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.

Real Estate Taxation Summary: From the Perspective of the Donor and the Charity

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: Cost Basis x Selling Price (Acquisition Indebtedness in this case)/Fair Market Value = Basis Allocation. Then Selling Price – Basis Allocation = Taxable Gain. The charitable income tax deduction is the Fair Market Value – 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: ____________

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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.

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2. Real estate gifts can be too complicated. After representatives of the nonprofit organization reach an initial decision to consider the gift of a particular piece of real estate—generally stopping far short at this stage of actually committing to accept the gift—then the more labor intensive (for donor prospect and for charity) work of due diligence begins. It is at this stage that the complexities of the situation must, indeed, be explored. A detailed questionnaire can often be used to gather more extensive information about environmental issues, property operating costs, leases, etc. Even here, it generally makes sense for a gift officer to work with the prospect in completing the questionnaire and gathering the information, as opposed to sending it in the mail and asking for its completion in two weeks. Donor friendliness at this stage can make all the difference in the world.

Most real estate gifts processed by nonprofits are relatively straightforward. However, issues that can emerge in the course of due diligence investigations may include: pre-arranged sale issues; unrelated business income tax possibilities; issues of self-dealing, private inurement or excess benefit. Some of these are issues that require careful attention by the donor's legal counsel. Generally, a charity's internal staff coupled with an attorney and/or a consultant can sufficiently navigate these issues.

It is common for the donee organization to retain an attorney operating in the vicinity of the gift property to review existing deeds, mortgages (if any) and title work and to commission a title search. This same attorney may often be asked to handle the legal closing of the gift acceptance (recording of deeds, purchasing of title insurance, etc.) on the organization's behalf, and to render similar services upon resale of the property.

3. Real estate gifts come with worrisome environmental problems. Often cited as the primary reason most charities are uncomfortable with real estate, this is entirely overblown. A very small percentage of real estate properties, whether offered as gifts or not, pose environmental liability problems. Engaging an environmental

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assessment expert to complete a Phase I environmental assessment is usually a rather quick way to determine any issues.

The Phase I environmental assessment is intended to identify anything at all problematic with regard to environmental hazards that can be found through a thorough review of public fire and safety records, interviews with existing and previous owners and a physical inspection of the property. In order for the charity to be in control of this important investigation, and to assure that a quality review is conducted by a qualified environmental engineer or the equivalent, it is important for the nonprofit to arrange for and pay for this service. This is a critical step in protecting the organization from exposure to environmental liability, and the fees paid for a Phase I assessment (typically in the range of $1,000 to $2,000 for most properties) are dollars well spent by the charity in the interest of completing a gift with minimal risk. (If a Phase I assessment suggests the need for further explorations in a Phase II assessment, donor and charity may elect to share the payment responsibility.) It may be appropriate in some instances for the charity to hold off on commissioning the Phase I while awaiting other elements of the due diligence.

To ask the prospective donor to pay for a Phase I assessment can be quite off-putting, and doesn't make

any more inherent sense than asking the donor prospect to pay for the organization's title insurance. Both services—environmental assessment and title insurance—are intended to protect the donee organization's balance sheet, and are thus appropriate financial obligations of the charity.

In some instances, purchase by the charity of an environmental liability insurance product might be appropriate. However, the expense of such policies has generally limited their use to large commercial transactions, rather than charitable transactions. Such policies generally are in effect for a maximum of 10 years (sometimes with renewal options), with a large premium payable upfront.

4. What about property management and holding period issues? The best way to handle issues associated with owning and managing gifted property is to structure the gift arrangement in such a way as to minimize the period of time that the charity owns the property. Strategies for doing this are addressed later in this issue, in "Minimizing Risk Through Alternative Structures for Charitable Gift of Real Estate" by Emanuel J. Kallina II.

When a charity does interim property management, these responsibilities often fall on the business or finance office of the organization. Gift officers should consider that property management work often means increased responsibilities in the "other duties as assigned" category for the business office. For example, it is critically important to know who is responsible for changing the property insurance, managing the landscaping, paying the water bill, renewing leases, paying the property tax, etc. Many business officers feel ill-equipped to perform these functions because of their lack of real estate knowledge, or a lack of staff time. Consultants and other outside agents can be helpful in these cases. For these reasons, it is critical that the business office be in the loop as early as possible in the gift acceptance process.

