Gift Planning Now

A Newsletter for Berkeley's Donor Advisors

Spring 2015

The Time May Be Right for Gifts of Real Estate – And It Doesn't Have to Be 100%

With a strong real estate market in many areas, now might be a good time to consider an outright gift of appreciated real estate. An outright gift to charity **of all or a portion of real property** is accorded special treatment that may make it the ideal gift asset for certain clients. Some of the potential benefits include:

- Reduced income taxes
- Reduced estate taxes
- Avoidance or reduction of capital gains taxes
- Financial security with increased liquidity

Jean is a real estate investor who has done well over the years trading property on a tax-deferred basis – so-called "like-kind exchanges." As a result, she owns a parcel of highly appreciated property with a very low cost basis. Jean wants to cash in on her real estate success in a tax-wise way that will build a nest egg. Additionally, she faces substantial capital gains taxes if and when she sells.

Jean might consider, prior to any sale, donating a part of the property. For example, if the fair market value of the property is $500,000, she could give an undivided fractional interest – a portion worth $200,000, for example – and get a charitable deduction of approximately $200,000. The deduction could save up to $70,000 in taxes in her 35% tax bracket. Any unused deduction can be carried over for up to five more years. Assuming a combined 18.8% capital gain and net investment income tax rate (federal only), if the capital gain on the portion she retained was $200,000, her capital gain and net investment income tax upon a sale would be $37,600. This tax liability could be substantially reduced by her charitable deduction tax savings.

Another Record Year in Freshman and Transfer Applications

Figures released in January show more than 78,800 high school students have applied for 2015-16 freshman admission to UC Berkeley, a 7% increase over the previous year. Applications from transfer students increased as well, to about 17,200 applications, roughly a 4% increase over the previous year. The UC Office of the President released data that shows, for all campuses in the UC system, freshmen applications were up 6.5% and transfer applications were up 2.6%. Academically, Berkeley's 2015-16 applicant pool remains strong, with an average GPA of 3.65 (unweighted) and an average SAT composite test score of 1924. Transfer applicants have an average GPA of 3.49.

Retained Life Estates in a Low Interest Rate Environment

Sec. 7520 rates have started inching upwards lately, after hitting an all-time low of 1.2% in 2013. The March rate is 1.8%. These rates are used to value split-interest charitable gifts. Low §7520 rates generally make the charitable deduction somewhat less attractive for most split-interest gifts (charitable remainder trusts, charitable gift annuities). However, one gift technique shines in times of low §7520 rates: a gift of a remainder interest in a home or farm [Code §170(f)(3)(B)(i)]. Unlike other split-interest gifts, this one doesn't pay income, but it does allow the donor to continue using the property for life. From the donor's perspective, this type of gift is nearly "invisible."

A donor can contribute a remainder interest in a personal residence, but it need not be the donor's principal residence [Reg. §1.170A-7(b)(3)]. Therefore, a donor may contribute a remainder interest in a vacation home and continue to use the home for life. Consider Earl and Alice, ages 70 and 73, who own a second home in a popular vacation area. Assuming the value of the land to be $200,000 and the value of the home to be $400,000, their deduction would be $319,424 at a §7520 rate of 2%. At a §7520 rate of 6%, the deduction would be only $178,310. The deduction computation requires that the donor determine depreciation on the structure, as well as its value at the

UC Berkeley Planning Pointer:

Planning Now for 2015 IRA Gifts

While *The Tax Increase Prevention Act of 2014* (the "2014 Tax Act") extended for 2014 only the "qualified charitable distribution" provision of the Internal Revenue Code (commonly referred to as "IRA charitable rollover gifts"), it still may make sense to plan now for 2015 IRA gifts. Here's why.

This provision of the Code (IRC §408(d)(8)) was originally enacted in 2006, and has been re-authorized several times, most recently on December 19, 2014 under the 2014 Tax Act. There is no way of knowing now whether legislation to extend this provision will be enacted for 2015, although legislation is already pending in the House of Representatives (H.R. 644 would make the provision permanent).

The key requirements of the recently expired provision were that:

(i) the IRA account holder must be at least age 70½ at the time the distribution is made to the charity;

(ii) the distribution must be made directly from the IRA custodian to the charity;

(iii) the gift cannot exceed $100,000 per donor per year; and

(iv) no goods or services can be received by the donor in exchange for the IRA gift.

If a client needs to take his or her required minimum distribution for 2015, and they want to make a charitable gift of some or all of that amount, then making an IRA gift in compliance with the noted requirements should not adversely impact the client and may be beneficial if the provision is extended for 2015. If it is extended and those requirements remain the same, then by having complied with the requirements their gift could be made without incurring income tax on the withdrawal. (Of course a charitable deduction would not be allowed since the distribution would not be included in the client's gross income.)

