ADVISOR'S QUARTERLY

Giving Real Estate in Trust

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A gift of real estate into a charitable remainder unitrust can help you avoid capital gains taxes, qualify for an income tax charitable deduction, receive lifetime income, and provide for the future of your favorite charity. Funding a trust with real estate, however, is significantly more complex than funding it with cash or marketable securities. This article outlines the major steps involved in making such a gift, highlights important responsibilities that you and your charity have, and notes some special tax rules that must be followed.

Before Your Gift

Property Due Diligence. If you sold your property to a private individual, you would expect the buyer to go through an appropriate due diligence process. Your charity will want to do the same if it is to be named as trustee of your trust. The due diligence process typically includes an inspection of the property, a review of its title, and an investigation into its marketability. In many cases, the charity will arrange for a "Phase I audit" to ensure that there are no environmental liabilities connected with the property. If repairs or improvements are recommended to improve the property's salability, the charity will discuss these with you in advance. Please note that all outstanding mortgages generally must be removed prior to funding the trust in order to preserve the tax benefits associated with the gift.

Drafting the Trust Document. Many charities will provide you with a draft charitable remainder unitrust document and work with you and your attorney to be certain the document reflects your intent. While the planned giving officer at your charity can also estimate your tax benefits, it is very important that your own tax advisor confirm the income and transfer tax consequences of establishing your trust. Your planned giving officer can also illustrate the impact of your choice of payout rate on your income stream over time and on the value of your remainder gift to charity.

Once the document is executed and the trust funded, the trust cannot be amended except to comply with changes in the tax law. For this reason, it is important to provide the trustee with appropriate flexibility in dealing with the real estate. For example, Kaspick & Company recommends that the trustee be given the power to allocate expenses of the trust between income and principal at the trustee's discretion. This provision will sometimes enable the trustee to increase the income paid to you immediately after the real estate is sold.

Choosing a Trustee. In many cases, the charity will serve as trustee of the unitrust. It might also be desirable for you to serve initially as your own trustee until the property sells. This would allow you to negotiate the sale of the property. If you are considering this option, your planned giving officer can supply you with a checklist of "Dos and Don'ts" and also discuss whether it makes sense for the charity to serve as your agent for handling the specialized trust administration tasks associated with unitrusts.

Serving as your own trustee allows you to negotiate the sale of the property.

Funding the Trust. Once the trust instrument is signed, title to the property can be transferred to the trust. Your attorney must prepare the actual deed. (If you have named the charity as trustee, the planned giving officer at your charity can supply the formal name that should appear as grantee.) Please note that under most states' laws, the gift to the trust is complete when the deed is delivered to the trustee. In order to avoid being taxed personally on the capital gain inherent in your property, it is very important that you not legally commit to sell the property prior to delivery and acceptance of the deed.

After the Gift

Claiming Your Tax Deduction. If you wish to claim a charitable deduction for your real estate gift in trust, you must obtain a "qualified appraisal" of the property not earlier than 60 days prior to the date of the gift, and not later than the due date (including extensions) of the federal income tax return on which you will claim your deduction. Donors, appraisers, and advisors should refer to IRS Notice 2006-26 and Treasury Regulation 1.170A-13(c) to ensure that the appraisal meets the detailed requirements of the tax law. Both the appraiser and the trustee of the unitrust must sign a particular form—IRS Form 8283—that you must attach to your tax return. If you are serving as your own trustee, you will need to sign Form 8283 in your trustee capacity.

Always consult your tax advisor on the deductibility of your charitable gifts.

Because you (or others that you name) will receive an income from the trust, an income tax charitable deduction will be allowed only for a portion of the value of your gift. The deduction for a given year is generally allowable up to 30% of your adjusted gross income. Any unused deduction can be carried over for up to five additional years. As noted above, you should always consult your tax advisor on the deductibility of your charitable gifts.

Payment of Real Property Expenses. Nearly all real estate is subject to ongoing expenses such as property taxes, utilities, insurance, etc. After the property is deeded to the trust, it is the trustee's legal responsibility to pay these expenses from trust assets. Income from the property might or might not be sufficient to cover these expenses. Your charity will ask you to agree to contribute liquid assets to the trust (either at the time of the contribution of real estate or on an as-needed basis) to pay expenses that exceed property income. Each such transfer is treated as an additional gift, providing you with an additional income tax deduction. Please note that if the charity were to pay these expenses directly, they could be characterized as either a loan to the trust or a gift to the trust, either of which could endanger the tax benefits associated with your gift.

Many charities prepare a Letter of Understanding to be signed by the donor and the charity prior to the gift. This letter outlines the specific responsibilities you and the charity have with respect to the funding of the trust and the administration of the trust until the property is sold. Payment of property expenses after the trust is funded is one of the items generally covered in the Letter of Understanding.

Sale of the Real Property. After title to the property has been transferred to the trust, the charity will market the property. (Responsibility for handling the sale is often spelled out in the Letter of Understanding.) If the property is sold within three years of the contribution to the trust, the trustee is required to report the sales price to the IRS on Form 8282. If you choose to serve as your own trustee, you may resign upon the sale of the property in favor of your charity, which will then perform all trustee duties for the balance of the term of the trust.

Your Trust Payments

After you deed your property to the trust, any income produced by the real estate (reduced by expenses chargeable to income) will be paid out of the trust as beneficiary payments to the extent it does not exceed the unitrust percentage rate.

After the real estate is sold by the trustee, the net proceeds will be invested in a portfolio of financial assets. In today's interest rate environment, the net dividends and interest from these financial assets is very often less than what is produced by rental real estate. Your charity's planned giving officer can provide you with an estimate of the income you will receive for the balance of the calendar year in which the property is sold. You might wish to discuss with your attorney and planned giving officer whether it might make sense to treat post-contribution capital gains as income during this period.

Beginning on January 1 of the year after the real estate is sold, the trust will "flip" from a net income unitrust to a standard unitrust. From that point forward, trust payments will no longer be limited to dividends and interest, but will be equal to the payout rate times the net fair market value of all trust assets on the valuation date (usually the first day of the calendar year). Under policies established by your charity as trustee, Kaspick & Company will invest your trust in a broadly diversified portfolio of low-cost institutional mutual funds. More information about the investment approach is available from the planned giving officer at your charity.