5. Real estate gifts entail market and liquidity concerns. Most charities want to sell a gift property as soon as possible for the highest price reasonably attainable. This is why a charity should consider an independent assessment of the marketability and value of the property as a critical component of due diligence. The donee organization should, at the very least, seek its own opinion of value and marketability from a qualified local broker or other real estate professional. This need not be a full-blown and fully-documented (and expensive) real estate appraisal, since this is ultimately the responsibility of the donor. An opinion of value, and an informal report of how the subject property is positioned in relation to current market trends, can often be obtained for $500 to $1,000. This is an important and worthwhile expenditure, as the charity needs to make its own estimate of likely sales price and likely holding period prior to the time of sale. These are critical pieces of information leading to the ultimate decision as to whether to accept the gift property and, if so, subject to what terms and conditions.

REAL ESTATE APPRAISAL ISSUES

For any contribution of more than $5,000, the donor must substantiate the real estate gift with a qualified appraiser completing a qualified appraisal under IRC 170 (f)(11). The appraiser must sign Form 8283 as to the fair market value, and the charity's representative signs the form as having received it on the date specified. The donor must have the appraisal completed as early as 60 days prior to making the gift or as late as the time the donor files his/her tax return for the year of the gift—typically April 15th of the following year, which can include extensions. The charity must complete Form 8282, colloquially known as the "tattle-tale" form, if the property is sold or otherwise disposed of within three years.

The Pension Protection Act of 2006[10] specifically tightened the qualified appraisal process by changing the following:

- Refined the definition of a qualified appraisal to include USPAP (Uniform Standards of Professional Appraisal Practice) as an example of generally accepted appraisal standards.
- Refined the definition of a qualified appraiser as someone who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Treasury secretary, (2) regularly performs appraisals for which the individual receives compensation, and (3) meets other requirements as may be prescribed by the secretary in regulations or other guidance.
- Added a penalty provision for appraisals that result in a substantial or gross valuation misstatement in IRC 6662 and also created IRC 6695A for these types of valuation misstatements.
- Extended the Form 8282 reporting period from two to three years.

On one hand, these changes have clarified who can be a qualified appraiser and what must be included in a qualified appraisal. These changes were important to both encourage and enforce more accurate substantiation appraisal, which will benefit the charitable sector in the long run.

On the other hand, these changes have dramatically increased the appraiser's personal risk and compliance efforts, and therefore donors are finding the process more lengthy and costly than before.

6. Handling real estate gifts is too complicated within our institution.
Some nonprofits have not elected to encourage real estate gifts for lack of internal procedures for processing such gifts, or because such procedures are cumbersome and involve too many parties.
The NCPG Survey provides solid evidence that the most successful real estate gift programs have in place clear and somewhat streamlined policies and procedures regarding the acceptance of real estate gifts. The purpose of such policies and procedures is generally to establish what sorts of real estate assets and what sorts of real estate gift structures will and will not be accepted by the institution, as well as to clarify exactly who does what—gift planning office, treasurer's office, general counsel, outside counsel, real estate office—in moving a potential gift through the process. Many times, a real estate gift acceptance committee will be involved in the approval process. If so, experience shows that this committee should consist of staff who are generally available on relatively short notice. Donor relations can become quite strained if a recommendation to proceed with a gift gets bogged down while waiting three or four weeks for a committee to convene.

The process of developing, or fine-tuning and streamlining, real estate gift acceptance policies and procedures can be very valuable within an institution. Such a process can provide all interested parties with the opportunity to raise concerns and questions, to clarify who is involved at what stages of the process and to educate all involved as to the potential of real estate gifts. For example, having just one point person for the due diligence process helps ease any confusion about who is specifically responsible for investigating the gift. Another important aspect of this process is that it provides front-line gift officers with the confidence that the next time they identify a real estate gift prospect, there are specific procedures in place for investigating and approving the gift. The existence of such policies and procedures will also tend to give the institution confidence in proceeding to market an interest in accepting real estate gifts.

