SUCCESSFULLY NAVIGATING GIFTS OF REAL ESTATE

PG CALC WEBINAR

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I. INTRODUCTION

In many instances, a donor's real estate accounts for much of their wealth. Under a variety of circumstances, it can make sense for a donor to use real estate to make a charitable gift during their lifetime. It is also acceptable for gifts of real estate to be made upon death through charitable bequests. The focus in these materials is on gifts made during life.

There are many factors that may influence a donor's decision to make a charitable gift of real estate. With real estate that has been used for family purposes, there may be emotional considerations. For the "mom and pop" real estate investor, being free from management responsibilities while still receiving income from the gift can be an attractive alternative to ownership. For more sophisticated investors with commercial, industrial, or large multi-family properties, financial and tax considerations will play a significant role in the decision-making process. In every decision, there must be philanthropic intent for the gift to happen.

Sometimes it is appropriate for a charitable gift to be made using property that is owned by an entity, such as a corporation or a limited liability company, or located in another country. Nevertheless, such situations can present certain complications. For this reason these materials will focus only on gifts made by individuals and real estate located in the United States.

II. WHY CHARITIES ARE RELUCTANT TO CONSIDER GIFTS OF REAL ESTATE

Gifts of real estate can be among the most generous of all the gifts that an organization receives. However, with the potential for significant reward, comes the potential for significant risk. Each piece of real estate is considered unique – no two properties are 100% alike. There is no marketplace where a piece of real estate can be valued with absolute certainty on any given day and time and no centralized marketplace where real estate can be liquidated instantaneously as there is with publicly traded securities. The risks posed by environmental contamination cannot be overstated. Also, the expense to the charity in accepting, maintaining, marketing, and selling a gift of real estate can be substantial.

For the above reasons, many charities are reluctant to even consider gifts of real estate. However, with sound policies and procedures for due diligence, most risks can be identified and addressed prior to accepting the gift. Also, some community foundations and other public charities may be willing to accept a gift of real estate with the proceeds to benefit a charity designated by the donor. (see Section V). Charities should investigate the options available that will make it possible for them to consider gifts of real estate.

III. DEVELOPING THE INFRASTRUCTURE FOR GIFT ACCEPTANCE

It is essential for a charity to have well-defined policies and procedures codified in a Gift Acceptance Policy prior to entertaining a gift of real estate. Drafting of the policies and procedures should be a collaborative effort among members of the development, finance, and legal departments, executive officers, and board. The policies should establish a committee that will review the results of due diligence efforts and that will make a recommendation to leadership as to whether the property should be accepted – or not. Donors offering a gift of real

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estate should be made aware of the policies so that they understand the charity's process for carrying out due diligence.

The Gift Acceptance Policy should outline the steps to be taken during due diligence, including the information to be obtained regarding the property, inspection and environmental reports, the qualified appraisal, site inspections, and who is to bear the responsibility for payment of the expenses associated with the due diligence. The procedures outlined in the Gift Acceptance Policy are intended to ensure that committee members have the information required to make an informed recommendation to organization leadership as to the advisability of accepting the property as a gift.

IV. DUE DILIGENCE

A. Phasing of the due diligence process

A comprehensive due diligence process is essential to ensuring that a charity only accepts those gifts of real estate that are readily marketable and where any risks have been identified, evaluated, and deemed not to pose a liability to the charity. There are many aspects of the due diligence process that can be accomplished by charity staff with a minimum of cost. This information can be obtained from the donor (subject to verification), on-line databases, basic searches of public records, and from phone conversations with municipal officers. Once this first stage of due diligence has been completed, members of the Gift Acceptance Committee can determine if the proposed gift warrants moving to the second – and more costly- stage of the due diligence process.

1. First stage of due diligence

Property questionnaire – Have the donor complete a comprehensive questionnaire disclosing information about the property (see example on pp. 21-22). The questionnaire should ask about property ownership, current and previous uses, taxes, maintenance costs, known defects, environmental issues, renovations, pending or threatened litigation, outstanding liens and mortgages, leases if applicable, etc. Ask if the property has been offered for sale within the last two years and, if so, request details.

Property description – Ask the donor to describe the property and to provide photos and a copy of the deed. If the property is a condominium, co-op, or part of a homeowners association, obtain a current set of the governing documents from the management company. Are there restrictions on which types of entities can own a unit in the community? Ask the management company if the fees for which the owner is responsible are current and if any assessments are pending or anticipated.

Title – Order a title search from a title insurance company or attorney. This may cost a few hundred dollars, but the information is invaluable. The resulting report will show the owner of record, mortgages, judgments, liens, a legal description of the property, and agreements of record that may affect the property.

Local government – Contact the municipal Building and Planning Office and ask about the permitted use of the property and if any code violations exist on record. Contact the tax collector to see if the real estate taxes are current and how much they are.

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Site visit – If a site visit is possible, visit the property. Take along a colleague. Two sets of eyes are better than one. If the property is not in a location where staff can conveniently visit, see if a volunteer to the organization can visit. While the purpose of the site visit is primarily to view the subject property, also view the surrounding area, as this goes to the marketability of the property. Determine what would need to be done to the property to ensure marketability and to maximize the value when offered on the market.

On-line databases – On-line databases are another tool to use when researching the property. Websites such as trulia.com, zillow.com, and realtor.com contain information about properties for sale and neighborhood statistics. Information on these websites is a good starting point, but should be verified.

Once all of this information has been compiled, a package should be assembled for the Gift Acceptance Committee to review. With this information in hand, the Committee can determine if there is sufficient interest to warrant further due diligence – at greater cost.

2. Second stage of due diligence

If, after reviewing the information assembled during the first stage of due diligence, the Gift Acceptance Committee chooses to move to the second stage of due diligence, the following steps should be taken.

