Visual Planned Giving

(in color)

An Introduction to the Law & Taxation of Charitable Gift Planning

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PREFACE

This is not your father's law and tax book (Part I). The purpose of this text is to communicate to fundraisers and financial advisors the basic concepts of planned giving in a friendly, straightforward, and visually attractive format, while providing explanatory text that might be helpful where the visual elements are insufficient. The intended use is for the reader to flip through the images in the sections of interest until reaching an image that seems new or confusing, at which point the surrounding explanatory text may be helpful. The citations in the text are relatively sparse and for those desiring more technical texts with superior citations I recommend Thomas J. Ray, Jr.'s, *Charitable Gift Planning*, Catherine W. Wilkinson & Jean M. Baxley's, *Charitable Giving Answer Book*, Bruce R. Hopkins' *The Law of Fundraising*, and Bryan Clontz's *Charitable Gifts of Noncash Assets (2nd Edition)*.

This is not your father's law and tax book (Part II). This book is intentionally published in a print-on-demand format. This means that changes can be incorporated into the current version of the book within a matter of days. It also means that I would be most appreciative of any information related to errors, trivial or otherwise, because these are easily corrected. Please e-mail me at russell.james@ttu.edu if you happen to find such. (Special thanks to Jill Gary Hughes, Leo O'Connor, Jr., Peter Hayward, Robert Constantine, and Ray Tyler for their past guidance in this way.) Note, however, that some errors of omission are intentional as this is not intended to be an exhaustive treatment of every possible transaction type and option, but rather is intended to be a basic primer on charitable gift planning.

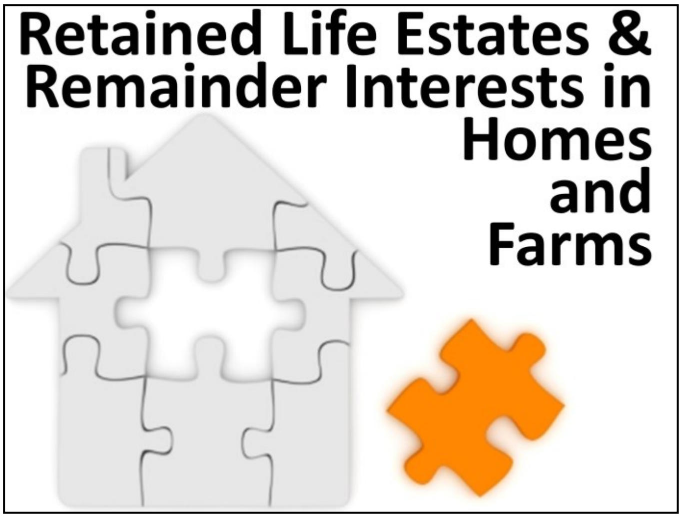
The slides used in this text are from the courses that I have taught for many years as part of the on-campus and online Graduate Certificate in Charitable Financial Planning and Master of Science in Personal Financial Planning both in the Department of Personal Financial Planning at Texas Tech University, as well as in my course in Charitable Gift Planning at the Texas Tech University School of Law. Information on the online Graduate Certificate in Charitable Financial Planning is available at www.EncourageGenerosity.com. Additionally, the PowerPoint or pdf version of many of the slides contained herein and audio of some related lectures are also available, for free, at the website.

And now, on to the disclaimers: *This notice is made in order to comply with applicable Treasury Department and other regulations (including but not limited to Circular 230): This book is not intended to provide personal legal, tax or financial advice. Consequently, I urge you to seek the advice of your own legal, tax, or financial professionals in connection with gift and planning matters. This text is not intended to be used and cannot be used for the purpose of avoiding tax-related penalties.*

This document is for information and illustrative purposes only and does not purport to show actual transaction results applicable to your specific situation. It is not, and should not be regarded as, investment, legal, or tax advice or as a recommendation regarding any particular transaction or course of action. Opinions expressed herein are current opinions as of the date appearing in this material only and are subject to change without notice. Reasonable people may disagree about the opinions *expressed herein. All transactions and investments entail risks. There is no guarantee that investment or tax planning strategies will achieve the desired results under all market conditions.*

This book contains text and images representing charities including The Salvation Army (as an example of a public charity) and The Bill & Melinda Gates Foundation (as an example of a private foundation). These are used for illustrative purposes only and should in no way imply any support, endorsement, or affiliation of these organizations with this text or its author. The trademarks of these organizations are owned by their respective organizations. Images in this text were purchased from www.istockphoto.com and www.stockfresh.com. The image of Bill and Melinda Gates is from http://commons.wikimedia.org/wiki/File:Bill_og_Melinda_Gates_2009-06-03_(bilde_01).JPG and was taken by Kjetil Ree in 2009. The image of Bill Gates alone is from http://commons.wikimedia.org/wiki/File:Bill_Gates_in_Poland.jpg

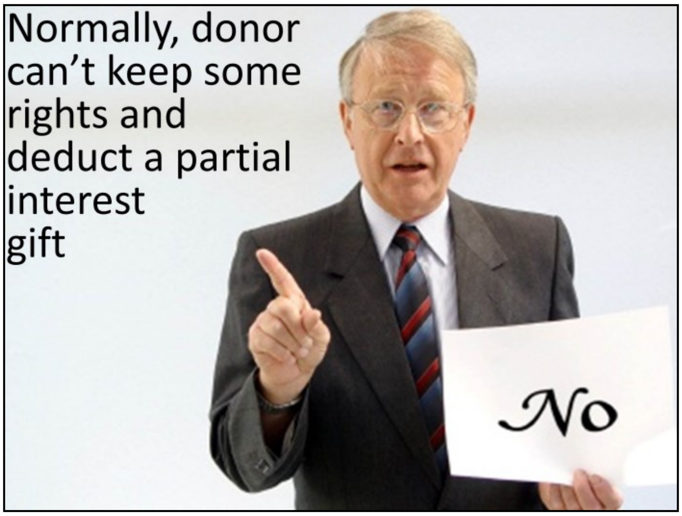
11 RETAINED LIFE ESTATES (REMAINDER INTERESTS) IN HOMES AND FARMLAND



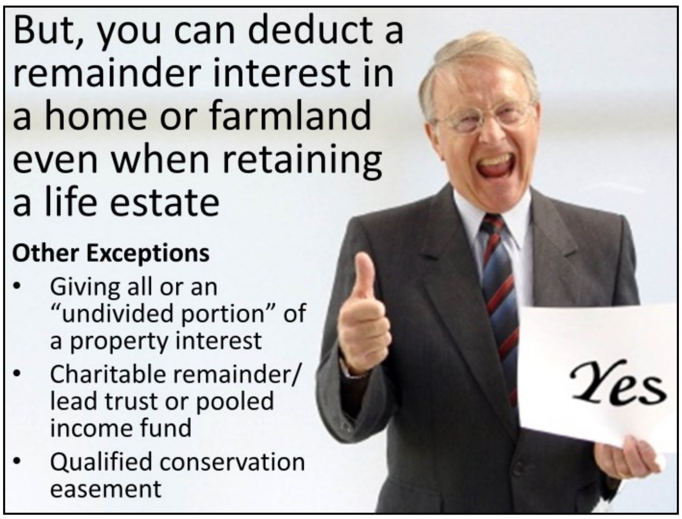
In this chapter, we will examine the somewhat-less-well-known charitable planning strategy of donating a remainder interest in a personal residence or farmland while retaining the life estate. This topic is useful for two reasons. First, this strategy can be valuable for donors with an interest in leaving a bequest gift who would also like to receive an immediate income tax deduction for their commitment. The remainder interest with retained life estate gift instrument itself is relatively simple, and because few fundraisers or advisors are familiar with this option, it may prove to be a useful niche strategy that can lead to attractive opportunities.

Second, this is the simplest type of planned gift that generates an immediate tax deduction for a transfer that will usually benefit the charity only years later. Typically, the charity becomes the owner of the property only after one or more lifetimes (or sometimes after a fixed number of years). This same concept—a transaction that benefits a charity primarily in the distant future, but still generates an immediate income tax deduction—appears in a number of more complex contexts. This same idea appears again in charitable structures such as Charitable Remainder Trusts and grantor Charitable Lead Trusts. But, in those cases the idea is combined with other financial benefits coming back to the donor from the trust. Before advancing to these more complex structures, it may benefit the reader to understand this relatively straightforward gift. In this way the remainder interest gift with a retained life estate is not only an independently useful transaction but serves as an important conceptual building block for even more sophisticated planning.

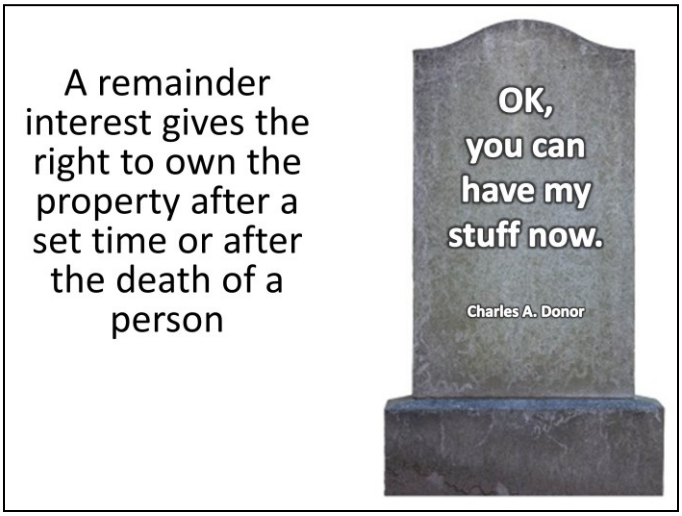
As was addressed in a previous chapter, a partial interest gift with retained interests occurs when a donor donates some types of rights to property but keeps other types of rights in the gifted property. Remainder interest gifts with retained life estates are exactly this type of transaction. The donor gives a remainder interest (the right to own after death or after a period of years) in a home or farmland to charity but keeps the right to use the property in the meantime (during life or for a period of years).



