Tax-Effective Charitable Donations of Debt-Encumbered Real Estate

By Janet A. Meade

Janet A. Meade examines the tax consequences of various types of real estate transfers to charity and discusses planning techniques that can assist donors in achieving their financial and philanthropic goals.

After years of skyrocketing real estate values, markets are cooling and prices are stabilizing. In this environment, many wealthy individuals find themselves with a large portion of their net worth tied up in real estate, some or all of which may be debt encumbered. Financial advisors who are called upon to develop tax planning and diversification strategies for such individuals should consider the benefits of charitable donations. Donors generally receive an immediate tax deduction, escape tax on part or all of the property's unrealized appreciation and reduce the value of their taxable estate. Charitable organizations benefit from a generous gift.

Donating debt-encumbered real estate to charity is not a simple procedure, and advisors must consider a number of important issues. Among these are questions regarding whether the donor or charity will be responsible for the indebtedness after the transfer, whether the charity will use or sell the property, whether the donor wants to retain an income or remainder interest in the property, and whether the donor has claimed prior depreciation deductions on the property.

Two significant obstacles to tax-effective charitable donations of debt-encumbered real estate are the tax rules involving "bargain sales" and "debt-financed income." If a private foundation or split-interest trust is to be the recipient of the donation, several other potential problems may arise as well. This article examines the tax consequences of various types of real estate transfers to charity, highlighting potential pitfalls and discussing planning techniques which can assist donors in achieving their financial and philanthropic goals.

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Bargain Sale

As its name implies, a bargain sale occurs when a donor, who intends to make a charitable donation, sells property to charity for less than its fair market value. The most common type of bargain sale occurs when a donor sells property to charity in exchange for cash or an installment note. However, bargain sales also arise when a donor transfers debt-encumbered property to charity and is relieved of the obligation.

The bargain sale rule is detailed in Code Sec. 1011(b) and Reg. §1.1011-2. Under this rule, the transfer of the property is decomposed into two parts: a sale portion and a donation portion. The sale portion is represented by the debt on the property and gain is recognized on the difference between the debt and the share of the property's adjusted basis allocable to the sale. The donation portion is equal to the equity in the property or, in the case of appreciated real estate transferred to certain private foundations[1] or property for which the donor makes a special election,[2] the share of the adjusted basis allocable to the donation.

Example 1. A donor owns property with a fair market value of $1 million but subject to a mortgage of $400,000 (40 percent of the property's value). The donor's adjusted basis in the property is $450,000, and he has never claimed any depreciation deductions on it. If the property and related indebtedness are contributed to public charity, the charitable deduction is equal to the donor's equity in the property, or $600,000 before considering the various limitations and phase-out rules applicable to charitable and itemized deductions (discussed later). The donor also must recognize gain on the sale portion of the transfer. This gain is the difference between the mortgage indebtedness and the donor's basis allocated to the sale portion of the property. Since 40 percent of the property is deemed to have been sold, 40 percent of the donor's basis is allocated to the sale, or $180,000 ($450,000 basis x 40%). The gain recognized by the donor consequently is $220,000 ($400,000 debt – $180,000 allocated basis). The donor gets a net reduction to taxable income from the charitable transfer of $380,000 ($600,000 charitable deduction – $220,000 gain). If the donor's marginal rate on ordinary income is 35 percent and the holding period of the property prior to the gift exceeds one year, his relevant tax savings from the contribution is $177,000 [($600,000 charitable deduction x 35%) – ($220,000 long-term capital gain x 15%)].

Application of the bargain sale rule is not affected by whether the debt is recourse or nonrecourse with respect to either the donor or charity. However, a charity may be unwilling to accept property subject to a recourse debt due to the "intermediate sanction" rule of Code Sec. 4958. Under this rule, the IRS can impose punitive excise taxes on both the donor and the charity managers if the contribution is determined to have generated excess benefits to the donor.[3] In addition, the IRS can revoke the tax exempt status of a charity if it determines that the transaction gave rise to private inurement.[4] State law may also preclude a charity from accepting property subject to a recourse debt. In such cases, one alternative is for the donor to convert the indebtedness to nonrecourse. Often, however, a donor is unwilling or unable to make such a conversion. Another alternative is for the donor to commit to continue making payments on the debt personally. If the donor and charity agree to such an arrangement, the charitable deduction is still reduced by the debt component of the contribution and the donor's commitment with respect to the indebtedness is treated similar to a pledge, with the payments deductible as charitable contributions when they are made.[5]

Installment Bargain Sale

A variation of the bargain sale occurs when the payment made by charity to the donor is spread over installments rather than all at once. As with the typical bargain sale, the donor receives a charitable deduction for the portion of the property that is donated. Likewise, the donor recognizes gain on the portion of the property that is deemed sold. When debt-encumbered real estate is contributed to charity in installments, the gain is calculated the same as with the typical bargain sale, except that it is reported ratably as the installments are received.

