Insight on Estate Planning

April/May 2008

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Should you donate real estate to charity?

The real estate "bubble" may have burst, but many landowners continue to hold property that has appreciated significantly in value. One option for tax efficiently divesting yourself of such real estate is to donate it to charity. But there are a number of traps for the unwary.

Understanding the benefits

If you're charitably inclined, donating appreciated real estate offers many advantages. An outright gift to a public charity allows you to deduct the property's fair market value (FMV) while avoiding capital gains taxes. But bear in mind that, if you donate real property to a private foundation, your deduction is limited to your cost basis.

There are several charitable planning techniques that allow you to receive income from the property while generating immediate tax benefits. A charitable remainder trust (CRT), for example, can be an effective vehicle for converting appreciated real estate into an income stream.

Donating real estate to charity may seem like a simple proposition, but you need to plan carefully to navigate a minefield of tax traps.

A CRT is an irrevocable trust that pays income to you or another income beneficiary for life or a specified term and then distributes the remaining assets to a qualified charity. When you transfer real estate to a CRT, you enjoy an immediate tax deduction for the present value of the charity's remainder interest.

As a tax-exempt entity, a CRT can sell the property income-tax-free and reinvest the proceeds in income-producing assets. The trust income distributed to the income beneficiary is taxable, but each payment may include a combination of ordinary income, capital gain and tax-free return of principal.

Another option is to use real estate to fund a charitable gift annuity. In exchange for the property, the charity pays you a fixed percentage of your gift's value annually for the rest of your life.

In the year you make the gift, you're entitled to an income tax deduction based on an actuarial estimate of the portion of the property's value the charity will ultimately keep. Each annuity payment you receive is treated as part ordinary income, part capital gain and part tax-free return of principal — at least until all of your principal has been returned to you. After that, the entire payment will be considered ordinary income.

Other alternatives for donating real estate include charitable lead trusts, bargain sales and conservation easements. Your estate planning advisor can help you determine which, if any, are right for you.

Sidestepping the tax traps

Donating real estate to charity may seem like a simple proposition, but you need to plan carefully to navigate a minefield of tax traps. Here are some tips for avoiding them:

Substantiate the value. Whichever vehicle you choose, it's critical to obtain an accurate valuation of the property and substantiate that value. Failure to do so can result in loss of deductions as well as penalties for overvaluation.

For property worth more than $5,000, you generally must have it appraised by a qualified appraiser, file Form 8283 with your federal tax return and have your appraiser sign the form. If you're claiming a charitable deduction of more than $500,000, you must attach the appraisal report to your return in most instances.

If the charity disposes of the property within three years, the IRS requires it to report the sale price on Form 8282. If the price is significantly less than the value you reported on your income tax return, the IRS may challenge your deduction.

Avoid mortgaged property. Donating real estate subject to a mortgage can cause a variety of problems. For one thing, you'll likely recognize taxable income for some or all of the outstanding mortgage's value. Also, the charity may have to pay unrelated business income tax on income generated by certain debt-financed property.

As a general rule, it's best to avoid this situation by limiting donations to debt-free property. If you can, pay off the mortgage before you make the donation or ask the lender to accept other property as security for the loan.

Put bargain sales in writing. If you're not prepared to part with a property's full value, a bargain sale may be a good compromise. You sell the property to a charity at a discounted price and claim a charitable deduction for the transaction's "gift element" — the difference between the property's FMV and the sale price.

You'll be subject to capital gains tax, however, on the "sale element" — the excess of the sale price over your proportional cost basis in the property. But if you sell the property for less than your cost basis, you can't claim a loss.

Be sure to document bargain sales in writing. If you don't clearly express your intent to treat the discounted sale price as a gift and the IRS views the transaction as a "bad deal" rather than a bargain sale, you may lose the charitable deduction.

Watch out for prearranged sales. One of the benefits of donating appreciated real estate to charity is that you avoid capital gains taxes. To preserve this benefit, don't donate property to charity after you've entered into a binding agreement to sell it.

This sometimes happens when a property owner with philanthropic intentions gets close to consummating a sale and then realizes a better tax result could be achieved by donating the property and then having the charity sell it to the buyer.

Unfortunately, the IRS may view this as a prearranged sale and require the donor to pay the capital gains taxes anyway. Even worse, the donor won't be able to pay the tax out of the sale proceeds paid to the charity. The tax dollars will have to come out of his or her own pocket.