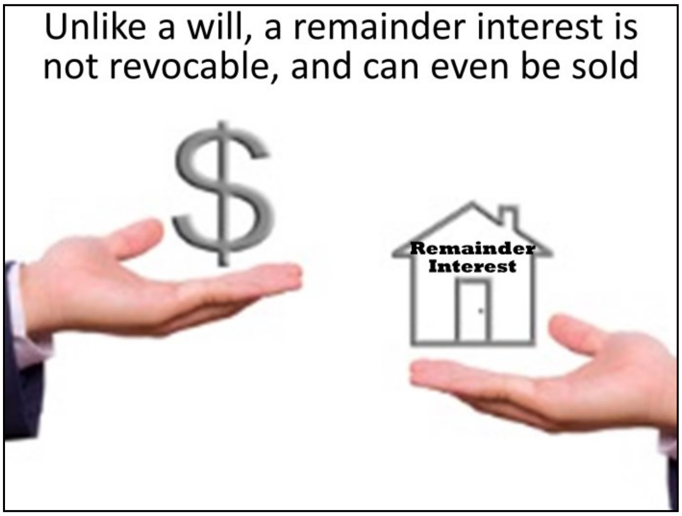
The general rule is that if a donor retains an interest in gifted property (giving the charity only a partial interest), the donor may not take a deduction for that type of transaction.



Gifts of remainder interests in a personal residence or farmland while retaining a life estate are a special exception to the general rule against deducting partial interest gifts where the donor retains other ownership interests in the gifted property. The other special exceptions to this general rule are Charitable Remainder Trusts, Charitable Lead Trusts, Pooled Income Funds, and qualified conservation easements.



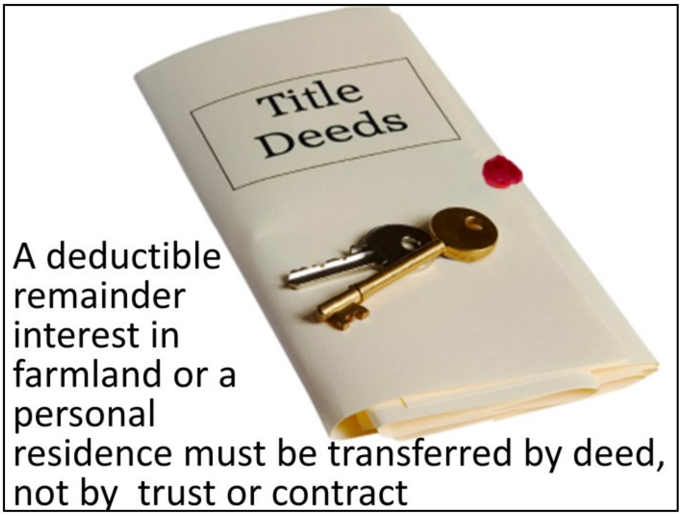
In many ways, a remainder interest gift with a retained life estate is similar to a will. A remainder interest gives the right to someone else to become the owner of property after the death of the current owner (or another person) or after a certain number of years. Typically, the donor, who owns the property, gives a charity the right to own the property after the donor's death (or after the last to die of the donor and the donor's spouse). But it is also possible to set up a remainder interest with a retained life estate in a variety of different ways. Any person or persons can be used as the "measuring life" after which the property would go to the charity as the remainder interest holder. For example, a donor could gift a remainder interest to a charity that takes effect only after the death of the donor, the donor's spouse, and all currently living children and grandchildren of the donor. Although the charitable deduction for such a transfer might be relatively small—given the likely number of years the charity would have to wait to become the owner of the property—there would still be some charitable deduction. In another twist, a donor could give a charity the right to own the property after the death of, for example, the donor's sister and then donate the right to use the property for her life to the sister. Many such constructions are allowed, but they are also quite rare compared with the standard approach of the donor retaining a lifetime right to use the property (i.e., retaining a life estate) and giving the remainder interest to the charity.



Although it transfers full ownership of property at death, the remainder interest with retained life estate differs from a will in important respects. Unlike a will, the decision to transfer a remainder interest in real estate is not revocable. Once the remainder interest is given, it is immediately owned by the recipient. This can be a tricky concept to understand. Even though a remainder interest might not result in the transfer of full ownership until after the death of the donor, that *right* to receive the property at death is *immediately* owned by the holder of the remainder interest. Because this right is immediately owned by the remainder interest holder, it can even be sold.

For example, suppose a donor gives a remainder interest in his home to his favorite charity while retaining the life estate. This gives the charity ownership of the right to receive the home at the death of the donor. The charity could wait until the donor dies and then the charity would become the full owner of the home. However, the charity could instead immediately sell this right to an investor, in which case the investor would receive the home at the death of the donor. The home, at the death of the original owner, will be owned by whoever owns the remainder interest at that time. These later transfers have no effect on the charitable deduction. (In the same way, the charitable deduction for a donation of a share of stock is not affected by whether or not the charity later sells the stock to someone else). It is this irrevocable and transferable nature of the remainder interest gift that makes it immediately deductible. Because the charity has received a valuable right today (one that can even be sold today), the donor can take a charitable deduction today even though she retains the right to use the property for the rest of her life. In contrast, no income tax deduction results from naming a charity in a will, because the charity has no rights prior to the donor's death. The charity can be removed from a will at any time, but giving a remainder interest deed is permanent.

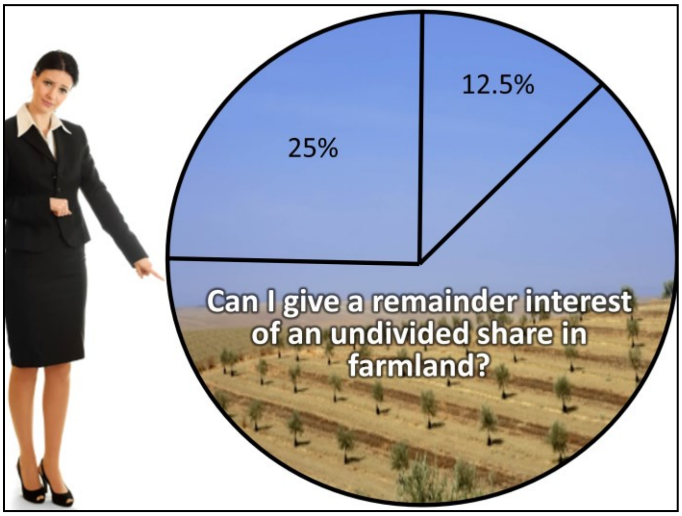
Although the donor cannot prevent the future transfer of these rights from the charity to another buyer, it would be common for the charity to communicate with the donor in advance regarding its plans. In some cases, the donor may encourage the charity to sell the rights in advance, so that the donor may see the impact of his gift while he is still alive. For some donors, this is an attractive concept that would be impossible if using a will instead of a remainder interest deed.



This remainder interest gift must be transferred by means of a remainder interest *deed*. Even an otherwise identical arrangement created by a trust or a contract will not generate an income tax deduction. Only a deed will work. This makes the transaction documentation extraordinarily simple. Using a standard deed form with the transferee listed as "life estate to John A. Donor, remainder interest to XYZ charity" will usually be effective. (The simplicity of this transaction may, ironically, contribute to its underutilization as some attorneys may favor more complex arrangements that generate more billable hours.)

Taking a charitable deduction for the transfer of a remainder interest to charity while retaining a life estate is limited to specific types of property. Only two types of property are eligible: farmland and a donor's personal residence(s). Any land and improvements used to raise crops or livestock qualifies as farmland. The land will qualify as farmland even if the donor is not farming the land himself, so long as someone is using it to raise crops or livestock. Land being used to raise crops or livestock is farmland, even if its valuation is based upon its usefulness as commercial development property.

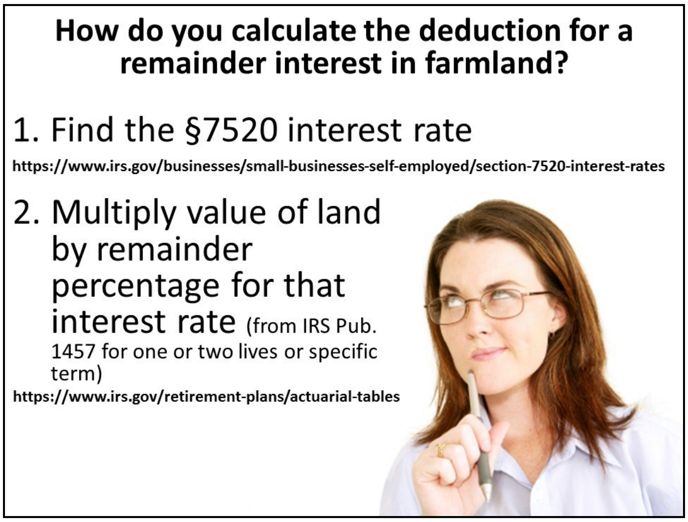
A donor need not transfer a remainder interest in his entire farm but can deduct a remainder interest gift in any part of a farm. (Using the term "farmland" rather than "farm" avoids the impression that the donor's entire farm must be given to charity at death in order to take this deduction.) For example, the donor who owns a 1,000-acre farm can take an immediate income tax deduction for giving a remainder interest with a retained life estate in 10 acres of that farm.



