Family Love Letter℠

Personal Property - The Forgotten Part of an Estate Plan

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Tangible personal property seems to be a forgotten part of the average client's estate plan. The failure to address the unique issues surrounding tangible personal property has created significant problems for many estates. This article will address a number of these issues. As used in this article, "personal property" will mean tangible personal property (e.g., furniture, clothing jewelry, vehicles, art and collectibles). It will not directly address intangible personal property issues (e.g., stocks and bond).

Drafting
There are a number of drafting issues which are somewhat unique to personal property, including the following:

- A frequent issue in dealing with personal property is whether the decedent intended to restrict an bequest of Aall my personal property" to tangible personal property, or whether the expression was also meant to cover intangible personal property. The interpretation will often turn on the context of the bequest, such as Amy residence and all of the personal property located therein". However, the careful drafter should clearly define what is intended by the phrase "personal property" and/or clarify the types of assets being bequeathed (e.g., "all my furniture").

- In order to avoid probate and provide for disability management, many clients have created revocable living trusts. While they may be diligent in transferring all of their stocks, bonds and real estate into the trust, clients often fail to execute a document transferring their tangible personal property into such a trust. Clients should be advised to execute a bill of sale listing the personal property being transferred to the trust. To the extent valuable personal property is being conveyed to the trust, the client should consider providing a detailed description of the item.

- Most states allow residents to reference a personal property list in their wills. The list is a separate document disposing of personal property. If a separate personal property list is not referenced in the will, the list may be without legal effect. The requirements vary from state to state. Some states require that the document must exist as of the date of the will. Other states allow a later writing if it meets certain statutory formalities designed to limit fraud. In order to limit objections, the document should define the personal property with reasonable accuracy, comply with local law, be signed by the decedent, and be witnessed and notarized with the same formalities as a will.

If state law limits the use of an external personal property list, the will may have to provide for such some special bequests. Particularly if an object is going to a non-decedent (e.g., "grandmother's wedding ring to my niece"), it is advisable to have the will contain a specific bequest to that heir.

In the absence of such a special bequest or a referenced separate personal property list, lifetime declarations of an intent to bequeath the asset may be wholly invalid.

- If the remainder of the personal property (after any special bequests) is being given to the donor's children, the will might contain a general personal property disposition among the children, with the executor being given the discretion to decide what assets each child receives. If the executor is independent, the client may provide the executor a list of how assets should be disposed of and then rely upon the executor to exercise the executor's discretion in the manner noted on the list.

- If the client intends to place the personal property in a marital trust (e.g., "I give my art collection to a QTIP trust for the benefit of my husband, Frank and at his death to the Getty Museum") it is important to provide language allowing the surviving spouse to sell the property in the trust so it can be converted to income producing property. The failure to give the spouse this power will result in the denial of the federal martial deduction. See IRC section 2056(b)(7) and Treasury Regulation section 20.2056(b)-5(f).

- If the transfer is to a minor, it must be held by an adult until the minor reaches majority. Generally, the donor should provide that any transfer to a minor be made to a named custodian "pursuant to the Uniform Transfer to Minor's Act". This eliminates any issue about whether state law requires a guardian to be appointed to hold the asset.

Taxes

The IRS takes the position that "all personal property found in the household and which was used in common by the decedent and all other members of the household may be presumed to have belonged to the decedent unless the contrary is shown." See IRM Part IV (Audit and Investigation), Section 4323(3). The burden rests on family members to demonstrate that the personal property was not owned by the decedent. Particularly on items of high value, the retention of receipts and the determination of who insured the object may provide sufficient evidence to indicate the actual owner. If the donor made a pre-death gift of property which was specifically bequeathed in the will, but failed to provide any evidence of the gift, such as a gift tax return, an assignment or a gift bill of sale, the IRS could argue that a completed gift never occurred. Once the IRS denies the gift, the donee will carry the burden of proof to show a gift was completed. The absence of the item from the decedent's home provides small evidentiary value, because the IRS could argue it was removed after the decedent's death or was on loan to the person in possession of the asset - and the taxpayer will bear the burden of proof.

