For Trusted Advisors

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The charitable opportunity for real estate.

By Bryan K. Clontz, CFP®, CLU®, ChFC®, CAP®, AEP®

Most donors have more of their wealth in real estate than in any other asset type. Despite this, in 2012 (the most recent year for which data is available), the IRS reports that donors gave only $4.5 billion worth of real estate. That may seem significant, but securities donations topped $22.3 billion, while clothing exceeded $9.3 billion. Indeed, real estate gifts were not quite 10% of the fair market value (FMV) of all noncash donations reported on IRS Form 8283—not even including cash contributions.

This may be because the risks and complications that often accompany gifts of real estate require a different expertise to accept, manage, and liquidate—a key aspect as real estate can often be less liquid than other assets.

This article highlights the magnitude of the real estate gift opportunity, reviews types of real estate assets, summarizes key issues organizations and donors face with real estate gifts, and reviews various mechanisms for receiving real estate gifts.

Tax implications of real estate gifts.

Real estate comes in many types, and each type has a number of ownership forms, which can create an array of tax consequences. As the most efficient charitable gift nearly always comes from the lowest adjusted cost basis, highest capital appreciation property held for the long term, real estate is clearly tailor made for charitable giving.

When owners sell real estate, tax rules generally require that any appreciation in value is taxed at capital gains rates—short term for property held less than a year, and long term for over a year. State taxes may apply as well. Additionally, depreciation recapture rules may apply. This means that the proportion of sale proceeds which can be donated to charity is lowered by amounts the donor pays for taxes. Essentially, only after-tax dollars can be donated if the property is sold by the donor.

If the owner donates the real estate directly to the charity, the result can be much more favorable. A direct gift to a public charity means a deduction of fair market value (FMV), limited to 30% of adjusted gross income with a 5-year carry-forward. If the owner instead donates to a private foundation, he or she would receive a deduction based on the lesser of the FMV or the adjusted cost basis. Regulations limit the deduction to 20% of adjusted gross income with a 5-year carry-forward. Note that real estate may be conducive for testamentary funding of a private foundation to the extent the property receives a stepped-up basis. Additionally, the deduction is reduced for any ordinary income elements, and may receive bargain sale treatment if there is debt on the property.

From the charity's perspective, the main tax issue is unrelated business taxable income (UBTI), which gives rise to unrelated business income tax (UBIT). The charity can trigger this treatment if the real estate represents an unrelated business (such as a golf course), or if the property has debt financed income. Charitable remainder trusts are subject to UBTI as well, in the form of a 100% excise tax on the unrelated income.

Risks, challenges, and solutions.

A general risk continuum can be an important starting point for gift acceptance discussions. It can indicate the potential complexity from the donor's perspective—the commitment of dollars, time, and effort. It also may help to identify certain challenges and possible solutions. A common concern is the time needed to explore proposed real estate gifts, especially when the charity may conclude, after many months, that it does not wish to accept the gift.

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To avoid this result, the donor's team and the charity should discuss basic and essential information on the gift as early in the process as possible. Similarly, tax and legal questions should be addressed head on, and exposure to potential environmental liability also must be investigated, as it may involve multi-phase assessments.

From a practical perspective, all of the expenses and headaches of real estate ownership—taxes, insurance, utilities, tenant issues, and so on—will simply transfer from the donor to the charity and will continue until the charity can sell the real estate, so lack of marketability can exacerbate or extend these issues.

Ways to donate real estate.

Options abound when it comes to the structure of a real estate gift. There are three general categories that these donations fall into:

- Current gifts,
- Deferred gifts, and
- Life income plans.

Depending on the donor's wishes and needs, some donation structures may be more appropriate, e.g., whether the donor would like income or wants to continue living on the property.

The most intuitive real estate donation is a form of current gift, donating the entirety of the property outright to charity. Donors also can give a smaller proportion of an undivided interest in their land. This means the donor can give some proportion of their interest that is less than 100%—half, a quarter, or any amount that is a "full slice" of the ownership interest. For example, a donor should not donate half of their mineral rights in property they otherwise own outright.