The donor can identify specific acreage within a farm to be gifted by a remainder interest deed while keeping the life estate (i.e., right to use during life). But could the donor deduct a remainder interest gift of an undivided share in farmland? In other words, could a donor deduct the gift of a remainder interest in an undivided 10% interest in 100-acres of farmland, rather than a remainder interest in 10 specific acres?

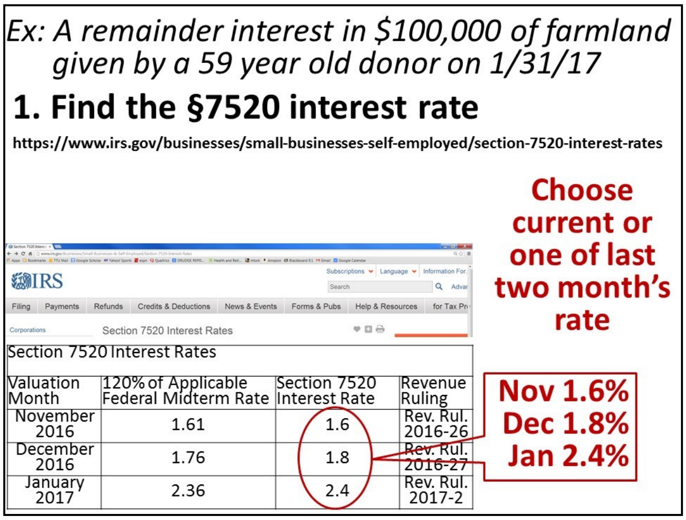
The answer is, "Yes." Thus, a donor could make a remainder interest gift of 5% of his farmland. The donor could even choose to do this every year for 20 years until all of the remainder interest in the farmland was transferred. Such a spreading out of deductible gifts might be attractive to a donor, depending upon the donor's tax circumstances and the ongoing appreciation of the property. Appreciation is important because the value of each gift increases as the value of the underlying farmland also increases. Further, each gift may generate a greater deduction because the donor is one year older at each transfer, making the remainder interest more valuable due to the reduced life expectancy of the donor. (This is, of course, assuming the typical arrangement where the donor's life is the measuring life for the life estate after which the property is transferred.) However, the deduction for such undivided interest gifts may be slightly reduced based upon the cost that a charity could incur to force a sale or division of the property (called "partitioning").

Can a donor deduct the transfer of a remainder interest in mineral rights while retaining a lifetime right to use them? If the donor is transferring a remainder interest in only the mineral rights, this will not qualify for a charitable deduction. Mineral rights, by themselves, do not constitute farmland. Farmland is land used to raise crops or livestock. Mineral rights, by themselves, cannot be used to raise crops or livestock. However, if the donor is transferring a remainder interest in farmland that includes both the farmland surface rights and mineral rights, this constitutes a deductible gift. Thus, the value of the gift will be based upon the total value of the land including both surface rights and mineral rights. But this is only available if the mineral rights are transferred as part of the transfer of the farmland. It is also acceptable to deduct the transfer of a remainder interest in farmland where the donor does not own any mineral rights.

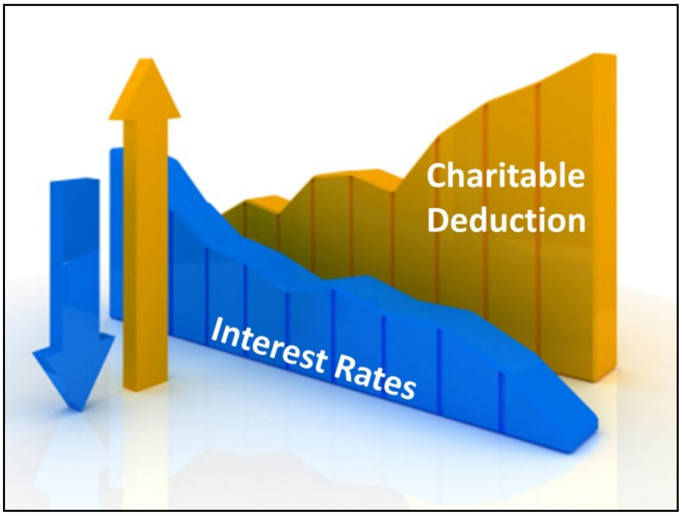


As mentioned above, transferring the remainder interest in farmland generates a charitable deduction even when the donor retains a life estate in the property. But how much is this deduction? Certainly, the deduction will be less than if the donor immediately gave the land to the charity, but, how much less? The deduction will be the present value of the right to receive the land in the future. This present value depends upon the current value of the land, the interest rate, and how long the charity would likely wait to receive the land (i.e., the life expectancy of the donor if the donor is the measuring life for the retained life estate).

As a practical matter, the calculation can be completed by identifying the interest rate (known as the §7520 rate) found at https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates and then using the interest rate to identify the correct remainder percentage for one or two lives or a specific term from the tables at https://www.irs.gov/retirement-plans/actuarial-tables Let's walk step-by-step through the process for completing such a calculation.

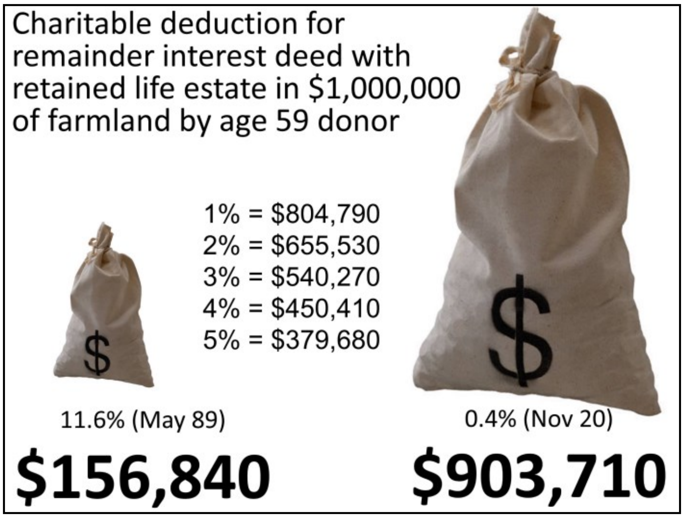


Suppose we wish to calculate the charitable deduction for a remainder interest gift in $100,000 of farmland given by a 59-year-old donor on January 31 of 2017 where the charity receives the right to own the farmland upon the death of the donor. For this calculation, the age of the donor is the age at their nearest birthday on the date of the gift. First, we must identify the appropriate §7520 interest rate. Following the link https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates on January 31 of 2015 displays the table containing the §7520 interest rate. The donor can choose the interest rate from the current month or the previous two months. In this case, the interest rate in the current month was 2.4% and the interest rate in the prior months was 1.8% and 1.6%. Which interest rate should the donor choose?

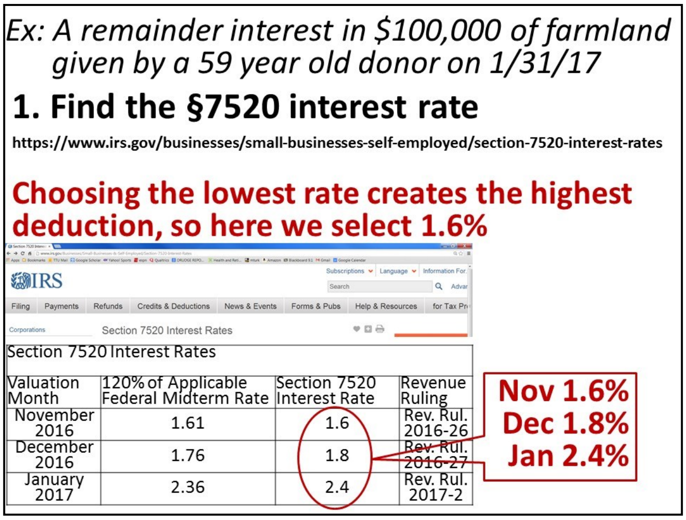


For gifts of remainder interests in homes and farmland with a retained life estate, the charitable deduction increases as the interest rate decreases. Consequently, the donor should always choose the lowest available interest rate. The gift to charity is calculated as the present value of receiving the farmland (at its current value) when the charity must first wait for the current life expectancy of the donor to expire. If interest rates are very low (e.g., 1%), then the cost of waiting is also very low. When the cost of waiting is low, the value of a gift requiring waiting will be relatively high. When the cost of waiting is high (e.g., a 10% interest rate), the value of a gift requiring waiting will be relatively low.

