Charitable Real Estate Options for Aging Property Owners

CPE Forum

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A Philanthropic and Planning Opportunity

- Approximately 37% of household wealth in United States is in real estate

- Less than 3% of charitable giving involves real estate assets

Sources: Federal Reserve Board "Balance Sheet of Households and Nonprofit Organizations", December, 2005; IRS "Individual Noncash Charitable Contributions, 2003"; Giving USA

Review of Topics

- **Trends in real estate wealth and real estate giving**
- **Profile of the real estate donor and the real estate gift**
- **Charitable tax law basics**
- **Familiar and alternative approaches to real estate disposition**
- **Case Study #1: Outright sale of second home**
- **Case Study #2: Outright donation of second home**
- **Case Study #3: Charitable remainder trust funded with a second home**
- **Case Study #4: Charitable Gift Annuity funded with a second home**
- **Case Study #5: Retained life estate when donating second home**
- **Case Study #6: Bargain sale of second home**
- **Case Study #7: CRT funded with a second home and land encumbered with a conservation restriction**
- **Conclusion**

SECTION ONE

TRENDS IN REAL ESTATE WEALTH AND REAL ESTATE GIVING

Trend: Real Estate is Where the Wealth is

- Real estate assets = 36.7% net worth of U.S. households
  - 51.7% when total assets < $1 million
- From 2001- 2005:
  - Value of real estate holdings grew 53%
  - Other non-cash financial assets grew 19.3%
- In 2005, estimated value of household real estate: > $18 trillion

Source: Federal Reserve Board "Balance Sheet of Households and Nonprofit Organizations," December, 2005

Trend: Second Home Real Estate Wealth

- In 2005, 1 in 10 households owned 2 properties
- 1 in 25 owned 3+ properties
- 39.9% of 8.4 million homes sold were “second” homes
  - -- 27.7% bought for investment purposes
  - -- 12.2% bought as vacation homes

Source: National Association of Realtors, 2005

Trend: Intergenerational Real Estate Wealth Transfer

- Assuming:
  - 37% of that wealth is in real estate assets
  - $41 trillion wealth transfer by 2052
  - > $15 trillion intergenerational real estate transfers by 2052

Sources: Schervish and Havens, Boston College, 1999; Federal Reserve Board, 2005

Trend: Converting "Nonperforming" Equity into Cash Flow

- Range of returns on real estate rented out as income property:

  1 - 5%

- Return if real estate is sold and put into cash or CDs: 1.5 - 4.8%

- Return if real estate is used to fund a charitable remainder trust: 5 - 9%

Profile of the Real Estate Gift and the Real Estate Donor

From 2003 Tax Returns:

- $5.9 billion in real estate donations per year
- Over 65% (in $) from taxpayers 65+
- Average size of donation for taxpayers 65+: $735,000

Also:

For persons over 65 years of age, 83% of that real estate is debt-free

Source: IRS, "Individual Non-Cash Charitable Contributions, 2003"; Statistical Abstract of U.S.

Profile of the Real Estate Gift and the Real Estate Donor

Motivations:

- Availability of tax deductions 64%
- Relief from headaches of owning/managing real estate 62%
- Charitable intent 60%

Source: 2005 Survey of Membership of Planned Giving Group of New England

Profile of the Real Estate Gift and the Real Estate Donor

<u>Composite Profile:</u>

- Age 65+
- Own multiple pieces of real estate, perhaps in multiple states
- Some is appreciated real estate – vacation home, rental property, inherited farm, other real estate
- No heirs, or children moved away and not interested in the real estate
- If there are children, other assets to pass on to them
- Capacity to use charitable income tax deductions
- Charitable motivation

Profile of the Real Estate Gift and the Real Estate Donor

Also:

- Ownership and management more burdensome than enjoyable
- Real estate producing little or no income
- Desire for supplemental retirement income
- Desire to shelter an unusual capital gain (sale of business, sale of other property, etc.)

Profile of the Real Estate Gift and the Real Estate Donor

<u>The Desmonds</u>

- Husband, 76; wife, 74 –residents of Springfield area, western Mass.
- As Mass taxpayers, they have a combined income tax bracket of 38%; capital gains tax bracket of 18%
- Country home on 20 acres in south Berkshire County
  - Adjoins land protected by a Conservation Restriction held by Berkshire Natural Resources Council (BNRC)
  - Frontage and zoning would allow subdivision of two additional home sites
- Two children settled elsewhere; not interested in Berkshire property

Profile of the Real Estate Gift and the Real Estate Donor

The Desmonds (cont.)

- Purchased property 25 years ago; tax basis is $300,000
- Current fair market value: $1,500,000
- Plan to sell family business soon, will trigger substantial gain
- Would like to make a meaningful gift to Coolidge School, several other charities
- Consider themselves charitably “tapped out” but have not considered gift potential of real estate

SECTION TWO

CHARITABLE TAX LAW BASICS

Charitable Tax Law Basics

<u>Charitable Deductions</u>

- The 30% Rule: For most gifts of appreciated assets, including land, the donor may deduct up to 30% of adjusted gross income (AGI) in the year of the gift. The unused portion may be carried forward for up to five additional years.

- The 50% Election: If claiming a deduction based on the property's "cost basis", rather than its appreciated value, the Donor may take a charitable deduction of up to 50% of AGI, with five years of additional carryover. This election may make sense for gifts of minimally appreciated property or if the donor can't use the full deduction within six years.

