

Complex Charitable Real Estate Gifts: Issues and Solutions

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I. Introduction

II. Why the Opportunity Is Too Great to Overlook

Charitable donations rose nationwide by 5% to \$248.52 billion in 2004, compared to 2003. Estimates indicate that real estate gifts were less than 2 percent of this contribution. With real estate accounting for approximately 50% of all individual wealth in the United States today and the second most common non-cash gift behind appreciated stock, this asset offers the most opportunity as an untapped resource for gift planning.

The individual and corporate donor should be considered as the primary sources for donating real estate to the charity. For the individual, the donation of real estate meets philanthropic intent, creates a charitable tax deduction, avoids or reduces capital gains, saves possible estate taxes, removes the burden of managing, marketing and selling the property, and potentially creates income.

The opportunity exists for the corporation to redirect unused or underused corporate facilities to charitable purposes with a deduction for the real estate value along with positive public relations. Motivation for the corporation could be the following: the property is functionally obsolete because in most cases it can no longer perform the intended use, the property is economically obsolete due to external market conditions, or the property is highly appreciated and has a relatively low tax basis.

In either case, the methodology and approach utilized for accepting the real estate asset should be considered from a legal, tax, environmental and business perspective.

III. Why Can Real Estate Be So Problematic?

Most of a charity's funds raised are from dollar donations. For obvious reasons, we like cash. Cash is simple and easily accounted for. There is no risk to accepting cash donations unless there are restrictions that we dislike. Occasionally, a donor provides a gift in the form of securities. Routinely, a charity will immediately sell the securities in order to avoid the market fluctuation of stocks and bonds. We do not like the uncertainty of transactions in flux. The securities are sold with minimal cost associated with the sale. Such is our tolerance for risk and uncertainty. But, what about personal property, intangible property, intellectual property and, the point of our session, real estate? Does your charity have the tolerance to accept these assets which have different levels of risk and uncertainty? Your charity should have a specific section in its Gift Acceptance Policy(ies) addressing real estate gifts. Following are the major, identifiable risks associated with real estate and recommended items to include in your gift acceptance policy. In the pre-gift, due diligence phase, each risk issue must be reviewed. Every risk is capable of underwriting in the due diligence phase and mitigation with focused solutions. We also recommend that at the inception of a proposed real estate gift, a written *Real Estate Gift Donation Plan* be prepared that a.) addresses all of the risks shown below for that particular property and b.) projects the process of gift acceptance, ownership and gift disposition for that real estate asset. This would then be submitted to your gift Acceptance Committee and/or Board for authorization of the real estate gift.

- A. *Valuation:*** Real estate is uniquely difficult to value. There is little fungibility or even homogeneity to real estate assets. No two properties are identical. At best, two similarly designed properties are located in different locations that affect their respective values. An appraisal is always an important step in evaluating a property. This is the legal obligation of the donor. A charity should ask the donor to provide a copy of his/her appraisal. In any significant transaction, the charity should engage an independent appraisal. The development officer responsible for this gift should read the appraisal and understand the contents. Do not accept the final value without comprehensively reviewing the contents of the appraisal. Ask questions of the appraiser if you have doubt about the methodology used. Involve real estate professionals associated with your charity to help evaluate the appraisal. We will later look at how to assess net proceeds from the asset sale.

