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REAL ESTATE GIFTS—BEYOND THE BASICS

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Why Real Estate?

Real estate is hot. Flip through any financial magazine and you will find extensive discussion on real estate investing. Those of us in the gift planning world are well aware of the philanthropic potential of real estate gifts.

For many individuals, real estate is the major asset of their estate, especially now with the steep decline in stock values. For example, the value of households' real estate holdings in the U.S. grew 43.3 percent from 1998 to 2002. The value of households' non-cash financial assets in the U.S. decreased 6.5 percent over the same period. Household real estate now accounts for 34.9 percent of household net worth.¹

For a charity, real estate is among the toughest assets to work with. For an advisor, dealing with the client who is land-rich and cash-poor can be a special challenge. In today's economy, real estate provides a perceived safe haven for investors uncertain of the market's future returns. That may mean that donors are reluctant to part with one of the few assets left in their portfolios retaining value and growth potential, unless a charity is prepared to go beyond the basics. What do we need to offer to our supporters to enable them to use real estate to achieve their philanthropic objectives?

Most charities are now comfortable accepting certain types of real estate, such as single family residences. Fewer are comfortable with accepting mortgaged property, commercial property and undivided interests. Couple the complex real estate asset with a donor's desire for income, and even fewer charities are interested. Approval of Flip charitable remainder unitrusts by the IRS in 1997 raised the comfort level for many advisors and charities and made gifts of real estate into CRTs even more commonplace, but what about funding charitable gift annuities with real estate? And how about life estate/bargain sales, the so-called charitable reverse mortgages?

In this article, we will discuss gifts of real estate that go beyond the basics. Charities must take their real estate programs to the next level to meet the needs of their donors. In many cases, the real estate is held within complex ownership structures or may be encumbered. Many owners will seek to exchange the real estate for an income flow. Charities and advisors need to be equipped to handle such gifts. In doing so, charities will be able to raise revenue lost by a marked decline in endowment portfolios and decreases in stock giving.

We assume that a basic real estate program is already in place before a charity would embark on the types of complex gift arrangements discussed in this article. Thus, we will not address matters such as the need for due diligence in assessing real estate, accepting and selling real estate, and related issues, except as they relate to the complex arrangement. Let's turn now to a discussion of creative real estate gifts. There are some exciting possibilities, but the road can be challenging.

Outright Gifts of Real Estate

An outright donation of real estate is generally the preferred transaction for a charity because it can provide funds for the charity's programs almost immediately. Once a basic real estate program is in place, then an outright donation can be handled efficiently and poses little risk to the charity, assuming the property is clean and marketable. For the donor, a gift is even easier. The tax treatment for an outright gift of appreciated real estate held long term is simple. Generally, an individual will deduct fair market value up to 30 percent of adjusted gross income with a five-year carryover provision. However, don't forget the reduction rules if the donor is a dealer or the real estate is subject to depreciation recapture.

What are the more complex planning twists that an outright gift can present? It is not uncommon that a donor cannot utilize the full deduction due to AGI limitations, even with the carryover provisions. That can dampen the enthusiasm of even the most committed donors. Consider two options. First, if appreciation is minimal, it may make sense to take the step down election and, in effect, deduct basis rather than fair market value, therefore utilizing the 50 percent limitation rather than the 30 percent limitation. Caveat: remember to consider the impact of the step down election on other charitable gifts during that taxable year.

Second, the real estate may be suitable for division and can be donated in parcels, or contributions of undivided interests can be made over a period of years to stretch out the deduction. If parcels are donated, the gifts can often be sold by the charity as they come in. If undivided interests are donated over a period of time, those interests generally will not be marketable until the entire, or at least the majority, interest is transferred. The charity must carefully consider whether it is prepared for a possibly lengthy holding period with a private co-tenant, and a co-tenancy agreement must be in place. The co-tenants must have a firm written agreement on such matters as selling the property, marketing responsibilities, maintenance and costs.