Example 2. The same facts as in Example 1, except that the charity conveys a new mortgage for $150,000 to the donor in addition to assuming the $400,000 existing mortgage on the property. In this case, the donor is deemed to have sold the property to the charity for $550,000 ($400,000 assumed debt + $150,000 new debt). His basis allocated to the sale is $247,500, or 55 percent ($550,000 sales portion / $1 million FMV) of his adjusted basis of $450,000. The donor's charitable deduction is $450,000 ($600,000 equity – $150,000 new debt) and his gain on the deemed sale is $302,500 ($550,000 sales price – $247,500 allocated basis). Because the charity will make installment payments on the new mortgage to the donor, the donor recognizes $152,500 of the gain ($400,000 assumed debt – $247,500 allocated basis) in the year of the donation and the remaining $150,000 of the gain as installments are received on the new mortgage.[6]

The installment payments can be any frequency or amount acceptable to both the donor and charity. For example, the donor may prefer less income in high tax bracket years and more income in low tax bracket years. Irrespective of the terms of the sale, however, the contract must carry a sufficient amount of interest or a portion of the sales price will be recharacterized as unstated interest income, and both the charitable deduction and gain will be reduced.[7]

Debt-Financed Income

Another obstacle in making a tax-effective donation of debt-encumbered real estate arises from the rule regarding debt-financed income. When encumbered property is acquired by charity, Code Sec. 514(c)(2)(A) treats the amount of the encumbrance as an indebtedness of the charity incurred in acquiring the property, even though the charity does not assume or agree to pay the debt. Any income from the property attributable to the indebtedness consequently is considered debt-financed income and is taxed to the charity as a form of unrelated business taxable income (UBTI).[8]

Several exceptions to the above rule exist. Under Reg. §1.514(b)-1(b)(1)(ii), if the encumbered property is used at least 85 percent in the exempt function of the charity, any income from the property is excluded from the definition of debt-financed income. Thus, no tax on UBTI results if the charity uses the donated property as part of its charitable function.

Two other exceptions are provided for in Code Sec. 514(c)(2)(B). Under the first exception, encumbered property acquired by charity by bequest or devise is not considered debt-financed or subject to tax on UBTI for 10 years (15 years for churches[9]) following the charitable acquisition. A second, similar exception applies to encumbered property acquired by charity when the indebtedness was placed on the property more than five years before the contribution and the donor held the property for more than five years prior to the transfer. These two exceptions do not apply, however, if the charity assumes and agrees to pay the indebtedness or pays the decedent or donor for the equity in the property. Thus, the donor generally must remain personally responsible for the debt until such time as the property is sold by the charity.

Example 3. The same facts as in Example 1, except that the mortgage was placed on the property seven years ago at the time of the original purchase by the donor. If the donor agrees to continue making payments on the mortgage, his commitment will be treated similar to a pledge and the payments will be deductible as charitable contributions as they are made. In addition, the charity will escape tax on UBTI because the encumbered property qualifies for exception to the rule regarding debt-financed income. The charity, however, will have only 10 years after the donation before some portion of the property's income (depending on the amount of debt still outstanding) is considered UBTI and subject to income tax.

In situations where the exceptions to the debt-financed rule do not apply, the charity can reduce its UBTI either by selling the property or claiming straight-line depreciation deductions[10] against its taxable income.[11] For these purposes, the charity's basis in the property is determined under the same rules that apply to gifts to individuals,[12] but modified to reflect the fact that the donation involves a bargain sale. The charity's basis therefore is equal to the basis of the donor allocable to the charitable contribution plus the portion of the property's fair market value deemed purchased by the charity *via* the bargain sale.

Example 4. The same facts as in Example 1. The charity's basis in the donated property is $670,000, calculated as shown in Table 1.

