SEPTEMBER/OCTOBER 2004

Provenance Wealth Advisor

Keeping harmony intact when transferring a family business

ILITs save estate taxes, but beware of the income tax pitfalls

Interest expense deductions: Are you planning your borrowing wisely?

Wealth management 101: Investing in venture capital funds

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

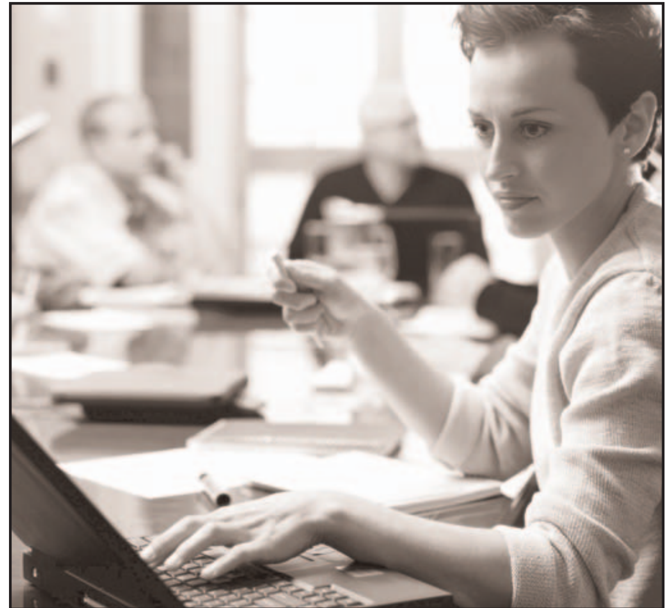
Securities offered through Walnut Street Securities, Inc.; NASD & SIPC

*Walnut Street Securities, Inc. is securities registered in all 50 states, DC and Puerto Rico. This shall not be deemed to be a solicitation in any jurisdiction where Walnut Street Securities, Inc. is not licensed to conduct business.

Keeping harmony intact when transferring a family business

Transferring a family business to the next generation is rarely easy. And it can become even more complex when you consider emotional, family-related issues.

Typically, business owners like to treat their children equally in their estate and business succession plans. But that can be difficult when all aren't actively involved in the business or they have varied positions within the company. So how does the reality of your family situation and your desire to create a structure to best allow the business to continue to prosper get reconciled with your quest for equal distribution of assets among your heirs? Let's examine your options.



Transfer interests equally to all children

On the surface, equal distribution of your ownership interests among your children is the simplest solution. You can even provide those children who work in the business with control by naming them as officers and by giving them a greater share of the voting stock.

This option can make estate planning easy but may create problems for your business. For example, the children running the company may feel they're working too hard on behalf of the rest of the family, while outside shareholders may have to wait a long time to realize real benefits from their ownership interests in a business in which they have no control.

Transfer interests only to children involved in the company

Under this scenario, you avoid the types of problems that can arise from family members not active in the business owning shares in it. But there is another potential problem to consider: Your company may represent a large enough portion of your total assets that you can't equalize your non-active children's inheritance with other assets. For example, what if one of three children will work in and take over the business, but the company represents 60% of your overall net worth? Here are three solutions:

1. Give separate business assets — such as real estate or equipment the business uses — to the inactive children. They can then lease them to the business, generally through a partnership or LLC. These arrangements can be complex, so careful planning is critical.
2. Have the business borrow additional cash and distribute it to you before you transfer your ownership interests. Doing so will reduce the company's value and increase the value of your nonbusiness assets. But you also must consider the financial consequences to your business.

3. Purchase life insurance and name the children not involved in the business as its beneficiaries.

Before you implement any of these strategies, be sure to discuss the advantages and disadvantages of each with your financial advisor.

Sell interests to active children

This strategy will keep value in your estate even if it involves an installment sale with payments spread over many years. The children who purchase the stock must build up additional value in the business before they'll benefit from owning it. If they pay a fair price for the stock, you may then leave other assets — including any note receivable from the sale — equally to active and nonactive children.