Another current gift is the charitable lead trust, which puts the real estate in a trust with income to be paid to the charity for life or a term of years. At the end of the payment term, the remainder or residual may be paid to the donor or to loved ones chosen by the donor. Inter vivos or lead trusts established during life offer no step-up in basis of the land received for heirs, whereas a testamentary lead trust permits a step-up in basis when the heirs inherit the assets.

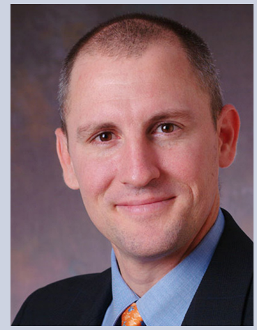
Deferred gifts can be intuitive as well, after all, bequests in a will or revocable living trust are the most popular form of planned gift. Of course, prior to acceptance upon the death of the donor, the charity must conduct due diligence pursuant to its policies and procedures as explained above. An alternative to a bequest in a will or trust is a transfer on death (TOD) deed that may be allowed under state law.

Another type of deferred gift of land is the irrevocable gift of a remainder interest in a personal residence or farm with a life estate retained by the donor. This technique is particularly helpful where the donor wants to use the property for life but the charity wants to ultimately use or sell the property. The donor and charity must sign an agreement stipulating respective rights and responsibilities relative to property tax, insurance, and maintenance.

Finally, there are life income options such as charitable remainder trusts and charitable gift annuities. A charitable gift annuity is a contract where the donor contributes assets such as land and the charity provides fixed and guaranteed income for one or two lives. If land is donated, then the charity either may sell the land to fund the annuity or it may draw from its budget or endowment to fund the annuity payments. A deferred payment gift annuity can permit time for the charity to sell the land.

Charitable remainder trusts allow the donation of highly appreciated property, such as land, that the trustee may then sell without payment of capital gains tax. The cash proceeds can then be invested to earn income for the named beneficiaries. The trust can either pay a unitrust or annuity trust format. An annuity trust pays a fixed dollar amount; real estate must either produce income or be sold to satisfy the fixed payment amount obligation.

The unitrust format pays a fixed percentage of the trust value, either from income and principal or from the lesser of the fixed percentage amount or net income. The net income format is appealing since this allows time to sell the land to fund the payment obligation. It can even "flip" from a net income type unitrust to a standard unitrust after the land sells.



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Summary.

Real estate offers many ways to leave a lasting legacy to a charitable organization. To learn more about the benefits and concerns of gifting real estate, consult with an experienced financial services provider.

Business Planning

Managing succession in the family business.

By W. Gibb Dyer

As a doctoral student at MIT in the early 1980s, I was the teaching assistant to one of our faculty members, Dick Beckhard, a well-known consultant. I was having lunch with Dick one day when he asked me the following question: "Gibb, what do you know about family businesses?" I admitted that I didn't know much about them, only that my grandfather ran a family owned grocery store in Portland, Oregon, for many years. Dick then told me that many of his clients owned family businesses and they were extremely difficult clients to work with, for he would try to help the family solve various business issues only to have family conflicts and dynamics undermine his consulting work. He then proposed that he bring some of his clients into Boston for several days, we'd listen to their issues and problems, and then develop a research agenda based on their issues. I spent three days listening to the issues and problems of the leaders of five family businesses (one from Canada, two from the United States, and two from Venezuela), and I heard things that I never encountered in my MBA program, which focused primarily on issues facing large, public corporations.

