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Accepting Complex Gifts of Real Estate: A Builder's Guide

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NATIONAL ASSOCIATION of Charitable Gift Planners

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I. Introduction

Our *Real Estate Gift Acceptance Procedure Manual* ("Manual") was born out of necessity because University of the Pacific ("University") is located in California and for many of our donors real estate is the most significant part of their net worth. Our planned giving team identified that the University's ability to accept real estate gifts would increase a donor's ability to give a larger gift. However, we soon identified a serious issue with institutional readiness to accept real estate gifts. In addition to some of the usual cultural tensions between development and finance, turnover of planned giving staff and a generally low volume of real estate gifts in the recent past meant that we did not have a strong institutional memory to draw upon.

We had only piecemeal procedures in place so the obvious solution was to build a Manual that included step-by-step processes to evaluate, accept, and close real estate gifts in a timely manner—this proved easier said than done. The Manual needed to include document templates and responsible party charts that could be easily replicated each time the University received a real estate gift opportunity. This would help lay the foundation for the University to develop a real estate gifts program and ultimately lead to a robust pipeline built out of these unique assets.

II. Real Estate is Unique

Real estate is both unique and complex because there are many different types, and because no two pieces of real estate are identical. While real estate often comprises a significant portion of a donor's net worth, it is illiquid and there are often onerous taxes attached to selling the asset. Therein lies the inherent benefit of a donor giving a piece of property rather than a similar amount of cash or liquid assets.

Convenience may be another reason donors would prefer to give real estate; even in cases where there may be no tax cost to selling, older donors might appreciate being able to give a property rather than selling it themselves. This can be particularly true in cases of advanced age, incapacity or when the move from the personal residence is an emotional event (i.e., after the death of a spouse or a move to assisted living).

Primary Residences. Typically, a residence is the traditional single-family home -- but a primary residence suitable for donating could also be a condo or a cooperative apartment. T*ax Considerations if contemplating a sale:*

- ✓ Capital gain. The tax code excludes $250,000 of appreciation for a single homeowner ($500,000 for a married couple), provided certain requirements are met for ownership and use of the home as a primary residence. Thus, higher-end properties or modest homes in expensive regions may be highly appreciated and subject to capital gains tax.
- ✓ Depreciation recapture: In some instances a homeowner who sells may face depreciation recapture. Possible scenarios include periods in which the house served as a rental or depreciation claimed for a home office. There is no exclusion from depreciation recapture, and the federal tax rate is 25%.

Vacation/Second Homes. The National Association of Home Builders estimated that in 2014 over 5% of the nation's housing stock was second homes (i.e., a non-rental property that is not the taxpayer's principal residence). *Tax Considerations if contemplating a sale:*

- ✓ The exclusion from capital gains for sale of a primary residence applies <u>only</u> to a primary residence; but note that what is now a second home might have been a primary residence in the past and thereby qualify for the exclusion.
- ✓ Attention should be paid to possible depreciation recapture issues (see above).

Farms. The definition of a farm comes from <u>Reg. 1.170A-7(b)(4)</u>: "…any land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock...A farm includes the improvements thereon." Thus, a farm may include a personal residence. Even though "farm" is the all-inclusive term used by the tax code, it may be helpful for marketing/education purposes to use terminology reflecting the culture and economy of the area, such as "vineyard" or "ranch", which are also "farms" in the above definition. *Tax Considerations if contemplating a sale:*

- ✓ If the farm includes a house, the personal residence exclusion rules will apply to capital gain. Otherwise, all appreciation will be subject to federal capital gain taxes.
- ✓ Selling a farm may give rise to issues related to ancillary assets such as crops, livestock, and equipment. The exact tax treatment of these assets is heavily dependent on the underlying facts.
- ✓ Depreciation recapture is also an issue.

Rental Properties. Single-family homes, and sometimes small apartment buildings, are good investments. Rental income may provide most or all of the cash flow for debt service, while the owner receives a significant tax deduction (claimed over 27.5 years) for depreciation. Once fully depreciated, however, owners have a strong incentive to divest, and many people who own rentals act as their own landlords; as they grow older, it can become more onerous to be called at midnight from a tenant who has locked himself out. *Tax Considerations if contemplating a sale:*

- ✓ Capital gain will be due on any appreciation, taxed in the donor's capital gain bracket.
- ✓ The owner must recapture any depreciation, taxed at the Sec. 1250 rate of 25%.