- B. *Title Issues:*** There are innumerable types of title conditions that may restrict full ownership rights and utilization of a property. Illustrations include easements, deed restrictions, zoning regulations, leases, licenses, encumbrances, tax liens, mortgage liens, other liens, etc. The variety of title issues is endless. A seasoned real estate attorney is necessary to review the condition of title. What may appear on the surface to be valuable, may not really be marketable if the title is significantly “clouded.” Related to this is what type of deed will you receive from the donor? Will it be a warranty deed, a special warranty deed or a quitclaim deed? The warranty deed is the best and the quitclaim deed the least desirable. It is essential to address the condition of title early in the due diligence phase. In some situations, monetary payments can remove the title issue. If this is the case, you must determine who will pay to remove the title issue.
- C. *Environmental Concerns:*** Probably the single greatest concern that plagues real estate and confounds such donations is the potential for liability associated with environmental issues. Although this issue is highly visible, it is rare that environmental contamination would emerge as a problem. However, the one time you neglect the environmental evaluation is precisely when the problem will emerge. It must be taken very seriously. You must have a qualified Phase I environmental audit. The development officer or a trusted colleague must personally inspect the property. The combination of these two steps should reveal any potential environmental concern. If there is any doubt about potential contamination, additional, invasive testing should be performed, i.e. a Phase II study. By following standard, prescribed procedures, environmental contamination should be identified. Then the question becomes scope of problem, cost of remediation and who will burden the cost. Commercial environmental insurance is available as well. Without detailing the specifics of the law, Congress enacted the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act in 1996. The Act amended fiduciary liability rules to limit environmental liability to the real estate itself and to protect fiduciaries against personal liability. However, this safe harbor rule does not limit the liability of a fiduciary whose negligence causes or contributes to a release or threatened release of contaminants. There are other options to address environmental concerns including options to purchase and the Winston F. C. Guest concurrent, deferred closing which we will review later.
- D. *Ownership Issues:*** There are several concerns that we would include in this category. Once you have done all the due diligence on a real estate gift, now your charity will take ownership of the asset. How will you manage the multi-faceted ownership demands of real property? Is the real estate gift encumbered by mortgage indebtedness, i.e., acquisition indebtedness? How will the tax treatment be for both your charity and your donor? Is there unrelated business taxable income (UBTI) to your charity? The gift may range from a simple, vacant parcel of land to a multi-tenanted, commercial office building or retail shopping center. The intensity of management is greater for the latter types of property. There are general property management needs, marketing and leasing needs, maintenance concerns, revenue and expense issues, tax assessments, banking arrangements, and cash flow concerns. It is possible that your charity has the internal resources to manage a less complicated property such as a single-family detached residence. Multi-tenanted and commercial type properties should be entrusted to a professional property management firm. Property management fees will cost 3-6% of the gross revenue depending upon the complexity of the asset under management. This represents a sound investment for proper management.
- E. *Disposition Issues:*** The last area of risk to be assessed involves disposition of your real property gift. How long will the disposition take? How intensive will the marketing of the property be? How costly will the marketing be? Who should you hire to sell the property? What expenses should be anticipated in a sale? Should you discount the selling price from the appraised value? It is important to answer these questions during the due diligence period and include them in your *Real Estate Gift Donation Plan*. Your board will want to see reasonable projections of gross revenue, less holding costs and selling expenses to arrive at net proceeds. Careful underwriting of these projections is necessary to establish credible net proceeds. This is particularly critical if your charity is going to issue a charitable gift annuity based upon the net proceeds of the real estate gift.

- F. *Real Estate Gift Acceptance Policy:*** In order to address the issues of risk, the charity should understand the importance of prescribed gift acceptance standards and utilize a gift acceptance policy as a guideline and procedural process for accepting the real estate gift. The gift acceptance policy exists to protect the charity and serves as a risk management tool. The policy also provides an objective way to decline real estate as a fiduciary.

The following are recommended items and procedures that should be followed and covered in the real estate section of the charity's gift acceptance policy. These include items covered above.

1. Potential gifts of real estate should be reviewed by a Gift Acceptance Committee.
2. The donor should be responsible for obtaining an appraisal of the property and paying for same.
3. Due to the costs associated with the gifting of real estate, the property value should exceed a certain minimum amount.
4. Existing and potential liabilities of a real estate gift should be considered and identified. A title commitment and a Phase I Environmental Assessment should be obtained.
5. Maintenance and carrying costs of the real estate should be evaluated and analyzed relative to the income from the property.
6. Marketability factors should be thoroughly considered due to the affect on the holding period and the conditions of sale.
7. Disposition costs associated with the sale of the real estate should be considered as part of the evaluation process. In some cases it would be appropriate for the donor to incur some of these costs prior to the gift transfer.
8. Other documents such as the deed, tax bill, survey, plot plan and zoning status should be reviewed.