If the charity later sells debt-financed property, gain on the sale must be prorated and included in UBTI in the same percentage as determined by dividing the highest amount of debt-financing on the property during the 12-month period preceding the sale by the average adjusted basis of the property during that same time period.[13] Additionally, depreciation deductions allowed or allowable in computing UBTI are recaptured as ordinary income if the property was held for less than one year.[14]

Example 5. The same facts as in Example 1, except that the mortgage on the property is considered debt financing and the charity holds the property for two years before selling it for $1.3 million. During the two years that the charity holds the property, it claims straight-line depreciation deductions of $16,500 in the first year and $17,200 in the second year.[15] The donor also makes principal payments on the mortgage of $10,000 in the first year and $11,000 in the second year. Gain on the sale of $401,339 is considered UBTI and subject to income tax, calculated as shown in Table 2.

Table 1.

Donor's property basis allocable to the donated portion ($450,000 basis x 60%)	$270,000
Portion deemed purchased *via* bargain sale (*i.e.*, debt)	400,000
Charity's tax basis in donated property	$670,000

Table 2.

Sales price	$1,300,000
Basis at time of sale ($670,000 basis – 33,700 depreciation)	(636,300)
Gain on sale	$663,700
Highest debt-financing during 12 months prior to sale ($400,000 debt – 10,000 paid in first year)	$390,000
Basis at start of year 2 ($670,000 – 16,500 depreciation)	653,500
Basis at end of year 2 ($653,500 – 17,200 depreciation)	636,300
Average basis during 12 months prior to sale (($653,500 + $636,300) / 2)	644,900
Debt/basis percentage ($390,000 / $644,900)	60.47%
Gain on sale considered UBTI[1] ($663,700 gain x 60.47%)	$401,339

1 None of depreciation deductions are recaptured under Code Sec. 1250(b)(1) because the property was held for more than one year and straight-line depreciation was claimed.

Private Foundations

Occasionally, a donor may want to contribute debt-encumbered property to a private foundation. Such a contribution, however, may subject the donor and foundation managers to punitive excise taxes if it constitutes an act of "self-dealing."[16] Under Code Sec. 4941(d)(2)(A), self-dealing includes contributions to a private foundation if the foundation assumes an indebtedness or takes property subject to a debt placed on the property by a disqualified person, such as the foundation's grantor, within the previous 10 years. Thus, in order to avoid punitive excise taxes, the donor must have placed the debt on the property more than 10 years before the charitable transfer. Alternatively, if the debt was placed on the property less than 10 years prior to the transfer, the donation can still avoid the self-dealing restriction so long as it is the donor's initial contribution to the foundation. This is because the donor is not considered a disqualified person under Code Sec. 4946(a)(1) until he or she becomes a substantial contributor to the foundation.[17]

Another key issue the donor needs to consider with respect to such a contribution is that donations of appreciated, long-term capital gain property, such as real estate, to certain nonoperating private foundations are valued at the donor's basis, rather than fair market value.[18] Gifts of appreciated property to these nonqualified private foundations, therefore, often provide minimal tax benefit. The donor consequently might be better advised to contribute the property to either a donor-advised fund or a supporting organization, either of which would allow him or her to receive the maximum tax benefit from fair market valuation while still maintaining a philanthropic role with respect to the gift.

Charitable Remainder Trusts

Donations of debt-encumbered real estate to charitable remainder trusts (CRTs) pose similar difficulties as contributions to private foundations because CRTs are subject to the same set of self-dealing rules.[19] There are, however, additional negative consequences to a donation of encumbered property to a CRT. Unlike a charity, which pays tax on only its UBTI, a CRT that has any UBTI will lose its tax exemption for all of its income that year and taxes will be imposed under the rules for complex trusts.[20] Also, the CRT will be treated as a grantor trust rather than as a qualified CRT if the trust makes any payments on a debt for which the donor retains personal liability.[21]

Several alternatives have been proposed as possible solutions to these problems. Among the simplest is the inclusion of language in the trust instrument indemnifying the trustee from liability on the indebtedness and preventing it from making direct payments on the debt. With this strategy, the CRT would avoid the prohibition of Reg. §1.664-3(a)(4) against payments to or for the use of any person other than a qualified charity.[22] The donor, however, would need to remain personally responsible for making the debt payments until such time as the property was sold by the CRT.

