS disregards these transactions for income tax purposes. (There is no “step-up” on the sale and neither will there be at death, seeing as how you will no longer own the asset.) So if you hold low-basis property (such as closely held business interests or real estate) for a long period before selling it, the low basis will carry over to the buyer. This is true for all sales to defective grantor trusts, including SCINs (when combined with defective grantor trust sales).



Second, the premium you must build into the sale price or the interest rate can greatly affect your planning. If you live long enough, the buyer may bring as much

or more increased note payments back into your estate — erasing any previous benefit. In this situation, the tax treatment is favorable only if you (the seller) fail to live to your life expectancy.

Last, the complexity of SCINs may also increase your risk for an IRS audit. The U.S. Court of Appeals decision in the *Costanza* case earlier this year offers some comfort, as it upheld a SCIN's validity.

## Apply These Tools Properly

Installment sales, IDGTs and SCINs are important tools because they can help you transfer future appreciation out of your estate. But please discuss these strategies with your tax advisor or attorney before implementing them. ■

# Assets for Less

## Small Business Incentives Under JGTRRA

For many years, the tax law has included a provision allowing businesses to expense rather than depreciate certain assets other than buildings and land improvements. This amount had gradually risen to \$25,000 but, with the arrival of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), it is now \$100,000 per year for both new and used property during the full years 2003 through 2005. Let's look at why such JGTRRA changes, though small in number, can make a big difference for small businesses.

### Acquire Reasonably

Because of the immediate tax write-off, small businesses will “pay less” to acquire business assets. In fact, for a person or corporation in the highest federal tax bracket (35%), the net cost of \$100,000 of equipment would be only \$65,000, while the net first-year cost of “seven-year property” to the same taxpayer without this provision or the bonus depreciation (see “Depreciate Prudently” on this page) would be \$95,000.

But be careful about how you use the expensing election. (And yes, you may decline to use it.) Too many new asset purchases in one year — more than \$400,000 — will cause you to lose the immediate deduction. And for many individuals with lower levels of income, even \$50,000 or \$100,000 might be too much for one year and may reduce their overall income into the lower tax brackets. This could mean you'd be better off taking depreciation over a five- or seven-year period at higher rates, rather than getting an immediate deduction that brings your income for one

year to zero or very low brackets. A tax deduction over a five- or seven-year period at or near the highest tax rates may be better than an immediate tax deduction that is so large that it brings you down to the 10% or 15% marginal brackets.

### Expense Judiciously

On the bright side, you can elect to expense all or any portion of your asset additions — even choosing which particular assets to expense. Generally, choosing those that otherwise would have the longest life (such as seven years instead of five) for expensing makes the most sense, because you're accelerating the deductions even further.

But examine each situation carefully. For example, if you rent business equipment or furniture, the lease terms will determine whether you may treat it as a normal operating lease or as a purchase (capitalized lease). Although the difference between normal depreciation on a “purchase” versus rent on a lease may often be insignificant, the election to expense clearly favors the capitalized lease treated as a purchase. Thus, where possible, consider negotiating terms that will qualify for this treatment.

Also note that depreciation on business autos is still limited by the luxury auto rules. But JGTRRA continues and expands a special exception for those — generally larger sport utility vehicles — that exceed 6,000 pounds and are used more than 50% for business.

### Depreciate Prudently

If the expensing election doesn't cover all of your new asset acquisitions (and for many

small businesses, it will), then JGTRRA has also increased first-year “bonus” depreciation. This provision was initially put into the law after the Sept. 11 terrorist attacks to stimulate new investments by giving an additional 30% deduction in the year of acquisition for assets placed in service after Sept. 11, 2001.

It has now been extended to remain in effect through Dec. 31, 2004. And for those assets placed in service on or after May 6, 2003, it increases from 30% to 50%. Unlike the expensing election, it applies to only new property. If you don't need this deduction,

take the 30% bonus depreciation or simply use normal depreciation rules. If your total acquisitions exceed \$100,000 and include some used property, use the expensing election for the used property because first-year bonus depreciation won't apply to it.

## Spend Wisely

Keep the expensing and bonus depreciation rules in mind as you plan your asset acquisitions and as your tax returns are prepared. Of course, you can make good choices only with a professional's help. So please call us. ■

## Recent Wrinkles Change The Face of Account Allocation

Because of the potential tax impact, which investments you place in IRAs, 401(k) plans and other qualified retirement plans versus which you hold in other, taxable accounts has always mattered. For instance, in a period of normal investment returns (in other words, *not* the 1990s), you're usually better off keeping investments that generate ordinary income (such as taxable bonds) inside retirement plan accounts and those that generate capital gains or losses (such as stock) outside. But what about now, in light of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)?

Well, the same principle is now even truer — particularly with the highest long-term capital gains rate lowered from 20% to 15%, and the difference between that rate and almost all ordinary income rates now a bit greater than before. In addition, you should keep any investments with a built-in “tax shelter,” such as tax-exempt bonds or oil and gas partnerships, outside of retirement plans, and those that may generate ordinary income or short-term gains, such as hedge funds or short-term trading accounts, inside qualified plans.

Plus, JGTRRA also brings us a new category of taxable income called qualifying dividends, which are taxed at a maximum 15% rate rather than as ordinary income. This change actually helps clarify the allocation process, because you should now view qualifying dividend-paying stocks no differently than you do non-dividend-paying stocks. That is, they're ideally suited for investment *outside* a qualified plan, whereas such preferred stock previously represented a more ambiguous hybrid of ordinary income and potential capital gain.

Thus, make your first goal to always ensure that you allocate funds properly among your accounts to create a well-diversified portfolio. Then look at how to best distribute various securities or funds among your accounts so that you achieve overall tax efficiency and promote your portfolio's after-tax growth. Please contact a professional for account allocation advice specific to your needs.



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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