Alternatively, consider using estate planning strategies that operate like a sale, such as a gift to a grantor retained annuity trust (GRAT). While technically you're making a gift, this technique operates more like a sale because you, the grantor, retain the right to receive payments or a percentage for a specified number of years. If the payments are set so the gift value is near zero, the result is similar to a sale. You're essentially giving away only the future appreciation in the business's value while you receive payments back from the trust that equal the fair value plus interest.

Find the best solution for your family

If only some of your children are active in your business and you want it to continue and prosper while minimizing family conflict, you may want to rethink an equal split of ownership interests among all your children. There are no easy answers. But with careful planning, you can find the best solution to help ensure family harmony and the continuity and success of your business. ■

ILITs save estate taxes, but beware of the income tax pitfalls

Bob buys a $1 million life insurance policy. For him to reduce estate tax liability, who should own the policy? a) Bob. b) His wife. c) An irrevocable life insurance trust (ILIT). If you said an ILIT, you'd be correct. In fact, you can reduce your estate tax liability by as much as $480,000 in 2004 by having an ILIT own a $1 million policy (if you're in the highest estate tax bracket). But unexpected events can result in unexpected income tax consequences.

How an ILIT works

An ILIT is a popular estate planning vehicle for holding a life insurance policy because it allows the policy to be removed from your estate — as well as your surviving spouse's estate — for federal estate tax purposes. The trust must be both the insurance policy's owner and its beneficiary to accomplish this result. Thus, an ILIT downside is you'll lose some control over the insurance policy.

To pay the policy's annual premium, you can make gifts to the ILIT in an amount equal to the premium. Cash should remain in the trust's account long enough to satisfy a Crummey power the trust's beneficiaries hold.

A Crummey power allows gifts to the ILIT to be treated as a present interest, therefore qualifying for the $11,000 annual gift tax exclusion. With a Crummey power, beneficiaries may withdraw all or part of the new gift during a short (generally 30- to 60-day) period of time. If beneficiaries don't exercise this power — and the presumption is they won't — the power lapses and the gift becomes irrevocable.

Income tax consequences

The income tax treatment of the ILIT generally is simple. While the insurance policy remains in force, the trust receives an annual gift (which isn't taxable for income tax purposes), and it pays an annual premium (which isn't deductible). Therefore, its taxable income is zero, and filing an annual income tax return isn't necessary.

But placing funds in a taxable interest-bearing account of the ILIT until the premium is paid may generate enough interest income to require a tax return. A complex trust is entitled to a $100 exemption before it's subject to federal tax. Alternatively, depending on trust provisions, the ILIT may be treated as a grantor trust, which means its income will be taxed to the trust's grantor (its creator).

Only on your death and after the policy's proceeds are paid does the ILIT become an income tax paying entity — holding investments, incurring expenses and owing taxes. But events can occur during your life that cause the ILIT to own assets other than the policy. As a result, the ILIT will be required to file an annual income tax return.

For example, the trustee may cash in the policy for its cash surrender value during your lifetime. This may occur because of family or financial changes, or because the policy hasn't performed well. A taxable gain may result if the total cash surrender value is greater than the premiums paid. Alternatively, the ILIT may borrow against the policy to generate cash for other investment purposes.

The income tax treatment of the ILIT generally is simple.

In either event, there's now cash in the ILIT that must be invested. Remember, the trust is irrevocable, and the funds can't simply be paid out to you. It might be possible under the trust agreement to pay out funds to your spouse, but this would normally run contrary to the ideal estate planning theory because funds removed from your and your spouse's estates would now be back in your estates.

When an ILIT becomes a stockholder

In recent years, as a result of legislation affecting the insurance industry, many insurance companies that were mutual companies (owned by policyholders) have become stock companies (owned by shareholders). When these demutualization transactions

occur, policyholders typically receive stock shares — sometimes in quite substantial amounts. As a result, the ILIT — as the policy owner — becomes the stock owner, although it generally will have the option to receive cash or enhancements to the insurance policy as an alternative.

