

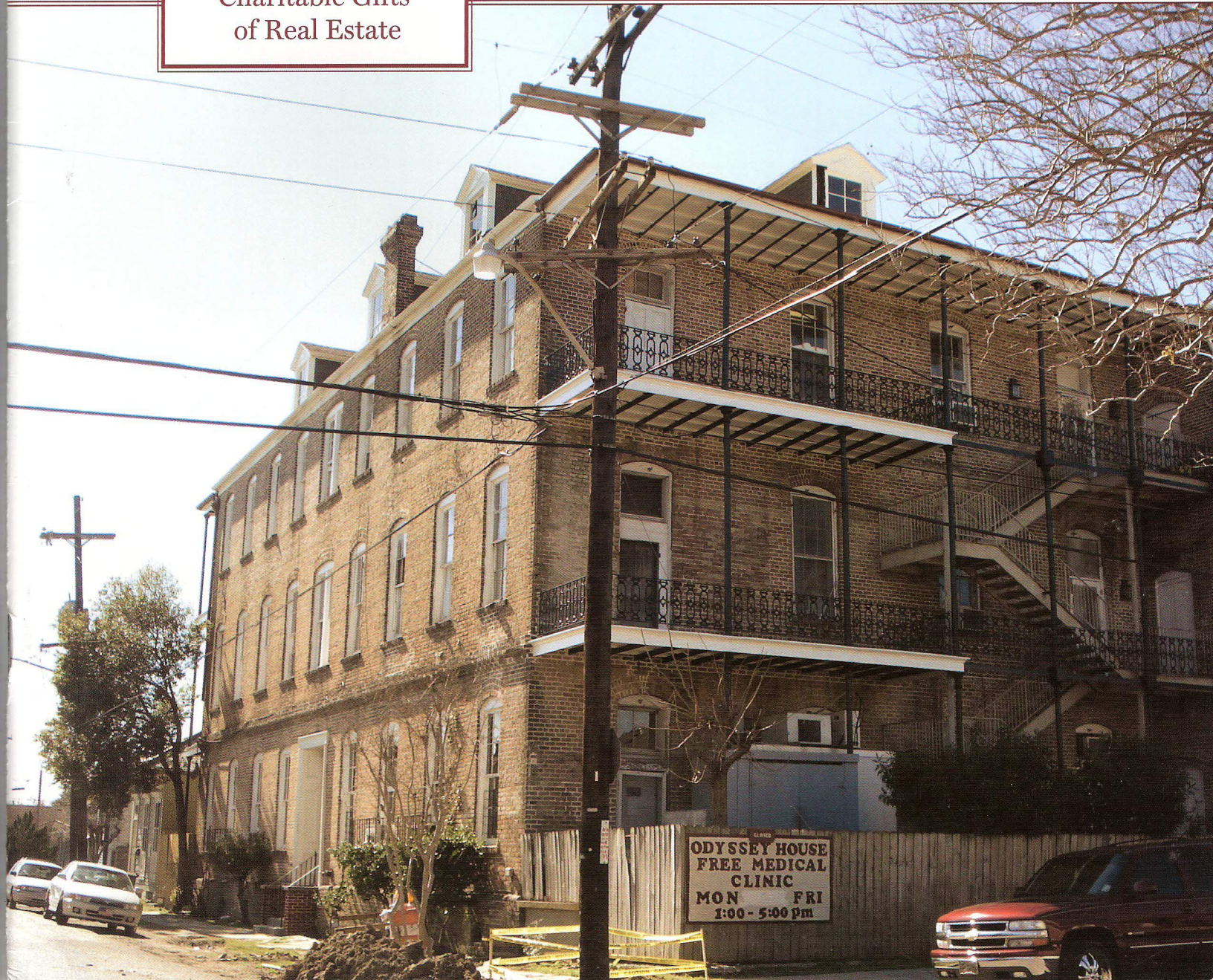
The Professional Journal for the Gift Planning Community
Published by the National Committee on Planned Giving®

The Journal of Gift Planning®

Volume 12, Number 3 3rd Quarter, 2008

SPECIAL ISSUE:

