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Given the choice, most charities and asset managers would prefer that donors fund life income gifts with cash or publicly traded securities. These assets are easy to value and easy to sell. Real estate, on the other hand, can be difficult to value and hard to sell. It also carries with it financial risk due to environmental problems, hidden structural defects, and a host of other possible issues.

That said, the real estate market is red hot. Some economists argue that we are experiencing a real estate bubble that may burst anytime, after which prices will tumble. This potential risk may motivate some prospects to cash out, lock in their gains and generate extra income for retirement.

Other prospects, particularly those who are more entrepreneurial, may enjoy income from rental real estate. However it is hard work being a landlord. These prospects may be looking to convert their rental units into a more worry-free income stream.

Let's review how to identify gift opportunities with real estate, protect your organization against the risks associated with these assets, and create proposals that will help you close these types of gifts.

Types of Real Estate

Real estate gifts may be in the form of owner-occupied residential property, raw land, investment property, property used in a business, or agricultural land. The property may be held by a donor in his or her name or in a business entity such as a corporation, partnership, or limited liability company.

The real estate may be occupied by a donor or the donor's family; it may be income producing or non-income producing. All of these factors can affect the marketability of the property and the risks associated with holding the property and paying life income.

Risks of Real Estate Ownership

The risks of owning real estate are well known. They include environmental risk because anyone in the chain of title is potentially responsible for contamination without regard to who caused the hazard. Therefore, don't accept real property

without a Phase One environmental study. This will reveal evidence of any obvious pollution on the site.

There is a risk associated with the valuation of the property. Obtain an independent appraisal even if the donor has already gotten one. The value can vary depending on who is asking. Have the property evaluated by someone working for your interests, not the donors.

There is also a risk associated with marketing the property. In addition to an opinion of the value of the property, know how long it may take to find a buyer. Particularly with unique properties it can take some time to find a buyer willing and able to pay the appraised value.

Insurance can protect against some of the risks of property ownership. Title insurance protects against disputes over ownership or access to a piece of property. Since the property may have changed hands many times, title insurance protects against mistakes made over the years. Property insurance protects against claims that originate in the period while your charity or a charitable trust owns the property.

If the property is rented to residential or commercial tenants, your charity or a charitable trust will be the landlord until the property sells. The landlord has the right to collect rent but is also responsible for maintaining and operating the property until the sale. Hiring a professional management company is one solution.

The prospective donor may not own the real estate directly. Real estate property is often owned indirectly in a business entity such as a partnership, corporation or limited liability company. It is outside the scope of this discussion, but transfers from these entities raise additional potential tax issues. Seek the assistance of a qualified tax professional on the best way to structure these transactions.

Life Income Vehicle Selection and Real Estate

The usual arsenal of life income gifts are available if the donor wants to use real property to fund the gift. However, there are differences in life income vehicles that make the choice of the gift plan particularly sensitive in the case of real estate.

Charitable Remainder Trusts

Liability for assets held in a CRT is limited to the assets inside the trust. Therefore, if the trust is sued, for example because of environmental hazards found on the property, the plaintiff's only claim is to the assets held in the trust. If the trust runs out of money, there is no further recourse. It also means there is no gift to charity!

Gift Annuities

Gift annuities are an unlimited obligation of charity. Assets accepted to fund the annuity become the property of charity to do with as it wishes. Once accepted by charity to fund the gift annuity, real property can subject the entire organization to significant potential liability. The liability for the environmental hazard mentioned above would not be limited to the donated property. All of the assets of the organization could be at risk. Therefore, consider carefully before accepting this type of gift.

Pooled Income Funds

It is possible to fund a pooled income interest with real estate. Most organizations are reluctant to do so. The reason is that the real estate donor would be entitled immediately to a portion of the pooled fund's income equal to the value of the real estate. However, it could take the pooled fund a long time to liquidate the property and invest the proceeds in income-producing assets. In the meantime, the income to the other pooled fund participants is reduced because they must share the fund's income with the real estate donor. For this reason, many charities do accept real estate into their pooled funds.

