

GIFTS OF REAL PROPERTY TO PUBLIC CHARITIES

By Ted Hellman

1. What types of real estate are appropriate to give to a public charity?

Most improved or unimproved real property may be an appropriate gift to a public charity. Property that has appreciated in value since its acquisition is ideal because the Donor will receive an income tax charitable deduction for the full fair market value of the property if the donee is a public charity rather than a private foundation. The income tax deduction will offset up to 30% of the Donor's adjusted gross income for the year of the gift, and any unused deduction amount may be carried over for five years.

Contributed property should be unencumbered by debt at the time it is given to the public charity. Contributing property subject to debt will reduce the amount of the charitable deduction and will cause some capital gains tax to be incurred under the "bargain sale" rules. Also, property subject to debt should not be used to fund a charitable remainder trust (discussed below). From the standpoint of the public charity, contributed property should be free of environmental issues or impediments to sale of the property.

An interest in real property can be split between an interest retained by the Donor for the Donor's life or a term of years and a "remainder" interest following the retained life or term interest. The Donor will receive an income tax deduction for the actuarial value of the remainder interest that will pass to the public charity in the future even though the Donor retains the current and future economic benefits of the property. Such a transaction can be structured by using a charitable remainder trust (discussed below) or by a direct gift to a public charity of the remainder interest in a personal residence or farm.

2. Is it better to give real estate today, or through one's estate?

With a gift of real estate at death, the fair market value of the property at that time is excluded from the Donor's taxable estate such that no tax (federal estate tax or capital gains tax) is payable with respect to the property. Because the federal estate tax that applies above a threshold exclusion amount (currently \$1.5 million of net asset value) is about 45%, a testamentary charitable gift saves estate tax in the amount of 45% of the value of the property, and the effective "cost" to the Donor or the Donor's family is therefore 55% of the value of the property.

By giving real estate today rather than at death, one still obtains the benefits noted above because the property

will not be included in the Donor's estate. In addition, the Donor receives a current income tax charitable deduction that offsets a portion of the Donor's current taxable income, in the manner described in the response to Question 1 above. As noted above, the deduction is based on the full fair market value of the property, and capital gains tax and federal estate tax on the property is avoided altogether.

Of course, with a current gift of the property, the Donor does not retain the beneficial enjoyment of the property as an asset. A solution that allows a Donor to retain beneficial enjoyment in the property, to obtain the tax benefits of a charitable contribution of a gift of appreciated real property, and to provide a meaningful gift to a public charity is to give the property through a charitable remainder trust, discussed below.

3. How is the value of a real estate gift determined?

The value of a real estate gift to a public charity is the fair market value of the property, which is the price that a willing buyer and a willing seller would agree on for the purchase and sale of the property, neither of them being under a compulsion to buy or sell the property. Thus, the value would take account of any limiting restrictions or conditions (*e.g.*, restrictive covenants or other factors).

The value of real estate is not objectively ascertainable the way that the value of marketable securities is. For that reason, and because of substantiation that is required to claim a charitable deduction, a professional appraisal of the real estate is ordinarily required. Depending on the nature of the property, the appraiser's analysis will be based primarily on comparable sales or on an "income approach" by which an appropriate multiple is applied to the historical income stream (capitalization rate) or to anticipated future cash flows (discount rate). To substantiate the charitable income tax deduction for a gift of real estate, a qualified appraisal is required; and an appraisal summary must be attached to the income tax return on which the deduction is claimed.

In calculating the charitable deduction, the amount of the deduction must be reduced by any appreciation in the property (value in excess of the Donor's cost basis) that would not be long term capital gain if the property were sold. For example, a reduction would be applied if the Donor held the real estate for less than a year (making it short-term rather than long-term property) or if accelerated depreciation had been taken on the property.