A question also arises as to the valuation of a gift of an undivided interest. Should the value be discounted to reflect a possible lack of transferability and marketability? Unfortunately, it does not appear to be as simple as taking 50 percent of the value when a 50 percent interest is contributed. For example, if the holder of the 50 percent interest that will not be donated to a charity agrees with the charity to market and sell the property, then should it really be necessary to discount the donated 50 percent interest? How is a minority or majority interest valued? The answers will be provided by a qualified appraisal.

Outright gifts of encumbered real estate can present a special challenge. But there is no need for a charity to simply refuse such gifts—not without a fight, at least! A mere transfer of mortgaged property is deemed a bargain sale. Treas. Reg. Sec. 1.1011-2(a)(3). The donor will recognize gain on the difference between the amount of the debt and allocated adjusted basis. An important consideration for the charity is whether this will create debt financed income to the charity. If the charity can put the property to a related use, there will be no Unrelated Business Taxable Income (UBTI) due to the debt. Also, if the gift is through a devise or if the donor had owned the real estate for more than five years and the debt is more than five years old, then the debt financing rules do not apply for the first 10 years. IRC Sec. 514.

Some advisors have suggested that one way to deal with the capital gain issue is for a donor to convey a fractional undivided interest in the property to the charity while retaining an interest sufficient (upon subsequent sale by the donor in conjunction with the charity) for the donor to repay the entire debt and to pay the tax on the gain attributable to the retained interest. From a practical standpoint, the question is whether a lender would agree to such a transaction and, in effect, remove the debt attributable to the donated portion. If one wishes to proceed with this proposed solution, the lending agreement should be carefully scrutinized for such clauses as prior consent by the lender to any transfer, and of course the donor and charity must be well advised of possible consequences.

A more cautious alternative is for the donor to first pay off the entire debt, perhaps with the proceeds of a loan backed by some other asset, donate a fractional undivided interest, join in the subsequent sale with the charity, then use his or her share of the proceeds to recover the funds used to pay off the original debt.

A bargain sale/purchase can be an excellent option for donors and charities when the donor is unable or unwilling to make an outright gift of the entire interest. Real estate is sold to the charity at less than fair market value. The difference between fair market value and the sales price is the charitable contribution deduction. As with encumbered real estate, the donor's cost basis is allocated on a pro rata basis between sale and gift portions. Only the gain attributable to the sale is taxable to the donor. In evaluating whether to enter a bargain sale/purchase, the charity must understand that it will have to use funds to make the purchase and must be realistic over how long it might take to sell the property and recoup its funds. An important question to consider is whether having these funds temporarily unavailable for program purposes makes business sense.

A gift of a partial interest in land for conservation use is another example of an outright gift of real estate. This can give rise to a charitable deduction as long as the gift of a lease, easement, etc., is made exclusively for conservation purposes. IRC Sec. 170(f)(3)(B)(ii). While this type of real estate gift is especially close to the hearts of the authors, further discussion is best left to another forum.²

In the preceding paragraphs we have assumed that a charity is willing to accept an outright gift of real estate. But what if a donor wishes to make such a gift and a charity does not want to be in the chain of title? Reasons might include environmental concerns, a charity's inability to work with real estate in a given location, or even valuation or marketing issues with the donor. It has been suggested that a very short-term, donor-trusteed, net-income charitable remainder unitrust can be used to achieve most of a donor's objectives. The property would be donated to the trust thereby avoiding any potential capital gains tax, and if, for example, the trust were for a two-year term, the donor would be entitled to charitable deduction equal to about 90 percent of the value of the property. The donor as trustee would sell the property, and when the trust terminated, the charity would receive an amount approximately equal to the original value of the property. Before entering into this arrangement, it is important to determine that the property will sell within the time frame of the trust.

