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NEWSLETTER

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INVESTMENT POLICY STATEMENT: Developing An Investment Process

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What is an Investment Policy Statement (“IPS”) ? An IPS is a document written by the trustee to explain why he or she has made certain investment decisions. The IPS should comply with the criteria set forth under the California Uniform Prudent Investor Act (“UPIA”), *California Probate Code Section 16045-16054*.

The UPIA does not require a trustee to guarantee a specific level of return for trust investments. However, the UPIA does require the trustee to use a procedural approach in investing.

The analytical process of selecting assets should be supervised by the trustee’s qualified financial advisor. The trustee’s team of professionals should work together in order to make sure the trust provisions are properly satisfied by the investment choices. It is the trustee’s duty to monitor the trust portfolio not less than annually.

Some trusts have been drafted to “opt out” of the UPIA requirements. Often this means diversification is not required in order to satisfy the trustee’s investment duties. While opting out of the UPIA may not require the trustee to diversify, it may still be advisable for the trustee to invest among a variety of asset classes.

IPS Scope An IPS should be broad enough to endure changing market conditions. However, it should be specific enough to guide the trustee, or successor trustees, with benchmarks to gauge portfolio performance. The UPIA identifies client factors and market conditions that are the building blocks for designing a portfolio.

Client Factors A variety of client factors should be considered by a trustee. A key client factor is the investment time horizon. Different types of beneficiaries have different time horizons. In general, a current income beneficiary would prefer to have a portfolio that generates substantial net income. However, a remainder beneficiary would prefer that a trustee invest in assets geared towards growth (capital appreciation). An income beneficiary is concerned with liquid assets generating sufficient cash flow while the remainder beneficiary wants more growth for tomorrow, when his or her interest vests.

Every trust is unique and must be reviewed carefully with the trustee's attorney. For example, some trusts focus on paying for the surviving spouse's needs. If the survivor is in good health and has a life expectancy of twenty years the trustee should invest in both income and capital appreciation investments. The assets selected for principal preservation would be a key factor to hedge against inflation in order to provide sufficiently for the surviving spouse. If a trustee only invested in income producing assets the trust could be exhausted before the survivor's lifetime ends. The exact allocation would require a close analysis with the trustee's qualified financial advisor.

Other trusts may limit the income beneficiary's right to principal or income because he or she has other resources. In this scenario the trustee would be justified to invest in a portfolio with fewer income producing investments and focus instead on capital appreciation to benefit the remainder beneficiaries.

Risk tolerance is another client factor that must be weighed against a desired return. If the trustee could select an asset that generates a 20% return half the time and a 3% return the rest of the time, should the trustee select this asset? What percentage of the overall portfolio should hold that type of investment? The Modern Portfolio Theory is based on maximizing return for a given risk tolerance based on the portfolio as a whole. Risk cannot be avoided, but instead can be managed, by allocating risk among different asset classes.

The trustee's investment advisor will offer statistical analysis regarding historical returns of different asset classes in order to determine a *suitable* portfolio allocation. "Suitability" is a term of art. It is a measure of appropriateness between asset allocation and a client's risk tolerance. This process is based on probabilities, not predictions as to which combination of asset classes will yield a desired return.

Tax status may also affect the assets selected by a trustee. The marginal income tax rate at the trust level is much higher than for

individuals. Generating too much income taxed at the trust level may trigger unnecessary income tax consequences. In 2008, a trust will reach the maximum income tax rate (35%) if the trust earns \$10,700 or more income annually. By contrast, the maximum (35%) rate for single individuals is not reached until the income level is \$335,700. If there is no requirement to make income payments to beneficiaries, the trustee may want to consider tax-free municipal bonds. The trustee's financial advisor can offer advice about the issuing agency's ratings.

Market Factors In addition to client factors, the trustee must also consider the current state of the economy. What types of assets offer protection against inflation? What are the market assumptions to should consider when designing a portfolio? Should the trustee consider refinancing promissory notes when the Applicable Federal Rate (AFR) has dropped substantially?

