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Funding Gift Annuities With Real Estate

BY JAMES E. CONNELL

The major job of a planned gift officer (PGO) is to acquire both current and future assets for his or her charity. Planned gifts have grown in popularity as fund-raisers have directed donor assets into life-income programs.

Charities have placed little emphasis on securing current or future gifts of real estate. Several reasons account for this, including the inexperience of many PGOs regarding real estate, low risk tolerance of nonprofit boards and lack of adequate financial models to guide donor negotiations.

Real Estate

The dramatic rise in real estate values in the last 15 years makes property an attractive gift asset for donors. Senior donors may wish to simplify their financial lives by selling excess real estate such as vacation homes, rental buildings, lots and farms. For the donor, a gift of real estate avoids the burden, bother, expense and taxation associated with a commercial sale.

Why haven't charities viewed real estate as a valuable asset for charitable giving? Perhaps it is the administrative concern generated by gifts of real estate. Perhaps the acquisition risk involved in valuations and environmental concerns. Perhaps the disposition risk involved in converting the property into investable assets. Each of these concerns may be overcome with well-reasoned policies and procedures for real estate outright gifts and funded life income agreements.

Why should charities consider real estate gifts in a donor-focused program? First, the vast majority of seniors own real estate, and many seniors own two homes, investment property or land. Second, most seniors own their real estate without the burden of mortgage debt. Third, as seniors simplify their lives during retirement years, the burden of property management may become far greater than the personal gains achieved by keeping the property for investment or estate purposes.

As a practical matter, it is easier to fund a gift annuity with real estate than a charitable remainder trust or a pooled income fund since the charity's general assets are used to make the annuity payments. One of the major benefits of a CGA over a CRT is the charity's immediate promise to pay the donor a fixed guaranteed lifetime income and no delay of payments or payment risks associated with the sale of property within a CRT.

Charitable Gift Annuities

The charitable gift annuity agreement (CGA) is the most popular life-income arrangement for senior Americans. While normally funded with cash or marketable securities, real estate should be considered as an acceptable funding asset. Properly structured, a real estate funded CGA will provide many personal and financial benefits to the donor and a better-than- average return for the charity's gift annuity account.

The following procedures may be helpful in developing an acceptable real estate charitable gift annuity agreement.

Donor Negotiations

As with all life-income agreements, the PGO needs to focus on the financial and personal needs of the donor. In the initial phase, there should be full and fair disclosure about the nature of the proposed property gift. Both the donor and the charity must determine what the property is worth to an interested and motivated buyer. I suggest the donor obtain an appraisal and the charity obtain an independent appraisal. Averaging the two appraisals assists in establishing an acceptable evaluation of the fair market value and avoids a donor-tainted appraisal. A more conservative approach would be to use the lowest appraisal.

In the early stages of donor discussions, the charity should present a typical model which will explain the income the donor may expect to receive from the charitable gift arrangement. The most appropriate approach is to inform the donor that the income will be based upon two factors. First, the appraisal will be discounted 15 percent to compensate the charity for market risks and marketing expenses. Second, the agreement payment will be based upon 85 percent of the fair market value and will be a market rate payment determined by the donor's age and current economic/investment conditions.

Concerns of Charity

The charity must determine the carrying costs for the property on an annual basis. What are the real estate taxes and when are payments due? What are the costs for utilities, insurance, property improvements and management? What are the costs involved in transferring the deed from the donor to the charity and, subsequently, from the charity to the new owner?

Will the charity have to pay two sets of transfer costs? What does state real estate law say about the value of the transfer when there is a bargain sale arrangement? Is the value of the transfer a fair market appraisal amount, an amount determined by the nature of the gift annuity agreement or a value determined by another method? For example, in Texas there are no significant transfer costs for real estate given to charity. However, in Pennsylvania there is a 1 percent transfer fee payable upon acquisition and disposition determined by tax value of the property

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gift. It is valuable to investigate state laws on real estate transfers to charity to properly explain the financial aspects of the gift arrangement to both the donor, the advisor(s) and the charity's board of directors.