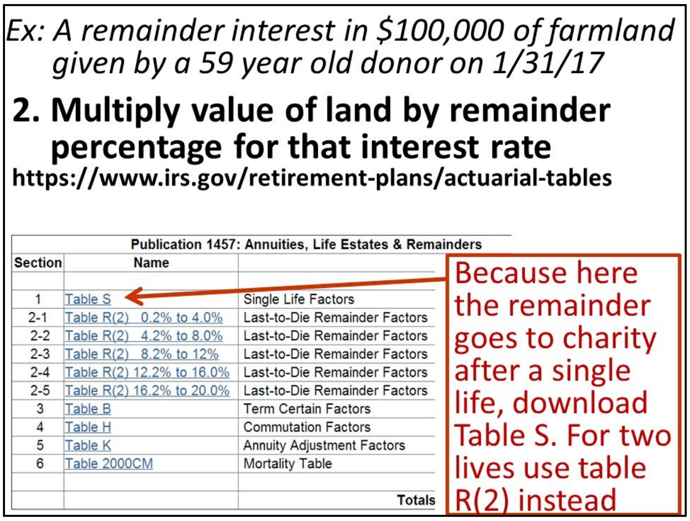
It may help to think about the present value of a remainder interest gift in these terms: How much money would a person have to put in the bank today such that it would be worth $100,000 at the end of the current life expectancy of the measuring life? If the bank paid 1% interest on the account, then a larger initial deposit would be required than if the bank paid 10% interest on the account. Similarly, the present value of a remainder interest gift with a retained life estate is higher if the prevailing interest rate (a.k.a. the §7520 rate) is lower.



The impact of different interest rates on the charitable deduction for a remainder interest deed can be seen dramatically in this example. If the §7520 interest rate used is 11.6%, then the deduction for a gift of a remainder interest deed with retained life estate in $1 million of farmland by a donor aged 59 is $156,840. If the §7520 interest rate is 1.0% the deduction is $804,790. Since both of these interest rates were, at different times, the actual §7520 interest rate, this demonstrates real differences in the deduction of otherwise identical transactions. This is also why gifts of remainder interests in homes and farmland with a retained life estate are so attractive during a low interest rate environment. This remainder interest giving technique is useful to keep in mind during such times because other more common techniques (such as Charitable Remainder Annuity Trusts) are often less attractive during a low interest rate environment.



Understanding the relationship between interest rates and the charitable deduction for gifts of remainder interests results in selecting the lowest available interest rate from the §7520 table in the current or previous two months. In this example, the lowest interest rate is 1.6%. Consequently, we will use 1.6% as the interest rate for all subsequent calculations in this example.



Publication 1457: Annuities, Life Estates & Remainders

Section	Name	
1	Table S	Single Life Factors
2-1	Table R(2) 0.2% to 4.0%	Last-to-Die Remainder Factors
2-2	Table R(2) 4.2% to 8.0%	Last-to-Die Remainder Factors
2-3	Table R(2) 8.2% to 12%	Last-to-Die Remainder Factors
2-4	Table R(2) 12.2% to 16.0%	Last-to-Die Remainder Factors
2-5	Table R(2) 16.2% to 20.0%	Last-to-Die Remainder Factors
3	Table B	Term Certain Factors
4	Table H	Commutation Factors
5	Table K	Annuity Adjustment Factors
6	Table 2000CM	Mortality Table
		Totals

To find the percentage of the value of the land that will be deductible with a remainder interest gift, we must download the relevant table. (Links to these tables may be found at https://www.irs.gov/retirement-plans/actuarial-tables) The tables provided allow calculations for a remainder interest when transferring at the death of one person, at the last to die of two people, or after a specific number of years (term certain). In the current example, we are calculating the deduction for a gift of a remainder interest in $100,000 of farmland given by a 59-year-old donor on January 31 of 2017 where the donor is the "measuring life" for the remainder interest. Consequently, we will click on Table S, which contains the single life factors. If the remainder interest would transfer to the charity at the death of the last to die of the donor and the donor's spouse, for example, then we would need to click on one of the table R(2) links (in this case, the first one, because it contains the remainder factors for a 1.6% interest rate).

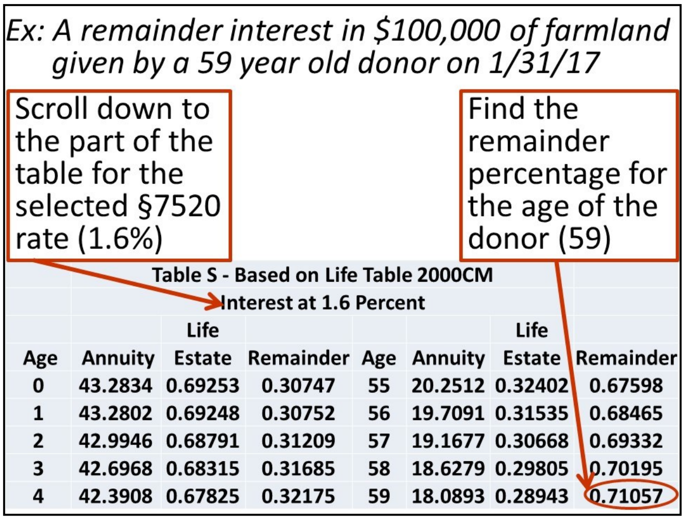
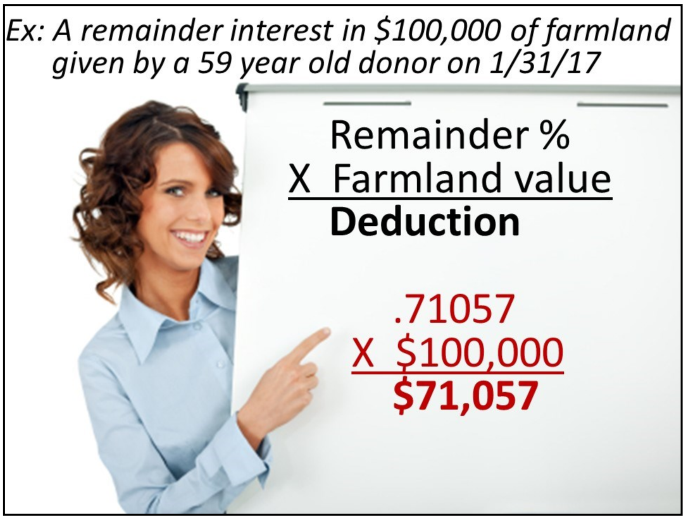


Table S - Based on Life Table 2000CM
Interest at 1.6 Percent

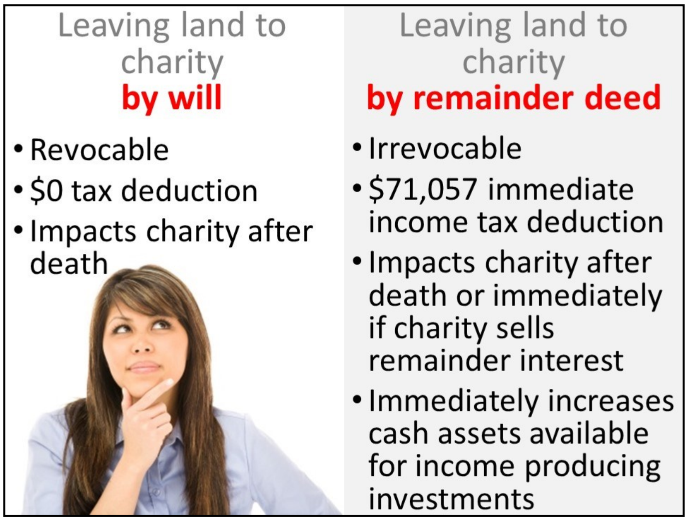
Age	Annuity	Life Estate	Remainder	Age	Annuity	Life Estate	Remainder
0	43.2834	0.69253	0.30747	55	20.2512	0.32402	0.67598
1	43.2802	0.69248	0.30752	56	19.7091	0.31535	0.68465
2	42.9946	0.68791	0.31209	57	19.1677	0.30668	0.69332
3	42.6968	0.68315	0.31685	58	18.6279	0.29805	0.70195
4	42.3908	0.67825	0.32175	59	18.0893	0.28943	0.71057

Clicking on the Table S link downloads an Excel file. The first task is to scroll down through the Excel file until reaching the portion of the table labeled as "Interest at 1.6 Percent," because this is the §7520 interest rate being used in this example. In this section, the row associated with the age of the donor/measuring life shows a remainder interest factor of 0.71057. In simple terms, this factor means that this remainder interest gift will generate a charitable tax deduction of 71.057% of the value of farmland.

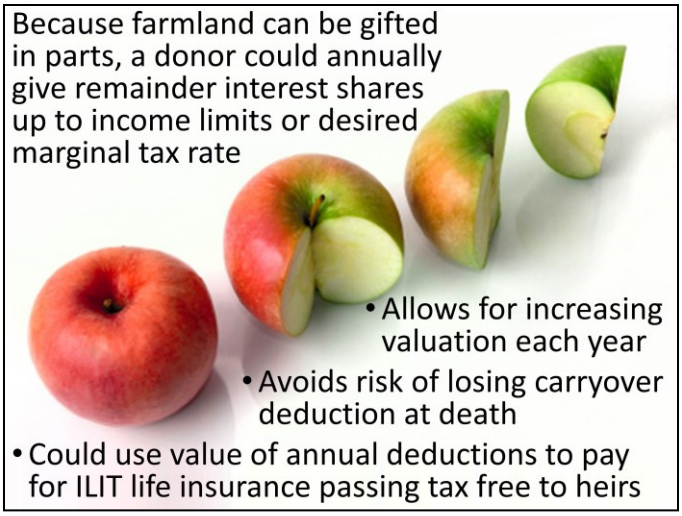
As you can see when scrolling through the table, the charitable deduction will be larger when the measuring life for the remainder interest is older. This makes sense because as age increases, life expectancy decreases, meaning that the charity will, on average, receive the property earlier.