4. How would a charitable remainder trust be used for a gift of real estate to a public charity?

By using a charitable remainder trust, a Donor can obtain the income tax benefits of a current charitable gift

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and the future estate tax benefits of a charitable gift at death while retaining ongoing economic benefits from the contributed property. A charitable remainder annuity trust provides for the payment to the Donor (or others) of a specified percentage (at least 5%) of the initial value of the property; the amount so determined is paid to the Donor as a fixed annuity regardless of fluctuations in the trust income and in the value of the trust assets. A charitable remainder unitrust provides for the payment of a specified percentage (at least 5%) of the value of the trust re-valued each year. A unitrust will provide a variable payment, will be responsive to economic changes and will be less vulnerable to erosion caused by inflation.

- A charitable remainder trust is tax-exempt. The transfer of appreciated real estate to the trust will not result in taxable gain to the Donor; and the sale of the real estate by the trust will not result in taxable gain to the trust. Therefore, the full sales proceeds, undiminished by any capital gains tax, remain in the trust.

- The effect of the tax-exempt status of a charitable remainder trust is that the Donor's appreciation in the real estate can be "unlocked": the trust can sell appreciated property tax-free and diversify or reinvest the proceeds in higher yield investments for the Donor's benefit (as lifetime beneficiary) without the usual capital gains tax cost.

- The trust distributions paid to the Donor will be taxed as ordinary income to the extent that the trust (which itself pays no tax) earned ordinary income for the year, then as capital gains tax to the extent that the trust had capital gain in the current or any prior year (including the initial sale of the real estate contributed to the trust).

- During the lifetime of the Donor, the Donor may be the trustee of the trust or may engage professional management. On the death of the Donor, the trust assets will not be subject to probate administration, and will not generate any estate tax in the Donor's estate unless persons other than the Donor and the Donor's spouse are beneficiaries.

Example: A Donor, age 65, funds a charitable remainder unitrust with real estate valued at \$500,000 for which he paid \$100,000 ten years ago, reserving the right to receive 8% of the value of the unitrust each year for life. At the Donor's death, the assets in the unitrust will be distributed to a public charity .

Overall Economics. In the first year, the Donor will receive \$40,000 from the unitrust. In future years, the payout will vary according to the value of the trust principal. The Donor will also receive an income tax charitable deduction of \$160,000, which can offset up to 30% of the Donor's adjusted gross income for the current year and (if

not all used) for five additional years. At a 35% income tax bracket, the deduction will reduce the Donor's taxes by \$56,000. The long-term economics will depend on the actual investment performance of the trust assets. As an example, if the assets produce a total return (income plus growth) of 9% per year, the Donor will receive payments aggregating \$858,000 over the Donor's life expectancy; and \$579,000 will be distributed to the public charity on the Donor's death.

Tax Benefits. On sale of the property, no capital gains tax is payable on the \$400,000 of appreciation in the property, thereby avoiding federal and state net capital gains tax of \$80,000. This is true even though the income tax charitable deduction is determined by reference to the full fair market value of the real estate.

Increase in Cash Flow. If the real estate had been non-income producing or generating a low yield, the increase in yield to an 8% payout rate would substantially increase the Donor's cash flow. The Donor could have sold the real estate and reinvested the proceeds in higher-yielding investments; however, the proceeds to be reinvested would have been diminished by the capital gains tax, so that only \$420,000 would have been available for reinvestment. With a unitrust, the full value of the property is reinvested, undiminished by capital gains tax.

In sum, a charitable remainder trust makes it possible to unlock appreciation and reinvest the full value of real estate or other appreciated assets without diminution by capital gains tax. Subsequent appreciation inures to the benefit of the Donor for the Donor's life or for a term of years. The growth is tax-free and payments to the Donor may be partially capital gain rather than ordinary income. As a result, although the Donor gives up access to the principal contributed to the unitrust, if the Donor expects not to need the principal, the Donor can be better off economically by using a unitrust than by either retaining the real estate or selling the real estate and incurring a capital gains tax.

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