

REAL ESTATE MEETS ESTATE PLANNING – A strategy for highly appreciated property

By Robert J. Silverman, Esq.

True or False: It is possible to create a financial, tax and philanthropic bonanza out of a transfer of highly appreciated property. The answer is true, and it's not a trick question!

It is almost universally accepted that charitable giving is laudable. Nevertheless, due to lack of liquidity, many people, including real estate investors whose assets are largely tied up in equity in their property, are unable to make substantial charitable gifts. Moreover, they usually don't usually even think about making charitable gifts of real property or in any form other than cash.

Fortunately, those who own highly appreciated real property can benefit from gifting their property to a Charitable Remainder Trust (CRT), from which both the owner and the owner's chosen charity receive benefits. Benefits to the owner include some or all of the following: a) eliminating management headaches; b) increasing cash flow; c) avoiding property-related liability; d) diversifying assets; e) sidestepping immediate capital gains tax normally triggered by a sale; f) reducing or eliminating potential estate tax liability; and g) making a meaningful charitable gift.

A number of different types of CRT's are available to suit a property owner's particular goals or needs, and many technical rules apply (Internal Revenue Code sections and Revenue Regulations). Generally, however, CRT's work in the following manner:

- 1) a donor (e.g. real property owner) establishes a CRT – an irrevocable trust - into which the donor gifts one or more (typically highly appreciated) assets (e.g. real estate);
- 2) as a result of the unlimited gift tax exclusion for charitable gifts, the owner is neither liable for paying gift tax on the transfer nor does he use up any of his lifetime gift tax exemption.
- 3) the donor names a qualified charitable organization as the remainder beneficiary of the CRT;
- 4) the trustee named by the donor sells the asset without paying capital gains tax (the sale by a charitable organization is income tax exempt) for which the donor would have otherwise been liable;
- 5) the trustee reinvests the entire net sale proceeds in income-producing assets;
- 6) the trustee of the CRT pays the donor an income stream from the reinvested property sale proceeds - either a fixed amount (Charitable Remainder Annuity Trust) or variable amount (Charitable Remainder Unitrust) - during the existence of the CRT, which is either the donor's lifetime or a certain term not exceeding 20 years;

- 7) the donor receives an immediate income tax deduction - in the year the property is gifted to the CRT – in the amount of the present value of the charitable organization’s “remainder interest” (the projected remaining balance of trust assets when the CRT terminates);
- 8) the income stream distributed to the donor is taxed on a multi-tiered system (i.e. capturing relevant portions as ordinary income, capital gain, then tax free distribution of principal); and
- 9) upon the termination of the CRT, the remainder/balance in the CRT (which, at the time of the gift, must be calculated to be at least 10% of the value of the property being gifted) is given outright to the charitable organization.

So, a property owner can essentially "have his cake and eat it too" with a CRT. Despite these many benefits, property owners are often reluctant to establish a CRT because their loved ones will be deprived of the gifted property or sale proceeds they would have otherwise inherited upon the donor's death. What is often missed on a surface glance, however, is that the potential aggregate, after tax, financial benefits during the donor's lifetime (some or all of which may eventually be inherited by the donor's loved ones) sometimes match or exceed the projected appreciated value of the property during the donor's lifetime.

Of course, there is some downside (besides the fact that the remaining CRT funds don't go to loved ones), and a CRT is not right for everyone. First and foremost, the owner needs to understand and accept that his gift to the CRT is irrevocable. The owner will also no longer have control over the property he's gifting to the CRT or the reinvested CRT assets, and as mentioned, the CRT may or may not leave the owner ahead financially. Also, technical issues make it more difficult to fund a CRT with mortgaged property.

Certainly, careful consideration is merited before an owner decides to establish and gift property to a CRT, and anyone inclined to set up a CRT should absolutely obtain specific advice from his own qualified independent professional legal, tax, and financial advisors. The numbers must be "crunched" to determine whether the specific financial and tax benefits are satisfactory to the owner, and how the CRT impacts inheritance issues.

Interestingly though, even when the CRT's financial benefits are not enough for a given owner to justify establishing the CRT, creative techniques are available to allow the property owner to compensate for the "inheritance deficit". For example, if the property sale proceeds in the CRT are projected to generate income greater than that which the owner is currently receiving from the property, some or all of the excess income can be used to purchase insurance on the life of the owner. The life insurance policy can be purchased with a death benefit equivalent to the projected appreciated value of the property being gifted to the CRT. Furthermore, if the owner establishes an irrevocable life insurance trust (ILIT) to purchase the life insurance, the death benefit is not subject to estate tax on the owner's death. From an estate tax perspective, this is in sharp contrast to the owner keeping the property or selling it on his own (rather than setting up a CRT and ILIT). In that event, if the owner's total net assets at death exceed his estate tax exemption, his loved ones would be vulnerable to estate tax on the date of death value of the property or sale proceeds (at a rate of 45-50%!).

This is not to suggest that every property owner should decide whether or not to establish a CRT solely on the basis of whether it produces a net financial gain. Frankly, given the philanthropic component, some owners don't care. Others are happy to employ related estate planning techniques, like the one outlined above, to make up any anticipated net financial loss. In any event, it is nice to know that using a CRT and/or other similar advanced estate planning strategies, it is frequently possible for all of the stakeholders – in this case, property owner, loved ones, and charitable organization - to win. Well, the taxing authorities may be the losers, but most property owners won't feel badly about that!

Robert J. Silverman, Esq., “Of Counsel” to Berding & Weil LLP, in Alamo, is an attorney whose practice emphasizes Estate Planning & Probate, Real Estate, and Business.

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