REAL ESTATE LIFE INCOME OPTIONS

There are two major ways to transfer real estate to charity and create life income for you and your spouse and perhaps others. Life income from real estate flows from the use of Charitable Gift Annuities (CGA) and/or Charitable Remainder FLIP Trusts (FLIP CRT).

Charitable Gift Annuity (CGA)

A CGA is a contract between the Arts Council and a donor whereby the donor transfers property to the Arts Council in exchange for income payments for one or two lives. Although many CGAs are funded with cash or securities, homes and land may be used to provide the donor with important benefits. The benefit is donors will not incur any immediate capital gains tax. Instead, the donor will bypass the capital gains tax on the gift portion and recognize a pro rata share of the gain on the contract portion of the annuity. Any capital gain will be reported over the life expectancy of the donor.

When establishing a life income agreement (CGA or CRT), the donor will not retain the right to live in the residence or the right to use the property.

There are potential market risks and carrying costs associated with real estate therefore the current appraised value of the property will be discounted by 10-15% to cover these costs. This increases the charitable value of the deduction for the property. The CGA payment rate may also be reduced to safeguard the Arts Council.

Example 1 – Gift and Gift Annuity – Jason just made the final mortgage payment on his home, which is valued at $500,000. He wants to sell the property and reinvest the proceeds for retirement income while he travels the country. Jason has heard that a CGA would provide him with reliable income while bypassing part of his capital gains. His favorite nonprofit, the Arts Council, has some concerns. First, the home may sell for less than $500,000. Second, the Arts Council would be responsible for property taxes, insurance and maintenance until the home is sold. Finally, the nonprofit knows it will pay closing costs and broker's fees of 5% to 8% upon sale.

After weighing the risks, the Arts Council offers Jason a CGA with a funding amount of $425,000, which is equal to 85% of the appraised value. Under the CGA agreement, Jason will receive a 6.4% annuity, or $27,200 each year. Jason receives a charitable deduction of approximately $163,000. He also receives an additional deduction of $75,000 for the outright gift, the difference between $500,000 (appraisal value) and $425,000 (CGA funding value). Jason is pleased with his total deduction of $238,000 and his steady stream of payments as he travels in retirement.

Charitable Remainder Unitrusts (CRUT)

A CRUT may be a good option for a donor who desires to move out of his or her residence but would incur significant capital gains taxes if the house were sold outright. This tax-free sale of the home inside the trust allows the trustee to reinvest all the sale proceeds, providing investment diversification without immediate payment of any capital gains tax. In addition to a tax-free sale of the home, a CRUT provides a charitable income tax deduction and an income stream.

One of the risks, however, of funding a CRUT with real estate is that the home cannot always be sold immediately. Thus, there may be no liquidity to make a unitrust payment. To alleviate this concern, a Net Income plus Makeup Charitable Remainder Unitrust (NIMCRUT) or FLIP CRUT is usually recommended. With either type of CRUT, the trustee is not forced to make a trust distribution unless there is actual trust income.

REAL ESTATE LIFE INCOME OPTIONS (continued)

Example 2 - Brent and Suzanne have lived in their large 4-bedroom home for many years. It has a cost basis of $200,000 and is valued at approximately $1,000,000. They are interested in obtaining cash to move to a retirement condominium. Although they qualify for the $500,000 home exclusion of capital gain, they would still owe some capital gain tax if they sold the property. They are also worried that, with mortgage rates so high, the home may not sell right away.

Brent and Suzanne learn about the benefits of a FLIP unitrust. If they transfer their home into a 6% FLIP unitrust, the trustee will not have to make immediate payments. Once the property is sold tax-free, the trust will flip to a straight unitrust payout. Since they can use their $500,000 exclusion to offset the gain, they will bypass $300,000 of gain on the unitrust. In addition, they receive an income tax deduction of $288,920 with the CRUT. This saves additional taxes on their other income.

For their two lives, the unitrust is expected to earn 7% and make payments of 6%. Over the course of the trust, their payments will start at approximately $60,000 per year and increase each year, reaching $75,000 as they approach life expectancy. Over the anticipated 28.3 years, the trust will pay almost $1.9 million to Brent and Suzanne. The couple uses their savings to purchase their retirement condo and they use the unitrust income for their living expenses.

Unitrust and Sale

Another strategy for donors who would like to receive cash back or pay off debt on the property is a Unitrust and Sale gift. With this plan, a donor transfers an undivided percentage of the property into a CRUT and retains the remaining undivided percentage. For example, a donor may transfer 60% of a home into the CRUT and retain the remaining 40%. After the trust is funded, the home is sold, and the sale proceeds are divided between the CRUT and the donor in proportion to the ownership interests. This plan is an effective way for a donor to fund a CRUT and receive some cash back. Furthermore, if apportioned carefully, this plan can potentially provide a zero-tax solution by offsetting the tax on the cash portion with the charitable deduction.

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