THE RETAINED LIFE ESTATE: A MOST UNDERUTILIZED GIFT

PG CALC WEBINAR

Presented by:

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I. INTRODUCTION

For many donors, their home is their most valuable asset. They most likely plan to live there for many years and it might never occur to them that they could use their home to make a charitable gift during their lifetime. Likewise, there are many donors with a valuable second home that they continue to use regularly and have never considered giving to charity. In both cases, the retained life estate may offer the key to unlocking just such a gift.

From the perspective of the charity, a retained life estate can provide an opportunity to obtain by charitable gift properties that the organization wishes to acquire for future use. For example, properties adjacent to an organization's campus may be acquired over time and held for future expansion.

II. WHAT IS A RETAINED LIFE ESTATE?

With a retained life estate, the donor irrevocably deeds a personal residence or farm to a charitable organization, but retains the right to live in it for the rest of the donor's life, a term of years, or a combination of the two. The term is most commonly measured by the life of the donor or of the donor and the donor's spouse. When the life estate ends, typically when the last of the life tenants dies, the charity can either keep the property for its own use or sell the property and use the proceeds for purposes designated by the donor.

If the donor decides to vacate the property before the end of the life estate, there are several possibilities. The preferred option is to simply surrender the remaining life estate and receive an additional income tax charitable deduction for the contribution. Alternatively, in collaboration with the charity, the donor could rent the property to someone else or sell the property with the proceeds divided between the charity and the donor.

A personal residence does not have to be the donor's primary residence. It can be a vacation home or any other structure that the donor uses as a residence, such as a boat. A farm can include raw farmland, farmland with buildings on it, or just the homestead on the farm.

One of the appealing features of a retained life estate is that the donor gives up nothing while alive other than the ability to sell the residence and receive the proceeds. In all other respects, nothing changes for the donor after making the gift. The donor will continue to live in the house, still has access to all other assets, and still has the same cash flow as before the gift. Importantly, the donor also has the same responsibility to maintain the property, pay utilities and taxes, and handle other routine expenses. See below for more details regarding these responsibilities.

Immediate income tax benefit

A retained life estate is a split interest gift similar, in many respects, to a charitable remainder trust. In return for making an irrevocable gift of the property while retaining the right to use it, typically for life, the donor receives an income tax deduction in the year of the gift for the calculated remainder value of the gift of the residence or farm. The usual IRS 30% of AGI limitation and five-year carry-forward apply to a gift of long term appreciated real estate. If the real estate has not appreciated or lost value since the donor acquired it, then the 50% of AGI limitation would apply.

Unlike life income gifts, especially gift annuities and remainder annuity trusts, the lower the IRS discount rate, the higher the deduction for a retained life estate. Currently, the applicable IRS discount rate is at a near historic low, 0.6% as of this writing, which means that the charitable deduction for a retained life estate is at an all-time high.

For example, a 75-year-old who puts a $400,000 home into a retained life estate and reserves the right to live in it for the rest of his life will receive an income tax deduction of about $329,000 based upon a discount rate of 0.6%. If the IRS discount rate were 3.2%, the average over the past decade, the deduction would be about $257,000. Using a 5.0% discount rate (the average since 1989), the deduction would be only $220,000.

The charitable deduction calculation for a retained life estate is more complex than for a charitable remainder trust because the total fair market value of a residence or farm includes both the value of the underlying land, which is not depreciable, and the value of the buildings and structures attached to the land, which are. In addition to the overall fair market value of the property, estimates must be obtained for three additional elements:

- Value of buildings – the value of the house and other structures separate from the value of the underlying land
- Salvage value of buildings – the estimated value of the structures at the end of their useful life
- Estimated useful life of buildings – the estimated length of time that the structures would ordinarily remain usable

These variables may seem abstract. Does anyone really anticipate that, at the end of the estimated useful life, the home is going to be demolished with the wreckage sold for scrap? Nevertheless, these variables are a critical part of the deduction calculation because of the way depreciable assets (in this case the house and structures) and non-depreciable assets (the land) are treated under tax law.

