Donating Real Estate

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Charitable gifts of real estate can be a great way for a client to avoid capital gains taxes, generate an income tax deduction and achieve personal objectives such as leaving a legacy by making a substantial gift to the client's favorite charity. In order to structure gifts of real estate that will benefit both the client and the charitable organization, it is important for both charities and professional advisors to understand the basics of real estate transactions, the role of the professionals who are typically involved in the transaction as well as several common strategies to use when structuring gifts of real estate.

The Real Estate Donation Process and the Professionals Involved

There are several steps involved in real estate transactions regardless of whether the transfer occurs as part of a sale or as a charitable gift. It is important for all parties involved to understand these steps to ensure that the transaction occurs in the most cost and tax efficient way possible for the parties.

Identify a Charity

Many charitable organizations accept gifts of real estate. These organizations will make aware – through marketing materials or educational events – their willingness to accept gifts of real estate. The real property owner seeking to donate property, or an attorney or advisor acting on the owner's behalf, should contact the charity's gift officer to discuss the prospect of making such a gift.

The gift officer may be able to explain some of the potential tax benefits related to the gift. These benefits will vary depending on: (1) the kind of gift the client is contemplating – for example, is the client considering an outright gift versus using the real estate to fund a planned gift such as a Charitable Remainder Unitrust; (2) specifics related to the property – such as the fair market value or whether the property is the client's personal residence and the client wishes to continue to live in the property; as well as (3) the client's specific tax circumstances – such as the client's income tax rate, cost basis in the property and whether the client has depreciated the property.

In addition, if possible, the gift officer may want to visit the property to determine whether it is the sort of property that will meet the organization's gift acceptance standards or policies. The more the client or their advisor can share this kind of information up front with the gift officer, the sooner the client, their advisor and the gift officer can determine if the gift of real estate is worth pursing for both the client and the charity.

Exchange Information and Obtain an Appraisal

If the initial discussions go well, the client and charity may agree to move to the next steps of selecting the gift method that best meets the client's objectives and determining how best to structure that gift. At this point, the gift officer can discuss with the client various gift strategies and their potential tax benefits. It is very common for the client to include a financial planner, attorney or accountant in this exchange of information with the charity. Professional advisors often play a significant role during this part of the process as they help determine the gift strategy that will be best for the client, given the client's tax situation.

During this phase, the charity will engage in due diligence to learn more about the specifics of the real estate. At this stage, the client should obtain a "qualified appraisal" for the property to determine its fair market value. Be sure to select a real estate appraiser who has experience in appraising the kind of property that will be the subject of the gift, whether it is industrial, commercial, residential, agricultural or rural real estate. The appraiser will value property using different methods, but the three most common methods are the "comparable sales" method – which looks at the value of comparable nearby properties; the "cost replacement method" – which determines what the buyer would pay to build an equivalent; and the "income valuation method" – which determines fair market value based on the income the property can produce.

The client often pays for the appraisal. If the charity pays for the appraisal instead of the client, then pursuant to IRS rules, the charity may be required to either reduce the value of the deductible gift or 1099 the client for the cost of the appraisal. Assuming that the parties have agreed upon how to structure the gift, once the appraisal is completed, the gift officer should be in a position to provide the client with a final illustration explaining the full tax benefits of completing the gift. This illustration will use the appraised value (or in some cases, a discounted value) as the fair market value of the property.

Inspect the Property

As part of its due diligence, a charity's gift acceptance policy may require that a licensed inspector inspect the property to ensure that everything is in good and working order. The inspector will look at the property's foundation, roof, heating, ventilation and air conditioning ("HVAC") system, electrical system, plumbing, water and sewer system, any fire suppression system as well as any other aspects of the structures and the lot or ground upon which the structure is situated. If the inspector finds any code violations or other repairs, these may reduce the value of the property. In such case, the client and charity may agree to reduce the gift value to take the cost of repairs into account, in which case the charity would likely make the repairs or, alternatively, the client may simply decide to make the repairs.

In addition to a physical inspection of any structures and the real property, the charity may choose to obtain an Environmental Site Assessment (ESA). The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) was enacted by Congress in 1980 in order to locate, investigate and clean up the worst environmental hazard sites, so-called “Superfund” sites, across the country. CERCLA allows the Environmental Protection Agency (EPA) to sue both current and past owners of contaminated property. This means that if a client or charity owns property that is later found to be contaminated with hazardous waste, the charity and the client can be sued by the EPA under CERCLA for the cost of the environmental remediation. CERCLA is a strict liability statute, as the EPA does not need to prove fault or negligence related to the cause of contamination, and creates joint and several liability, meaning that any single party can be held liable for the contamination caused by third parties.

