The 23rd Annual

Planned Giving CONFERENCE

presented by the Northern California Planned Giving Council

in association with Colonial Consulting, LLC

MASTERS TRACK

Session 1: 9:30 am – 10:45 am

Topic:

Make the Most of Real Estate Gift Opportunities

Presented by:

David Wheeler Newman, Esq

Workshop Summary:

Some of the largest gift opportunities involve real estate, and it sometimes requires creative thinking (not to mention perseverance) to close these gifts. This session will include tips for overcoming obstacles as well case studies to illustrate some unconventional real estate gift structures, with the objective of helping you push more of these gifts over the goal line.

Workshop Presenter

David Wheeler Newman, Esq., chairs the Charitable Sector Practice Group at the Los Angeles law firm of Mitchell Silberberg & Knupp LLP. For what seems to him like forever he has advised families and individuals concerning their foundations and other philanthropy, as well as charitable organizations and their donors on the legal and tax aspects of planned giving. He also advises these organizations on transactional and governance matters. David is a former member of the Board of the National Committee on Planned Giving, where he served as an officer and member of its executive committee, and a former member of the Board of Directors of the American Council on Gift Annuities. In 2012 he received the Dana Latham Award from the Los Angeles County Bar Tax Section. He is a founder and President Emeritus of New Roads School in Santa Monica and a member of the Professional Advisors Council of the Los Angeles Chamber Orchestra.

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CHARITABLE GIFTS OF REAL PROPERTY

DAVID WHEELER NEWMAN

I. Amount of Deduction.

A. General Rule. The donor may generally obtain a charitable contribution income tax deduction equal to the full value of the real property contributed.

B. Equity Limitation. The charitable contribution deduction is limited to the donor's equity in the property. The full value of the property is therefore reduced by the outstanding balance of any mortgage, or the amount of any other liability, which encumbers the property. The results are the same whether the charity assumes the debt or simply receives title to the property subject to the debt.

C. IRC Section 170(e) Limitation. The charitable contribution deduction is future reduced by the amount of gain which would not have been long-term capital gain if the property had been sold by the donor at its fair market value. Depreciation previously taken and subject to the recapture rules would reduce the amount of the charitable contribution deduction otherwise allowable.

D. AGI Limitation. The deduction is generally limited to 30% of the donor's adjusted gross income. The donor may elect instead to reduce the amount of the total deduction to his tax basis in the property, in which case the reduced deduction may offset up to 50% of the donor's adjusted gross income.

II. Gain Recognition.

A. In General. In addition to the charitable income tax deduction, the other major tax benefit arising from a gift of appreciated property is the opportunity to avoid recognition of capital gain. The capital gains tax which is avoided, when added to the tax savings which results from the deduction, dramatically reduces the after-tax cost of charitable giving.

B. *Example 1*. Assuming donor in the maximum federal income tax bracket, the after-tax cost of a gift of $100,000 cash is reduced by approximately $35,000 (the federal tax savings resulting from the charitable deduction) to $65,000. If the donor instead contributes land with a value of $100,000, with a cost basis of $20,000, the after-tax cost of the gift is further reduced by the approximately $12,000 of federal capital gains tax the donor would have had to pay had the property instead been sold. The combined federal tax saving in this illustration results in a total federal government subsidy of over 47% of the value received by charity. State income taxes typically increase the amount of this tax subsidy for the gift of appreciated property.

C. Capital Losses. The value of some properties includes unrealized capital *losses* rather than gains — after all, there is no rule that says property can only increase in value. If such a property is the asset to be contributed, it is generally preferable for the donor to sell the property and recognize the capital loss, and to then contribute the proceeds of the sale. Contribution of a property with a built-in loss will result in the loss of the tax benefit of that loss.

III. Bargain Sales.

A. In General. A bargain sale is a part gift, part sale transfer of property to charity. Real property is ideal for bargain sales. A bargain sale donor is entitled to a charitable contribution deduction equal to the difference between the property's fair market value and the amount received from the charity.

B. IRC Section 1011(b) Basis Allocation. The donor may recognize some capital gain in a bargain sale transaction because the transfer consists of both a gift and sale element. The donor's tax basis in the property must be allocated between the gift and sales components, using the following formula:

$$\frac{\text{Amount Realized}}{\text{Fair Market Value}} \quad \text{X} \quad \text{Adjusted Basis}$$

The difference between the amount realized in a bargain sale transaction and the tax basis allocable to the sale element constitutes a taxable gain to the donor.

C. *Example 2.* Donor owns property adjacent to the charity's existing campus. The charity would like to acquire the property, and the donor is willing to sell it to the charity at a bargain price.

Fair market value	1,000
Adjusted basis	200
Amount realized	300

Allocation of Basis

$$\frac{\text{Amount Realized}}{\text{Fair Market Value}} \quad \text{X} \quad \text{Adjusted Basis}$$

$$\frac{300}{1{,}000} \quad \text{X } 200 \quad = 60$$

Gain Calculation

Amount realized	300
Bargain sale basis	(60)
Gain recognized	240

IV. **Gift Annuties Funded with Real Property.**

A. In General. A charitable gift annuity may be funded with appreciated real property, allowing the donor to spread the resulting bargain sale gain over the donor's life expectancy. However, if payments on the CGA are to begin immediately following the transfer of property to charity, this creates uncertainty for the charity since it doesn't know how much cash proceeds it will recognize from sale of the property.