Once the remainder interest factor has been correctly identified, the calculation for the deduction is simple. In this case, the donor can deduct 71.057% of the value of any land in which he makes a remainder interest gift subject to his lifetime right to use the property. Thus, the charitable income tax deduction for such a remainder interest gift with a retained life estate in $100,000 of farmland is $71,057.



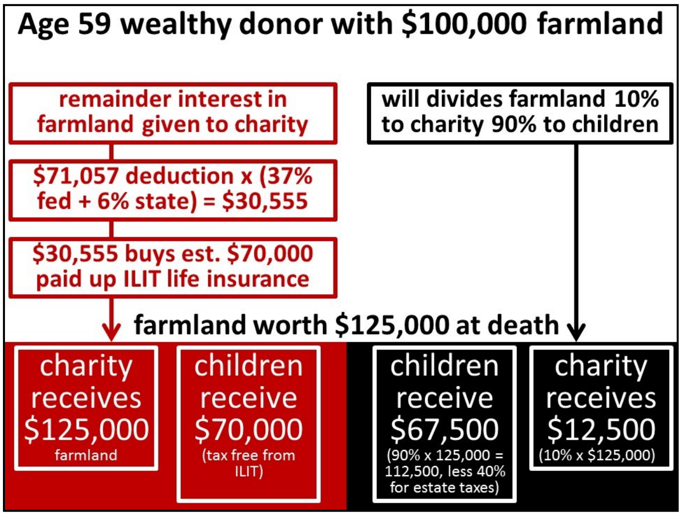
For a donor who has intent to leave a bequest gift to charity, a remainder interest gift may be particularly attractive. In both cases—whether through a will or through a remainder deed—the charity receives a gift at death. However, with a remainder interest deed, the donor receives an immediate income tax deduction that can often be large. This does come at a cost. The primary cost is that the remainder interest gift, unlike a will, is irrevocable. The donor cannot change his mind later and decide to take back the remainder interest gift. Also, to be deductible, a remainder interest gift must be a gift of farmland or a home. Because of typical mortgage prohibitions against transfers, such a gift normally requires debt-free farmland or a debt-free house. Some donors may also be attracted by the reality that a charity can sell the remainder interest, and thereby generate immediate cash for current projects. The substantial tax deduction may also benefit the donor by increasing spendable assets (which now do not have to be spent on tax payments). This may be particularly attractive for a donor who does not wish to sell the home or farmland but wishes to get an immediate monetary benefit from the property in order to supplement current income.



As discussed previously, remainder interests in farmland with a retained life estate can be gifted in parts. This can be done either by gifting remainder interests in specific acreage on a farm or by gifting an undivided fractional share interest (e.g., 10.72%) in specific acreage. (Such undivided fractional share gifts are also available for gifts of remainder interests in personal residences with a retained life estate.) This can provide the donor with tremendous flexibility. For example, the donor could make a remainder interest gift up to the point at which income giving limitations would result in further deductions being carried forward to future years. Making additional remainder interest gifts in future years may be preferable to carrying forward charitable deductions because (1) the deduction will, *ceteris paribus*, be larger as the donor/measuring life is one year older, (2) the deduction will be larger if the farmland has appreciated in value, and (3) the death of the donor, or donor's spouse if a joint gift, would not result in the loss of carryover deductions.

An additional reason for considering a series of remainder interest gifts would be to coordinate the receipt of tax benefits with the offsetting payment of life insurance premiums through an Irrevocable Life Insurance Trust (ILIT). Although dealt with in detail in another chapter, the basic idea is that the use of life insurance allows the heirs to receive money as a replacement for the value of the home or farmland they will no longer be inheriting. In some cases, the heirs may prefer the life insurance proceeds because life insurance purchased through an ILIT is not normally subject to estate taxes. However, only a limited amount of money can be used each year to pay premiums of ILIT-owned policies without generating gift taxes (in 2023 this was $17,000 annually per donee for each donor). Thus, spreading the deductions over a long period of time can help to match with the life insurance premiums paid over several years.

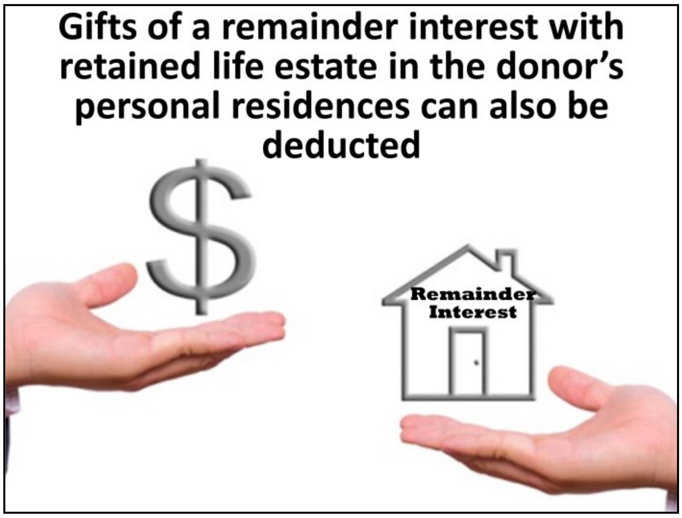
This combination of transactions, where a donor gives a remainder interest to a charity and then uses the value of the resulting tax deductions to purchase life insurance not subject to estate taxes, can be very attractive. The heirs lose the ability to inherit the property subject to the gifted remainder interest but gain the opportunity to inherit life insurance proceeds. Because the home or farmland might have been subject to a 40% estate tax, estate tax-free life insurance proceeds could be particularly attractive. Let's examine the details comparing this type of transaction with less sophisticated charitable planning.



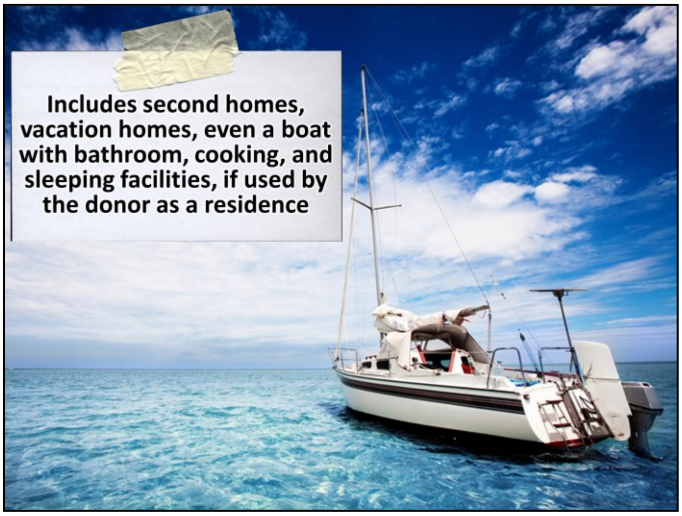
Let's return to the 59-year-old donor contemplating the disposition of $100,000 of farmland. In this case, suppose the donor is subject to a 43% marginal estate tax rate, a 37% federal income tax rate, and a 6% net state income tax rate (assuming no additional federal income tax deduction for payment of state income taxes due to the $10,000 cap). Further, suppose the donor wishes to benefit both the charity and his children at his death with the $100,000 of farmland. A simple, unsophisticated approach would be to draft a will in which part of the farmland (e.g., 10%) would go to the charity and the rest (e.g., 90%) would go to the children. Assuming that the property appreciates to $125,000 at the time of death, this would result in the charity receiving $12,500 (10% x $125,000). The children's share would be 90% (90% x $125,000 = $112,500), but their share is first subject to estate taxes of 40%, leaving a net inheritance of $67,500.

Let's compare the results from that simple planning with the use of a remainder interest deed with retained life estate and an ILIT. As described above, a remainder interest gift in $100,000 of farmland by this age 59 donor generates an income tax deduction of $71,057. The value of a deduction depends upon the marginal income tax rate of the taxpayer. In this case, assuming that the donor is at a 37% federal income tax rate and a 6% net state income tax rate (assuming no additional federal deductions due to the cap on state tax deductions), this deduction would be worth $30,555. Using a rough estimate, let's suppose that this money could be used to purchase a $70,000 death benefit paid up life insurance policy. (As a side note, the amount of insurance that can be purchased from the remainder interest deduction may remain relatively stable in different interest rate environments. A low interest rate causes the deduction to be larger and the insurance to be more expensive, whereas a high interest rate causes the deduction to be smaller and the insurance to be less expensive.) At death, the children receive the $70,000 death benefit from the life insurance policy. However, this death benefit (because of the use of the ILIT) is not subject to estate taxes, so the children receive the entire $70,000. In this case, the children's inheritance is approximately the same with either charitable plan. However, with the use of the remainder interest, the charity receives the entire farmland, not just 10% of it. Thus, through sophisticated planning, the donor is able to give 10 times as much to charity at death without disadvantaging his children.