A client often intends that a item of personal property be "transferred" to an heir, but the client keeps control of it for now (e.g., a heirloom engagement ring). If an asset remains in the decedent's home, the IRS provides that in the absence of evidence to the contrary, the asset is treated (solely for tax purposes) as a part of the decedent's taxable estate (c.f. E. Trotter Estate, 82 TCM 633 and F. Honigman Estate, 66 TC 1080 (1976)). The decedent's retained enjoyment or possession of the property results in its inclusion in the donor's estate pursuant to IRC section 2036(a). Retention of the item by the donor means that the gift was never completed and the asset remains an asset of the donor's estate. The burden lies on the executor and/or others to prove that ownership did not rest in the decedent. This is often a problem when jewelry or collections are "given" but transfer of control is never made. The solution? If a gift is truly made, get it out of the donor's control.

A similar concept applies to charitable gifts. In general, a donor cannot obtain an current income tax charitable deduction by "giving" a charity the remainder interest in an item of personal property (e.g., painting), while retaining the asset's present possession and enjoyment. See Treasury Regulation 1.170A-5. However, under such an arrangement, if the asset passes to the charity at the decedent's death, an estate tax charitable deduction would generally apply.

To the extent the personal property is subject to estate taxes, the client needs to deal with how the transfer tax on the property is apportioned. In many wills (and in some state statutes), special bequests do not pay estate or inheritance taxes, effectively resulting in residuary heirs assuming the tax cost for the special bequests of personal property. In the case of valuable personal property, this can create a significant reduction in the assets of the residuary estate.

Until the 2001 tax bill, most states adopted the maximum federal credit for state inheritance taxes as their state inheritance tax. As a result, the tax situs of tangible personal property was largely ignored (i.e., the effective state inheritance tax rates and rules did not vary from state to state). However, the 2001 bill replaced the credit with a deduction. As a result most states will change their state inheritance taxes in the coming years. States may not provide the large tax exemptions allowed by the federal government. As a consequence, the tax situs of personal property (particularly valuable objects) may become a pivotal issue. Clients may want to maintain such objects in states which have the lowest state inheritance taxes. For example, assume a client owns a painting worth $5.0 million. Holding the asset in a state with a 5% inheritance tax versus a state with an 8% inheritance tax might save up to $150,000 in state inheritance taxes.

Even when the gift of personal property is not taxable because of a federal gift tax exclusion or exemption, state gift taxes may still apply. Connecticut, Delaware, Louisiana, New York, North Carolina, Puerto Rico, and Tennessee impose a gift tax. Unlike the federal estate tax, no federal gift tax credit is given for state gift taxes paid by the donor. Local tax issues can create other tax problems. Because the federal gift tax laws do not permit a state gift tax credit like the estate tax credit, in those states which have a gift tax, the advisability of making a lifetime gift versus waiting until death to make a transfer, should include a calculation of the state gift tax cost.

SPECIAL BEQUESTS AND GIFTS

It is generally best to convey tangible personal property by special bequest. First, if the property is specifically bequeathed, it normally does not absorb a portion of the federal estate tax. If a an estate tax were imposed on the transfer, the donee would either have to sell the asset or find other sources to pay the tax. Second, if a special bequest is not made, the asset may fall into the residue of the estate. As such the donor may be required to sell the asset, even when a particular family member may be sentimentally attached to it. Finally, if such an asset passes into the residue and is subsequently passed to an heir, the heir may have income tax liability to the extent that the estate or trust had distributable net income. Had the asset passed pursuant to a special bequest (even if delayed until the heir were an adult), no income tax liability would be due. Often there are generalized items of personal property (i.e., "all my cabin furniture")which the decedent wants to generally convey. By making a general bequest of the remaining personal property, the above problems can be avoided.

One of the greatest difficulties in planning for personal property is determining the basis a donee received from a donor on a gift. As a part of the planning process, the donor should provide the donee copies of supporting detail on the donor's basis in the gifted assets. Closing statements, old estate or gift tax returns, receipts and other supporting detail should be retained by the donee to support his reported taxable gain upon a subsequent sale. These documents should never be destroyed.