Retain an attorney – The charity should retain a real estate attorney familiar with the geographic area where the property is located. The title company that performed the title search should be asked which attorneys they regularly see at their closings. In all likelihood, these are attorneys experienced in real estate transactions. Interview the attorneys for what a projected fee will be for the transaction.

Building and Environmental Reports – Retain a professional building inspector to inspect the property and issue a report. Determine the level of environmental report warranted and have the report prepared by a qualified professional. Based on the findings in the report, determine if additional environmental testing is warranted. Order any further inspections or tests such as for radon, water quality, or on-site sewage systems.

Real estate agents– Have three real estate professionals visit the property and submit a competitive market analysis of the property. (see Section IV(3)(b) below)

All of the information gathered in both stages of the due diligence process should be presented to the Gift Acceptance Committee for a recommendation to charity leadership. If the charity accepts the property, it is advisable to provide the building inspection, environmental report, and any other property reports to a prospective purchaser, with the express understanding that the purchaser is advised to obtain reports from professionals of their choosing to represent their interests.

3. Valuation and Marketability

a. Qualified Appraisal Requirement

If as the result of any gift of real estate (whether made outright or by means of some other arrangement) the donor will be entitled to an income tax charitable deduction of more than $5,000, he or she will need to substantiate the deduction with a qualified appraisal. In addition to obtaining the appraisal (and, if the deduction is greater than $500,000, actually attaching the appraisal to the tax

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return on which the deduction is claimed initially), the donor will need to file IRS Form 8283 after Section B of the form has been signed by the appraiser and by the charitable donee. The charitable entity, in turn, will need to file IRS Form 8282 if it disposes of the property within three years of the gift.

As revised by the Pension Protection Act of 2006, IRC Sec. 170(f)(11)(E)(ii) defines a qualified appraiser as an individual who "(I) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary, (II) regularly performs appraisals for which the individual receives compensation, and (III) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance." In addition, the individual must demonstrate "verifiable education and experience in valuing the type of property subject to the appraisal." To date, the only regulatory guidance provided by the Secretary has been Section 3 of Notice 2006-96. Nevertheless, until actual regulations are issued at some point, Reg. Sec. 1.170A-13(c)(5) will remain valid.

The numerous requirements of a qualified appraisal are set forth in IRC Sec. 170(f)(11)(E)(i) and in Reg. Sec. 1.170A-13(c)(3)(ii). In lieu of directing the appraiser to the statute and the regulation, it should suffice for the donor simply to advise the appraiser to review pages 8-11 of IRS Publication 561.

A sound appraisal is not merely important to the donor in substantiating his or her tax deduction. It is also important to the charity, which will want to know the likely value of the property before it accepts the gift. Despite the fact that, for tax purposes, the donor does not need to have an appraisal in hand until the due date (plus extensions) for the return on which the deduction is being claimed, in practice an appraisal will usually be completed prior to the time the gift is made (recognizing that a qualified appraisal can be performed no more than 60 days in advance of the gift). In some cases, the charity may obtain (and pay for) its own appraisal. This can happen if the charity questions the validity of the appraisal obtained by the donor or if, for some reason, the donor refuses either to obtain an appraisal before making the gift or to share with the charity whatever appraisal has been obtained. (If the donor waits until afterward to have the appraisal done, then the appraiser will need to focus on the fair market value as of the date of the gift.)

Normally, however, there is a single appraisal paid for by the donor but shared with – and found acceptable by – the charity before the gift is made. The cost is customarily borne by the donor because he or she is ultimately responsible for substantiating the charitable deduction claimed. Accordingly, a charity will usually take the position that if it pays for some or all of the cost of an appraisal relied upon by a donor, it is discharging an obligation of the donor. This means that the charity may end up issuing an IRS Form 1099-MISC to the donor for the amount spent on the appraisal. The donor thereby avoids an expense (which, depending on the donor's status with respect to miscellaneous deductions, may

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ultimately be deductible in whole or in part) but will have a corresponding increase in taxable income. An alternative approach, if the donor balks at paying for the appraisal, would be for the charity to obtain the appraisal and then make it available to the donor along with a written indication that the donor's deduction will need to be reduced by the amount the charity paid for the appraisal, on the theory that the appraisal constitutes "goods and services" provided to the donor in exchange for a charitable contribution.

As noted above, if the charity orders a separate appraisal for its own use, the charity will logically be the one to cover the cost. Similarly, if the charity has concerns that prompt it to obtain an inspection, an environmental analysis, a survey, or some other assessment of the property, it will likely pay the bill or negotiate with the donor to share the expense.

b. Marketability

The qualified appraisal is an opinion of value by a qualified appraiser. It is prudent for the charity to also get an opinion of value and marketability from real estate agents active where the property is located. Identifying those real estate companies with a market share can be accomplished by going on-line and seeing which real estate companies have a number of properties listed for sale in the zip code where the subject property is located.

It is preferable for a representative of the charity to be present when the real estate agents visit the property. The real estate agents should follow-up with a written competitive market analysis with information about recent sales of similar properties, sale prices, time on market, and an estimate of value of the subject property. Inquire about the length of time the agent anticipates it will take to sell the property in the current market.

Many charities when putting the property on the market use the value in the qualified appraisal. While in most cases that is a sound approach, using recommendations provided by real estate professionals familiar with the neighborhood and market conditions can result in a faster sale at the current fair market value.

V. Having Another Public Charity Accept The Gift

The charity has another route it can follow should it continue to have interest in the property as a gift, but no longer wishes to do further due diligence or be involved in accepting and disposing of the property. Many community foundations and some other public charities will accept illiquid assets as gifts and then sell those assets, with the proceeds to be used to benefit the charity suggested by the donor. Each public charity that offers this service has its own criteria for what it will accept and its own terms for application of the proceeds upon sale. This is an alternative worth exploring for charities that do not wish to have direct involvement in accepting and selling a gift of real estate.

