The Estate Planner

September/October 2008

Abracadabra!
Sec. 1031 exchange can make capital gains tax disappear

Art direction
5 estate planning strategies for your art collection

Do you wish to disinherit a spouse or child?

Estate Planning Red Flag
You don't have a gifting plan

Passaro & Kahne
LAW OFFICE, P.L.L.C.

Visit us at www.passarokahne.com

ABRACADABRA!

SEC. 1031 EXCHANGE CAN MAKE CAPITAL GAINS TAX DISAPPEAR

If you own a highly appreciated business or investment property that you wish to sell or otherwise dispose of, you can possibly avoid capital gains tax by exchanging it for new property that you plan to hold (or continue exchanging) for life. Section 1031 allows you to eliminate the tax — or at least defer it until you sell the new property.

This strategy isn't right for everyone, though. Depending on your situation, you may end up saving income taxes at the expense of a higher estate tax bill. Also, the IRS imposes strict requirements that you must follow to complete a successful exchange; one misstep and the tax may reappear out of thin air.

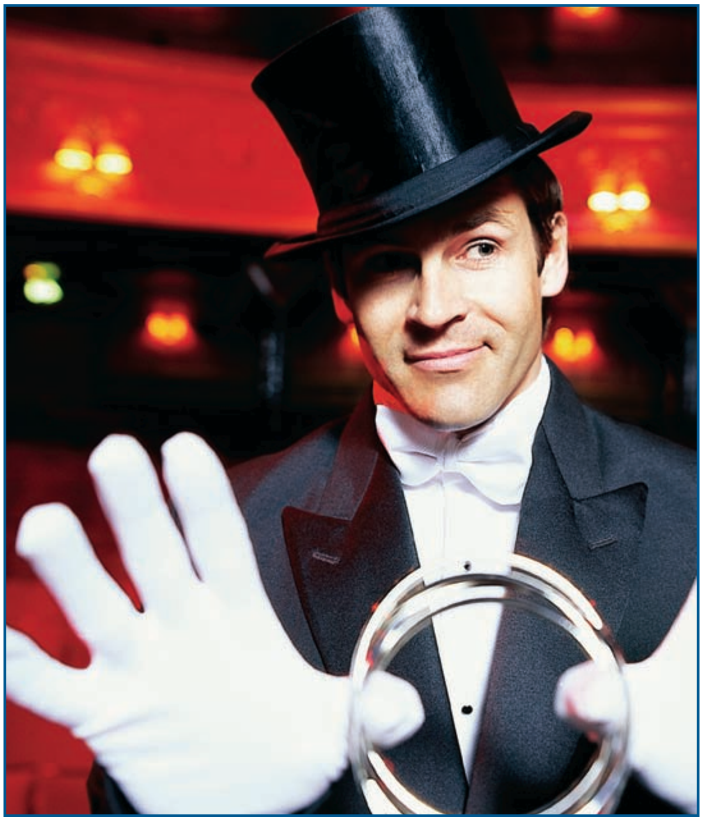
THE SECRET

The rationale behind Sec. 1031 is simple: You can defer the gain on real or personal property used in a trade or business or held for investment by exchanging it for property of a like kind. For personal property, "like kind" means property in the same asset or product class. So, for example, you can't exchange a car for a backhoe.

For real estate, on the other hand, virtually any type of property will suffice, so long as it's business or investment property. You can exchange a factory for a farm or a shopping center for an apartment building. You can't, however, trade (or trade for) a personal residence unless you convert it into rental property. (See "Tools of the trade" on page 3.)

Certain types of property are ineligible for a Sec. 1031 exchange, including inventory, stock and other securities, partnership interests, and certificates of trust or beneficial interests. The last category may create some estate planning challenges. Therefore, it may be desirable to exchange property held in a trust for replacement property held directly. Or you may wish to exchange property you hold directly for replacement property held in trust.

This shouldn't be a problem if you have revocable living trusts and other grantor trusts, because you, as the grantor, are considered the owner of the trust property for federal income tax purposes. It may also be possible to transfer property into or out of a grantor trust immediately before or after the exchange.