Under the tax law prior to 1997, the IRS can revalue any gift at the donor's death and effectively open up the statue of limitations on prior gifts. The 1997 Tax Act reduced this infringement of the statute of limitations if the gift were "adequately disclosed" on a gift tax return.. The IRS has issued regulations to define "adequate disclosure."See Treasury Regulation section 301.6501(c)-1(e) for the rules governing adequate disclosure. "Problems Created by New Prop. Regs. on Revaluation of Gifts," Est. Plan., May 1999; "Transfer Tax Valuation Finality and Prop. Regs. On >Adequate Disclosure of Gifts," Tax Advisor, June 1999; "Final Regs. On Disclosure of Gifts Liberalized, but Problems Remain," Est. Plan. May 2000. The new rules required detailed information on the gift. In order to trigger the three year statute of limitations, whenever a valuable personal property asset is transferred, the planner should consider whether to create enough gifts in the same year to trigger the required filing of a gift tax return and the adequate disclosure for all gifts.

DETERMINING OWNERSHIP

One of the most difficult issues for an executor is determining the proper ownership of an item of personal property. This determination carries both estate tax and dispostional concerns. For example, assume a client in his second marriage dies. He indicates that all of his personal property should pass to his second wife. The executor finds a safety deposit box in the husband's name which contains his deceased wife's jewelry. The daughter (who has signature authority on the box) says that her father always intended that her mother's jewelry go to her and had "gifted" the items in the box to her. The second wife wants it to. In the absence of strong evidence of the decedent's intent, the executor is going to be in a very difficult conflict.

Particularly when there are children of prior marriages, a conflict often arises between the children of a prior marriage and a new spouse. This conflict may come in two principal manners. First, the surviving spouse may believe that he or she should inherit all the personal property of the deceased to the detriment of children of the deceased. If such a transfer occurs, family heirlooms or sentimentally valued personal property may end up passing to remote relatives of the surviving spouse - to the detriment of the original owner's family. Second, the title to the asset may be in question. Unlike real property or securities, there is generally no title document evidencing ownership of personal property. A decedent who says "pass my personal property to my children" without providing some evidentiary proof of what property he owns, is asking for a family conflict.

The answer? Have clients put together a book with pictures of their important assets. On the same page as the picture, note who the owner is of the object and to whom the owner intends to pass the item. Make sure that the designation is consistent with the "external list" of personal property dispositions or any personal property list in the will.

VALUATION; APPRAISALS

Valuation of personal property can be a special problem for an executor. In many cases personal property can be massed together and valued somewhat arbitrarily (e.g., "two suits, fifteen ties, eight slacks, ten shirts, various underwear and socks, four belts, total value $100). Because the value of such assets is generally low, it is unlikely to create any conflict among the heirs or with the IRS.

The failure to properly value a gifted asset can result in the imposition of a number of penalties, including a 20% penalty for a "substantial valuation understatement", with the penalty increasing to 40% if there is a "gross valuation understatement See IRS section IRC section 6662. Given the increased IRS focus on transfer tax issues and the examination of more estate and gift tax returns, clients should be required to obtain qualified appraisals of valuable personal property before gifts or bequests are made. If a lifetime gift is made to a charity, the client must be careful to abide by the rules governing charitable gifts.

When the object being appraised has significant value, special issues may arise. Was the value overstated by an unqualified appraiser? Did the appraisal take into account current market conditions? If the recipient of the valuable asset is not required to pay any estate tax on the special bequest, he or she will want an appraisal as high as possible to get a higher step-up in basis - creating a small capital gain or income tax when the asset is sold. If the residuary heirs are paying the tax, they would like to see a much lower value to reduce their estate tax burden. The executor is well advised to obtain a "forensic appraisal" which conforms to the Uniform Standards of Professional Appraisal Practice. A sloppy appraisal by someone who has no special skill in valuing the type of personal property being appraised is to invite an audit and family conflict. See the excellent articles by Robert Zises, "Forensic Appraisals of Tangible Personal Property", Valuation Strategies, July 2001 and Robert Reilly and Manoj Dandekar, "Complexities Involved in Valuing Tangible Personal Property", Valuation Strategies, January 2001. If the disposition of the personal property is to a charity, see Treasury Regulation section 170A-13 for the requirements in the appraisal.