B. Mitigating the Risk to the Charity. One way to mitigate the risk to the charity arising from this uncertainty is to apply a discount when setting the amount of the annuity payment. For example, if the annuity for a donor age 75 would otherwise be 5.8% of the appraised value of the property, the charity might instead offer to pay 4.5% if the CGA is funded with real property.

C. Wait to Set the Annuity Rate. Another, and perhaps more precise, way to mitigate this risk is to wait to set the annuity rate until after the property sells, by entering into a gift agreement with these provisions:

1. The annuity payment will be determined by multiplying the agreed annuity rate (5.8% in this case) by the net proceeds realized by the charity from the sale of the property. So if the qualified appraisal says the property is worth $1,000,000, but the net sales proceeds after commissions and other sales expenses amount to $900,000, the annuity payment wll be $52,200 rather than $58,000.

2. But what will the donor report as her income tax deduction, since the deduction is the appraised value of the property less the present value of the annuity payments from the charity? This won't be an issue if the property sells way in advance of the due date of the tax return on which the gift will be reported, since the annuity amount will be known by that time. But just in case, the gift agreement could provide that the annuity will be the agreed percentage, 5.8%, of the net proceeds if the property sells by, say, March 31 of the year following the gift, but if the property doesn't sell by then the annuity will be the discounted rated of 4.5% of the appaised value.

3. The gift agreement would provide for annuity payment period to begin on the the first day of the month following the date when the net sales proceeds are received by the charity. For CGA with quarterly payments, the first payment would therefore be made at the end of the calendar quarter in which that start date falls.

4. *Example 3.* In May of Year 1 the donor age 75 transfers property with an appraised value of $1,000,000 to charity under a gift agreement in which the charity agrees to issue an annuity to the donor with payments of 5.8% of the net proceeds from sale of the property, so long as those proceeds are

received by March 31 of the following year. The property sells and the net proceeds of $900,000 are received by the charity on September 15. The charity issues an annuity contract to the donor providing for annual payments of $52,200, beginning with the first quarterly installment due December 31. In this case the donors deduction would be calculated as a deferred CGA funded with property valued at $1,000,000, with the deferral from the gift in May to the first payment at the end of December.

5. Assume instead that the property takes a while to sell and the charity doesn't receive the sales proceeds by March 31 of Year 2. The charity issues a contract providing annual paymens of $45,000 with the first quarterly payment due June 30.

V. **Encumbered Property.**

A. Outright Gifts. If property is transferred to charity subject to a liability, the amount of the liability is treated as an amount realized for purposes of applying the bargain sale rules described above, even though the charity does not agree to assume or pay the liability.

B. UBTI. Debt-financed income, which is one category of unrelated business taxable income, arises when there is acquisition indebtedness with respect to the property producing the income (e.g., gain from sale of that asset). Acquisition indebtedness results if the charity (or charitable remainder trust) assumes the debt or takes the property subject to a debt that is not sufficiently aged. To avoid acquisition indebtedness, the debt must have been placed on the property five years before the gift, and the donor must have owned the property for five years. In no event should the charity assume the debt.

C. Charitable Remainder Trusts. Funding a charitable remainder trust with encumbered property requires a thorough analysis regarding the liability on the property. If the debt is sufficiently aged to avoid the UBTI issue discussed above, and if it can be determined that the donor is not personally liable for the debt, by contract or by statute, it may be possible for the donor to transfer property to the trust, subject to the liability, in which case the bargain sale rules discussed above will apply to determine the recognition of gain resulting from this transfer. If the donor is personally liable for the debt, a transfer of the property to the trust subject to the debt may prevent the trust from qualifying as a charitable remainder trust under the grantor trust rules. In this situation, it may be possible for the trust to be funded with the equity in the property (only if the debt is sufficiently aged), as follows:

1. The donor transfers an undivided interest in the real property to the trust.

2. The donor retains an undivided interest in the property that, when sold, will yield enough cash to pay off the entire liability.

3. The donor and the trust enter into a written co-tenancy agreement which spells out the rights of the donor and trust with respect to the property. In this agreement, the donor indemnifies the trust from liability for the debt.

4. The donor and the trust, as co-tenants, join together in selling the property.

5. The donor uses his or her share of the sales proceeds to repay the debt.

D. *Example 3*. Larry, age 70, owns an apartment building with a depreciated basis of $200,000 and a current fair market value of $1,000,000. The property is encumbered by a mortgage resulting from refinancing with a current balance of $300,000. Larry would like to use his $700,000 equity in the property to fund an 8% charitable remainder net income unitrust.

CRT factor	40%
Co-tenancy split	700,000/300,000
Basis of retained portion 30% of 200,000	60,000
Amount realized	300,000
Adjusted basis	(60,000)
Gain recognized	240,000
Deduction 40% of 700,000	280,000

VI. UBTI in Charitable Remainder Trusts.

A. Any UBTI of a CRT is subject to an excise tax equal to the UBTI – in other words, UBTI of a CRT is taxed at a rate of 100%. The remaining income of the CRT is exempt from tax.