A solid policy dealing with real estate gifts will incorporate these items and provide a framework for you and your Board to evaluate a gift. This is important to establish a comfort level within your charity to accept real estate donations. As indicated above, good due diligence will identify, quantify and isolate potential risk and uncertainty. By following these steps, your charity will succeed with an asset class that is increasingly important in today's gift environment.

IV. Creative Structural Alternatives For Isolating Risk

Even though you may have all the best resources for evaluating a real estate gift and conduct thorough due diligence, your board may still be uneasy about your operating charity taking title to unrelated real property. What can you do to isolate the risk of real estate ownership from your operating charity? Following are a few recommendations for creative, "deal structuring" that will further minimize risk to your charity.

- A. *Establish a Charitable 509(a)(3) Supporting Organization:*** Under the Internal Revenue Code, a 501(c)(3) charity may establish what is called a 509(a)(3) supporting organization. This supporting organization is incorporated for the benefit of, to perform the functions of, or to carry out the charitable purposes of the sponsoring charity. The supporting organization is established for the exclusive benefit of the sponsoring charity. Distributions of income and assets may be made at any time from the supporting organization to the sponsoring charity. The supporting organization is also exempt from federal income taxation under section 501(c)(3) of the Code. All donations to the supporting organization are to a 501(c)(3) charity and are fully deductible by the donor as qualified charitable donations.

In the past year, Devereux has established a new 509(a)(3) supporting organization named The Devereux Real Estate Asset Legacy Foundation, or abbreviated as The Devereux REAL Foundation. The Devereux REAL Foundation is created to exclusively accept real estate donations on behalf of Devereux. Title to all real estate donations is in The Devereux REAL Foundation. When the real estate gifts are sold, all proceeds are directed to Devereux, the

sponsoring charity. Each year, Devereux appoints the Board of Trustees of The Devereux REAL Foundation. It is a related entity and is controlled by Devereux. However, the governing board of the supporting organization must act independently from the control of the sponsoring charity. This is necessary to ensure that it is regarded as a distinct legal entity separate from the sponsoring charity. For accounting purposes, The Devereux REAL Foundation is consolidated with Devereux in its annual financial statement.

The benefit of The Devereux REAL Foundation is that all real estate gifts are segregated from the operations of Devereux. Devereux has no liability for assets held in The Devereux REAL Foundation. Furthermore, the Articles of Incorporation for The Devereux REAL Foundation include language that makes the purpose of the supporting organization to accept many different types of real estate. Thus, what might have been a gift unrelated to the purpose of Devereux is now a gift related to the purpose of The Devereux REAL Foundation. Income generated by the real estate gift will not be unrelated business taxable income (UBTI) to The Devereux REAL Foundation. Certain real estate gifts may be inventoried for an extended period of time in the supporting organization without risk to the sponsoring charity.

- B. *Establish a Limited Liability Company:*** If there is a concern over UBTI from a gift of real estate, the charity may establish a limited liability company (LLC) to hold the asset. The LLC would be structured as a sole member LLC with the charity as the sole member. The UBTI may arise because the real estate gift is encumbered by mortgage indebtedness and the real estate is unrelated to the purpose of the charity. If the charity maintained ownership of debt encumbered real estate unrelated to the purpose of the charity, any income from the asset would be UBTI to the charity. Under this scenario, the charity accepts title to the real estate gift and immediately transfers title to the LLC. The LLC is a taxable, for-profit entity and the income from the real estate is no longer UBTI. Any income is subject to ordinary taxation in the LLC. Note: This structure would not relieve the charity from liability if the real estate gift were to have environmental contamination since the charity was in the chain of title.
- C. *Utilize an Option to Purchase:*** Another alternative is for your charity to enter into an “option to purchase agreement” with your donor. The option to purchase agreement is granted to the charity at less than fair market value for the real estate. The option price contained in the option to purchase agreement could be for a very nominal amount, say \$100 when the asset is worth hundreds of thousands of dollars. The charity, or another charity, must exercise the option to purchase at the stated option price for the donor to receive a charitable deduction. There is no authority for the donor to receive a charitable deduction if the charity assigns the option to purchase to a non-exempt entity, i.e. an individual or a for profit entity. The donor receives a charitable deduction for the difference between the appraised fair market value of the real estate and the sum of i) the cost of the option paid by the charity and ii) the stated option price in the option to purchase agreement. The donor is not entitled to the charitable deduction until the option to purchase agreement is exercised. The benefit of this arrangement is that the charity can defer settlement on the property for some period of time in order to find a buyer for the property. The charity, not the donor, must identify the buyer to avoid the “step transaction” rule which disqualifies the donor’s charitable deduction. See Revenue Ruling 82-197 and progeny.