Gifts Of Real Estate In Exchange For Income

While the best gift for a charity is usually an outright gift, gifts of real estate structured to provide income back to the donor or others can also be attractive. Typically, a Flip charitable remainder unitrust is used to provide lifetime or term of years income when real estate is the funding asset. We will delve further into the choices in structuring the unitrust in this section and discuss alternate options, such as charitable gift annuities.

The Flip CRUT

A Flip CRUT, which combines the features of a Net Income CRUT and a Standard CRUT, is now the most commonly used life-income arrangement when donors want to receive income in return for a gift of real estate. Prior to flipping, when it is a Net Income CRUT, the trust makes income payments to the designated income beneficiary(ies) based on the lesser of the trust's actual income or a fixed percentage of the fair market value of the trust's assets, as revalued each year. After flipping, the trust becomes a Standard CRUT and makes income payments determined solely by the fixed payout rate and is not limited to income produced by the trust.

A Flip CRUT flips in the year following the occurrence of a triggering event specified in the trust agreement. That event must be a “specific date or single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons.” Treas. Reg. 1.664-3(a)(1)(i)(c) and (d). For example, it can be a death, marriage, divorce or the birth of a child; or the sale by the trust of an unmarketable asset, such as real property.

Typically, the triggering event for a Flip CRUT funded by real estate is the sale of the real property, but it need not be. The advantage of specifying that event—especially if the donated real property is not income-producing—is that by doing so, the trustee can avoid a situation in which a trust does not have enough income to make a required payment to the beneficiary(ies). If the income available for distribution is insufficient, neither of the choices then available to a trustee is attractive. The least attractive option is to make an in-kind distribution of a fractional, undivided interest in the real property. The alternative is for the donor to make an additional contribution to the trust of cash or securities sufficient to make the required income payment.

However, there is also a disadvantage to using the sale of the property as the triggering event. The property may sell and the trust may flip sooner than the donor would have liked. In most cases it is in all parties’ interests for the real property to be sold as quickly as possible under the existing market conditions. But, as an example, the donor might prefer to minimize the receipt of income until his or her expected retirement date. This timing dilemma could be avoided, if it were possible to specify in the trust agreement the *later* of the sale of the property or a specific date. Is that possible? We believe it is. In its regulations on acceptable triggering events, the Treasury has included as an acceptable event the *earlier* of the sale of a stock or its release from the restrictions on its sale. Treasury Reg. 1.664(a)(1)(i)(e). Since ordering of the *earlier* of two events is specifically allowed in the Treasury Regulations, we believe that ordering of the *later* of two events would also be allowed. Obviously, a donor contemplating creating a trust with this kind of triggering language would need to obtain his or her own legal opinion on the question.

Note that a Flip CRUT funded by real estate has three phases, not two. There is a period when the trust owns real estate and may have little or no income. There is a period after the triggering event has occurred but before the trust flips. And then there is a period after the trust has flipped. In discussions of Flip CRUTs with donors, the second period is often glossed over, but it is important to address this, as this period could easily be longer than the first. Decisions need to be made regarding the investment of the trust’s assets during this second period. And because the trust will be a Net Income CRUT during this period, the asset allocation that is most appropriate may well be different from what will be appropriate after the trust flips. For example, the trustee may conclude that during this period, balancing the interests of the income beneficiary(ies) and the charity requires the trust to hold more fixed income securities than it would after it flipped.

As we discussed in the outright gift section, a donor might own an undivided interest in a property and wish to donate that interest to a Flip CRUT. The same caveats apply and we believe this can be an excellent gift, provided the owner of the other interest agrees to sell the property as well.

Of much more interest is the situation where the potential donor owns the property in its entirety in fee and would like to donate a fractional, undivided interest to a Flip CRUT and retain the remaining fractional interest. This can be a very attractive option for an owner of a principal residence who, if he or she sold the residence, would have a capital gain of more than \$250,000 (\$500,000 for married couples).