7. It's hard to analyze the cost-benefit of real estate gifts.
One approach to weighing the potential costs of a real estate gift against its potential benefits is to adopt an approach to real estate gift minimums that quantifies—to the extent possible—

both the costs of the project (including the costs of risk management and mitigation) and the true net benefits of the gift. In this approach, the real estate gift minimum is based on an estimated net present value basis, which is to say a projected minimum amount to likely be realized by the institution net of all estimated costs in assessing and closing the gift, and net of projected payments (life income payments or bargain purchase amount), all translated into current dollars. This approach allows for one yardstick against which to measure outright gifts, life income gifts, retained life estates, bargain sales and the like. It allows for the complexity and risk of a gift—as reflected in projected likely staff, legal, consulting and due diligence costs—to be taken into account in estimating the true value to the institution of the prospective gift. (One approach to estimating staff time on a real estate gift is to use the Pi rule: multiply how much internal work you think it will take and how long you think the property will be on the market and multiply by Pi, or 3.14.) Such real estate gift minimums tend to run from $50,000 to $250,000.

8. How do we actually get to a gift closing on a complicated real estate gift? Once due diligence investigations have been completed, the benefits and risks have been assessed, and other necessary information gathered, officials at the nonprofit organization with the authority to do so can make an informed decision on whether to accept the proposed gift, and if so, with what terms and conditions. It is generally helpful to communicate this decision in a gift acceptance letter or memorandum of understanding that details any remaining information or documents to be provided, that describes the alternative gift structure that may have been agreed to by the parties and that outlines the responsibilities of the various parties and their attorneys in moving toward a completion of the gift. Often, the donor is asked to countersign this letter as acknowledgment of her understanding of the terms upon which the gift may proceed, and in order to manage the donor's expectations as to timetable and financial results of the gift. Sometimes, in more formal versions of such a document, environmental indemnification language is included for review and signoff by the donor. This letter, besides being useful to assure agreement among the parties on exactly how the gift will be structured, can be useful as a "roadmap" detailing how the various parties—donor's attorney, real estate broker, various staff and consultants at the nonprofit, nonprofit's local counsel—will coordinate with one another to get to the successful closing of the gift.

9. But no one ever calls us to suggest they give us a piece of real estate. No amount of internal procedures, thorough due diligence process and capacity to manage legal and tax complexity will be of any use if no one is inquiring about real estate gifts. Though some calls proposing real estate gifts will occasionally come from nowhere, the institutions that report a high level of real estate inquiries—and a high level of substantial real estate gifts—are the institutions that effectively communicate their interest in real estate to their constituents and friends. When discussing any major or planned gift, real estate should be listed as a funding option. Any donor materials should also include the willingness to discuss real estate gifts in various forms. Donor research should include information about real estate holdings, so that conversations can be initiated with prospects who own multiple pieces of real estate and otherwise have the ingredients that make up a promising real estate gift prospect.

Few real estate gifts come in "out of the blue," and not as many as we would like are suggested by professional advisors. Most real estate gifts are the result of marketing and research-driven prospect cultivation on the part of the nonprofit.

Capturing More Gifts Directly and Indirectly

When marketing for real estate gifts, too many charities think the only way to receive the gift is to accept it directly. If they choose to decline the gift, they get nothing and have a disappointed donor. What follows is a new approach to non-cash gift acceptance involving four levels of what we will refer to as acceptance triage. The objective is to receive as many gifts as possible, while limiting risk; retaining the maximum net proceeds and keeping the donor as happy as possible.

Four Approaches to Real Estate Gift Acceptance

Option 1 – This is the traditional method of accepting real estate. Donor brings property to charity; charity completes due diligence and accepts property. Charity is on the chain of title and attempts to sell the property for the highest price possible as soon as possible.

Option 2 – From the NCPG Survey on Real Estate Gifts, approximately 10 percent of the respondents had created separate corporations or trusts to receive real estate. Almost always, a supporting organization is the structure that is employed.

Option 3 – These are the various legal strategies to reduce risk. See "Minimizing Risk Through Alternative Structures for Charitable Gift of Real Estate" in this issue for more on these strategies.

Option 4 – There are numerous public charities that can receive real estate, sell it within a donor advised fund and then allow the donor to grant some or all of the net proceeds to the charity of his choice (subject to the charity's grant-making and donor advised fund policies). So rather than declining a gift, or being compelled to create additional legal structures, community foundations and some national donor advised funds can receive the property and take on all the aforementioned challenges directly. Generally, the total charitable fee charged by these advised funds is between one and five percent of the proceeds. And because these organizations do such a large volume of real estate gifts, many of the gifts that may be too complex, too risky or require a decision too quickly can be successfully "outsourced" so that charities can still receive the gift proceeds indirectly.