Example: Donor owns a warehouse with an appraised value of \$500,000. The donor enters into an option to purchase agreement with his favorite charity for \$100 granting the charity the right to buy the warehouse for an additional \$100. The charity actually pays \$100 to the donor for the option to purchase agreement. The charity then exercises the option to purchase for \$100. Thereafter, the charity sells the property to a third-party for \$500,000. The donor is entitled to a charitable deduction of \$499,800 when the option to purchase is exercised by the charity. The charity has sold the property and received the fair market value for the real estate. Note: To the extent that i) the cost of the option paid by the charity added to ii) the option price in the option to purchase agreement, is less than fair market value of the asset, the bargain sale rules apply. In this case, the donor would have to pay \$200/ \$500,000 of any capital gains. The charity paid \$100 for

the option and the option price in the option to purchase agreement was \$100, adding together to \$200. This is not a significant issue to the donor unless the cost to the charity is substantial.

- D. *Utilize a Concurrent, Deferred Closing (Winston F. C. Guest):*** This is a little known technique that has been blessed by the tax court whereby the charity enters into a written agreement with a donor to accept a gift of real property. The charity agrees to accept the gift subject to a reasonable due diligence period to evaluate the real estate. The charity then identifies a third-party buyer. The charity then assigns its rights and interest in the agreement with the donor to this third-party buyer for fair market value of the real estate. The charity instructs the donor, as agent and nominee of the charity, to transfer title to the charity's assignee, the third-party buyer. The tax court in the Guest case (77 T.C. 9) found that, even though actual title did not pass to the charity, the charity had all rights of ownership and title granted to them under the written agreement with the donor. The court did say that the charitable deduction for the donor did not materialize until title passed to the third-party buyer.

The Guest technique has several important advantages. The charity does not ever take title to the real estate and has no risk of liability that may arise from ownership. The transfer is deferred thereby allowing the charity time to market the property and find a buyer. Lastly, in those jurisdictions where there are real estate transfer taxes, this technique eliminates a second transfer tax.

In order to ensure that this process validates the Guest decision, the transaction must at all times be arms length. The donor cannot have any control or influence over the charity. There must not be any direct or special benefit to the donor from the sale of the real estate to the third-party buyer. The charity must identify the third-party buyer and avoid a "step transaction". Title passes directly from the donor, as agent and nominee of the charity, to the third-party buyer.

One might ask how to reconcile the Guest decision with the IRS position on options to purchase discussed above. In the Guest case, title does not pass to the charity and the donor still receives a full charitable deduction. On the other hand, the IRS requires that an option to purchase actually be exercised by a charity before the donor is entitled to a charitable deduction. Here are a couple of thoughts. A bona fide inter vivos gift requires, inter alia, a.) that there be a clear and unmistakable intention on the part of the donor to absolutely and irrevocably divest himself of the title, dominion, and control of the subject matter of the gift; and b.) there must be an irrevocable transfer of the present legal title and of the dominion and control of the entire gift to the donee, so that the donee can exercise no further act of dominion or control over it; and c.) there must be an acceptance of the gift by the donee. *Weil v Commissioner* 31 B.T.A. 899 (1934). The tax court determined that Guest had directed all of his right, title and interest in the real estate gift even though title had not transferred directly to the charity. In contrast, the option to purchase is an open, unfulfilled right until it is exercised. This seems to be the difference.