Under current law, as long as certain residency requirements are satisfied, an owner can exclude up to \$250,000 of gain on the sale of a principal residence (\$500,000 for married couples). If a couple simply sells a principal residence for a gain of more than \$500,000, tax will be due on the amount of the gain

over \$500,000. But the couple could donate to a Flip CRUT a large enough fractional interest in the property so that when the property is sold, the gain associated with the fractional interest the donor retained would be no more than \$500,000. The couple avoids any capital gains tax; the entire \$500,000 exclusion can be used to offset the gain realized on the fractional interest retained in the property. Indeed, they could retain a fractional interest with respect to which the capital gain would be more than \$500,000 because the capital gains tax would be offset by the charitable deduction on the fractional interest contributed to the trust.

But determining the most advantageous division of the property between a Flip CRUT and a retained interest is rather complicated. The best way to obtain an approximate answer is to compare some “what if” scenarios that take into account the \$500,000 exclusion, the charitable deduction, the 30 percent limitation on charitable deductions, a reduction (or even loss) of personal deductions and exemptions resulting from an increased AGI, and perhaps even the Alternative Minimum Tax.³

The number of potential donors who own homes that, if the home were sold, would have a capital gain of more than \$250,000 (\$500,000 for married couples) is almost certainly greater than it otherwise would have been because of the capital gains tax rules for the sale of principal residences that applied prior to the *Tax Reform Act of 1997*. Prior to the enactment of the 1997 legislation, owners could defer paying capital gains tax on the sale of a principal residence as long as they used the proceeds from the sale to purchase a replacement property of equal or greater value. Instead of recognizing a gain at the time of sale the owner would roll their basis over into the replacement property. If eventually a gain were realized, an owner over age 55 had a one-time capital gain exclusion of \$125,000 (\$250,000 for a married couple).

Clearly, the pre-1997 legislation encouraged owners to defer realizing capital gain if they sold homes and purchased new, more expensive ones. Today, those owners are likely to find themselves with a very low basis in their current home as a consequence of their having, over the years, rolled over their basis from their least expensive home to increasingly more expensive homes. The enactment of the 1997 legislation brought that process to an end. If owners sell now they cannot roll the gain over, and they might well find themselves in a position where making a gift to a Flip CRUT of a fractional interest in their property may be very advantageous.

There are some potential pitfalls in making a gift of a fractional interest of real estate to a Flip CRUT. The issue of self-dealing is a major one. IRC Section 4941 and the regulations promulgated thereunder set forth the self-dealing rules. The question in this context is whether the income or assets of the CRT are used “by or for the benefit of a disqualified person.” Does simple co-ownership constitute self-dealing? Despite some private letter rulings by the IRS on the matter, the question remains unsettled. Some believe that it would not be self-dealing if the donor’s only right were a share of the proceeds from the sale of the property. Others are not so sure. If the IRS does find self-dealing, then an excise tax is imposed for each year the self-dealing occurs. Thus, it may be advisable to enter these transactions only when it is certain that the co-ownership period will be brief and the consequences of the self-dealing excise tax are understood.

Having raised the issue, it is important to note that to avoid self-dealing, donors must vacate the property in which they have donated an interest before it is transferred to the trust, regardless of whether they have donated their entire interest or a fractional undivided interest.

There is also the continuing debate over the potential issue of a partial interest. This issue is not of as much concern as that of self-dealing, but is raised from time to time. In general, a donor is not allowed a deduction for income, gift or estate tax purposes for the contribution of a partial interest. Examples of specified exceptions to the rule are: qualified charitable remainder trusts, lead trusts, remainder interest in a personal residence or farm and others. To be entitled to a deduction, the donor must contribute an

undivided interest that includes each and every incident of ownership. If a donor owns a fractional interest in real property and makes a gift to a Flip CRUT of the entire fractional interest, there is no question that the donor contributed his entire interest. But if the donor owns a property in its entirety in fee and makes a gift to a Flip CRUT of a 50 percent undivided interest in the property, has the donor contributed his or her entire interest? Most commentators do not believe this constitutes a violation of the partial interest rule, but there is some disagreement.