Charitable Gifts
of Real Estate





Converting Real Estate Wealth to Gifts

Opportunities and Challenges

By Dennis Bidwell and Bryan K. Clontz

The nonprofit world is paying increasing attention to the fact that most donors have more of their wealth in real estate than in any other asset type. The reality that about 30 percent of the nation's private wealth is in real estate is sinking in for more and more gift planners (especially when compared to 16 percent for equities and mutual funds, 20 percent in pension funds and life insurance reserves, and just 11 percent in cash and equivalents).¹

This article looks more closely at the magnitude of the real estate gift opportunity, reviews the types of real estate assets and the various structures through which they are owned, examines key issues and challenges faced by organizations that seek and accept real estate gifts, and reviews various mechanisms for receiving real estate gifts.

Real Estate Wealth: A Largely Untapped Opportunity

Here's why gift planners and professional advisors are increasingly aware of real estate and its charitable potential:

- The total amount of U.S. privately-held real estate is approximately \$38 trillion (with approximately \$13 trillion of debt or \$25 trillion net equity). Interestingly, nonprofit

organizations own \$2 trillion of real estate.² Worldwide, real estate represented 54 percent of total developed country wealth in 2002.³

- By comparison, the total value of all U.S. publicly-traded stocks (NYSE, NASDAQ, etc.) is approximately \$13 trillion.⁴
- A *Wall Street Journal* article estimated that real estate only represented two percent of total charitable donations.⁵
- In 2004, total real estate gifts were \$3.1 billion from more than 25,000 donors, with 36,000 distinct contributions and an average gift over \$85,000 (the average was \$172,000 for gifts exceeding \$5,000). This represented slightly more than one percent of total 2004 giving. In 2003, approximately the same number of donors made contributions of real estate, but the total was nearly double, amounting to \$6 billion in contributions (these amounts exclude conservation easements). Interestingly, closely-held stock gifts were more than \$15 billion in 2004, or five times all real estate donations in that year.⁶

The total value of all privately-held real estate is approximately double that of the entire publicly-traded stock market, yet represents less than three percent of all charitable gifts.

For many in the gift planning community, these numbers have caused growing curiosity about the disparity between the amount of the nation's wealth in real estate compared with the percentage of total charitable giving coming from real estate assets, which is estimated at something less than three percent. Why, if almost 30 percent of the nation's private assets are in real estate, has so little of this real estate come to nonprofits as gifts? Isn't there enormous potential to attract capital to the charitable sector by even modestly increasing the percentage of real estate wealth that flows to nonprofit organizations?

Certainly much of the disparity between the amount of real estate wealth in the country and its share of total giving has to do with the backgrounds and comfort zones of development personnel, who have generally become familiar over the years with cash gifts, with gifts of easily marketable securities, and increasingly (thanks to the Pension Protection Act of 2006) with gifts of retirement fund assets. Real estate has traditionally loomed as a very different, more complicated and less liquid asset, requiring expertise not typically developed in a gift officer's career experience.

The challenges of real estate gifts have been reinforced by the prevalence of real estate gift "horror stories" that are part of the lore of almost every development operation. There's the story of the gift property that proved difficult to sell because of limited street frontage, the gift property that turned out to have contaminated soil or an underground oil tank, the gift property that required substantial improvements before sale was possible, and on and on. There can be no doubt that these stories, shared among colleagues at other institutions, help to perpetuate the belief that real estate gifts tend to be "more trouble than they are worth."

On the other hand, many institutions have stories (usually less well-circulated) of successful real estate gifts that proved extremely lucrative while being very satisfying to the donor. There are also the stories of the rejected real estate gift that, with today's knowledge of approaches to risk mitigation, would surely have been

accepted. Included in this category are gifts of very valuable and marketable real estate that were turned down because of the donor's refusal to incur the costs of an environmental assessment or the costs of a minor building repair.

