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Planning Potpourri

When Should You Update Your Will? Careful What You Read: No shortage of newsletters in your mailbox or inbox, but can you really rely on what you read? A recent newsletter we received from a financial planner identified 6 reasons to update your will. Let's review it. The newsletter advises you to revise your will if: (1) There is a birth or death in your family. Reasonable advice, but most wills are written with sufficient flexibility so that the birth or death of a beneficiary will often not require any modification.(2) Marriage, divorce or separation. This certainly is a time to revise your will, but that is never enough. Powers, living wills, beneficiary designations, and more, all need to be revised. Not just your will. (3) If your executor is disabled or dies. Reasonable, but it's likely you've named a successor executor to serve in this event. (4) Revoking a bequest to a son-in-law or daughter-in-law who has divorced your child. Sure, you'd want to do that, but very few people make such bequests, and when they do the bequest itself is generally contingent on a divorce not having occurred. (5) If the witnesses are not alive or cannot be located a codicil could be done with new witnesses. Does anyone actually track the status of witnesses? The use of a self-proving affidavit may obviate the issue altogether. If you want to modify your will and you're competent, why use a codicil instead of a new will? A codicil can often introduce interpretation and other problems such that it can be simpler and safer to sign an entirely new will revoking the prior will. Also, a codicil documents what you changed creating a more obvious trail that might attract a will challenge. (6) Tax law changes. That's valid, but not enough. Apart from the newsletter listing reasons that probably won't require action, it ignores many of the obvious and important reasons to change your will. If the value of your estate has changed you might require additional tax planning, or perhaps you can eliminate previously used planning (e.g. a testamentary CLT). Specific dollar bequests might have to be modified to reflect your new net worth. If the composition of your assets changes modification may be essential (e.g., you sold your business and now own only securities). If laws other than tax laws change revision may be vital. This could include the rules governing investment, duration of trusts, and so on. Be careful what you read, too often articles in the mass media lack the sophistication and accuracy you need. PP

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PRACTICAL PLANNER

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Trusts Owning LPs and LLCs — Passive Losses

Wealth is often structured to be held in trusts. Trusts hold an array of assets, including investments which might be subject to the passive loss limitations (e.g., losses from an equipment leasing or real estate rental LLC). Can the trust deduct those losses? A court said yes, the IRS recently said no, and a conflict is brewing.

What are the Passive Loss Rules

The passive loss rules of Code Section 469 limit your ability to deduct losses from passive real estate rental (e.g. an investment in a real estate limited partnership) and other activities in which you don't "materially participate". The initial goal of these rules was to prevent wealthy taxpayers from buying tax shelters that would be used to offset other income, such as income from a professional practice. Example: You buy a 10% interest in a limited liability company (LLC) that rents out a condo. You have no involvement in the rental activity. The LLC loses $100,000. Your share of the loss is $10,000. You can only deduct that loss against other passive income (e.g., from other passive real estate deals), not against your salary from your OB-GYN practice. But, if you're treated as materially participating in the activity you'll get a current tax write-off. If not, the write off could be deferred indefinitely and even lost.

Key to Your Write-Off: Material Participation

If you "materially participate" in a particular activity, then the tax losses from that activity would be considered "active" and can be used to offset your income from other "active" endeavors, such as salary, without limit.

Trusts and The Passive Loss Rules

As more wealthy taxpayers transfer interests in business and investment activities to trusts it becomes increasingly important to determine whether the trust is materially participating in the activity to apply the passive loss rules. Why care? Apart from all this helping you be the hit at your next cocktail party, this stuff affects wealthy taxpayers who frequently use trusts. Example: The Brady Trust is a dynasty trust that owns a personal use condo for each of Greg, Peter and Bobby, and bling for each of Marcia, Jan and Cindy. The trust has a marketable securities portfolio, and owns interests in several rental properties, each in a single member limited liability company ("LLC") owned by a parent/master LLC. The trust owns an architectural supply company. A bank is named investment adviser for the marketables. Alice is investment adviser for the closely held businesses. The rental properties and the supply company all lose money this year. Can these losses be deducted? How is the material participation rule applied to a trust? Here's the law:

1: The Primary Source -- The Statute: Material participation requires involvement "on a regular, continuous, and substantial basis". IRC Sec. 469(h)(1).

2: The Senate Finance Committee Report: Involvement in day to day operations, not merely intermittent management activity, is necessary. "A...trust is treated as materially participating in an activity … [if the] fiduciary in his capacity as such, is so participating. "In the case of a grantor trust, however, material

(Continued on page 2)

Checklist: SubPrime Taxes!

