



CAPE COD
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Planned Giving

An Investment in Cape Cod's Future

How to Realize Maximum Benefits from Your Real Estate

Historically, real estate has proved to be one of the best long-term investments; and most experts quickly agree that a single-family residence is *still* one of the best investments available to the average individual.

In this guide we examine some of the problems you might face as the owner of real estate in its various forms and point out potential solutions. We also explore how you can arrange a charitable gift of your residence, vacation home, or investment realty to enhance income and produce maximum tax benefits for you and your family.

Sheltering Your Appreciation

Despite the sharp decline in real estate that occurred earlier this century, there are still many individuals who have seen the value of their residential property increase over the years—especially recently. Preserving this appreciation for future investment has been made easier because of the liberalized rule regarding taxation of the gain on the sale of a personal residence.

Exclusion rule for capital gain: You may exclude up to \$250,000 of gain on the sale of a principal residence, and that amount is doubled to \$500,000 if you and your spouse file a joint tax return. While there is no age limit on the exclusion, the residence must have been used as a principal residence for at least two of the previous five years. The exclusion may be taken every two years and is also available to individuals who may have already taken advantage of the previous \$125,000 exclusion for those 55 and older.

Liquidity: A Major Stumbling Block

The major disadvantage of real estate investments is that they are not liquid. It could take many months to convert a piece of real estate to cash, and you may not realize a fair price if you need to dispose of the property quickly.

Disposing of listed securities involves no greater effort than a call to your broker. The transaction is consummated within minutes and for a price that reflects the fair-market value of the securities on that day. However, disposing of real estate, even a prime parcel, takes time. If it is urgent to sell quickly, the results may be costly. In the event of a forced sale, you are not likely to receive what the property is actually worth.

While the illiquid nature of real estate can be troublesome and sometimes costly during an owner's life, it is at the death of the owner that the full force of the liquidity crunch becomes real. If illiquid assets make up a large portion of an estate, the family's financial security, at least in the near term, could be threatened.

Planning Opportunities with Charitable Gifts

If you have been considering a substantial charitable gift, you might make that gift with real estate. You would realize tax savings in the year you transfer ownership, and you would remove an illiquid asset from your estate.

One tax benefit is a charitable deduction. If you give the property outright and you have owned it for more than a year, your deduction would be the appraised value of the property. The maximum amount of the deduction that you can use in a year is 30% of your adjusted gross income, but you have up to six years—the year of the gift plus five carryover years—to use the deduction. (With an outright gift you relinquish all interests in the property, and our organization is able to use the property or the sales proceeds.) Another tax benefit you realize is avoidance of tax on the capital gain in the property.

Example: Mrs. B owns a tract of non-income-producing land worth \$200,000 that she acquired by inheritance many years ago. Her cost basis in the property is only \$10,000; so if she sold the property for its full value, she would have \$190,000 of taxable capital gain. The tax on that gain would be her capital-gain tax rate of 18.8% multiplied by the \$190,000 of gain, which is \$35,720. (The 18.8% rate on the gain results from the fact that she

is subject to the Affordable Care Act surtax of 3.8% and a regular capital-gain tax rate of 15%.)

If she contributes the parcel of real estate rather than selling it, she would receive a charitable deduction which, given her 24% regular income-tax rate, results in tax savings of approximately \$48,000. Thus total tax savings are \$83,720 (\$35,720 + \$48,000), meaning that the net cost of making a \$200,000 charitable gift is only \$116,280. Also, she would be relieved of the responsibility for listing and selling the property. Please note that the exact amount she can claim as a charitable deduction depends on two factors: the total amount of her charitable gifts (including the deduction described here) and her adjusted gross income.

Alternative Gift Options

Family considerations can preclude making an outright charitable gift of your entire interest in real estate. However, there are several options available that allow you to realize some payment or income from the property or to retain use of the property until sometime in the future.

Bargain sale of property: Unlike Mrs. B in the previous example, you may be unable to simply make an outright gift of a parcel of real estate. Although you would like to help our organization, you need to receive a payment for your property that you can invest. If this is your situation, you might want to consider a bargain sale.

Under this arrangement, with the intention of making a charitable gift, you knowingly sell property to us for less than its appraised value. Our organization obviously benefits because it acquires the property for a price below what it would otherwise have to pay, and you benefit because you receive an income-tax charitable deduction and you avoid a portion of the capital-gain tax you would incur if you sold the property for full value.

Example: Mr. W owns a lot valued at \$250,000 that he purchased many years ago for \$50,000. Our organization would like to acquire the lot to expand

our facilities, and we ask Mr. W if he would consider contributing the lot. He declines to do this; but he offers to sell the lot to us for \$150,000, and we agree.

