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PLANNING POTPOURRI

Sometimes you have to wonder ...

Viva Las Vegas: You can deduct gambling losses only up to the amount of gambling gains. IRC Sec. 165(d). A partnership passed through its gambling gains which a partner used to offset his personal gambling losses on his personal income tax return. Partnerships (including LLCs taxed as partnerships) must pass through to their partners that partner's distributive share of each class of income, gain, loss, deduction and credit. The partnership tax regulations direct the pass through of gambling gains and losses as a separate item. A partnership may thus have profits from its regular business and losses from gambling and the two are not offset. Reg. Sec. 1.702-1(a)(8)(i). ILM 200725036.

Home Ownership Going to Pot: Harold was convicted of marijuana cultivation and his ½ interest in the marital home was forfeited to the government, but his wife Kathleen's interest was not. She and the government remain co-owners of the house. *von Hofe v. United States*, 05-2969-cv.

Are In Vitro Grandsons Heirs: In 1969 seven trusts were established by Grandpa which were to benefit his descendants. Before Grandpa's son died his son's semen was cryogenically preserved. After son's death, son's wife bore two children by artificial insemination. Were these grandsons to be considered descendants the trust was to benefit? Are in-vitro grandchildren born after his son's death "descendants" for purposes of the trust? The trust stated that its purpose was to "...benefit his sons and their families equally." Based on what the court found to be an overall dispositive scheme to benefit grandfather's bloodline, the in vitro grandchildren were deemed included as trust beneficiaries. *Matter of Martin B.*, NYLJ 8/1/07 p. 1. Note that New York law was recently amended to provide that children conceived after a parent's death (post-conceived) are precluded from sharing a parent's estate unless expressly provided to do so.

Wrestler Benoit's Probate: Whether Chris or his wife Nancy died first, according to CNN, will determine who inherits their estate. James Brown, Anna Nicole Smith, the list of the rich and famous that can't seem to take care of their affairs [pun intended] goes on and on. Perhaps regular folk can learn the lesson and

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PRACTICAL PLANNER

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TRUSTING YOUR TRUSTEES

Selecting a trustee is a tough decision but the concerns you may have over potential candidates can often be mitigated by naming additional fiduciaries and including provisions in the trust document to address these concerns. These steps can make the selection process less difficult or worrisome.

The Decision

Struggling over who to put in charge of Junior's treasure trove? The most important decisions you'll have to make in completing an estate plan is choosing a trustee to manage the trusts you establish. Whether the trust is for yourself, your spouse, or other heirs, the control a trustee can wield makes the decision daunting. You need to identify someone with the integrity to carryout the job appropriately, the sensitivity to the beneficiaries and the sophistication to deal with tax, legal and other complex matters. What non-tax factors should you consider in choosing a trustee? What steps can you take to mitigate the concerns you have that a trustee may not have all the requisite attributes, or even if she does that she may not perform as expected? How can you design your trust to mitigate the worries over trustee selection? Careful planning and drafting can often address the concerns you have with this decision.

Role of a Trustee

The trustee you designate will be charged with managing the trust and implementing your wishes as expressed in the trust agreement. Trustee responsibilities vary depending on the nature of the particular trust. However, there are duties which are common to most trusts: investing trust assets, making distributions to beneficiaries, coordinating investment decisions and distributions to current and future beneficiaries, recordkeeping, filing trust income tax returns, and communicating with beneficiaries. A clear trend in trust planning is to opt for longer term trusts; trusts that last a lifetime, or even perpetual trusts. The difficulty of the tasks and time periods faced by trustees are compounded by the tremendous diversity, even hostility, amongst heirs. Identifying a perfect trustee is almost impossible. If you view the decision in a broader sense of the flexibility and controls a trust can provide over trustee selection and trustee actions, the decision becomes more complex, but often much easier to make.

Switch Trustees

Sometimes different trustees are appropriate for different phases of your trust. Name an initial trustee and when a child reaches a specified age, he or she can join the existing trustee as a co-trustee. On an insurance trust you might name your long time accountant as trustee while you are alive. On your death when the insurance proceeds are collected the role of trustee changes from an administrative role to one of investing and distributing funds to your children. The trust agreement could state that a new trustee takes over at that time.