Commercial Real Estate. Strictly speaking, even farms and single-family homes held for rentals are "commercial property", but the term generally is applied to non-residential property used for business purposes, such as retail space, office buildings, factories, and industrial parks, or for large apartment complexes. Tax Considerations if contemplating a sale:

- ✓ Capital gain will be due on appreciation, and depreciation recapture is also a consideration.

Undeveloped/Vacant Land. A typical scenario may be a couple who buys a rural lot, intending to build a house later. It is also common to buy lots in in the path of future growth, which could give rise to large appreciation. *Tax Considerations if contemplating a sale:*

✓ Of course, capital gain will apply if the property is appreciated.
✓ Raw land does not normally generate income but does generate property taxes; thus, the owner may have a financial incentive to divest.

Other. Some assets connected to real estate include real estate limited partnership interests (RLPs), real estate investment trusts (REITs), cemetery plots, and timeshares. REITs and most RLPs are securities and need not be reviewed under a real estate acceptance protocol (though counsel should ascertain whether accepting the gift would create a liability for the charity).

Cemetery plots, while dirt, are also not real property for purposes of this discussion; rather, they are intangible personal property. Timeshares are often simply the right to occupy premises under conditions spelled out in the purchase agreement or other legal document; sometimes, however, they are indeed real property transferred by deed, in which case normal real estate acceptance procedures would apply. In any case, cemetery plots and timeshares have a well-deserved reputation for being a time drain from the charity's point of view and should be approached with extreme caution.

III. Types of Real Estate Gifts

Outright. The donor's entire interest in the property.

Undivided Fractional Interest. A percent of the donor's entire interest.

Retained Life Estate. A special deed that gives an irrevocable right to the charity to receive the property after the expiration of the life interest or term of years.

Bargain Sale/Installment Bargain Sale. A donor sells property to charity for less than its fair market value, with the gift being the reduced purchase price. The sale can be spread out in installments, which will defer recognition of gain. Typically, bargain sales happen when the charity wishes to acquire the property for its mission. Note: bargain sale **treatment** comes into play when a property has debt but is not to be confused with the bargain sale as a gift type.

Charitable Remainder Trust (CRT). A donor transfers assets to the CRT; the trust sells without incurring capital gains taxes; and the full net value goes to work to pay an income to the donor.

Charitable Gift Annuity (CGA). Just as donors give cash or securities in exchange for a gift annuity, they can give real estate. In practice, however, charities should approach such gifts with caution. When a charity wishes to acquire a property that would be important for its mission, a CGA can be a mutually beneficial alternative to a bargain sale (or an installment bargain sale). On the other hand, if the real estate is an asset destined for sale, the charity should consider the gift plan closely.

CGA in Exchange for a Retained Life Estate. Many charities offer gift annuities in exchange for a retained life estate, although not all states permit this technique. As with other gift annuities funded with real property, check with the pertinent state(s) to determine any reserve requirements. To the extent that the charity is making a loan to the reserve fund, it should be recognized that the funds will be tied up for the rest of the donor's lifetime.

Conservation Easements. Easements are an important gift type for conservation charities but are beyond the scope of this presentation, as they are not an asset that can be sold to a third party for value.

IV. Building a Real Estate Program

Well Documented Procedures. Well-designed processes and procedures are key to consistent "internal" communication. Our focus is on procedures, rather than policies, because in our organization policies must be approved by our Board of Regents. By implementing procedures, we were able to streamline the process for accepting gifts of real estate without a major restructuring of our policies. Through internet research, reviewing relevant articles and reaching out to peer and aspirant universities we determined a Manual would best meet our needs. (See *Real Estate Gift Acceptance Procedure Manual*).

Well Defined Roles and Responsibilities. In addition to identifying key action items, it was critical for our department to assess the roles and responsibilities required to take a real estate gift from start to finish. The *Real Estate Gift Responsible Persons Legend and Checklist* (See Manual at Appendix A-1) outlines who should take responsibility for each action item by initialing and dating when it is completed. The *Real Estate Process Flow Charts* (See Manual at Appendices A-2 and A-3) help us, as well as parties who are not familiar with the process, understand the "the big picture." We can see at a glance where we are in the acceptance process. This particular document was inspired by an excellent example shared with us by the University of California, Berkeley, Office of Gift Planning.

Phase I: Pre-Acceptance

Documentation. The pre-acceptance phase highlights documents that should be provided by the donor and to the donor by the development officer, estimation of value and visual inspection of the property before a conditional acceptance can be requested. When a donor first inquires about making a real estate gift, or after a proposal is accepted by the donor, the development officer presents the donor with our *Real Estate Gift Donor Inquiry Packet*. The *Packet* includes documents found in Appendices B-2 through B-4c and should include a preliminary gift illustration where applicable. We are grateful to our planned gift endowment managers at TIAA Kaspick for providing us access to a library of resources including checklists, questionnaires and articles.