Another alternative is for the donor to sell a fractional interest in the property to the charity, use the proceeds to discharge the debt and pay capital gains tax on the sale, and then transfer the remaining unencumbered fractional interest to the CRT. Because the donor is transferring the entire interest in the property, the problems associated with self-dealing are avoided. The strategy, however, requires the charity to either commit funds to the fractional purchase or join the CRT in sale of their respective interests.

Example 6. The same facts as in Example 1, except that the donor, age 67, wishes to transfer the property to a charitable remainder unitrust with a five-percent annual end-of-the-year payout over his life and a Code Sec. 7520 rate of eight percent. If he sells an undivided 30-percent interest in the property to the charity, his gain on the sale is $165,000 ($300,000 sales portion – $135,000 allocated basis), producing capital gains tax of $24,750 ($165,000 x 15%) and after-tax proceeds of $275,250 ($300,000 sales proceeds – $24,750 tax). Transferring the remaining 70-percent interest to the unitrust generates a charitable deduction of $356,429 ($700,000 charitable portion x 0.509184 present value factor of the remainder[23]) and tax savings of $124,750 ($356,429 charitable deduction x 35%). Together, the after-tax proceeds of $275,250 and tax savings from the charitable deduction of $124,750 equal $400,000, the amount needed to discharge the mortgage.

A similar strategy is for the donor to persuade the debt holder to release its security interest in a fraction of the property so that the unencumbered fractional interest can be given to the CRT. The remaining encumbered interest is then transferred to charity as a bargain sale. Like the earlier strategy, the CRT and charity have the option to join in sale of their respective interests after the transfer.

Example 7. The same facts as in Example 6, except that the mortgage holder releases its security interest in 50 percent of the property. The donor then gives the unencumbered 50-percent interest to a charitable remainder unitrust and the encumbered 50-percent interest to charity. The donor recognizes gain on the bargain sale to charity of $175,000 ($400,000 mortgage – $225,000 allocated basis) and has capital gains tax of $26,250 ($175,000 x 15%). He also receives a charitable deduction from the transfers of $354,592 ($100,000 equity transferred to charity + ($500,000 equity transferred to unitrust x 0.509184 present value factor of the remainder[24])) and tax savings of $124,107 ($354,592 charitable deduction x 35%). The net tax effect is a savings of $97,857 ($124,107 charitable savings – $26,250 capital gains tax).

Pooled Income Funds

Although a pooled income fund (PIF) is technically a CRT, the acceptance of debt-encumbered real estate does not place it at risk for being treated as a grantor trust and thereby forfeiting its tax-exempt status because it has no tax-exempt status to forfeit. Instead, PIFs are generally taxed as complex trusts, but are allowed an unlimited deduction for all amounts of income distributed to fund participants and a charitable deduction for long-term capital gains permanently set aside for charitable purposes.[25] PIFs, therefore, can accept debt-encumbered property, sell it and generally pay no tax on the gain.

When a donor transfers debt-encumbered real estate to a PIF, the bargain sale rule applies. Thus, the entire amount of the indebtedness is treated as an amount realized and gain attributable to the debt is recognized in the same ratio as would have been realized had the entire property been sold on the date of the transfer. Because the donor or the designated beneficiaries receive income from the PIF for life, the charitable deduction is based on a formula that considers the donor's age, the ages of the income beneficiaries, the projected assumed payout of the fund, and a federal index rate. Using this formula, the charitable deduction is determined by computing the present value of the life income interest at the time of the contribution and subtracting that value from the fair market value of the donated property, net of encumbrances.[26]

Most PIFs are reluctant to accept real estate unless it produces substantial income or is readily marketable. This is because the acceptance of non–income-producing property risks diluting the income of other fund participants. When the property is subject to an indebtedness, additional problems can arise because PIFs are subject to the same excise taxes on self-dealing as private foundations.[27] In addition, income from debt-encumbered property may cause the fund to have UBTI. As a result, PIFs generally do not accept debt-encumbered real estate unless the charity maintaining the fund intends to purchase the property from the PIF immediately after the contribution and then either sell it in due course or use it in connection with its tax-exempt function.