When dealing with a gift of this type, the prudent course for a charity is to disclose the potential issues of self-dealing and partial interests and to ensure that the donor is well represented by adequate counsel. As discussed earlier, it is important to have a co-tenancy and/or co-marketing agreement as well.

Before we leave the discussion of flip CRUTs, we must address the matter of mortgaged property. A proposed gift of debt encumbered property to a CRUT is among the hardest gifts to deal with because the consequences can be severe. Many charities will flat-out refuse to consider it. Authority from the IRS is sparse in this area. Possible UBTI, bargain sale treatment of gain, implication of grantor trust rules, self-dealing—it can be a nightmare. Why consider it? Because, if structured properly, an offer of mortgaged property to fund a CRUT can become a great gift for the donor and the charity.

Note, first, that if the donors have owned the property for more than five years and the debt is more than five years old, then UBTI is not a problem for the CRUT. If those conditions are not met, a CRUT is probably not feasible.

Even if the debt is more than five years old, the existence of a mortgage may still be a problem. The simplest solution may be the least attractive to the donor. As discussed in the outright gifts section, the donor can pay off the mortgage by borrowing against another asset. Also, as discussed with outright gifts, the donor may wish to retain an undivided fractional interest in the donated property so the donor can use the proceeds from the sale of the retained fractional interest to repay the new loan. As before, there will need to be a co-tenancy agreement spelling out each party's rights and responsibilities. The charitable deduction from the gift to the CRT helps to offset the gain from the sale of the retained interest.

Finally, some charities will agree to purchase an undivided fractional interest in the property from the donor in the amount equal to the debt. The donor uses these funds to pay off the debt, then contributes the remaining interest to the CRUT. The charity joins in the sale of property with the CRUT and recoups its purchase funds. Gain realized by the donor in the sale to the charity is balanced by the charitable tax deduction from the gift to the CRUT. This alternative can be utilized if concerns exist over possible self-dealing or nonqualified partial interests when the donor retains a fractional interest.

The Charitable Gift Annuity

Many charities do not issue charitable gift annuities in exchange for real estate, or only do so if it is a deferred payment gift annuity. A deferred payment gift annuity gives the charity time to sell the property in order to make the annuity payments. The primary concern with issuing an immediate payment gift annuity is the obligation to make annuity payments prior to the liquidation of the real estate. However, with proper structuring and adequate handling procedures for gifts of real estate, real estate can be an excellent funding source for a gift annuity.

Unlike a charitable remainder unitrust, a charitable gift annuity is a contractual rather than a trust agreement that obligates the issuing charity to make fixed, annual income payments to the designated income beneficiary(ies) for life. As such, there are lessened concerns over certain of the trust "killers," i.e., self-dealing, disqualified persons, etc. Of course, a new set of problems emerges. A charity must first

determine if it can issue a gift annuity in exchange for real estate in the state where the annuitant resides. New York State prohibits such gifts altogether. Five other states (Arkansas, California, Florida, New Jersey and Wisconsin) limit the issuance of such annuities in some way.

Second, the face value of the annuity must be determined. The beginning point is an approximation of the market value to which the donor and the charity agree. This agreed-upon value is not to be confused with the appraised value that will be required to substantiate the donor's charitable contribution deduction. From that agreed-upon value, to determine the face value of the annuity, the charity's gift acceptance (closing) costs would need to be subtracted. These costs would be incurred at the very outset, when the property is received. In addition, for as long as the charity owns the property there are carrying costs for such things as real estate taxes, utilities, insurance and maintenance. Later, when the property is sold, there are more closing costs and a broker's commission that must be subtracted. All these costs are incurred regardless of when the annuity payments begin. In addition, annuity payments may need to be subtracted if they are likely to begin before the property is sold.