V. The Pros and Cons of Real Estate Subject to Retained Life Estates

A Retained Life Estate (RLE) is a simple transaction to structure and complete with your donor. The donor gives a personal residence or farm to a charity and reserves a lifetime estate for one or more persons. The donor issues a deed to the charity, title passes to the charity and the donor/life estate beneficiary(ies) live on the property for his/her/their lifetime(s). The RLE may be for joint lives of related or unrelated individuals. At the time title passes to the charity, the donor is entitled to a current charitable deduction. The deduction is the fair market value of the property less the net present value of the retained life estate(s) for his/her/their combined actuarial life(ves).

As with other real estate donations, it is essential to have a written agreement with the donor that clearly documents the respective responsibilities of the parties. The costs of annual maintenance for the property should be the responsibility of the life estate beneficiary(ies). The same is true for real estate taxes and insurance. The charity should be named as the primary payee under the insurance policy. The next

question to consider is what happens if the life estate beneficiary(ies) default(s) on his/her/their obligations to maintain the property? The charity must be prepared to intervene and fund any of these costs to preserve the value of the property. The written agreement should specify that a breach of these terms by the life estate beneficiary(ies) will be cause for eviction. Obviously, this is a very harsh remedy when you're dealing with a valued constituent and donor to your charity. For this reason, it is important to ask the necessary questions in the due diligence phase about other assets that the donor has and how liquid are they? Does the donor have sufficient other assets to provide annual income for living expenses. What is the status of the donor(s)'s health? Could there be a need for some form of congregate care facility or skilled nursing facility in the future? Where would the funds come from if this were necessary? If the personal residence or farm is his/her/their major asset, the proceeds from a sale might be needed to fund living costs or nursing/medical care in the future.

Care should be taken to prepare a written *Real Estate Gift Donation Plan* that addresses the issues of annual care for the property and ultimate disposition of the real estate asset. As mentioned earlier, your board will want answers to how your charity will manage the gift, what protections have been structured in the transaction and what net proceeds should be expected upon disposition.

Example: The donors own a single-family residence located in suburban Dallas. The home has 2,750 sq. ft. and is located on a 22,000 sq. ft. lot. Joe and Mary Donor have owned the home for 41 years. They purchased it for \$47,000 in 1964. The residence is worth \$645,000 today. Joe is 83 years old and Mary is 81 years old. They want to give the house to your charity subject to a life estate for each of them.

- i. They are entitled to an immediate income tax deduction of \$365,970. This is available in the year of the gift and for a carryover of 5 more years.
- ii. The joint life expectancy for both Joe and Mary is 11.4 years. This is when the charity would expect to be able to dispose of the home.

What gift value will you ascribe to this RLE? Will you project that the value of the property will increase over the joint life expectancy of Joe and Mary? The conservative valuation would be to recognize the gift at its present fair market value of \$645,000. From this figure, you should deduct an estimated 10% selling expenses, legal fees, transfer taxes and brokerage commission.

VI. Funding Charitable Gift Annuities with Real Estate

When properly structured, the use of real estate can be an acceptable funding approach for the charitable gift annuity. The donor's real estate may be transferred to the charity for an income stream pursuant to the gift annuity contract. State laws regarding the issuance of gift annuities in exchange for real estate should be considered. For example, California allows no real estate in the gift annuity reserve fund; Florida has a 5% limit with no more than 1% in any one property; and Arkansas and Wisconsin limit real estate to 20% overall, plus limits as to particular investments.