Returning to our 75-year-old donor whose home has a fair market value of $400,000, his $329,000 charitable deduction assumes that the value of the buildings is $266,667 (2/3 of the total value) and that the buildings will have a salvage value of $66,667 (1/4 of their value) when they reach the end of their useful life, assumed to be 45 years from now. These ratios are the defaults built into *PGM Anywhere* (and *Planned Giving Manager*), but a qualified appraiser must provide the specific values for the donor's tax purposes.

In general, the charitable deduction value will be larger when:

- the value of the land is higher relative to the total value
- the salvage value is a higher proportion of the value of the buildings
- the estimated useful life is increased

For example, if $300,000 of the value in the donor's $400,000 home were attributable to the value of the land, and the salvage value of the building were $50,000 with a 45-year useful life, his deduction would be $363,000 rather than $329,000.

The Terms of the Life Estate Agreement

Transferring the deed to create a retained life estate is the easy part. The charity also needs to create a detailed agreement with the donor regarding a variety of responsibilities, such as:

a. On-going costs
   - real estate taxes
   - liability and casualty insurance
   - utilities
b. Capital expenses:
   - maintenance and minor repairs
   - remodeling and major repairs
c. Options for early termination
   - accelerating the remainder interest in favor of the charitable remainderman
   - procedures for selling the property during the tenancy and dividing the proceeds
   - criteria for evaluating subtenants, if the property is sublet by the life tenant
d. Procedures for removal of the personal property of the life tenant upon the end of the tenancy
e. Donor’s representation regarding potential environmental issues
f. Provisions to allow the charity reasonable opportunities to inspect the property from time to time
g. A comprehensive dispute resolution process

While the life tenant is responsible for expenses customarily borne by the owner of real property (such as maintenance, insurance, and taxes), expenses for improvements that benefit the charitable remainderman are subject to negotiation. For example, capital improvements that will last beyond the life tenant’s use of the property, such as new windows, a new roof, or similar types of improvements, will benefit both the life tenant and the charitable remainderman. To the extent that the donor covers more than her share of these expenses, she should be eligible for an additional income tax deduction based on the increased remainder value of her property resulting from the improvements.

As with most gifts of real estate, the charity should conduct due diligence regarding the potential environmental risks concerning the property. In addition, it should secure the donor’s commitment that she will avoid activities that could create new or unforeseen environmental risks on the property and reach agreement on how and how often the charity can inspect the property.

The last item on the list – a comprehensive dispute resolution process – is critical. While the donor and charity will be best friends on the date of the gift, that relationship can change over time for any number of reasons. An agreed-upon process for resolving disputes that is in place from the outset may help you avoid major headaches later on.

Due Diligence

As with every gift of real estate, the property needs to be inspected by one or more knowledgeable persons who have the interests of the charity 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 the charity can also secure its own appraisal. Any legal counsel the charity may need should be obtained from a lawyer familiar with the law of the state where the property is located.

It is best if all this work is guided by formal policies and procedures on gifts of real estate that the charity has already put into writing. This way, the charity is most likely to uncover any problems with the property before accepting the gift. If there is a problem that makes the charity want to decline the gift, having formal policies and procedures in place may make it easier for the charity to explain to the donor why it won't accept the gift.

Paying for Various Costs

The donor generally pays for the cost of the appraisal, with the costs of the 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.

Donor Profile

The profile of the ideal retained life estate donor is someone older, 70-plus, who owns multiple residences. A donor with this profile will often be looking for the generous current charitable income tax deduction that a retained life estate gift can deliver, especially now.

Another cohort of retained life estate donors are those who want to make a large donation, but are of modest means and therefore lack the liquidity to make a large current gift. For these donors, their home may be their most valuable asset. Because of their relatively low incomes, they may not be able to take full advantage of the charitable income tax deduction they receive for funding a retained life estate, even with the five-year carry-forward of unused deduction. For them, the satisfaction of being able to make a major gift to a cause they feel passionate about needs to be the primary motivation and saving taxes must be secondary. It is also likely that they do not have heirs to whom they want to pass on their home.