Charitable Tax Law Basics

Charitable Deductions (cont'd)

- Corporations: C Corporations are limited to 10% of corporate taxable income with five years of carryover.

- If property is worth less than its cost basis, the donor should sell the property in order to claim a capital loss, and then donate the proceeds as a charitable contribution.

Charitable Tax Law Basics

<u>Capital Gains Tax Rates</u>

- For sales of securities and most real estate, top federal rate is 15%.
- Straight-line depreciation recapture on sales of depreciated real estate is taxed at top federal rate of 25%.
- Gains on sale of tangible personal property and qualified small business tick is taxed at 28%.

Charitable Tax Law Basics

Gift and Estate Taxes

- The Gift Tax exemption remains at $1 million, while Estate Taxes decline through 2009, disappear completely in 2010, and returns to pre-2001 levels in 2011. Plan your death accordingly.
  - The top Gift and Estate Tax Rate is scheduled to fall from 48% in 2004 to 45% in 2007, but returns to 55% in 2011. The gift tax rate in 2010 is 35%, but for one year only.
  - The Estate Tax exclusion increases from $1 million in 2003 to $1.5 million in 2004, $2 million in 2006, and $3.5 million in 2009. It goes to $0 in 2010, and back to pre-2001 levels in 2011
  - As a practical matter, it seems likely that the 2001 Gift and Estate Tax changes won't sunset entirely. Congress is likely to amend the law, but how and when they do so is anybody's guess.

Charitable Tax Law Basics

Donation of Qualified Conservation Easement

- Donor eligible for charitable contribution deduction of up to 30% of AGI, with 5-year carry forward (10% of AGI for corporations) [IRC Sec. 170 (h)]

- Reduces value of land for estate and gift tax purposes
  [IRC Sec. 2055(f) and 2522(d)]

- Reduction in assessed value for property tax purposes, *sometimes*

Charitable Tax Law Basics

<u>Donation of Qualified Conservation Easement – Pension Protection Act of 2006</u>

- Donor eligible for charitable contribution deduction of up to *50% of AGI, with 15-year carry forward*

- Qualified farmers or ranchers may deduct up to *100% of AGI*, with 15-year carry forward

- Provision is temporary, applying only to qualified conservation easements donated from *1/1/06 to 12/31/07*

Charitable Tax Law Basics

Post-Mortem Elections for Conservation Easement

- Heirs may make a "post-mortem" election to conserve land and exempt part of its value from estate taxes, and treat it as if the decedent had made the election.
  - If land is not conserved, the value of the easement will be exempt from the estate tax.
  - If the land is conserved, the estate can elect to exclude 40% of the land's value (no buildings), up to $500,000.

Charitable Tax Law Basics

Post-Mortem Elections for Conservation Easement Donations (cont'd)

- Election must be made within 9 months of death. All the heirs must agree.
- Formerly, this election was available only within specified geographic areas (proximity to urban areas, national parks, etc.). Now the election can be used anywhere.

SECTION THREE

FAMILIAR AND ALTERNATIVE APPROACHES TO REAL ESTATE DISPOSITION

Property Disposition – Familiar Approaches

- Sell the property, pay the capital gains taxes, invest the proceeds, and move on.
- Pass it on through the estate, let the kids figure it out.
- Donate it outright, or by bequest, to a charity.

Property Disposition – Alternative Approaches

- Life income arrangements
  - Charitable remainder trust funded by real estate
  - Charitable gift annuity
  - Installment bargain sale

- Maintain use of property
  - Donate remainder interest in property, retaining life estate

- Life income and continued use of property
  - Combine charitable gift annuity with retained life estate

- Bargain sale
  - Part donation, part taxable sale

- Conserve the property
  - Any of above can be combined with conservation easement/restriction

Case Study #1

Outright Sale -- The Benchmark

Gross sales price	$1,500,000			
Less 10% selling costs	<u>($150,000)</u>			
Net proceeds		$1,350,000		
Less cost basis		<u>($300,000)</u>		
Taxable gain			$1,050,000	
Less Capital Gains tax (18%)			<u>($189,000)</u>	
Net proceeds after tax				$1,161,000

Case Study #2

Outright Gift

<u>Financial Outcome-Desmonds</u>

Charitable deduction (subject to limitations)	$1,500,000
Federal/state income tax savings (38%)	$570,000

Total financial benefit for Desmonds is 49% of $1,161,000 outright sale net

<u>Financial Outcome – Coolidge School</u>

Sale of property	$1,500,000	
Less 10% selling costs	<u>($150,000)</u>	
Net proceeds to Coolidge School		$1,350,000

SECTION FOUR

CHARITABLE REMAINDER TRUST

Charitable Remainder Trust

CRT Basics

- Irrevocable trust, generates income payments for one or more “persons,” with remainder eventually going to one or more charities.
- Assets are donated to the tax-exempt trust, triggering income tax deduction.
- No capital gains taxes are paid when the exempt trust liquidates appreciated assets.

Charitable Remainder Trust

<u>CRT Basics (cont.)</u>

- Property transferred to trust is removed from taxable estate.
- Upon death of beneficiaries or termination of trust, remainder interest passes to one or more charities (designated by trust, designated by will, or chosen by trustee).
- Advantage: provides great planning flexibility.
- Disadvantages: It's complicated and expensive to set up.

