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For many individuals, real estate represents a significant portion of their wealth. The availability of a variety of planning techniques can make charitable gifts of real estate financially appealing to donors. Real estate is, therefore, a logical candidate for charitable giving. But as an asset class, real estate tends to be illiquid and presents other planning challenges as well. Like gifts of art, the focus of our October issue, gifts of real estate require the donor and the charity to work closely with each other to develop a plan that is agreeable to both. And donors will need advice from their own tax, financial, and legal advisors to make sure they are optimizing the tax and financial benefits associated with their gift.

A fundamental question is whether a charity will accept a gift of real estate at all. The New York Community Trust generally will accept a real estate gift only if it is contributed to a charitable trust with one of our trustee banks serving as trustee and shouldering the responsibility for managing and disposing of the real estate. We generally do not accept real estate gifts to Community Funds, Inc., our nonprofit corporate affiliate.

This issue is the fourth in the series devoted to charitable gifts of unusual assets. It concentrates on outright charitable gifts of a future or fee interest in real estate, rather than gifts of real estate held in an entity. Many concepts of general relevance to gifts of unusual assets—such as deductibility, appraisals, and the use of entities—are covered in greater detail in prior issues of the series. This issue focuses primarily on charitable gifts of real estate.
on lifetime charitable gifts of real estate, although we touch on some estate tax issues as well.

**Outright Gifts**

If real estate (other than inventory) is held for more than a year, it generally is treated as a long-term capital gain asset and the donor who gives the real estate to a public charity may be entitled to a charitable contribution deduction equal to the fair market value of the real estate. Such deductions are subject to the adjusted gross income and carryover limitations explained in detail in the March issue.

However, the depreciation recapture rules may reduce the amount of the deduction, particularly if the donated real estate was depreciated using an accelerated depreciation method. For example, if a donor makes a charitable gift of real estate (other than inventory) held for more than one year with a fair market value of $100,000, and $10,000 of the gain would be recaptured as ordinary income if the property had been sold for its fair market value (rather than donated to charity), the donor’s potential charitable deduction would be reduced from $100,000 to $90,000.

Before accepting a gift of real estate, charities typically seek a tremendous amount of information. The existence of certain statutory liabilities, including liabilities for possible zoning and building violations and liabilities imposed under various environmental laws, may present legal and financial risks to the charity. Often, charities will request broad indemnities and require environmental audits before they will accept a gift of real estate. Indeed, a charity may insist that the real estate be placed in a limited liability company and that the LLC interest be donated, in order to insulate the charity to the extent possible from liabilities associated with the property. When keeping the charity out of the chain of title is of paramount importance, a supporting organization might be used to accept and dispose of the gift. Some charities have supporting organizations established solely for such purposes.

With virtually any type of real estate, lack of liquidity is a concern. That concern is heightened if there are substantial carrying costs such as taxes, insurance, or maintenance, or if there is a limited ability to make the property produce income (ideally, tax-free rental income) during the period before sale. A charity may insist on doing a great deal of due diligence on marketability and carrying costs before it will agree to accept a gift of real estate.

Strictly speaking, a cooperative apartment is not real estate. It is shares of stock in a cooperative housing corporation coupled with a proprietary lease. Because many donors think of their co-op apartments as real estate, they should know that a proposed gift of a cooperative apartment presents an especially complex proposition—for them, for the charity, and probably for the co-op corporation as well. Even assuming the charity will be admitted as a shareholder, the charity still has to be comfortable with the finances of the corporation and its limitations on the use and transferability of the co-op shares.

**Partial Interest Gifts**

Under Code Section 170, a deduction is allowed for a charitable contribution of a partial interest in property made in qualifying form. One type of partial interest gift that qualifies for the charitable deduction is a gift of a remainder interest in a personal residence or a farm. Even though state law generally spells out the respective responsibilities of the life tenant and the owner of the remainder, it is generally advisable for these issues to be specifically considered in advance and dealt with in some form of agreement between the donor and the charity.