Site Inspection. An initial site inspection involves a planned giving officer, financial officer or development officer visiting the property. This inspection should include photographs of the property and notes detailing obvious issues. "Obvious issues" are those that can be seen on a visual site inspection. We recommend that your organization take note of septic tanks, wells, storage of potentially hazardous materials that could leak into the ground and/or ground water (e.g. gasoline, oil, paint or pesticides), as well noting adjacent properties that could create contaminants (e.g. farm land, drycleaners or gas stations). This is the preliminary inspection, your organization should request an in-depth inspection by a licensed real estate inspector during the due diligence phase.

Broker Opinion. Another useful tool for determining an estimated value of the property is the real estate broker opinion, commonly referred to as a "drive by appraisal." Broker opinions, while not qualified appraisals for tax reporting purposes, are useful during the preliminary review of a potential gift. An educated estimate of value drives which options are available to the donor for gift purpose (e.g., endowment minimums) and donor recognition levels. Showing value is especially important when your team must make a case to the finance office as to why your organization should accept a particularly complex real estate gift. Generally, real estate brokers charge minimal fees for their opinion in the hope that you will list the property with them when you are ready to sell.

Departmental Collaboration. The give and take between the development and finance teams is vital to the success of any real estate gift. Regardless of the size and value of the potential real estate gift, or how much benefit your organization might receive from that gift, if the key financial officers or members of your governing board are uncomfortable with accepting gifts of real estate, your real estate gift program will not flourish.

Frequent Donor Communication. At each stage, communication with the donor is critical. Keep in mind that the donor is waiting to hear whether their generous gift meets muster. The party who maintains the donor relationship, along with the planned giving offer, will report back to the donor. If the gift is conditionally accepted, the donor receives a *Real Estate Gift Conditional Acceptance Agreement* outlining the conditions to be met prior to the closing the gift. If the gift is declined, the donor receives a declination letter explaining the reasoning. (See Manual at Appendices C-4 to C-5).

Phase II: Conditional Acceptance and Due Diligence

Support from Professionals. From the organization's perspective, employing professionals, whether directly in the real estate field or in the legal, financial planning, or accounting fields, can help your organization navigate the due diligence process. Professionals can help your organization determine which conditions should be met, which evaluations may or may not be necessary, as well as offer qualified opinions on usage, repairs and value.

Alternately, while the donors likely have their own professional team (i.e., family lawyer, financial advisor and tax preparer), the truth is that their professionals are generally unfamiliar with unique complexities of charitable gifts. Thus, the onus falls on the organization to do most of the "heavy lifting" with regard to running tax illustrations, drafting charitable trust templates, preparing contracts and identifying how highly appreciated assets can be used. The relative imbalance of expertise can sometimes pose diplomatic and ethical challenges.

Chain of Title. We recommend developing a relationship with a local title company so that you can request a preliminary title report as the first step in the due diligence process. The title report will identify any existing vesting issues and liens on the property, as these encumbrances can affect future marketability. Investing in a legal review of chain of title shows your finance partners that the property is a sound investment.

Environmental Site Assessment. Involves an assessment of various known, potential and contingent environmental contamination liabilities in addition to confirming compliance with local, state and federal obligations associated with owning and selling real property. The most common type of assessment, commonly referred to as a Phase 1 Environmental Site Assessment (ESA), is a report that identifies and analyzes contaminants in underlying the land and structures. It protects your organization from accepting a contaminated property, provides assurances that any environmental concerns are within reasonable limits and provides information needed in order to conduct additional due diligence. Unless the site inspection raises concerns, it is our regular practice to only order a Phase I ESA for non-residential property. If we determine that a property should have a Phase I evaluation and that uncovers possible contaminants then the gift will likely be declined by the University. Thus, a Phase III ESA would never be needed during the due diligence process.

Real Property Inspection. A real property inspector, commonly referred to as a home inspector, should be licensed in the county and/or state where your property is located. The inspector will thoroughly inspect all aspects of the property including HVAC, plumbing, electrical, roof and foundation. The inspector will provide a thorough and detailed report including photographs identifying areas of concern and potential future issues with the property.

