DON'T FORGET THE PICASSO: 7 TIPS FOR ESTATE PLANNING WITH NONCASH ASSETS

By Caroline A. Camougis

Growth in the value of real estate and personal property, such as art and antiques, has resulted in these assets becoming a major component of your client's net worth. The beach house purchased twenty years ago for $75,000 may now be worth well over $1 million, the Picasso lithograph bought at auction for $5,000 may be valued today at over $80,000 or the Early American chest acquired for $2,500 may now be worth upwards of $10,000.

In fact, today, 50% or more of an individual's net worth is likely to be invested in real estate and in other personal property such as art and valuable collectibles.

- Real estate is a major component of the US economy, and a significant portion of real estate is privately held – estimates range from $24 trillion to over $40 trillion. According to the National Association of Realtors, one in ten individuals own two residential properties and one in twenty-five own three or more properties. Further, over 22% of all homes purchased in 2006 were for investment purposes and more than 14% were for vacation homes.

- *World Wealth Report 2007* issued by Cap Gemini and Merrill Lynch noted that an increasingly important component of a portfolio is "investments of passion" which include luxury collectibles (e.g., cars, watercraft, aircraft), jewelry, art, sports-related investments (e.g., race horses, professional teams) and other collectibles (antiques, wines, coins, etc.). Billions of dollars are spent annually on these investments and they are increasing. In the art market alone, in 2006, global public auction sales surpassed $6.4 billion, and auction houses like Sotheby's and Christie's reported their highest-ever annual revenues (Artprice.com).

With a significant portion of wealth invested in tangible assets, it is important that your clients give these assets the same consideration as their financial investments in their estate plans. Without properly accounting for real estate and other personal property, a range of challenges can result: an estate may be forced to sell assets at fire-sale prices to pay estate taxes, the estate may end up paying considerably more in taxes than necessary or the estate may be forced to liquidate assets that it wants to keep or keep those it wants to sell.

An estate plan is built around personal and financial goals. These goals generally revolve around four fundamental concerns for the individual: 1) Lifestyle – how can the current lifestyle be maintained? 2) Family – how can family be adequately cared for? 3) Charity – how can favorite nonprofit organizations be supported? 4) Taxes – how can income, capital gains, estate and wealth transfer taxes be minimized? Once these goals are articulated, professional advisors such as an attorney, accountant, or financial planner can develop an estate plan that meets one's objectives.

In order to effectively address noncash assets in estate planning, there are seven steps:

1) Inventory real estate and personal property
2) Professionally appraise the property
3) Determine the cost of maintaining the property
4) Identify which real estate and personal property, if any, should be sold or transferred
5) Factor the property's value and ultimate disposition into an estate plan
6) Determine the best way to dispose of the asset to fulfill estate plan goals
7) Take note of IRS guidelines

#1 THE INVENTORY – WHAT DO I HAVE?

Portfolios of stocks, bonds and other financial assets, such as IRAs, 401Ks, and insurance policies are routinely incorporated into an estate plan, as are primary and secondary residences. But, other real estate such as land, or personal property such as art, are often not considered. So the first step is to inventory all real estate and personal property. A listing of real estate holdings should include residential and commercial property as well as land; note that both wholly-owned property as well as partial interests should be detailed. An account of personal property should include watercraft, cars, art, antiques, decorative objects, rugs, porcelain and silver as well as collections, such as stamps, coins and rare books. Inventories must be comprehensive so that items of significant value are not overlooked.

Elizabeth von Habsburg, President of Gurr Johns, the leading art appraisal and advisory firm based in New York City recalls a recent situation in which their firm was called in to appraise and oversee the sale of the contents of an apartment in Manhattan. The contents were part of a modest estate, and the proceeds were to go to charity. "When we spoke to the attorneys, they indicated that the decedent had mentioned a mantle clock that was the most valuable item in the estate. Upon examining the clock, we found it to be worth under $100. However, hidden in a dark hallway, we discovered an unknown major Old Master painting by Lodovico Carracci, which we arranged to be sold at auction on behalf of the estate. The painting brought $1.8 million. If the decedent had had an appraisal done prior to death, she might have allocated her resources differently."

