



It's a Great Time to Consider a Retained Life Estate

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For many donors, their home is their most valuable asset. They most likely plan to live there for many years and it would never occur to them that they could use their home to make a charitable gift. Likewise, there are many donors with a valuable second home that they continue to use regularly and have never considered giving to charity. In both cases, the retained life estate may offer the key to unlocking just such a gift.

What is a retained life estate?

With a retained life estate, the donor irrevocably deeds a personal residence or farm to your charity, but retains the right to live in it for the rest of her life, a term of years, or a combination of the two. The term is most commonly measured by the life of the donor or of the donor and the donor's spouse. When the term ends, typically when the last of one or more tenants dies, your charity will either keep the property for its own use or sell the property and use the proceeds as designated by the donor. If the donor decides to vacate the property before her life estate has terminated, she may rent the property to someone else or sell the property in cooperation with your charity.

A personal residence doesn't have to be the donor's primary residence. It can be a vacation home or any other structure that the donor uses as a residence, such as a boat. A farm can include raw farm land, as well as farm land with buildings on it.

The beauty of a retained life estate is that the donor gives up nothing while alive other than the ability to sell the residence and use the proceeds. In all other respects, nothing changes for the donor after making the gift. She still lives in her house, still has access to all her other assets, and still has the same cash flow she had before the gift. Importantly, she also has the same responsibility to maintain the buildings, pay utilities and taxes, and handle other routine expenses. See *The Terms of the Life Estate* below for more on these responsibilities.

Immediate income tax benefit

In return for making an irrevocable gift of a personal residence, the donor receives an income tax deduction in the year of her gift for the charity's remainder value in the residence. The usual IRS 30%/50% AGI limitations and five-year carry-forward apply. Unlike life income gifts, especially gift annuities and remainder annuity trusts, the lower the IRS discount rate, the higher the deductibility of a retained life estate. With the IRS discount rate at an all-time low of 1.4%, this means that the deduction for creating a retained life estate *is at an all-time high*.

For example, a 75 year-old who puts his \$200,000 home into a retained life estate and reserves the right to live in it for the rest of his life will receive an income tax deduction of \$140,000 - \$150,000. Just last May when the IRS discount rate was 3%, the donor would have received a deduction that was \$20,000 less.

The exact amount of the deduction depends in part on how much of the property value is attributable to the buildings and how much to the land on which they sit, as well as the salvage value and estimated useful life of the buildings. Although PG Calc's *Planned Giving Manager* software provides default amounts for these values, a qualified appraiser must provide these numbers for tax purposes.

Donor Profile

The profile of the ideal retained life estate donor is someone older, 70 plus, who owns multiple residences. A donor with this profile will often be looking for the large current charitable income tax deduction that a retained life estate gift can deliver, especially now.

Another cohort of retained life estate donors are those who want to make a large donation, but are of modest means and therefore lack the liquidity to make a large current gift. For these donors their home may be their most valuable asset. Because of their relatively low incomes, they may not be able to take full advantage of the charitable income tax deduction they receive for funding a retained life estate, even with the five-year carry-forward of unused deduction. For them, the satisfaction of being able to make a major gift to a cause they feel passionate about needs to be the primary motivation and saving taxes must be secondary. It is also likely that they do not have heirs to whom they want to pass on their home.

The Terms of the Life Estate

Transferring the deed to create a retained life estate is the easy part. The charity also needs to create a detailed agreement with the donor regarding a variety of responsibilities, such as:

- a. real estate taxes
- b. liability and casualty insurance
- c. utilities
- d. maintenance and minor repairs
- e. remodeling and major repairs
- f. criteria for evaluating subtenants, if the property is sublet by the life tenant
- g. procedures for selling the property during the tenancy and dividing the proceeds
- h. accelerating the remainder interest in favor of the charitable remainderman
- i. procedures for removal of the personal property of the life tenant upon the end of the tenancy
- j. a comprehensive dispute resolution process

While the life tenant is responsible for expenses customarily borne by the owner of real property (such as maintenance, insurance, and taxes), expenses for improvements that benefit the charitable remainderman are subject to negotiation. For example, capital improvements that will last beyond the life tenant's use of the property, such as new windows, a new roof, or similar types of improvements, will benefit both the life tenant and the charitable remainderman. To the extent that the donor covers more than her share of these expenses, she should be eligible for an additional income tax deduction based on the increased remainder value of her property as a result of the improvements.

The last item on the list – a comprehensive dispute resolution process – is critical. While the donor and charity will be best friends on the date of the gift, that relationship can change over time for any number of reasons. An agreed-upon process for resolving disputes that is in place from the outset may help you avoid major headaches later on.

Due Diligence

As with every gift of real estate, the property needs to be inspected by one or more knowledgeable persons who have the interests of the charity in mind. This can include structural/mechanical inspections, pest inspections, and various environmental inspections. There will also need to be a title examination to ensure that the donor is indeed the owner of the property and that there are no liens or other claims against it.

Ideally, the appraisal obtained by the donor will be made available to the charity before the gift is completed, although the charity can also secure its own appraisal. Any legal counsel the charity may need should be obtained from a lawyer familiar with the law of the state where the property is located.

It is best if all of this work is guided by formal policies and procedures on gifts of real estate that the charity has already put into writing. This way, the charity is most likely to uncover any problems with the property before accepting the gift. If there is a problem that makes the charity want to decline the gift, having formal policies and procedures in place may make it easier for the charity to explain to the donor why it won't accept the gift.

Paying for Various Costs

The donor generally pays for the cost of the appraisal, with the costs of the various inspections borne by either the donor or the charity or both, depending on various factors unique to each situation. In addition, each party should pay for its own legal counsel, and state law will determine who pays any real estate transfer taxes. In some cases, costs that are the responsibility of the donor can be paid by the charity initially, so long as there is subsequent reimbursement by the donor or a proper accounting for tax purposes.

Conclusion

The current extremely low IRS discount rate makes the retained life estate an attractive gift arrangement for donors who are seeking a large current income tax deduction. The retained life estate can also be attractive to donors who want to make a major gift, but for whom their home is the only asset valuable enough to make one. Even though the arrangement itself is straightforward, it is critical for the charity to do proper due diligence prior to accepting the real estate and to define carefully who will have ongoing responsibility for what once the arrangement is in place. While these steps may make the process more complex, the size of these gifts – and their potential pitfalls – make the work and expense involved well worthwhile.