If cash or stock is chosen, the ILIT doesn't have any income tax basis in it and, thus, the entire amount is taxable either immediately (if the cash option is taken) or on the stock's sale. If stock is taken and then held by the trust, it may be dividend-paying stock. So the trust, its beneficiary or the grantor must pay tax. And if the stock is sold, the capital gains may be substantial. Grantor trusts can be particularly troublesome because the cash remains in the trust while you owe income tax. And though this is excellent estate planning (income goes to the next generation and you still pay the income tax), it may cause a cash flow burden, particularly if the amount is unexpected and substantial.

If the amount of stock is large enough, the trustee may have a duty to sell at least a portion to more prudently diversify the ILIT's investment portfolio. Even if the trustee isn't required to do so, this may indeed be the most cautious strategy for a trust that owns a large position in one insurance company's stock.

Operate with care

Having an ILIT own your life insurance policy is smart estate planning, but beware of the potentially negative income tax consequences that may result. Because an ILIT may greatly reduce your estate tax liability, it's important to adhere to all rules regarding its operation. ■

Interest expense deductions: Are you planning your borrowing wisely?

What should be on your radar screen from an income tax perspective in planning your level and type of borrowing? Most people's first concern is mortgage interest expense on their home, but you also should consider investment interest expense and mortgage interest on any rental properties you own.

Acquisition indebtedness

You can deduct mortgage interest on as many as two homes (your principal residence and another — such as a vacation home), but your deduction can't exceed the interest on acquisition indebtedness of $1 million plus home equity debt totaling an additional $100,000.

Acquisition indebtedness is debt you incur acquiring, constructing or substantially improving a residence. You essentially get a fresh start each time you buy a new home because you don't have to reinvest cash proceeds.

For example, let's say you sell a house for $500,000 with a $200,000 mortgage balance. You then buy a new house for $500,000, borrow $400,000 and keep the excess $200,000 for personal purposes, such as buying a car or furniture. In this scenario, your new mortgage interest expense will be deductible.

If instead you buy a house and borrow as little as possible and then discover you need additional funds for other purposes, your deduction limit on the new borrowing will be the home equity loan limit of $100,000. So it may be to your advantage to borrow more when you buy a home if you know you'll need cash soon thereafter.

If you refinance your mortgage, your new mortgage will still count as acquisition indebtedness to the extent it doesn't exceed your original mortgage. Thus, the typical refinance when you replace one mortgage with another in the same amount to get a lower interest rate won't harm your tax situation.

You can deduct prepaid interest on a mortgage, or points, only if you pay them in connection with the purchase of your principal residence. Any other points paid — such as on a refinancing or in connection with a second home — will need to be amortized over the life of the new loan.

Investment interest expense

If you need to borrow amounts in excess of your mortgage and home equity deduction limit and are borrowing only for investment purposes, consider nonmortgage financing. Investment interest expense has its own set of rules, and it's deductible only to the extent of net investment income. This includes taxable interest income and short-term capital gains, as well as qualified dividends and long-term capital gains if you elect to give up the favorable tax treatment they would otherwise receive.

Examine your alternatives carefully before you make this election. For example, giving up the long-term gains treatment may save tax this year, but may cost more over the long term if you could have used the interest expense as an ordinary deduction in later years. Unlike excess mortgage interest, you may carry forward disallowed investment interest expense until it's gone.

Keep in mind that interest expense you use to buy tax-exempt securities won't be deductible, and if you borrow from an investment account containing tax-exempt securities, at least some of the interest expense won't be deductible. If a large

Use deductible debt to pay off nondeductible personal debt

One option to reduce or eliminate nondeductible personal debt, such as credit cards or auto loans, is to use deductible debt, such as a home equity loan. Here's a fictional example of this strategy.