Exchanges involving other types of trusts, such as land trusts, are more complicated. Whether an interest in a trust is eligible for a Sec. 1031 exchange depends on whether it's considered an interest in a business entity or an interest in the underlying property. If the trustee's authority is limited to collecting income and distributing it to the beneficial owners, for example, the owners may be deemed to hold undivided fractional interests in the real estate, which *is* eligible for a Sec. 1031 exchange. If the trustee's duties go further, however, the IRS may view the owner's interests as the equivalent of ineligible partnership interests or corporate stock.

THE STRATEGY

If tax-deferred treatment required a person to actually swap properties with another owner, Sec. 1031 exchanges would rarely happen. Most Sec. 1031 transactions are deferred exchanges, in which the owner disposes of one property (the relinquished property) and then later acquires a replacement property. The strategy is to avoid gaining control of the proceeds from the sale of the relinquished property. If the IRS determines that you

Tools of the trade

The benefits of a Section 1031 exchange are available only for property used in a trade or business or held for investment. A personal residence doesn't qualify. In some cases, however, it may be possible to convert replacement property into a personal residence after an exchange.

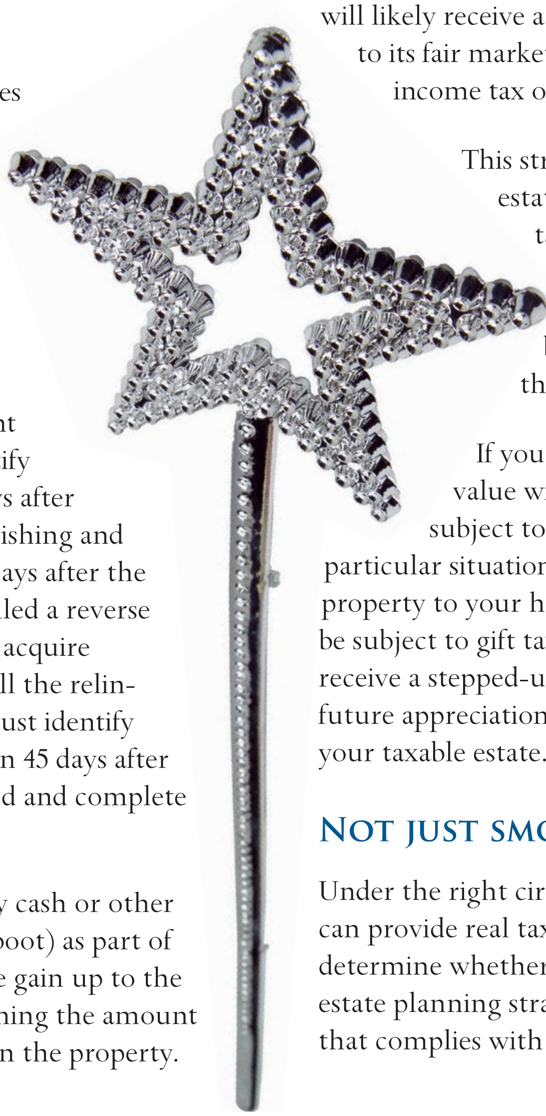
The key to tax-deferred treatment is your intent at the time of the transaction. That is, property will be treated as business or investment property if, at the time of the exchange, you show that you intend to use it as such. A rule of thumb is that you should use the property for business or investment purposes for at least two years after the exchange.

For example, let's say that Bob and Carol would like to sell their small rental apartment building and reinvest the proceeds in a large, lakeside home. To avoid capital gains taxes on the sale of the apartment building, they structure the transaction as a Sec. 1031 exchange. To qualify for the exchange, they rent out the new home for two years, after which time they move into the home and convert it to a personal residence.

actually or constructively received the funds, your capital gains will become immediately taxable.

Fortunately, IRS regulations provide several safe harbors for Sec. 1031 exchanges. If you follow the rules carefully, you most likely won't be deemed to have received the sale proceeds.

The most popular safe harbor involves the use of a qualified intermediary (QI) who receives and holds the proceeds from the sale of the relinquished property and uses them to purchase the replacement property. Other safe harbors include qualified escrow accounts and qualified trusts.



To qualify for tax-deferred treatment under a safe harbor, you must identify replacement property within 45 days after you sell the property you're relinquishing and complete the purchase within 180 days after the initial sale. A similar safe harbor, called a reverse exchange, allows you to use a QI to acquire replacement property before you sell the relinquished property. To qualify, you must identify the property you'll relinquish within 45 days after the replacement property is acquired and complete the transaction within 180 days.