#2 THE APPRAISAL – WHAT IS IT WORTH?
Once the real estate and personal property have been inventoried, it should be appraised professionally to get an objective valuation. Financial investments are evaluated periodically, but this is not often the case with tangible personal property. Even if your client has provided you with an inventory and evaluation of the assets, consider how current the valuations and if they are Fair Market Value (FMV) appraisals.

There are different types of valuations for property, which serve different purposes. In general, for estate, gift and income tax purposes, property valuations are based on Fair Market Value (FMV). As defined by the IRS, Fair Market Value (FMV) is the price that property would sell for on the open market between a willing buyer and seller, with neither being required to act and both having reasonable knowledge of the relevant facts. Valuations that often cause challenges with estate planning and estate settlement are Assessed Value for real estate and Replacement Value for personal property. Assessed Value is the value placed on real estate by a public tax assessor for purposes of taxation and it is generally less than FMV. Valuable personal property often has an appraisal for Replacement Value, which as defined by the IRS, is the amount it would cost to replace an item with one of similar and like quality purchased in the most appropriate marketplace in a limited amount of time. Replacement Value is generally the highest valuation for personal property and is applied most commonly to insurance policies. For estate planning purposes, always request an FMV appraisal for both real estate and personal property.

To ensure an accurate appraisal consult only with qualified professionals. The IRS has specific guidelines governing appraisals, which include obtaining a "qualified appraisal" made by an independent "qualified appraiser". For detailed information on these guidelines visit www.irs.gov. Additional resources for information about appraisals and for referrals are the following three professional associations:

- American Society of Appraisers (www.appraisers.org) – for real estate and personal property
- Appraisal Institute (www.appraisalinstitute.org) – for real estate only
- Appraisers Association of America (www.appraisersassoc.org) - for art and select personal property only

For estate tax purposes, the IRS requires that appraisals are submitted with the estate tax return for single items worth more than $3,000 or for a collection of similar items valued at more than $10,000. For gifts of art and other collectibles that are valued at $20,000 or more, the IRS will consult its Art Advisory Panel. Comprised of art experts from many disciplines, the Panel meets several times a year to review art appraisals submitted with tax returns. The Panel is empowered to make adjustments to the appraisals and will often do so for overvaluing donations of art to nonprofit organizations or for undervaluing property left to heirs. As noted in the March 23, 2006 issue of the *Chronicle of Philanthropy*, almost 25% of all appraisals reviewed by the Art Advisory Panel in 2005 were adjusted. These adjustments exceeded $60 million. So getting an accurate appraisal and keeping it current is critical. The market for personal property changes frequently, and if property is worth more than expected, the estate may bear additional tax liability. Professional appraisers can provide guidance on how frequently appraisals should be updated.

#3 THE BOTTOM LINE – WHAT IS THIS COSTING ME?

Once the inventory and appraisals for property are completed, the next step is to determine ongoing carrying costs.

While financial investments involve little expense and generally create positive cash flow, the same cannot be said of real estate and personal property. Tangible assets require active management and expense – property maintenance, taxes, insurance and sometimes storage – creating a negative cash flow.

Roberta Zuckerman, Senior Private Banker at First Republic Bank has worked with many clients who own noncash assets that are expensive to maintain and who need advice on how to manage these assets in terms of cash flow and estate and financial planning. "I remember when one of my clients purchased an airplane for the first time. He had not researched the annual costs, which included insurance, ongoing maintenance for the plane, financing costs, and hangar expenses, which ran hundreds of thousands of dollars per year. In addition, it cost over $6,000 an hour to simply fly the plane. Despite the emotional attachment to the plane, he ultimately realized that his usage did not justify the expense. It is always important to understand what the carrying costs are, even if they are pricey, at least it is clear where the money is going."