The IRS has provided information on the type of information which should be contained in an appraisal. See: Revenue Procedure 66-49, 1966-2 CB 1257; Treasury Regulation section 301.6501(c)-1(f)(3). The appraisal should include the appraiser's credentials, a statement of the asset's value (and how it was determined), the valuation date and the appraiser's signature. The Code provides that the appraiser can be subject to penalties for improper valuations. Appraisals which merely state an opinion of value without stating how the opinion was reached are substantially worthless. Although it is sometimes expensive, the client should be encouraged to obtain an appraisal from a qualified expert who is not related to the client by business or family relations. If necessary the appraiser may be needed to testify in court about the appraisal and may be required to meet the Federal Rules of Evidence Rule 702 standards as an expert witness. See: "When the Appraiser Takes the Stand," Valuation Strategies Nov./Dec. 1998 and Dougherty Estate v. Comm'r, TC Memo 1990-274.

COLLECTIONS

It seems that everybody collects something today. Most collectors have spent a lifetime gathering together the items of their collection. The sentimental value attached to the collection is often greater than any other asset the client owns. A careful discussion of the collections' disposition is critical. Among the issues to be resolved:

Ownership. The owner should be encouraged to create files or notebooks containing detailed information and receipts for the objects in the collection. This will aid the executor in confirming ownership and determining the cost of the objects. If the owner has loaned parts of the collections to others (e.g, museums), the planner should make sure that the nature of the transaction as a loan (as opposed to a gift) is clearly documented in a written instrument signed not only by the owner, but also by the borrower. If the intent is to give the object to the borrower at the donor's death, it may be necessary under applicable state law to have the disposition mentioned in the client's will. In the course of such a discussion, the planner should also discuss with the client how much insurance the borrower is required to maintain on the items, and whether the owner has proof (e.g., an insurance binder) that the insurance has been obtained. The same issues must be addressed when the client is the one borrowing the personal property.

Value. A skilled collector will often have a better understanding of the value of his or her collection than anyone else Be careful, though, the sentimental attachment tends to distort the deemed value. This inflated value may also be reflected in the collection's value placed in any insurance policy - making it hard to argue that the IRS's higher expectation of value (partially based upon the insurance values) is inflated.

The skilled collector generally knows who the other collectors are in the field. They will often serve as the best valuers of the collection particularly collections which have no recognized market (e.g., old documents from the client's hometown). Have the client list the names, addresses and telephone number of other collectors in the files on the collection. If the client knows of markets for the items, he should list them in the files.

If the client's collection is significant, its placement on the market could depress the entire market for that type of personal property. In such an event, the planner may ask the appraiser to provide a valuation discount for the impact on the market.

It will also be important to maintain any reference works which the client has on the collection. Such works can prove invaluable to the executor in deciding how to handle, store and dispose of the collection.

Disposition. Perhaps the most difficult issue is the collection's disposition. The client's documents should specifically address how the collection will be treated after the donor's death. If the collection is to be transferred to a museum or charity, arrangements for such a disposition should be made by the collector before death. The client will have the greatest incentive to assure his intents (often elusive for executors) are carried out. Issues such as denying the charity the right to sell the property, how often it will be displayed, whether the donor's prior ownership will be acknowledged should all be addressed..

If the collection is to be passed to family members, the planner should discuss with the client whether the collection should remain in tact by giving it to one family member or whether it will be divided among a group of heirs. If a group of heirs will receive the collection, the manner in which the collection will be divided up should be addressed. For example, are specific items passed to specific heirs or does the executor have the authority to decide how to make the dispositions.