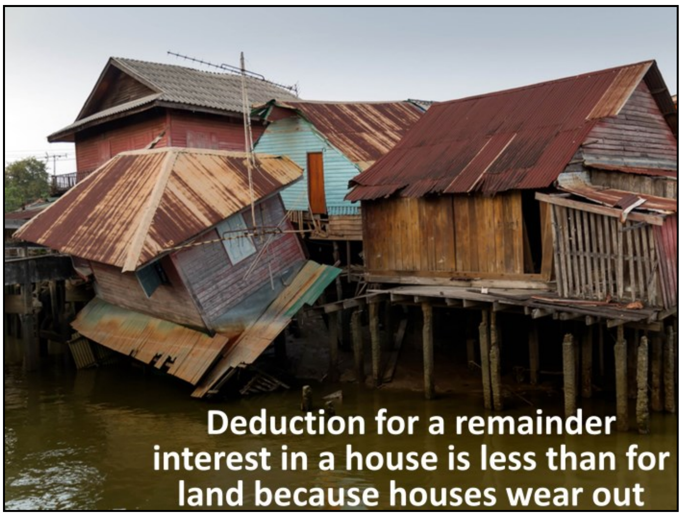
As a side note, it is still critical to engage in charitable planning only for those clients who have charitable interests. There are usually sophisticated non-charitable estate planning strategies that are more effective at transferring wealth to heirs as compared with charitable strategies. But, for the client who wishes to have a charitable impact, these charitable strategies are powerful. One simple approach to identifying a client's charitable interests is to draw a circle and explain, "You can leave your estate to three groups: people (family), charity, and government. Divide this circle into a pie chart showing how you would want your estate divided between these three groups." This conversation can quickly identify those who have charitable estate interests and those who do not. Additionally, of use to attorneys and financial advisors is the likelihood that the share assigned to government may be lower than that resulting from estate and gift taxes, thus generating the motivation for exploring sophisticated estate tax planning.



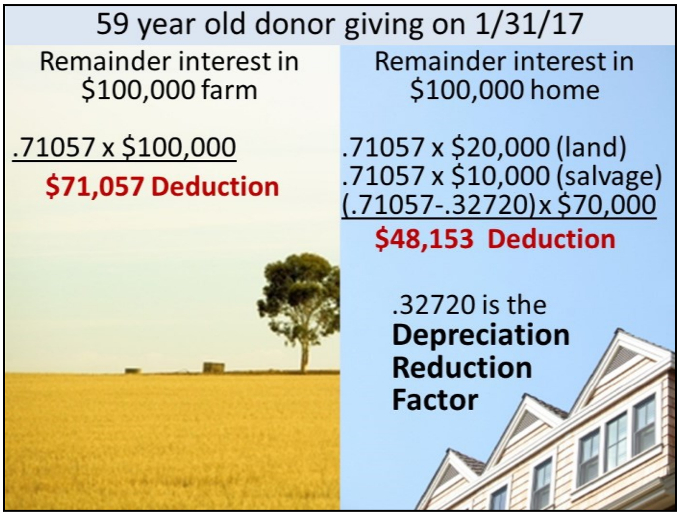
To this point, we have been considering gifts of remainder interests with retained life estates in farmland. However, gifts of remainder interests in the donor's personal residence(s) with a retained life estate can also be deducted, although the calculations are a bit more complex. The remainder interest must be in a personal residence of the donor, but it need not be the donor's primary residence. Thus, for example, the gift of a remainder interest in a donor's vacation home is deductible.



In fact, any home owned by the donor and used by the donor as one of his or her residences will qualify for a deductible remainder interest gift. This can even include a boat with bathroom, cooking, and sleeping facilities if it is actually used by the donor as a residence.

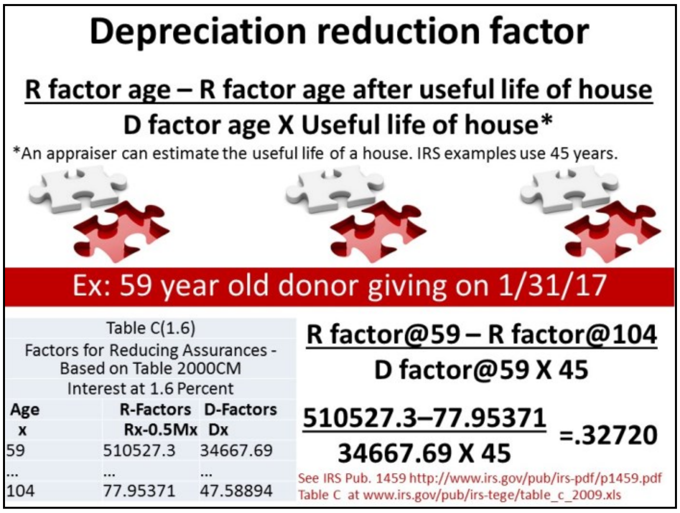


Calculating the deduction for a charitable gift of a remainder interest in a house is more complicated than calculating the deduction for a remainder interest in farmland. The deduction for a remainder interest in a house will be less than the deduction for a remainder interest in farmland of the same value. This is because farmland does not wear out or depreciate. In contrast, houses, over time, wear out. This expectation of the wearing out (depreciation) of the house must be incorporated in the estimation of the amount of value that the charity will receive at the end of the life of the donor/measuring life.



Returning to our previous example, suppose that the 59-year-old donor gave a remainder interest in a $100,000 personal residence, rather than a remainder interest in $100,000 of farmland. The deduction for the gift of the personal residence remainder interest would be less than for the farmland remainder interest ($71,057 for the farmland v. $48,153 for the home).

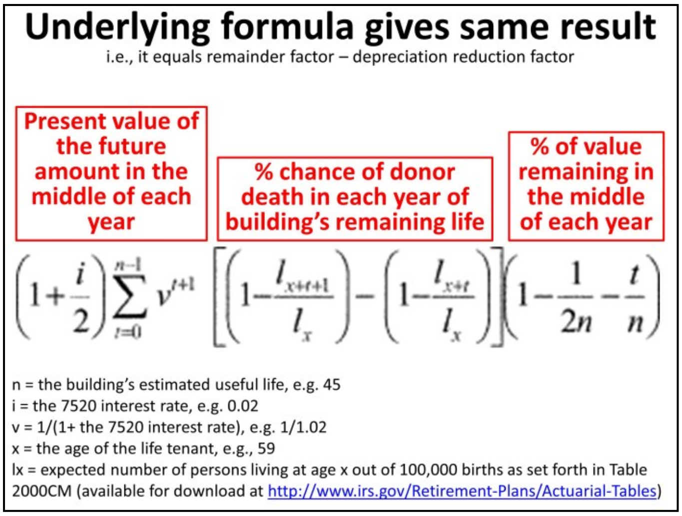
How is this deduction calculated? Part of the value of the personal residence is the value of the land on which the residence sits. The deduction for this part of the personal residence is calculated exactly like the deduction for the farmland. Thus, the remainder interest gift generates a deduction of 71.057% of the value of the *land* underlying the personal residence. (The 71.057% comes from the calculation process described previously for farmland.) There is also presumed to be an element of the house that does not depreciate, which is referred to as "salvage" value. Because this "salvage" value does not depreciate it is also deducted at the same percentage as the land (71.057%). The remaining value of the residence, however, is presumed to depreciate. Consequently, this portion of the value of the residence may not be deducted at the full 71.057% used for farmland but must be reduced by a depreciation reduction factor. In this case, using the example described below, the depreciation reduction factor is .32720, or 32.720%. Thus, the depreciable part of the residence may be deducted at 38.337% (i.e., 71.057% less 32.720%). Combining the parts that can be deducted at 38.337% with the parts that can be deducted at 71.057% results in a total deduction of $48,153 for the $100,000 home.



How is this depreciation reduction factor calculated? The calculation can seem at first to be complex or overwhelming. But actually, it is simply a matter of copying the correct numbers into a division problem. Aside from the information located in the IRS table C of publication 1459 and the §7520 rate, the only additional information needed is the age of the donor/measuring life and the useful life of the house.

Unlike other areas of tax law where depreciation is incorporated into tax calculations, there are no set years for the depreciable life of a residence in this context. An appraiser or engineer should estimate the useful life of the house. The IRS examples use 45 years for the useful life of a house, and so this is often treated as a viable estimation depending upon the condition of the home.

Following the cue from the IRS example for this type of deduction, suppose that the residence will depreciate over 45 years. This, along with the §7520 interest rate and the donor's age, is the only information needed to use the IRS tables to complete the calculation. Following the instructions of IRS publication 1459 (www.irs.gov/pub/irs-pdf/p1459.pdf) download table C (www.irs.gov/pub/irs-tege/table_c_2009.xls) and scroll down to the segment titled with "Interest at 1.6 Percent" (or whatever the appropriate §7520 rate is for the date of the transaction). The numerator of the depreciation reduction factor is the R factor at the donor's age minus the R factor at the donor's age after the useful life of the house (assuming the donor is the measuring life for the retained life estate). In this case, the numerator is the R factor at age 59 minus the R factor at age 104 (i.e., the age 59 measuring life + the 45-year useful life of the house). (If the life tenant's age plus the useful life of the house exceeds 109, which is the highest number on the table, simply use zero for the R factor at the donor's age after the useful life of the house.) When using table C with a 1.6% §7520 rate, this makes the numerator 510,527.3–77.95371 (or 510,449.34629). The denominator of the depreciation reduction factor is the D factor at the donor's age multiplied times the useful life of the house. In this case, the denominator is the D factor at age 59 multiplied by 45, or 34667.69 X 45 = 1,560,046.05. Combining the numerator and denominator results in 510,449.34629/1,560,046.05, or 0.32720. This is the depreciation reduction factor used in the previous calculation. In other words, this is how much less the percentage deduction for the depreciable portion will be as compared with the land portion. In this example, the land portion can be deducted at 71.057%. The depreciable portion must be deducted at 32.720% less (i.e., 38.337%).



