Portsmouth COMMUNITY Foundation

ADVISORS EDGE

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UNEARTHING CHARITABLE DREAMS: DONATING PROPERTY

Giving property can allow a substantial gift to a favorite cause while reducing taxes on an estate and possibly giving a lifetime income stream. The Portsmouth Community Foundation accepts gifts of real estate.

With real estate values skyrocketing amid historically low mortgage rates, many wealthy donors find themselves with a large percentage of their net worth tied up in real estate. Financial advisors who are called upon to develop tax planning and diversification strategies for clients should consider the benefits of real estate donations. Donors receive an immediate tax deduction and reduce the value of their taxable estate, while nonprofits benefit from a generous gift.

Increasingly, donors around the country are calling on their advisors to help them use the appreciated value of their property to benefit their favorite charities. For example, residents of Baton Rouge, Louisiana, who drive due north will encounter a prosperous real estate development with an unlikely owner: the local community foundation.

Late last year, a charitably inclined property developer donated 16 acres of raw land that make up a critical piece of the development, which now includes homes, a hotel, and commercial buildings. The property donation netted the benefactor a healthy tax deduction. And when the property is sold, the expected windfall will enable the donor and his spouse to recommend grants to local organizations and thus fulfill their charitable goals.

Flexible Philanthropy

One of the immediate benefits of donating property is the ability to provide a large gift without disrupting a client's investment portfolio or cash position. When wealthy donors gift real estate, they don't have to sacrifice liquidity by laying out cash, nor must they give up potential investment appreciation by selling securities from their portfolios.

Clients also reap important tax benefits. Donors who contribute real property to a private foundation generally can deduct only the cost basis of the property up to 20% of the donor's adjusted gross income. However, clients who contribute long-term capital gain property – real estate they have held more than one year as an investment – to a public charity, such as a community foundation, can deduct the property's fair market value up to 30% of the donor's adjusted gross income. In both scenarios, excess deductions may be carried forward and deducted over the next five years.

An equally important benefit: unrealized capital gains won't be taxed if a property is given to charity. In addition, property that is donated – along with any future appreciation – is excluded from the client's taxable estate.

Issues to Consider

Donating real estate to charity is not a simple procedure, and advisors must consider a number of important issues. For example, clients will likely be better off donating real estate to a public charity, such as community foundation, given the likelihood of a more favorable income-tax deduction.

In addition, a signed appraisal by a qualified third party will be required to support the tax deduction. Donors are generally responsible for getting, and paying for, a fair appraisal. "If a charity sells the real estate within two years, which usually will be the case, Form 8282 will be filed with the IRS. If there is a significant discrepancy between the sale price on this 'tattle-tale' form and the valuation claimed for tax purposes, the IRS may question the deduction," says Gid Smith, president of The Community Foundation of Greater Memphis, which has been handling charitable property transactions through its real estate division since the early 1990s.

Further complications arise if clients donate mortgaged property. "The transaction will be treated as a bargain sale if the property is encumbered," says Harvey Berger, national director of Not-for-Profit Tax Services at Grant Thornton LLP. "Under the bargain sale rules, a contribution of such property is treated as part-sale and part-gift, reducing the tax deduction."

Donating real estate for which the donor has claimed depreciation deductions on prior tax returns also raises important tax considerations. "You have to reduce the contribution by any amount that would be taxed as ordinary income on a sale," says Berger. "This includes depreciation recapture. While you technically don't pay tax on the recapture, reducing the contribution amounts to the same result."

Planned Giving Strategies
By using sophisticated giving strategies, clients can remain more involved with donations, retain the right to use a residential property that has been gifted, or even receive lifetime income, in addition to the benefits mentioned above.

Smart planned giving techniques include:

Donor Advised Funds. A client might gift real estate to a donor advised fund at a community foundation and receive an immediate tax deduction. After the property is sold, the proceeds are held in the donor advised fund. The donor can then suggests specific charitable gifts, which may be spread over a period of years, to local organizations from this fund. This strategy gives clients ongoing participation in philanthropic efforts.

Retained Life Estates. Some clients would like to give their homes or farms to charity, while continuing to live in or use the property. If such rights are preserved, the client's upfront tax deduction will be reduced to a percentage of the property's value; the longer the charity is expected to wait, the smaller the immediate tax benefit. In addition, a donor who retains a life estate also retains the responsibility to maintain the property and pay necessary expenses.

Charitable Remainder Trusts. Another strategy is to donate real estate to a trust that will sell the property and pay the donor (or perhaps a donor and spouse) a lifetime income stream. That income might be a fixed amount or a fixed percentage of trust assets. Eventually, assets left in the trust will be donated to charity. This is usually an option only if the property to be donated is free from debt.

Although there are minimum charitable requirements, it is possible for clients to retain a relatively large income stream and receive a relatively small (as little as 10 percent) upfront tax deduction. Conversely, clients with substantial charitable intent can specify a smaller income stream and receive a larger tax deduction. Charitable remainder trusts must be created and administered carefully so many charities, including community foundations, will need to work closely with donors' advisors to see that the proper steps are taken.

If executed carefully as part of a comprehensive estate plan, gifts of real estate offer many benefits to clients and their favorite charities. Advisors who understand the intricacies of real estate donations will be in a better position to help their clients achieve their giving goals in a way that's consistent with their overall financial plan.

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