NATIONAL CAPITAL GIFT PLANNING COUNCIL

15TH ANNUAL PLANNED GIVING DAYS
WASHINGTON, D.C.

GIFTS OF TANGIBLE PERSONAL PROPERTY

10:15 a.m. – 11:30 a.m.
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Key Bridge Marriott
Arlington, Virginia

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I. Gifts of Tangible Personal Property

1. Deductibility of gift of tangible personal property (for example, art or other collectibles) deductible at fair market value only if gift is deemed as being made for a related use. If gift is being deemed for an unrelated use, gift is limited to cost basis.

2. See special rule of Code Section 170(a)(3) below.

3. Transfer of Tangible Personal Property to Remainder Trusts. Is A Puzzlement!

A. Code Section 170 (a) (3):

Future Interests in Tangible Personal Property -- For purposes of this section, payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession of enjoyment of, the property have expired or are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in section 267(b) or 707(b). For purposes of the preceding sentence, a fixture which is intended to be severed from the real property shall be treated as tangible personal property."

B. The Krugerrand Rulings:

(1) LTR 9225036 held that appreciated in value Krugerrands are more like money than collector's coins (tangible personal property), thus the deduction for a transfer to a CRT would be based on full fair market value -- not cost. The Service also said that funding an otherwise qualified CRT with Krugerrands would not disqualify the trust. And, since the coins were not tangible personal property, the rules of IRC Section 170 (a)(3) won't apply.

(2) A second Kruggerand ruling submitted some nine months later, which was withdrawn because of the tax payer's death, appeared to indicate that IRS had changed its mind.

C. LTR 9452026 held that funding a CRT with an appreciated musical instrument is OK.

(1) IRS did not rule on the qualification of the trust referring to its Revenue Procedures containing specimen CRT documents.

(2) Since the instrument is tangible personal property, no income tax deduction is allowed under IRC Section 170 (a) (3). A deduction is allowed only when it is sold.

(3) It's an unrelated use gift and, therefore, the income tax contribution deduction is based on cost, not fair market value.

D. A dilemma, what to do?

II. A CASE STUDY

1. BACKGROUND. Donor, a widower, had amassed a significant collection of Italian baroque art with a estimated fair market value of over $30 million. Donor's strong desire was to keep the collection intact; but, he also wished to take care of his only child, her husband and their two children. The family was concerned with the potential substantial estate tax bite which would require an auction sale of the art to pay estate taxes and expenses, since the art constituted the bulk of the estate.

2.. THE ADOPTED PLAN. The art was transferred to a revocable trust of which Donor and his daughter were trustees with daughter's husband as successor trustee. At his death, the trust became irrevocable and its assets – basically the art -- were divided into two equal shares:

A. The first share was placed into a net income with makeup unitrust paying a unitrust amount of the lesser of (i) 5% of the fair market value of the trust assets, as revalued annually and (ii) the actual unitrust income. Any deficiencies in distribution from an earlier year would be made up in any later year where the trust income exceeded the stated 5%. The trust term was 20 years; the beneficiary was Donor's daughter or, if she died during the 20 year trust term, her children. The trustees have the power to name the charitable remainder organization.

B. The second share was placed into a charitable lead annuity trust paying an annuity amount equal to 8% of the initial fair market value of the assets placed in trust; the trust term was 20 years; the charitable beneficiaries were to be selected by the trustees; the trust remainder was payable to Donor's daughter or, if she was not then living, to her children.

The plan would:

(1) Generate substantial estate tax charitable deductions for the remainder and lead charitable interests;

(2) By having the ability to designate the charitable beneficiaries, give the trustees leverage to negotiate;

(3) Generate significant income for daughter and her children;

(4) Would keep the collection intact if a museum purchaser could be found.

3. THE HAPPY ENDING. Agreement was reached with a art museum to sell the collection for its true fair market value.

A. Twenty percent went to the revocable trust which used the proceeds to pay administration and other expenses and to pay back a loan which was used to pay estate taxes.

B. Forty percent went to the unitrust, paid with tax exempt paper issued by the University, and generating a tax free income stream to daughter which included, of course, the make up of the deficiencies from the date of death.

C. Forty percent went to the charitable lead annuity trust with interest and principal payments sufficient to satisfy the annuity amount payable to charity while leaving an excess to reinvest and create a remainder fund for the daughter or her children.

The entire collection goes to the University Art Museum with the bulk to be hung in a new building and part to be used for educational purposes.

The University is designated charitable beneficiary and since it will now receive the remainder of the unitrust and the annuity amount stream from the lead trust, it's cost of acquiring the art has been significantly reduced. It receives over $30,000,000 in art value at a cost of $10,000,000 to $14,000,000 in present value terms.

III. Estate Tax Savings for Testamentary Plan - - Follow Up to Case Study Above

1. An extremely simplified example of the horrific estate tax on the death of a surviving spouse (or, for that matter, a single person).