III. Case Studies

Give Personal Residence

A long time donor, age 72, is interested in making a legacy gift to your organization and has been considering a charitable bequest. She owns her own home and expects to live there for the rest of her lifetime. Her home has appreciated significantly during the 35 years she has lived there. With a retained life estate gift she could solidify her legacy gift and secure a large income tax deduction now.

Example: **Retained Life Estate with a personal residence**

Assumptions:	
Life Tennant Age	72
Value of Property	$400,000
Cost Basis of Property	$75,000
Value of Building(s)	$266,667
Estimated Useful Life of Building(s)	45 years
Salvage Value of Building(s)	$66,667
Charitable Deduction	**$318,436**

For the rest of her lifetime, the donor would continue to live in her home and remain responsible for regular expenses including maintenance and upkeep, insurance, and taxes. If, in the future, she decided to move out of her home, she could simply surrender her remainder interest and receive an additional income tax deduction or, in collaboration with your organization, she could rent the property or sell it.

Give Farm

Another donor, a bachelor farmer aged 78, owns and works a 160-acre farm that he inherited from his parents some years ago. The farmer was surprised to learn that similar farmland in the area recently sold for $6,000 an acre. His farm includes a modest homestead and a barn. The farmland is contiguous to a field study station operated by your organization and would make a good addition to the station. The farmer has no heirs and the idea of his family's farm being used for research purposes is appealing to him.

Example: **Retained Life Estate with a farm**

Assumptions:	
Life Tennant Age	78
Value of Property	$960,000
Cost Basis of Property	$19,200
Value of Building(s)	$200,000
Estimated Useful Life of Building(s)	45 years
Salvage Value of Building(s)	$50,000
Charitable Deduction	**$878,737**

Bonus: Retained Life State Plus Charitable Gift Annuity

A retained life estate plus charitable gift annuity combines two gift arrangements to allow a donor to contribute a remainder interest in a home or farm and, simultaneously, use some of the value of the home or farm for a charitable gift annuity making payments for life to the donor or others for life.

The first part of this gift plan is a retained life estate; the donor contributes the remainder interest in a home or farm but retains the right to use it for life. The second part is a charitable gift annuity issued by the charity based upon the remainder value of the donor's home or farm that was contributed subject to the retained life estate.

As with any other retained life estate, the donor continues to be responsible for all routine expenses – maintenance fees, insurance, property taxes, repairs, etc. When the donor's retained life estate ends, the charity can then use the property or the proceeds from the sale of the property for the purpose the donor designates.

Like all charitable gift annuities, the gift annuity part of this plan is a contract issued by the charity promising to pay a fixed amount annuity for the lifetime or one or two annuitants and creates a financial obligation for the charity. However, unlike other charitable gift annuities where the donor has contributed money or property which can be used to fund the annuity payments, in this case the charity must provide another source of funds for the annuity payments.

For example, assume a donor, now age 75, owns his home near your organization's primary facility. He is willing to consider a retained life estate contribution reserving the right to continue living in the home, but he is concerned about his retirement income. During the time the donor has lived in the house it has appreciated substantially. Following is an illustration of a combination retained life estate plus charitable gift annuity.

Example: **Retained Life Estate plus Gift Annuity**

Assumptions:	
Annuitant Age	75
Value of Property	$450,000
Cost Basis of Property	$180,000
Value of Building(s)	$300,000
Estimated Useful Life of Building(s)	45 years
Salvage Value of Building(s)	$75,000
Charitable Value of Life Estate Gift	**$370,532**
Gift Annuity Payout Rate	5.4%
Payment Schedule	Annual
Charitable Deduction	**$157,913**
Annuity	**$20,009**
Tax-free Portion	$6,859
Capital Gain Income	$10,289
Ordinary Income	$2,861

Total reportable capital gain of $127,571 must be reported over 12.4 years, the expected life expectancy of the donor age 75. After 12.4 years, the entire annuity becomes ordinary income.