Charitable Remainder Unitrust

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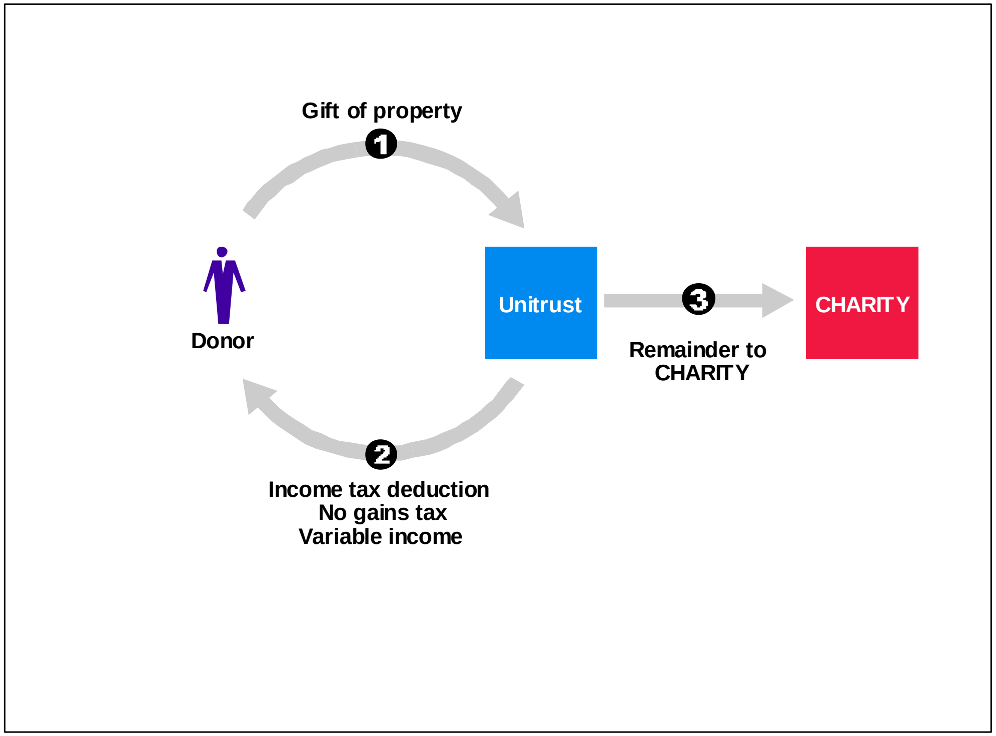
October 12, 2004



How it works

1. You transfer cash, securities, or other property to a trust.

2. You receive an income tax deduction and pay no capital gains tax.

   During its term, the trust pays a percentage of its value each year to you or to anyone you name.

3. When the trust ends, its remaining principal passes to CHARITY.

Charitable Remainder Trust

Types of CRTs

- Charitable Remainder Annuity Trusts
  - Pays fixed annuity based on initial FMV
- Charitable Remainder Unitrusts
  - Type I – Standard – Pays fixed percentage of FMV as predetermined annually
  - Type II – Net income only with makeup provision
  - Type III – Net income only without makeup provision
  - Flip Trusts - Switch from Type II or Type III to Type I upon specified date or event, including sale of real estate.

Charitable Remainder Trust

Trustee Options

- Donee charity
- Donor (if limited trustee powers)
- Banks/trust companies
- Community foundations
- Individuals

Income Beneficiary Options

- One or more individuals, trusts, estates, associations, corporations or partnerships
- Survivor beneficiaries

Charitable Remainder Trust

Term of a CRT

- Up to 20 years
- Life of beneficiaries
- Life or 20 years
- Life plus 20 years

Charitable Remainder Trust

Funding a CRT

- Cash, stock, bonds
- Life insurance
- Real estate (generally not mortgaged)
- Tangible personal property

Charitable Remainder Trust

<u>Determining the Tax Deduction for Remainder</u>

- Value of contributed property
- Trust payout rate must be at least 5%, and is generally between 5% and 9%.
- Term of the trust
  - life of income beneficiaries
  - fixed number of years
- IRS discount rate, updated monthly

Charitable Remainder Trust

<u>Tiered Taxation of CRT Income</u>

- Income retains its character (ordinary income vs. capital gains) and is taxed upon distribution to non-charitable beneficiaries.
- Highest tax rate income is distributed first.
- First, ordinary income/short-term capital gains
- Second, long-term capital gains
- Third, tax-free income/return of principal

Charitable Remainder Trust

CRT Cautions

- No self-dealing
  - Can't occupy or use property owned by a CRT
  - Can't sell property to a relative
- No pre-arranged sale of the assets
- Select the right trustee
- If a conservation easement is involved, donate the easement before putting land in CRT
- Donor may need to put some cash into the CRT to cover initial carrying costs
- Need a separate CRT for each owner
- Annual tax filings required

Case Study #3
Charitable Remainder Trust

Desmonds' Objectives

- Unburden themselves of ownership and property management responsibilities
- Unlock equity in Berkshire County home, generate additional retirement income
- Provide funds to the Coolidge School and other charities
- Reduce and postpone capital gains tax
- Generate an income tax deduction
- Remove property from taxable estate

Case Study #3

Charitable Remainder Trust

<u>Proposed Solution</u>

- CPA proposes funding charitable remainder trust with Berkshire property, with Desmonds as income beneficiaries
- Remainder interest would endow scholarships for Coolidge School and go to other charities
- Coolidge School is very interested, provided they can call on expertise of their local community foundation, Berkshire Taconic Community Foundation
- Coolidge and Berkshire Taconic propose a 5% charitable remainder unitrust (CRUT)
- Desmonds' attorney and CPA support proposed CRUT arrangement as serving clients' objectives