1. *Example 4***.** A CRT is funded with an apartment building. Although the building is free and clear of any mortgage, the property includes a coin-operated laundry that generates $10,000 per year in net income after taking into account expenses including depreciation of the washing machines. The CRT is able to sell the property after only 3 months (during which the net income from the laundry is $2500) for a capital gain of $1,000,000. The UBTI from the laundry is subject to an excise tax at the rate of 100%, while the CRT retains its tax exemption with respect to other income – in this case resulting in federal tax payable by the CRT of $2500.

2. *Example 5*. The CRT is funded with an apartment building that needs work. The trustee of the CRT borrows $100,000 to put on a new roof and make some cosmetic improvements to the property to prepare it for sale, and sells the property for a

gain of $500,000. Assume that the $100,000 mortgage increased the property's basis from $300,000 to $400,000. The result is that the CRT has 100,000/400,000 x 500,000, or $125,000 of debt financed income. The CRT retains its general tax exemption, but the debt financed income results in tax of $125,000.

B. **Character of Distributions.** The regulations address the impact that the new 100% excise tax has on the four-tier system of IRC § 664(b) for characterizing CRT distributions for tax purposes. Under the four-tier system, CRT distributions are characterized as made, first, from ordinary income of the trust; second, from capital gain; third, from tax-exempt income; and, finally, from trust corpus. The regulations provide that the excise tax imposed on UBTI of a CRT is treated as paid from trust corpus. At the same time, the UBTI is treated as income of the trust. In other words, the UBTI would be included in the first or second tiers of the trust, while the 100% excise tax on that income would be treated as paid from that corpus. The regulations specifically provide that the 100% excise tax is not deductible in determining taxable income distributed to a beneficiary.

1. *Example 6***.** A charitable remainder annuity trust distributes 100 per year. In the current year, the CRAT has ordinary income of 60, of which 10 is UBTI. The CRAT has undistributed tier 1 income from prior years of 15 and undistributed tier 2 capital gain of 50. The current year distribution of 100 will be characterized as ordinary income of 75 (60 from the current year and 15 accumulated from prior years) and capital gain of 25. The excise tax of 100% of UBTI, or 10, is allocated to corpus and does not affect the taxable income of the CRAT in tiers 1 and 2.

VII. Partial Interest in Real Estate.

A. General. No charitable deduction is allowed (for income, estate or gift tax purposes) to a charitable gift of less than the donor's entire interest in a piece of property. While there are exceptions to this general rule which form the basis for the field of planned giving, these exceptions are narrowly construed by the IRS and the courts.

B. Exceptions.

1. A contribution of the donor's entire interest in the property may be deducted, even if what the donor owns is a partial interest.

2. A remainder interest in a charitable remainder trust or pooled income fund.

3. The income interest in a charitable lead trust. Note that, while contributions to all qualified charitable lead trusts will qualify for the gift and estate tax deduction, only contributions to those which are also grantor trusts will qualify for the income tax deduction. IRC §170(f)(2)(B).

4. A remainder interest in a personal residence or farm.

5. An undivided portion (not in trust) of the donor's entire interest in the property.

6. A qualified partial interest for conservation purposes. IRC §170(F)(3)(B).

C. Common Violations.

1. A gift of the right to use property without the transfer of ownership.

2. Retention by the donor of substantial rights to the property**.**

VIII. **Remainder Interest in Personal Residence.**

A. General. A charitable deduction is allowed for a contribution of a personal residence, subject to a life estate retained by the donor. This given vehicle is very well suited to these situations:

1. A donor wishes to make a testamentary charitable gift of real property while enjoying a current income tax deduction;

2. A donor who is receiving income, for example from an IRA or from investments, but with no available tax deductions;

3. A donor who wants to make a substantial charitable gift now without losing any security;

4. A donor who is "house rich but cash poor";

5. A donor who would like to plan her estate to avoid the probate process by making a non-probate transfer of a substantial asset.

Four main requirements must be met for this type of gift to qualify for income, estate and gift tax deductions.

B. Personal Residence: To qualify, a personal residence does not need to be the donor's principal residence. For example, a donor's vacation home qualifies as a personal residence. Under IRS guidelines, all that is required for something to qualify as a personal residence is that it contain facilities for cooking, sleeping, and sanitation. Rev. Rul 74-241. The IRS has even ruled that a boat meeting these requirements qualifies as a personal residence. PLR 8015017. The regulations provide that a personal residence also includes stock owned by a donor in a co-op if the unit that the donor is entitled to occupy is used by the donor as a personal residence.

1. In PLR 8711038, a portion of the residence was rented by the donor to an unrelated tenant. The IRS nevertheless concluded that the property qualified as a personal residence for purposes of this provision. The Private Letter Ruling cited Revenue Ruling 78-303 in which a retired

farmer, a portion of whose farm was leased to an unrelated third party, contributed the farm to charity subject to the farmer's retained life estate. (Note that the same provision of the Code provides for gifts of both personal residences and farms, subject to a retained life estate). It seems that this logic should be extended to a duplex or triplex, so long as a portion of the property has been used by the donor as a residence.