Bear in mind that, if you receive any cash or other non-like-kind property (known as boot) as part of the transaction, you must recognize gain up to the amount of boot you receive, presuming the amount of boot is less than the entire gain on the property.

The magic

A successful Sec. 1031 exchange allows you to defer capital gains taxes until you sell the replacement property. But if you hold the property for the rest of your life, you should be able to eliminate these taxes permanently: Your heirs will likely receive a stepped-up basis in the property equal to its fair market value when you die, thereby avoiding income tax on any previous appreciation in value.

This strategy is particularly effective if your estate will be exempt from federal estate taxes. But if your estate is large enough to make federal estate taxes a concern, weigh the income tax benefits of a Sec. 1031 exchange against the potential estate tax cost.

If you hold property for life, its fair market value will be included in your estate and subject to estate taxes. Depending on your particular situation, you may be better off gifting property to your heirs during your life. The gift will be subject to gift tax and your heirs generally won't receive a stepped-up basis in the property, but any future appreciation in value will be removed from your taxable estate.

Not just smoke and mirrors

Under the right circumstances, a Sec. 1031 exchange can provide real tax savings. Your advisors can help you determine whether an exchange fits within your overall estate planning strategy and, if so, design a transaction that complies with IRS requirements. ✤

Art direction

5 estate planning strategies for your art collection

All too often, people overlook their art collection when planning their estates. But paintings, sculptures and other pieces of art can be very valuable, in some cases representing a significant portion of one's estate. So it pays to include them in your plan.

You can apply many traditional estate planning strategies to an art collection. But art also presents unique challenges. A fundamental principle of estate planning is to remove appreciating assets from your estate as early as possible to minimize gift and estate taxes. But art is more than an investment: Most collectors want to enjoy displaying these works in their homes and may be reluctant to part with them.

Let's examine five tips for addressing art in your estate plan.

1. Get regular appraisals

Having a qualified appraiser annually or every other year determine the value of your art gives you an understanding of how your collection is appreciating and can help you avoid unpleasant tax surprises. For estate tax purposes, an appraisal must be attached to your return for any items worth more than $3,000 or for a collection of similar items worth more than $10,000.

For gift tax purposes, the statute of limitations within which the IRS can challenge the valuation of a gift doesn't begin until you adequately disclose the gift on a gift tax return. A qualified written appraisal is usually the best way to comply with this disclosure requirement.

Finally, to support a charitable income tax deduction for art valued at more than $5,000, you'll need to include a qualified appraisal with your return.

Most important, a valuation by a qualified appraiser will help substantiate an item's value in the event of an IRS challenge, protecting you from back taxes and undervaluation penalties. Auditors are required to refer all gifts of art valued at $20,000 or more to the IRS Art Advisory Panel, and the panel's findings typically become the IRS's official position on the art's value. It's to your advantage to provide the panel with the evidence it needs to make an informed decision.

2. Seek an advance ruling

For transfers of art collections containing at least one item valued at $50,000 or more, you can eliminate uncertainty over whether the IRS will accept your valuation by asking the agency for an advance ruling. You must make the request after you transfer the property and attach copies of IRS Form 8283 for noncash charitable contributions and a qualified appraisal to the request. The fee for obtaining an advance ruling is $2,500 for the first three items; $250 for each additional item.

3. Donate art to charity

As with other assets you've held for more than a year, donating highly appreciated art to charity not only can provide a substantial income or estate tax deduction, but also allow you to avoid capital gains taxes. This is particularly advantageous for art, because it's subject to a top capital gains tax rate of 28%, compared to only 15% for most other assets.

Keep in mind, though, that the amount of your income tax deduction depends on whether the donation is related to the organization's charitable purpose. If it is — for example, if you donate a painting for display at a tax-exempt art museum — you can deduct the art's fair market value, up to 30% of your adjusted gross income (AGI). Deductions that exceed AGI limits can be carried forward for up to five years.

If donated art isn't related to the organization's charitable purpose — for example, if the museum sells the painting and uses the proceeds for operating expenses — your deduction is limited to your cost basis (but up to 50% of your AGI).