Charitable Gift Annuities

Contributions of debt-encumbered real estate are often better suited for charitable gift annuities (CGAs) than CRTs or PIFs because the tax risks are significantly reduced. A CGA does not involve a trust so, unlike a CRT, it cannot run afoul of the grantor trust rules. Additionally, the charity issuing the CGA is not treated as having debt-financing with respect to the encumbered property for 10 years so long as

(1) the charity accepts the property subject to the indebtedness rather than assuming it, (2) the donor has held the property for at least five years prior to the transfer, and (3) the debt was placed on the property at least five years before the donation. Most charities, therefore, have ample time to dispose of debt-encumbered property before subjecting themselves to punitive tax consequences.

Despite the advantages, many charities are reluctant to accept debt-encumbered real property in exchange for CGAs because their obligation to make annuity payments to the donor is a general obligation which begins immediately regardless of when the contributed property is sold. State law may also barr some charities from accepting real property in return for a CGA. Those charities willing to accept debt-encumbered real estate, therefore, typically require evidence of sufficient income to service the debt and/or an indication that the property can be sold quickly for an amount in excess of the indebtedness. They may also reduce the annuity rate used to determine the donor's annuity payments in order to compensate for the liquidity risk associated with the contribution.

The tax consequences of a transfer of debt-encumbered real estate in exchange for a CGA follow the bargain sale rule for determining the amount of the charitable deduction and recognition of gain, with a few modifications. The amount realized is the sum of the indebtedness plus the present value of the annuity. Gain is then recognized based on the difference between the amount realized and the apportioned basis. Part of this gain may be reported ratably over the life expectancy of the annuitant when all of the following conditions are met:

- The transfer qualifies for a charitable contribution tax deduction.
- The donor is one of the annuitants.
- The annuity is nonassignable except to the issuing organization.[28]

Under Reg. §1.1011-2(a)(3), it does not appear that gain attributable to the debt-encumbered portion of the property qualifies for ratable reporting. Thus, gain attributable to the indebtedness is presumably recognized by the donor in the year of the contribution.

Example 8. The same facts as Example 1, except that the donor, age 67, wishes to transfer the property to a charity in July 2006 in exchange for an immediate payment single life CGA, payable quarterly. Applying the bargain sale rule, he recognizes gain of $413,262, calculated as shown in Table 3.

Table 3.

Annuity amount payable on an annual basis ($600,000 equity x 6.2% annual annuity rate for age 67[1])	$ 37,200
IRS adjustment factors	
Charitable federal mid-term rate for July 2006	6.0%
Single life annuity factor for age 67 at 6.0%[2]	9.2407
Quarterly adjustment factor at 6.0%[3]	1.0222
Present value of single life annuity, payable quarterly ($37,200 annuity x 9.2407 x 1.0222)	$ 351,385
Debt on property	<u>400,000</u>
Total amount realized	$ 751,385
Basis allocated to sale ($450,000 basis x $751,385 amount realized) $1,000,000 FMV)	(<u>338,123</u>)
Gain recognized	$ 413,262
Gain reportable in year of transfer ($413,262 gain x $400,000 debt) $751,385 amount realized)	$ 220,000
Gain reportable ratably over life expectancy ($413,262 gain – $222,000 reportable in year of transfer)	$ 193,262
Charitable deduction for present value of remainder interest ($600,000 equity - $351,385 present value of annuity)	$ 248,615

1 Suggested Charitable Gift Annuity Rates, Approved by the American Council on Gift Annuities, May 12, 2003, effective July 1, 2003, and thereafter.

2 IRS Pub. 1457, Table S (6.0).

3 IRS Pub. 1457, Table K.

Charitable Lead Trusts

Charitable lead trusts (CLTs) differ from CRTs and other split-interest trusts in that a CLT pays an income interest to charity for the trust term and at the expiration of that term, the remainder interest reverts to the grantor or trust beneficiaries. CLTs are not exempt from income tax. Rather, they or their grantors are taxed on trust income and gain under the rules applicable to either complex or grantor trusts. Transfers of real estate consequently are generally not advisable unless there is an intent to hold the property until the conclusion of the trust term before transferring it to the noncharitable remainderman. If real property is sold after being transferred to a CLT, any gain on the sale is taxed to either the grantor, if the trust is a grantor lead trust, or the trust itself, if it is a nongrantor lead trust.[29]