Another form of partial interest gift of real estate is a gift of an undivided fractional or percentage interest in the donor’s entire interest in the property. This technique enables a donor to donate undivided fractional

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1 All Code references are to the Internal Revenue Code of 1986, as amended, and all Regulation or Treas. Reg. references are to the treasury regulations promulgated thereunder.
or percentage interests in the property over a period of years until he or she has given his or her entire interest to charity. Donors who are unable to absorb a large charitable deduction can use undivided fractional or percentage interest gifts to spread their deduction over multiple tax years and maximize the value of their income tax deductions—and perhaps enjoy the benefit of any appreciation in the real property that occurs during the period over which the gifts are made. As we explained in our October issue, donors of works of art can no longer benefit from similar appreciation in the value of an artwork donated in fractional or percentage interests over a period of years.

In the case of fractional gifts, the ensuing ownership as tenants-in-common raises complex issues between a donor and a charity. As with gifts of remainder interests, state law provides default rules, but it is generally advisable that the parties expressly address the issues of co-ownership in a written agreement signed when the first fractional or percentage interest gift is made. This is particularly important if there are carrying costs that are to be allocated entirely to the donor during the period that the tenancy-in-common continues. A charity ordinarily will insist that the donor execute a binding agreement to donate his or her entire interest in the real property at, or before, death.

Bargain Sale
Real estate contributions can be structured as bargain sales or even bargain installment sales. In such an arrangement, the donor would either sell the real estate to charity for substantially less than the fair market value or would donate the property subject to a mortgage—that is, if the charity is willing to accept the financial burden of the mortgage and the potential exposure to unrelated business taxable income (UBTI), explained in greater detail below. The donor’s gain on the bargain sale would be equal to the sales price of the real estate (which would include the amount of any mortgage debt) less the allocable portion of the donor’s basis, and the donor’s charitable contribution deduction would be the fair market value of the real estate less the sales price. Bargain sale treatment resulting from a contribution of assets subject to liabilities is explained at length in the June issue.

Charitable Remainder Trusts
A charitable remainder trust (CRT) is a popular estate and financial planning tool and one that should be considered whenever a gift of real estate is contemplated. Typically, a CRT offers two important tax benefits:

• A current income tax deduction for the donor, equal to the present value of charity’s remainder interest in the CRT; and

• The CRT’s exemption from income tax, both on the capital gain generated when an appreciated asset, such as contributed real estate, is sold and on the subsequent amounts of income and gain earned when the proceeds of sale are reinvested (except with respect to UBTI, as noted below).

The CRT’s exemption from income tax has led some financial planners to analogize a CRT to an individual retirement account. And as with an IRA, the individual beneficiary of a CRT is subject to income tax on what he or she receives from the CRT—in the case of a CRT, based on the character of the distributed amounts within the CRT as either ordinary income, short-term capital gain, or long-term capital gain. (A distribution of CRT corpus is not treated as income to the beneficiary.) A CRT must meet the strict requirements of Code Section 664 and the corresponding Treasury regulations.

Ordinarily, a CRT funded with real estate will be structured as a “Flip CRUT” (explained in the October issue), so that there is no obligation to distribute any amount until the donated real estate has been sold. A gift of cash or marketable securities, in addition to the real estate, may also be advisable, so that the CRT has the liquidity it needs to meet its basic obligations (e.g., paying the trustee and professional advisors such as the accountant who prepares the CRT’s tax returns).
Careful planning is advisable on many fronts if a donor is contemplating the creation of a CRT. It is necessary, among other things, to ensure that the CRT is not a grantor trust (in which case it would fail to qualify under Code Section 664) and to be mindful of the private foundation rules that apply to CRTs. In particular, there must be no “acts of self-dealing” (e.g., no use of the real property by the donor or other “disqualified persons” and no sale or lease to a disqualified person).

