# An Alternative to the 1031 Exchange

## Helping Your Clients Explore Their Charitable Options with Real Estate

*By K. Gene Christian*

Several charitable techniques are available to accountants to facilitate real estate transactions for their clients. The charitable remainder trust (CRT) is one of the most important. Following is a review of the most significant considerations when helping your client create a real estate funded CRT—instead of simply exchanging again for another property.

### *Types of CRTs*

Standard Charitable Remainder Unitrusts (CRUTs), Net Income with Make-Up Provision Unitrusts (NIMCRUTs), and FLIPCRUTs offer significant planning advantages for charitable gifts of real estate. If the real estate can be sold with virtual certainty very soon after the donation to the standard CRUT, then income payments can begin on an expected schedule to the income beneficiaries.

If something unforeseen should delay the sale of the donated property to the CRUT, additional gifts (cash, stock, etc.) may be made to any type of CRUT to fulfill income payment obligations until the donated real estate is sold. However, if it is clear at the outset that the real estate may be slow to sell, or if the sale may be delayed for any reason, then consideration of the NIMCRUT or FLIPCRUT is most appropriate.

With NIMCRUTs, the income beneficiary(ies) receives the stated percentage of payout, or the actual income earned, whichever is less. If the actual income the trust produces is less than the stated percentage, then an opportunity exists to *make up* the payment deficiencies in later years if/when the trust is growing at a rate that exceeds the stated percentage payout.

A FLIPCRUT begins as a NIMCRUT typically during the year the trust is created and funded. As of the first day of the calendar year following a *triggering event* as defined in the trust document, the trust switches or *flips* to become a standard CRUT. At that point any NIMCRUT make-up balance is forfeited. The triggering event may be a specific date or a single event the occurrence of which is not discretionary within the control of the trustees or any other person.

Examples included in the regulations of triggering events include marriage, divorce, death, or the birth of a child. Also, a triggering event may include the sale of an unmarketable asset other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents. NOTE: Examples of unmarketable assets include real estate.

Today, it is advisable for most accountants to encourage their clients who want to create a CRT with their real estate to consider the FLIPCRUT program.

### *The Prearranged Sale*

The donor cannot be obligated pursuant to a sales contract, opening of escrow, informal written agreement, option obligation, or any other binding agreement to sell the property to a third party prior to a contribution to a CRT. The IRS may utilize the step-

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transaction doctrine to recharacterize the transaction as lacking requisite donative intent. In those instances the transaction may be considered a personal sale by the donor rather than a sale by the CRT—resulting in all the capital gain being taxed to the donor. Since avoiding capital gain tax is one of the primary incentives for most CRT donors, avoiding a prearranged sale situation is most necessary.

### *Unrelated Business Taxable Income (UBTI)*

If a CRT receives even one penny of UBTI, the trust may lose its tax-exempt status for the entire tax year, resulting in all income being subject to taxes for that year. Furthermore, the CRT that has UBTI will owe capital gains tax on the sale of appreciated assets such as real estate, depreciation recapture, and alternative minimum tax. In future years when no UBTI is received, the CRT may be tax exempt, except in the case of the disposition of debt-financed property. Listing the various types of UBTI items is beyond the scope of this writing.

### *Debt-Encumbered Property*

A gift of mortgaged property to a CRT presents a number of potential and significant problems that should be avoided in all cases. Some of the legal problems with a gift of debt-encumbered property to a CRT include loss of tax exemption due to Unrelated Business Taxable Income (UBTI), self-dealing violation, application of bargain sale and/or grantor trust rules, and prohibited payments.

Several options may be considered, such as paying off the debt prior to donation to the CRT. Also, the donor may choose to sell an undivided fractional interest in the property to pay off the debt. Another option may be to shift the debt from the real estate to be donated to other non-gift assets such as with a swing loan. Additionally, a mortgage could be converted to a personal debt if permitted by the mortgage holder. Finally, a thoughtful and capable charitable organization may be willing to purchase an ownership interest in the property to eliminate debt considerations.

### *Self-Dealing Rules*

The self-dealing rules in IRC Sec. 4941 prohibit all transactions between a CRT with a disqualified person. A disqualified person includes the Creator, Trustee, income beneficiaries, and relatives just to name a few.

With respect to a disqualified person, the rules require that there can be no sale or exchange; lease; extension of credit; furnishing of goods, services or facilities; payment of compensation; and/or transfer to the use by, or for the benefit of, a disqualified person.

### *Ordinary Income Property*

The charitable deduction for gifts of ordinary income property to a CRT is not the fair market value of the property as with most non-cash gifts. Rather it is based on the lesser of fair market value and adjusted cost basis, that is, the amount that would have represented ordinary income per IRC Sec. 170(e)(1)(A). Examples of ordinary income property include short-term capital gain property and business inventory, such as land lots of a real estate developer.

### *Valuation*

Unmarketable assets donated to a CRT must be valued by an independent trustee or by a qualified independent appraiser. Unmarketable assets are defined as assets that are not cash or cash equivalents, such as publicly traded stock. Real estate, therefore, is determined to be an unmarketable asset. All donations of real estate of $5,000 or more require a qualified appraisal per Reg. 1.170A-13(c). A helpful resource is IRS Publication 561, ***Determining the Value of Donated Property***. The donor must complete and file IRS form 8283 with the income tax return on which the charitable deduction is made. If

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the recipient CRT disposes of the real estate within two years of receipt, the trustee must notify the IRS of the sale price using IRS Form 8282.

### *Environmental Review*

The 1980 federal Comprehensive Environmental Response, Compensation and Liability Act – CERCLA, aka Superfund law – can make any owner (including charity or CRT) of real estate liable for hazardous waste clean-up and damages even if the charity, or the donor, did not cause the substance to be on the property. Many states have similar laws also imposing liability for cleaning up and "remediating" the site. A Phase I Review is now standard for nonresidential, and for many older residential, real estate donations in order to determine if there are structural defects, asbestos, lead paint, and so forth.

### *Expert Counsel*

The CRT trustee and donor should utilize competent legal, tax accounting, real estate, and financial counsel, especially when facilitating gifts of real estate to a CRT. Once funded, each year the CRT will need special tax returns filed, such as forms 990, 5227, and CT-12.

### *Conclusion*

With property values continuing to soar in our area and as our larger community ages rapidly, there will be a growing opportunity to help your clients understand more about their CRT options in the years ahead. The OSCPA Educational Foundation has resource material, and people, to assist you. If you are interested in learning more about the OSCPA Educational Foundation Planned Giving Program, please contact us at 503-641-7200/1-800-255-1470, ext. 25 or ext. 27, and a representative will be happy to assist you.

***Author's Note:*** *The content of this article draws significantly from an article written by Phil Purcell and published in the October 2004 issue of* ***Planned Giving Today.***

## Firms

### 2005 MAP Survey Update!

PCPS/TSCPA has announced the Practice Management Survey will change to a biennial survey and will not be completed during 2005 as results indicate similarities over multiple years. Watch for the next survey in early summer of 2006! Your participation does make a difference to Oregon firms to ensure statistical validity. Questions/Need order details for 2004 results? Contact Professional Development Division at 503-641-7200 / 1-800-255-1470, ext. 3 or email to profdev@orcpa.org.