The trustee should be aware of changes in the economy and how such trends may affect an investment policy statement. What has been a good investment strategy in the past may not be a prudent investment philosophy today. The trustee should monitor investment returns and make adjustments to a portfolio when necessary. The IPS will provide a tool for the trustee to make decisions based on a systematic investment process rather than reacting to current market conditions out of fear. A trustee may delegate the investment duty to a "qualified" investment advisor. However, the trustee still has a duty to review and monitor the portfolio performance at least annually.

Trustee Beware A trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to invest as prudent investor would. A trustee must exercise reasonable care, skill and caution. The consequence of not acting prudently is illustrated by the following example.

In 1995, a grandmother served as successor trustee for her granddaughter's trust. JANE had a great relationship with her granddaughter SALLY. JANE wanted to make sure she invested wisely so that the trust would grow and pay for SALLY's college education. JANE hired an investment advisor who helped allocate her investment portfolio.

JANE was heavily invested in small cap assets predominantly in the technology sector. After historic gains in the 1990s the NASDAQ (small cap technology sectors especially) suffered devastating losses in 2000-2003.

The investment choices made by JANE and her advisor resulted in substantial losses to SALLY's inheritance. JANE was sued for breach of fiduciary duty because she was over weighted in the technology sector. Her failure to diversify led to a substantial loss of trust assets held in the investment portfolio. JANE was personally liable and required to pay damages to SALLY for the amount of the loss.

This is a good illustration of the problems trustees can encounter in investing. Trustors should keep this example in mind when nominating successor trustees. Many people nominate a trusted family member rather than focusing on the skills, competency and time necessary to manage trust assets appropriately.

Conclusion The trustee is not strictly liable for a portfolio's performance. The trustee does not have to predict investment returns. But a trustee can be liable if he or she does not invest prudently. By creating an IPS, the trustee can invest systematically in order to maximize a return for a given level of risk.

We strongly encourage trustees to draft an IPS in order to improve the investment process and provide some protection against a claim of breach of fiduciary duty. Any investor, but especially a trustee, should always manage risk against the desired return of a portfolio.

WHICH FINANCIAL RECORDS SHOULD YOU KEEP?

MARY J. PESHEL, ESQ.



Now that tax season is over, you might be considering some Spring cleaning of your paperwork. While it may not be necessary to retain *every* bill, statement, and receipt, there are certain financial documents, such income tax returns, W-2 Forms and other income statements, which you should keep. The

following are some guidelines to consider:

Income Tax Returns: Keep in mind that the IRS can audit tax returns beyond three years in certain circumstances. It is recommended that you retain your income tax returns for *at least* seven years, as well as the supporting documents used to substantiate each return, including W-2 Forms and other income statements. The income statements can also be used to verify the information provided on your annual Social Security earnings statements.

Brokerage/Mutual Fund Statements: You should retain documentation for the *entire* period you hold an investment. The statements will assist you with calculating and verifying your cost basis for any sale of the investments. Once an investment has been sold, it is advised that you retain the statements for at least three years from the date you filed the income tax return which reported the sale.

Receipts: Keep the receipts and warranty records for big-ticket items, such as jewelry, computers, and major appliances to prove the value or verify the warranty in case of loss or damage.

Documents/Receipts Related To Your Home: While you own your home, certain expenses will affect your home's basis. Home improvements are a common example. When you sell your home, you need to know your basis in order to determine any gain or loss for tax purposes. In order to calculate the basis, several key documents and/or receipts are needed.

Certain selling expenses increase your home's basis. You should retain documentation for commissions, advertising fees, legal fees, and loan charges paid by you (as the seller), such as loan placement fees or "points." Additionally, when you bought your home, you may have paid settlement fees or closing costs above the purchase contract price of the property. Most of these expenses are included in the Final Closing or Settlement Statement from the escrow or title company that handled the purchase and sale.

