Undeserved Neglect: The Installment Bargain Sale

A donor approaches your organization to gauge its interest in purchasing a building he owns next door. Your organization is interested, but cannot afford to pay market price for it. The donor is willing to consider making part of the transfer a charitable gift, but wants to receive some immediate financial benefit, too. What should you suggest?

A charitable remainder annuity trust won't work because the parcel won't generate the income needed to make the annuity payments. A gift annuity would address this problem, but payments would be spread over the donor's lifetime, which would be too slow a financial return for his purposes. A commuted payment gift annuity could frontload the payments, but would require deferring them for at least a year and may be considered too risky without obtaining a private letter ruling from the IRS, which would be expensive and time-consuming. A bargain sale would satisfy the donor's needs, but would create a cash flow problem for your organization. But what about an <u>installment</u> bargain sale?

What is an installment bargain sale?
The basic concept of a bargain sale is straightforward. The owner of an asset, typically real estate, sells it to a charity for less than the property's appraised fair market value. The charity pays the donor the sales price in a single lump sum at the time of the transaction and the donor gets a charitable deduction for the difference between the value of the property on the date of gift and the sales price. If the property is appreciated, the donor must pay tax on the gain attributable to the sales price.

An <u>installment</u> bargain sale is a variation on this concept, where the charity pays off the donor in a series of payments rather than in a single lump sum. With an installment bargain sale, the donor receives a charitable deduction for the difference between the value of the property and the <u>present value</u> of the payments to the donor. In effect, the donor is making a loan to the charity during the installment period, so the payments are treated partly as interest, partly as capital gain income, and partly as tax-free return of principal. Sounds a little bit like a gift annuity, doesn't it?

The amount and timing of the installment payments are negotiated between the donor and the charity. Typically the payments are all the same amount and made annually, but this is not required. The first payment can be larger than the rest, like a down payment on a house, or conversely, the installments can end in a balloon payment that is larger than all that came before. Payments also can be deferred until a few years after the gift. Whatever schedule of payments is agreeable to both parties can be followed. No gift annuity or charitable remainder trust offers that kind of flexibility.

When might an installment bargain sale be of interest?
A bargain sale is most commonly used to facilitate a gift of real estate that the charity wants to keep. The arrangement enables the owner to collect an amount of sales proceeds with which the owner is comfortable and make a gift of the rest, thereby earning some tax benefits. At the same time, the charity is able to acquire a parcel it wants to keep for less than market price.

Even at a bargain price, however, the receiving organization may not have the wherewithal to make the payment comfortably in one lump sum. By making its payments in installments, the charity can spread the cost over several fiscal years, easing its cash flow burden in the process.

There are also instances where the donor drives the desire for payments to be made in installments rather than the charity. For example, the donor may want to spread any reportable capital gain over several years. Or the donor may view the sale as a way to create a fixed term annuity that will provide a few years of steady income before he or she starts taking funds from other sources, such as an IRA or other retirement account.

An example

Sharon Johnson has owned a small apartment building located next to her town's hospital for over 25 years. She bought it for $200,000 and it is now worth $750,000. Although it has provided her with some nice rental income over the years, she is now in her mid-60s and has grown tired of the work associated with maintaining the building and dealing with her renters. She is ready to sell.

Sharon contacts the president of the hospital to see if it is interested in acquiring her property. The hospital is, in fact, eager to add space. The president raises the possibility of Sharon donating the property, but Sharon makes it plain that she needs to realize some profit on her original investment. The president thanks Sharon for visiting, then heads down the hall and sticks his head in the door of Lisa Strich, his Director of Gift Planning. "What can we do for Ms. Johnson?" he asks.

Lisa describes a bargain sale to the president and suggests that Sharon might be comfortable selling her building for half its market value, $375,000, as that would still be almost double her purchase price. The president is intrigued, but wonders if that cost could be spread over several years, as the hospital is still recovering from financial strain it encountered during the Great Recession. Lisa then mentions an installment bargain sale. "Great!" exclaims the president. "Work up a proposal for me that shows a total payment of $375,000 spread out in five $75,000 installments over five years."

One challenge of doing an installment bargain sale calculation is choosing an appropriate interest rate for determining the interest component of the payments. This interest rate should reflect current market interest rates for loans of a term length similar to the term length of the installment payments. It does not need to be the IRS discount rate (Section 7520 rate) that is used to compute the deduction for most planned gifts. The higher the interest rate used, the greater the interest component of the installment payments will be (and the higher the charitable deduction).

Once the interest rate has been settled on and a payment schedule agreed to, the rest is mechanics. In the illustration Lisa puts together for Sharon, she assumed a 2.4% interest rate. Note: the calculations below were generated with PG Calc's *Planned Giving Manager*.

ASSUMPTIONS:

Date of Gift	12/12/2013
Value of Property	$750,000.00
Cost Basis of Property	$200,000.00
Interest Rate for Installment Loan	2.4%

Payment Schedule	annual

BENEFITS:

Charitable Deduction	$392,194.43

PAYMENTS AND TAXATION:

Payment Date	Payment Amount	Capital Gain	Tax-free Portion	Interest Income	Remaining Balance
12/12/2013					$357,805.57
12/12/2013	$75,000.00	$54,982.95	$19,993.80	$23.25	282,828.82
12/12/2014	75,000.00	50,022.21	18,189.90	6,787.89	214,616.71
12/12/2015	75,000.00	51,222.75	18,626.45	5,150.80	144,767.51
12/12/2016	75,000.00	52,452.09	19,073.49	3,474.42	73,241.93
12/12/2017	75,000.00	53,710.75	19,531.18	1,758.07	0.00
Total	**$375,000.00**	**$262,390.75**	**$95,414.82**	**$17,194.43**	**$0.00**

The illustration shows that Sharon would receive an income tax charitable deduction of over $390,000 in addition to five payments of $75,000 each. The tax deduction will help her offset the roughly $50,000 in capital gain she will need to report each year as she receives payments. In addition, close to $20,000 of each payment will be considered a tax-free return of principal and only a modest (and declining) amount will be interest income taxable at ordinary income rates. In contrast, if Sharon were to receive her $375,000 all at once, she would earn a deduction of $375,000, but have to report $275,000 of capital gain income in the same year.

A caveat

If a charity acquires an asset through an installment bargain sale, it must make use of the asset in fulfilling its charitable purposes. If it fails to do so, then it is deemed to have incurred acquisition indebtedness, and this will generate unrelated business taxable income in connection with the interest component of the installment payments received by the donor. By contrast, this issue does not arise with a bargain sale featuring a single payment made at the time of the sale.

In the example above, the hospital intends to use Sharon’s property to expand its facilities, so the gift will not generate any unrelated business taxable income for the hospital. This would be true even if the hospital were to raze the apartment building in order to build a new facility on the land beneath it.

Conclusion

The installment bargain sale can be an attractive solution in select gift situations. The example above illustrates a set of facts where the installment bargain sale is a natural fit, but its usefulness is not limited to gifts of real estate. Also consider the installment bargain sale whenever you work on a gift of tangible property, such as artwork or antiques.