H has $5,000,000 estate. His wife W has a $5,000,000 estate of her own. H gives an amount equal to the equivalent exemption to his children and the balance of his estate is set up in such a way as to obtain the unlimited marital deduction. H dies in February 2007; his wife then dies later in 2007, leaving her entire estate to their children. Here is what the estate tax computations would look like:

H's Estate		
Gross estate		$5,000,000
Less: Estimated expenses -- at 5%	$ 250,000	
Marital deduction -- balance of estate less $2,000,000 federal exemption amount	$2,750,000	$3,000,000
Taxable estate		$2,000,000

Tentative federal estate tax	$ 780,800
Less: Applicable credit amount	$ 780,800
Federal estate tax	-0-

W's Estate

Her separate assets	$5,000,000
Marital share from H	$2,750,000
Gross Estate	$7,750,000
Less: Estimated expenses -- at 5%	$ 387,500
Taxable estate	$7,362,500
Tentative federal estate tax	$3,247,550
Less: Applicable credit amount	$ 780,800
*No state death tax credit available as of 2005	
Federal estate tax	$2,466,750

2. Integrating Split-Interest Charitable Gifts Into the Estate Plan to Save Estate Tax

Assume that W is charitably inclined. Her Will divides her estate into two parts. With the first part, she creates a 6% charitable remainder unitrust (furnishing a potential hedge against inflation) providing payments to her children in equal shares for a term of 20 years after her death. The other half is placed in a charitable lead trust providing for payment of 8.2% of the initial value of the assets (a guaranteed annuity) to charity for a term of 20 years with the remainder payable to children (or grandchildren) at the end of the 20 year term. Here is what the estate tax calculation in W's estate would look like using a discount rate of 5.4%:

Gross estate			$7,750,000
Less: Estimated expenses -- at 5%		$ 387,500	
Gross charitable deduction computation:			
Gross principal into unitrust of $3,681,250 x 30.228% factor	$1,112,768		
into lead annuity trust of $3,681,250 x 100% factor	$3,681,250		
		$4,974,018	
Less: Estate tax payable*	$ 262,949		
Net charitable deduction		$4,531,069	
Total deductions:			$4,918,569
Taxable estate:			$2,831,431
Tentative federal estate tax			$1,163,258
Less: Applicable credit amount			$ 780,800
Federal estate tax			$ 382,458

The estate tax savings is $2,084,292

*Tax attributable to non-charitable portion of unitrust. Gross principal of each trust is reduced by ½ of estate tax, thereby reducing charitable deduction for each trust. Estate tax is determined by interrelated calculation.

IV. Valuation and Substantiation Rules

1. Valuation -- General Rules.

A. Basics. If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution... fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

B. Comparable sales.

(1) Comparable sales technique (also known as "market data method") most useful when donated property similar to other property available on open market.

(2) Appraiser locates several similar items -- called "comparables" -- that were sold or available for purchase near time of donation.

(3) That gives ballpark figure. Then value increased or decreased, depending on how donated property stacks up against comparables.

C. Capitalization of income.

(1) If asset generates income, value can sometimes be appraised by estimating how much income it can be anticipated to earn.

(2) Then match to market rates.

D. Replacement cost.

(1) This method most often used when property to be valued is unique and isn't expected to generate income.

(2) Because replacement cost represents value of brand-new asset, adjustments may be made to reflect depreciation on property before its donation.

E. Subsequent sales.

(1) Often, charities that have no immediate use for donated property sell property and use sales proceeds for charitable endeavors. Although sale price of donated asset is not conclusive evidence of fair market value, IRS and the courts generally find it very persuasive.

(2) Indeed, new reporting requirements for certain contributed property sold within two years of gift show how probative Congress finds that information.

2. <u>Form 8283</u>: Appraisal summary.

3. <u>Form 8282</u>: The "tattle tale" form.

4. <u>Appraisals</u>.

A. What must be appraised?

(1) Property gifts (other than money and publicly traded securities) if claimed or reported value of property exceeds $5,000. To determine whether $5,000 threshold crossed, only part of gift claimed as charitable deduction counts. Thus, if land worth $25,000 is placed in charitable remainder unitrust, appraisal requirements apply only if charity's remainder interest more than $5,000 and donor claims income tax charitable deduction.

(2) What is "qualified appraisal"?

(a) Qualified appraisal can be done any time from 60 days before donation up until due date (including extensions) for return on which donor reports or claims gift; post-donation appraisals are okay.

(b) Regulations require qualified appraisal to give following information:

(i) Description of property in sufficient detail for person who is not generally familiar with type of property to ascertain that appraised item is property contributed.

(ii) In case of tangible property, its physical condition.

(iii) Date (or expected date) of contribution to donee-charity.

(iv) Terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of donor (or donee) that relates to use, sale or other disposition of contributed property; includes, for example, terms of any agreement or understanding that –

(A) Restricts (temporarily or permanently) donee-charity's right to use or dispose of donated property;

(B) Reserves to, or confers upon, anyone (other than charity or organization participating with charity in cooperative fund-raising) any right to income from donated property or possession of property - including right to vote donated securities, to acquire property by purchase or otherwise, or to designate person having income, possession, or right to acquire; or

(C) Earmarks donated property for particular use.

(v) Name, address and TIN of qualified appraiser (or appraisers) and - if qualified appraiser is a partner in partnership, employee of any person (whether individual, corporation, or partnership or independent contractor engaged by person other than donor - name, address and TIN of partnership or person who employs or engages qualified appraiser.

(vi) Qualifications of appraiser who signs appraisal, including appraiser's background, experience, education, and membership, if any, in professional appraisal associations.

(vii) Statement that appraisal was prepared for income tax purposes.