

credit to which this section applies shall be reduced by six dollars (\$6) for each two thousand five hundred dollars (\$2,500) or fraction thereof, by which the taxpayer's federal adjusted gross income exceeds the threshold amount." (Underline added)

When applying the phaseout amount, you must apply the \$6 amount to each credit, but do not reduce any credit below zero. (R&TC Sec. 17054.1(a)(4)) So, if a personal exemption credit is less than the phaseout amount, do not apply the overage against a dependent exemption credit. The FTB has advised us that they are changing the worksheet in the instructions to reflect this change.

Example of Exemption Credit Phaseout

Joe is a single taxpayer with one dependent. His federal AGI is \$152,000. He must phase out each of his exemptions by \$90. That is: $(\$152,000 - \$116,777) \div \$2,500 = 15$ (rounding up); $15 \times \$6 = \90 . His exemption credits for 1998 are:

Joe's personal exemption	\$70
Less phaseout amount	(90)
Exemption allowed	\$0
Joe's dependent's exemption	\$253
Less phaseout amount	(90)
Exemption allowed	\$163

Joe may claim \$163 in exemption credits for 1998.

— Lynn Freer

Irrevocable Trusts

California's prudent investment requirements

Two types of irrevocable trusts — a QTIP and an exemption trust — often start as a revocable trust set up by a married couple while both are alive. Then, one of them dies. It is then the duty of the trustee, often the surviving spouse, to invest trust assets in a prudent manner, which may differ from the historic investment strategy of the deceased spouse.

It is not enough for the new trustee to simply gather the trust's assets, collect its income, pay its expenses, file its tax returns and make distributions. Within a reasonable time of becoming a trustee, the trustee must also review the trust's assets and make and implement decisions to bring the trust portfolio into compliance with the purposes, terms, distribution requirements and other circumstances of the trusts and the trust law. (Cal. Probate Code Sec. 16049)

Investing

When deciding how to invest the portfolio, the trustee has a duty to diversify the investments, unless, under the circumstances, it is prudent not to do so. (Cal. Probate Code Sec. 16048) Thus, unless the trust states that the trustee can retain the trust's historic assets, the trustee must act prudently and diversify the trust's investments if they are not diverse. This prudent-person standard is determined in light of the facts and circumstances existing at the time of the trustee's decisions and "not by hindsight." (Cal. Probate Code Sec. 16051)

When making prudent investments, the trustee cannot act in isolation. Rather, investments should be made considering the portfolio as a whole and the risk and return objectives reasonably suited for that trust. California law states that among the circumstances that are appropriate to consider in light of the trust's beneficiaries are:

- ◆ General economic conditions;
- ◆ Inflation or deflation;
- ◆ Expected tax consequences of investment decisions;
- ◆ Each investment within the overall context of the trust portfolio;
- ◆ Total return from income and appreciation;
- ◆ Other resources of the beneficiaries known to the trustee as determined from information provided by the beneficiaries;
- ◆ The needs for liquidity, regularity of income, preservation or appreciation of income; and
- ◆ The assets' special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries. (Cal. Probate Code Sec. 16047(c)(1)-(8))

Diversifying

The problem with the trust law is that the above list of criteria seems to add more complexity than if none were provided. For example, if the trust consists

primarily of stock of one publicly traded company, it would be easy to sell the stock and diversify the investments through a mutual fund or similarly diversified investment. The problem is, which mutual fund is proper and how much diversification is required? Can mutual funds be the exclusive investment, or must the portfolio also consist of bonds, foreign stocks, REITS and life insurance? Good questions; tough answers, since it will depend on the size of the trust and the needs of the beneficiaries.

The tax aspects of diversification may be simple following a spouse's death, since most assets (except income in respect of a decedent) will have a fair market value basis and no gain or loss will occur if the assets are sold. As time passes, however, and values change, gain or loss will result if assets are sold in order to diversify the portfolio.

A trustee may have a difficult time diversifying if the trust consists solely of one major asset, such as a limited partnership interest or a closely held business, which is difficult to sell. A similar problem exists if the family residence is the trust's major asset. In the absence of proper guidance in the trust instrument, is a trustee required to sell the real estate at a discount in order to diversify or sell the family residence causing the surviving spouse to move into an apartment?

These questions do not appear to have simple answers, and there is only limited guidance in the law. Some is provided by Restatement (Third) of Trusts (Prudent Investor Rule) (1992).

The balancing act

Even if the trustee can diversify, how should the interests of the current-income beneficiary (the spouse) balance with the remainder beneficiaries, e.g., the children? This is a difficult problem absent instructions in the trust. Remember, investments must be made after considering all beneficiaries, not just the surviving spouse.

There is a solution for a trustee who feels that implementing a prudent investment strategy may be beyond his or her ability: Hire an outside advisor. The law states that a trustee may delegate the investment and management functions as long as he or she:

- ♦ Uses prudence in selecting the agent;
- ♦ Ensures that the scope and terms of the delegation are consistent with those of the trust; and

♦ Reviews periodically the agent's overall performance and compliance with the terms of the delegation. If the trustee follows these three steps, he or she will not be liable to the beneficiaries or to the trust for the decisions or actions of the chosen agent. (Cal. Probate Code Sec. 16052(c))

It is important to understand that the prudent-investor standards apply to all trustees, unless the trustee is also the grantor of a revocable trust. Thus, the next time you prepare a tax return for an irrevocable trust or even a revocable

trust in which the trustee is not the grantor, consider whether the portfolio is invested prudently given the terms of the trust and California law. If it appears that the proper investment standards have not been followed, you

may want to discuss these issues with the trustee, if the trustee is your client. If there is a potential problem, solutions are probably best provided by the attorney who drafted the trust or the attorney who represents the trust.

—Richard B. Malamud

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LLC and Partnership Law Changes

On August 3, 1998, Governor Wilson signed AB 1703 (Ch. 98-243), making several changes to conform California LLC law to federal law and the California check the box regulations. These changes affect the dissolution of LLCs and admission of limited partners.

Term of LLC changed

Effective January 1, 1999, Form LLC-1, **Articles of Organization in California**, filed with the Secretary of State will no longer be required to state a dissolution date for the LLC. Under prior law (continuing