Case Study #3
Charitable Remainder Trust

Structure of Gift

- Berkshire Taconic to serve as trustee of CRUT and take title to property
  - Gift must meets Berkshire Taconic's gift acceptance criteria:

    -- due diligence investigations must be OK

    -- at least 50% of net charitable proceeds must stay at the foundation as permanent endowment for the charity (ies)
- Desmonds to donate some cash to trust if needed to cover property expenses pending sale

Case Study #3

Charitable Remainder Trust

Structure of Gift

- Upon death of Desmonds, half of remainder will be held by Berkshire Taconic as scholarship endowment fund for Coolidge School; half will be distributed directly to other charities
- Desmonds and Berkshire Taconic sign gift acceptance letter laying out all details of gift arrangement
- Rigorous due diligence, managed by Berkshire Taconic, checks out – clean title, environmental assessment, marketability, etc.

Case Study #3
Charitable Remainder Trust

Outcome

- Once trust is established and property conveyed, Berkshire Taconic, as trustee, works with local realtor, sells property within six months for $1.5 million

- Desmonds trigger charitable tax deduction of about $725,000 by funding CRUT with their property

- In current and 5 carry-forward years, Desmonds use deduction to shield ordinary income and the gain from sale of family business and other assets

Case Study #3

Charitable Remainder Trust

Outcome

- Capital gains taxes of $189,000 are avoided
- Entire net proceeds of $1,350,000 invested by Berkshire Taconic
- Desmonds' projected annual trust after-tax income: $50,000 to $58,000 for their joint lives

Case Study #3

Charitable Remainder Trust

<u>Outcome</u>

Charitable deduction for donating
$1.5 million property to CRUT: $726,375

Tax savings over 6 years from
use of deduction @ 38%: $276,023

Total trust payments over 17
years, after tax: $919,587

Total trust payments, present value: <u>$559,322</u>

Total financial benefit, present value: $835,345

Total financial benefit for Desmonds is 72% of $1,161,000 outright sale net

PLUS: Benefit to charity projected to be $589,757 (present value)

Case Study #3
Charitable Remainder Trust

Summary

- Berkshire Taconic, as trustee, markets and sells property, invests proceeds
- Desmonds receive about $55,000 a year in after-tax trust payments for life
- Value of deductions and trust payments is 72% of what they would have netted from outright sale

Case Study #3

Charitable Remainder Trust

Summary

- $1.5 million property removed from Desmonds' taxable estate
- Coolidge School, other charities will receive remainder interest of about $590,000 (present value)
- Desmonds could purchase life insurance for their children with portion of increased cash flow.

Case Study #3

Charitable Remainder Trust

Fractional Interest Variations

The majority of the property is donated to the CRT, but fractional interests can be used for other purposes:

- A fractional interest is deeded directly to the charity, resulting in some current gift and some deferred gift
- Fractional interests are deeded directly to the children, resulting in immediate gifts to them.
- Fractional interest is retained by the Desmonds, yielding immediate cash for them.

SECTION FIVE

CHARITABLE GIFT ANNUITY

Charitable Gift Annuity

<u>CGA Basics</u>

- A Charitable Gift Annuity is a combination of a charitable gift and an annuity contract.
- Assets are transferred to a charity in return for fixed income annuity for life of one or two income beneficiaries.
- Annuity rates, based on life expectancy and interest rates, are recommended by American Council on Gift Annuities.
- Annuity payments may be deferred for one year or more, providing time to liquidate the asset, and increasing the annuity rate and deduction for the donor.

Charitable Gift Annuity

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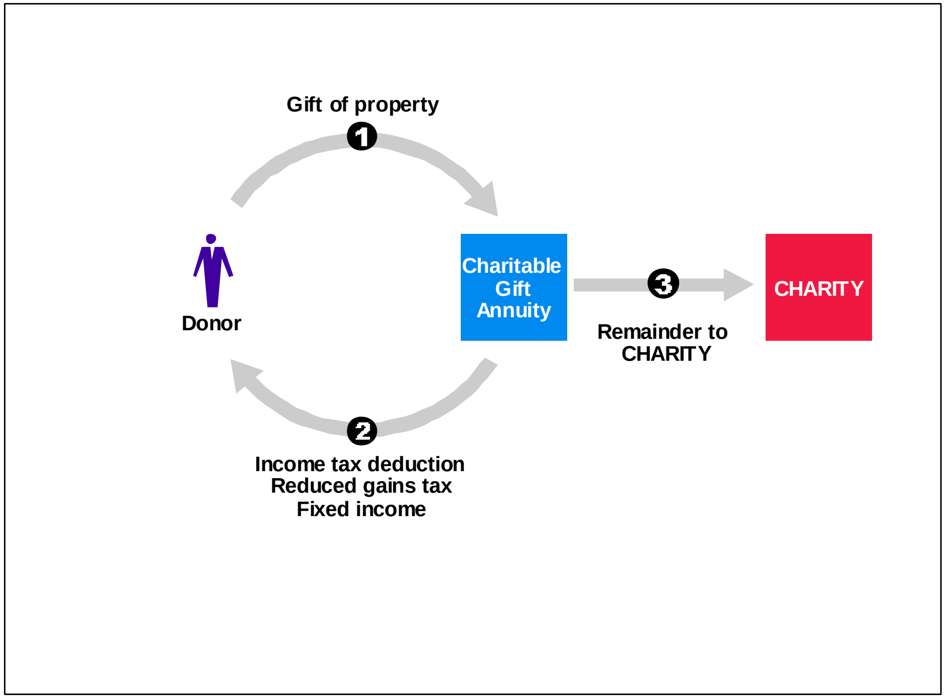
October 12, 2004



How it works

1. **You transfer cash, securities, or other property to CHARITY.**

2. **You receive an income tax deduction and may save capital gains tax.**

   CHARITY pays a fixed amount each year to you or to anyone you name for life. Typically, a portion of these payments is tax-free.