Key Concept: As real estate opportunities are uncovered, the traditional straight acceptance is just one way to receive the gift. More often than not, three different real estate prospects might require three different approaches to directly or indirectly receiving the gift. Remember, the goal is to maximize net real estate contributions while minimizing risks and internal direct/indirect costs.

Real Estate: Three Case Studies

What follows are three real estate case studies for a representative sampling of charities. Each case describes how the respective charities handle two different prospective gifts.

Small Local Risk-Averse Charity

This eight year-old local ministry has four total staff and a particularly conservative board. Over the last year, the following gifts were offered to them:

Gift #1: A board member mentioned he was preparing to sell his mountain vacation home. The ministry's pastor suggested he consider instead making a donation of the property. The charity hired local counsel and a charitable real estate consultant to help perform due diligence on the property. The house had no debt, was in a prime location just one hour away and had two buyers that had expressed interest. The ministry agreed to accept the property upon the advice of counsel, and then sold the property for a net $312,500 (property appraised for $335,000). After paying the attorney and

consultant fees of approximately two percent of the net proceeds, the ministry had over $305,000 in cash. This represented more than half of its budget for the entire year. The board member was particularly happy because he received a current charitable income tax deduction of $335,000 and, most importantly, he was passionate about the ministry's work and could see a benefit today.

Gift #2: An elderly widow approached the ministry with 50 unimproved acres she wished to use to convert into income for the rest of her life and a gift to the ministry. Ministry staff suggested she fund a flip-CRUT with the property. The charity's gift acceptance policies permitted them serving as trustee, provided due diligence on the property checked out. This worked well for the donor, because at her advanced age her attorney advised that she not self-trustee the trust.The ministry provided her with illustrations as well as a fund agreement for the endowed program she wanted to establish with the remainder interest.

Medium Regional Risk-Tolerant Charity
This regional hospital foundation has significant experience with real estate gifts and aggressively markets real estate options to its donors. In the last year, the following gifts were offered to them:

Gift #1: A long-time major donor was asked to consider a large capital campaign request. He asked if the charity would consider receiving an interest in an LLC that owned a large industrial park with multiple tenants. There was no debt on the LLC or the real estate, but the property had been on the market for two years. The hospital performed due diligence on the LLC and agreed to accept it into their Type II supporting organization. The supporting organization was used to receive all illiquid gifts to the foundation. The donor had an adjusted cost basis of $125,000 and the property recently appraised for $1.6 million. The donor sold another large commercial property earlier in the year and needed a large charitable deduction to help reduce taxable income.

Gift #2: An attorney who serves on the hospital's planned giving advisory board had a client wishing to donate a partial interest in an apartment complex. The partial interest was worth $650,000, but the donor only wanted to contribute $100,000 to the hospital, and then donate the rest to five different charities over time. The hospital contacted the local community foundation and a national donor advised fund, and found out both were willing to accept the property into a donor advised fund and then make multiple grants based on the donor's recommendations. The hospital relayed the information to the donor's attorney so she could make the final recommendation.

Large National Risk-Neutral Charity

A 150 year-old charity was luke-warm toward real estate gifts because of some gifts that didn't go well in the mid-1980s. The field development officers called the real estate acceptance process "painful," and almost hoped donors didn't bring up property gifts. The home office staff, however, had developed a comprehensive set of procedures to protect the charity's substantial assets and stellar reputation. In the last year, the following gifts were offered to them:

Gift #1: A long-time donor wanted to give a vacation residence in exchange for a CGA. The charity proposed either a two year deferral and 20 percent ACGA rate discount, or executing a charitable put option to insure immediate liquidity at a specified price (see "Minimizing Risk Through Alternative Structures for Charitable Gift of Real Estate" by Emanuel J. Kallina II later in this issue for a full description of this strategy). The donor's advisors were comfortable with the put strategy and the donor pre-marketed the property for six months. Prior to any legally-binding agreement, the put option was executed with the intended buyer and the donor contributed the $475,000 vacation home to the charity. The charity then "put" the property to the buyer for $475,000 and funded the gift annuity.