It is worth noting that many nonprofit organizations have enjoyed great success in attracting real estate gifts as part of their development operations. Of 590 respondents to NCPG's recent Survey on Real Estate Gifts ("NCPG Survey"), 74 (12.8 percent) reported that in the last three years **more than 10 percent of the total gifts to their organization, measured in dollars, have come in the form of real estate gifts. Indeed, 38 respondents (6.6 percent) reported receiving more than 15 percent of their total contributions in the form of real estate gifts.** [See "Charitable Gifts of Real Estate: Findings from a National Survey" in this issue for more data from the NCPG Survey, with an emphasis on the characteristics and practices of those nonprofits reporting the greatest success in attracting substantial real estate gifts.]

Almost 13 percent of survey respondents report receiving more than 10 percent of their total contributions, measured in dollars, as real estate gifts.

Real Estate Asset Types, Ownership Structures and Taxation

Real estate comes in many types, and each type can be owned in a number of ways, as summarized by the accompanying chart, "For Reference: Types of Real Estate and Common Issues."

If the most efficient charitable gift nearly always comes from the lowest adjusted cost basis, highest capital appreciation property held for the long-term, then real estate is clearly tailor-made for charitable giving.

If real estate is sold, the general taxation rules are:

1. The owner can receive long-term capital gains tax treatment on real estate held more than one year. Under current tax rates, this would generally equate to 15 percent federal tax plus any applicable state income tax. To the extent the donor has a negative adjusted cost basis in the property, any recapture is generally taxed at capital gains tax rates as well. Do note that with the current political environment combined with the phased-in tax regime, it is particularly important to seek specific tax counsel for the gift being considered.
2. If the owner has any unrecaptured depreciation Section 1250 gain in the property, the income tax rate is 25 percent.⁷
3. If the owner used an accelerated depreciation schedule, then any recapture up to straight-line depreciation is generally taxed at ordinary income rates.⁸
4. If the owner had furnished the property, any gain on tangible personal property would be taxed at 28 percent federal tax plus any applicable state income tax.

If real estate is donated, the general charitable income tax deduction rules are:

1. Charitable gifts of long-term, unencumbered real estate to a qualified public charity allow the donor to receive the greater of fair market value or an adjusted cost basis deduction. The deduction is limited to the 30 percent of adjusted gross income limitations with a five-year carry-forward.
2. The same piece of real estate donated to a private foundation would receive a deduction based on the lesser of the fair market value or the adjusted cost basis. The deduction is limited to 20 percent of adjusted gross income limitations with a five-year carry-forward. Note that real estate may be conducive for testamentary funding of a private foundation to the extent the property receives a stepped-up basis.
3. Any charitable income tax deduction is reduced for any ordinary income element of the gift.
4. If the real estate has any debt—recourse or non-recourse—the donation will trigger bargain sale rules.

This results in part gift and part sale. To determine the indebtedness considered realized by the donor, the formula is: $\text{Cost Basis} \times \text{Selling Price} / (\text{Acquisition Indebtedness in this case} / \text{Fair Market Value}) = \text{Basis Allocation}$. Then $\text{Selling Price} - \text{Basis Allocation} = \text{Taxable Gain}$. The charitable income tax deduction is the $\text{Fair Market Value} - \text{Selling Price}$. For a complete explanation see IRC Section 1011(b). (Note, for persons over 65 years of age – and most real estate donors fall into this category – 83% of their real estate is debt free.)

From the charity's perspective, an important tax issue is the possible existence of unrelated business taxable income (UBTI), which gives rise to unrelated business income tax (UBIT). This can be triggered if the real estate represents an unrelated business (e.g., a golf course), or if the property has debt-financed income.

The two exceptions are debt-financed income where the debt was placed on the property more than five years prior to the donation, and the donor owned the property for at least five years. This is known as the "old and cold" exception. In this case, the charity has 10 years to dispose of the property before any UBTI will be triggered.

The second exception is where the charity is bequeathed encumbered property. It is allowed 10 years to dispose of the property before UBTI applies.

As it relates to charitable remainder trusts, keep in mind that any UBTI realized by the trust post-January 1, 2007, results in a 100 percent excise tax. While certainly harsh, it no longer automatically disqualifies the trust, so relatively small amounts of UBTI now represent new planning opportunities for the right fact sets.