Avoid self-dealing

If you donate real estate to a charitable entity or vehicle that you established, watch out for the self-dealing rules. These rules impose harsh excise taxes on certain arrangements between a tax-exempt entity and a "disqualified person."

Donor beware

Donating real estate can be an attractive strategy for benefiting a charity while disposing of property in a tax-efficient manner. These donations should be planned carefully, however, to avoid traps that can quickly erase their tax benefits.

Many happy returns

Total return unitrusts align beneficiaries' interests

At times, traditional trusts can create conflicts among beneficiaries, making it more difficult for your estate plan to achieve its objectives and placing your trustee in a difficult position. A total return unitrust (TRU) may offer a solution.

The problem

Consider Ted's dilemma: When his brother Zack died, Ted was named trustee of a trust for the benefit of Zack's wife, Chloe. The trust provides for Chloe to receive all of the trust's income for the rest of her life, after which the trust assets will be divided equally between Chloe and Zack's two children from a previous marriage, Rebecca and David.

As trustee, Ted has a fiduciary duty to treat all three beneficiaries impartially. But he soon finds this to be a thorny challenge. The problem is that it's in Chloe's best interests for Ted to place the trust assets in bonds or other fixed-income investments to help pay her living expenses. Rebecca and David, on the other hand, would prefer that Ted invest in growth stocks or other assets that will appreciate in value, thereby maximizing the amount they receive when the trust funds are distributed.

Suppose Zack leaves $1 million to the trust and that Chloe lives another seven years. If Ted invests it all in bonds that earn a 5% return, Chloe will receive $50,000 in income each year. When she dies, the trust principal will still be $1 million, but the value of Rebecca and David's shares will have been eroded by seven years of inflation.

If, on the other hand, Ted invests all the trust assets in a diversified portfolio of growth stocks that appreciate at a rate of 8% per year, the trust's value will grow to more than $1.7 million by the time Chloe dies. Rebecca and David may be happy with their inheritances, but there will be no current income to distribute to Chloe, who will therefore receive nothing. Either approach leaves someone dissatisfied and increases the chances of a dispute or litigation.

Like many trustees, Ted attempts to satisfy his duty to all beneficiaries by allocating the trust assets equally between stocks and bonds. Chloe receives income of $25,000 per year and the trust is worth about $1.35 million when it's time to distribute the funds. Not a bad compromise, but there may be a better solution.

A tried and TRU approach

With a TRU, instead of receiving all of the trust income, the current beneficiary receives a fixed percentage of the trust's value, recalculated annually. Because the current beneficiary enjoys a regular income stream regardless of the trust's actual earnings, the trustee is free to disregard traditional notions of income and principal and focus on maximizing the trust's total return.

Suppose that the trust in the previous example is structured as a TRU with a 3% annual unitrust payment to Chloe. Ted is relieved of the burden of generating current income for Chloe, so he can choose investments that maximize total returns — in this case, stocks that yield an 8% annual return.

The result: At the end of Year 1, Chloe receives a unitrust payment of $30,000, or 3% of the trust's value at the beginning of the year. Because the trust's value is recalculated annually, however, her payouts increase gradually over time, ending up at more than $40,000 in Year 7. In addition, even after making healthy distributions to Chloe, the trust's value grows to more than $1.4 million by the end of its term.

Handle with care

A TRU can be an effective tool for easing tensions between income and remainder beneficiaries, but it requires careful planning. Your trustee must select an appropriate unitrust payment and invest the trust assets wisely. If the trust's portfolio fails to outperform the payout rate, the trust won't meet your objectives.

One potential disadvantage of a TRU is that short-term swings in stock prices may cause unitrust payments to fluctuate significantly from year to year. To smooth payouts to current beneficiaries, some TRUs provide for asset values to be calculated based on a rolling three-year average.

It's also important to consult state law before establishing the trust. Not all states allow TRUs, though many empower trustees to make "equitable adjustments" of trust income and principal to ensure that all beneficiaries are treated fairly. This may allow trustees to achieve similar results. Even if you don't live in a state that authorizes TRUs, it may be possible to set up a trust in a state that permits them.

Most state TRU statutes establish a percentage for unitrust payments (4% is typical) or allow trustees to select from a range of unitrust rates (3% to 5%, for example).

In addition to checking state law, make sure a TRU is consistent with applicable federal tax laws and regulations. Federal law requires certain estate planning trusts to pay out all of their "income" to a specified beneficiary.