If the collection is to be sold, other issues arise. For example, if the sale is by a private sale, what assurance does the executor have that the price is appropriate? In most cases an independent appraisal should be obtained before the sale to protect the executor from fiduciary liability. If the sale is through a dealer, the executor should make sure to check the dealer's background and reputation and confirm that the sale price is in the range of any independent appraisal. If the sale is by auction, the executor may want to maintain a reserve price. Thus if the bidding does not reach the reserve price, the executor can remove the object from the auction. The commission to a dealer or auction house may also be negotiable.

MINIMIZING THE CONFLICT

The attention (and related conflict) paid to personal property after its owner's death is often disproportionate to both its focus in the pre-death estate plan and its appraised value. This imbalance is a result of the undue conflict which often accompanies the passage of personal property. One of the more interesting dynamics of estate planning is that in many cases, the greatest intra-family conflict is not over a large inheritance or the placement of assets in spendthrift trust, but as an unexpected result of personal property dispositions. This conflict is a result of a number of dynamics, including:

- The parents may have inadvertently create the conflict by telling different children that they will receive the same asset. For example, we had a client who ten years before her death told her son hat she would receive an old family grandfather clock. Then, a few months before the client's death she promised the clock to her daughter. After the mother's death, the son started carting the grandfather clock out of the house and the children got into a fist fight over who was entitled to the asset. Today they barely talk to each other. The grandfather clock was broken in the altercation.

- In some cases, it's merely an element of a greedy child saying that, "Mom said that I got this asset." Years ago we had a client who was heavily drugged because of her terminal cancer. Right before her death, her daughter had her to sign a statement indicating that all of her silver, china and jewelry was to be bequeath to the daughter. Obviously this created a huge conflict with the other children. Luckily for the rest of the family, the document was unenforceable in Georgia.

- Immediate family members (and sometimes remote family members) may start taking things out of the home long before there has been any appraisal or even an understanding of what assets are in the home. The explanation is sometimes: "When I was ten, your dad said I could have his shotgun." Often there is no evidence of such an intent. In most cases the declarations are also legally unenforceable.

- Parents may not realize that items that have little intrinsic or sentimental value to them may have significant emotional value to their children. Passing the asset to another child may potentially cause a conflict among the children if the issue is not addressed before death. For example, a nephew of the decedent told the executor that his deceased uncle (who has helped raise him) had always promised him the old German chair that the grandfather had won in a drinking bout in the early 1900s. The nephew warmly remembered sitting as a young child in his grandfather's lap in the chair in front of a fire. Unfortunately, all of the personal property passed to the uncle's children and one of the children also wanted the chair. The cousins are no longer on speaking terms.

- Many parents are convinced that their children would never fight over their assets. But the combination of lingering sibling hurts and the trauma of mom or dad's death can magnify small conflicts into large ones. Moreover, in many cases it is not even the children who are fighting. It may be the resentment of an in-law who you were never sure you liked, "pawing over mom's stuff before she's barely in the grave."

- Clients will sometimes say that they are not concerned because a surviving spouse will "do the right thing" and pass the assets to the client's children. My client's first wife had died years before and he had been married to his new wife for 10 years. Both had children from a prior marriage. He died in the accident and she died the next morning. His will passed all the personal property and family heirlooms to her on the assumption she would return family assets to his children. Unfortunately, her children insisted these were their assets because they belonged to their mother for the 12 hours she survived her husband.

The Client's Solutions. To minimize these conflicts, there are a number of things which clients should do to reduce or eliminate the potential for conflict. Among these are the following:

- To the extent the client wants a particular asset to go to a particular person, the client is best advised to provide a legally enforceable document that passes that particular asset (defined with specificity) to a particular heir. This is especially important when assets are being transferred to more remote heirs (e.g., family friends or remote cousins).

- Clients should be strongly encouraged to talk to their adult children about which assets they want to receive upon the parents' death. These desires should be documented. This brings to the fore any ownership conflicts that may exist prior to the parents' death. Because the parents resolve the conflict, any long term damage in the children's relationships can be minimized.