- A. *Tax Benefits:*** The capital gains treatment of the real estate transfer for the charitable gift annuity is a benefit to the donor. Capital gains will be less than the gain realized if the property were sold by the donor. When the donor sells the property, the entire amount of the gain is realized and taxed in the year of the sale. In most cases associated with a real estate transfer for a gift annuity, the capital gain is proportionally spread over the donor's life expectancy (or joint life expectancy of the donor and a spousal beneficiary). If the donor sets up the gift annuity for the benefit another, the capital gain is reported entirely in the year of the property transfer.

- B. *Issuance of the Annuity:*** Upon completion of the review process, and if the charity decides to sell the property, the charitable gift annuity can be issued before or after the sale of the property. Some charities will issue the annuity, payable quarterly based on the annuity rate recommended by the American Council on Gift Annuities for the month in which the sale of the property by the charity to a third party occurs. The face value of the annuity will be the cash proceeds less any sale expenses.

If the gift annuity is structured as an immediate payment agreement, the financial impact of the gift should be analyzed by developing a property/annuity proforma to quantify the risks and costs associated with achieving the net proceeds for reinvestment from the sale of the property to meet the return objective to support the annuity payment. In this case the charity should make the annuity payment on an annual or semi-annual basis until the property is sold. At the time the agreement is entered, ACGA rates should be used.

- C. *Considering Real Estate with Debt:*** When real estate is subject to a mortgage, debt or other encumbrance, the gift is considered a bargain sale. The charitable contribution is reduced by the outstanding debt regardless if the charity assumes the debt or if the donor pays the debt off after the property is gifted to the charity. If the donor continues to pay the debt after the gifting, the debt payments may be deductible gifts.

If the charity assumes the debt, and the encumbered real estate is not considered a related use for the charity, the charity could possibly incur debt-financed income. Charities are reluctant to take title to a property that would create unrelated business taxable income (UBTI) and capital gains tax if sold.

Certain exceptions to the debt-financing rules apply when the debt of the property is five years old and the donor has owned the property for five taxable years. Under this five and five test, the charity has 10 years to sell the property. Also, the debt-financing rules do not apply for the first ten years after receipt of the property if received by a bequest. Other solutions regarding real estate with debt would be to encourage your donor to pay off the debt or to the transfer the debt to other properties.

- D. *The “Double” Bargain Sale Charitable Gift Annuity:*** Consider the tax ramifications to your donor in the situation where a CGA is funded by debt-financed real property that would be subject to capital gains if sold by the donor. This will create a “double” bargain sale for the donor. When the debt-financed real estate is received by the charity, the donor must recognize an immediate capital gain in proportion to the debt divided by the fair market value. For instance, if there is a net capital gain of \$100,000 and the debt represents 30% of the fair market value, the donor must pay capital gains taxes on \$30,000. This is the first bargain sale element in the transaction.

Secondly, the value of the annuity to the donor is another bargain sale element. Neither Crescendo nor PG Calc currently provide the complete analysis of this gift in a single illustration. The two component parts of bargain sale must be illustrated separately.

Example: Your donor, Fred, gives your charity a small commercial property worth \$300,000 and it is subject to a \$100,000 mortgage. Fred has a tax basis in the property of \$200,000. If he sold the property, he would be subject to \$100,000 of taxable capital gain. In exchange, he receives a charitable gift annuity for his life. Fred is 81 years old.

- i. You base the value of the CGA at \$170,000. Start with the \$300,000 fair market value and subtract \$30,000 or 10% of the fair market value for estimated selling expenses, legal fees, transfer taxes and brokerage commission. This leaves \$270,000. You must now deduct the mortgage of \$100,000. The net value to calculate the CGA is \$170,000.
- ii. Your donor has an immediate capital gain to declare. If he sold the property, it would subject him to a capital gain of \$100,000. The mortgage represents 30% of the total fair

- market value. Thus, the gift to the charity causes the donor to recognize 30% of the capital gain or \$30,000 in the year of the gift.
- iii. Lastly, the CGA is part gift and part annuity contract. This is the second bargain sale. You should input a \$170,000 value for the CGA. Fred would have had \$100,000 of capital gain if he sold the property. He has recognized \$30,000 in the previous step. He still has \$70,000 of capital gain remaining to deal with. His basis in the property for purposes of this calculation should be \$100,000 (\$170,000-\$70,000).
 - iv. At age 81, Fred would receive an annual annuity of \$14,110 (8.3% of \$170,000) and a current charitable deduction of \$85,000. Of the \$14,110 annual annuity amount, \$3,980 is treated as capital gain for Fred's life expectancy of 8.8 years.