CLTs are subject to the same punitive excise taxes on acts of self-dealing as private foundations and other split-interest trusts. In addition, donations of debt-encumbered real property may cause the CLT to have UBTI if the property produces income or is sold for a gain.[30] Contributions of debt-encumbered real estate to CLTs consequently are most viable when the donor has held the property for more than 10 years before the contribution, the indebtedness was placed on the property more than 10 years prior to the transfer, and the trust does not assume any part of the debt.[31] The trust, however, may make payments on the indebtedness without having UBTI or engaging in an act of self-dealing if the loan is nonrecourse.[32]

The most suitable type of real estate for a CLT is property that produces a constant stream of income. This provides the trust with sufficient liquidity to satisfy the required charitable distributions during the trust term. Should this income stream prove inadequate in later years, additional contributions can be made by the grantor, but no income, gift or estate tax deductions are allowed unless the CLT is a unitrust.[33] Loans to the CLT are also allowed, but the proceeds must be used exclusively for charitable purposes and interest and other fees must not be charged.[34] Loans, however, may cause the CLT to have problems with debt-financing and UBTI, and for this reason are not recommended.

Whether a donation of debt-encumbered real estate to a CLT causes the donor to recognize gain under the bargain sale rule is an unanswered question. At the present time, the IRS has not issued any public or private rulings to clarify the treatment. The statutory language of Code Sec. 1011(b), regarding bargain sales to charity, suggests that gain recognition is required only when the contribution gives rise to a charitable deduction. Thus, in the case of a nongrantor CLT, the bargain sale rule should not apply because the donor does not receive a charitable deduction from the contribution.

In contrast, a contribution of debt-encumbered real estate to a grantor CLT does produce a charitable deduction. The deduction, however, is for the present value of the income interest, with the remainder interest retained by the grantor or trust beneficiaries. As such, when the CLT takes encumbered property subject to an indebtedness rather than assuming it, the donor is not relieved of the obligation; it remains his or her responsibility past the expiration of the trust term when the remainder interest in the property reverts back to the donor or the trust beneficiaries. Based on this interpretation, it seems reasonable to conclude that a transfer of debt-encumbered real estate to any CLT, irrespective of whether it is a grantor or nongrantor lead trust, is not a bargain sale requiring gain recognition.

Title Transfer

Prior to contributing debt-encumbered real estate to charity, the donor and charity need to agree as to who will bear responsibility for the costs related to the transfer. The IRS requires that the donor obtain a written, professional appraisal to substantiate the value of any donation valued at more than $5,000. In addition, most charities require that a title search be performed to determine whether there are any defects, liens, unpaid taxes or other restrictions against the property's title, and some may require a property survey and environmental hazard inspection. If the contribution involves the issuance of new indebtedness by the charity, RESPA disclosures may also be required.[35] If the debt is to be removed prior to the transfer to charity, the removal should be evidenced by a recorded reconveyance.

Costs associated with the management and sale of the property generally are borne by the charity. These costs typically include legal fees, brokers fees, property taxes, repairs and maintenance. If the property is to be transferred subject to an existing indebtedness, both the donor and charity need to agree beforehand as to which party will service the debt until the property is sold.

Disposition of Property

Most debt-encumbered real estate is contributed to charity with an understanding that it will be sold immediately after the transfer. If the property is not readily marketable, many charities will not accept it unless it can be otherwise used in their charitable function or held for the production of income. Real estate that is neither marketable nor income-producing is probably not a candidate for charitable giving.

Gain realized on the sale of appreciated real estate by a charity is not taxed to the donor so long as the charitable transfer takes place prior to the sale. Generally, an obligation to sell arises when the property is placed in escrow or has a sale contract executed on it. However, if the donor retains direct or indirect control over the property or imposes an express or implied prearranged obligation on the charitable recipient to sell the property, the donor may be treated as having given the charity the proceeds from the sale rather than the appreciated property. Depending on the nature of the prearrangement, gain from the sale could be included in the donor's income.[36]

Charitable Limitations

As previously discussed, contributions of real estate are generally deductible in an amount equal to their fair market value on the date of the donation, net of any encumbrances. In determining fair market value, one or a combination of methods can be used. The comparable sales method compares the donated property with other properties having similar features, such as location, size, zoning, accessibility, condition, structures and use. The capitalization of income method capitalizes the estimated income from the property at a rate that represents the time value of money and the risks involved. The replacement cost method estimates what it would cost to replace the improvements on the property, taking into consideration their workmanship, materials, square footage, physical deterioration and probable obsolescence.