C. Not in Trust. The second requirement for the remainder interest to qualify is that the gift may not be made in trust. Note that this can be an issue for testamentary gifts of a remainder interest through a living trust.

1. *Example 7*. A mother provides in her living trust that, at her death, her residence will be held in trust for the ultimate benefit of her alma mater, retaining for her daughter the right to use this trust asset during the daughter's lifetime. The estate tax charitable deduction could be denied since the gift of the remainder interest to charity is made via the trust. Rev. Rul 76-357. This result could have been avoided, and the estate tax deduction preserved, if the living trust instead provided that, at the mother's death, the trustee is to distribute the property to charity subject to the daughter's life estate.

D. Irrevocable. The third requirement is that the remainder interest passing to charity must be irrevocable. In Revenue Ruling 85-23, the donor's will provided for a bequest of the family farm to Child A for life, with the remainder to charity. So far, so good. However, the will further provided that, if Child B survived Child A, the remainder will vest in Child B instead of the charity. The IRS ruled that this bequest to a charity was contingent, and the estate tax charitable deduction was denied.

1. *Example 8*. The donor retains the right to live in her house for the rest of her life and provides that, at her death, the property should go to charity, but only if her brother fails to survive the donor. If the brother is living at the death of the donor, the house goes to him instead. The IRS disallowed the charitable income tax deduction in this situation, ruling that if the probability exceeds 5% that the non-charitable beneficiary will receive the property, no deduction is allowed.

2. *Example 9*. The gift of the residence to charity must be unrestricted (subject only to the retained life estate). For example, if the donor provides for the transfer of his residence to charity, subject to his life estate, but further provides that, when the charity sells the house, 20% of the proceeds must be given to the donor's brother. In this situation, no charitable income tax deduction is allowed since the gift of charity is not unrestricted.

3. Assume, instead, that the donor transferred the property 80% to the charity and 20% to the brother, with the interest of both co-tenants subject to the

donor's life estate. In this way, when the charity and the brother join together to sell the residence following the death of the donor, the desired result will be achieved. In Revenue Ruling 87-37, the IRS determined that the donor was entitled to a charitable income tax deduction as to the 80%.

E. Remainder in the Property Itself. A fourth requirement that the IRS takes quite seriously, but which has caused a surprising amount of confusion over the years, as demonstrated by a series of rulings, is that the charity must receive the remainder interest in the property itself, as opposed to the proceeds from a sale of the property. In Revenue Ruling 76-543, as amplified by Revenue Ruling 77-169, the IRS held that no charitable deduction is allowed for a remainder interest in a decedent's personal residence bequeathed to charity under a will that provides that the remainder is to be sold upon the life tenant's death and the sale proceeds paid to charity. This is a painful result since the donor probably thought he was doing the charity a favor by making the executor of his estate, rather than the charity, responsible for selling the residence.

1. Even if the charity is given an irrevocable remainder interest in the personal residence, it might not be unreasonable for donor to want to retain the flexibility to convert a retained life estate into cash. Suppose that, in the life estate agreement, the charity agrees that, if the donor needs to move out of the residence due to poor health, the charity will join with the donor in selling the residence with the proceeds of the sale divided actuarially between them. The IRS held, in Revenue Ruling 77-305, that this created a chance that the charity would eventually receive something other than outright ownership of the residence – namely, the proceeds of sale of its remainder interest in the residence. The deduction was denied.

2. The desire of a donor to retain this flexibility is understandable, especially if the equity in the home is her largest asset. For example, she may require substantial assets in the future to move into an assisted living facility. However, the experience of several organizations with active residential remainder programs is that the same result is often achieved voluntarily with no legal right retained by the donor to compel this result. This is for a couple of reasons. First, one of the few drawbacks of a life estate arrangement, as with some other forms of planned gifts, is that the charity must wait to receive the cash proceeds from a gift. If the donor needing to convert her life estate in a residence into cash were to approach the charity with a proposed sale, many organizations would go along with the plan in order to accelerate the maturity of the gift. Moreover, since one of the core concepts of planned giving is for the charity to attempt to accommodate the legitimate interests of the donor, simple donor relations would make charities receptive to this proposal, even if the life tenant has no legal right to compel the result.

F. Steps for the Gift. Before the personal residence is accepted by the charity, the charity should investigate things that will affect it's responsibilities as the owner of the property.

1. Obtain a title report to ensure a clear chain of title and consider obtaining title insurance.

2. Verify the existence of covenants, easements and other agreements affecting the property.

3. Confirm zoning compliance.

4. Verify building codes.

5. Inspect property for material defects.

6. Follow standard procedures described below regarding environmental hazard of real property.

G. Documentation Required. A deed is the form of documentation required to transfer the property from the donor to the charity. The deed should contain language reserving to the donor (or one or more other persons) the right to live in the residence for life or for a term of years. Requirements for the formalities of the deed vary from state to state. The deed should therefore be prepared or at least reviewed by an attorney admitted to practice in the state where the residence is located. Since under the deed the life tenant(s) and the charity will each own an interest in the property, there should be a written life tenancy gift agreement that clearly provides for the terms of the life estate. The life tenancy gift agreement should provide that the responsibilities of the life tenant include responsibility to maintain the property and pay property taxes. The life tenancy gift agreement should require the life tenant to carry insurance on the property naming the charity as one of the insured parties. The agreement should provide the charity with the right of access to the property at any time, after appropriate notice, for the purpose of inspecting the property. The document may allow the life tenant to lease the property to another person, but only if the charity consents to the lease.