In order to recognize all its costs, the charity must determine where the funds to cover the gift acceptance costs, the carrying costs and the annuity payments (if not deferred) are to come from. Typically, the closing costs and broker's commission will be paid from the proceeds at the time of the sale. The gift acceptance costs and the carrying costs could be covered from the charity's general funds and may be considered an internal loan. If considered a loan, the interest would be another cost associated with the gift. The borrowed funds would be repaid with interest to the general fund when the property is sold. The annuity payments, if any, would be paid from the charity's gift annuity account. They could also be treated as a loan with the interest on them deemed to be a cost.

In short, to determine the face value of the annuity the charity should discount the agreed-upon value by some figure to take into account all the costs, including the interest costs, noted above. Since the carrying costs and the annuity payments increase over time, some assumption will have to be made about how long it will take to sell the property. Finally, there should be an adjustment for uncertainty. If then, for example, the resulting discount figure were 20 percent of the agreed-upon value, the face value of the annuity would be the agreed-upon value less 20 percent. The charity would issue an annuity providing an income payment calculated by applying the ACGA rate to that discounted value. Alternatively, the charity could issue an annuity with a face value equal to the agreed-upon value, but reduce the ACGA rate by 20 percent.

Either approach yields the same income payment and the same charitable deduction, but may need to be calculated differently, using a planned giving software program. The critical value in determining a charitable deduction is the appraised value obtained by the donors as required to substantiate their charitable deduction.

If the annuity is determined by applying a discounted ACGA rate to the agreed-upon value, and if the appraised value and the agreed-upon value are the same, then the calculation of the charitable deduction is straightforward—simply replace the default ACGA rate with the discounted rate. If the appraised value and the agreed-upon value are *not* the same, then the appraised value and the actual income payment must be entered into the software program, thus producing the “actual payout rate” and the correct charitable deduction.

When utilizing the alternative approach, i.e., applying the ACGA payout rate to the agreed-upon value as discounted, there are two ways to calculate the charitable deduction, assuming the agreed-upon value as discounted and the appraised value are different. First, one can manipulate the software program as described above to arrive at the “actual payout rate” and thus, the correct charitable deduction. Second, the charitable deduction can be arrived at as the sum of two things, namely, a) an outright gift equal to the

difference between the appraised value and the agreed-upon value as discounted; and b) the charitable deduction resulting from the annuity itself. To further complicate matters, note that the cost basis of the property must be allocated between the outright gift and the annuity.

If the charity's gift annuity account has excess reserves, it may not be necessary to record the real estate received as an asset of the gift annuity fund. If the account does not have excess reserves, it may be necessary to include the real estate as an asset of that account. In either of these cases, once the property is sold the proceeds presumably will be credited to the gift annuity account. Alternatively, if the annuity account does not have excess reserves, but the charity does not want to record the real estate as an asset of the annuity account or state law does not allow it to do so, it could advance to the annuity account an amount equal to at least the required reserves associated with the annuity issued. Then, when the property is sold, the advance would be repaid, presumably with interest.

Can mortgaged property be transferred in exchange for a charitable gift annuity? Apparently so. And indeed, this gift arrangement may be the solution to the many problems presented by such a gift to a CRUT. Since the gift annuity is a contract and not a trust, the self-dealing and grantor trust rules are inapplicable. However, bargain sale rules for the gain will apply, so a careful analysis of the tax consequences to the donor must be made. And, be sure to consider the UBTI consequences, if any, to the charity. Also, it is important for the charity to take into account the need to make mortgage payments prior to the sale.

An undivided fractional interest in real estate can also be exchanged for a charitable gift annuity. Again, the contractual nature of the gift annuity relieves some of the concerns that may be raised in the context of a CRUT, but valuation and marketability issues remain.

When we discuss real estate contributions for charitable gift annuities, we take a highly analytical approach using spreadsheets to determine what is the best offer we can make to the donor while ensuring the best gift to further our mission. If the annuity is an immediate payment as opposed to a deferred payment annuity, we also find it helpful to negotiate annual or semiannual annuity payments rather than quarterly or monthly payments, to give us more time to sell the property before annuity payments begin.