#4 CLEANING HOUSE – DO I WANT TO KEEP IT?

Now that your clients understand the value and carrying costs of their real estate and personal property, an analysis is needed. What role are these assets playing in their overall wealth management strategy?

Unlike financial investments, real estate and personal property often carry an emotional and sentimental attachment, and a decision to transfer property either while living or through a bequest can be difficult. Is the property a family heirloom? Should the property remain within the family? Should it be sold or gifted? If gifted, to who or what organization and under what circumstances? If the property is a collection, should it be kept together or separated?

Taking property that is no longer used or wanted out of an estate will reduce estate taxes and generate positive cash flow since ongoing carrying costs for the property will be eliminated through sale or transfer. Further, during retirement years, having additional liquidity is very important. Whether the funds are used to travel, pursue an avocation, support family members, pay medical and education bills, or even cover unplanned expenses, having cash available is critical – before it is needed.

Therefore, your clients should decide which property they currently enjoy so much they want to keep and which property they will dispose of. The following questions can help your clients with these decisions:

- Do I own property that I don't use very often?
- Do I have a piece of property that I no longer enjoy as much as I once did?
- Do I have property that is difficult or expensive to manage?
- Do I own property that is highly appreciated and will I owe significant capital gains taxes if I sell?

Answering "yes" to any of these questions, may indicate that disposing of property and taking it out of the estate makes sense.

Disposing of noncash assets always requires careful consideration, especially if the property is highly appreciated. Note that if one decides to dispose of assets before death, selling may not be the optimal way to do so. Determining a tax-efficient disposition strategy is critical so that the gain is not eliminated through taxes and other related expenses. See *Smart Planning* below for strategies on asset disposition. What the client keeps will be part of the estate and factored into the estate plan.

#5 THE ESTATE PLAN – WHO GETS WHAT?

With a clear picture of your client's assets – inventory, value, carrying costs as well as an indication as to which assets will be kept during life and which will be disposed of – the critical inputs for the estate plan are ready. How the client's net worth is distributed among financial assets, real estate and other personal property will also impact the development of the estate plan.

There are three main federal wealth transfer taxes: the gift tax, the estate tax and the Generation-skipping transfer tax (GST). The gift tax is imposed on a donor who gifts property to an individual, and the exemption is currently $1 million over a lifetime. Indexed for inflation, the annual gift tax exclusion for 2008 is $12,000 per individual and $24,000 per couple. The federal government also imposes an estate tax on all property in excess of $2 million passing from an estate to heirs. Estate taxes are hefty: under current tax law, estate assets (real estate, art and other personal property) are subject to a tax rate of 45% in 2008. The rate will drop to zero in 2010 and increase to 55% in 2011. Estate taxes are due in cash within nine months of death. This can pose problems for an illiquid estate such as necessitating a forced sale of the assets to pay taxes. Transfers of assets to grandchildren and other transfers that skip a generation are subject to GST in addition to any applicable gift or estate tax. Like the estate tax, the GST tax exemption is currently $2 million. Note as well that some states also have their own wealth transfer taxes, and these vary widely.

As noted previously, professional advisors create estate plans that take into account the client's goals for lifestyle, family and charity, in a tax-efficient manner. However, for clients with a significant portion of their net worth in noncash assets, fulfilling their estate planning goals can be challenging. Individuals typically indicate that they want to treat all their children equally, by leaving them the same amount of money or property of equivalent value. However, each child's financial situation will be different – a child earning a comfortable salary might be better off receiving a piece of property with money for carrying costs. And a child with erratic earnings may be better off receiving income from a trust. So each child's situation, along with the value and carrying costs of the real estate and personal property that they will inherit – and their tax liability – should be considered.

