LAND HO!
THE MANY WAYS TO GIVE REAL ESTATE

PG CALC WEBINAR

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I. INTRODUCTION

In many instances, a donor's real estate accounts for much of his or her wealth. Under a variety of circumstances, it can make sense for a donor to use real estate to make a charitable gift during his or her lifetime. (While it is also quite often acceptable for gifts of real estate to be made upon death through charitable bequests – as well as through testamentary versions of most of the techniques available to donors while they are still alive – the focus in these materials is on gifts made during life.) Especially if a donor thinks a local, regional, or national real estate "bubble" is about to burst or if there are other factors that make it time to dispose of a piece of property, using it to make a charitable gift may be just the solution, provided the donor possesses sufficient charitable intent.

Of course, even if a bubble has already burst, a donor may own real estate that is still worth substantially more than when it was acquired. This is frequently the case with property purchased some decades ago, and if prospects for a rebound in value in the coming years do not appear all that promising, the time to act may be now. In fact, donors seldom complete gifts of property owned less than a year and a day or held at a loss because the resulting income tax charitable deduction under either of those scenarios will be limited to the lesser of the property's cost basis and its fair market value.

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. This is particularly likely to be so if the donor is, in turn, the sole owner of the entity. Nevertheless, such situations can present certain complications, and for this reason these materials will focus only on gifts made by individuals. Similarly, even if an individual owns various parcels of real estate and even if they have grown in value over the years, if that individual happens to be a developer who owns them as inventory, seldom will those parcels be attractive assets to draw upon to make a charitable gift, due to the tax disincentives.

Finally, even though real estate located in countries other than the United States can be suitable for use in making a charitable gift, many important details will be a function of the law of the country in question (as well as of any tax treaty between the United States and that country). Due to the potential for complexity this can present, this paper focuses solely on real estate in this country.

II. REAL ESTATE OVERVIEW

A. What Real Estate Is

Basically, "real" property is to be distinguished from "personal" property. Even though people often conceive of real estate as tangible (i.e., land and things built on land), there are actually a variety of "interests" a person can have in land or in structures or other "improvements," and some of these interests may be intangible (e.g., an easement or other right to use a piece of property). Sometimes a donor may own all interests in a particular piece of property, in which case he or she is said to have "fee simple" or "fee

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simple absolute" ownership. In other instances he or she may own only one or more specific interests.

A third possibility is that the donor shares fee simple ownership with one or more other owners. For example, the donor might own an undivided 70-percent interest in a piece of property, with one or more other parties owning the remaining undivided 30 percent. Another option would be for the donor and one or more other individuals to be "joint tenants with right of survivorship." Additional options include being one of two or more "tenants in common," or, in the case of a married donor and his or her spouse, being "tenants by the entirety" or sharing "community property" ownership.

B. 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.

III. 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 first takes a brief look at each option and then presents a handful of situations in which one or more options might be particularly appropriate. To the extent an IRS discount rate is involved in the

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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, they are assumed to be made at the end of each calendar quarter, unless otherwise indicated.

A. Outright Transfer

1. In General

The donor simply deeds the property to the charity, although in practice there can be any number of steps the donor and the charity will need to take before the transfer is finalized. *Moreover, most of the considerations involved with an outright transfer (such as those related to the qualified appraisal requirement discussed below) 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. 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.

It follows, then, that owners of long-term appreciated real estate who are interested in using the property to make a charitable gift often have as a prime motivating element the desire to avoid tax on the capital gain. Yet if they do not proceed cautiously as they go about making a gift, they may find not only that they will be taxed on the gain but also that, in seeking resources with which to pay the tax, they will not have access to any of the proceeds received by the charity upon its sale of the property. This irony is what can come to pass if a donor contributes property the charity is already obligated to sell to a particular buyer according certain terms.

Needless to say, 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.

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2. 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 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

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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 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.

3. Example

Ms. Adams, who now lives on the west coast, owns a vacation cabin in a popular resort area in the eastern U.S. where she used to live. As the years have passed, she has found it increasingly difficult to spend any time at the cabin, and she believes doing so will pose even more of a challenge in the years to come. Ms. Adams is a graduate of a university in the state where the cabin is located, and she would like to make a substantial gift to the school for the purpose of setting up an endowed scholarship fund during her lifetime.

A qualified appraisal indicates the cabin is now worth $235,000, even though Ms. Adams purchased it decades ago for only $30,000. If she sold it, she would have to pay tax on capital gain of $205,000, but she instead contributes it to the university in order to establish the scholarship fund (once the university sells the cabin, which it has determined it should be able to do fairly readily). She receives a $235,000 tax deduction and avoids paying tax on any of the capital gain.