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Should the charity be willing to accept the gift but want to protect the main entity from liability, the charity can establish a Single Member Limited Liability Company (SMLLC) to accept the property. Legal counsel should be consulted for the IRS requirements for a SMLLC so that the donor can take an income tax charitable deduction by donating the property to the SMLLC.

VI. Common Types of Real Estate

Although gifts of real estate can conceivably be made using many different (sometimes rather esoteric) property interests, here are some of the types of assets gift planners encounter most frequently:

1. Undeveloped land

2. Single-unit residences

3. Multiple-unit residences

4. Farms

5. Commercial property (e.g., stores, hotels, warehouses, industrial facilities)

6. Selected Partial Interests
   a. Condominiums
   b. Cooperatives
   c. Time Shares
   d. Conservation Easements
   e. Rights to Natural Resources

Note: Certain types of real estate identified above can be held by real estate investment trusts (REITs). Accordingly, donors sometimes invest in REITs as a way of participating in the real estate market without actually owning real estate. Typically, however, a donor wishing to use his or her interest in a REIT to make a charitable contribution will ultimately be making a gift of securities, not a gift of real estate.

VII. Ways Real Estate Can Be Used to Make a Charitable Gift

Depending on the type of real estate a donor has, as well as on a number of other factors, the donor may select from a variety of giving arrangements. This section of the materials primarily deals with the most common ways donors can choose to make a charitable gift of real estate. To the extent an IRS discount rate is involved in the calculation of the tax aspects associated with a particular gift, the rate used in these materials is 2.4 percent. To the extent a particular gift arrangement involves the making of periodic payments, the payments are assumed to be made at the end of each calendar quarter, unless otherwise indicated.

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A. Outright Transfer – Primary Residence and Vacation Home

1. In General

The donor simply deeds the property to the charity after all due diligence has been performed and the charity has agreed to accept the property. Moreover, most of the considerations involved with an outright transfer (such as those related to the qualified appraisal) will be also be involved with any other type of gift arrangement.

In return for the contribution, the donor receives a charitable deduction for the fair market value of the property. There is often less motivation to make a gift of a primary residence due to the exemption from capital gains taxes if the property has been used as a primary residence for at least two of the last five years. In that case, a single seller is exempt from the first $250,000 of gain. A married couple would be exempt from the first $500,000 of gain. However, where a donor has owned a property for many years in an area where properties have appreciated greatly, the property may have appreciated more than the exemption amount. In this case, a gift of the property could result in a savings of capital gains taxes, as well as an income tax charitable deduction.

Owners of vacation homes cannot take advantage of the exemption from capital gains available to owners of a primary residence. All gain in value of a vacation home is subject to capital gains taxes if sold. Thus, from a tax perspective a vacation home is a better candidate for a charitable gift than a primary residence.

Caveat: A donor should be counseled not to go too far in trying to assure the charity that the piece of property to be donated can be liquidated readily. Either the donor or the charity can properly make it known to potential buyers that the property likely will be the subject of a charitable gift and that, once the charity has acquired the property, it will be available for purchase. Nevertheless, the closer the donor comes to entering into a binding deal, the greater the risk of a so-called “step transaction” that will result in the donor being taxed on the gain.

2. Special Considerations

Properties that a donor has held for investment can be especially advantageous from a tax perspective to use in making a charitable gift. In return for the contribution, the donor receives a charitable deduction for the fair market value of the property. If the donor claimed accelerated depreciation on the property, his or her deduction would need to be reduced by the difference between the total depreciation claimed and the “straight-line” depreciation that would have been taken had accelerated depreciation not been claimed. The donor also avoids being taxed on any long-term capital gain, regardless of whether the gain is attributable to an increase in the value of the property (such gain is currently taxable at a maximum rate of 20 percent) or to straight-line depreciation taken by the donor (such gain is currently taxable at a rate of 25 percent). In addition, were a donor with an especially high adjusted gross income to sell appreciated real estate in lieu of contributing it, the 3.8-percent net investment income tax might apply.

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B. Bargain Sale

1. In General

A bargain sale appeals to a donor who would like to make a gift to charity but cannot afford to make an outright transfer. The donor sells the property to the charity at a "bargain" price, i.e., something less than the property's appraised fair market value. The gift is made by means of a deed, along with separate documentation substantiating the fact that the price paid by the charity is purposely less than fair market value because the donor is intending to make a charitable gift of the difference.

Whatever the price paid by the charity, the donor receives a charitable deduction for the difference between the sales price and the appraised fair market value of the property. The cost basis of the property is prorated between the sale and the gift in proportion to the price paid. This means that the donor will recognize some, but not all, of the capital gain.

2. Special Considerations

Sometimes, a donor will want the charity to make the payments over the course of several years. With an installment bargain sale, the tax deduction is available in the year of the gift, but the capital gain is spread over the number of years in which the payments are made. Also, if the parties agree, the total amount paid can fluctuate from year to year. A portion of each year's payment will be taxed as capital gain and a portion as ordinary income (due to interest determined in light of I.R.C. § 483), with a third component being tax-free return of capital. The precise amount of each component will vary from year to year depending on the amortization, and payments received by the donor will cease with the last installment (or perhaps sooner, if the donor dies before the last installment is made and has either provided for someone else to receive the remaining payments or has arranged to have them payable to his or her estate, with a third option of having the donor's will provide that any amount still owing by the charity upon death is forgiven).