To the extent the particular assets are to be passed to the children, we typically recommend that either a digital or video-tape be made of the object and a notation be made of which family member receives that asset. Through the video representation of the asset, there can be little question as to which asset is being passed. Moreover, if a video camera is used, it is an excellent way of providing the legacy of any heirloom assets so the heirs understand the family history of the particular asset.

- Clients should document the ownership of their assets. For example, if a daughter has loaned her mother a china cabinet, then it needs to be documented somewhere that the china cabinet belongs to the daughter and not the mother. In the absence of such written information, it would generally be presumed that it belonged to the person in whose home it was found.

If a married couple has children from a prior marriage, they should create a notebook with pictures of their important assets (as defined by the family), noting the heir of the asset and the current owner. Each spouse should sign a document irrevocably relinquishing the right to the other's assets.

- The choice of executor can be very important because the client wants to make sure that these personal properties dispositions occur in exactly the manner that the client desired. Therefore, the choice of a child or second spouse as executor may sometime create a conflict with the other children and may not be the best choice.

- Some clients want to give a life estate in personal property to a spouse and then pass the property to their family. Unfortunately, this is a terribly cumbersome approach. What happens when the object breaks, is stolen or lost? Particularly with heirloom and emotionally significant assets, it is generally best to pass them at death to the end recipient.

The Executor's Solutions. There are also a number of things that the executor should do early in the representation of the estate. These include:

- As soon as the client becomes disabled, or immediately upon death, we typically advise the executor (perhaps even before an appointment) to immediately change the locks on any residence or other location holding personal property so that the executor is in control of the property. There may be a number of people who have access to the property who may think they are entitled to some particular asset.

- To the extent that the client has not directed the disposition of assets, the best approach to the disposal of the remaining assets may include the following:

First, allow each individual family member who has a right to participate in the disposition of personal property walk through the house, including any in-laws. We have found that in many cases, the in-laws are a major source of conflict over the passage of personal property. Keeping them away from other children when they discuss a parent's assets reduces this conflict.

After each family member has walked through the property, only the heirs are allowed back into the house for decision on the disposal of the remaining assets. The heirs walk into a room, pick a straw with the longest straw choosing any asset in the room. Each room of the house is gone through in a similar basis. A third party (e.g. the family attorney) may serve as the judge and arbitrator of this process. In the event that any family member receives significantly more in value than the other family members, then there may be an agreement before the disposition of assets to make up the difference for the person with less valued assets by using cash or other assets of the estate. An appraisal should be conducted of all assets prior to this process beginning so that each person understands the estate appraised value for that asset.

In the alternative, each family member could submit a bid on each asset they want and the highest bid price will be deducted from their inheritance. In most cases, it make sense to have the bidding be secret until the bids are opened. However, this process may encourage the IRS to use the higher values in the bids to determine the purchase price.

Remaining assets are generally sold at an estate sale or given to charity.

- To minimize family conflicts, establish the date of death basis of unique assets (which the heirs may sell) and properly prepare any required estate tax, the executor should obtain an appraisal of all personal property. The appraisal should be attached to any estate tax return. If the value of the personal property is lower than would be expected for an estate the size of the deceased's estate (e.g., $30,000 in personal property in a $4.0 million estate), the executor should place an explanation in the estate tax return (e.g., "the deceased lived in a one room assisted care facility at the time of her death"). Such an explanation can reduce the possibility that the IRS will raise questions which could trigger an audit.

- The basis in personal property steps up to its fair market value at the time of the owner's death. If the personal property is unique (e.g., a stamp collection), the executor should obtain an appraisal of the asset to establish the date of death value - even if no estate tax return is due. If the estate contains a unique asset, the appraiser should be someone skilled in valuing such an asset.

One of the worst tragedies in the estate process is children who twenty years after their parent's death are barely talking, because of fights over insignificant assets. One important legacy that a parent needs to leave is disposing of such assets in a manner designed to minimize this potential conflict - LEAVING A LEGACY OF RELATIONSHIPS RATHER THAN A LEGACY OF CONFLICT.

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