During his lifetime, the donor will continue to live in his home and the charity will pay him an annuity of $20,009. At the end of his lifetime, gift annuity payments will cease and the charity will own the property outright to either retain for its use or sell.

There are several special considerations with this gift plan:

- As noted above, the charity must be willing to provide funds to make the gift annuity payments because there is no immediate transfer of assets. The donor is going to continue to live in the home and the charity will not be able to sell it until after the end of the donor's lifetime. However, particularly if the charity is interested in acquiring the property in the future, providing funds for gift annuity payments could be an advantageous way to obtain the property.
- Of course, the donor will not be able to claim the income tax deduction for the retained life estate because that value was exchanged for a charitable gift annuity. However, there will be a charitable deduction for the gift annuity. This deduction will be less than the retained life estate deduction because the donor will be receiving a lifetime stream of payments from the gift annuity.
- Finally, special attention must be paid to state gift annuity requirements and limitations. Some states frown on issuing a gift annuity in conjunction with a retained life estate. For example, New York regulators have indicated that accepting a gift of real property with a retained life estate would be contrary to the prudent investor standard that governs the gift annuity reserve fund. Hence, a charity that is registered to issue gift annuities in New York should steer clear of issuing a gift annuity in exchange for a retained life estate gift.

IV. Conclusion

The current extremely low lRS discount rate makes the retained life estate an attractive gift arrangement for donors who are seeking a large current income tax deduction. The retained life estate can also be attractive to donors who want to make a major gift, but for whom their home is the only asset valuable enough to make one. Even though the arrangement itself is straightforward, it is critical for the charity to do proper due diligence prior to accepting the real estate and to define carefully who will have ongoing responsibility for what once the arrangement is in place. While these steps – and their potential pitfalls – may make the process more complex, the potential size of these gifts make the additional work and expense involved well worthwhile.

Life Estate Contract for a Personal Residence

Life Estate Contract for Personal Residence

THIS AGREEMENT is made between John D of Seattle, Washington ("Life Tenant") and the ABC Charity ("Charity"), a Washington Nonprofit Corporation having its principal office at Seattle, Washington.

John D residing at 1234 Pleasant Boulevard, Seattle, Washington 98100 has conveyed to the ABC Charity the real property commonly known as 1234 Pleasant Boulevard, Seattle, Washington 98100 ("the Premises"), reserving to himself a life estate for and during his life.

Life Tenant and Charity hereby enter into this Agreement establishing certain rights and responsibilities of each with respect to the Premises. Accordingly, Life Tenant and Charity hereby agree as follows:

Payments by Life Tenant

1. Life Tenant shall be responsible for the payment of all property taxes, assessments, utilities, and any mortgages secured by the Premises. Life Tenant shall pay all amounts due for such expenses on a timely basis and shall keep accurate records of payments.

2. Life Tenant shall pay for all ordinary repairs, both internal and external, to the Premises, including but not limited to mechanical, electrical and plumbing systems, yard, sidewalk and driveway maintenance.

3. If Life Tenant desires to make substantial improvements, such as for fixtures, additions, replacements, roofs, swimming pools, air conditioning and other major improvements, Life Tenant shall have the option of making such improvements at Life Tenant's own expense or making a determination in advance as to whether Charity is willing to participate in such expenditure. In the event that a major expenditure is necessary due to wear, tear, obsolescence or Act of God, and such expenditure is essential to the preservation of the value of the Premises, Life Tenant and Charity shall agree at that time as to the proportion of the expenditure to be borne by each party.

4. Life Tenant shall insure the Premises and improvements against damage by fire or other hazard in an amount not less than the replacement cost of the Premises, and shall name Charity as an additional insured. Life Tenant shall further obtain a policy of public liability insurance covering the Premises, with Charity as an additional named insured.