An installment bargain sale is to be contrasted with a charitable gift annuity, discussed below. The latter involves uniform taxation of payments during the life expectancy of the donor (or any one or two persons who may be the annuitants), as figured at the time the gift is made, plus payments that cease only upon death, although each payment is taxed entirely as ordinary income if the annuitant lives beyond his or her date-of-gift life expectancy. Note: If a charity acquires real estate on an installment bargain sale basis but does not make use of the property in fulfilling its mission, this can produce unrelated business taxable income for the charity.

Finally, a *de facto* bargain sale will occur if a donor makes an outright contribution of mortgaged real estate, with the "price paid" (i.e., the value of the benefit conferred by the charity upon the donor) being the amount of the mortgage debt.

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3. Example

Several years ago, Ms. Decker bought a condominium unit so that her elderly mother would have a place to live. Unfortunately, her mother recently had to make a permanent move into a skilled nursing care facility.

Ms. Decker has no use for the condo and just wants to get back what she paid for it - $150,000. Its fair market value, as shown by a recent qualified appraisal, is $250,000.

For some time, Ms. Decker has been wanting to make a significant gift to support the local community college. She approaches the community college foundation about purchasing the condo for $150,000. After performing its due diligence, the foundation accepts her offer. While she receives a $100,000 charitable deduction, she also recognizes $60,000 in capital gain. This is true despite the fact that she sold the condo for the same amount she paid for it. The reason is that three-fifths of her cost basis, or $90,000, is attributable to the $150,000 sales price because $150,000 is three-fifths of $250,000. Of course, depending on Ms. Decker's adjusted gross income, the taxable capital gain may be completely offset by the deduction, with any excess deduction resulting in tax savings in the year of the gift plus any applicable carryover years.

C. Retained Life Estate

1. In General

Here again, the donor simply deeds the property (which must be either a personal residence or a farm) to the charity, although in this instance he or she also reserves the right to occupy and otherwise use the property for life (or a term of years). Even though initially the charity receives only a partial interest, it will eventually become the fee simple owner – so long as the charity and the holder(s) of the life estate(s) do not decide to sell the property to a third party prior to the expiration of the life estate(s). The term "personal residence" includes any property used by the donor as his or her home and is not limited to the donor's principal residence. When a remainder interest in a farm is contributed, the gift entails all real property on the premises – including any residences and buildings – rather than just land devoted to pasture or cultivation.

The donor avoids being taxed on any capital gain and also receives a charitable deduction, but only for a portion of the property's fair market value, as established by a qualified appraisal. Specifically, the deduction is equal to the present value of the charity's remainder interest in the property. In addition to all of the various considerations involved in appraising the overall fair market value of the property, when a remainder interest is given the appraisal will also need to set forth how much of the fair market value is attributable to the land and how much is attributable to the improvements. Furthermore, it must fix the useful life of the improvements, along with their salvage value at the end of that period.

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2. Special Considerations

Another complexity to be addressed with this type of gift is the care that must be given to how the charity and the life tenant(s) will handle numerous actual and potential costs and responsibilities associated with maintaining the property. In practical terms, this means having a detailed written agreement between the charity and the donor regarding matters such as:

a. real estate taxes
b. liability and casualty insurance
c. utilities
d. maintenance and minor repairs
e. remodeling and major repairs
f. criteria for evaluating subtenants, if the property is sublet by the life tenant(s)
g. procedures for removal of the personal property of the life tenant(s) upon the end of the tenancy
h. a comprehensive dispute resolution process

Costs for items a, b, c, and d are customarily borne by the life tenant, whereas with item e the parties are usually left to negotiate the sharing of costs.

Regardless of who a life tenant is, he or she may decide not to continue occupying the premises. This leaves the life tenant free to lease the property and receive rent for it or to contribute it to the charity and receive an income tax deduction (or life income in the form of a charitable gift annuity, if this is an option from the point of view of the charity). If the charity and the life tenant (and any other subsequent life tenant) agree to do so, the property can be sold, with the proceeds apportioned according to the present value of each interest in the property. Such a sale could result in some taxable capital gain being realized by the life tenant, whereas a donor's mere contribution of the remainder interest to charity is not a taxable event.

3. Example

Dr. & Mrs. Smith, both age 78, have owned a vacation home at the shore for over 40 years. Now in retirement, they no longer feel comfortable with the three-hour drive it takes to get from their primary residence to their shore vacation home. However, they still periodically make trips for long weekends and are not ready to sell the home.

The Smiths have a desire to benefit the local hospital foundation where the property is located. After consultation with the hospital foundation planned giving office, the Smiths have agreed to deed the property now to the foundation, reserving a life estate for themselves. The house is mortgage free. A qualified appraisal fixes the value of the property at $770,000. Of this amount, $513,300 is attributable to the value of the building, which is deemed by the appraiser to have a useful life of 45 years and a salvage value of $128,300. In exchange for the gift to the foundation, Dr. & Mrs. Smith

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receive a charitable deduction of $495,695. They can continue to use the property for their lifetimes.

Note: To maximize the charitable deduction, the lowest discount rate in the month of the gift or the previous two months should be used. If Dr. & Mrs. Smith had sold the property outright instead of giving a life estate to the hospital foundation, they would have had to pay capital gains taxes. As mentioned earlier, unlike when selling one's primary residence, there is no exemption from capital gains taxes when selling a vacation residence.

D. Charitable Remainder Trust

1. In General

In this case, the gift is made not to a charity directly, but instead to a separate entity – a trust – established for the ultimate benefit of one or more charities. (It may be, however, that a charitable beneficiary of the trust also agrees to serve as the trustee.) The trust makes payments to the donor (and/or anyone else named by the donor) each year for life or a period of years. The donor receives a charitable deduction for part of the property's appraised fair market value. The donor also avoids paying capital gains tax, either at the time the trust is funded or at the time the trust sells the property, although once such a sale has occurred, the payments made to the income beneficiary each year will likely include a portion of the capital gain realized by the trust upon its sale of the property.