Gift #2: A board member called the vice president of development one Thursday at 4:30 to discuss a pending sale of an LP interest in apartments. She said she didn't think the sale would happen, but verbal negotiations were moving very quickly and she wanted to see if she could donate a 50 percent interest as soon as possible. On Friday, the attorney called and said that "as soon as possible" meant Tuesday before noon. Knowing that the average due diligence time for the charity was usually 2-3 months, she knew this would not be possible. Rather than losing the gift, she contacted a third party charity to see if the timing was possible. That organization's due diligence process started immediately, continued over the weekend and was completed on Monday. The $3,000,000 gift was accepted on Tuesday morning into a donor advised fund. The apartment was sold 60 days later, and after the third party's fee of 1.8 percent, the national charity received a donor advised fund grant of $2,946,000 30 days after settlement.

Conclusion

Given the enormous documented wealth in the private real estate market, and the fact that real estate can be the ideal asset from a charitable income tax perspective, clearly it should represent a much greater share than two to three percent of total contributions. Most importantly, if charities confidently market real estate gifts and "shake the proverbial tree," any kind of "fruit" that falls can be handled directly or indirectly using a multitude of risk management strategies. In the end, the donor will be happy from both a giving and a tax perspective, and the charity will receive more and larger contributions because of a sound real estate marketing/acceptance program designed to fit its unique risk tolerance.

Endnotes
[1] Federal Reserve Balance Sheet of Households and Nonprofit Organizations, March 6, 2008, at www.federalreserve.gov/releases/Z1/20080306/z1r-5.pdf
[2] ibid.
[3] See en.wikipedia.org/wiki/Real_estate in Market Sector Value section.
[4] See www.world-exchanges.org/WFE/home.asp?menu=426&document=4770 and www.world-exchanges.org/publications/EQU1108.pdf.
[5] "Plan for Donating Real Estate Gains Momentum" by Barbara Martinez. *Wall Street Journal*, October 13, 1999. page A2.
[6] "Individual Non-Cash Contributions—2004," Janette Wilson and Michael Strudles, at www.irs.gov/pub/irs-soi/04innoncash.pdf.
[7] See Taxpayer Relief Act of 1997 at usgovinfo.about.com/library/weekly/aa101797.htm
[8] For an excellent discussion on the technical aspects of depreciation and charitable gifts, see "Real Estate Depreciation Issues for Charitable Contributions and Charitable Remainder Trusts," Tom Wesley, CPA, published on the Planned Giving Design Center at www.pgdc.com/pgdc/article/2002/02/real-estate-depreciation-issues-charitable-contributions-and-charitable-remainder-trusts
[9] These strategies come from "Charitable Business Planning—The Sole Proprietorship," Crescendo's Gift Law Pro Article of the Month for September 2005. Viewed on September 22, 2008, at wakemed.giftlegacy.com/giftlaw/article.jsp?WebID=GL2006-0937&D=200509
[10] For a particularly good summary of the entire Pension Protection Act of 2006's charitable provisions, see the Council on Foundation's resource at www.cof.org/Action/content.cfm?ItemNumber=5275

Dennis Bidwell is the principal of Bidwell Advisors, a Massachusetts-based real estate consulting firm providing services nationally to non-profit organizations and to private property owners. The firm specializes in real estate gift planning services for colleges and universities, community foundations and other nonprofits seeking to increase their level of real estate gift activity. Prior to forming Bidwell Advisors in 2001, Bidwell served as national real estate director for American Farmland Trust. Previous positions include: vice president of Leggat McCall Advisors, a Boston-based real estate consulting and appraisal firm; development officer for the National Trust for Historic Preservation; program officer for Associated Grantmakers of Massachusetts. A graduate of Dartmouth College, Dennis earned his MBA from Boston University and his M.Ed from Harvard University. Bidwell writes and speaks frequently on real estate philanthropy and land conservation.

Bryan K. Clontz is president of Charitable Solutions, LLC, in Jacksonville, Florida. He holds a BS in Business Administration from the College of Charleston, a Masters of Science in Risk Management and Insurance from Georgia State University, a Masters of Science in Financial Services from The American College and has completed PhD coursework in consumer economics at the University of Georgia. Clontz has spent 13 years in gift planning, three at his current position. He has served as vice president of advancement at The Community Foundation for Greater Atlanta, as director of planned giving at the national office of the Boys & Girls Clubs of America, as director of planned giving at the United Way of Metropolitan Atlanta, and as a planned giving consulting and charitable planning specialist at RE Baxter & Associates.