The process of plugging in the R-factor and D-factor numbers and then subtracting this result from the remainder interest factor in order to get the factor to apply to the depreciable part of the home is a shortcut to getting the result generated by the formula found in the IRS regulations. This formula is

$$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} v^{t+1}\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\right]\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

Where:
n = the building's estimated useful life, e.g. 45
i = the 7520 interest rate, e.g. 0.02
v = 1/(1+ the 7520 interest rate), e.g. 1/1.02
x = the age of the life tenant, e.g., 59
lx = expected number of persons living at age x out of 100,000 births as set forth in Table 2000CM (available for download at http://www.irs.gov/retirement-plans/actuarial-tables)

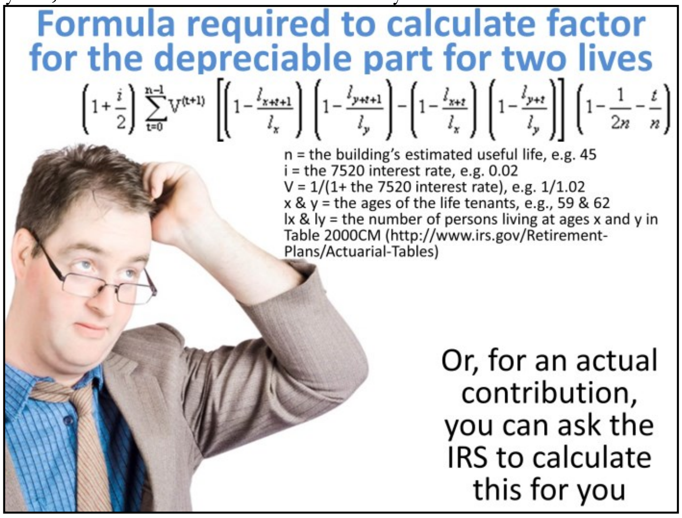
It is possible to calculate this formula directly. The result of calculating the formula directly is the remainder interest factor to be applied to the depreciable portions of the personal residence (not just the depreciation reduction factor). The results should match those from using the shortcut method described above.

Although the formula above looks quite intimidating, it can be explained descriptively. $\left(1-\frac{l_{x+t+1}}{l_x}\right)$ Starting inside the equation, this ratio uses the Lx numbers, representing the number of people, out of 100,000 births, expected to be alive at any given age. The ratio is the number of people, out of 100,000 births, alive at the donor's age+t+1 years over the number of people, out of 100,000 births, alive at the donor's age. For example, if the donor were 59 years of age, then the first calculation where t starts at zero would be the number of people projected to be alive, out of 100,000 births, at age 60 (87,595) divided by the number of people projected to be alive, out of 100,000 births, at age 59 (88,441). This ratio (87,595/88,411), or 99.08% is the likelihood that a person who is age 59 will live another year. Subtracting this ratio from 1 (in this case resulting in 0.92%) gives the likelihood that a person who is age 59 will *not* live another year.

$\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\right]$ This bracketed part of the formula identifies the probability that the donor will die during a particular year for each year of the useful life of the home. We start with t=0, in which case the right hand parenthesis also equals zero. In our example of a 59 year old donor, the probability of death in the first year is, as calculated above, 0.92%. The probability of death occurring in the second year is the probability of death occuring within the first two years (left side parentheses) minus the probability of death occurring in the first year (right side parentheses). The probability of death occurring in the third year is the probability of death occurring within the first three years (left side parentheses) minus the probability of death occurring within the first two years (right side parentheses). This probability is thus calculated for each year of the useful life of the home (e.g., 45 years).

$\left(1-\frac{1}{2n}-\frac{t}{n}\right)$ This parenthetical calculation gives the percentage of value that will remain in each year, assuming straight line depreciation, for the depreciable parts of the house. For example, if the house is expected to have a 45 year useful life, then by year 20, it would be 44.4% depleted (20/45 = 44.4%), meaning that 66.6% (1-44.4%) of the value would remain. This explains the left and right portions of the parenthetical statement, but not the middle piece. Why would we also subtract 1/(2 X the useful life of the house)? This simply reflects the additional depreciation (wear and tear) that occurs for the 6 months required to get to the middle of the year. This assumes that if the person dies during a year, they will die not at the beginning or the end, but in the middle of the year, so the depreciation will be ½ year. For example, the projected remaining share of the value if the donor died in the first year (t=0) would be 1-(1/90), or 98.89%, (the right side ratio is zero), reflecting the idea that the donor is projected to die in the middle of the year. The projected remaining share of value if the donor died in the tenth year (t=9), would be 1-(1/90)-(10/45), reflecting the idea that the donor/life tenant is projected to die in the middle of the year and the 1/90 depreciation that occurs during those six months must be substracted.

$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} v^{t+1}$ This final portion of the summation calculates the present value of the future amount. The *v* represents 1/(1+ the §7520 interest rate). If the §7520 interest rate is 1.6%, *v* would equal 1/1.016, or 98.425%. Thus, the present value of receiving the asset in year one is 98.425% of the projected value of the asset. The present value of receiving the asset in year two is 96.875% (from 98.425% X 98.425%) of its projected value in year two. The present value of receiving the asset in year three is 95.3649% (from 98.425% X 98.425% X 98.425%) of its projected value in year three, and so on for each year of the projected life of the home. The final adjustment noted by the parenthetical component to the left of the summation symbol increases the present value based upon the idea that the amount will be received not at the end of the year, but in the middle of the year. Thus, if interest rates are 1.6%, the final amount is increased by .08% (multiplied by 1.008 because 1+(.016/2)=1.008) to reflect the value of receiving the asset in the middle of the year, rather than at the end of the year.



Unfortunately, there is no shortcut method for calculating the remainder interest factor to be applied to the depreciable portions of the personal residence if the life estate is for more than one life. If the life estate will last for the lives of two people, then the formula for the remainder interest factor to be applied to the depreciable portions of the personal residence is the following:

$$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} V^{(t+1)}\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)\left(1-\frac{l_{y+t+1}}{l_y}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\left(1-\frac{l_{y+t}}{l_y}\right)\right]\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

Where:
n = the building's estimated useful life in years, e.g. 45
i = the 7520 interest rate, e.g. 0.02
v = 1/(1+ the 7520 interest rate), e.g. 1/1.02
x and y=the ages of the life tenants, e.g., 59 & 62
lx and ly=the number of persons living at ages x and y as set forth in Table 2000CM (available for download at https://www.irs.gov/retirement-plans/actuarial-tables)

This can be calculated by hand, in this case requiring a summation of 45 different calculations, one for each year of the useful life of the property. However, it requires more steps than the short-cut method available for single life calculations. The parts of the equation represent the same ideas as in the one-life example. The only difference in the equation is that the middle bracketed portion

$$\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)\left(1-\frac{l_{y+t+1}}{l_y}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\left(1-\frac{l_{y+t}}{l_y}\right)\right]$$

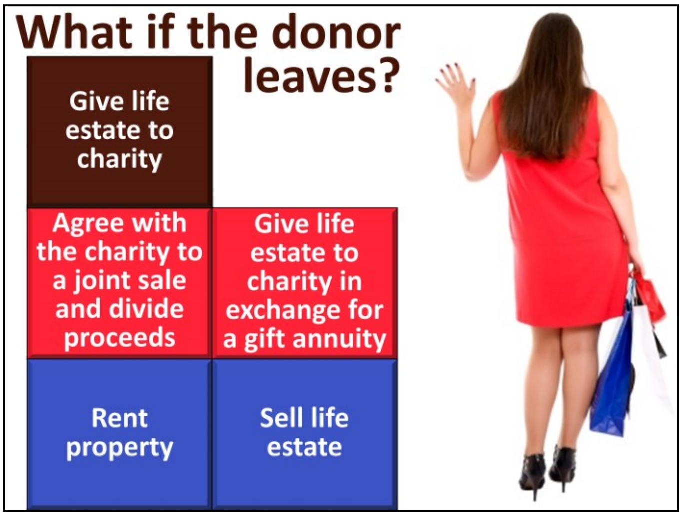
now estimates the joint likelihood of the death of both life tenants, rather than just one.

If the calculation for the remainder interest factor to be applied to the depreciable portions of a two-life remainder interest gift appears too daunting, you may request the IRS to furnish this factor to you. To do so requires that you are dealing with an actual contribution (not simply a proposal), and that you forward the sex and date of birth of each life tenant, copies of the relevant instruments, and a statement of the estimated useful life of the depreciable property to the Commissioner of Internal Revenue, Attention: OP:E:EP:A:1, Washington, DC 20224.