Gift Annuities Funded with Remainder Interests

Many individuals would like to donate their homes, live in them, and receive income. We've all received those calls! This cannot be accomplished with a charitable remainder trust due to self-dealing issues, but it can be done nicely with a charitable gift annuity. Basically, this is a combination of two gift transactions—a gift of a personal residence or farm retaining a life or term of years tenancy, and a charitable gift annuity issued for the remainder interest. We will not go over the basics of the retained life estate transaction with the exception of stressing that this must be a personal residence or farm, but not necessarily the principal residence.

In order for a charity to determine the value of the annuity it might issue, it needs first to determine the value of the remainder interest in the personal residence and determine the maximum payout rate appropriate for the donor's age(s), generally provided by the American Council on Gift Annuities. Next, the charity should project when it will receive the property in question and what its market value will then be. Given the ages of the prospective annuitants and actuarial tables, the charity can begin to estimate when it might receive the property. The future market value of the property is the key input, however, and that depends on the property's current market value and future appreciation or depreciation. The assumption regarding appreciation or depreciation is a critical one, and if they are available, the charity should base its assumption on long-term appreciation or depreciation figures for the local market.

Conservative projections of when a charity will receive a property and what its future market value will be protect the charity's ultimate gift.

As discussed in the earlier section on gift annuities, a charity should also estimate the various costs associated with a gift. These would include the charity's gift acceptance (closing) costs, its carrying costs when it eventually receives the property, closing costs and broker's commissions upon the sale of the property and any appropriate interest charges associated with these costs. But the major cost would be the annuity payments and interest on them. Using a spreadsheet, the charity could assume annuities of various amounts and determine, given the projected market value when the property was received and the other costs mentioned, the annuity that provided the charity with an appropriate gift.

It is important to remember that, unlike the gift annuity funded with real estate immediately available for sale by the charity, the uncertain length of the holding period of the real estate (unless it is for a short term of years) combined with the costs of funding the annuity payments over this period, can substantially decrease the funds that are eventually received by the charity upon the ultimate sale of the property and repayment of the costs advanced. It is important to be cautious, but there is no need to refrain from such gifts as long as adequate funding exists.

Where do funds to pay the annuity come from? If the charity has excess reserves in its annuity account, it may be able to pay the annuity from that account. But if it does not, it probably ought not record such an illiquid asset as an asset of the annuity account. Thus, if the charity does not have excess reserves, it would almost certainly have to borrow from the charity's general funds an amount at least equal to the reserve requirement associated with the gift. Eventually, when the property is received and sold, the charity's general funds would be repaid, presumably with interest.

Pooled Income Funds

A pooled income fund (PIF) is a trust to which a donor transfers property that is co-mingled with the gifts of other donors. In return one or two designated income beneficiaries receive a proportionate share of the PIFs income for life. IRC Sec. 642(c)(5) Largely because of declines in interest rates and dividends, PIFs have not been very popular in recent years. But many charities do offer them. Treasury regulations prohibit a gift of tax-exempt securities to a PIF, but there is no prohibition against a gift of real estate to a PIF.

While the trustee of a PIF could accept a gift of real estate, there are several reasons why it probably should not. The first problem stems from the valuation of the gift used to determine a donor's proportional interest in the PIF. A donor of real estate would be credited with a certain number of units in the PIF based on an assumed fair market value of the real estate. But the property may sell for a very different amount. If it sells for less than the assumed value, all of the other participants in the PIF will be penalized. If it sells for more, the donor of the real estate will be penalized. Even if real estate sells for the assumed market value, because of selling costs the net proceeds realized by the PIF will probably be somewhere between five and 10 percent less than that market value. As a result, all of the other participants in the PIF will receive less income than they would have received if the real estate gift had not been accepted. Finally, if the real estate is not income-producing while it is being held by the PIF, all of the PIF beneficiaries will receive income payments below what they would have received if the donor of the real estate had contributed securities or cash instead. In addition to the above, the disclosure statements for most PIFs do not disclose investments in real estate and this could cause problems for the trustee.