In addition, there should be no UBTI in the CRT. Unrelated business taxable income could be triggered in a variety of ways—for example, if the real estate is being leased out in exchange for a share of the net profits of the tenants, if it is being developed and sold off as inventory, or if there is acquisition indebtedness (explained below). The concern about UBTI in a CRT is a very serious one. If a CRT has any UBTI during a given tax year, it will be liable for a 100% excise tax on its net UBTI. And because the tax is treated as having been paid out of corpus rather than the UBTI itself, the UBTI is effectively taxed again in the hands of the income beneficiaries.

Generally speaking, a CRT’s rental income and gain earned on real property subject to “acquisition indebtedness” is “debt-financed income” and as such is UBTI. There is a notable exception to this general rule: Mortgaged property acquired by a CRT by lifetime gift will not be treated as having acquisition indebtedness for the first 10 years after the gift if (i) the mortgage was placed on the property more than five years before the gift, (ii) the property was held by the donor for more than five years before the gift was made, and (iii) the CRT does not assume the mortgage or make any payment for the equity in the property owned by the donor (excluding the unitrust or annuity payments). A similar 10-year grace period (without the five-year holding requirements) applies when a CRT or other exempt organization acquires mortgaged property by bequest. Obviously, the exception is workable only if the CRT does not assume the mortgage debt (but rather, takes the property subject to the mortgage debt). The trustee of a CRT accepting such property might require comfort that the property will be sold or the mortgage will be paid down on a timely basis and paid in full within the 10-year grace period.

Conservation Easements
The Code permits an income tax deduction for a “qualified conservation contribution,” which is a transfer of a “qualified real property interest” to a “qualified organization” (i.e., a public charity or a governmental unit) for “conservation purposes.” A “qualified real property interest” is (i) a donor’s entire interest (other than a qualified mineral interest); (ii) a remainder interest; or (iii) a permanent restriction or easement on the use of the real property. “Conservation purposes” are defined to include preserving the land area for outdoor recreation by the public, preserving open space if it yields a significant public benefit, protecting a wildlife habitat, or preserving a historically important land area or a certified historic structure (subject to additional requirements). In the broadest terms, in order to qualify, a conservation easement must be a permanent restriction on the use of property to protect its resources and to protect against future land development or a particular use.

The Treasury regulations make it clear that any interest in the property retained by the donor and the donor’s successors in interest must be subject to legally enforceable restrictions (e.g., by a recorded deed restriction) that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation. Further, the regulations require that the qualified organization “have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions.” A donor should ensure that if the property is subject to a mortgage, the mortgage holder agrees to subordinate its rights in the property to the rights of the donee charity to enforce the easement in perpetuity. Otherwise, the donor will not be allowed a deduction for his or her contribution.

A donor who grants a conservation easement meeting the above requirements to a qualified organization can claim a charitable deduction for that
donation. As a general rule, the income tax deduction for the conservation easement is equal to the fair market value of the real property immediately before the easement reduced by the fair market value of the property after the conservation easement is granted—i.e., the amount by which the conservation easement has reduced the value of the property—subject to applicable deductibility limitations.

As we go to press, there is some uncertainty about the deduction limitation threshold and carry-forward period applicable to qualified conservation contributions. Under current law, a qualified conservation contribution generally is subject to a deduction limitation of 30% of an individual's "contribution base" (generally, the individual's adjusted gross income), with a five-year carry-forward of any unused deduction left over from the year the easement was granted. The Pension Protection Act of 2006 introduced temporary provisions that increased the deduction limitation for a conservation easement to 50% of adjusted gross income (AGI) for individuals and 100% of AGI for qualified farmers and ranchers, and extended the carry-forward period for unused deductions to 15 years. These provisions were extended through the end of 2009, but have since expired. There are proposals in Congress to extend these provisions or make them permanent—with retroactive effect for contributions made in 2010—but no such legislation had passed at press time.