A donor may also choose to give a remainder interest in a personal residence where the donor will retain the right to use the property (or give that right to someone else) for a fixed number of years. For example, the donor could deed a personal residence to a charity with the provision that the donor retains the right to use the property for 20 years. In this case, the deduction is based upon the projected value of the personal residence in 20 years. The current land and salvage value of the building are not depreciable, and so they are assumed to be worth the same amount in 20 years as they are today. The depreciable part of the personal residence will be reduced in value by the fixed number of years divided by the useful life of the building. For example, if a $100,000 residence was estimated to have a useful life of 45 years, with land value of $20,000 and salvage value of $10,000, then in 20 years the estimated value would be $20,000 land + $10,000 salvage + $70,000 depreciable building – [$70,000x(20/45)] depreciation, or a total of $68,888.89. Based on the idea that the charity is projected to receive an item of property worth $68,888.89 in twenty years, the deduction for such a transfer would be $68,888.89 multiplied by the remainder interest factor for a term certain of 20 years. These remainder interest factors are published in Table B: Term Certain Factors available for download at https://www.irs.gov/retirement-plans/actuarial-tables. For a 20-year term when the §7520 rate was 1.6% at the time of the gift, the remainder factor would be 0.727991. Thus, the deduction for the transfer of this future interest in the personal residence would be $68,888.89 x 0.727991, or $50,150.49.

Finally, if the value of the land may be reduced by depletion of its natural resources (e.g., valuable mineral rights), the expected depletion must be taken into consideration in estimating the value of the charity's remainder interest, although no specific methodology is mandated.

The remainder interest gift allows the donor to retain the use of the property for the rest of his or her life. (Actually, it is much more flexible than this, allowing for any period of years or the life or lives of any person or group of people, but such alternatives are rarely used.) What happens if the donor no longer wishes to use the property? Perhaps the property is a personal residence, and the donor decides to move away to a warmer climate or to a nursing home. Or perhaps the property is farmland, and the donor becomes unable or uninterested in continuing to farm. Whatever the circumstances, either anticipated or unanticipated, the donor still has a variety of options available when he or she no longer wishes to personally use the property.

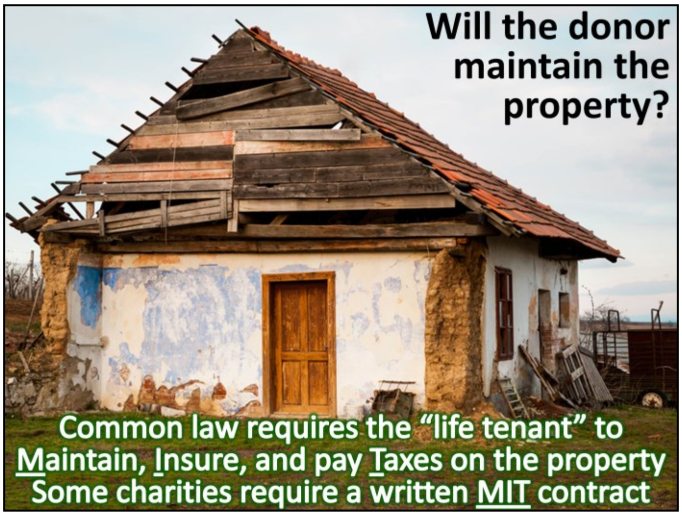


One easy solution is for the donor to simply rent out the property and take the income. If moving to a distant state, the donor will likely hire a property manager to manage the leasing and maintenance of a residence. It is also possible to sell the life estate to an investor who would then rent out the property, although such transactions are rare. If the charity owning the remainder interest is co-operative, both the life estate and remainder interest can be combined, and the property can be sold with normal "fee simple" ownership. (The division of proceeds between the charity and donor must give the charity at least as much of a share of the proceeds as the IRS tables indicate the remainder interest is worth, based upon the donor's age at the time of the sale.) Most charities holding a remainder interest would be more than happy to agree to a sale and division of the proceeds.

Although less common, a charity could agree to issue a Charitable Gift Annuity (discussed in a separate chapter) in exchange for the donor gifting the life estate. The gift of the life estate would allow the charity to combine the life estate and remainder interest and sell the property whole. Proceeds from this sale could then fund the gift annuity payments. Of course, the same could be accomplished by a joint sale where the donor used the proceeds from his or her share of the sale to then purchase a gift annuity. However, this transaction would require the donor to immediately recognize any capital gain upon the sale of the property, whereas the gift annuity transaction would postpone such taxation. (Conceptually, the donor could even place her life estate interest into a Charitable Remainder Trust prior to a joint sale in order to avoid capital gains taxes. However, this is rarely done because the transaction amounts are not normally large enough to warrant the use of the more complex transaction and because the donor could not use or live in the property after it was transferred to the Charitable Remainder Trust.)

Finally, of course, if the donor was financially capable and charitably inclined, the donor could give his or her life estate to a charity. The gift could be to a charity holding the remainder interest or to any other charity. This is a deductible gift (even though it is the transfer of only a partial interest in property) because the donor would be retaining no interests in the gifted property.

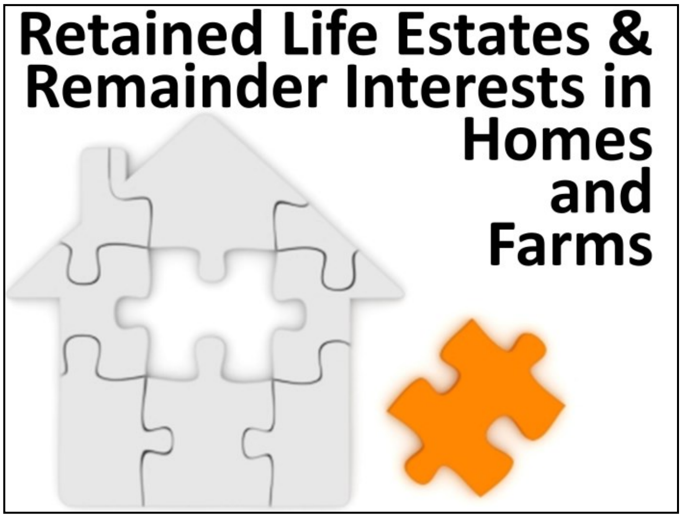
One concern a charity may have about such transactions is whether the donor would choose to maintain the property. Of course, a charity could take the attitude that some gift is better than no gift and not concern itself about the risk of the property deteriorating or burning in the meantime. But, suppose the charity wished to maintain the value of its remainder interest – what are its options?



Although unfamiliar to most people, the life estate / remainder interest property division is a very old form of property ownership. Because of its long history, the rules for such ownership are well established in court cases (referred to as common law). These rules require that the owner of the life estate, referred to as the "life tenant," pay for maintenance, insurance, and taxes (a.k.a. MIT) on the property. Should a life tenant fail to pay for these, the holder of the remainder interest has the right to force payment through court action. Some charities like to avoid such legal actions, if possible. This is one reason it is common for charities soliciting remainder interest gifts to require a written "MIT" contract (Maintenance-Insurance-Taxes). By requiring such an agreement, the charity can ensure that the donor understands his or her obligations. Even if the agreement places no more obligations on the donor than those provided for in common law, it can help to resolve conflicts by serving as a reference point for future conversations. This can be especially important in circumstances where the original donor is no longer managing the property due perhaps to incapacity or where the donor was not the life tenant. The typical scenario, where a donor is the life tenant, usually creates few problems because the donor wishes to benefit the charity. However, if the life tenant is hostile to the charity, problems are more likely to arise. For example, a donor could direct in his will that a personal residence could be used by his sister for life with the remainder interest going to the donor's favorite charity. In this case, the life tenant may have no interest in or connection with the charity. When there is no relationship and the life tenant fails to maintain, insure, or pay taxes on the property, the charity can take one of several strategies. Using a standard approach, the charity can simply enforce its legal rights through court action. Although this path is available, some charities might decide not to enforce their legal rights because of a risk of "bad press." In this case, it would probably be best for the charity to sell its rights to another investor, who would likely be far less concerned about public relations. If the charity is unwilling to enforce its rights or sell its rights to another investor, then the charity must be content with the land or salvage value of the property remaining at the life tenant's death. Note that, depending on state law, it may not be wise for a charity to intervene by paying taxes on the property. Unpaid taxes will ultimately result in the forced sale of the property, the proceeds of which will be subject to distribution, in part, to the charity as holder of the remainder interest.

The life tenant has the obligation, either under common law or under a written "MIT" contract, to maintain, insure, and pay taxes on the property. But, what about a life tenant who wishes to make improvements to the residence? Such improvements are certainly allowed by common law, although they must truly be improvements and not diminish the value of the property. What are the tax consequences of making improvements to property in which the remainder interest is owned by a charity?

The indication from IRS private letter rulings is that improvements made to property where the remainder interest is owned by a charity constitute additional charitable gifts. Improvements to a residence, such as the addition of a bedroom, increase the value of the property. The deduction would be based upon the increase in the value of the property multiplied by the percentage attributable to the remainder interest owned by the charity. This would be the same calculation process used previously but updated for the donor/life tenant's current age. Thus, a donor who has given a remainder interest in his home to his favorite charity can generate additional tax deductions for any improvements made to his home so long as a charity owns the remainder interest at the time of the improvement.



The charitable gift of a remainder interest in a home or farmland with a retained life estate is a relatively simple transaction that begins to demonstrate the power of sophisticated planning. Donors can take an immediate tax deduction without making any changes to the way they will use the property for the rest of their lives. Donors can use the value of this deduction to spend on themselves, invest in income producing assets, or even purchase tax-free life insurance for heirs through an ILIT. Although infrequently used, for the right donor and the right charity, gifts of remainder interests in homes and farmland with a retained life estate can be a powerful technique. As this simple strategy demonstrates, creative and powerful charitable planning is not just for the wealthy.