The amount to be paid by the trust each year can be determined in one of two basic ways, and for this reason there are really two different types of charitable remainder trusts:

Charitable Remainder Annuity Trust (CRAT) – Pays to beneficiaries a sum certain, which must not be less than 5 percent or more than 50 percent of the initial fair market value of the assets transferred to the trust, even if principal must be invaded. IRC Sec. 664(d)(1). Subsequent additions to CRATs are not permitted. CRATs appeal to older individuals who want the security of predictable income.

Charitable Remainder Unitrust (CRUT) – Pays to beneficiaries a fixed percentage of not less than 5 percent or more than 50 percent of trust assets as re-valued annually. IRC Sec. 664(d)(2). Subsequent additions to a CRUT are permitted. CRUTs appeal to individuals who would like for income to keep pace with inflation if possible, although there is also a risk that income will decrease from one year to the next.

These variations of a CRUT are permissible:

- Standard Charitable Remainder Unitrust (SCRUT) – Pays the fixed percentage even if principal must be invaded.

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- Net-income Charitable Remainder Unitrust (NICRUT) – Pays the lesser of the fixed percentage or actual net income. IRC Sec. 664(d)(3)(A). Principal may not be invaded.

- Net-Income with Make-up Charitable Remainder Unitrust (NIMCRUT) – Pays the lesser of the fixed percentage or actual net income, but can pay make-up distributions to beneficiaries to the extent of accrued past deficiencies in payments. IRC Sec. 664(d)(3)(B). Again, principal may not be invaded.

- "Flip" Trust – Treasury regulations permit a NICRUT or NIMCRUT to flip to a SCRUT upon the occurrence of a triggering event. The change is effective at the beginning of the taxable year immediately following the taxable year in which the triggering event occurs. Reg. Sec. 1.664-3(c). If the trust starts out as a NIMCRUT, any make-up amount not paid out by the end of the year in which the triggering event occurs is forgone. A trust may flip only once.

Payments are typically made quarterly at the end of the calendar quarter, although they can also be made annually, semi-annually, or monthly, either at the end of the period or at the beginning. The present value of the remainder interest must be at least 10 percent of the value of the property contributed to the trust. When beneficiaries are young and payments are for their lives, this requirement may limit the payout rate to the 5- to 6-percent range

2. Special Considerations

Trusteeship – There are conceivably many options a donor has in selecting a trustee for a charitable remainder trust (CRT), but probably the three most common are a charity that is also a remainder beneficiary, a professional fiduciary, and the donor himself of herself. Discussed below are a few considerations applicable to each choice.

Not all charities have the authority to serve as trustee of a CRT, and many whose bylaws or other constituting documents permit them to do so elect instead not to take on this role. If a charity is able and willing to serve as trustee, a common prerequisite is that it be designated irrevocably as beneficiary of either all or at least a significant portion of the charitable remainder interest. Moreover, when the trust is to be funded with real estate (whether initially, or in the case of a CRUT, possibly after it has already been established), the charity will scrutinize carefully numerous aspects of the property in question – if the charity as trustee is even willing to consider real estate in the first place.

Professional fiduciaries, such as banks, trust companies, and certain individuals will often be open to acting as trustee of CRTs with real estate. Nevertheless, they, too, will need to take the time to do a thorough review of the advisability of accepting any particular piece of property.

As someone who is presumably already quite familiar with the property to be contributed, the donor could be the best choice to serve as trustee. Whereas a charity or a

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professional fiduciary serving as trustee could be expected to be hard-nosed in assessing whether the trust should accept the property, this should not be an issue when the donor will be serving as trustee. Of course, the donor as trustee would need the skills and dedication not only to do a good job of managing or liquidating the property, but also to perform all the other duties of a trustee. One idea might be for the donor to serve as the sole trustee initially, but then resign or enter into a co-trustee relationship with a relevant charity or with a professional fiduciary or other reliable source of expertise and acumen, once the trust has sold the property.

Trust Structure – A CRAT funded with real estate is a risky proposition unless: 1) each year, the property produces enough income to cover trust expenses and the payment obligation; 2) there is virtual certainty the trust will be able to liquidate the real estate prior to the end of the first taxable year of the trust; or 3) the trust is funded not only with real estate but also with liquid assets sufficient to ensure the trust's obligations can be met without resort to deeding small fractions of the property to the income beneficiaries in order to fulfill the payment obligation.

Fortunately, so long as a CRUT is desired, the usual approach is to use one of the "income exception" methods, meaning the trust will be either a NICRUT, a NIMCRUT, or a flip CRUT. The third variation is generally the most appealing, for it affords the trustee an indefinite amount of time to sell the property without concern about making any unitrust payments, and once the real estate is liquidated, the trustee is thereafter permitted to invest with the objective of maximizing total return. Interestingly, even if in its initial phase a flip trust is structured as a NIMCRUT, the trust may well be unable to earn enough distributable net income to make up any deficiencies from prior years before the flip to a SCRUT occurs and the income exception and make-up concepts become irrelevant. Therefore, a NIMCRUT-to-SCRUT flip trust may offer perhaps only marginally more benefit than a NICRUT-to-SCRUT trust.

Technically, a donor could elect to fund a SCRUT with real estate, but there are drawbacks associated with this approach. If the property produces insufficient income to cover the payment obligation and other costs and if the property cannot be liquidated, the donor will need to assure that either from the start or at some later point, liquid assets are contributed to the trust.