VII. Methodology for Underwriting a Charitable Gift Annuity Coupled with a Retained Life Estate

The CGA funded by a donated home or farm, subject to a life estate is a complex transaction having considerable risk. The charity will be making gift annuity payments to the annuitants for some period of time without having liquid assets to generate income from. The underlying risks of the CGA funded by real estate are compounded by not having complete control of the property and the right to sell for a number of years. In the nine (9) states where there is a reserve requirement, the charity must also front-end the reserve from its own endowment funds. All of the issues discussed above concerning retained life estates and charitable gift annuities funded by real estate exist in this situation. The gift benefit to the charity is greatly diminished by combining the two. How do you calculate the right amount of the CGA after compensating for the RLE? Are some charities underwriting the CGA by inflating the value of the home during the period of the RLE? How is the calculation impacted if the property fails to appreciate during the period of the RLE? Our recommendation is to maintain conservative fundamentals in keeping with ACGA formulas. First, do a simple CGA illustration for your donor(s) to determine his/her/their life expectancy(ies). Once the estimated life expectancy(ies) of the annuitant(s) is determined, assume that the value of the house or farm does NOT increase during the period of the RLE. Deduct estimated selling expenses, legal fees, transfer taxes and brokerage commission. Then, calculate the net present value of the house for the number of years in the estimated life expectancy(ies). The net present value so calculated is the amount that the CGA is then determined.

Example: This gift concerns a rural 120 acre farm located in Ohio. The property has a four bedroom farmhouse that Steve and Joan Donor live in. They have owned the farm for 53 years. They purchased it for \$36,000 in 1952. The farm is worth \$890,000 today. Steve is 84 years old and Joan is 80 years old. They want to give the farm to their favorite charity subject to a life estate for both of them AND receive a charitable gift annuity for the remainder of their lives.

- i. Determine the joint life expectancy of Steve and Joan. This is 11.5 years.
- ii. Calculate the net present value of the farm for 11.5 years after deducting 10% for estimated selling expenses, legal fees, transfer taxes and brokerage commission.
- iii. $\$890,000 - \$89,000 = \$801,000$
 $\$801,000$ net present valued at 6% per year for 11.5 years is
 $\$417,000$. This is the amount the CGA is based upon.
- iv. Charitable gift annuity for Steve and Joan is 7.2% per year on an amount of \$417,000. The annual annuity is \$30,024.
- v. They receive a current tax deduction of \$185,640.

VII. Funding Charitable Remainder Unitrusts with Real Estate- Features and Benefits

- A. **The Donor and the CRUT:** The Charitable Remainder Unitrust funded with real estate is a life income plan whereby the income beneficiary is entitled to receive a variable income for life or for a term of years. The income beneficiary is entitled to receive a percentage of the fair market value of the trust assets revalued annually. The income payment can fluctuate depending upon the change in the property's market value. Additional gifts are allowable without the creation of a new

trust. Conversely, with a CRAT, the income payments are set at the trust's inception and the income payments do not fluctuate and have no correlation with the future value of the trust's assets and subsequent gifts require the establishment of a new trust. With the potential for increases in market value associated with inflation, tenancy changes, or improving economic, the CRUT is in most cases the choice of the donor with risk tolerance.

In addition to being able to accept the potential for fluctuations in market value, the typical CRUT donor desires more income with increases in the trust's market value, wants income for life or a fixed term of years and would like to make additional gifts to the trust. If the donor is a corporation, the corporation can receive a tax deduction for the donation, avoid the capital gains taxes associated with sale of the property and receive trust income for a period up to 20 years. When the trust terminates, the charity receives the assets of the trust.