Legal Counsel. When we talk about legal counsel for a charitable gift, there are two types of legal counsel, the donor's and the organization's outside counsel. Our focus is on the type of counsel your organization will need access to in order to close the gift. The real estate specialty itself includes various subsets: vesting and titling, zoning and utility restrictions, city, county and state law, and expertise handling various types of property (e.g. commercial, residential or farm). Thus, it is important to employ counsel familiar with both the type and location of the gift property.

Qualified Appraisal. We discovered the hard way that appraisals create their own headaches. Like most charities, our organization wants to have an appraisal as part of the pre-acceptance review, but therein lies a complication: to meet IRS requirements for a qualified appraisal, it must be dated no earlier than 60 days prior to the date the gift is received (in most instances that is the date it is recorded). It is often extremely difficult to complete all the steps and close the gift before the appraisal grows stale.

While ultimately the appraisal is the donor's and their advisor's responsibility, as often happens in planned giving, we find that we have more experience and greater expertise obtaining an appraisal that will pass IRS muster. Many appraisers are unfamiliar with the IRS rules, including the requirement to complete a Form 8283, and being asked to sign a form that will go to the IRS is sometimes a source of anxiety.

As a courtesy to donors, and as part of our new closing process, we review all appraisals. During past reviews, we discovered numerous instances in which the appraisals contain inaccurate or missing information. To help avoid these types of issues in the future, we now furnish our donors with an article published by our planned giving asset manager, TIAA Kaspick. The article outlines the appraisal requirements (See Manual at Appendix B-4b) and we supplement with our own cover letter (See Manual at Appendix B-4a).

Phase III: Closing the Gift and Reaching the Finish Line

Escrow and Related Procedures. The closing phase begins once conditions are met and includes preparation of documents particular to the type of real estate gift, donor review of proposed closing documents and recording the relevant documents as well as various "in house" housekeeping tasks. For example, a retained life estate requires a maintenance, insurance and tax agreement, while an outright gift of real estate does not. We find it most efficient to ask the donor sign the recording documents and the University documents in one sitting with the escrow officer. The final documents are presented in the *Real Estate Gift Donor Closing Binder* broken into two sections: documents to be signed at escrow and documents that are completed. (See Manual at Appendices D-2 to D-7).

Recording the Gift. Prior to recording the deeds, planned giving is involved in either drafting or at least reviewing the vesting documents. Planned giving provides any necessary exhibits for the deeds such as: maintenance, insurance and tax agreements, legal description, trust abstract, or community property transmutation agreements. Escrow handles the document signing and deed recording. Escrow meets with the donors and planned giving in order to execute and notarize deeds and closing documents required by our organization. Lastly, escrow delivers the executed documents for recording with the appropriate county recorder's office.

Institutional Concerns. Several institutional concerns arose as we started accepting a wider variety of real estate gift structures. One such example was how best to document important future dates for certain types of gifts. For example, the gift of a retained estate for a term of five years requires our organization to know when that five year term will end. Our solution came in the form of a division-wide calendar managed by all administrative staff assistants so that regardless of who was, or was not, with the organization, there would be calendar "ticklers" in place.

Stewardship. The development officer works with our stewardship team to finalize the Endowment Gift Agreement so that we have a clear record of how the donor wants their real estate gift used. They also develop a recognition plan to celebrate the gift, as well as a stewardship plan which, if appropriate, includes membership in our legacy society, so that the donor is properly thanked and acknowledged for years to come.

Post Gift Clean-up. Often, the acts of signing the gift paperwork and recording the deed are carried out with much tension, under tight deadlines, so that once the deed is done, there is a tendency to want to kick back and relax -- but there is still more to be done. At Pacific, we have found that it is helpful to provide donors with a post-gift letter summarizing the pertinent information about their gift.

- ✓ Gift Receipt
- ✓ Final gift Illustration (required)
- ✓ IRS Form 8283 signed by appraiser and our organization
- ✓ *Special Election Statement to Accompany Donor's Tax Return* (if applicable) (See Manual at Appendix D-8)

Finish Line. After the deeds are recorded, they are returned to Pacific for safe keeping. Planned giving reviews the closing documents and the *Real Estate Gift Responsible Person Legend and Checklist* to ensure that all action items are completed. The checklist, along with all hardcopies of executed documents are uploaded into our system. We provide a digital copy of the deed, appraisal and gift illustration to gift processing for gift counting purposes and another copy, along with the IRS Form 8283 to our finance team. Lastly, if the gift is sold within three years of the date of gift, our finance team is responsible for generating IRS Form 8282, and the gift officer in charge of stewardship will be asked to provide the donor with a copy.

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