As something of an aside, regardless of the structure selected, the donor must understand that he or she will need to cease any use of the property before it is contributed to the trust so that the private foundation rules, which apply to CRTs, will not be violated. The temptation to do otherwise, perhaps quite inadvertently, is most likely when the donor will be serving as the trustee and the property has been used by the donor as a personal residence (although not necessarily as the donor's principal residence, for if this were the case and if the property had appreciated less than the applicable $250,000 or $500,000 exclusion amount available under IRC Sec. 121, the donor might simply sell the house rather than use it to fund a CRT). Despite that fact that a CRT allows a donor to turn real estate into a stream of income, the guiding maxim is, "You (or members of your family) can't live in (or camp on) your unitrust."

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3. Examples

a) Martha, age 79, has owned a rental house for many years. She is retiring and moving to a life care community and no longer wants the responsibility of property management. The property has no mortgages. Martha paid $175,000 for the property and a recent qualified appraisal values the property at $450,000. Martha depreciated the property using a straight-line depreciation schedule. If Martha were to sell the property, she would owe tax on the appreciation at her capital gains tax rate of 15%. She would also owe tax on the amount of depreciation she has taken at a 25% tax rate.

While Martha's goal is to not own the property, she would still like to receive a stream of income to replace the rental payments she will no longer receive. If possible, she would also like to defer the payment of capital gains taxes that will be due immediately if she sells the property. Martha has thought about using this property as a gift to benefit her alma mater. Her accountant has advised her to contribute the property to a flip CRUT with a 5% payout rate. Beginning the year after the trustee sells the property, and each year thereafter until Martha's death, she will receive distributions from the trust equal to 5% of the value of trust assets as established at the start of each year. In addition, Martha will be entitled to an income tax charitable deduction of $298,417 in the year she funds the trust, with the ability to carry forward for up to five additional years any deduction she is unable to use.

b) *Same facts as in the example above, but in this scenario Martha: 1) has a mortgage balance of $50,000, and 2) does not want to place her entire ownership interest into the flip CRUT. She wants to contribute a 50% interest to the trust, and keep a 50% interest in the property to help her pay the entrance fee to the life care community. She still wants to sell the property to be free from the responsibility of property management.*

Martha borrows $50,000, pays off the balance of the mortgage, and then contributes a 50% free and clear interest in the property to the flip CRUT. This is done by a deed from Martha in favor of the trustee.

She receives a qualified appraisal valuing the 50% interest she contributed to the flip CRUT at $225,000, and receives a charitable deduction of $149,209 for that gift. Martha and the trustee of the flip CRUT join together and sell the property for $450,000, the value established by the qualified appraisal. After deducting closing costs of $25,000, the net proceeds from sale at closing are $425,000, of which Martha receives $212,500. The trustee receives the remaining $212,500 as trust assets.

Martha will owe capital gains tax on the 50% ownership interest that she retained, but the charitable deduction from the 50% interest she contributed to the flip CRUT can be used to offset the capital gains taxes she owes. Martha will also use some of her $212,500 proceeds to repay the $50,000 loan she took to pay off the mortgage. Finally, the flip CRUT will make distributions to Martha for the rest of her life, and she has made a generous gift that will ultimately benefit her alma mater.

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E. Charitable Gift Annuity

1. In General

This is really just a special type of bargain sale. It is special in part because the bargain price is paid over the lifetime of the donor (rather than all in one lump sum or over a fixed period of years), in part due to various other IRS requirements, and in part because in certain states a charity must be authorized to issue gift annuities. Note: Even if a charity is or potentially could be authorized to issue gift annuities, a gift annuity may not always be wise from the standpoint of the charity. Indeed, because gift annuity payments are ultimately secured by all of the charity's assets, rather than just those attributable to the donor's contribution, many charities rightly balk at embracing this responsibility. As discussed under Special Considerations immediately below, the risk assumed by a charity increases when the gift annuity is funded with real estate.

The donor receives a charitable deduction for the difference between the appraised fair market value of the real estate contributed and the present value of the annuity payments, calculated taking into account various factors. Because a gift annuity is a bargain sale, some capital gain will be taxable if long-term appreciated property is used to fund the annuity. The tax can be prorated over the donor's date-of-gift life expectancy as annuity payments are received if the donor is an initial annuitant, but otherwise must be paid up front. Typically, another portion of the payments will be tax-free during the donor's date-of-gift life expectancy, with the rest taxed as ordinary income. As noted above in connection with bargain sales, each payment becomes taxable entirely as ordinary income if the annuitant lives beyond his or her date-of-gift life expectancy.

2. Special Considerations

Whereas with an outright gift of real estate the donor and the charity may each obtain and rely on separate appraisals for their own separate purposes (the donor to substantiate his or her tax deduction, the charity to evaluate whether the gift should be accepted or rejected), with a gift annuity the parties will need to agree upon a single appraised value. Accordingly, even if two or more appraisals are obtained by one or both parties, a single, bottom line figure will be necessary, as the value of the contribution will determine both the amount of the annuity to be paid by the charity and, in combination with other factors, the donor's deduction and the manner in which annuity payments will be taxed.

In theory, a charity is free to pay any gift annuity rate acceptable to the donor, so long as the present value of the annuity payments is less than 90 percent of the value of the assets contributed for the annuity. See I.R.C. § 514(c)(5)(A). In practice, however, most charities offer rates in accordance with those suggested by the American Council on Gift Annuities (ACGA). If a charity issues gift annuities in certain states, then it will need to file with the state a set of maximum rates. Lower rates than those on file may be offered, so long as the donor consents in writing to the lower rate.

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In all likelihood, if a gift annuity is being funded with real estate, the annuity rate the charity will agree to pay will be lower than if cash or liquid assets such as publicly-traded securities were being contributed. This is so for a number of reasons.