Should a charity accept a gift of property that is later the subject of a Superfund lawsuit, that lawsuit would place the charity at risk. As a result, many charities require that an environmental engineer assess the property for potential environmental hazards prior to accepting certain gifts of real estate. In general, there are three levels of ESAs that can be completed. These levels are referred to as Phase I, Phase II or Phase III site assessments.

In many cases, ESAs occur progressively – or in a series of steps. An engineer may begin by conducting a Phase I ESA. If there is nothing noteworthy, the Phase I report will summarize the engineer’s findings. However, if the report includes potential issues, the engineer may recommend that the charity conduct a Phase II. The same thing can occur following the Phase II assessment. The engineer may recommend undertaking a Phase III assessment.

In certain circumstances, depending on the type of property being donated, the engineer may recommend skipping one of the phases to move directly to the next phase. For example, a Phase I report is reasonable for property that has long been used as a personal residence, whereas the engineer would likely recommend moving directly to a Phase II for commercial property formerly used as a gas station.

Increasingly, charities are engaging in strategies to insulate the charity for economic liability resulting from the acceptance of certain gifts. One such strategy is to take title to gifts of real estate using a single-member limited liability company (LLC) where the charity is the sole member of the LLC. The Internal Revenue Service (IRS) in August of 2001 issued Private Letter Ruling 200150027 in which the IRS stated it would allow a charity to establish a wholly-owned LLC for purposes of accepting certain gifts. Later, in Notice 2012-52 the Service confirmed that a transfer of property directly to such an LLC would be deductible as if it were a gift to that parent-charity. This approval has given charities a method to manage risk and liability without affecting a client’s deduction related to a charitable gift. The charity will be allowed to acknowledge the client's gift for purposes of an income or estate tax deduction as if it were made directly to the charity.

Complete a Title Search

Most charities' gift acceptance policies will require the charity to conduct a title search before closing or accepting a gift of real estate. In addition, these policies may require that the charity obtain an Owner's Policy of Title Insurance.

A title search is the process of reviewing the ownership history of the property. This is accomplished by retrieving and examining the deeds used to transfer the property to determine whether any other parties have rights to the property such as mortgage liens or fractional ownership interests, easements and rights-of-way for roads, utilities or other purposes, as well as any use restrictions that may impact the value or expected use of the property. The title search, if completed by a title insurance company, is sometimes called a title commitment.

Knowledge about any outstanding mortgage debt is important to both the client and the charity. In some cases, if a charity agrees to assume any debt obligations of the client, the client may be required to pay tax on the relief of indebtedness. In addition, this acceptance may subject the charity to unrelated business income tax (UBIT) related to the amount of the assumed debt. There is an exception to this rule for property financed with non-recourse debt that has been on the property for more than five years and held by the client for more than five years. If the property passes this "five and five" test, then the charity may accept the property and will not be subject to UBIT if it sells the property within ten years.

The charity can conduct its own title search or can hire an examiner at a title insurance company to complete the title search. If the charity chooses to hire a title insurance company, then the company will thoroughly examine the records related to the property to make sure the client is transferring the property free and clear without any liens or encumbrances while noting any exceptions to the insurance policy.

As part of the title process, the title insurance company may require a surveyor to visit the property to conduct a "metes and bound" survey of the property using the real property description that will be used in the deed of transfer. The survey will typically certify the property boundaries, depict the location of any improvements such as buildings and roadways located on the property, as well as note the location of any restrictions or encumbrances on the property such as the location of any utility easements. The best way to choose a title insurance company is to ask an experienced and trustworthy real estate professional for a referral.

Transfer Ownership

Typically the client, the client's advisor and a representative from the charity will be present when the property transfer occurs. In order to transfer legal title to the real estate, the client(s), who are the "grantor(s)" must sign a deed transferring title to the property to the "grantee." If this is an outright gift, a gift of a life estate reserved, a bargain sale, or a transfer to fund a charitable gift annuity, then the charity or the charity's wholly owned LLC would be the grantee. If the transfer will convey the real estate to a charitable remainder trust, then the deed would name the trust as the grantee.

The deed is a legal document that will include a legal description of the property, which description must be consistent with the title insurance commitment as well as the real property description contained on the surveys. To complete the transfer, the deed must be "delivered" from the grantor to the grantee and should be recorded in the county clerk's office (sometimes called the registrar of deeds) as soon as possible to protect the rights of the grantee. As a practical matter, the title insurance company will accept the deed and have it recorded on behalf of the grantee.

There are several kinds of deeds. A warranty deed transfers ownership and makes explicit promises that the client has transferred good title and will compensate the charity if it turns out there are any problems with the transfer. Grant deeds transfer ownership and make certain implicit promises to the charity that the property has not been transferred to anyone else or been otherwise encumbered. Finally, a quitclaim deed transfers whatever ownership interest the client has in the property without making any guarantees as to the extent of that interest.