Tax-advantaged marital trusts, for example, must distribute all of their income, at least annually, to a surviving spouse. IRS regulations now provide that a marital trust structured as a TRU satisfies this requirement provided TRUs are authorized by state law and the unitrust amount is between 3% and 5%.

Whenever the validity or tax treatment of a trust depends on how or to whom it distributes "income," it's critical to review applicable laws and regulations to determine whether a TRU will qualify.

Get on the same page

Even in the strongest families, conflicting interests between income and remainder beneficiaries can create tension and turn the trustee's job into a delicate balancing act. By aligning your beneficiaries' interests, a TRU can relieve this tension and allow your trustee to concentrate on developing the most effective investment strategy.

Using TRUs for postmortem planning

Many state total return unitrust (TRU) statutes allow you to convert an existing trust into a TRU. This option provides some interesting post-mortem planning opportunities.

Typically, TRUs are used to maximize payments to the income beneficiary while preserving reasonable growth for the remainder beneficiaries. But in some circumstances, if state law permits, it may be desirable to use a TRU to minimize income payments.

In a recent private letter ruling, a husband who was the income beneficiary of his deceased wife's credit shelter trust found that the trust was generating too much income and threatened to boost his own estate's tax liability.

The IRS allowed the trustee to convert the trust into a TRU without adverse gift, estate, income or generation-skipping transfer tax consequences. This strategy minimized the husband's income and preserved more of the trust assets for the remainder beneficiaries — his children.

Estate planning in the 21st century

The digital revolution has changed virtually every aspect of our lives, and estate planning is no exception. Today, many people do business, communicate and manage their finances online. The result is a wealth of "digital assets," which may take the form of e-mails, online accounts or other information stored on the Web or on remote servers.

Typically, digital assets are guarded by a phalanx of user names, passwords, security codes and other protections. Unfortunately, in many cases, when the owners of these assets die, this information dies with them. Not only do family members lack the information they need to access the owner's accounts, but they may not even be aware that certain accounts exist. Thus, the next time you update your estate plan, be sure to leave instructions on how to access your digital accounts.

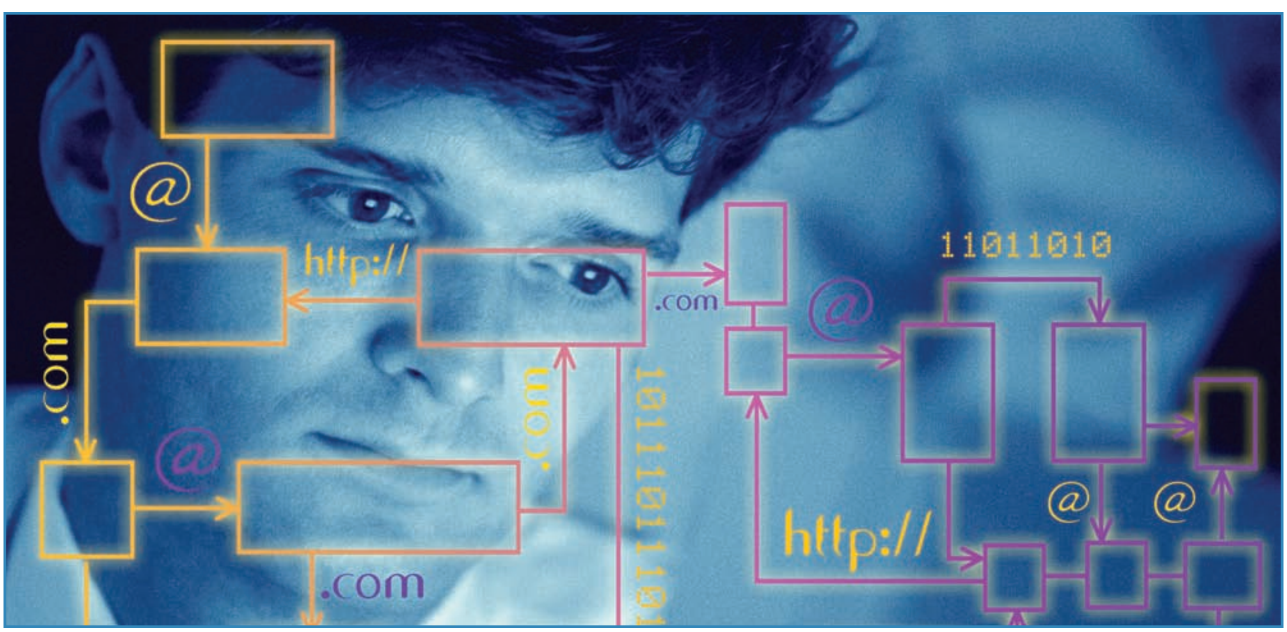
Learn from Joel

Most online service providers have procedures your loved ones can follow to gain access to your accounts. But these procedures can be burdensome, and delays can be costly.