Name a Co-Trustee

Name two trustees to serve together as co-trustees. Each trustee provides a check and balance on the other. Each trustee can bring different skill sets to the trust management function. One might be compassionate and empathetic towards the beneficiaries; the other may bring investment and other technical expertise.

Name an Institution

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CHECKLIST: REALTY CAP GAINS

Sales of real estate can generate favorably taxed capital gains if you're an investor, or higher taxed ordinary income if you are a dealer. The following checklist will help you characterize your activities as those of an investor and avoid dealer taint.

Capital gain is realized on the "sale or exchange" of real estate which is not held primarily for sale to customers in the ordinary course of your trade or business. Code Section 1221 (a)(1). Investors do not sell to customers at a mark-up, they realize their profits from the long term appreciation of the property held. Dealers earn a profit by selling in excess of their cost as a result of their efforts and labors as middlemen. Investors, in contrast, don't perform merchandising functions. The determination is fact sensitive. Your actions, and how you document them, are vital to your success. Corroborate and strengthen the factors consistent with capital asset characterization, and to avoid, minimize or downplay the factors indicative of assets held primarily for sale in the ordinary course of business.

√ Try to avoid continuous sales of properties to purchasers. Make sales sporadic and over longer time periods if you can. *Black v. Comr.*, 45

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...TRUSTING YOUR TRUSTEES

(Continued from page 1)

There is a clear trend toward more frequent use of banks and trust companies as trustees. They can provide the objectivity and professionalism that Uncle Joe may just lack. A common approach is to name a family member as co-trustee with an institution. The institution can provide investment management and administrative services so that there is less imposition on the family member who likely has her own family, work and other responsibilities. This approach permits the family member to focus on bringing the personal touch you want, while the institutional co-trustee bears much of the work and responsibility. If the trust you're forming is long term (lifetime or perpetual) institutions provide the certainty of having a trustee for the duration.

Delineate Distribution Objectives More Clearly

Most trust documents use rather generic language for what should be distributed. That language is often based on tax and asset protection considerations, often tempered by your wishes for more control or certainty. Distribution provisions don't have to be limited to legalese. You can provide some level of detail as to distributions you want in order to more clearly guide the trustees as to the lifestyle you want for the beneficiary (e.g., summer camps, and overseas travel), or that you don't want (e.g., no purchase of airplanes or boats). You can even specifically authorize a trustee to use trust funds to buy a house for a beneficiary. Reasonable detail can mollify worries over the trustee not distributing funds in the manner you wish.

Define Investment Parameters more Explicitly

Too many trusts simply default to standard language mandating that a diversified investment portfolio be held as mandated under the Prudent Investor Act. Many trusts simply provide that state law governing investments can be ignored. That might be acceptable, or disastrous, depending on the circumstances. If you tailor the investment provisions more carefully, the decisions as to who manages the trust investments can be less difficult to make. For example, if you have a family business, you could authorize the trustee to hold that business without regard to diversification requirements. You could even provide parameters as to when the business can be sold (e.g., no heir is working in the business for a period of two years). You can create subtrusts under the trust with one trust holding family business interests and the other trust being invested in accordance with modern portfolio theory. Reasonably limiting and guiding what investments can and cannot be made can provide greater assurance that whoever is serving as trustee will carryout your investment wishes.

Name Additional Fiduciaries

Dividing up trust functions with additional fiduciaries responsible for specific roles that are thus removed from the purview of the trustee, can often solve the dilemma of who to name as trustee. You can name a trustee but carve out the investment role for a person or institution who has great investment expertise but is not appropriate to serve as a trustee. You can remove the distribution decision from the trustee and name a separate distribution committee. You can name a trust protector and grant specified oversight powers to him (e.g., change the institutional trustee). A combination of trustee, investment adviser, distribution committee and trust protector, each with specified powers and responsibilities, can often provide a structure to address the reality that you may not be comfortable vesting all power in a single trustee, or that you don't have anyone who can alone fulfill all the roles required.

Terms in red defined in the glossary at www.laweasy.com. For e-newsletter sign up at www.laweasy.com.