It is important to note that if a client engages in a prearranged sale he or she will forfeit any bypass of capital gains. A prearranged sale exists under state contract law when there is a binding agreement to sell the property. See Rev. Rul. 78-197, 1978-1 C.B. 83. In Private Letter Ruling 9029021, the IRS noted that the ability to bypass capital gain was negated by "an express or implied obligation to sell the contributed property." In effect, a prearranged sale exists where there is an identified purchaser, an identified price and a legally enforceable agreement to sell the property.

While there can be no binding obligation to sell, two excellent strategies include having a buyer waiting in the wings or entering into a contingent escrow agreement. For example, perhaps Larry wants to make a real estate gift to his local food bank. Larry has already listed the property for sale and has already received offers from a number of interested buyers. There is one buyer in particular that has made a very generous offer. Larry approaches his next door neighbor, James, who just happens to be the gift planner at his local food bank. James explains that Larry might transfer the property to the food bank on day one. On day two, the food bank would list the property for sale in an appropriate public newspaper or other venue. On day three, there is no activity. On day four or later, the food bank would contact the prospective buyer and both parties sign a sale agreement. This establishes a clear record that there was no binding agreement between Larry and the prospective buyer.

A more aggressive strategy might be to enter into a contingent escrow agreement. The food bank and the prospective buyer complete the customary escrow process as though the food bank actually owns the property. However, all parties are under notice that any actions taken are contingent upon the food bank receiving the property. Larry then gives the property to charity outright or in trust. In two to five days, the property is sold and the proceeds are available to the food bank. This strategy has not been tested in Tax Court. However, Larry has no contact with the buyer. Therefore, he may reasonably maintain that there is no binding obligation between himself and the prospective buyer.

Provide Tax Information

After the property is transferred to the charity, the charity must provide the proper tax information to the client. This includes a contemporaneous written acknowledgment of the contribution. This acknowledgment must include a description of the property contributed and it must acknowledge whether the organization gave the client any goods or services in exchange for the contribution. If goods or services were exchanged (such as in a bargain sale), then the acknowledgment must give a good faith estimate of the value of those goods or services. In addition, Form 8283 must accompany the client’s tax return and be signed by the charity and the qualified appraiser.

Subsequent Sale of the Property

In the event the charity intends to sell the property, unless the charity has a buyer waiting in the wings, the charity can enlist the help of a real estate agent to help with this process. The costs of sale typically include items such as paying real estate agent commissions to not only the seller’s agent but also the buyer’s agent, property transfer taxes, recording fees, paying the cost for buyer’s title insurance policy, and other closing costs. These costs may be borne by the charity. However, the original client may agree to make additional cash contributions to cover these costs. In that case, the client would receive a charitable income tax deduction equal to the cash contribution.

Common Real Estate Gifts

A number of gift options exist when donating real estate to charity. Here are a few of the more common gift arrangements.

Outright Gift

The client may desire to avoid capital gains taxes while generating the largest possible income tax deduction. In this case, an outright gift of real estate would accomplish both financial goals. In general, the deduction will be for the fair market value of the property as determined by the appraisal. If the gift is made to a public charity, then the deduction may be taken by the client up to 30% of the client's adjusted gross income for the year, with any unused deduction carried forward for up to an additional five years. The deduction must be reduced to basis if the property has been held for less than one year. Other factors such as debt and depreciation may also affect the deduction and present unrelated business income tax issues for the charity accepting the property.

Bargain Sale (including a charitable gift annuity)

A bargain sale is a transaction where the client sells the property to charity for an amount below the property's fair market value. Consider the following example:

A charitable gift annuity (CGA) is considered a bargain sale. With a CGA, the property is transferred to charity and the client receives an income stream for life (or lives) or a term of years. That income stream has a present value less than the fair market value of the property. So, it is a bargain sale. A gift annuity may be funded with real estate. For a client who is both the donor and the first annuitant, part of the capital gain associated with the property will be bypassed and part will be recognized over the donor-annuitant's life expectancy. This arrangement is most advantageous when there is no debt on the property. Debt causes the funding value to be reduced by the amount of the debt and recognition of any capital gain allocated to the mortgage.

A bargain sale, whether in the form of a sale below market value or a gift annuity, can be a great opportunity for the client to receive a large tax deduction, bypass part of the capital gain and receive either a lump sum or payments over a number of years.

