

MILLER, MONSON, PESHEL, POLACEK & HOSHAW

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

NEWSLETTER

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VALUING UNDIVIDED INTERESTS IN REAL PROPERTY

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Discount Appraisals. Many professionals are surprised to learn that our firm prepares “discount” appraisals to determine the fair market value of undivided interests in real property. We routinely prepare these types of valuations for filing estate and gift tax returns and establishing purchase prices for transactions involving family members. For those familiar with our firm’s family wealth preservation and IRS audit practice areas, it should come as no surprise that we offer these services.

For years, we have assisted local attorneys, accountants, trust companies and other professionals in providing discount appraisals for all types of ownership interests. We do not compete with other attorneys in providing these services, but rather are an important part of the overall “valuation team” retained by a client. Because we are knowledgeable in understanding co-tenant, partner, member and shareholder rights, we can offer insight as to how these legal rights affect the value of an interest and whether these rights have been considered for valuation purposes.

Repairs and Maintenance. It is often the case that an apartment or office building is in need of repairs to bring it to a saleable condition, but the underlying appraisal of the fee interest failed to adequately discuss these costs. In situations where children have inherited several properties, not only does obtaining a detailed property repair report inform them as to the expected cost to be incurred to maintain the property in a safe condition, but such a report may justify a reduction in value to reflect the property’s “as-is” condition.

EXAMPLE. We recently filed an estate tax return involving over 30 rental properties built in the 1970’s. After an on-site analysis, needed repairs were estimated at \$950,000. This amount was included in our Section 6166 calculation and approved by the IRS.

Methods Used to Determine Discounts. Data relating to sales of undivided interests is scarce. It is the rare case where there has actually been a sale of an undivided interest in the subject property. Thus, alternative approaches must be used to value the subject interest. In valuing undivided interests, the Tax Court has approved many methodologies, including a modified “**cost-to-partition**” approach. This approach involves a discounted cash flow analysis which examines the following factors:

- The time to complete a partition action
- Expected legal, appraisal, surveyor and other costs and timing thereof
- Expected brokers’ commissions

- Likelihood of physical division of the property
- Likelihood of a higher or lower forced sale price
- Affirmative defenses available to the other owners
- The required rate of return for the subject interest and increased risk associated with partition
- The size and value of the subject interest

By analyzing these specific attributes of the property, a more tailored approach can be presented without having to resort to otherwise scarce “comparable sales.” This approach usually results in larger discounts for smaller value interests and lower discounts for larger value interests, with the amount of the discount generally falling between 15% to 35%.

Other approaches can be used such as comparing the undivided interest to privately-owned real estate limited partnership interests and making adjustments to reflect the following factors:

- Yield and distributions
- Management
- Number and identity of co-owners
- Net asset value
- Investment size (dollars)
- Voting rights (including partition)
- Debt-to-equity ratio
- Market for trading

Support and Defense. For over 45 years, our office has settled estate and gift tax audits with local IRS examining attorneys. We have established a solid reputation for thoroughness and respectability and are familiar with the IRS’ methods in examining appraisal reports and challenging valuation discounts. If needed, we welcome the opportunity to work with you in resolving IRS tax controversies.

If you would like to review a sample appraisal report or discount appraisal pricing information, please contact us at (619) 239-7777 or

newsletter@mmpph.com.

TOTAL RETURN TRUST: A WAY TO BALANCE THE INTERESTS OF BENEFICIARIES

BRADFORD N. DEWAN, ESQ.



A typical revocable trust is divided into two or three subtrusts on the first death. The first subtrust is the credit shelter (or “bypass”) trust which uses the deceased spouse’s lifetime exemption amount to reduce federal estate taxes. The second subtrust is the marital deduction or qualified terminable interest property trust (or “QTIP” trust) whose assets are subject to estate tax upon the survivor’s demise.

The bypass trust often pays out all its “income” to the current beneficiary, who usually is the surviving spouse. Additionally, the trustee may be given the power to distribute some of the principal of the trust but only for limited purposes such as health, support and maintenance. The objectives are to provide the surviving spouse with funds to preserve an accustomed standard of living but also to have assets available to distribute to the children upon the death of the surviving spouse.

The terms of the QTIP trust must require the distribution of all trust “income” to the surviving spouse in order to qualify for the marital deduction. But there is no requirement that any principal must be distributed. Indeed, the intention is again to have a significant amount of assets, i.e. principal, left for the remainder beneficiaries who typically are the children of both spouses or, if there was a prior marriage, the children of the deceased spouse.

