TRUSTS & ESTATES

A Golden Age for Real Estate Gifts?

Feb 19, 2016 **Robert F. Sharpe, Jr.** | ***Trusts & Estates***

When advising clients who are considering the best ways to make significant charitable gifts, it can be helpful to begin with what I refer to as the "anatomy of a gift." In addition to who's making the gift and why he's making it, it's increasingly important to examine what assets are best to give, when to give them and how to transfer those assets. In my experience, this process will more often result in a gift that better serves the needs of both the donor and the charitable recipient.

When deciding what's best to give, a client may want to consider real property, which can sometimes be a wise choice for use in funding larger charitable gifts. While real estate has long been the source of significant gifts to educational institutions, medical centers, religious organizations and other charities, economic, demographic, tax law and other factors are converging in ways that may make such gifts more important than ever now and in the coming years.

Baby Boomer Assets

In 2016, the first Baby Boomers will reach age 70. The estimated 76 million people who comprise this group[1] are the first generation to pursue nearly their entire working careers contributing to 401k plans, individual retirement accounts and other income tax deferral plans created by Congress in the late 1970s in contemplation of the Baby Boomer retirement wave that's now upon us. As a result, many individuals in their prime earning (and giving) years now hold a substantial portion of their net worth in qualified tax-deferred savings accounts.

Many Boomers are entering retirement with the bulk of their wealth held in a combination of these tax qualified retirement accounts and the equity in their homes and other real estate. Given this fact, fewer among the 70 and over age group will be prospects for charitable gifts of securities and other financial assets as fewer individuals will hold significant investment portfolios outside their qualified plans.

Fortunately, Congress acted in December 2015 to make permanent legislation allowing individuals over the age of 70½ to make tax-free gifts from their IRAs in amounts up to $100,000. The bulk of qualified retirement plan assets, however, are held by individuals under the age of 70½, and/or in 401(k), 403(b) and other plans from which it's not possible for those of any age to make gifts directly to charity.

Charities are increasingly realizing that because the bulk of many Boomers' assets are "locked up" in retirement accounts, it will be more important than ever to encourage gifts from other assets such as real estate.

By way of review, there are significant tax benefits associated with gifts of real estate. In addition to bypassing capital gains tax that would be due on a sale, a donor to a public charity is allowed a federal income tax deduction of up to 30 percent of adjusted gross income (AGI). The donor can use any excess deductions to reduce income taxes for up to five future years. Real estate donated to charity during lifetime or at death will also be removed from the donor's taxable estate.

Let's briefly review a number of ways real estate can be used to make charitable gifts and summarize the possible tax and other financial benefits.

Outright Gifts

Perhaps the most common way to make a gift of real estate is through an outright donation. The donor is allowed a charitable income tax deduction for an amount determined under a qualified appraisal. If the property has increased in value and been held for longer than 12 months, the deduction is for the appraised value of the property, less any amount reportable as ordinary income if sold by the donor, up to a limit of 30 percent of AGI. If the property has been held for less than 12 months, the deduction is limited to the lesser of cost basis or fair market value, up to 50 percent of AGI. The donor can carry forward any unused deductions for use in up to five future tax years.

Example: Mary, age 75, is recently widowed. She owns a home worth $350,000 that she no longer wishes to occupy. She decides to make a gift to a charitable interest to fund a gift in honor of her deceased husband. She'll enjoy a charitable deduction for $350,000 that she can use to eliminate tax on that amount of income during a period of up to six years (that is, the year of the gift plus five more years).

Bargain Sale

There can be situations in which a donor may wish to donate only a portion of the value of real estate.

Example: Suppose John, age 75, enjoys a balance of $4 million in his 401(k). He also owns a home valued at $1 million, with a cost basis of $250,000.

He would like to generate cash to fund the $500,000 entry fee for a retirement community but doesn't want to take a taxable retirement plan withdrawal to fund this cost. He would also like to make a $500,000 commitment to a capital gift campaign. To achieve his multiple goals, he sells the home to the charity under the terms of a bargain sale arrangement for $500,000. He uses the cash received for the retirement community fee and is entitled to a charitable deduction equal to the remaining $500,000 in value. This transaction results in generating the cash he requires for the retirement community fee, funds the desired gift, affords a partial bypass of capital gains in the home and makes it possible for him to eliminate tax on up to $500,000 of future mandatory required retirement plan withdrawals.

Gift With Retained Use

In today's lower interest rate environment, other clients may be interested in donating a personal residence or farm while maintaining the right to enjoy the property for life or other period of time.

Example: Mary and George, both age 76, own a vacation home worth $500,000. They would like to eventually leave the home to one of their charitable interests but would like to enjoy the use of it for the rest of their lives.

In this case, assuming the 2.2 percent applicable federal midterm rate in effect for February 2016, Mary and George could give the home and maintain a dual life estate. They would enjoy an immediate income tax deduction of $334,000. Through making their gift in this way, they generate a valuable income tax deduction for what would otherwise be a bequest that would yield no tax savings for their nontaxable estates.

As an alternative, they could make a 5-year pledge commitment to a campaign and donate the home with a retained use for just five years. At the end of the 5-year period, the home becomes fully owned by the charity. They enjoy an immediate income tax deduction of $434,000, about 86 percent of the value of the home. These generous tax benefits are possible in part because they're being "charged" just 2.2 percent per year for the five years they retain use of the home.