1. A sample life tenancy gift agreement is attached as Appendix A.

H. Calculation of Deduction. To calculate the donor's income tax deduction, the planner must know the market value of the property, the useful life of the building on the property, the salvage value of that building, the term of the retained interest (typically for one or more lives, but maybe for term of years) and the applicable federal rate (AFR) for the month of the gift. The reason you need the useful life of the building and its salvage value is that Code Section 170(f)(4) directs that depreciation and depletion must be taken into account for purposes of determining the remainder value. Straight-line depreciation is used, which requires the useful life and salvage value of the building.

1. *Planning Tip:* The greater the value of land in relationship to the value of the building, the larger the deduction. This produces larger charitable deductions for residential remainder gifts in parts of the country with high residential property values.

2. The useful life is calculated beginning on the day of the gift. The allocation between land and building may be taken from the appraisal or possibly from the property tax bill. Once the portion of the property's value which is allocable to the structure has been determined, a typical calculation would assume that the structure will have an eventual salvage value of 20% of that amount following a forty-five year useful life.

3. The AFR may be selected from the AFR from the current month or for the prior two months, whichever produces the largest charitable deduction.

4. *Example 10*: The donor, age 80, owns her home valued at $1,000,000 without any mortgage or other encumbrance. When she contributes the home to her alma mater, subject to her retained life estate, she is entitled to an income tax deduction of approximately $668,000. If, on the other hand, the same donor instead leaves the property to her alma mater in her will, subject to a life estate in her daughter, then age 50, the donor's estate will be entitled to a charitable tax deduction of about $255,000. (The substantial difference in the deduction is attributable to the difference in ages of the life tenants.)

I. <u>Planning Opportunities</u>. Even though the IRS takes the basic requirements very seriously, this does not mean that this planned giving vehicle is completely inflexible. In fact, there are plenty of opportunities for planners to exercise their creativity.

1. The regulations specifically allow the charity's remainder interest to follow a term of years, rather than a life estate.

   Example 11: The donor anticipates that he will not be using the cabin by the lake after his children are grown. He might give the residence to charity, subject to a retained right to use the property for, say, seven years. This will yield a substantially larger deduction for younger donors, as compared with a retained right to use the property for their entire lives.

2. Speaking of vacation homes, Revenue Ruling 75-420 involved a remainder interest in a personal residence combined with a current gift of a tenancy in common. (One of the other exceptions to the partial interest rules is for a gift of an undivided portion of the donor's entire interest in the property.)

   Example 12: The donor only used the lake house during the summer. He transferred the property to his alma mater, retaining the right to use the property during his life only in the summer months. The college had the right to use the property the rest of the year (and the college in fact planned to use the property during the academic year for a study center and for events). The IRS allowed a double deduction – for the tenancy in common as to the exclusive right to use the property during the academic year, and a remainder interest and the right to possession of the personal residence in the summer.

J. Transfer Tax Issues. Gift or estate taxes will need to be considered if the donor transfers the right to use of the residence to a non-spouse beneficiary, such as a child, rather than retaining that right for herself.

1. If the transfer is made during the donor's life, a current gift tax arising from the life estate transferred to the non-charitable beneficiary may be avoided by the donor retaining the right to revoke that person's interest, either during life or through the donor's will.

2. *Example 13*: The donor may transfer the property to charity, subject to her right to remain in the property for her life followed by the right of her daughter to reside in the property for her life. If she has retained the right to revoke the daughter's interest, there will be no current gift tax arising from the gift of the daughter. However, if the donor dies without exercising the right to revoke, the actuarial value of the daughter's life estate in the residence, determined at the death of the donor, will be included in the donor's estate for estate tax purposes.

K. Exclusion of Gain.

Code Section 121 provides that gross income does not include gain from the sale of a residence if during the five year period ending on the date of the sale the property has been used by the taxpayer as a principal residence for a period aggregating two years or more. The exclusion is gain of up to $250,000 (or $500,000 for taxpayers filing a joint return, provided certain requirements are met).

1. There is a specific provision allowing the exclusion of gain under Section 121 if the interest disposed of is not the principal residence itself but a remainder interest in the principal residence. Since the funding of a gift annuity with a remainder interest in the residence is treated for tax

purposes as a bargain sale of that remainder interest, this provision of Section 121 allows gain resulting from that bargain sale to be excluded from gross income.

2. So long as the donor is an annuitant, capital gain recognized from the transfer of appreciative property in exchange for an annuity is recognized over the life expectancy of the donor/annuitant. This means that of each annuity payment received, a portion will be taxed as ordinary income, a portion will be tax free recovery of the donor's basis in the property, and the remainder will be capital gain recognized. If the donor otherwise meets the requirements for exclusion of gain under Section 121, the capital gain portion may be excluded from gross income up to the entire amount allowable ($250,000, or $500,000 if filing jointly). As shown in the following examples, this may be accomplished by adding the available exclusion amount to the donor's basis in the residence when calculating the taxation of annuity payments

L. Combination With Gift Annuity. This is a popular variation on the bargain sale transaction. The actuarial value of the annuity received is treated as the amount realized by the donor in connection with the transfer. The amount of any liabilities to which the property is subject is also treated as part of the amount realized.