Remember that there are a number of planning strategies to reduce or eliminate real estate debt for both outright and deferred gifts. The simplest solution is for the donor to pay off the debt. The donor can also try to arrange for a release of the security interest and then the debt can be placed on a different property. Or, the donor can obtain a bridge loan to pay off the debt, or a margin loan on a securities portfolio, prior to making the transfer. And finally, the charity can buy the debt encumbered proportional interest from the donor and then subsequently sell its interest to recoup the investment.⁹

Real Estate Risk Continuum

Charitable organizations' receptivity to real estate gifts is clearly increasing. In the NCPG Survey, 22 percent of respondents said they were more receptive to such gifts in recent years, compared to only four percent who said they were less receptive.

When NCPG Survey respondents were asked the source of their institution's reluctance (if any) to accepting real estate gifts, the top three responses were:

Concern about not being able to sell the property in a timely manner	28%
Concern about getting stuck with operating costs pending sale of the property	18%
Concern about environmental liquidity risk	16%

Respondents also reported that reluctance in the finance office was an impediment to more real estate gifts (although it's likely that finance office reluctance is related to liquidity and environmental concerns), as well as unfortunate experiences with earlier real estate gifts.

What follows is a risk continuum approach for various kinds of real estate contributions. This continuum includes only some of the many possible real estate gift scenarios that a charity might encounter. It is intended to be illustrative, not exhaustive. Clearly, each charity will have its own risk tolerance level with various real estate scenarios, but this can be an excellent starting point for gift acceptance discussions, policy drafts and risk management strategies. The following real estate gift scenarios are *subjectively* ranked from one, being the least risky, to five, the most risky.

Level One

1. Outright gift of local residential property or LLC/limited partnership interests with no debt and a non-binding "buyer-in-the-wings."

Level Two

2. FLIP-CRUT gift of local residential property or LLC/limited partnership interests with no debt and a non-binding "buyer-in-the-wings."
3. Outright gift of local commercial or agricultural property or LLC/limited partnership interests with no debt and a non-binding "buyer-in-the-wings."

Level Three

4. Outright gift of partial interest in undivided real estate.
5. Outright gift of non-local residential or commercial property (LLC/limited partnership/fee simple) with no debt and no "buyer-in-the-wings."
6. Any real estate transaction where donor wishes to make multiple donations to multiple charities.
7. Charitable gift annuity funded with real estate. (The risk is greatly reduced if the "charitable put option" strategy is used.)

8. Real estate charitable installment bargain sale.
9. Any residential or commercial property that has been listed for sale for more than one year, or has been listed several times for sale in the recent past, or the price has been lowered several times.

Level Four

10. Operating partnership units from UPREIT exchange.
11. General partnership interests with real estate.
12. Any non-U.S. real estate.
13. Charitable gift annuity issued for retained life estate.
14. Commercial property with multiple tenants or apartment complexes.
15. Asset donation from a business entity with multiple owners.

Level Five

16. Any real estate donation that triggers unrelated business taxable income (UBTI)—operating business or acquisition indebtedness.
17. Any real estate donation with environmental issues that cannot be easily remedied..
18. Any real estate donation with unusually complex legal issues.
19. Any real estate donation involving three or more layers of entities.

Key Concept: A charity can determine its own risk tolerance for various types of real estate and then can develop acceptance policies, legal structures and referral relationships for anything the charity is uncomfortable accepting.



Real Estate: Challenges and Solutions

If real estate is so well-suited for charitable giving, why do many charities report receiving few, and in some cases, no real estate gifts? In some cases, charities choose to not seek or accept real estate gifts because of the belief—mistaken in our view—that the challenges in dealing with real estate gifts are too overwhelming. We describe below a number of perceived challenges in accepting real estate gifts, and what are emerging as best practices for addressing and overcoming them.

1. Real estate gifts are too time-consuming. Many charities commit a great deal of staff time and resources to exploring proposed real estate gifts, only to conclude after many months have transpired that they do not wish to accept the gift. This can be very off-putting to the donor prospect, and can reinforce the belief that real estate gifts just take too much time.