The housing market collapse affects more than the stock market. Lots of tax issues affect homeowners, and different techniques are called for to sell a house in a buyer's market. This topic is so hot the IRS just issued FAQs on it. IR 2007-159.

Many homeowners leveraged their purchases with the maximum debt possible to get a McMansion. As values increased, home equity lines were used to extract cash. When the homeowner cannot meet mortgage payments, the house may be foreclosed by the lender. Unfortunately, many of the common scenarios in this type of market have lousy tax results. Use the following checklist to make sure you're getting your share of tax pain:

√ No Deduction on Sale: When a homeowner sells a home at a loss, there is unlikely to be a tax deduction permitted for the loss. Treas. Reg. Sec. 1.165-9(a). A deduction is permitted for business property (e.g., a portion of the home is rented or used in a trade or business and depreciated). IRC Sec. 162(a). A deduction may also be permitted for a casualty affecting the residence. IRC Sec. 165.

√ Converting to Business Property: Trying an end run

(Continued on page 3)

...Trusts Owning LPs and LLC — Passive Losses

(Continued from page 1)

participation is determined at the grantor rather than the entity level." S Rept No. 99-313 (PL 99-514). A grantor trust is a trust whose income is reported by the grantor (usually the person who set up the trust), not the trust.

3: Staff of the Joint Committee on Taxation Report: "No special rule was provided for determining material participation by a trust...it is unlikely that a trust…will be materially participating in a trade or business activity, within the meaning of the passive loss rules. In the case of a grantor trust, to the extent that the grantor or beneficiary is treated as the owner for tax purposes…the material participation of the person treated as the owner is relevant to the determination of whether income or loss from an activity owned through the grantor trust is treated as passive in the hands of the owner…"

Review: Andrew Wolfe, CPA, JH Cohn LLP, Roseland, NJ.

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4. Case Law --The Mattie K. Carter Trust v. US: Mattie's will set up a trust which managed assets including the Carter Ranch which had cattle, oil and gas. The trustee hired a ranch manager to carry out most ranching duties. The IRS argued that only the trustee's efforts should be considered in determining if the trust met the test of materially participating in the ranch. If he did, almost $1.7 million in losses would have been deductible in the two years under audit. The steaks were high! The trust argued that its involvement should be evaluated based upon the efforts of all fiduciaries, employees and agents. The court said the law didn't mandate that only the trustee's activities could be considered. So when it considered the aggregate of the efforts of the trustee, ranch manager and others, it was regular, continuous and substantial involvement so that the trust was deemed to materially participate and could deduct the losses. 256 F. Supp. 2d 536 (Tex. 2003).

5. IRS Ruling: In a recent private letter ruling, PLR 200733023, the IRS nixed a trust's effort to characterize losses as active instead of passive (and hence deductible). The IRS said only trustee's activities count. It disagreed with the Carter court. The will creating the trust in this Ruling permitted the appointment of a special trustee for any of the trust property, who had all the rights of a trustee, except as limited in the trust. The IRS noted that "ultimate decision-making authority remained vested solely with the trustees" so it rejected the trust's argument that these "special trustees" were "fiduciaries" for purposes of the Code Section 469 material participation test. The IRS then looked at the definition of "fiduciary" to evaluate this.

The tax law defines a "fiduciary" as a trustee or any other person acting in any fiduciary capacity. IRC Sec. 7701(a)(6). If someone is granted broad discretionary power of administration and management over an asset, a fiduciary relationship exists. Rev. Rule. 82-177. If the person doesn't have administrative duties, they aren't a fiduciary. Rev. Rul. 92-51. Since the "special trustees" in this Ruling were controlled by the trustees and had no power over trust property, their participation was disregarded.