1. The allocation of basis to the property transferred, and the resulting capital gain, is determined in a manner similar to the allocation in bargain sales transactions. If a discharge of liabilities occurs, the basis must be allocated among the retained life estate, the annuity portion, the discharge of liability portion, and the gift portion of the property transferred.

2. Gain attributable to the discharge of the liability is recognized by the donor in the year of transfer, but gain attributable to the value of the annuity is spread ratably over the life expectancy of the annuitants if the annuity is nonassignable.

Example 14: Donor age 75 would like to fund a gift annuity with her residence with a market value of $300,000 and a basis of $50,000. Since the potential gain from selling the residence does not exceed the available Section 121 gain exclusion of $250,000, the gift planner may treat the annuity as funded with cash for purposes of calculating the taxation of annuity payments.

Value of Remainder	$176,100
Annuity 5.8%	$10,214
Ordinary income	$7803
Tax free	$2,411

Example 15: Assume instead that this donor's home is worth $1,000,000 with a basis of $50,000. Since the potential gain of $950,000 exceeds the Section 121 exclusion amount, we will need to perform the following calculation to determine what, if any, portion of her annuity payment will be recognized as capital gains.

Value of Remainder	$591,535
Annuity 5.8%	$34,309

Gain Recognition

Allocate basis to remainder	
591,535/1,000,000 X 50,000	29,577
Present value of annuity	325,179
Bargain sale basis	
325,179/591,535 X 29,577	16,259
Plus section 121 gain exclusion amount	250,000
Adjusted bargain sale basis	266,259
Gain recognized (over 12.4 years)	58,920

Taxation of Annuity

Tax-free portion	11,798
Capital gain	14,414
Ordinary income	8,097

Example 16. Assume the donor (age 75) owns her home worth $1,250,000, subject to a mortgage of $200,000 in which she has a basis of $300,000, which she would like to use to fund a gift annuity.

Calculation of Annuity

Equity in property ($1,250,00 - 200,000)	$1,050,000
Value of remainder (59.2%)	621,600
Annuity 5.8%	36,053

Gain Recognition

Liability allocated to remainder (59.2%)	118,400
Present value of annuity	341,706
Total amount realized	460,106
Basis allocated to remainder (59.2%)	177,600
Bargain sale basis	
460,106/621,600 X 177,600	131,459
Total gain 460,106 – 131,459	328,647
Gain allocable to liability	
118,000/460,106 X 328,647	84,286
Use this amount as Section 121 exclusion	(84,286)

Gain taxable this year	0
Remaining gain	244,361
Less remaining Section 121 exclusion	(165,714)
Capital gain attributable to annuity (recognized over 12.4 years)	78,647

M. Risk Management. A charity issuing a gift annuity in exchange for remainder interest in a residence is assuming risks associated with that remainder, including the risks that the property may not sell for its appraised value when the life estate terminates, and that the property may take an extended period of time to sell, meaning that the charity will have maintenance, taxes, insurance and other carrying costs pending the sale. At the same time, the charity is incurring the substantial obligation of the annuity. To mitigate the risks inherent in this gift funding vehicle, the issuing charity may apply a discount to the amount of the annuity it is willing to pay in exchange for the remainder interest in the residence. For example, rather than the 5.8% annuity otherwise payable to a 75 year old in the preceding 3 illustrations, the charity might offer a reduced amount of, say, 4.5%.

IX. Appraisal Requirements and Valuation Issues.

A. In General. Donors must obtain qualified appraisals for charitable contributions of certain property, including real estate, if the claimed value of the property is greater than $5,000. These rules were strengthened by the American Jobs Creation Act (2004) and the Pension Protection Act (2006).

B. IRS Form 8283. The donor must attach this form to his tax return for the year in which the deduction for the gift is claimed.

1. The appraisal must me made not earlier than 60 days before the date of the contribution, and before the filing of the tax return on which the deduction is first claimed.

2. The appraisal must be performed by a qualified appraiser who is an individual with verifiable education and experience in valuing the relevant type of property for which the appraisal is performed. Under regulations proposed by the IRS, an individual has verifiable education and experience if the individual has successfully completed professional or college-level coursework in valuing the relevant type of property and has two or more years experience in valuing that type of property. In addition, because significant education and experience are required to obtain a designation from a recognized professional appraisal organization, appraisers with these designations are deemed to have demonstrated sufficient verifiable education and experience.

3. The appraisal must include:

   - Description of the property
   - Date of gift
   - Terms of any agreement relating to use of the property
   - Name, address, etc., of the qualified appraiser
   - The appraiser's qualifications
   - The specific standard of valuation used (e.g., replacement cost, capitalization of income of sales of comparable property)

4. If the deduction claimed is more than $500,000, the complete appraisal (not just the Form 8283) must be attached to the tax return on which the appraisal is claimed.

C. <u>Timing</u>. The appraisal must be made no earlier than 60 days before the gift. It must be received before the due date (including extensions) of the return on which a deduction for the gift is first claimed.