3. **When the gift annuity ends, its remaining principal passes to CHARITY.**

Charitable Gift Annuity

CGA Basics

- Capital gains on appreciated assets used to fund a CGA are spread out over life of annuity.
- Typically, charities set a lower gift threshold ($5,000 or less) for CGAs than for CRTs ($100,000 or more).
- Charitable contribution deduction for difference between fair market value of the asset and present value of the actuarially-determined income stream.
- Payments are fixed (often appealing to older donors), and often larger than income currently produced by the asset (especially true with land).
- The charity can legally use the funds not required to fund annuity payments. However, a safer course is to invest all of the funds and not use any funds for the land trust's purpose until the annuitant(s) die.

Charitable Gift Annuity

<u>CGA Cautions</u>

- Check State laws!
  - Some states regulate CGAs as commercial annuities (but not MA, NY or CT)
  - Some states prohibit funding CGAs with real estate (no longer NY)
  - Some states have stringent disclosure and reserve requirements

    -- MA: none

    -- NY: 10 yrs. operation required, segregated reserves of at least $100,000 required

    -- CT: 3 yrs. operation required, reserves of at least $300,000 required.
- The CGA contract obligates annuity payments whether or not the asset has been liquidated.

Charitable Gift Annuity

CGA Cautions (cont'd)

- All of the charity's assets stand behind the annuity obligation.
- If the charity intends to administer the CGA, be certain to set up a system for making the payments automatically.
- Invest CGA assets "conservatively."

Charitable Gift Annuity

CGA Cautions (cont’d)

- Some charities choose to “re-insure” the annuity by purchasing a commercial annuity.
  - Allows them to use some of the CGA proceeds immediately
  - But, cost of commercial annuity may be 60% or more of gift
  - Charity is still obligated to pay if insurance company folds or fails to make the payments.

Charitable Gift Annuity

CGA Cautions (cont'd)

- Beware of funding a CGA with mortgaged property – it is technically possible, but creates bargain-sale issues.
- The donor should have a "qualified appraisal" in hand at the time the CGA is established.
  - Charitable deduction may be disallowed if property value cannot be determined at the time of the gift.

Charitable Gift Annuity

Marketing a Difficult or Unusual Property

- Sometimes there is genuine uncertainty about how much a property is worth or how long it will take to sell, which puts the charity at risk.
  - Donors cannot market the property, or sale may be attributed to them.
- If the charity is confident about the value, but uncertain when it will sell, propose a deferred CGA.
- If donor and charity are uncertain about the value, the charity can acquire an "option" to purchase the property through a CGA establishing a "floor" value.

Charitable Gift Annuity

The CGA Contract

- Can be very simple -- just 1 or 2 pages
- Defines the one or two annuitants (income beneficiaries)
- Defines the amount on which the annuity is based
- Defines annuity terms: percentage rate, frequency of payments (*e.g.*, quarterly), and deferral period before payments begin.

Charitable Gift Annuity

Determining Gift Annuity Rates

- Based on life expectancies and interest rate environment.
- Recommended rates are revised periodically by American Council on Gift Annuities.
- Recommendations are not binding, but are widely followed.
- Designed to leave at least 50% of the principal value for the charity.

Charitable Gift Annuity

Current Gift Annuity Rates

The ACGA-suggested rates as of April, 2006 for joint annuitants:

Ages	Rate
56 and 54	5.0%
66 and 64	5.6%
76 and 74	6.3%
86 and 84	7.9%
96 and 94	11.0%

Charitable Gift Annuity

<u>Funding a CGA</u>

- Cash, stock, bonds
- Life insurance
- Tangible personal property. *Caution: Value may be limited to "cost basis," if property will not be used to further the donee organization's exempt function (e.g., art to art museum).*
- Real estate, *if allowed under state laws*

Charitable Gift Annuity

Taxing CGA Income

- Components
  - Ordinary income
  - Capital gain (long-term)
  - Tax-free income
- The mix of taxable and tax-free income depends on the annuitants' age, the extent of asset appreciation, selected annuity rate, and IRS discount rate in effect.
- When actuarial life expectancy is exceeded, full annuity payments are taxed as ordinary income.

Case Study #4

Charitable Gift Annuity

<u>Desmonds' Objectives</u>

- Get out from under property management headaches and carrying costs
- Provide secure retirement funding by unlocking equity from Berkshire Co. home
- Provide funds to the Coolidge School and other charities
- Reduce and postpone capital gains tax
- Generate an income tax deduction
- Remove property from taxable estate

Case Study #4
Charitable Gift Annuity

<u>Proposed Solution</u>

- CPA proposes the Desmonds fund a CGA with their property.
- Coolidge School is interested, provided the Community Foundation will become involved.
- Community Foundation agrees, provided property checks out, and provided there is a one year deferral before annuity payments would begin.