Jimmy has $50,000 of personal debt. His auto loan has a 5% interest rate and his credit card debt has a 12% rate, and neither is deductible. He takes out a home equity line of credit with an interest rate of 5% to pay off his personal debt. By doing so, Jimmy reduces his interest rate, and the interest is now deductible. He uses the tax and cash savings to make regular principal payments so he can pay off the home equity loan in a few years.

Using this strategy involves a certain amount of risk. For example, you may lose your home if you're unable to pay off the loan. Be sure to discuss potential risks with your financial professional to determine whether this strategy is right for you.

portion of your investments are in tax-exempt securities, you won't receive a large deduction.

Interest expense on rental property

If your home (or vacation home) becomes a rental property, the mortgage interest rules no longer apply, and the expense instead reduces your net rental income from the property. There is no separate limit on interest expense related to a rental property.

If your net rental activity is a loss, it will generally be considered passive but qualify for the active participation exception. This exception lets you deduct up to $25,000 per year in net losses if your adjusted gross income (AGI) is under $100,000. (The deduction is phased out for AGIs between $100,000 and $150,000.)

An evolving strategy

Because there are several categories of interest expense, it's important to analyze your situation by taking a closer look at both where your borrowing costs will turn out to be lowest over time and where the tax benefits will be greatest. Only then can you make the best choice for your situation. ■

Wealth management 101: Investing in venture capital funds

While not appropriate for average investors, one of the alternative asset classes that can complement your core investment portfolio of stocks and bonds is venture capital (VC) funds. Wealthy or institutional investors should consider this investment class to add diversification into their portfolio mix.

VC funds can provide cash to growing businesses that need a bridge between their owners' capital investments and the business's ability to borrow from a bank or other conventional source. A VC fund also may lend funds, take equity ownership and receive stock warrants, stock options or conversion rights.

From an investor's standpoint, VC funds are at the higher-risk end of the portfolio but also provide the potential for high reward. As a result, this fund type isn't for the risk-averse investor and generally shouldn't make up more than 5% to 10% of a portfolio. Because funds typically look for investments of at least $250,000, this will leave VC funds primarily for an investor who has $5 million or more in assets.

Typically, the fund is set up as a partnership or limited liability company, thus allowing income or losses to flow through to investors. Because of the nature of the investment, it may take years before investors realize any profits. In the meantime, any losses generated may not be tax deductible because of the passive activity rules.

The fund manager typically charges the fund an annual 2% fee plus 20% of the profits generated, although fees may vary. The higher level of fees is necessary because the fund manager will generally have active involvement with the companies in which it invests.

There are many different types of venture capital funds. Some specialize in companies in a certain industry or a certain region of the country. Some require a specific structure to their investment — for example, they make loans only with options to buy stock. Some focus on start-up companies while others look for well-established, successful businesses.

Although VC funds won't follow the fluctuation of the stock market, they can be affected by the health of the economy, and thus won't be completely market neutral. VC funds provide an interesting and potentially rewarding alternative to the more mature, established companies whose stock is publicly traded, but note that these types of funds aren't available through all financial advisors.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and accordingly assume no liability whatsoever in connection with its use. Individuals are encouraged to seek the guidance of their own personal legal or tax counsel. The hypothetical examples used are for illustrative purposes only and not intended to represent the value or performance of any specific product or to predict or guarantee actual results, which will vary. ©2004 PFP/WMAso04

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 Walnut Street 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

PROVENANCE

WEALTH ADVISORS

BERKOWITZ DICK POLLACK & BRANT
CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS, LLP

515 East Las Olas Boulevard
Fifteenth Floor
Fort Lauderdale, Florida 33301
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

Securities offered through Walnut Street Securities, Inc.; NASD & SIPC

*Walnut Street Securities, Inc. is securities registered in all 50 states, DC and Puerto Rico. This shall not be deemed to be a solicitation in any jurisdiction where Walnut Street Securities, Inc. is not licensed to conduct business.