Gift With Retained Income

Homes, investment property, agricultural property and other types of real estate can also be used to make gifts that provide a donor with income for one or more individuals for life or another period of time.

The most common tool used to make gifts in this way is the charitable remainder unitrust (CRUT). Because of lack of income being generated by the subject property or income in amounts that aren't predictable or dependable, the net income with makeup (NIMCRUT) is the type of CRUT most often used to facilitate gifts of real property. The NIMCRUT allows the trust to be funded with undeveloped land or other non-income-producing property and only make payments of a certain percentage of the value of the trust assets each year (by law, at least 5 percent) or the income of the trust, whichever is less. Shortfalls can be made up in future years when income exceeds the trust payout percentage.

In other instances, the gift of choice will be a flip CRUT. This type of CRUT begins as a net income trust before automatically converting to a straight unitrust following the sale of the property used to fund the trust.

Example: Alex is a 68-year-old recently retired physician. He owns a substantially depreciated apartment building appraised at $2 million that currently yields income of 6 percent. He and his advisors believe the building may have peaked in value, and he would like to liquidate the property and invest the proceeds on a more diversified basis.

He decides to create a 6 percent flip CRUT and transfer the building to the trust. The trust will make payments equal to the lesser of 6 percent of the value of the building or the actual income from the building until it's sold. Subsequent to a sale, the trust will begin making payments of 6 percent of the value of the trust assets each year.

The capital gains tax on the difference between the sales price and adjusted basis isn't due at the time of the sale. As a result, the full value of the sales proceeds, less expenses, remains in the trust, providing greater earning capacity over time.

Alex is entitled to a charitable deduction of $868,000 (43 percent of the value of the building) that he can use beginning in the year of the gift. In addition, much of Alex's future income from the trust will be taxed at capital gains rates that could be lower than the tax on other sources of income.

For those who would prefer to receive a fixed income following the gift of real estate, the charitable gift annuity (CGA) or charitable remainder annuity trust (CRAT) offers an alternative.

In the case of a CGA, however, when the charitable recipient has a contractual obligation to make agreed-on payments from its general assets, the lack of certainty of the amount of proceeds from the sale of real estate can present a significant barrier to moving forward with such a gift. The same is true of a CRAT, in which case the trust has payment obligations that can't be delayed, as would be possible for a NIMCRUT or flip CRUT described above.

The donor may not remedy this situation by having a binding contract for the sale of a property prior to the donation of appreciated real estate or other property without running afoul of Internal Revenue Service "buyer in the wings" proscriptions that would negate tax benefits.

It can, however, be possible for a charity or trustee to prudently engage in due diligence designed to determine the marketability of property and the likely sales proceeds prior to the acceptance of a gift, thereby mitigating the risk of encountering payment obligations with insufficient liquidity.

Tax-Favored Inheritances for Heirs

It may also be possible to temporarily redirect income for charitable purposes while transferring real estate to heirs through charitable gift planning techniques, such as the charitable lead trust.

This option can be especially helpful in the case of a commercial property that's expected to increase in value over time and generates significant cash flow. A donor can transfer such property to a charitable lead annuity trust (CLAT) for a period of time before the heirs receive the property free of gift and estate tax.

Example: John and Harriet own an office building valued at $5 million that produces annual income of over $400,000. They use it to fund a 7 percent CLAT that will make payments to a charitable interest of $350,000 per year for 18 years. The charity will receive $6.3 million over the term of the trust. Under campaign gift crediting policies, the discounted value of the income stream is $5 million, and John and Harriet are credited with a gift of this amount.

The trust is structured to transfer the building to their 22-year-old son in 18 years when he's 40. A gift of $5 million to their son is reported at the time the trust is funded, but no gift tax is due because the deduction for the value of the charitable income stream fully offsets the gift amount.

When the trust terminates, their son will own the building at its then current value with no gift or estate tax due on any increased value. He'll also receive any amount of income in excess of the required payment amount that's accumulated in the trust over its term free of additional tax, as those amounts will have been taxed as received by the trust.

Gifts Through an Estate

Finally, a client may wish to leave a residence or other real estate to charity at death through a will, trust or other testamentary disposition.

The donor maintains full ownership and access to income and sales proceeds if the property is sold prior to death. If the property isn't sold prior to the donor's death, the charity will receive it as the means of funding a bequest. While there are no lifetime tax benefits associated with a gift structured in this way, the full value of the property will be deductible for federal estate tax purposes. There may also be state tax savings.

Such gifts are often made by those who decide to provide for heirs from liquid assets in their estates while fulfilling their charitable wishes through a gift of their home or other real property. Wealthier individuals may wish to devote illiquid real estate to charitable purposes and offset taxes due on other assets in the estate.

Other Partial Interests

In addition to the gift methods described above, it's also possible to make gifts of mineral rights, water rights, conservation easements and other gifts of less than the complete ownership of property. Alternatively, a donor may wish to make a gift of the property while retaining these rights for himself or his heirs.

Endnote

1. Population Reference Bureau, *www.prb.org/Publications/Articles/2002/JustHowManyBabyBoomersAreThere.asp*.