If the law is ultimately not extended for 2015, then the IRA distribution would not qualify for exclusion from gross income, but the gift would qualify for an income tax charitable deduction as do other gifts to qualified charities.

end of the useful life, even though the value of a home may actually appreciate rather than depreciate.

A donor can also consider contributing farm property. Consider a donor, age 67, who owns land worth $750,000 that is currently used for farming. If he contributes a remainder interest in the property to his favorite charity, his charitable deduction would be $550,194 (using a §7520 rate of 2%). The same gift calculated with a §7520 rate of 6% – a rate not seen since mid-2007 – would yield a deduction of only $325,224. The donor can continue farming the property himself or rent it and keep the income.

What constitutes a "farm"? Reg. §1.170A-7(b)(4) defines it as any land used by the donor or his or her tenant for the production of crops, fruits or other agricultural products or for the sustenance of livestock.

Note that there are a few issues that should be addressed before making a gift of a remainder interest in a home or farm:

What if the donor later wants to sell the property? The donor and UC Berkeley can jointly agree to sell the property, with each taking the respective actuarial value of the sales proceeds. The gift cannot be conditioned on charity being required to sell at some future time [Rev. Rul. 77-305, 1977-2 C.B. 72]. The donor could also make a second gift to UC Berkeley of his or her retained life interest in the property, thereby qualifying for an additional charitable deduction.

Who is responsible for expenses (e.g., insurance, maintenance, taxes) during the donor's life? Most state laws address the rights and responsibilities of a life tenant. At UC Berkeley, we have a written agreement governing these issues. In it, the donor will continue to be responsible for the property expenses.

Will the donor be able to use the entire deduction? The deduction for remainders in homes and farms is subject to a 30%-of-AGI limit [Reg. §1.170A-8(d)(3)]. Although there is a five-year carryover for excess deductions, the donor may or may not be able to use the full amount in six years [Code §170(b)(1)(B)].

Tax Planning Pointer – Charitable Gift Annuities

Under the bargain sale rules that apply to charitable gift annuities, the long-term capital gain realized when appreciated assets are used to fund a gift annuity can be reported ratably over the annuitant's life expectancy only when the annuity is either nonassignable or assignable only to the issuing charity [Reg. §1.10112(a)(4)(ii)]. Therefore, when a donor uses appreciated assets to arrange a charitable gift annuity to benefit another, the donor must recognize the gain on the annuity portion in the year of the transfer. If a donor wants to create a gift annuity with separate property but have it payable to donor and spouse, the capital gain can be spread only over the donor's life expectancy.

Estate Receives Costly Lesson with Charitable Bequests

Verne's living trust included pecuniary bequests to two charities. Verne's trust was also the designated beneficiary of his IRA, At his death, the value of the charitable bequests exceeded the trust's non-IRA assets.

A state court order reformed the trust to provide that the trust's distribution of IRA assets to charity would be treated as direct bequests, rather than as income in respect of a decedent under Code §691. In the alternative, the reformation was designed to qualify for a charitable deduction under Code §642(c)(1).

In general, if a trust or estate satisfies a pecuniary legacy with property, the payment is treated as a sale or exchange of the property [*Kenan v. Comm'r.*, 114 F.2d 217 (2d Cir. 1940)]. Because the trustee will use a portion of the IRA assets to satisfy Verne's pecuniary legacies, the IRS ruled that the trust must treat the payments as sales or exchanges and thus include the IRA in the trust's gross income to the extent the IRA was used for the charitable bequests. No charitable deduction is allowed under Code §642(c)(1) because the trust terms do not require the pecuniary gifts be made from the trust's gross income. Thus, the transfer of the IRA assets to satisfy pecuniary bequests does not entitle the trust to a deduction under §642(c)(1). Because the court order was designed to obtain tax benefits, not resolve a bona fide will contest, the IRS said it is not required to respect the reformation (Ltr. Rul. 201438014).

When Business Gifts to Charity Do Not Qualify for Charitable Deduction

A limited liability company that was required to make payments to charity – as a condition for operating in the state – conveyed a portion of its annual gross income from three facilities that it ran. In 2010, 2011, and 2012, there were deficiencies between the required payment amounts and the LLC's actual gross income transfers. For those three years, the LLC made cash contributions to charity to address the shortfall.

Under Rev. Rul. 72-314 (1972-1 C.B. 44), whether payments to a charity are deductible under Code §170 as a charitable deduction or under Code §162 as a business expense depends upon whether the payments are completely gratuitous or whether they bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of a financial return commensurate with the amount of the payment.

The IRS found that because the payments satisfy a condition of its certificate to operate in the state, they are not deductible as charitable gifts. Failure to make the payments could jeopardize the LLC's continued operation in the state, the IRS said. Therefore, the payments bear a direct relationship to the business and are deductible as ordinary and necessary business expenses under Code §162(a) (Ltr. Rul. 201437004).

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