- As in the case of outright transfers, the charity will be exposing itself to various costs in holding and selling property, even if a sale occurs relatively soon after the contribution is made.
- When the property is sold, the charity may not be able to get full price.
- Perhaps most important, the charity does not know when or even if it will be able to sell the property. In the meantime, the longer it takes to liquidate the donated asset, the greater the costs of holding that asset and the greater the chance of there being some unusual and significant cost the charity will need to bear. Moreover, all the while, the charity will have an obligation to make payments to the annuitant(s), unless annuity payments are deferred, as discussed below.

Of course, to some extent, these risks can be offset if the charity exercises caution and prudence in deciding to accept the property and also if the property is income-producing. Yet apart from these potentially mitigating factors, the charity will focus on the fact that it is obligating itself to make regular payments to one or two persons for life in exchange for an illiquid asset. The result will be an annuity rate that attempts to compensate for the various uncertainties. Reductions of 10 to 20 percent, or even more, are justifiable and common. For example, if, based on the age(s) of the annuitant(s), the charity would normally pay a rate of 8 percent in connection with a contribution of cash or blue-chip stock, it might offer only 6.4 percent in connection with a contribution of real estate. Fortunately for the donor, the lower the annuity rate, the higher the charitable deduction.

As an alternative or supplemental measure, the charity could defer payments for a period of years during which one could realistically expect the property to be sold for a suitable price. The drawback here is that once payments begin deferred gift annuities generally provide for the payment of a higher amount, not only because the annuitant(s) is/are older, but also on the assumption that during the period of deferral, the charity will receive some hypothetical return on its investment of the asset contributed. Therefore, the charity might be willing to compensate for some of its risk by deferring payments and some by lowering the rate from that which it would otherwise offer, or it could elect not to lower the rate at all and simply defer payments for a comfortable period of time.

If the charity intends to use the property for charitable purposes once the contribution is made, then it will need to have sufficient separate assets from which to make the payments for the life of the annuity obligation, unless the property produces enough income to cover the annuity payments. For some charities, this will be no great hardship, but for others it may represent a bit of a gamble. Accordingly, in such a situation, the charity should try to insure that, in its zeal to acquire a particular piece of property owned by the donor, it does not burden itself unreasonably.

Finally, a charity should avoid a couple of misguided approaches sometimes taken in dealing with the risks of accepting real estate for gift annuities. Occasionally, a charity

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will attempt to lower the value of the contribution but not the annuity rate. Even though offering an annuity rate that is 20 percent below the standard rate when receiving a gift of property worth $100,000 yields the same annual payment as offering the standard rate but applying that rate to $80,000, the latter route overlooks the fundamental significance of the appraised fair market value in the gift annuity arrangement. A second flawed approach is to base the annuity payments on the net proceeds received by the charity once the property sells. Here again, what counts is the value of the property on the date of contribution. Even if the donor and the charity agree that some reduction should be made to account for what the charity will actually have in hand once the property is eventually liquidated, there must be – at the time of the contribution – a sufficient "meeting of the minds" as to what the annuity amount will be, regardless of when the property is sold and how much the charity nets from the sale.

F. Charitable Lead Trust

1. In General

Once again, the gift is made to a trust, rather than to a particular charity directly. During the trust's existence, payments are made each year to one or more charities. When the trust ends, its assets (which by that time may or may not include the real estate used to fund the trust) are typically distributed to the donor's heirs although, in relatively rare circumstances, they are distributed to the donor. Such trusts are usually established for gift and estate tax reasons, rather than for income tax reasons, and they are not very common.

As with a CRT, a charitable lead trust (CLT) can be structured either to pay an annuity (in which case it is referred to as a CLAT) or a unitrust amount (in which case it is referred to as a CLUT). Whereas a CRT is a tax-exempt entity, a CLT is a taxable entity, except in the relatively rare instance in which the donor elects to be taxed on the CLT's income.

2. Special Considerations

Funding a CLT with real estate presents some imposing challenges, the biggest of which is making certain that the income from the property is adequate – and preferably more than adequate – to cover the payment obligation on an ongoing basis. One way to head off this potential problem is to pick a modest payout rate, perhaps even one below 5 percent, as this minimum percentage payout for CRTs does not apply to CLTs. Of course, the lower the payout rate, the lower the gift and estate tax savings (or, the longer the trust will need to last to result in the same tax savings that would accompany a higher payout rate).

If the trust is a CLAT and the income from the trust's assets – combined with any liquid assets the donor may have transferred to the trust when it was funded with the real estate – is insufficient to cover trust expenses (which can include income taxes) and still leave enough to pay the annuity amount, then the trustee will have no choice but to make up the difference either by distributing trust principal to the recipient(s) of the annuity amount or by liquidating a portion of the principal, paying tax on the gain, and using the

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net proceeds to make the payment. If one of the key objectives in setting up the trust in the first place is to pass assets to heirs intact, ideally with the benefit of any appreciation in value escaping gift and estate taxation, then any such distribution is a setback.

Even if the trust is a CLUT, the net income exception variation available in the case of a CRUT is not an option. Thus, as with a CLAT, if income is insufficient, the trustee must look to trust corpus. Fortunately, additional contributions to a CLUT are permitted, although making such contributions may not be consistent with the donor's financial or estate plan.

In light of the foregoing, care must be taken in using real estate to fund a CLT. Unless the donor is especially keen on using a particular piece of property to benefit charity while ultimately keeping the property in the family, he or she would probably do better to use other assets to fund the trust.

VIII. Special Considerations Related to Gifts of Mortgaged Real Estate

A. Outright Transfers, Retained Life Estates, and Charitable Lead Trusts

As noted earlier in these materials, if mortgaged property is transferred outright, the gift will effectively become a bargain sale because the value of the debt from which the donor is being relieved will be considered an amount received by the donor. This will reduce the donor's deduction and will result in the donor recognizing some capital gain if the property has appreciated in value. Bargain sale treatment can also result when a donor contributes a remainder interest in mortgaged property and retains a life estate (PLR 9329017) or, in certain instances, when a charitable lead trust is funded with mortgaged property

B. Bargain Sales

If mortgaged property is used for an actual bargain sale, then the amount of the mortgage will effectively be added to the bargain sale price already being paid by the charity. As a result, the donor's deduction will be reduced and, if the property has appreciated in value, the amount of capital gain to report will be increased.