While issues related to family conflicts, nepotism, the role of nonfamily managers in family firms, etc., were discussed by Dick's clients, the issue that most concerned them was succession *in the family business—the transfer of ownership and management from one generation to the next. Since that time, I've done research on succession in family businesses and consulted with many family firms dealing with the succession problem. In this article, I summarize the keys to managing a successful transition from one generation to the next that I've learned over the past 35 years.*

Succession Planning Process

Unfortunately, most leaders of family businesses manage succession poorly. One reason for this is that family leaders often view succession planning as "planning your own funeral." One founder of a large family business told me that for him, planning for succession felt like committing *hara kiri* (the Japanese form of suicide). Just thinking about succession was so painful that he hadn't started developing a plan. Not only do leaders of family firms find it difficult psychologically to plan for succession, but family members, nonfamily managers, board members, and others involved with the business often fail to encourage family business leaders to plan for succession. Raising the issue of succession planning can be seen by the family leader as a sign of disloyalty, since it amounts to asking the leader when he or she will retire. Encouraging succession planning also may call into question the competence of the family leader. Given these "resistance factors," very few family firms have a well thought out succession plan. Furthermore, research has shown that family businesses that don't plan for succession do poorly financially after succession, as compared to those family firms who have a plan in place that is shared with the family and senior management.

A number of years ago I did a study of 40 family firms where I looked at the conditions in the business, in the family, and in the board of directors that were associated with a successful transition from one generation to the next. The following are the conditions of success that I found.

Conditions in the Business:

1. The transition occurred when the business was healthy and not in crisis. Less stress on the business made for a smoother transition.
2. The founder/leader gradually moved away from active management of the business. A sudden departure of the family leader often created uncertainty and a power vacuum that wasn't helpful in the succession process. The family leader had a clear timetable for moving out of active management of the business to a more advisory role (typically as chair of the board of directors).

3. There was a well-developed training program for the successor and the successor was chosen based on skills and experience, not just birth order or position in the family. A development plan was put in place to help the successor gain needed skills and experience to lead the business.
4. There was a good relationship between the family leader and the successor. Each helped and supported the other.

Conditions in the Family:

1. The family shared a common view of what was fair. If family members felt that the process and outcomes related to succession planning were unfair, this led to significant conflicts that often undermined the succession process.
2. The family had a plan for what to do if the family leader suddenly died or became seriously ill. The family leader had a will in place to deal with any contingency that might arise.
3. The family was able to manage conflict successfully. In some cases, family counselors were hired by the family to help manage the conflicts they faced.
4. The family had common goals for the business and the family.
5. The family members trusted one another.

Conditions in the Board of Directors:

1. The business had an effective, functioning board of directors or advisors that helped manage the succession process. While most family firms don't have effective, formal boards of directors or advisory boards, those family businesses that had effective, functioning boards managed succession more effectively. Effective boards typically have two to three company outsiders on them who have solid business experience.
2. The board had the experience and expertise needed to help the family develop a detailed succession plan for transferring ownership and leadership to the next generation.
3. The board helped the family create a succession plan that left ownership to family members who were running the business and other assets to family members outside the business. Unhealthy conflicts typically arose when family members not connected with the management of the business had ownership, since they wanted financial returns from the business while family members working in the business wanted to put money back into the business to help it grow.

I have found that if the family leader and family members work to create these conditions in the business, the family, and the board, the likelihood for a successful transition increases dramatically

So how does a family get the succession planning process started?

This is not an easy question to answer. I often find that family leaders only think about succession if they become seriously ill or have a near-death experience. One approach is to encourage family leaders to visit with other leaders of family firms who have done succession planning. Learning from the experience of other family leaders can motivate them to create their own succession plan. Hiring consultants who are expert in succession planning also can help. Most importantly, an effective board of directors or advisors can encourage the family leader to plan for succession and ensure that the plan is shared with the family and key nonfamily employees. In some cases, if the family business is having many problems—there are conflicts in the family, a successor is not available, or the business is not performing well—then selling the business may be the best option.

Succession planning is not easy. Thus, families need to be able to discuss this issue openly with the family leader and plans need to be put in place to make sure that the family and the business are successful after leadership is turned over to the next generation.

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