Another option is to use a charitable planning vehicle, such as a charitable remainder trust (CRT), which allows the trustee to sell the art tax free and reinvest the proceeds in a diversified portfolio of income-producing assets. You (or another noncharity beneficiary) would receive income from the trust for its term, and the designated charities would receive what's left at the end of the term. This strategy will limit your current income tax deduction to your basis in the art (up to 50% of AGI), however, because the donation is unrelated to the CRT's tax-exempt purpose. Your current income tax deduction will also be limited to the actuarial value of the charity's remainder interest in the artwork.

If you're not ready to give up your art collection, consider donating an undivided fractional interest to a museum or other charitable organization.

4. Give away part of your art

If you're not ready to give up your art collection, consider donating an undivided fractional interest to a museum or other charitable organization. For example, if you own a painting worth $1.2 million and you donate a one-twelfth interest to the local art museum, the museum gains the right to display the painting for one month of every year. You retain the right to enjoy the painting for the rest of the year and receive a $100,000 charitable income tax deduction.

This can also be a great strategy when an outright donation would exceed the 30% or 50% AGI limit, as discussed above.

Donating fractional interests allows you to transfer the art to a charity gradually, without having to worry about the five-year carryforward period.

Most likely, the museum will accept this arrangement only if you agree to donate the entire painting to the museum in your estate plan. Your estate would then be entitled to a charitable estate tax deduction for your eleven-twelfths interest in the painting (based on its value at the time of your death).

5. Share it with your heirs

If you decide to keep your collection in the family, it's best to make specific bequests. If you leave art to your heirs through residual gifts (that is, whatever is left in your estate after paying debts, expenses, and specific gifts), they may also inherit some unexpected income taxes. Specific gifts will also minimize conflict among your beneficiaries over who gets what.

Whatever you decide to do, be sure to discuss your plans with your family to avoid surprises or hurt feelings.

The art of estate planning

The greatest value of art may be intangible, but with careful planning and qualified valuation assistance it can also create significant tax benefits. Qualified valuation and estate planning advisors can design a strategy that's right for you. ✤

Do you wish to disinherit a spouse or child?

If your relationship with a spouse or child has deteriorated, you may be considering the difficult decision of disinheriting him or her. Here are answers to some frequently asked questions about disinheriting a family member.

Can I disinherit my spouse?

The laws in most states make it difficult or impossible to disinherit your spouse. A few states still retain the concept of "dower interest." Historically, this term referred to a wife's interest in her husband's real estate or other property at his death, but in some states both spouses have dower interests.

A valid prenuptial or postnuptial agreement, however, generally supersedes state law. If the agreement includes a valid waiver of each spouse's rights to the other spouse's property, it may be possible to give your spouse as much or as little as you wish.

Additionally, in a few states, it's possible to use a revocable living trust to disinherit a spouse. And some states allow you to disinherit your spouse if you're separated at the time of death.

Can I disinherit a child?

The short answer is "yes." If a child has given you so much grief that you feel leaving him or her an inheritance would only make matters worse or would be unfair to your other children, disinheritance is an option.

In a few states, it's possible to use a revocable living trust to disinherit a spouse. And some states allow you to disinherit your spouse if you're separated at the time of death.

In some states, you can disinherit a child simply by omitting him or her from your estate plan. Other states require you to name each child to make your intentions clear. In that case, you could leave the child $1 or some other nominal amount.

Disinheriting a child is a drastic measure, however, and there may be better alternatives. For example, you could place assets in a trust that pays for basic necessities — like food, shelter and health care — and condition further distributions on the child meeting certain goals, such as finishing college or staying gainfully employed.

How do I prevent a disinherited child from contesting my estate plan?

To successfully challenge your plan, the child would have to prove that you were incapacitated at the time you executed or amended your plan, or that your decision was the result of fraud, duress, mistake or undue influence. There are several ways you can avoid such a challenge:

- Use a living trust rather than a will. Typically, living trusts don't go through probate, so they're more difficult and expensive to contest.
- Leave the child a modest inheritance and include a "no contest" clause providing that, if the child contests your will or trust and loses, he or she receives nothing.
- At the time you execute or amend your plan, have a medical professional examine you and provide a written opinion regarding your mental capacity.