5. Life Tenant agrees to pay all taxes, encumbrances, and other charges which may be a lien on the Premises as of the date of termination of his life estate.

Maintenance and Inspection

6. Life Tenant shall maintain the Premises in good condition. No major improvements, including but not limited to additions and changes in floor plans, shall be undertaken without written consent of Charity.

7. In the event of loss or damage to the Premises by fire or other cause, Life Tenant, except as provided below, shall repair or rebuild the Premises to its original condition, but shall not be obligated to spend in excess of the proceeds received from insurance required hereunder. In the event of substantial loss or damage which makes it appear impossible or impractical to rebuild the Premises, Life Tenant and Charity jointly shall determine whether it is economical and feasible to repair or rebuild the Premises. If not, the proceeds received from the insurance coverage shall be paid to Life Tenant and Charity in accordance with the actuarial values of their respective life estate and remainder interests, as determined at the date of damage and in the manner set forth in Internal Revenue Code section 170(f)(3)(B) and Regulation section 1.170A-12 thereunder used to value the gift of a remainder interest in real property.

8. Charity shall have the right to inspect the Premises with reasonable notice given to Life Tenant, but in no event less than 30 days notice.

Usage by Life Tenant

9. Life Tenant agrees to use the Premises for Life Tenant's residence and for no other purpose without written permission of Charity. Life Tenant shall have the right to rent the Premises with the approval of Charity as to the tenant for purposes of preserving the value of the property; however Charity shall have no right to approve or determine the amount of rent to be received. Both parties agree that they will not dispose, nor make any agreement to dispose, of any interest in the Premises during Life Tenant's lifetime except by mutual written consent.

10. Life Tenant reserves the right to terminate Life Tenant's life estate in the Premises by surrendering complete title to Charity. In the event the Premises are sold by mutual consent, the net proceeds from the sale shall be divided between Life Tenant and Charity in accordance with the then actuarial values of their respective life estate and remainder interests, as determined at the date of damage and in the manner set forth in Internal Revenue Code section 170(f)(3)(B) and Regulation section 1.170A-12 thereunder used to value the gift of a remainder interest in real property.

Termination of Life Estate

11. In the event of the death of Life Tenant the personal representative of Life Tenant will be allowed a reasonable time to appraise and remove household furnishings and contents from the Premises. Life Tenant authorizes and directs the personal representative of Life Tenant to pay all taxes, encumbrances, and other charges which may be a lien on the Premises as of the date of Life Tenant's death.

12. In the event of relinquishment of the life estate, Life Tenant shall have a reasonable time to remove household furnishings and contents from the Premises. Life Tenant shall pay all taxes, encumbrances, and other charges which may be due and owing or a lien on the Premises as of the date of relinquishment of the life tenancy.

Remainder Interest

13. In exchange for the remainder interest in the property, Charity agrees to issue a charitable gift annuity, the terms of which are described in the Gift Annuity Agreement dated September 16, 2020. Following the termination of the charitable gift annuity, Charity agrees to use the proceeds from disposition of the Premises that remain, after reimbursing itself for annuity payments and other expenses, for the purposes specified in the Gift Annuity Agreement.

Miscellaneous Provisions

14. This Agreement may only be amended by a written instrument executed by both parties, and it shall be binding upon and inure to the benefit of both parties and their respective successors, assigns, heirs, and legal representatives.

15. If the parties fail to agree on any provision in this Agreement, including the provisions that require later agreement in certain events, the unresolved issue shall be submitted to arbitration.

16. This Agreement shall be governed by the laws of the State of Washington.

IN WITNESS WHEREOF, Life Tenant and Charity hereby execute this Agreement on September 30, 2020.

John Doe, Life Tenant

ABC Charity

By:

[Name, Title]

Note: In most states the signatures must be notarized.

This agreement is adapted from the software program Docs in a Box and used by permission. The program, which provides specimen agreements for charitable remainder trusts and other gift arrangements, was developed by Lynda L. Sands (formerly "Moerschbaecher"): www.lyndam.com.