Empower the Beneficiaries to Replace the Trustee

Give the beneficiaries a right to replace the trustee. In many cases this may be limited to replacing an institutional trustee with another institutional trustee. The threat of replacement can often do wonders to assure a more attentive trustee. This power, however, should be tempered to avoid empowering beneficiaries to trustee shop for the trustee who will simply do their bidding however inappropriate. PP

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...CHECKLIST: REAL ESTATE AND CAPITAL GAINS

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B.T.A. 204 (1941), acq., 1941-1 C.B. 2. Continuous and substantial activities sufficed to characterize the taxpayer as a dealer even without the other indicia of a trade or business. Suburban Realty Co. v. U.S., 615 F.2d 171 (5th Cir), cert. denied 449 U.S. 920 (1980).

√ Keep a diary. Document the actual time you spend on development and marketing activities versus other activities. While devoting extensive time to the real estate endeavor alone won't taint a property as being held for sale to customers, it's a significant factor. *Marrin v. Comr.*, 147 F.3d 147 (2d Cir. 1998).

√ Limit or avoid subdivision and "other improvement activity" to minimize the likelihood of the property being deemed to be held for sale to customers. *Gruver v. Comr.*, 142 F. 2d 363 (4th Cir. 1944) Limit your development activities, subdivision work and lot sales to comply with the tax law exceptions from dealer status. Code Section 1237.

√ Minimize sales activity. The greater the sales activity the greater the likelihood of your being a dealer and the property not being a capital asset. *Comr. V. Covington*, 120 F.2d 768 (5th Cir. 1941). Hiring an independent broker to handle all sales activities may help if those activities are not imputed to you.

√ Have a single purpose LLC purchase investment property and minimize involvement with other entities. A professional developer and owner who regularly buys and subdivides tracts of land, sells using sophisticated marketing techniques, holds lots primarily for sale to customers, will recognize ordinary income, not capital gains. *Pierce v. Comr.*, 74 T.C.M. (CCH) 572 (1997).

√ Consider an intervening sale to characterize some gain as capital. An increase in value due to appreciation while merely holding property might be classified as capital gain if you sell the property to a related entity before any development activities occur. Be certain to have an appraisal of the value at that date. Then have the new entity conduct sales activities. Only the profits attributable to development activities conducted by the related entity should be characterized as ordinary income.

√ Document your activities. Substantial efforts to obtain subdivision approval and to increase the value of the land increases the likelihood of ordinary income. Jarret v. Comr., 66 T.C.M. (CCH) 1224 (1993).

"Substantial" is a qualitative term. So maintain a diary, correspondence, and other records to demonstrate how little effort you expended may defeat the substantiality issue.

√ Keep LLC minutes corroborating that the purpose of the acquisition is to invest and hold the property.

√ Maintain contemporaneous records (e.g., business plans, memorandum, letters to counsel, etc.) that demonstrate your purpose was holding the property for investment.

√ Be sure your operating or partnership agreement supports investor status. Sanford Homes, *Inc. v. Comr.*, T.C. Memo 1986-404. PP

RECENT DEVELOPMENTS

Partnership Agreement: A law firm changed its partnership agreement by majority vote from accrual to cash basis. While state law provided that a unanimous vote is required to change any agreement between the partners, the provision of the partnership agreement trump the statute. The partnership agreement provided in general that majority vote governs, although several provisions provided for unanimous approval. The provision involved in this case did not provide for the higher standard. *Bailey v. Fisch & Neave*, 8 N.Y.3d 523 (5/8/07). Too often it's only with hindsight that the implications of a provision are really understood. This case is a great caution to those rushing through governing documents and not giving them the care and thought needed.

Real Estate Brokerage Commissions: As the residential real estate market continues to soften, it may become more common for brokers to rebate or reduce brokerage commissions to benefit buyers and thereby encourage sales. A recent ruling addresses the tax consequences of such rebates. A buyer's agent paid the buying customer a portion of the commission after closing. The IRS held that the buyer does not have to recognize this payment as income. Instead the payment should be treated as a downward adjustment of the purchase price. Also, the broker does not have to issue a Form 1099 to the IRS reporting the payment to the buyer. The rationale is that since the amount is not income it did not have to be reported. PLR 200721013.

Art Valuation: An estate was entitled to discount the value of its ½ undivided interest in artwork for the cost it would likely incur in a partition action to sell the art. This discount was based on an estimate of the cost to sell the paintings at auction. The court also allowed a further discount to reflect the volatility of the art market and its impact on the timing of a sale. *R. Stone* DC Cal. 2001-1 USTC Para. 60,540. PP