A tough decision

Making the decision to disinherit a family member can be difficult. If you decide to do so, you'll need to revise your estate plan in addition to checking your state's law regarding disinheritance. Your estate planning advisor can help you with these arrangements. ✤

Estate Planning Red Flag

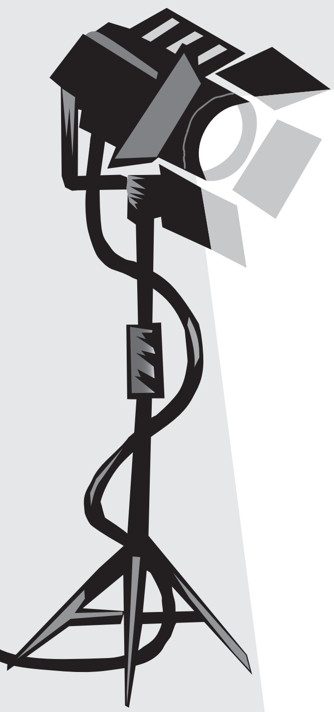
You don't have a gifting plan

If your estate plan doesn't contain a gifting strategy, you're missing out on a relatively simple way to pass substantial amounts of wealth to your heirs *and* reduce your estate tax liability. You're currently entitled to a lifetime gift tax exemption of $1 million, though the amount you use during your life will reduce the estate tax exemption available at your death. In addition, the annual gift tax exclusion allows you to give up to $12,000 a year tax free to any number of recipients without tapping your lifetime gift tax exemption or reducing your estate tax exemption.

Even though $12,000 may not sound like much, your annual exclusion can shelter a substantial amount of wealth. Suppose you have four children and eight grandchildren. If you give each child and grandchild $12,000 a year for 10 years, you'll transfer a total of $1.44 million free of gift and estate taxes. Assuming the entire amount would otherwise be taxable at the highest current rate of 45%, your gifting plan would produce a tax savings of $648,000. And, that amount ignores any appreciation that may have accumulated on the assets.

Also keep in mind that the annual exclusion is indexed for inflation, but only in $1,000 increments. This means it usually goes up every few years. The 2009 adjustments haven't been announced as of this writing, but the amount hasn't been increased since 2006 so it's possible that it will increase in 2009 or 2010.

Passaro & Kahne Law Office, PLLC Spotlights



Helpful Hints

Review your Estate Plan

Now may be a good time for you to review your estate plan. The way the Federal Estate Tax exemption is currently structured, the federal estate tax exemption amount is $2,000,000 in 2008, increasing to $3,500,000 in 2009. The federal estate tax rate is 45% in 2008. The federal estate tax will is set to be repealed (no Federal Estate Tax) in 2010. Beginning in 2011, the federal estate tax will be reinstated with a federal estate tax exemption amount of only $1,000,000 and a maximum estate tax rate of 55%. Therefore anyone who is currently subject to an Estate Tax, or may be under these rules, should consider reviewing their estate plan.

It may also be a good time to consider adding a Charitable module to your estate plan. And it is always a good idea to review all titling on your assets to make sure they are still set up to accomplish your goals.

Year End Tax Planning

This is a good time to look at anticipated tax liability as it relates to capital gains and dividends. These rates may be increasing and proactive planning may save taxes in the future.

Children Starting College

If your children are starting or have recently started college, you may want to consider creating documents for them. Creating a Durable Power of Attorney will allow you access to a child's account to help manage finances or allow you to communicate directly with the College or University regarding grades, transcripts or other accounts. Also creating a Health Care Power of Attorney for your child can be very helpful, especially with the HIPAA privacy restrictions that are in place, if the child needs medical treatment while away from home.

Corporation/Business

We have seen an increase in corporation audits by the IRS. Now is the time to make sure your documentation regarding loans, leases and annual reports and minutes are current and in place.

If all or any of these issues apply in your situation, or if you would like further clarification regarding any of these ideas, feel free to call one of our attorneys to set up an appointment to discuss.

Mark your calendars for our Winter Open House on Tuesday December 2, 2008 from 4:00 p.m. to 7:30 p.m. at the Curious Kids' Museum in St. Joseph, Michigan.

Passaro & Kahne
LAW OFFICE, P.L.L.C.

2900 South State Street, Suite 3 East
St. Joseph, MI 49085

Tel: 269.983.0325
Fax: 269.983.0328
info@passarokahne.com

Visit us at www.passarokahne.com