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

What Does it all Mean

The IRS disagrees with the Carter court insisting only "fiduciary" activities count. What about trust protectors, investment advisers, etc.? The IRS did not address these, but the IRS might have enunciated a test. If an investment adviser doesn't have "broad discretionary power of administration and management" he will not be a fiduciary for this test. This IRS standard is fraught with uncertainty. A trust protector whose role is usually limited may not qualify. Will the IRS consider the activities of all fiduciaries together? If the trust is structured as a grantor trust (e.g., Mike Brady remains taxable) then his efforts, not Alice's would count. If the trust were structured with annual demand (Crummey) powers so that gifts to it qualify for the annual gift tax exclusion, then the six kids would be taxable on trust income and the kids' activities would be evaluated to determine if material participation occurred, not Alice's or Mike's. "That's the way - we became

...SubPrime Taxes Pain Home Ownership

(Continued from page 1)

around the above rule won't work. A homeowner whose home has declined in value might think that if they rent it out for a sufficient period of time to qualify the home as a rental property, then they can sell it at a loss and qualify to deduct that loss. No dice. First, the conversion process is not simple. The IRS and the courts are well aware of the potential for abuse. The conversion will require real independent steps to corroborate the change to rental status, demonstrating that personal use of the property has been permanently abandoned, that a lease or other evidence of the business use exists, the quantum of business activity, reporting for tax purposes as a business property, not residence, etc. Merely attempting to rent the home may not suffice. *Grohse*, TC Memo 1968-47. But the real clincher is that any decline in value occurring prior to the conversion won't be able to be deducted. Only declines in value after the conversion can be deducted. The mechanism by which the tax laws effect this is to provide that the homeowner's tax basis (the amount on which gain or loss is calculated) is the lesser of the cost basis or fair value on the date of conversion. Treas. Reg. Sec. 1.165-9(B)(2). Tip: Obtain an appraisal of the house on conversion.

√ Rental Losses May Not be Deductible: Some homeowners may legitimately want to convert their home to a rental if they cannot sell it. Unlike the homeowner above seeking to take a tax deduction for the loss on sale, this homeowner may hope to use the tax losses from the rental to offset other income. Good try, but the passive loss limitation rules may prevent this benefit from being realized.

√ Renting and Home Sale Exclusion: Renting your home in a down market may also undermine the ability to take advantage of the home sale exclusion. This rule permits a homeowner to exclude the first $250,000 of gain ($500,000 joint). To qualify the home had to be used as a principal residence for 2 of the 5 years before sale. Too long a rental will disqualify the home. Example: You bought a home for $800,000. It appreciated to $1.8 million, then dropped to $1.2 million. You may have a psychological loss of $600,000, but you still have a tax gain of $800,000.

√ Lease Option Arrangement: In tight real estate markets some homeowners will rent rather than sell and lock in their loss. However, to entice a tenant to consider buying at a later date, an option is sometimes included in the transaction. When an option to purchase is given to the tenant in the lease agreement the IRS may assert that the lease with an option to purchase should be re-characterized as a sale of the property on the installment method. If the tenant is given credit for some of each rental payment, as the percentage increases, the risk of recharacter-ization will also increase.

√ Mortgage Forgiveness: If a lender forgives a borrower's debt, the borrower realizes income on the cancellation of the debt. If the borrower is insolvent gain may be avoided. IRC Sec. 108(a)(1(B). If the home is foreclosed, the excess of the debt over the fair value of the home (which is presumed to be the foreclosure sales price) is characterized as income from the discharge of debt. PP

Recent Developments

You can swap real estate and other assets tax free in a tax deferred like kind exchange under Code Section 1031. To qualify: (1) The form of the transaction is a sale or exchange; (2) Both the property transferred and the property received are held either for productive use in a trade or business or for investment; and (3) The property transferred and received is like-kind property. A special rule is provided if the exchange is between related parties. Related parties include family members, limited liability companies in which the same individual owns more than 50% of the interests, etc. 267(b), 707(b)(1). If you exchange like-kind property with a related party, and either of you transfers the property received in the exchange within two years, the tax deferral of 1031 will be forfeited, and gain will have to be recognized. IRC Sec. 1031(f). This result won't be triggered by death, as a result of a compulsory conversion, or if you can convince the IRS that the exchange and later disposition of the like-kind property were not intended to avoid tax. In a recent private letter ruling the IRS held that the taxpayer's exchange of 1/3rd of property A for his brother's and niece's (she was the sole beneficiary of a deceased sibling's trust) 2/3rds interests in property B was not done to avoid tax. The fact that one of the properties was sold to the city in which it was located within 2 years did not imply a tax avoidance motive. The tax deferral of Code Section 1031 was not tainted. The brother was the trustee of a trust of which the niece was a beneficiary. A trustee and a beneficiary are related parties for this test. However, the IRS noted that had the property been distributed to the niece on the trust's termination, the brother and she would not have been related parties since there would have been no trustee/beneficiary relationship. Finally, a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either an entire interest in a single property or a larger undivided interest in any of such properties, is generally not viewed as