The charity must consider the costs of selling the property. For example, when the charity lists the property for sale, what will be the sale's commission to the real estate agent? Normally, homes carry a 5-7 percent commission and land has a 10 percent commission. Does the broker expect any up-front money to support advertising, direct mail or other marketing costs prior to the sale of the property?

Of course, the charity must determine any environmental risks associated with the property using either a phase I or a phase II environmental audit. The charity may choose to skip the audit if it has some knowledge of the property, or the property is land in a planned development or the property is recently constructed residential real estate.

Market Risks and Market Wait

The major financial concern of a charity acquiring real estate pertains to the market risk and market-timing risk associated with the gift. How do the risks affect the ultimate financial return to the charity? A charity should accept a real estate funded gift annuity agreement when it makes financial sense; it is more an asset than a liability and it is in the long-term interest of the charity.

In the October 1996 issue of *Planned Giving Today*, Scott Goyetche discusses valuation concerns and conversion costs and says that it is unfair to discount the value and charge the conversion expenses to the donor. In the same issue, Debra Ashton discusses the charity's perspective for real estate gifts including appraisals, environmental assessments, attorney fees, selling costs and payment liabilities. She suggests the use of a deferred charitable gift annuity agreement.

State laws may prohibit gifts of real estate for gift annuity agreements, such as New York does, or may restrict the nature of the assets a charity may have in their annuity reserve funds. Not all states regulate annuities and not all states that regulate annuities restrict the use of real estate. Some charities may not wish to accept real estate funded gift annuities as it might affect writing annuity agreements for donors in regulated states. In real estate prohibited states you may want to consider a 10-payment bargain sale agreement.

Real Estate Gift Annuity Model

If the charity's board approves accepting real estate, the PGO needs a gift model that evaluates the financial impact of these gifts. Establishing a Real Estate Gift Annuity Model (REGAM) will assist charities with the acceptability of property gifts.

The model form outlined below can be developed using a computer spreadsheet or a word processing table feature. The form should allow several assumptions to be compared. The model forces charities to quantify the risks and costs, and converts the net cash received from the appraisal to the investment return needed to support annuity payments. The target investment return goal should be near the 7 percent stated rate-of-return assumption built into the American Council on Gift Annuities suggested annuity rates.

Here is a quick summary of the model, background on the model components and evaluation suggestion. The model can be used with the donor or by the charity's board to examine the risk/reward relationship of a real estate gift.

Appraisal. Charity and donor should get independent appraisals. Average the appraisals or a more conservative approach uses the lowest appraisal.

Establish Selling Adjustment. The selling adjustment represents market risks or simply the charity's guess at the property selling price. Establish risk as a percentage of appraisal value. Use 3-5-7 percent or 10 percent adjustments to test assumptions.

Estimate Selling Expenses. Establish conveyancing costs as a percentage. Expenses will include the real estate commission, title report, title insurance, attorney fees, real estate transfer fees, environmental inspection, home inspection and other miscellaneous closing fees associated with the deed transfer.

Cash Received by Charity. This represents the net cash available to charity after market risks and transaction costs.

Carrying Expenses Before Sale. How long must the charity hold property prior to sale? The gift is completed when the deed is transferred from donor to charity. Immediately, the charity assumes the costs of owning the property prior to sale. These costs will include property taxes, insurance, maintenance, management fees, assessments, promotional and selling expenses, and any other expenses normally associated with owning land or buildings.

Annuity Payment Adjustment. Assuming the annuity is an immediate payment agreement, it is to the charity's advantage to make the payment annually at the end of the payment period. This may not be acceptable to many donors as semi-annual or quarterly payments may be preferred. Monthly payments should be avoided. The charity must use its cash prior to the property sale. The charity should estimate a one-year payment, or more conservatively, two years of payments.

Total Cash Received. After the property sale, the charity should reimburse itself for both the carrying expenses and prior annuity payments, netting the cash to fund future annuity payments.