Estate and gift tax deductions also are allowed for qualifying conservation easements. In addition, up to 40 percent of the value of land covered by the easement (reduced by the amount of any estate tax deduction for the value of the conservation easement itself) may be excluded from a decedent's gross estate, up to a maximum exclusion of $500,000. The 40% exclusion is phased out by two percentage points for each percentage point by which the value of the easement is less than 30% of the value of the underlying land (determined without regard to the value of the easement and reduced by any retained development rights). Although the federal estate tax is currently phased out for decedents dying in 2010, it is scheduled to return in 2011. Congress likely will review the estate tax, so it is uncertain how much of an effect the exclusion will have going forward. It also should be noted that certain geographic limitations with respect to the proximity of the land to a metropolitan area, wilderness area, national park, or "Urban National Forest" will be restored in 2011 unless the law is changed.

When a donor contributes a conservation easement to charity, a portion of the basis of the underlying property is allocated to the conservation easement, reducing the basis in the property that the donor continues to hold. If the conservation easement represents \( x \) percent of the value of the entire property (before the granting of the conservation easement), then the basis of the conservation easement will be \( x \) percent of the total basis of the property. This newly reduced basis may have adverse income tax consequences for the donor if he or she later sells the property subject to the easement at a gain.

Some organizations will purchase a conservation easement in a bargain sale transaction so the donor is partly compensated for the easement. The gain on the bargain sale is calculated only with reference to the portion of the donor's basis that is allocable to the sale portion of the transfer. In other words, the donor may not use his or her entire basis as an offset to the proceeds of sale. However, the donor's gain is partly offset by the resulting charitable deduction from the gift portion of the transaction—although the donor's charitable deduction is less than it would have been, of course, if the easement had been donated without consideration.

Several states have enacted income tax deductions or credits for the contribution of conservation easements. For example, New York's Conservation Easement Tax Credit gives individuals, estates and beneficiaries, certain corporations (excluding New York S corporations and not-for-profit corporations), and partnerships that own fee interests in New York land are subject to a qualifying conservation easement a refundable income tax credit.
of up to 25% of the property taxes paid on the restricted land, up to a maximum of $5,000 per year. When a trust or partnership owns a fee interest, the trust beneficiaries or partners respectively share the entity credit. The credit, which is subject to a variety of technical limitations, is available to the current owners of the restricted land regardless of when the easement was created. Donors should also consult with local or state taxing authorities to determine if they are eligible for a reduction in their real property tax for contributing a conservation easement to charity.

Façade Easements
A façade easement is a type of conservation easement that preserves a historical structure by restricting changes to the structure, assuring that the façade of the structure will be maintained, protected, and preserved forever. To qualify for a charitable deduction, a façade easement must be on a “certified historic structure,” which is defined as (i) a building, structure, or land area listed in the National Register of Historic Places or (ii) a building which is located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district. A structure must be a certified historic structure at the time of the contribution of the façade easement to charity and on the due date (including extensions) for filing the donor’s income tax return for the taxable year of the contribution.

Like a conservation easement, a façade easement must be donated to a “qualified organization” with the resources and commitment to enforce the easement. However, there are additional requirements for façade easements. For example, Treasury regulations require that the public have visual access to the façade or, if the façade is not visible from a public way, the terms of the easement must permit regular viewing of the façade by the general public. The IRS Form 8283 (Noncash Charitable Contributions) instructions impose a $500 filing fee for donors of façade easements claiming deductions of more than $10,000.

The statute imposes the following additional requirements with respect to façade easements on buildings located in registered historic districts and certified as being of historic significance to their districts: (a) the donor must place restrictions on the easement that preserve the entire exterior of the building and prohibit any change to the exterior of the building inconsistent with its historical character; (b) the donor and the donee organization must enter into a written agreement certifying that the recipient organization is a qualified organization with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, has the resources to manage and enforce the restriction, and has a commitment to do so; and (c) the donor must include a qualified appraisal, pictures of the entire exterior, and a description of all restrictions on the development of the building with the donor tax return for the year of contribution. The IRS appears to apply those three additional statutory requirements even to certified historic structures that are listed in the National Register of Historic Places.

A façade easement is generally valued in the same way as a conservation easement and is subject to the general rules and requirements of appraisal and valuation of real estate.

A word of caution about façade easements: The IRS frequently challenges donations of façade easements on buildings that already are “landmarked” and subject to restrictions under local zoning ordinances on the basis that “[a] taxpayer cannot give up a right that he or she does not have.”