If you conduct your business and financial affairs electronically, leave instructions for your executor or family members with lists of critical URLs, user names and passwords.

Consider the case of Joel, who owns a lucrative online business. Like many Internet entrepreneurs, Joel does business almost exclusively by e-mail and through his Web site, but his estate plan provides little or no guidance for his family on how to take control of critical accounts.

When Joel dies, his family can't access his business e-mail account without a court order, which takes weeks to obtain. One of the e-mails is a renewal notice for the company's domain name, which has expired by the time the family retrieves the notification e-mail.



This is just one of many examples of digital assets that Joel's family needed to deal with after his death. Others included online investment or bank accounts, electronic invoices, and important messages from customers and business partners.

The solution is simple, but it requires some planning. If you conduct your business and financial affairs electronically, leave instructions for your executor or family members with lists of critical URLs, user names, passwords, security codes or other information they'll need to gain access to your accounts.

Keep the list in a secure place, such as a safe deposit box. But keeping this list up to date can be cumbersome if you open new accounts and close old ones and change your passwords regularly. One way to deal with this problem is to establish a master password that gives your loved ones access to a password-protected file — on your computer or an online storage site, for example — containing information about all your electronic accounts.

Show them the way

Most people keep their wills, insurance policies and other key estate planning documents in a safe place and let their families know how to find them. It's just as important, if not more so, to provide similar guidance for your digital assets.

Estate Planning Pitfall

You and your spouse own most of your property as joint tenants

There's a common misconception that holding property as joint tenants with rights of survivorship is an effective estate planning technique. Sure, owning real estate, investment accounts or other assets jointly is a simple way to ensure that property passes directly to a spouse without going through probate. But for many people it's also a sure way to increase their tax bill.

If your wealth exceeds the $2 million estate tax exemption and you and your spouse own most of your property as joint tenants, you're losing out on valuable estate planning opportunities.

When jointly held property passes from one spouse to another, it's shielded from estate taxes by the unlimited marital deduction, but the exemption of the first spouse to die is wasted. Later, when the surviving spouse dies, the property's value is included in his or her taxable estate.

A better strategy is to own property as tenants in common, or otherwise "equalize" your estates by owning separate property that's roughly equal in value. Doing so, you can take advantage of each other's exemption and other techniques for minimizing estate taxes.

For example, if you own property separately, you can use some of it to fund a bypass trust that provides your spouse with income during his or her life, but then passes to your children or other heirs at death, thereby "bypassing" your spouse's taxable estate.

If you live in a community property state, holding assets as community property rather than as joint tenants offers significant income tax benefits. Community property is entitled to a full basis step-up.

But if you and your spouse jointly own highly appreciated assets that aren't considered to be "community property," the surviving spouse is entitled to a stepped-up basis on only half of its value. If that asset is subsequently sold by your surviving spouse, he or she may incur a substantial capital gains tax liability as a result of the sale. So it's important to convert any property held as joint tenants into community property.

About Us

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Our seven core practice areas cover a range of issues that face our clients.

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Our Corporate Law and Business Transactions Group represents entrepreneurs and businesses in all aspects of business law including choice of entity, contract negotiations, mergers and acquisitions, employment matters and financing transactions.

Litigation and Dispute Resolution

Our Litigation and Dispute Resolution Group has extensive experience in complex commercial litigation in all state and federal courts, involving contract disputes, shareholder rights, environmental litigation, employment law, probate litigation and many other areas.

Estate Planning and Administration

Our Estate Planning and Administration Group provides sophisticated wealth transfer and estate planning strategies to individuals and families, with special emphasis on developing business succession solutions to family—owned businesses. We represent clients in all aspects of the administration of decedents' estates and family trusts.

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Our Real Estate Group provides effective and efficient legal counsel to developers, investors and banks in all aspects of commercial and residential real estate transactions and financing.

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