Annuity Payments. Should the charity use the suggested annuity payment rates established by the ACGA, or another rate? My experience indicates that donors will accept a "market-based rate" over the ACGA rate when difficult-to-value and difficult-to-sell property is used to fund a CGA. With the current economic conditions, I would use a 6 percent payment rate by donors aged 60-69, a 7 percent payment for donors aged 70-79, and a 7.5 percent payment for those over age 80. Of course, the rate may be negotiable depending on the acceptability of the property gift. Never exceed the ACGA rates for property gifts.

Base the annuity payment on the appraisal value minus a 15 percent adjustment for market risk and marketing expenses.

Annuity Rate on Appraisal. The model figures the actual annuity rate the charity is paying on the full appraisal fair market value.

Annuity Rate on Net Cash. The model figures the actual rate-of-return the net-invested cash must earn to sustain the annuity payment without using principal.

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Tax Considerations

Most property given for a CGA will be appreciated property subject to capital gains taxation. There are some additional tax considerations for real estate funded charitable gift annuities where there is both an outright gift portion and a portion used to fund the annuity agreement. It is important to allocate the cost basis of the property between the outright gift portion and the annuity portion.

The donor payments are determined using the standard federal tables based upon the agreed-upon payment rate and age of the donor(s). The taxability of the payments will be affected by the cost basis allocated to the annuity portion. The payments will be taxed as ordinary income, capital gain income and tax-free payments for an annuity funded with capital gain property. The gain associated with the annuity portion can be spread out over the period of the donor's life expectancy rather than being recognized all in the year of the transfer.

Since the annuity is based upon a value which represents a 15 percent discount from the appraisal fair market value, this discount must be considered in the overall tax effect for the donor. The annuity contract and deed transfer should reflect this 15 percent discount as an outright gift to the charity. The annuity agreement established with 85 percent of the property value generates an additional charitable contribution deduction.

Thus, the donor receives two income tax deductions, one for the outright gift and one for the remainder value of the annuity agreement. In essence, the donor is receiving a charitable contribution deduction for the market value risks and market timing risk being transferred to the charity. Provided the donor itemizes, appraisal fees are deductible as an expense to figure income tax liability.

Case Study

Mrs. Wilson is an 83-year-old (birth date: 7-7-13) widow who wishes to dispose of one of her several rental properties. Real estate is an increasing burden and she wishes to simplify her life. Her accountant points out the value of considering a charitable gift since her current retirement income provides a comfortable living. Her cost basis is $10,756 and the appraisal value is $102,000.

Here's how the real estate funded CGA would work for her. Using our model, we take a 6 percent selling adjustment ($6,120) and reduce the expected gross sales price to $95,880. If selling expenses equal 10 percent ($9,580), the charity will receive net income of $86,292. Anticipating six months of actual carrying expenses of $1,996 before the sale and adjusting for six months of income paid to Mrs. Wilson, results in the charity receiving $82,845 of investable assets. Since one of the apartments is rented, the charity would receive income for six months of $3,225 for final net investment assets of $84,269.

Mrs. Wilson is being paid a 7.50 percent payment on 85 percent of the $102,000 appraisal value. Her annual income would be $6,502.52, with $2,594.51 taxed at ordinary income rates, $3,495.22 in capital gains income and $412.79 received tax-free. In addition to a charitable deduction of $56,233 for the annuity portion of the agreement, she receives an additional $15,300 for the outright portion of the property value.

The result is an annuity rate on full market appraisal of 6.38 percent and the charity needs to earn 7.72 percent on the net cash received to have 100 percent of the annuity gift amount upon the donor's death.

Conclusion

Combining the benefits of the most popular life income gift arrangment, the charitable gift annuity, with an asset owned by the majority of Americans (real estate) can lead to new and rewarding agreements for charities and the donors who wish to unlock the gift potential of their property holdings.

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For a complimentary copy of the Evaluation Model work sheet call Jim at 717-272-3243, or fax your request to 717-228-2453.

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