Case Study #4
Charitable Gift Annuity

<u>Structure of Gift</u>

- The Community Foundation would take title to the property, then sell it.
- The Foundation agrees to base the annuity value on a conservative estimate of projected net proceeds from sale of the property, which in this case is estimated at $1,250,000.
- Upon the death of the last of the Desmonds, half of the remaining funds would stay at the Foundation as permanent endowment for Coolidge School, and the rest would be distributed to charities specified by the Desmonds.

Case Study #4

Charitable Gift Annuity

Calculating the Charitable Deduction

- The suggested annuity rate for a one-year deferred CGA, for two lives 74 and 76, is 6.6%. (If there is no deferral, the rate would be 6.3%.)
- Based on $1,250,000 projected net resale proceeds, a 6.6% rate would give the Desmonds $82,500 in annual annuity payments.
- However, because the Desmonds donated property with a qualified appraised value of $1,500,000, the annuity rate must be recalculated.
- A rate that would yield $82,500 on $1,500,000 is 5.5%. A one-year, 5.5% deferred CGA for two donors ages 76 and 74 on $1,500,000 of gifted property, with a 6.0% federal discount rate, provides a charitable deduction of $777,630.

Case Study #4

Charitable Gift Annuity

Outcome

Charitable deduction for funding a one-year deferred CGA with a $1,500,000 property	$777,630	
Value of deduction at 38%		$ 295,499
After-tax future value of annuity payments, assuming joint life expectancy of 17	$1,040,029	
Present value of these payments		$636,357

Total financial benefit for Desmonds (present value) $931,856
(present value)

Total financial benefit for Desmonds is 80% of net proceeds from outright sale

PLUS: Benefit to charity, present value, projected to be $480,044

PG Calc calculations

Case Study #4

Charitable Gift Annuity

Summary

- The Community Foundation sells the property, for $1,400,000.
- The Desmonds emerge with 80% of what they would have gotten through an outright sale, plus removal of their property from their taxable estate.
- Coolidge School expects a scholarship endowment of about $240,000 (present value) to be held by the Community Foundation, and another $240,000 will flow to other charities.

SECTION SIX

RETAINED LIFE ESTATE

Retained Life Estate

Retained Life Estate Basics

- aka Reserved Life Estate, or donating a Remainder Interest
- Similar to outright gift, except one or more “life estates” are reserved for individuals named in the deed.
- Allows continued use/occupancy of the property, as if nothing has changed.
- “Life tenants” maintain full use and control of the property, along with full responsibility for property taxes, insurance, and normal property maintenance.
- Life tenant may not "commit waste” on the property and must comply with any conservation easement or other restrictions in effect.

Retained Life Estate

<u>Retained Life Estate Basics</u>

- A clear written agreement between donor and charity should cover such matters as responsibility for major improvements, incapacity of the life tenant, vacating the property, etc.
- As opposed to a gift by bequest, the owner has the satisfaction of knowing gift is completed in owner's lifetime
- Generates tax deduction at time of conveyance.

Retained Life Estate

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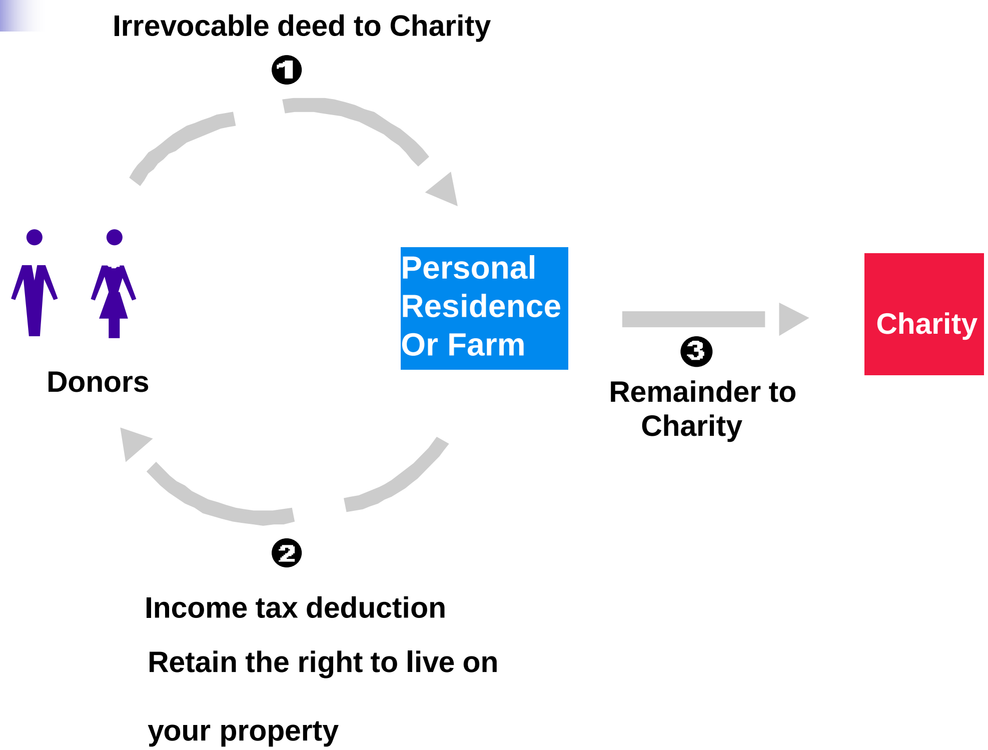
Oct. 12, 2004



How it works

1. **You irrevocably deed to Charity your home or farm, but retain the right to live in it for the rest of your life, a term of years, or a combination of the two.**

2. **You will qualify for a federal income tax deduction.**

   If you decide to vacate your property, you may rent all or part of the property to someone else or sell the property in cooperation with Charity.

