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Funding a Charitable Gift Annuity with Real Estate
PG Calc Featured Article, September 2012
http://www.pgcalc.com/about/featured-article-september-2012.htm

When a donor wants to give real estate to a charity in return for lifetime payments, the donor typically creates a charitable remainder unitrust, probably containing a "flip" provision that allows the trust to convert to a standard charitable trust upon the sale of the property. However, if the charitable remainder unitrust value shrinks, the trust payments shrink, too. With this in mind, some donors may prefer a gift annuity because the amount of the payments is fixed. The payments also constitute a general obligation of the charity – an attractive measure of security for many donors. In addition, a gift annuity may be the only practical life-income alternative for the charity when the value of the property is too low to justify establishing a trust.

Real estate gifts entail greater risk for the charity

In accepting a gift of real estate for a gift annuity, it is important to recognize that the charity assumes considerable risk. It commits itself to fixed payments without knowing when the property will sell or for how much. Prior to the sale, it must use its own funds to make the annuity payments, and cover any other various expenses. The net amount remaining for the charity to invest after absorbing these expenses, and paying selling costs, may be insufficient to sustain the payments for the life of the annuitant, in which case the charity will lose money.

Strategies a charity can use to minimize risk

If a charity is considering accepting a gift of real estate to fund a gift annuity because a trust isn't practical, there are ways that it can minimize risk:

1. Adjust the gift annuity rate to take into consideration the fact that net proceeds might be less than the appraised value.

The gift annuity payment can be any amount mutually agreed upon by the donor and the charity subject to two conditions:

a) The payment must result in the present value of the annuity being less than 90 percent of the value of the property transferred; otherwise the gift annuity may result in unrelated business taxable income. (See IRC Secs. 501(m) and 514(c)(5)); and

b) If the annuity is issued in a regulated state to which the charity has submitted a schedule of rates, it cannot vary from those rates, except to offer a lower rate with the donor's knowledge and consent.

Fearing that the net sales proceeds may be substantially less than the appraised value, some charities offer to pay an annuity equal to the calculated rate for a person of the annuitant's age multiplied by the net sales proceeds. They may therefore delay executing the gift annuity agreement until the property is sold, and they indicate on Schedule A of the gift annuity agreement that the value of the property contributed was the net sales proceeds.

If the charity does not want to delay the creation of the agreement, the safest way to proceed is to make a conservative estimate of the net proceeds and offer a gift annuity rate equal to:

$$\frac{\text{estimated net proceeds}}{\text{appraised value}} \times \text{normal gift annuity rate}$$

This calculation results in discounting the gift annuity rate. The donor, of course, should consent to the rate through a written document.

It is the rate, not the property value, that should be discounted, for the value of the property reported on Schedule A of the gift annuity agreement should be the same as the value determined by the appraisal of the real estate and that which is entered on IRS Form 8283. The financial consequences to the charity are the same whether the property value or the gift annuity rate is discounted 10 percent.

In the event this is a hot property and a sale is expected soon after the transfer, the gift annuity payment might be determined and the gift annuity agreement executed after the sale. This would enable the rate reduction, if any, to be based on the known proceeds rather than on an estimate of them. The effective date of the agreement, which is the date of the gift, would be the date the deed to the property was transferred by the donor to the charity.

Keep in mind that the charitable deduction is based on the appraised fair market value of the property, using the nearest age of the annuitant and the applicable IRS discount rate as of the date the deed is delivered (or the rate for either of the two preceding months). The date of sale is not the contribution date, nor are the net sales proceeds the contribution amount.

2. Do advance marketing and possibly identify a buyer prior to the date the property is transferred.

According to Revenue Ruling 78-197, a sale of real estate will not be considered prearranged, and the donor will not be taxed on the capital gain, if the charity is under no binding obligation to sell the property. If the charity, in anticipation of a gift of real estate, talks to prospective buyers, determines that one or more of them is seriously interested, receives the property, and soon thereafter enters into a purchase and sale agreement with one of these buyers, the donor should not be exposed to taxation on the gain because the charity was under no binding obligation to sell at the time of the gift.