D. <u>Valuation Adjustments</u>. The same discounts that work to the taxpayer's benefit for gift and estate tax purposes -- e.g., discounts for lack of control and marketability that affect the value of a partial interest in real estate or an interest in a family limited partnership -- must also be taken into account when determining the amount of the charitable deduction.

E. <u>Disclosure by Charity</u>. If the charity disposes of the contributed property within 2 years of the gift, it must notify the IRS of the sales price using Form 8282.

X. **Mitigating Risk to the Charity.**

A. <u>Environmental Hazards</u>. Charity as owner (in the case of an outright gift), or as trustee (in the case of a gift in trust) may be exposed to liability for the expense of cleaning up hazardous waste.

B. <u>Environmental Review Policies</u>. Many charities have adopted policy that the organization may not accept a gift of real property without first evaluating the environmental risks.

1. An evaluation can uncover problems and help quantify the costs of correcting them.

2. The evaluation may also protect the charity against problems that are discovered later, since the organization has exercised due diligence in investigating the property, even if problems which later come to light are not discovered in the evaluation.

3. If the evaluation uncovers a hazardous waste problem, the person arranging for the evaluation must notify eventual purchaser of material problems.

C. Use of a Real Estate Gift LLC. In its Notice 2012-52, the IRS confirmed that a donor may transfer property to a single member limited liability company (SMLLC) owned by a charity, and treat the transfer for tax purposes as a contribution to the charity. If properly formed and maintained by the charity, the SMLLC protects the charity against liability arising from assets of the SMLLC, yet unlike a corporation, or even another tax-exempt entity like a supporting organization, the SMLLC is disregarded for tax purposes.

1. The contemporaneous written acknowledgement required by the donor to substantiate the charitable deduction is issued by the charity, not its SMLLC.

2. Note that this solution is so effective and easily implemented, organizations developing gifts of real property should seriously consider creating a SMLLC to receive and dispose of these gifts. Some charities use a separate LLC for each property gift while others use one such entity for all such gifts.

XI. Practical Issues.

A. Property Management. Among other considerations, the charitable organization must determine if it has adequate administrative resources to act as a property manager of real property on the assumption that the property will be held and operated for some time prior to sale.

B. Negative Cash Flow. Similarly, the organization must analyze the operating income (if any) and expense arising from the property to determine the likelihood and extent of any negative cash flow. It is a financial decision to determine whether the organization is willing to fund any negative cash flow associated with real property received from donors.

The Charitable Sector Practice
at
Mitchell Silberberg & Knupp LLP:

Serving the Community Since 1908

Contact David Wheeler Newman
(310) 312-3171 ▪ dwn@msk.com

DATE: ____________________

THE UNIVERSITY OF XXXX FOUNDATION
Director of Planned Giving

Re: Gift of Personal Residence to
THE UNIVERSITY OF XXXX FOUNDATION

Ladies and Gentlemen:

This letter will confirm my desire to make a charitable contribution to THE UNIVERSITY OF XXXX FOUNDATION (“THE UNIVERSITY OF XXXX FOUNDATION”), in the form of a gift of a remainder interest in my personal residence located in XXXX, XXXX, and will set forth my understanding of the terms of the gift.

I have agreed to execute a Grant Deed, granting to THE UNIVERSITY OF XXXX FOUNDATION my entire interest in my personal residence in XXXXXXX, XXXX, as more fully described in Exhibit “A” attached hereto. This transfer is subject to my right to reside in the residence during my lifetime.

My right to reside in the residence may be terminated at any time prior to my death if either I, the person holding a duly executed Power of Attorney authorizing him or her to act on my behalf or a conservator or guardian appointed to administer my estate gives written notice to THE UNIVERSITY OF XXXX FOUNDATION of the voluntary termination of my right to occupy the residence. A form of Notice of Termination is attached hereto as Exhibit “1”.

It is my understanding that THE UNIVERSITY OF XXXX FOUNDATION will record in the Office of the County Recorder the Grant Deed which I execute.

I will maintain the residence in a condition as good as it is today, except for normal wear and tear, and agree to make all necessary repairs. I will make all mortgage payments, if any, in a timely manner. I understand that by accepting this gift, THE UNIVERSITY OF XXXX FOUNDATION assumes no responsibility to pay taxes, insurance premiums, maintenance or repair charges, mortgage payments, assessment or management fees (“Assessments”) which relate to the period during which I reside in the residence. Rather, I have agreed to pay in a timely fashion all Assessments for so long as I live in my residence.

I will not make any structural changes or improvements to the residence, nor will I make major changes in the use of the residence, including rental, without the prior written consent of THE UNIVERSITY OF XXXX FOUNDATION.

The insurance coverage I provide will be sufficient to cover the full replacement value of the residence, and shall name THE UNIVERSITY OF XXXX FOUNDATION as an additional insured. In the event of a loss covered by insurance, at my election, available insurance proceeds may be used to repair and replace any damage to the residence. I agree that if I do not so elect, the proceeds of such insurance shall be divided between THE UNIVERSITY OF XXXX FOUNDATION and myself in proportion to our respective interests in the residence at the time such proceeds are received.