B. 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.

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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.

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. Also, even though in many cases the only life tenant will be the donor, it is possible for the donor to make an *inter vivos* gift that results in another person (either in lieu of or in addition to the donor) receiving an immediate or contingent life tenancy. In such an instance, extra care will need to be taken in drafting the agreement to ensure that it will be appropriate and enforceable.

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, as noted above, a donor's mere contribution of the remainder interest to charity is not a taxable event.

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3. Example

For over 50 years, Mr. Baker, age 82, has lived on a five-acre farm 35 miles from a major metropolitan area. Even though he and his late wife both taught school in a nearby town for many years, they both valued being able – with the help of their only child, a son – to meet some of their needs with what they raised on the farm. Their son, however, ended up making his fortune, literally, as a computer programmer in a distant part of the country. He comes back to visit Mr. Baker occasionally but no longer feels any close ties to the property.

Despite being retired and all alone now, Mr. Baker is in good health and still tends a fair-sized vegetable garden near the house. He plans – if possible – to live on the farm the rest of his life, although upon his death he would like to make the farm available to the regional hospital to help it meet the future health care needs of a growing population.

While Mr. Baker could have simply made a charitable bequest of the farm through his will, he chooses instead to deed the farm to the hospital now, reserving a life estate for himself. A qualified appraisal fixes the value of the farm at $470,000. Of this amount, $185,000 is attributable to the farm house and outbuildings, which together are deemed by the appraiser to have a useful life of 35 years and a salvage value of $20,000. In exchange for the gift, Mr. Baker receives a charitable deduction of $368,976.

C. 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

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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.

3. Example

Several years ago, Ms. Campbell 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.

At this point, Ms. Campbell has no use for the condo and thinks to herself, "I'd just like to get back what I put into it," meaning she would be content to sell it for the $150,000 she paid for it. Its fair market value, as shown by a recent qualified appraisal, is $250,000.

For some time, Ms. Campbell has been wanting to make a significant gift to support the local library system. She approaches the library system foundation about purchasing the condo for $150,000, and 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 the $150,000 sales price because $150,000 is three-fifths of $250,000. Of course, depending on Ms. Campbell'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.

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D. 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 will attempt to lower the value of the contribution but not the annuity rate. Even though

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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.

3. Example

Mr. Duckworth, age 79, has owned a rental house for 16 years. He purchased it for $130,000 shortly before retiring, partly so that he would have a supplemental source of retirement income and partly because he figured that cutting the grass and otherwise tending to the place would give him something constructive to do. In the last few years, however, he has come to view as a burden having to maintain the property and occasionally find new tenants.

He would like to sell the house, but he knows he would have to pay quite a bit of capital gains tax, some of it at a rate of 25 percent, as a result of the straight-line depreciation he has taken on the property over the years (making his cost basis now just $80,000). More importantly, however, he would simply like to be able to assure that he continues to receive at least the same $13,000 annual net cash flow he has been receiving from the house, which rents for $1,500 per month.

Mr. Duckworth has been a member of the same church all his adult life and wants to do what he can to assure the church's future will be as strong as possible. Upon learning that the national body with which the church is affiliated issues gift annuities and is willing to accept gifts of real estate, he obtains a qualified appraisal of the house and learns it is now worth $340,000.

In sharing this information with the organization, he finds that even though the organization would normally offer to pay a person his age the ACGA rate of 6.6 percent, in his case it would be willing to pay a rate of only 5.5 percent. Still, this is quite acceptable to him, as he would receive fixed payments of $18,700 each year for life in monthly installments. He would also receive a $195,564 charitable deduction and his payments would be taxed favorably for many years, as shown below:

Ordinary income	$4,263
Long-term capital gain	$11,040 *
Tax-free	$3,397
TOTAL	$18,700

* Some of this would be taxed at a rate of 25 percent and the rest at a rate of 15 percent.

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E. 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 donor 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:

<u>Charitable Remainder Annuity Trust (CRAT)</u> – 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.

<u>Charitable Remainder Unitrust (CRUT)</u> – 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:

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

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

- <u>Net-Income with Make-up Charitable Remainder Unitrust (NIMCRUT)</u> – 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.

- <u>"Flip" Trust</u> – Treasury regulations permit a NICRUT or NIMCRUT to flip to a SCRUT upon the occurrence of a triggering event. The change is effective at

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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. In addition, with a CRAT there cannot be a greater than 5-percent probability at the time of funding that trust assets will be exhausted before the trust ends. Rev. Rul. 77-374. Currently, due to the relatively low federal discount rate, the 5-percent test effectively rules out a CRAT lasting for the life of an individual much younger than about age 71, with the ages needing to be higher still if the trust is to last for the lives of two or more individuals.