For all these reasons, charities should not accept gifts of real estate to PIFs, unless the PIF was specifically created to accept such gifts or to hold real estate in connection with the charity-sponsor's tax exempt purposes.

Donor Advised Funds

In recent years, there has been a good deal of interest in donor advised funds (DAF). Community foundations have offered them for quite some time. More recently, mutual fund companies such as Fidelity and Vanguard, as well as brokerage firms such as Schwab, have created charitable organizations to offer DAFs. A number of traditional charities, mostly colleges and universities, also offer them. DAF sponsors normally accept gifts of cash or securities, but few are willing to accept gifts of real estate. But they could, and such a gift can be very attractive to potential donors.

Individuals have found DAFs attractive because they can separate in time their income tax charitable deduction from the contributions to the ultimate charity-beneficiaries in a way that can be very advantageous. They also can free themselves of investment responsibilities, and if they had been making gifts of securities previously, they can simplify the gift-giving process. In most cases, the gift of securities or cash that donors make to establish a DAF could have been divided and contributed to individual charities. But that is not the case with real estate, and that is what makes a gift of real estate to establish a DAF so attractive. In addition to all the other advantages of a DAF, a gift of real estate enables donors to make a gift of an asset that would be very difficult to divide among individual charities. Once the DAF sponsor has sold the real estate the donors can advise the sponsor to make gifts of varying amounts to many individual charities.

If a DAF sponsor accepts gifts of real estate for other purposes, we are unable to think of any reasons why it should not be willing to accept real estate gifts to establish a DAF. The DAF sponsor would have to deal with the usual issues surrounding an outright gift of real estate. But there do not appear to be any significant special issues that arise because a gift of real estate is being made to establish a DAF. A minor issue might arise if a DAF sponsor requires donors to make distributions each year. When such a requirement exists, the sponsor might have to relax it until the real estate has been sold.

Charitable Lead Trusts

For certain donors a gift of real estate to a Charitable Lead Trust (CLT) may be an attractive gift, especially now that the IRS Discount Rate is at historically low levels. Highly appreciated, income-producing property with growth potential is an ideal asset to fund a nongrantor CLT. The property is retained by the trust and the income is used to make the required payments to charity during the term of the trust. The income is taxed to the trust, but deductions are allowed for payments to charity and costs associated with the real estate. Eventually, the property passes to the noncharitable remaindermen. For high net worth families, a gift of real estate to a nongrantor CLT may accomplish the multiple objectives of minimizing gift tax, passing on a significantly appreciated asset to descendants, and making current gifts to charity. Gifts of undivided interests in real estate can also be donated to a CLT, taking into consideration the issues that have been addressed earlier in this article.

Psst... mister, can you spare some real estate?

With many individuals experiencing significant loss of value in their stock portfolios, gifts of real estate represent enormous potential to charities. Charitable remainder trust activity, which has recently declined

in comparison with gift annuities, will benefit from an emphasis on using appreciated real estate as the funding asset. Expanding a charity's gift planning tool kit to include offering the attractive fixed income of charitable gift annuities funded with real estate and accepting real estate in other vehicles is another way to meet the needs of today's donors in a competitive market.

Endnotes

¹ Federal Reserve Board, "Balance Sheet of Households and Nonprofit Organizations," March 6, 2003.

² David Handler and Bree Holt, "Uses and Benefits of Conservation Easements After the 2001 Tax Act," *Trusts & Estates*. December 2001.

³ Marc D. Hoffman, "What to Do with the Empty Nest? Planned Giving for the Affluent Home Owner," *Proceedings of the 15th National Conference on Planned Giving*. Indianapolis: National Committee on Planned Giving, 2002. pp. 417-35.

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