C. Charitable Gift Annuities

If property subject to a mortgage is contributed for a gift annuity, the amount of the mortgage will be treated as an amount realized for purposes of calculating the donor's capital gain. The gain attributable to the mortgage cannot be reported ratably over the life expectancy of the donor, even though other gain in the property can be reported ratably. Rather, it must all be recognized in the year of the gift.

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The existence of the mortgage represents yet another risk a charity would assume in connection with a gift annuity. Even if the arrangement is acceptable from the standpoint of the charity, the donor will need to be aware that he or she may be "out of pocket" initially if the upfront taxable capital gain is not offset by the deduction plus the after-tax cash flow from the annuity payments.

D. Charitable Remainder Trusts

A host of problems will flow from funding a CRT with mortgaged property (or from the trust's acquisition of such property). Here are some possible ways of handling a gift of mortgaged property to a CRT.

1. The donor could use available cash to pay off the mortgage before the transfer. This is ideal but not likely, unless the mortgage balance is small.

2. The lender might be willing to release the property from the mortgage and substitute other property owned by the donor as security for the loan.

3. The charity could purchase an undivided fractional interest in the property. The donor would use the proceeds to pay off the mortgage and then transfer to the CRT the remaining undivided fractional interest free of encumbrance. A co-tenancy agreement should be executed, and the donor should not occupy the property. This solution depends on the charity's being able to advance funds in expectation of recovering its money when the property is sold.

4. Additional, more complex strategies exist, but they are beyond the scope of these materials.

IX. Promoting Gifts of (Marketable) Real Estate

For a planned giving program to maximize its potential, it is important to educate the charity's constituency as to the assets that the charity will accept to fund planned gifts. Beyond gifts of cash or securities, most donors are unaware of other asset classes acceptable to the charity where the tax benefits to the donor also can be considerable. Gifts of real estate fit within this category. However, since a very small percentage of donors will be in a position to make a gift of real estate, marketing dollars promoting gifts of real estate must be wisely spent.

One of the most cost effective methods to promote gifts of real estate is to piggyback on other development communications. Insert a box in newsletters stating that the organization welcomes gifts of marketable real estate. Other text can highlight that a donor can give a vacation home and continue to use it. Or emphasize that a gift of an investment property can save tax dollars, end management headaches, and still provide a stream of income (i.e. a CRT).

Targeted communications can also be effective. Send a print or electronic message to donors who have both a primary and seasonal address in the development database. If the research department has identified a donor who owns multiple properties, this is presumably a real estate investor who might benefit greatly from the tax benefits of giving investment real estate. Testimonials are always a powerful tool when promoting any type of planned gift. Remember,

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with gifts of real estate volume does not matter. Any single gift has the potential to bring significant resources to the organization.

X. CONCLUSION

Real estate represents a great source of wealth for many donors and thus presents opportunities for charities to obtain significant gifts to fund organization priorities. However, the potential reward also carries potential risk. With proper infrastructure and Gift Acceptance Policies, charities need not be reluctant to encourage gifts of real estate. Thorough due diligence should identify risks so that charity leadership can make an informed decision about whether the property is a suitable gift. Smaller charities without the staff to navigate gifts of real estate can still benefit from them through community foundations and other public charities that will accept gifts of real estate and use the proceeds from their sale to benefit organizations designated by the donor. Gifts of real estate present unique opportunities for both donors and charities. Seize the day!

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REAL ESTATE QUESTIONNAIRE

Name of donor(s): ____

Location of Property

Street address ____

City, State, Zip ____

Municipality, County ____

Ownership

Title is in the name(s) of ____

If joint ownership, how is title held? _______________________ Date acquired ___________

How acquired/price _______________________________ (Please provide a copy of the deed)

Occupancy

Property is: ___ Occupied by donor ___ Tenant occupied ___ Vacant

If tenant occupied: Names(s) of tenants ____

Date lease expires ____
(Please provide a copy of the lease)

Description of property

___ unimproved land ___ residential single family ___multi-family - # units ______)

___condo/coop ___Other (describe) ____

Please describe the building (lot size, age, construction, # stories, basement, etc.) ___________

____

Other structures, such as a swimming pool (Describe) _________________________________

____

Current use _______________________________ Zoning _____________________________

Are you aware of a prior use? If so, please describe ____________________________________

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Utilities
Water source ____

Electric provided by ____

Fuel for heat: ___ Natural gas ___ Electric Other ______________________

Sewer (details if not municipal) ____

Value

Estimate of Fair Market Value $______________________________

Appraised __ Yes __ No (Date of last appraisal _____________________)
(If appraised, please provide a copy of the appraisal)

Expenses

Assessment $____________________ Annual real estate taxes $___________________

Fire insurance $__________________ Flood insurance $_________________________

Utilities $_______________________ Landscaping/snow removal $________________

Other costs (describe) ____

Environmental
Are you aware of any of the following in or near the property? (please circle as many as apply)

Asbestos Underground oil/gas storage tanks Near a gas station or commercial/industrial

Radon Lead based paint Water contaminants

Any other environmental issues (please describe) ___________________________________

Has an environmental report ever been issued for the property? ___ No ___Yes (please provide a copy)

Mortgages/Home equity loans
Are there any mortgages/loans on the property? ___ No ___ Yes (Please describe, including name of lender, interest rate, loan balance, loan number)
1. ____

2. ____

Completed by: _______________________________________ Date ______________

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