Remainder Trusts Funded With Real Estate

While charitable remainder unitrusts and annuity trusts can both accept gifts of real estate, annuity trusts are rarely funded this way. The annuity trust is obligated to begin making payments immediately regardless of when the trustee sells the trust property. If the real estate does not sell and the trust is unable to pay the income beneficiaries, the trust can be disqualified. That means the donor loses the deduction, any capital gain realized is reportable to the donor, and the trust becomes taxable. If the donor is willing to fund an annuity trust along with sufficient liquid assets to meet the payment obligations until the real estate is sold, the annuity trust might work.

The charitable remainder unitrust is the vehicle of choice for most real estate gifts. The reason is the availability of the flip unitrust. The flip unitrust acts like a net income unitrust prior to a specified flip trigger event. That means that during this period the trust pays the lesser of the income it earns or the unitrust amount. If the real estate produces no income, the trustee is under no obligation to make any payments. If the real estate does produce income, the donor is entitled to all of the net income up to the unitrust amount. The resulting distribution is likely to equal what the donor would have received if she had not transferred the property into the trust. Consequently, the pressure is off the trustee to sell the property immediately.

The flip triggering event typically is the sale of the property. Beginning in the year following the sale of the real estate, the trust begins to pay the unitrust amount without regard to how much income is earned. The costs of liquidating the property are paid out of the trust principal. The unitrust amount will then be based on the net sale proceeds. Since trust distributions will no longer be limited to net income, the trustee will be able to invest for total return, benefiting both the income beneficiaries and charitable remainderman equally.

Gift Annuities Funded with Real Estate

While technically possible to fund a remainder annuity trust with real estate, it is not the ideal vehicle for the reasons mentioned earlier. The donor seeking fixed income from real estate is left to consider funding a charitable gift annuity instead.

As mentioned, the challenge for the charity is the risk of real estate ownership. It may take some time to sell the property, so the charity will have to begin making payments right away from other assets. Moreover, the charity is not likely to net the fair market value of the property because of the sales expenses and costs of ownership. The charity also will be liable for taxes, maintenance, insurance and other expenses until after the sale. These costs will further reduce the net proceeds with which to fund the annuity.

One solution is to offer a lower annuity rate adjusted for the expenses and time needed to sell the property. Here is an example of how that might work. Assume a donor wants to fund a gift annuity with residential real estate appraised at $300,000. Your marketability analysis shows that you will be able the sell the home fairly quickly for $290,000, but there will also be a broker’s commission of 6% of the $290,000 sales price ($17,400) and additional expenses of about $2,000 to cover

taxes, insurance, and maintenance costs prior to the sale. The net proceeds will be $270,600, as a result. In addition, there is a risk that the sale price will be lower than anticipated or take longer than expected to complete.

The donor is age 76 and normally would be entitled to an annuity rate of 6.0%. 6.0% of the net sales price of $270,600 is an annuity of $16,236 which translates to about 5.4% of the $300,000 fair market value of the property. You might further reduce this rate to 5.0% to reflect the inherent risks in selling real estate. If the donor lives in a state that requires your charity to follow a published rate schedule, the donor's written consent to a lower rate may be required. The calculation of the deduction in Planned Giving Manager should be based on a fair market value of $300,000 and the reduced annuity rate of 5.0%.

Why not just use the anticipated net proceeds of $270,600 as the funding amount for the 6.0% annuity? To pay the annuity on the net proceeds could be construed as a sham transaction in which the charity is just being used to sell the property on the donor's behalf. If that were the case, the donor would not be entitled to a deduction.

Another solution, if your donor is willing, is to defer the annuity payments for a year or two. This way, your charity will likely not need to make annuity payments until after the real estate is sold and the net proceeds are reinvested in income-producing assets. Again, your charity may want to reduce the annuity rate it is willing to offer to reflect the costs and risks associated with owning and selling real estate.

Conclusion

All of the cautions that apply to the acceptance of real property as an outright gift apply to life income gifts funded with these assets. Additionally, funding life income gifts with real estate present additional danger since these gifts create a payment obligation prior to having the liquidity to meet that obligation.

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