From the Professionals

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From Nuisance to Gold: A Charitable Strategy for Avoiding Capital Gains on the Sale of Appreciated Real Estate

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At a time when people have watched their stock portfolios shrink and many investments fail, real estate has continued the steady growth in value it has enjoyed, virtually unabated, since the Second World War. While it is wonderful to have at least one part of an investment portfolio performing well, commercial real estate investments can be a real day-to-day management headache. Even if the property is strictly "recreational" in nature or just being held for its investment potential, there are ongoing costs, and a "recreational" investment in land is neither liquid nor producing a net income stream.

Over the years I have met a number of people who have held an apartment building or other form of relatively labor-intensive income producing real estate who wished to liquidate it and transform it into investments that are easier to manage. Likewise, those who held highly appreciated recreational or investment real property sometimes wished to cash in on their bounty prior to their deaths. All these people felt deterred from selling their real estate because of the substantial capital gains tax liability that they would incur when they sold it outright.

Possible Alternatives

In these situations, doing a 1031 exchange is one alternative. Using that provision of the tax code, a holder of real estate is allowed to exchange one piece of real estate for another without incurring capital gain tax liability. However, if you do not wish to hold real estate anymore, the 1031 exchange has served only to change the address of your investment headache. It does not take it away. It has not helped you change your real estate investment into stocks or bonds or another type of asset that is not real estate.

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There is, however, another alternative. This option transforms your real estate into a current year tax deduction, allows it to be sold while avoiding capital gains tax, provides a lifetime income stream and allows you to leave a charitable legacy that can improve the world we all share. The Charitable Remainder Trust, when properly structured and funded, can do all these things for you and your real estate "headache."

Benefits

Although charitable remainder trusts were in existence long before, the Internal Revenue Code recognized the charitable deduction for gifts to a charitable trust in 1917. Like most other trusts, charitable remainder trusts are created by a written instrument and must be funded with assets either during your life or at your death.

A charitable remainder trust can be a wonderful mechanism for helping your favorite charities while deferring and, in most cases eliminating, capital gains tax on the transfer of the asset. It generates a sizeable current-year tax deduction; the proceeds of the sale provide lifetime income for you and/or your spouse; you avoid capital gains while transforming your real estate into an investment of a different character; and you also extend a benefit to your favorite charities in the process. So what's the catch? In most instances, there really isn't any "catch." However, once your assets are transferred into the trust, they belong to the trust and will not be available for your use, except for the distributions you will receive during your life.

Example: Individual

Let me explain the concept more

fully by using an example. Mrs. Widow, age 69, has a piece of commercial property worth $750,000 that was bought by her now deceased husband 12 ago. The current basis in the property is $50,000. Mrs. Widow does not enjoy being a landlord and the property needs maintenance and repairs. If she sells the property for $750,000, she will have a tax liability of $105,000 on her $700,000 capital gain. Her net will be $645,000, which she can then invest in other assets. If she receives a return of 5% on her investments, her asset will generate $32,250 in annual income.

However, if she creates a charitable remainder trust, which is funded with her property prior to making a contract to sell, her results look much different. The trust would receive the full $750,000, which, if the trust payout amount is set at 5%, will generate an income of $37,500 in the first year. In addition, she will receive a deduction for her charitable contribution of over $390,000[1], which, if she is in the 28% tax bracket, could save her an additional $109,000 in income taxes[2].

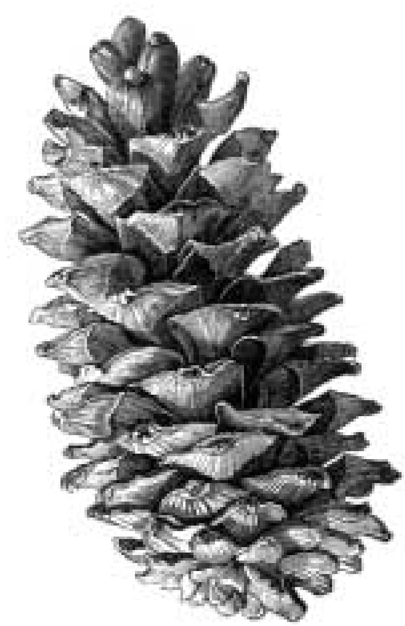
If she is subject to the estate tax, the assets of the charitable remainder trust will pass, without tax, to her favorite charities outside of her estate and avoid any estate tax that otherwise would have been incurred on those assets. In short, she will have the full $750,000 to provide her with an income stream. She will also have potentially saved another $109,000 in income taxes, which she can use or invest as she wishes.

Example: A Couple

What if a husband and wife, both ages 75, are in the same situation, but want some of the proceeds to use right now? They could also develop a plan in which they funded their charitable remainder trust with a ⅔ interest in the property. Then they would have an investment of $500,000 in trust that could then be sold without capital gains tax. With a 5% payout, they will receive income of $25,000 per year until the last of them dies. Although they will potentially have to pay capital gain taxes on $233,333 (⅓ less basis) of the proceeds, they will receive a charitable income tax deduction of over $249,000[3] that they can use to offset the tax liability on the gain.

Considerations

There are some things to remember if you do decide to create a charitable remainder trust. First, it is



charitable! Whatever remains in the trust after you and your spouse pass away will go to charity. This is a wonderful opportunity to leave a lasting legacy that can impact our world for years to come.

Second, this is a highly technical and specialized type of trust. To qualify for treatment as a charitable remainder trust, it must be properly structured in all details. Make sure your professional advisor is intimately familiar with the nuances of charitable trust law. If you do not have an advisor, please contact me or the Pinchot Institute's Kendra Miller for leads on estate planning attorneys in your area.

Third, when funding a charitable remainder trust with real estate, be sure that you have not contracted to sell the property prior to its transfer into the trust. If you have, the IRS may assert that you have made a "prearranged sale" and you will be taxed on the gain. Get your advisor involved early in the process and, whatever you do, do not sign a contract to sell your property before it is transferred into the trust!

With those things in mind, remember to keep this powerful, planning concept in your tax-planning arsenal. It can save you bundles now and help you leave a lasting legacy as well.

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1. *Figures are based on the AFR rate for the month of May 2003. These rates fluctuate on a monthly basis. Contact your professional advisor for the actual deduction based on current AFR rates*

2. *Unfortunately, charitable deductions for gifts of appreciated property may be deducted only to the extent of 30% of your adjusted gross income. Fortunately, the charitable deduction may be "carried forward" for up to five additional years. You could potentially see a 30% reduction in your income taxes for six years from one gift. Now that's a gift that keeps on giving!*

3. *Based on AFR for May, 2003.*