We believe it makes sense for a charity to divide the real estate screening process into two stages, aiming for a balance between donor-friendliness and the very

real need to gather extensive information. The first stage—designed to be minimally time-consuming for charity and donor, at least initially—aims at gathering enough essential information about the property and the prospect in order to render a relatively quick (one to two weeks) decision on whether to reject the gift out of hand or to move it to the next stage of intensive due diligence procedures. This information can typically be gathered in one or two phone calls or personal visits, with the gift officer guided by a Real Estate Gift Data Sheet that collects essential information about the proposed gift. This basic information, combined with informal inquiries of local real estate brokers as to general market conditions for a property of the sort proposed as a gift, is generally sufficient for an organization to render an initial Go/No Go decision, i.e., determining whether the proposed gift passes an initial screen and is worthy of further examination, or whether the donor should be told, before more of any one's time is wasted, that this gift does not hold promise. Such an approach, we believe, can help a charity to devote its scarce staff and consultant resources to only the promising gifts.

REAL ESTATE GIFT DATA SHEET

Legal Owner(s) of Property: _____

Mailing Address: _____

Daytime Phone Number (____) Email _____

Person providing information (if other than owner) _____

Daytime Phone Number (____) Email _____

Relationship to Property Owner: _____

Address/Location of Property proposed for gift: _____

Brief description of property: _____

Land area (acres or square feet): _____ Building area (square feet): _____

Current uses of property: _____

Abutting property uses: _____

Any obvious environmental hazards associated with property or abutting properties: _____

Estimated current fair market value of property: \$ _____

Date of acquisition/inheritance: _____

Estimated current cost basis (include improvements): \$ _____

Amount of mortgage or other debt currently on property (if any): \$ _____

Has property recently been listed for sale? _____

If yes, with whom, and for what list price? _____

Objectives of donor in wanting to make a gift: _____

Gift arrangement contemplated: (outright gift, partial interest, retained life estate, life income arrangement, etc.):

Is a gift designation for a particular purpose contemplated?

Note: If possible, please attach a photo of the property and one or more maps showing location and relation to abutting properties.

Gift Officer: _____ Date: _____

continued on page 28

FOR REFERENCE: TYPES OF REAL ESTATE AND COMMON ISSUES

Kathryn W. Miree

Type	Comments
Residential real estate	Single family homes—perhaps the most common type of real estate asset owned by individuals—may be used as an outright gift, a retained life estate gift, a bargain sale, or to fund a charitable remainder unitrust or gift annuity. Watch for condition of the home, marketability, outstanding debt, taxes, insurance, and general maintenance.
Condominium, town home	Condominiums give owners an absolute interest in the interior of the unit, but a shared interest in the common areas. There are fees assessed to owners to cover the cost of maintenance of the shared areas. In addition, owners must pay taxes, insurance, and general maintenance costs of the owned property and are subject to special assessments levied by the owner's association. Town homes are generally a fee simple interest, but units may share common walls and may assess fees shared by all owners for any common costs.
Rental home	Rental homes may be a single family or duplex residential home. Always check the lease terms (length and obligations) transferred with the rental that will bind the charity.
Apartments	First check the ownership of the apartments to determine if the property is owned in the individual's name or in the name of a corporate entity. Request multi-year statements of income for apartments to determine cash flow, percentage occupancy, expenses, and similar factors. Check lease terms; check marketability; and be prepared for the possibility of unrelated business taxable income.
Vacation home	Vacation homes—especially those that have been in the family for years – make great gifts. They generate expenses for donors, may no longer be used, and can be given outright or turned into an income stream through a charitable remainder unitrust or a charitable gift annuity.
Commercial real estate	Commercial real estate is generally problematic for several reasons. First, the property may be severely depreciated, affecting the amount that can be deducted by the donor. Second, there may be a marketability issue. Third, the property may be subject to leases or other long-term arrangements. And fourth, if occupied, may generate unrelated business taxable income.
Farmland	Farmland represents a large asset for many families. Check lease agreements on the property, marketability, expenses, structures, and other related issues before acceptance. Be aware of joint interests in farmland that have been passed down for generations.
Timber	Timber is a commodity—timberland is real estate with a primary use of generating timber. Determine where the timber crop is in terms of maturity, the market for timber, the costs to maintain the property, and be prepared for the possibility of unrelated business taxable income.
Oil and gas	How is the property owned? Many oil and gas interests are owned in partnership or limited partnership form. (Beware of accepting a general partnership interest and its attendant liability.) What type of royalties should you expect over the next five to ten years? Ask for the royalty statements before acceptance. Be aware of the potential for unrelated business taxable income. Is the property interest readily marketable?
Undeveloped lot	Undeveloped lots—especially those in a developed city—may be ripe for development or may be the former site of a gas station or dry cleaners. Do your homework to determine the history of the lot, check zoning for development, check marketability, and other due diligence.
Undeveloped property—open land	Undeveloped land that is not farmland, timberland, or other specialty purpose may be hunting property, a potential lake site, or simply holding the world together. Conduct an environmental inspection, check marketability, check zoning (if applicable), and consider costs to hold the property. Consider the possibilities of conservation easements.