2. Special Considerations

<u>Trusteeship</u> – 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 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. Especially in the case of a more elderly donor, for example, there may be some doubt in the mind of legal counsel for the donor. One idea might be for the donor to serve as the sole trustee initially, but then resign or enter into a co-trustee

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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."

3. Example

Mr. and Mrs. Emory, both age 64, own a 2-acre piece of raw land they bought decades ago for $50,000 thinking that someday it would have value as a site for a warehouse or other commercial development. Their patience has proven them to be correct, and they

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have recently received two unsolicited offers from parties willing to pay them five times what they paid for the land.

If Mr. and Mrs. Emory were to sell the property, they would have capital gain of $200,000, meaning that they would need to pay tax of $30,000. This would leave them with only $220,000 to reinvest. Even though over the years Mr. and Mrs. Emory have made other sound investments, they would at least like to have the benefit of whatever cash flow could be generated by the property's full $250,000 in value, which they have recently had confirmed by a qualified appraisal. They have also wanted for some time to arrange eventual large gifts to a few of their favorite charities.

Accordingly, Mr. and Mrs. Emory use the land to set up a CRT with a 5-percent payout structured as a flip CRUT. Beginning the year after the trust sells the land and continuing each year thereafter, they will receive payments equal to 5 percent of the value of trust assets as established at the start of each year. In addition, they will be entitled to a charitable deduction of $81,162.

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).

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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 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.

3. Example

Mr. Franklin, a single man age 61, owns a 12-unit apartment building that over the years has proven to be very easy to rent as vacancies occur. He would like ultimately to pass this asset on to his daughter, age 29, but not until she is older and more likely to be "settled" in life. He is also interested helping to meet the human services needs of his community in a significant way.

In doing his estate planning, Mr. Franklin has come to realize his estate is worth something in excess of $7 million. Accordingly, he is looking for ways to reduce gift and estate taxes. A qualified appraisal of the building reveals it to be worth $1.1 million.

His legal and tax advisors have suggested that Mr. Franklin use the building to establish a 15-year CLUT with a 7-percent payout rate. In view of the fact that the building currently generates net income of about $90,000 per year, it is likely the trust would have sufficient cash flow to make the required payments to charity (in this case, Mr. Franklin's local community foundation) each year during the trust's existence. In establishing such a trust, he would receive a gift tax charitable deduction of $719,708, and the money distributed to the community foundation at the end of each year would go into a donor advised fund, grants from which would be made based on input from Mr. Franklin.

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G. Pooled Income Fund

The threshold question is whether the fund will accept real estate. If the fund does not prohibit real estate altogether, it may nevertheless adhere to criteria that make acceptance unlikely. If the property can be sold soon after being contributed, then there is less concern about whether it produces adequate income than will be the case if the property is to be held for a period of years. Even though a pooled income fund is, like a CLT, a taxable entity, sale of the property should not result in the payment of tax, so long as the gain recognized is long-term in nature and so long as it is added to the fund's principal for the ultimate benefit of the charity that operates the fund. A further potential benefit is that depreciation deductions associated with any real estate held by the fund can sometimes flow through from the fund to its income beneficiaries.

Of course, the number of charities that operate pooled income funds is rather small. This, combined with the general reluctance on the part of the funds that do exist to accept real estate, makes such gifts rather infrequent. Still, if a gift or real estate is acceptable to a pooled income fund, the donor can avoid taxation on any of the long-term capital gain and can insure a stream of life income, although each year's payments will be taxed entirely as ordinary income.

H. Consideration of Various Scenarios

1. A *donor who would like to live in his or her house as long as possible but who is willing to have the house go to charity upon death* – For such a person, the only way an outright transfer can be made is upon death by means of a charitable bequest. On a current basis, however, the donor could establish a retained life estate arrangement that would leave him or her free to continue living in the residence for life. If later it became necessary or desirable to move, the residence could be sold (with the proceeds divided between the donor and the charity, based on the donor's life expectancy at the time) or rented to a third party.

2. A *donor can afford to part with the property only if he or she receives compensating cash flow for life or at least for a term of years* – If payments for life are sought, the donor could establish a gift annuity or a CRT (specifically a CRUT, rather than a CRAT). Payments for a term of years could be made with a CRUT or with an installment bargain sale (but not with a gift annuity). In any event, the preferable method of structuring the gift will be a function of many factors.