Joint Sale

In a joint sale the client transfers an undivided portion of the property to the charity and then the client and charity sell the property together. A joint sale is a great option where the client wants a lump sum in the year of the gift and the charity does not want to put up the money required to purchase part of the property in a bargain sale. After the sale, the client and the charity receive the sale proceeds based on the percentages of the property they own. The client receives a tax deduction for the portion of the appraised value owned by the charity.

Charitable Remainder Trust

A Charitable Remainder Trust (CRT) is a great option if the client wants to avoid capital gains and receive income as well as a charitable deduction. In the case of an outright gift, a bargain sale (including a gift annuity) and a joint sale the charity will be named the owner of the property. However, it is also possible to transfer real estate to a CRT. In this case, the trustee, in his capacity as trustee and acting on behalf of the CRT, will be made the owner of the property. In a case where the charity is named as the trustee of the CRT, the donation process would be very similar to what has already been discussed. Often the property will be sold by the trustee and the funds will be reinvested in a diversified portfolio on behalf of the trust. The trust will then pay out to the income beneficiaries for one or two lives, a term of years or a combination of each. Once the income beneficiaries pass away or the term ends, the CRT distributes the remainder of its funds to the charitable remainder beneficiaries.

Two very common CRTs funded with real property are the FLIP Unitrust and the Net Income Plus Makeup Unitrust (NIMCRUT). The NIMCRUT provides flexibility when accepting gifts of real estate. The trust pays out to the income beneficiaries the lesser of net income or the unitrust percentage for the duration of the trust. If the trust pays out net income in the early years then a cumulative deficit can build up. This deficit can be made up in later years after the property is sold.

The FLIP Untirust begins as a NIMCRUT and then on the occurrence of a “trigger event” will “flip” from a NIMCRUT to a standard payout percentage unitrust. This “trigger event” can be a specific date or the occurrence of a particular event stated in the trust document, such as the sale of all of the real estate held in the FLIP trust. The structure of the FLIP Unitrust allows the trust to hold the property and avoid paying out the unitrust percentage during times where the trust does not have liquid assets. Many times the FLIP arrangement gives the trustee time to market and sell the property without having to liquidate illiquid assets in order to make trust payouts.

In addition to transferring the entire property to a unitrust, the client might combine a unitrust with a joint sale. The client transfers an undivided portion of the property to the unitrust and engages in a joint sale with the trustee of the unitrust. The client receives a percentage of the proceeds based on his or her ownership of the property. The rest of the proceeds fund the unitrust. This provides the client with a lump sum and a tax deduction in the year of the gift as well as payments for life. The client must recognize any capital gain allocated to the lump sum payment he or she receives. However, the deduction may be enough to offset the tax the client will incur. Finally, unlike in the Life Estate Reserved section discussed next, a client and the client’s lineal descendants are not allowed to live in, occupy, rent or utilize unitrust property after the property is transferred to the trust.

Life Estate Reserved

A client may want to make a gift of a personal residence, but may not want to move out of the property. A client may transfer a personal residence to charity and reserve the right to live in the home for life. This is called a life estate. This arrangement is specified in the deed transferred to the charity. Usually, the client will also enter into an agreement with the charity specifying who has responsibility to pay for maintenance, insurance and taxes while the client lives in the home.

Jerry is age 75 and his personal residence was appraised at $500,000. He originally purchased the property ten years ago and has a cost basis in the property of $350,000. Jerry would like to continue living in his home, but would also like to make a gift to his favorite charity.

Jerry transfers ownership of the home to his favorite charity, but reserves the right to live in the home for his lifetime. In addition, he enters into an agreement whereby Jerry agrees to maintain the property and to pay the property taxes and homeowner’s insurance while he lives in the home. Jerry receives a tax deduction of $353,486 in the year he transfers the remainder interest to charity. He may take this deduction up to 30% of his adjusted gross income for the year and may carry forward any unused deduction for an additional five years.

Suppose five years later Jerry would like to move out of his home and into a retirement community. He would like a lump sum to help him pay for a small home in the community. At that time, Jerry and the charity can engage in a joint sale of Jerry’s residence. Jerry receives the present value of his life estate at that time and the charity receives the remainder of the proceeds. Jerry would have a substantial capital gains tax, but he could use his $250,000 exclusion for gain on the sale of a principal residence to cover this amount.

A life estate may also be combined with a gift annuity if the client would like income while living on the property. This is a great possibility for elderly clients with valuable real estate. The client reserves the right to live on the property for life and transfers the remainder to charity in exchange for a gift annuity. The charity must make sure they have the capability to make the payments out of existing reserves and still comply with state law requirements.

Conclusion

Professional advisors can provide a great service to their clients by learning more about how gifts of real estate can be an important part of any financial or tax plan. Understanding the process and the professionals involved is an important step toward a smooth real estate donation process.