Certain limitations to fair market valuation may be applicable. For individual donors, the charitable deduction may be limited as a result of their income and the organization receiving the donation. Contributions of appreciated real property held for investment or used in a trade or business more than one year generally are treated as long-term capital gain property with a limitation of 30 percent of the donor's adjusted gross income (AGI) before considering any net operating loss carryback to the tax year.[37] This limitation, however, is reduced to the donor's basis in the property if the contribution is made to certain private foundations other than private operating foundations, common fund private foundations and conduit private foundations.[38]

If the donor claimed depreciation deductions on the property on prior tax returns, the recapture provisions require that the contribution be reduced by any amount that would be taxed as ordinary income had the property been sold at fair market value.[39] The remaining value of the contribution is subject to the 30-percent limit.

Donors may elect to disregard the 30-percent limitations and instead use the 50-percent limit if the deduction is valued using the basis in the property. Such an election, however, is rarely advisable. A better option is simply to carry the excess contribution forward, where it is deductible subject to the 30-percent limit for up to five years.[40]

In addition to these limitations, individual donors also face an overall limitation on itemized deductions, sometimes referred to as the "3/80 percent rule" or the "pease limitation." This rule reduces an individual's otherwise allowable itemized deductions, including the charitable deduction but excluding deductions for medical, nontrade or business casualty and theft losses, investment interest and gambling losses, by the lesser of three percent of AGI or 80 percent of the otherwise allowable itemized deductions.[41] For 2006, taxpayers with AGI in excess of $150,500 ($72,250 for married filing separately) are subject to the limitation, but because of a phase-out provision, the reduction in their otherwise allowable itemized deductions is only two-thirds of the calculated amount.[42]

Conclusion

Donations of debt-encumbered real estate are complex transactions requiring careful planning and skillful negotiation. Because of the difficulties inherent in this type of contribution, they are often overlooked as a means for meeting a donor's financial and philanthropic goals. Yet, properly structured, they can be advantageous to both the donor and charity. Contributions of debt-encumbered real estate often allow a donor to transform a nonperforming asset into a source of supplemental retirement income or to diversify an investment portfolio without disrupting its cash position. Additionally, real estate contributions can provide a donor with an immediate tax deduction, eliminate tax on part of the property's unrealized appreciation, and reduce the value of his or her taxable estate. In return, charities benefit from a significant and valuable gift.

Endnotes

1 Code Sec. 170(e)(1)(B)(ii). The limitation on the charitable deduction applies to contributions to private foundations other than private operating foundations, common fund private foundations and conduit private foundations.

2 Code Sec. 170(b)(1)(C)(iii). The special election is primarily used by donors who contribute assets having a basis close or equal to fair market value. The election allows them to deduct charitable contributions of up to 50 percent of their adjusted gross income, as opposed to the 30-percent limitation that would otherwise apply.

3 Under Code Sec. 4958(a)(1) and Reg. §53.4958-(1), an initial tax is imposed on a donor who is deemed to be a disqualified person with respect to an excess benefit

transaction in an amount equal to 25 percent of the excess benefit from the transaction. A tax in an amount equal to 10 percent of the excess benefit from the transaction (maximum $10,000) is imposed on charity managers who participate in the transaction knowing it to be an excess benefit transaction. If the excess benefit transaction is not corrected within the tax year, an additional tax equal to 200 percent of the excess benefit is imposed on the disqualified person.

4 TAM 9812001 (Mar. 20, 1998).

5 Rev. Rul. 68-174, 1968-1 CB 81.

6 Rev. Rul. 79-326, 1979-2 CB 206, and LTR 7933009 (May 21, 1979).

7 Code Sec. 483.

8 Code Secs. 512, 513(b) and 681(a).

9 Reg. §1.514(b)-1(e).

10 The allowance for depreciation on debt-financed property must be computed only under the straight-line method, as stipulated in Code Sec. 514(a)(3).

11 Code Sec. 512(a)(3).

12 Code Sec. 1015 and Reg. §1.1015-1.

13 Reg. §1.514(a)-1(a)(1)(v).

14 Code Sec. 1250(b)(1) and Reg. §1.1250-2(d)(6).

15 $670,000 basis x 2.461% first-year MACRS depreciation percentage for nonresidential real property placed in service the first month of the year = $16,489, rounded to $16,500 for illustrative purposes; $670,000 basis x 2.564% second-year MACRS depreciation percentage = $17,179, rounded to $17,200 for illustrative purposes.