#6 SMART PLANNING – PROPERTY DISPOSITION STRATEGIES

One of the principal objectives and benefits of estate planning is reducing capital gains, estate, gift and other wealth transfer taxes. Clients with a significant portion of their net worth in appreciated assets can eliminate the gain through poor or no planning. Long term capital gains (property held for more than one year) is currently taxed at 15% for real estate, 28% for art and collectibles and 25% for real estate with depreciation deductions.

So what strategies are available for disposing of appreciated real estate and personal property? For transfer of assets to noncharitable beneficiaries in particular, there are several trust structures that will reduce the estate and minimize wealth transfer taxes. These include the grantor retained annuity trust (GRAT), the defective grantor trust (DGT) and the intentionally defective grantor trust (IDGT). Though complex, these trust structures can work well for assets that are expected to appreciate quickly or for those assets that generate income. Professional advisors can guide their clients on the benefits and risks, as well as the suitability of these structures based on the client's circumstances. One of the most common and effective disposition strategies incorporates a charitable beneficiary and involves funding charitable gifts or fulfilling pledges to a nonprofit organization or academic institution with a gift of appreciated property.

Depending on the nature of the gift, donors can, potentially:

- Avoid capital gains taxes due on the sale of property
- Reduce income taxes
- Reduce estate taxes
- Receive an annual income

- Eliminate the burden of maintaining and paying for property
- Avoid real estate transfer taxes
- Donate a home while continuing to live in it for life
- Create a significant legacy

These financial and tax benefits have contributed to increasing interest in property donations. Because these donations are growing steadily, the IRS has started tracking these gifts. According to an IRS report published in 2006, over $5.9 billion of real estate and $829 million of art and collectibles was donated to nonprofits in 2003.

Gifts of property, while motivated by charitable intent, have tax and financial planning implications. Real estate, art and personal property can be donated in many ways, from an outright gift to a charitable trust, depending on the donor's needs and objectives. An overview of five principal ways to gift noncash assets, along with details on the attendant tax and other financial benefits follows.

	Client Goal	**How it Works**	**Potential Benefits**
Outright Gift	Eliminate the burden of maintaining a property that is no longer wanted or needed.	Donor transfers the property to a nonprofit organization.	Receive a charitable tax deduction for the property's appraised value. Avoid capital gains taxes. Remove property from the taxable estate.
Charitable Remainder Trust	Diversify assets and benefit from additional income.	Donor transfers the property to a Charitable Remainder Trust, which sells the property. The donor receives an income payment for a set period of time or for the life of the donor. Upon the donor's death, the trust's assets are transferred to the nonprofit.	Receive an annual income. Receive a charitable tax deduction for a portion of the property's value. Avoid capital gains taxes. Remove property from the taxable estate.
Retained Life Estate	Continue to live in the donated property for life	Donor transfers ownership of the property to a nonprofit, but retains the right to live in the property for a specified period of time – often for the life of the donor and spouse.	Receive a charitable tax deduction for a portion of the property's value. Avoid capital gains tax. Remove property from the taxable estate.
Bargain Sale	Eliminate the burden of mortgage payments,	Donor sells property for less than appraised or	Receive a charitable tax deduction based on the

	taxes and other maintenance	fair-market value, often for the cost of an outstanding mortgage.	difference between the Bargain Sale price and the appraised value. Reduce capital gains tax Remove property from the taxable estate.
BEQUEST	Continue use of and control of property for life.	Donor bequeaths the property to a nonprofit in his or her will.	Receive an estate tax deduction for the amount of the gift.

Please note that the examples above are based on applicable federal tax regulations, which can change, and a number of simplifying assumptions (e.g., that the property involved would generate long-term capital gains).

Two of the most common ways to donate property are outright gifts and charitable remainder trusts.