3. **When the life estate ends, your home or farm passes to Charity.**

Retained Life Estate

<u>Tax Issues with Retained Life Estate</u>

- Actuarially-based IRS tables determine the deduction for property subject to a reserved life estate.

Retained Life Estate

<u>Retained Life Estate Cautions</u>

- Avoid the problems that will arise if there is not a clear understanding about responsibility for maintenance, improvements, taxes, and insurance.
- Maintain close contact with the property and the life tenants to avoid deterioration the charity’s asset value.

Case Study #5

Retained Life Estate

Desmonds' Objectives

- Continue using the property as long as they are able.
- Make arrangements now for the transfer of the property, avoiding hassles of sale and probate.
- Make a substantial contribution to Coolidge School and other charities
- Generate tax deductions.
- Remove the property from taxable estate.

Case Study #5
Retained Life Estate

Proposed Solution

- Desmonds explore with Coolidge School the option of donating their property, retaining a joint life estate.
- The School is interested, if they can work through the Berkshire Taconic Community Foundation to take title to the property.

Case Study #5

Retained Life Estate

<u>Structure of the Gift</u>

- Desmonds work out detailed life estate agreement with Berkshire Taconic.
- Berkshire Taconic will eventually take possession of the property and sell it.
- Berkshire Taconic will hold half of the net sales proceeds as an endowed scholarship for Coolidge School; other half to be distributed to several other charities.

Case Study #5

Retained Life Estate

<u>Outcome</u>

- Charitable deduction for gift of remainder trust (36%) $548,213
- Tax savings over 6 years from use of deduction @ 38% $208,321

Based on 17 year joint life expectancy, and 4% assumed annual appreciation, property worth over $2,900,000 will be sold by Berkshire Taconic once they take possession of it.

Case Study #5

Retained Life Estate

Summary

- The Desmonds continue to use and enjoy their property for as long as they choose.
- They have generated tax deductions worth over $200,000 – which would not have been available had they left the property through their wills.
- If they relinquish their life estate while still alive, they trigger an additional tax deduction.
- All disposition decisions are made now; children won’t have to worry about selling the house; probate is avoided.

Case Study #5
Retained Life Estate

<u>Summary</u>

- Desmonds are recognized now for their generosity.
- Creation of a $1.5 million gift for Coolidge School and other charities.

SECTION EIGHT

BARGAIN SALE

Bargain Sale

<u>Bargain Sale Basics</u>

- Bargain sale is a sale at below fair market price to a qualified non-profit organization.
- It combines elements of sale and gift.
- The difference between fair market value and sales price can be treated as a charitable contribution deduction, subject to limits.

Bargain Sale

Bargain Sale Benefits

- Its simplicity can be very appealing to all parties, particularly compared to CGA or CRT.
- Appeals to a seller/donor with ability and desire to manage own retirement investments.
- Appeals to a seller/donor with need for immediate cash – travel, business investments, health care, taking care of children
- Helpful when there are immediate cash needs (retiring debt, tuition, health emergencies) as opposed to desire for steady stream of long-term income.

Case Study #6

Bargain Sale

Desmonds' Objectives

- Get out from under property management headaches and carrying costs.
- Generate cash for current needs and augment retirement investments.
- Generate tax deductions.
- Remove the property from their taxable estate.
- Make generous contributions to the Coolidge School and other charities.

Case Study #6

Bargain Sale

Proposed Solution

- Sell the property to the Coolidge School for the bargain price of $600,000.
- Work through the Berkshire Taconic Community Foundation, which will take title to the property and sell it.
- Set the closing far enough away that the Community Foundation has time to identify potential buyers for the property.

Case Study #6

Bargain Sale

Outcome - Desmonds			
Proceeds from sale	$600,000		
Less selling costs @ 0%	($ 0)		
Net proceeds		$600,000	
Less allocated basis (600,000/1,500,000)		($ 120,000)	
Taxable gain		$480,000	
Capital gain tax @ 18%		($ 86,400)	
Net Proceeds			$513,600
Charitable deduction		$900,000	
Federal/state income tax savings (38%)			$342,000
After-tax benefit to landowner			$855,600

Total financial benefit for Desmonds is 75% of $1,1461000 outright sale net

Plus: Gifts worth $750,000 to Coolidge School and other charities

Case Study #6

Bargain Sale

Outcome – Charity

Proceeds from sale of property	$1,500,000
Less purchase price	($600,000)
Less 10% selling costs	($150,000)
Net proceeds to Community Foundation	$750,000

Case Study #6

Bargain Sale

Summary

- Landowners realize over $500,000 after-tax to fund travel and retirement needs
- They also receive tax deductions worth $340,000 to them
- Combined, this represents 75% of what they'd have realized through an outright sale.
- They are free from management of the property, with someone else assuming responsibility for selling it.
- Working through the Community Foundation, they have created gifts worth $750,000 for Coolidge School and other charities of meaning to them.