Carefully distinguish which fees and costs can be added to your basis. You can include in your basis some of the settlement fees and closing costs you paid for buying the home. You cannot include in your basis the fees and costs for obtaining a

mortgage loan or amounts placed in escrow for the future payment of items, such as taxes and insurance.

Some of the settlement fees or closing costs that you can include in your basis are abstract fees (abstract of title fees), charges for the physical installation of utility services, such as a water or electric meter (this does **not** include any fees you paid to the utility company to turn on or activate your service where the meter or services are already in existence), legal fees (including fees for the title search and preparing the sales contract and deed), recording fees, survey fees, transfer or stamp taxes, owner's title insurance, and any amounts the seller owes that you agree to pay as part of the purchase, such as certain real estate taxes, back interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions. A fee paid for buying the home is any fee you would have had to pay even if you paid cash for the home (that is, without the need for financing). A number of these fees will be included in the Final Closing or Settlement Statement from the escrow or title company, but others may be receipts or invoices. All of these documents should be retained to document the expenses paid.

If you contracted to have your house built on land you own, your basis is the cost of the land, plus the amount it cost you to complete the house, including the cost of labor and materials, any amounts paid to a contractor, any architect's fees, building permit charges, utility meter and connection charges, and legal fees directly connected with building the house. All contracts, invoices, change orders, billings, and other expense documents should be retained.

If you built all or part of your house yourself, the basis is the total amount it cost you to complete it. You should retain all paperwork in regard to the cost of materials and labor. However, you cannot include in the cost of the house the value of your own labor, or the value of any other labor you did not pay for.

Other items that are considered increases to your basis are additions and other improvements that have a useful life of more

than one year, special assessments for local improvements, and amounts you spent after a casualty to restore damaged property (in excess of any amount collected from insurance).

You should retain receipts and invoices for any improvements or restorations you have made to your home. These add to the value, prolong its useful life, or adapt it to new uses, thus increasing the basis of your property. Examples of improvements are additions to your home, such as a bedroom, bathroom, deck, garage, porch, patio, heating & air conditioning, pipes and duct work, central humidifier, filtration system, lawn, grounds, and landscaping, driveway, walkway, fence, retaining wall, sprinkler system, swimming pool, storm windows and/or doors, new roof, central vacuum system, wiring upgrades, non-removable satellite dish, security system, plumbing, septic system, water heater, soft water system, water filtration system. Certain improvements to the interior of home can also increase your property basis, such as built-in appliances, kitchen modernization, flooring, wall-to-wall carpeting, wall, floor and/or attic insulation.

Keep in mind that when you remove and replace improvements, such as carpeting, your home's adjusted basis does not include the cost of any improvements that are replaced and are no longer part of the home. When you replace carpeting you would no longer need to retain the receipt for the original carpeting, as it is no longer a part of the home. You would only retain the receipt for the current carpet. Also repairs made to maintain your home in good condition do not increase the basis of your property. For example, if you repaint your home, fix the gutters, and repair leaks or plastering, those are only considered repairs. However, the entire job is considered an improvement if the items that would otherwise be considered repairs are done as part of an extensive remodeling or restoration of your home.

You should keep all records which provide proof of the home's purchase price and purchase expenses, and receipts and other records for all improvements, additions, and other items to prove your home's adjusted basis. Ordinarily, you must keep records for at least three (3) years after the due date for filing your return for the tax year in which you sold your home, but if you sold a home

before May 7, 1997, and postponed paying tax on any of the gain, the basis of the prior home affects the basis of your new home. You should keep records proving the basis of both homes as long as they are needed for tax purposes.

The selling price of your home does not include amounts you received for personal property sold with your home, such as furniture, draperies, rugs, a washer and dryer, and lawn equipment. Personal property is any property that is not a permanent part of the home. A built-in oven or microwave would be considered a permanent part of the home, but a removable range or a refrigerator is not.

If you would like to receive further information regarding the topics in this newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or newsletter@mmpph.com.

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