Appraisal and Valuation
The general appraisal requirements, including qualified appraisals and penalties, explained in the March issue, apply to appraisals for real estate. In addition, for real
estate, including conservation easements, the IRS has provided specific valuation requirements.

Because each parcel of real estate is unique and its valuation is complicated, a detailed appraisal by a professional appraiser is necessary. In addition to a complete description of the property, the use to which the property is put, zoning and permitted uses, and its potential for other higher and better uses are also factors that are relevant in valuing real estate.

Other Considerations
Often, a donor will have engaged in negotiations with a potential buyer before a gift of real estate is completed. If there was an identified purchaser, an identified price, and a legally enforceable agreement to sell the property, the IRS may be able to demonstrate that the donor gave charity a gift of the proceeds of a sales contract rather than a gift of an appreciated asset. In such a scenario, the IRS would contend that the donor is taxable on the capital gain, albeit with a charitable deduction for the donor’s gift of the sales proceeds. This is an area where donors should proceed with particular caution.

Conclusion
Individuals who own real estate and have charitable interests should consider how a gift of real estate might advance their charitable planning objectives. Although there are complexities involved in giving real estate to charity, they do not diminish the ability of real estate to generate substantial tax benefits for donors and confer valuable financial and even programmatic benefits on the charities to which it is given.

For further reference see:
Code Section 170(b)(1)(C): Special limitation with respect to contributions of certain capital gain property
Code Section 170(e): Certain contributions of ordinary income and capital gain property
Code Section 170(f)(3): Denial of deduction for certain contributions of partial interests
Code Section 170(h): Qualified conservation contribution
Code Section 170(h)(4)(C): Certified historic structure
Code Section 170(o)(1): Special rules for factional gifts
Code Section 512(b): Unrelated business taxable income modifications
Code Section 514(a): Unrelated debt-financed income
Code Section 514(c)(2)(B): Exception to acquisition indebtedness treatment for certain property acquired subject to mortgage
Code Section 664(c): Taxation of trusts
Code Section 664(d): Charitable remainder annuity trust and charitable remainder unitrust definitions
Code Section 1011(b): Bargain sale
Code Section 2031(c): Estate tax exemption with respect to land subject to a qualified conservation easement
Code Section 2055(f): Estate tax deduction with respect to land subject to a qualified conservation easement
Code Section 2522(d): Gift tax deduction with respect to land subject to a qualified conservation easement
Code Section 4941: Excise tax with respect to acts of self-dealing
Treas. Reg. Section 1.170A-4(b)(1): Ordinary income property
Treas. Reg. Section 1.170A-4(b)(3): Unrelated use
Treas. Reg. Section 1.170A-7(b)(1): Undivided portion of donor’s entire interest
Treas. Reg. Section 1.170A-12: Valuation of a remainder interest in real property for contributions made after July 31, 1969
Treas. Reg. Section 1.170A-14: Qualified conservation contributions
Treas. Reg. Section 1.170A-14(d)(5)(iv): Public access to historically important land area or certified historic structure
Treas. Reg. Section 1.664-1(c) Excise tax on charitable remainder trusts
IRS Publication 526: Charitable contributions
IRS Publication 561: Determining the value of donated property
Internal Revenue Manual 4.48.2
Internal Revenue Manual 8.18.1.3
Rev. Proc. 96-15, 1996-1 CB 185
Rev. Rul. 87-37, 1987-1 CB 295
Rev. Rul. 79-419, 1979-2 CB 107
Rev. Rul. 78-303, 1978-1 CB 122
Rev. Rul. 75-66, 1975-1 CB 85
Stark v. Comm’r., 86 TC 243 (1986)
Notice 2004-41, 2004-2 CB 31
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About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to a community’s vitality.

Grants made from these funds—which now number nearly 2,000—meet the needs of children, youth and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works collaboratively with other funders and with government, and gets out information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester. In 2009, The Trust made grants of $123 million from $1.7 billion in assets.

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