3. A *donor wants to live in his or her home as long as possible but also wants to increase cash flow* – In certain circumstances, it can be possible for the donor to set up a life estate arrangement in which the remainder interest received by the charity is used to fund a charitable gift annuity. Generally, this is an option only for older donors and for relatively large charities that can afford to draw on other resources to make payments to the donor each year until he or she dies, as only then will the charity have full ownership the property. Note: Charities registered

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to issue gift annuities with the State of New York are precluded from entering into such arrangements.

If, for instance, Mr. Baker in the retained life estate example beginning on page 7 were to have contributed the remainder interest in his farm to the regional hospital in exchange for gift annuity payments, the hospital would first need to determine what annuity rate it would be willing to offer. Even though by virtue of his age Mr. Baker would be offered the ACGA rate of 7.2 percent if the hospital were receiving cash or publicly-traded securities, in this case the hospital determines that a reasonable rate would be 5.8 percent. Assuming Mr. Baker accepts this and assuming his cost basis in the farm is $140,000, he would receive annuity payments of $21,400.68 (5.8% of the $368,976 present value of the remainder interest in the farm) each year for the rest of his life. He would also receive a $228,075 tax deduction, and for the next 8.3 years $16,971 of what he receives each year would be tax-free, with the balance taxed as ordinary income. He would pay no capital gains tax because the long-term capital gain realized in connection with the gift annuity would be less than the $250,000 exclusion available to him under IRC Sec. 121 in connection with his disposition of the farm, which is his principal residence.

4. A *charity that would like to acquire full ownership of a piece of property as soon as possible* – The ideal gift, of course, is an outright transfer. Still, if the charity can afford to do so, it could acquire the property through a gift annuity or other bargain sale. It could even purchase the property from a CRT (or conceivably from a CLT, although this might not be wise from a tax standpoint), but in that case it would need to pay the full market price. Accordingly, what the donor could do – if he or she can afford it – is give an undivided fractional interest to the charity and contribute the remaining fractional interest to the trust, thereby lessening the cost to the charity and still obtaining the benefit of lifetime payments. Also, in the case of a CRT, the donor could contribute the entire property, with the trust then selling the property to the charity, which would structure the purchase by giving the trust an installment note. Each year, the charity would pay the trust only the interest owed on the note. When the trust terminated, the note would be distributed to the charity, which would thereupon cancel the note.

IV. STEPS IN THE GIFT PROCESS

A. Analysis

The property needs to be inspected by one or more knowledgeable persons who have the interests of the charity (or the trust) in mind. This can include structural/mechanical inspections, pest inspections, and various environmental inspections. There will also need to be a title examination to ensure that the donor is indeed the owner of the property and that there are no liens or other claims against it. Ideally, the appraisal obtained by the donor will be made available to the charity before the gift is completed, although as noted

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earlier, the charity can also secure its own appraisal. Any legal guidance the charity may need should be obtained from a lawyer familiar with the law of the state where the property is located.

B. Problem Solving

As a result of one or more of the inspections or other steps taken at the analysis stage, any number of difficulties may come to light. Often, the parties will be able to resolve such difficulties, but a charity should always be prepared to decline a gift if necessary in order to fulfill its fiduciary responsibility.

C. Completion of the Gift

This will entail drawing up a deed, along with any other relevant gift documentation, such as an agreement between the charity and the donor in connection with a retained life estate gift or a trust agreement for a CRT or a CLT. In addition, there may be numerous types of “escrow” details, such as prorating annual property taxes, transferring security deposits, etc. Also, the deed must be recorded in the county where the property is located. In some cases, real estate transfer taxes and fees will need to be paid.

D. Paying for Various Costs

As noted earlier in these materials, the donor generally pays for the cost of the appraisal, with the costs of various inspections borne by either the donor or the charity or both, depending on various factors unique to each situation. In addition, each party should pay for its own legal counsel, and state law will determine who pays any real estate transfer taxes. In some cases, costs that are the responsibility of the donor can be paid by the charity initially, so long as there is subsequent reimbursement by the donor or a proper accounting for tax purposes.

V. 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.

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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.

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.