Like Mrs. B, his level of income causes his capital-gain tax rate to be 18.8%. Thus, if he had sold the property for \$250,000 (not reduced by selling costs), he would have paid capital-gain tax of \$37,600—leaving net after-tax proceeds of \$212,400. By selling the property for \$150,000, he pays capital-gain tax of only \$18,800 because his reportable taxable gain is \$100,000 rather than \$200,000. Moreover, he receives an income-tax charitable deduction of \$100,000, which, given his 32% tax bracket, saves him approximately \$32,000 in income tax. Thus, as a result of the gift, he realizes \$150,000 (the bargain sale price) plus \$32,000 (the tax savings) minus \$18,800 (tax on the gain) = \$163,200. This is only \$49,200 less than he would have netted if he simply sold the property and made no gift. Please note that the exact amount he can claim as a charitable deduction depends on two factors: the total amount of his charitable gifts (including the deduction described here) and his adjusted gross income.

Sometimes, by mutual agreement, our payment could be made in installments over a period of time rather than in a lump sum. That would prevent you from having to report taxable gain all in one year.

Gift of a remainder interest in a personal residence or farm: If you want to make a charitable gift of real estate but still need the residence for a place to live or the land for providing a livelihood, then another planning option is available. You deed the property to us subject to the right to use of the property for your lifetime (and the lifetime of a survivor if you wish). Such a transfer causes no disruption in your lifestyle because you continue to occupy the residence or operate the farm as before. You also realize *immediate* favorable tax benefits.

As with other charitable transfers, you escape any potential capital-gain tax on your property's appreciation in value. Your gift also creates an immediate tax deduction based on the present value

of our final interest in the property. The deduction means that you will have more dollars to use for living expenses or investment purposes. What's more, your estate will receive an estate-tax charitable deduction for the *full value* of the property.

Example: Mrs. M, a widow, 74, owns a home valued at \$600,000. She has sufficient income for all of her needs and would like to make a significant gift to support our work, but she is hesitant to use her liquid assets to make the gift. After talking with a member of our staff and her advisors, Mrs. M discovers that she can make a gift of the remainder interest in her home and qualify for an income-tax charitable deduction of \$319,341, which she can use, subject to the annual limit, over the next six years. The amount of the deduction is based on certain assumptions regarding the values of the land and improvements, the useful life of the improvements, the current IRS discount rate, and, of course, Mrs. M's age. If Mrs. M had been planning to leave the property to us under her will, this could have been a way to obtain a significant reduction in her taxes while continuing to live in her home.

Planning pointer: Personal residences and farms are the only types of property from which a remainder interest can be transferred to an organization without the use of a qualifying trust.

- The term *personal residence* includes any property used by an individual as a personal residence—a single-family dwelling, a condominium, or stock owned by the donor as a tenant-stockholder in a cooperative housing corporation. A vacation home may also be included if the donor actually uses the home.
- The IRS defines the term *farm* to mean land used by a taxpayer or a taxpayer's tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. Consequently, an individual does not have to actually work the farm personally in order to obtain a deduction for the transfer of a remainder interest.

Reserving a Stream of Income

You may want to consider a charitable life-income plan that utilizes your real estate. For instance, you might have real estate that you would consider giving to us, but you want to continue receiving the income generated by the property. Or you might own non-income-producing property such as undeveloped land that you have thought about selling so you could reinvest the proceeds for income.

While there are several possible life-income plans that might be used, a particularly appropriate one is the charitable remainder unitrust. You would receive the following benefits from it:

- Payments for life, or for a term of years, to you and/or one or more other persons.
- An immediate income-tax deduction based on the full fair-market value of your property and the present age of each beneficiary.
- Avoidance of capital-gain tax on appreciated property.
- Relief from management responsibilities.
- Possible estate-tax savings, depending on the size of your estate.
- The satisfaction of providing future support for a worthwhile endeavor.

Example: Mr. and Mrs. G, ages 66 and 65, create a charitable remainder unitrust funded with a rental house valued at \$550,000. Beginning on January 1 following the year when the property sells, they will receive 5% of the value of trust assets as redetermined on the first of each year. Until that date, their income will be limited to the actual net income the property is producing.

In addition to life income from the trust, which could be larger than their net rents had been, they receive an income-tax charitable deduction of \$182,078, which, based on their income-tax rate of 32%, will reduce their taxes by approximately \$58,265. They will not be taxed on the capital gain when they transfer the property to the trust, and the trust will not be taxed on the gain when the property sells.

Thus the entire proceeds can be reinvested. If they had sold the property themselves, only the after-tax proceeds could have been invested. Please note that the exact amount they can claim as a charitable deduction depends on two factors: the total amount of their charitable gifts (including the deduction described here) and their adjusted gross income.

A gift of rental property to a charitable remainder trust may be especially appealing to people who have been depreciating the property, resulting in a low basis and significant tax on the gain if they were to sell the property themselves.

Final Note

Charitable gifts of real estate provide a variety of exciting opportunities to benefit donors, their families, and charitable causes. There are many ways you may arrange a real estate gift in addition to those discussed here, and such a gift should be planned carefully to derive maximum benefit for you and your beneficiaries.

We invite your inquiries and would welcome the opportunity to discuss these arrangements with both you and your legal counsel. Please write or give us a call.



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