If, prior to my death, I give notice to THE UNIVERSITY OF XXXX FOUNDATION disclaiming my right to occupy the residence, I will pay all Assessments which relate to the period during which I occupy the residence of which I have been given written notice by THE UNIVERSITY OF XXXX FOUNDATION. THE UNIVERSITY OF XXXX FOUNDATION shall be responsible for paying any Assessments which relate to the period after the date on which I cease to occupy the residence.

THE UNIVERSITY OF XXXX FOUNDATION shall have the right, but not the obligation, to make payments I am obligated to pay, if I fail to pay them in a timely manner as provided above. If THE UNIVERSITY OF XXXX FOUNDATION makes any payments which I am obligated to pay pursuant to our agreement, I agree to reimburse THE UNIVERSITY OF XXXX FOUNDATION for these amounts. Until repayment by me, THE UNIVERSITY OF XXXX FOUNDATION shall have the right to set off any payments otherwise due to me from THE UNIVERSITY OF XXXX FOUNDATION, including without limitation my right to receive annuity payments from THE UNIVERSITY OF XXXX FOUNDATION. Any amounts I am obligated to repay to THE UNIVERSITY OF XXXX FOUNDATION which remain outstanding at my death shall be a liability of my estate.

I hereby give to THE UNIVERSITY OF XXXX FOUNDATION all personal property located in the residence (or on the property on which the residence is located), unless such personal property is removed from the residence by my personal representative within thirty days of my death pursuant to a provision in my Will or a trust to which my personal property has been transferred. I agree to provide THE UNIVERSITY OF XXXX FOUNDATION with the names and contact information for my personal representatives (executors and trustees) and copies of any provisions relating to this personal property contained in my estate planning documents. I understand that THE UNIVERSITY OF XXXX FOUNDATION assumes no responsibility for my personal care or welfare, and that THE UNIVERSITY OF XXXX FOUNDATION encourages me to nominate a conservator and to provide THE UNIVERSITY OF XXXX FOUNDATION with the name and contact information of my nominated conservator.

If the foregoing accurately represents your understanding of our agreement, please sign this letter where indicated below.

Very truly yours,

____

JANE SMITH

Enclosures

ACCEPTANCE

The transfer of the residence which you currently occupy, as described in Exhibit "A" attached hereto, is accepted by THE UNIVERSITY OF XXXX FOUNDATION upon the terms and conditions set forth above.

DATED: ___________________ THE UNIVERSITY OF XXXX FOUNDATION

By: ____
VICTOR VEEPEE

RECORDING REQUESTED BY AND
WHEN RECORDED MAIL TO:

THE UNIVERSITY OF XXXX FOUNDATION

____

____

NOTICE OF VOLUNTARY TERMINATION

Pursuant to the terms of the reservation contained in that certain Grant Deed from JANE SMITH to THE UNIVERSITY OF XXXX FOUNDATION, granting real property in XXXX, XXXX described in Exhibit A, attached hereto, JANE SMITH hereby gives notice of voluntary termination of JANE SMITH's reserved right to the exclusive possession, use, and enjoyment of rents, issues and profits of said property.

Dated: __________________

____
JANE SMITH

STATE OF XXXX)
) ss.
COUNTY OF)

On ___________________________ before me, ______________________________________(here insert name and title of the officer), personally appeared JANE SMITH personally known to me (or proved to me on the basis of satisfactory evidence) to be the person whose name is subscribed to the within instrument and acknowledged to me that he/she executed the same in his/her authorized capacity, and that by his/her signature on the instrument the person, or the entity upon behalf of which the person acted, executed the instrument.

WITNESS my hand and official seal.

[SEAL]

____
Notary Public Signature

RECORDING REQUESTED BY AND
WHEN RECORDED MAIL TO:

THE UNIVERSITY OF XXXX FOUNDATION
Director of Planned Giving
____
____

MAIL TAX STATEMENTS TO:
JANE SMITH, 123 MAIN STREET, XXXX, XXXX

GRANT DEED

JANE SMITH hereby grants to THE UNIVERSITY OF XXXX FOUNDATION, the real property, commonly known as 123 MAIN STREET, XXXX, XXXX, described in Exhibit A attached hereto, reserving to the Grantor the exclusive possession, use, and enjoyment of rents, issues and profits of the above granted property for and during the lifetime of the Grantor. Such reservation shall be terminated prior to the death of the Grantor if written notice of voluntary termination of such reservation in recordable form is given to THE UNIVERSITY OF XXXX FOUNDATION by the Grantor, or by a person authorized by a duly executed Power of Attorney to give such notice on behalf of the Grantor, or by any conservator or guardian appointed by a court of competent jurisdiction to manage the Grantor's estate.

Dated: _________________

____
JANE SMITH

APPENDIX A

STATE OF XXXX)
) ss.
COUNTY OF)

On __________________________ before me, _____________________________________(here insert name and title of the officer), personally appeared JANE SMITH personally known to me (or proved to me on the basis of satisfactory evidence) to be the person whose name is subscribed to the within instrument and acknowledged to me that he/she executed the same in his/her authorized capacity, and that by his/her signature on the instrument the person, or the entity upon behalf of which the person acted, executed the instrument.

WITNESS my hand and official seal.

[SEAL]

____
Notary Public Signature

APPENDIX A