- B. *The Process for Setting-Up the CRUT:*** The trust document should be drafted to accomplish the needs of the donor (individual or corporation). The following are considerations in setting-up the trust: selecting the trustee; deciding the payout rate for the trust; establishing the frequency of the payments; designating the income beneficiaries; selecting the charitable remainder beneficiaries; and determining the term of the trust. The real estate assets must be transferred to the trust. The assets are sold by the trustee and reinvested to meet the income obligation. If the real estate is not immediately marketable, the primary concern will be the property's ability to generate sufficient income to meet the payment obligations of the trust.

If it is determined that the real estate cannot be sold within a reasonable amount of time to meet the income obligation, an income only or NIMCRUT with a make-up provision should be created to allow the income payment obligation to commence upon the sale of the property. Another alternative trust for the potentially difficult piece of real estate is a Flip net income charitable remainder trust. It is a net income remainder trust that is setup to allow for no income payments until the real estate is income producing or it has been sold. The trust flips from a net income trust into a unitrust paying a fixed percentage of the trust's assets with annual revaluations upon the sale of the real estate or on a predetermined date.

One obvious feature of the flip NICRUT is the donor's ability to claim a deduction in the year the real estate is donated with the trust not being required to pay income until the real estate is sold and the proceeds reinvested. This could occur in subsequent tax years.

Flip NICRUT Example: Your potential donor owns a vacant piece of land that is adjacent to a new planned unit development. The land is worth \$500,000 with a cost basis of \$50,000. A developer makes an offer to him for the purchase of the property for \$500,000. The purchase agreement calls for a due diligence period that includes rezoning and an environmental assessment, which can take up to one year. During this period of time, the developer is willing to pay \$2,000 per month plus taxes to your donor for taking the property off the market and holding the purchase price. If your donor sells the property directly to the developer, he will owe capital gains taxes on \$450,000, have substantially reduced reinvestment proceeds and no tax deduction.

In contrast, if your donor were to set up a "net income" charitable remainder trust with a flip provision, he could transfer the property to the trust and receive the following benefits in year one: eliminate the payment of capital gains; receive a federal tax deduction up to 30% of his adjusted gross income; and net income distributed to the beneficiary(ies) for the beneficiary(ies) life(ves). Upon the sale of the property to the developer, the trust would flip to a standard unitrust for a life or term of years. The assets (free of capital gains tax) would be invested by the trust and an annual fixed percentage of the assets would be paid out quarterly to the beneficiary(ies) for his/her/their life(ves) or a fixed term. This payment amount would be adjusted annually by a revaluation of the assets in the trust. The donor's estate may also have reduced probate costs and estate taxes and at the end of the trust's term your donor's charitable intent will be met.

To complete this example, let's assume that the property owner is Jim Donor, age 77. Jim transfers title of this vacant land valued at \$500,000 to the flip CRUT with your charity as remainder beneficiary. The flip CRUT has a 6% annual income payment after the "flip". Jim reserves the annual income to himself for his life.

- i. Jim is entitled to an immediate income tax deduction of \$294,695. This is available in the year of the gift and for a carryover of 5 more years.
- ii. We should deduct 10% for estimated selling expenses, legal fees, transfer taxes and brokerage commission leaving \$450,000.
- iii. Once the trust sells the property, Jim will receive an annual income payment equal to 6% of the value of the trust. This is estimated at \$27,000 initially after the flip and adjusted annually thereafter.
- iv. The life expectancy for Jim is 11.1 years. Your charity will receive the remainder in the trust upon Jim's passing.

VIII. Conclusion

Being able to utilize real estate as a gifting asset can enhance the potential for growth in the charity's investment portfolio and meet the gifting ability of donors with real property assets. By understanding the donors' objectives and structuring a real estate gifting vehicle that is best suited to meet donative intent, the donors' financial needs and the charity's investment goals, the charity can open the door to an asset class that has unlimited potential for future donations.