Wanting more assurance, the charity might go a step further and enter into an oral agreement to sell for a certain price, contingent upon its receiving the property for a gift annuity. Some would say the charity has not gone too far because it has stopped short of a legally enforceable sales agreement (assuming state law does not treat an oral commitment as binding).

The charity may go even further and actually enter into a written sales agreement with a prospective buyer and possibly open an escrow account. It could be argued that the donor has not subjected the charity to an obligation to sell, but that the charity, being under no compulsion to do so, has simply made arrangements to sell in the event it receives certain property by gift. This argument might prevail, but certainly the risk level has increased.

While these strategies may minimize the charity's financial risk, they progressively increase the risk of immediate recognition of all capital gain in the property. For that reason, more cautious gift planners may prefer to control risk by 1) offering a discounted annuity rate, 2) doing advance marketing but stopping short of any purchase and sale agreement, and/or 3) using one of the next two strategies.

3. Exercise a "put" agreement with a prospective buyer in advance of the transfer of the property.

In advance of the anticipated gift, the charity and the buyer can enter into a "put" agreement which would state that if the charity receives a gift of x property, it has a period of y days to require the buyer to purchase the property, based on certain terms and conditions that would be set forth.

This appears to satisfy the conditions of Revenue Ruling 78-197, which states that the gain will not be taxed to the donor, provided that the charity is under no legal obligation to sell the property. In this instance the "put" gives the charity the right to require a purchase, but it is under no obligation to exercise the "put." The charity would be subject to little financial risk, for it would not accept real estate for a gift annuity until the "put" is in place and it knows that it can sell the property for a specified price.

Although this strategy is not without risk, and is not supported by any ruling, it appears to be a lower risk than if the charity had a pre-existing or oral agreement that required it to sell the property subject to certain terms.

4. Ask the donor to defer gift annuity payments for a period of time.

Another possibility would be to see if the donor would agree to defer payments for perhaps two years or more so that the charity can avoid advancing money for annuity payments prior to the anticipated sale.

As an alternative, instead of deferring payments for a specified period of time, the donor might execute a flexible deferred gift annuity agreement. There would be an understanding between the donor and the charity that the donor would not elect to begin payments until the property has been sold.

Other risk considerations

In addition to the risks already noted, namely being unable to sell the donated real estate, or of realizing less of a charitable gift than anticipated, there are the risks associated with any type of real estate gift. To minimize these, the charity should always perform due diligence on the property such as researching the title and the possible liability for cleanup of environmental pollution.

Excise tax

Many states assess an excise tax on real estate sales. This could be one percent or more of the sales proceeds. If the state regards the present value of annuity payments as an amount received, that value could be subject to the excise tax. This would ordinarily be the responsibility of the seller, or the donor in the case of a gift annuity. Charities should determine the possible existence of excise tax when real property is contributed for a gift annuity and make the donor aware of any tax that will she will owe.

A gift annuity funded with mortgaged real estate

It is possible, though usually not desirable from the charity's standpoint, to transfer mortgaged property for a charitable gift annuity. The bargain sale rules under Reg. Sec. 1.1011-2(a)(3) apply in this situation, and so the donor will have to recognize the capital gain allocated to the mortgage. In some instances the donor may incur a net cost in the year of the gift because the capital gain recognized in the property exceeds the charitable deduction.

The charity should be mindful of the fact that it will have acquisition indebtedness, possibly resulting in taxable income, unless the mortgage was placed on the property more than five years before the gift and was held by the donor for more than five years before the gift. See IRC Sec. 514(c)(2)(B).

Still, giving real estate with a mortgage may be attractive to the donor, who is relieved of mortgage payments and can count on the fixed payments of an annuity. However, the charity not only has to make those payments but also has to service the mortgage, so it must carefully weigh the costs against the potential eventual benefits.

Conclusion

A gift of real estate to fund a gift annuity can work well for the donor and charity alike, but the charity must do its due diligence and be mindful of the potential risks. Since for many donors real estate is their most valuable asset, a gift annuity may be the only practical life-income option if the value of the property is too low to justify establishing a trust. As long as the charity carefully considers the possible risks, and takes steps to minimize them, a gift annuity funded with real estate can be an excellent gift in the long run.