FORMS OF REAL ESTATE PROPERTY INTERESTS

Note. This table provides a description of the most basic forms of real estate ownership. Forms of real property interests are governed by state law. Always check the law of your state to determine the applicable standards.

Type of Ownership	Description
Full Ownership	
Fee Simple Absolute	The most complete form of ownership; continues forever until conveyed.
Fee Simple Defeasible	Fee ownership, subject to a condition precedent or condition subsequent.
Fee Simple Determinable	Ownership ends upon the happening of an event, and the property reverts to the owner. For example, a donor makes a gift to the school board so long as the property is used for school purposes; if not used for school purposes, the property will revert to the donor.
Fee Tail	Ownership passes through lineal descendants; while possible to continue forever, ownership ceases when there is a generation without lineal descendants. This form of ownership is recognized only in Delaware, Maine, Massachusetts, and Rhode Island.
Partial/Shared Ownership Interests	
Tenancy in Common	Undivided interests in the whole (equal or unequal shares).
Joint Tenancy with Right of Survivorship	Equal undivided interests during the life of the tenants; when a tenant dies, that interest passes in equal shares to the remaining tenants.
Community Property	Under the laws of community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington; Wisconsin has similar laws), property acquired during marriage is owned equally by both spouses.
Tenancy by the Entirety	In some non-community property states, property purchased during marriage is owned by the husband and wife as tenants by the entirety. The property cannot be sold by the husband or wife individually during the marriage. The parties become tenants in common if the marriage is dissolved.
Condominiums	An exclusive right to own, occupy, sell, or transfer a specific unit, coupled with an undivided interest in the real and personal property in the common areas.
Life Estates	The right to occupy, use, and control the property for a stated life or other measuring term; at death, the life estate owner's rights in the property are extinguished.
Remainder Interests	The ownership of the full fee interest in real property subsequent to a life owner's rights in the property.
Indirect Ownership Interests	
Partnerships	Real estate may be owned by a partnership, which passes through the character and amount of income, losses, and liability to partners. If an owner is a limited partner, liabilities may be limited to a stated amount. Debt-financed property can generate unrelated business taxable income.
Corporations	Corporations may also own real estate; owners hold stock in the corporation (either C or S) rather than direct interests in the real estate.
Limited Liability	A limited liability company—an entity defined by state law—can operate as a partnership (passing through the character of the income, losses, and liabilities) or as a corporation. If it operates as a partnership, watch out for unrelated business taxable income.
Real Estate Investment Trusts	Real estate investment trusts (REITS) are publicly traded companies that own, trade, and manage real estate. Most income and gains pass to shareholders of the company, but it is possible to generate unrelated business taxable income.
Irrevocable Trusts	Irrevocable trusts—trusts with terms that cannot be altered—for individuals or for charitable interests may hold or receive property. Use extreme care when transferring real property or a real property interest to a charitable remainder trust, since any unrelated business taxable income in a year will cause the trust to lose its tax-exempt status for the year.
Life Estates	The right to occupy, use, and control the property for a stated life or other measuring term; at death, the life estate owner's rights in the property are extinguished.
Revocable Trust	Management tools that place title to property in a trustee but leave equitable ownership in the assets and the income from them in the trust owner/beneficiary—can hold real estate.