The dilemma arises because the “income beneficiaries” want the trustee to invest the principal so as to realize the greatest amount of income which will then be distributed to them. The “remainder beneficiaries,” however, want the trustee to invest the funds in a manner that achieves the highest rate of return on the assets so that the principal will appreciate significantly over time.

The problem confronting the trustee is several fold. First, interest rates on bonds have always been much lower than the long term rates of growth realized by equity investments. When the lower returns on bonds are further reduced by taxes, expenses and inflation, the differences in annual returns over, for example, a twenty year period, between bonds and stocks becomes very significant. Between 1870 and 1925, the consumer price inflation averaged 6/10th of one percent. Today, we feel fortunate if inflation stays below 3%. Due to increased inflation, the dollars received upon maturity have significantly less purchasing power than the original dollars used to purchase the bond.

Another component of this problem is that dividend rates on stocks have declined over the last fifty years and a 100% equity portfolio will yield an unsatisfactory return to the income beneficiary. Also, this level of income probably is much less than what the decedent wanted for the surviving spouse.

Added to these factors are the responsibilities imposed on a trustee under the Uniform Prudent Investor Act. For example, if a trust has two or more beneficiaries, the trustee has a duty to deal impartially with them and also must act impartially in investing and managing the trust property after taking into account the differing interests of the beneficiaries. This can be contrasted with the traditional favoring of the life income beneficiary to the potential detriment of the remainder beneficiary. Thus this duty of impartiality can create a great deal of consternation in the trustee who is trying to satisfy the interests (if not demands) of the current income beneficiary and the remainder beneficiary.

Finally, the trustee has a further duty to manage the assets as a prudent investor would and diversify the investments of the trust. Even if the trustee thought a 100% bond portfolio was appropriate to generate the highest income for the current beneficiary, such a concentrated

portfolio would most likely be a breach of the duties to diversify and to be impartial.

“Under a “total return trust,” the settlor directs the trustee to distribute . . . a percentage of the value of the assets as of a specified date”

To solve this problem, the California Probate Code was amended in 2005 to allow for a “total return trust” or sometimes referred to as a “unitrust.”

Under a “total return trust,” the settlor directs the trustee to distribute to the current beneficiary, not the income of the trust assets, but a percentage of the value of the assets as of a specified date, typically January 1 of each year. This percentage must be no lower than 3% nor greater than 5%. Consequently, the trustee now makes an annual distribution of assets that equals the applicable percentage of the value of the trust assets, e.g. 4%. The assets or funds distributed may well be comprised of what might generally be viewed as income as well as principal. In making the distribution, the trustee now has the ability to sell some portion of the assets which may well have appreciated over the last several years. If the assets of the trust grow as a result of the investment strategy, then the value of the 4% will also increase, thus likely appeasing the income beneficiary. The remainder beneficiary sees the principal growing and is similarly satisfied.

This trust design responds to several important goals in determining how a settlor might instruct a trustee to make distributions from a modern trust:

- The trust must enable the trustees to invest for the highest total return consistent with the level of risk acceptable to the trust and its beneficiaries.
- If possible, the distribution rule should create an identity of interest between the current beneficiary, the trustee and the remainder beneficiaries relative to investment decisions.
- This distribution rule should allocate returns

efficiently and fairly in all types of markets, even when there are times of unusual volatility, whether up or down.

- The flow of distributions to the current beneficiary should be as smooth as practicable while maintaining the identity of interest among the parties to the trust.
- The distribution rule should be simple and easily understood.

“this type of trust . . . creates a consistent identity of interest between the current income beneficiary . . . and the remainder beneficiary”

It can be reasonably stated that the “total return trust” (with a three year averaging rule as provided for in California) addresses all of the foregoing criteria. Very importantly, the greatest strength of this type of trust is the fact that it creates a consistent identity of interest between the current income beneficiary on the one hand and the remainder beneficiary on the other.

With this important development in the design and structure of trusts, we look forward to assisting and advising those clients who would like to learn more about converting an existing trust to a unitrust or revising a revocable trust so the subtrusts created in the future will be managed as “total return trusts.”

If you would like to receive further information on total return trusts, please contact us at (619) 239-7777 or newsletter@mmpph.com.

IRS Circular 230 Notice: Any tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, to avoid tax penalties under the Internal Revenue Code. No one may use any part of this communication to promote, market, or recommend to any person any arrangement relating to a tax matter.

This newsletter is provided to share knowledge and expertise with our colleagues with the goal that all may benefit.

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