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VI. THE IMPORTANCE OF POLICIES AND PROCEDURES

Before seeking or accepting any gift of real estate, a charity should devote careful attention to the types of property it will consider accepting, the ways gifts may be structured, and the criteria and process to be used in determining which particular gifts will be accepted. If a charity does not have adequate policies and procedures in writing and adopted formally by the charity's governing body, it can more easily fall prey to a donor who is "shopping" a piece of undesirable property to one charity after another until he or she finds one that is unsophisticated enough to accept a gift that no charity should accept. Indeed, gift acceptance policies and procedures can function as a "gift rejection" tool, i.e., a principled way to decline an inappropriate gift in a manner that decreases the likelihood the donor will feel alienated or that an *ad hoc* decision has been made. Such policies and procedures also play a very legitimate role in identifying issues that need further attention so that a gift that is in the end quite appropriate can eventually be made.

Many charities simply do not accept gifts of real estate under any circumstances. They may have concluded, quite properly, that they lack the expertise needed to evaluate, manage, and dispose of the property. Indeed, horror stories abound regarding charities that, in receiving gifts of real estate, have taken on liability associated with serious environmental concerns or have been unable to sell property for anything near appraised value, even after several years on the market, with real estate taxes and other costs draining precious resources all the while.

Thus, the smaller, newer, or less sophisticated the charity, the more likely a donor will encounter resistance when offering to make a gift of real estate. Yet an initial negative reaction does not necessarily mean that no donation will take place. The donor's camp can reasonably be expected first to probe regarding the nature and intensity of the charity's reluctance by inquiring about the following:

- Has the charity been "burned" on a gift of real estate in the past? If so, how might that gift have been different from the one the donor now proposes to make?

- If the charity has no direct experience with contributions of real estate, is it nonetheless giving credence to anecdotal accounts of problems experienced by other organizations? Here again, are there ways to distinguish the donor's proposed gift from those that have caused problems for other charities on other occasions?

- Are there aspects of the contemplated gift that make it a relatively low-risk proposition from the standpoint of the charity? If the donor is offering a well-maintained local house in a desirable neighborhood with no indication of any environmental drawbacks, the gift might be worthy of greater consideration than if industrial property in another state is to be given.

- Is the donor's relationship with the charity one of longstanding commitment? If so, and if in fact the property is free of impediments to ownership and sale, then perhaps discussions can move forward in this instance when they might not do so if the donor were someone else.

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- Would the property be of value to the charity in the furtherance of its mission, if not now then possibly at some point in the future? A different perspective can be warranted if the property is to be retained and used rather than if prompt liquidation is the objective.

Even if reluctance persists after matters such as those above are explored, other options exist. One is for the donor to work through a community foundation that is willing to consider gifts of real estate. In a typical case, the foundation would sell the property and then use the proceeds to establish a fund from which distributions could be made to one or more charities the donor desires to support. Another option is for the donor to establish a relatively short-term CRT, especially if the donor is willing to serve as trustee until the property is liquidated by the trust. The donor's income tax deduction would be somewhat less than with an outright gift, and the charity might have to wait a few years longer to receive the benefit of the arrangement, yet these facets of the arrangement might prove of little significance to the parties.

VII. Options for Promoting Gifts of Real Estate

As with planned gifts in general, an organization will occasionally be the beneficiary of certain gifts of real estate even if it does nothing to encourage donors to make such gifts, but it will receive more gifts if it is proactive in seeking them. Accordingly, the following techniques and messages should be kept in mind as marketing plans for gifts of real estate are developed and implemented.

1. If a charity accepts gifts of real estate that result in a transfer of ownership to the organization, donors should know this! Similarly, if only certain types of real estate are accepted or if only certain types of gifts can be funded with real estate, donors need to know this, too, along with any other relevant criteria (e.g., only if real estate is located within a certain geographical area, only if the appraised fair market value is at least $50,000, etc.).

2. The benefits donors will receive in making real estate gifts should be emphasized. Often, there will be a sizable charitable deduction, coupled with reduction or elimination of capital gains tax. Other donors may find most appealing the sense of relief that comes with disposing of an asset that has come to require too much time, attention, or money to maintain.

3. The fact that people can often have a rather strong emotional attachment to a piece of real property should be taken into account. This can be important if a charity will be retaining the property and using it in its mission, as the donor may feel a sense of comfort in knowing that the asset will continue to have non-monetary significance to others, just as it has to him or her.

4. Target markets, based on criteria such as age, marital status, length of property ownership, etc., should be identified and then pursued. For example, widows or widowers over age 70 who have lived at the same address for 20 years or more may be good candidates for a newsletter article or special mailing regarding retained life estate arrangements.

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5. The reality that a gift of real estate will probably require more time to complete needs to be confronted. Donors should be assured that the organization will provide help at various points in the process.

6. As always, a charity should emphasize the good work it does and the ways in which an appropriate gift of real estate will benefit the organization, as well as the donor.

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