COMMUNITY
FOUNDATION
of Northeast Alabama

Should You Donate Real Estate To A 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.

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/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.