16 Under Code Sec. 4941(d)(2)(A) and Reg. §53.4941(a)-1, an initial tax of five percent of the amount involved is imposed on a donor who is deemed to be a disqualified person with respect to the penalized act. A tax of 2.5 percent of the amount involved (maximum of $10,000) is imposed on foundation managers who willfully and knowingly participate in the penalized act. If the act is not corrected, a 200-percent tax is imposed on the disqualified person. If the foundation managers refuse to agree to correction of the act, an additional 50-percent tax (maximum $10,000) is imposed on them.

17 Reg. §53.4941(d)-1(a).

18 Code Sec. 170(e)(1)(B)(ii) requires that the donor's basis, rather than fair market value, be used when valuing contributions of appreciated, long-term capital gain property to private foundations other than private operating foundations, common fund private foundations and conduit private foundations.

19 Code Sec. 4947(a)(2).

20 *L.G. Newhall Unitrust,* CA-9, 97-1 USTC ¶50,159, 105 F3d 482, *aff'g*, 104 TC 236, Dec. 50,501 (1995); Reg. §1.664-1(c).

21 LTR 9015049 (Jan. 16, 1990).

22 LTR 9533014 (May 15, 1995).

23 Table U(1) under Reg. §1.664-4(e)(5), with rounding for illustrative purposes.

24 Table U(1) under Reg. §1.664-4(e)(5), with rounding for illustrative purposes.

25 Code Sec. 642(c)(3) and Reg. §1.642(c)-2(c).

26 Reg. §1.642(c)-6(a)(2).

27 Code Sec. 4947(a)(2).

28 Reg. §1.1011-2(a)(4)(ii).

29 There are four basis types of CLTs, each of which produces different tax benefits and serves different financial and philanthropic objectives. Donors transferring real estate to either reversionary or nonreversionary grantor lead trusts receive a charitable income tax deduction in the year of the transfer for an amount equal to the net present value of the income interest passing to charity. If the CLT is a nonreversionary grantor lead trust, the contribution also qualifies for a charitable gift tax deduction and this deduction can be used to offset part or all of the gift tax due on the present value of the remainder interest passing to the trust beneficiaries. All income and gain produced by the trust during the trust term, including amounts distributed to charity, are taxable to the grantor. Upon conclusion of the trust term, the CLT's assets revert to the grantor or the trust beneficiaries.

Nongrantor CLTs are taxed as complex trusts and do not provide the donor with a charitable income tax deduction for gifted property. Additionally, the CLT, rather than the donor, is taxed on all income and gain realized by the trust, after taking into account deductions allowed for trust expenses and amounts distributed to charity. If a nongrantor CLT is created on an *inter vivos* basis, the grantor receives a charitable gift tax deduction in an amount equal to the net present value of the income interest payable to charity. If a nongrantor CLT is created on a testamentary basis, the grantor's estate receives a charitable estate tax deduction, also based on the net present value of the income interest. If the CLT is nonqualified, no income, gift or estate tax deductions are allowed other than an annual gift tax deduction in the amount transferred to charity that year.

30 Reg. §1.514(b)-1(a).

31 Code Sec. 514(c)(2)(B).

32 LTR 7808067 (Nov. 28, 1977).

33 Reg. §§1.170A-6(c)(2)(ii), 20.2055-2(e)(2)(vii) and 25.2522(c)-3(c)(2)(vii). *Also see* LTR 8043077 (July 29, 1980).

34 The loan is not an act of self-dealing under Code. Sec. 4941(d)(2)(B) and the imputed interest rules of Code Sec. 7872 do not apply.

35 The Real Estate Settlement Procedures Act (RESPA) requires a lender to give a borrower certain disclosures during the course of the loan, including costs and escrow account practices associated with the closing.

36 Rev. Rul. 60-370, 1960-2 CB 203.

37 Code Sec. 170(b)(1)(C) and Reg. §1.170A-8(d).

38 Code Sec. 170(e)(1)(B)(ii).

39 Code Sec. 170(e)(3)(E) and Reg. §1.170A-4A.

40 Code Sec. 170(b)(1)(B) and Reg. §1.170A-10(c).

41 Code Sec. 68(a).

42 Code Sec. 68(f).