According to tax attorney Sam Mawn-Mahlau, a partner at Edwards Angell Palmer Dodge, "An outright gift of a $250,000 collectible can allow for a $250,000 charitable deduction, the avoidance of federal, state and local capital gains taxes and a reduction in the value of the donor's taxable estate, whereas an outright gift of cash only provides the benefit of a charitable tax deduction for the gift's value. Consider the following example. Mr. Smith donates a painting to a museum appraised at $100,000 which he had acquired for $25,000 a number of years ago. Generally, in a 35% income tax bracket, his tax deduction is likely to be worth about $35,000 (35% of $100,000). The tax gain had he sold the painting would have been about $21,000 (28% of $75,000). He pays $56,000 less in taxes than if he had sold the painting, so the real cost of the gift is just $44,000."

Charitable Remainder Trusts (CRTs) can also generate tax savings, reduce a client's taxable estate, and, produce income. "Increasingly clients are utilizing CRTs to increase both retirement income and estate tax liquidity," observes Kelly Welles, Managing Director of Welles Financial Services, specialists in life insurance strategies. "Indeed, a CRT coupled with a wealth replacement trust can be a powerful solution for clients who wish to simultaneously generate income during retirement, provide for their favorite charity at death, and replace the asset passed to charity to ensure that their children receive their share of the estate. An effective liquidity solution involves the creation of the irrevocable life insurance trust (ILIT) and the purchase of life insurance inside the trust to provide estate liquidity. To replace the assets that pass to charity, a wealth replacement trust can be created and funded with life insurance with the children as beneficiaries of the trust."

Almost any type of real estate, whether located in the U.S. or abroad, can be offered for donation. Such properties include: Single-family homes, apartments, condominiums and cooperatives, multi-family homes, vacation homes, undeveloped land, commercial properties, such as office buildings, shopping centers and farms, ranches and vineyards and industrial property. Personal property donations can range from art, antiques and collectibles to classic cars and watercraft. Not all nonprofit organizations are interested in receiving gifts of noncash assets, but the more innovative organizations are in order to accommodate donors who may not have the liquidity to make a large gift but who have valuable assets. For these organizations, such gifts are truly "found money" – gifts that would or could not otherwise be made.

Note that real estate can be donated to almost any type of nonprofit and the fair market value of the property will be the basis of the charitable tax deduction. For personal property, however, the IRS differentiates assets that are "for the benefit of" a nonprofit organization from assets that are "for the use of" a nonprofit organization. A donation that is "for the use of" an organization has to be relevant to its purpose (e.g. a painting given to a museum). For these gifts, the donor can deduct the fair market value. A donation that is for "the benefit of" an organization is not relevant to its purpose (e.g. a painting given to a cancer research organization that would sell the painting). For these gifts, the donor can deduct only the original cost basis.

#7 IRS REPORTING

And finally, let's not overlook the IRS. The IRS has many guidelines regarding donations of noncash assets. A gift of real estate or personal property worth more than $5,000 must have a qualified appraisal if the donation is to be claimed as an income tax charitable deduction. The IRS also requires that Form 8283, *Noncash Charitable Contributions* be filed. This Form is completed by the donor, appraiser and recipient organization. Note that the recipient nonprofit organization must also file Form 8282, *Donee Information Return*, if it sells the gift of property. For complete information and for advice concerning specific filing requirements, rely on tax experts or contact the IRS at www.irs.gov. IRS publications that are particularly useful include: IRS Publication 950, *Introduction to Estate and Gift Taxes*, IRS Publication 526, *Charitable Contributions*, and IRS Publication 561, *Determining the Value of Donated Property*.

Today's rapidly changing markets for real estate, art and other valuable collectibles present challenges for estates with substantial noncash assets. The value assigned to an item in an estate for gift tax purposes can be significantly higher than the ultimate selling price if the market subsequently declines. Further, the pressure to pay estate taxes within nine months may not leave enough time to maximize the value of the assets that are to be liquidated. As a result, the estate may end up paying more in estate taxes than necessary or it may be obliged to sell assets it wants to keep or keep those it wants to sell. By accounting for and properly valuing client assets and by developing effective disposition strategies, these issues can be minimized.

So don't forget the Picasso!

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