SECTION NINE

COMBINING A CONSERVATION RESTRICTION WITH A CHARITABLE GIFT OF REAL ESTATE

Conservation Restriction and a CRT

<u>Conservation Restriction/Easement Basics</u>

- Deed restrictions, authorized by state law
  - Mass. General Laws Chapter 184, Sections 31
  - Conn. General Stat. Sections 47-42a to 47-42c
  - N.Y. Envtl. Conserv. Law Sections 49-0301 to 49-0311
- Run in perpetuity, binding on all future owners of land
- Owner of land continues to own, manage and pay taxes on land once easement/restriction has been conveyed
- Owner retains all rights to sell, rent, bequeath, donate property (subject to conservation easement)

Sources:

Conservation Restriction and a CRT

<u>Conservation Restriction/Easement Basics</u>

- Conservation easement is held by a qualified non-profit land conservation organization or unit of government

- Though not all conservation easements are the same, most include:
  - Prohibition or limit on new structures, and limit on size of expansions to existing structures
  - Prohibition or limit on subdivision of the land

- Holder of easement must monitor and enforce terms of the restriction

Conservation Restriction and a CRT

Valid Conservation Purposes

- Preservation of open space, including farmland and forestland

- Preservation of land for recreation by, or the education of, the general public

- Preservation of natural habitat

- Preservation of historically important land or a certified historic structure

Conservation Restriction and a CRT

Types of Restrictions

- Prohibit or limit new structures, limit enlargement of existing structures
  - To protect scenic views
  - To protect agricultural or timber productivity
  - To protect watersheds
- Prohibit or limit subdivision of the land
- Prohibition on mining
- Limits on roads and trails
- *Not all conservation easements are the same*

Conservation Restriction and a CRT

Many Ways to Convey Conservation Easements

- Outright donation
- Sale
- Sale at a bargain price
- Donated or sold by one's estate
- Conveyed as part of a like-kind exchange

Case Study #7

Conservation Restriction and a CRT

Desmonds' Objectives

- Unburden themselves of ownership and management responsibilities
- Unlock equity in Berkshire County property, turn into supplemental retirement income
- Generate tax deductions
- Reduce taxable estate
- Make a significant gift to Coolidge School and several other charities

AND

- **Want to be sure that their 18 acres of scenic land next to the BNRC-protected land can never be developed**

Case Study #7

Conservation Restriction and a CRT

Proposed Solution

- 5% CRT, with Berkshire Taconic as trustee and Coolidge School and other charities as charitable beneficiaries, as before
- *Except,* Desmonds approach BNRC about accepting, monitoring and enforcing conservation restriction on the 18 acres
- BNRC agrees since they hold CR on adjacent 200-acres
- Desmonds and advisors understand that they must donate the CR first, then convey CR-restricted property to the CRT

Case Study #7

Conservation Restriction and a CRT

<u>Structure of Gift</u>

- Gift acceptance letter signed by Desmonds and Berkshire Taconic
- Rigorous due diligence, managed by Berkshire Taconic, checks out
- Desmonds agree to donate $10,000 in cash as stewardship endowment to BNRC
- Desmonds commission appraisal of 18 acres: $1.5 million as is, $1 million with conservation restriction

Case Study #7

Conservation Restriction and a CRT

Outcome

- Conservation restriction is donated and restricted property is conveyed to CRT
- Donation of CR triggers charitable tax deduction of $500,000 for Desmonds. ($1,500,000 less $500,000)
- CRT is funded with property valued at $1 million, triggering additional charitable tax deduction of about $485,000
- Berkshire Taconic, as trustee, sells property within 6 months for $1 million

Case Study #7

Conservation Restriction and a CRT

Outcome

- In current year and 5 carry-forward years, Desmonds can use these two deductions to shield ordinary income and gain from sale of family business and other assets
- Capital gains taxes of $189,000 are avoided
- Entire net proceeds of $900,000 invested by Berkshire Taconic
- Desmonds' annual after-tax trust income will range from $33,000 - $38,000 for joint lives, projected to be 17 years

Case Study #7

Conservation Restriction and a CRT

<u>Outcome</u>

Charitable deduction for donation of conservation restriction:	$500,000		
Charitable deduction for donating $1 million property to CRUT:	$484,250		
Tax savings over 6 years from these two deductions, @ 38%		$374,015	
Total trust payments over 17 years, after tax:	$613,058		
Total trust payments, present value		<u>$372,881</u>	
Total financial benefit, present value:			$746,896

Total financial benefit is 64% of $1,161,000 outright sale net

PLUS: Gift to charity projected to be $393,171, present value

Source: PGCalc Calculations

Case Study #7

Conservation Restriction and a CRT

<u>Summary</u>

- Berkshire Taconic, as trustee, sells restricted property, reinvests proceeds
- Desmonds receive about $35,000 a year in trust payments, after-tax, for life
- Value of deductions and trust payments = 64% of net if they'd sold property themselves
- $1.5 million property is removed from their taxable estate

Case Study #7

Conservation Restriction and a CRT

Summary

- Coolidge School and other charities receive remainder interest of over $390,000 (present value)
- Desmonds have option of purchasing life insurance for their children with portion of increased cash flow
- Desmonds have satisfaction of knowing their land will never be developed
- BNRC has added 18 acres to its protected land in county.

Conclusion

- Creative approaches to the real estate wealth transfer represent largely unexplored planning opportunities for CPAs and other professional advisors.
- Creative real estate disposal strategies can allow private property owners to make charitable contributions they have aspired to but never thought possible.
- More and more non-profit organizations are accepting real estate gifts in various forms, either directly or by partnering with a community foundation or another charity.