The Estate Planner

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FAQs about donating real estate

Making charitable donations during your life or at your death removes assets from your estate and thus reduces any potential estate tax liability. Perhaps you'd like to make a significant charitable contribution, and you think that because you're "property rich and cash poor" you don't have a good way to make that contribution. It's time to think again by considering the answers to these frequently asked questions about contributions of real estate.

What are the tax benefits?

First, you can take an immediate income tax deduction equal to the property's current fair market value. Second, you avoid capital gains taxes on any appreciation in the property's value over your cost basis.

By avoiding capital gains taxes, charitable donations of appreciated real estate generate greater tax savings than equivalent donations of cash or nonappreciated property.

Does donating property still make sense?

Even in today's dismal real estate market, many people own property that's worth significantly more now than it was when they purchased it. If you're among them, you can still reap substantial tax benefits from donating the appreciated property.

One advantage of charitable donations in the current real estate market is the ability to dispose of property quickly. Unless you're willing to slash your asking price, selling property today can take a long time. Assuming that you're otherwise charitably inclined, donating the property and taking an immediate tax deduction may be a more attractive option.

Can I donate a portion of the property?

Yes, there are techniques you can use to help a charity while retaining some of the economic benefits for yourself. In a bargain sale, for example, the charity purchases the property for a discount, and you obtain an immediate deduction for the "gift element" of the sale — that is, the difference between the property's market value and the sale price.

The excess of the sale price over your basis, if any, constitutes a taxable capital gain. But if you sell the property to charity for less than your basis, you can't claim a loss.

If you make a bargain sale, it's critical to document the transaction carefully. Your intention

to make a charitable gift must be clear; otherwise the IRS might argue that you simply got a bad price for the property.

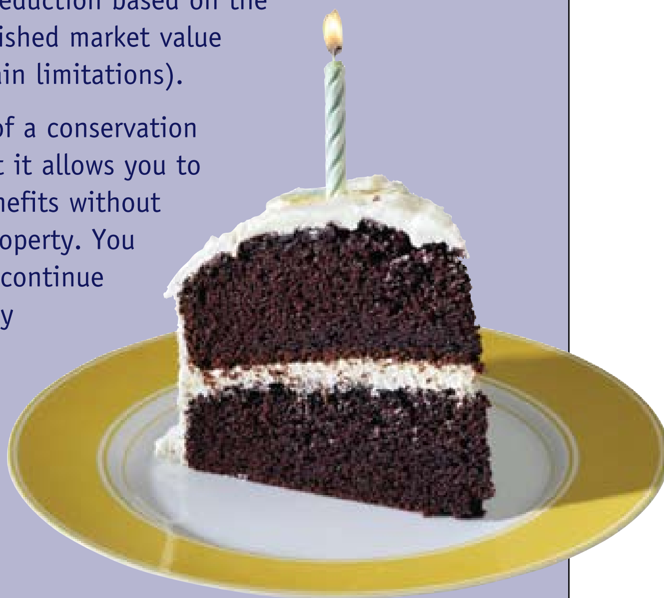
Other options, such as a charitable remainder trust (CRT) or a charitable gift annuity, allow you to donate your property in exchange for an income stream plus immediate tax benefits. With a CRT, for example, you contribute real estate to a trust, which sells the property tax free and places the proceeds in investments that provide you with income during the trust term, after which the assets go to the charity. When you set up the trust, you're entitled to a charitable deduction equal to the present value of the charity's remainder interest.

Conservation easement lets you have your cake and eat it too

If your real estate contains historically significant structures or land that can be preserved for recreation or other public benefits, a conservation easement may be an option.

You enter into an agreement with a government entity or conservation organization to permanently restrict development rights on the property. In exchange, you receive an immediate tax deduction based on the property's diminished market value (subject to certain limitations).

One advantage of a conservation easement is that it allows you to generate tax benefits without giving up the property. You and your family continue to own and enjoy it, and you can even sell it, subject to the easement's restrictions.



Are there limits on the charitable deduction?

Yes. Typically, charitable donations in a given tax year are deductible up to 50% of your adjusted gross income (AGI). But donations of long-term capital gains property — such as real estate — are generally limited to 30% of AGI.

The 30% limit may not apply, however, if you elect to reduce your deduction by the amount that would have been long-term capital gain if you had sold the property. In that case, the 50% limit would apply. Charitable deductions in excess of the limit can be carried forward and deducted as eligible during the following five tax years.

Are there tax traps to be aware of?

Yes, a few:

- If the charity sells the property within three years, it's required to report the sale price to the IRS, which may lead to a challenge if it's significantly less than the amount you deducted.
- Donating mortgaged property usually isn't a good idea. You'll likely be taxed on some or all of the mortgage's value, and the charity may end up with unrelated business income tax.
- If the charity sells the property to a buyer with whom you'd previously negotiated, the IRS may claim the transaction was a prearranged sale. Not only would you lose your charitable deduction, but you'd also have to pay taxes on any capital gains you would have realized had you sold the property yourself.

Also keep in mind that the failure to meet the IRS's substantiation requirements can result in the loss of the deduction, not to mention interest and penalties. Generally, for real estate donations, you'll need to have the property

valued by a qualified appraiser, have the appraiser sign Form 8283 ("Noncash Charitable Contributions") and, if you're claiming a deduction of more than $500,000, attach the appraisal report.

Seek professional help

Donating real estate can be an effective strategy for saving income taxes, reducing your taxable estate and achieving your philanthropic objectives. Given the amounts at stake and the risks involved, however, it pays to consult your tax advisor before you give your property away. ✤

The Roth IRA: Is it time to convert?

If you have a significant balance in a traditional IRA, it may make sense from an estate planning perspective to convert it to a Roth IRA. But choosing the right time to make the switch can be a challenge — and if your income is too high, you won't even be eligible to make the conversion until 2010.

Roth benefits

For many people, a Roth IRA offers distinct advantages over a traditional IRA. Contributions to a traditional IRA are tax deductible, but withdrawals are subject to ordinary income taxes.

With a Roth IRA, on the other hand, contributions aren't deductible, but qualified withdrawals — including earnings — are tax free. In terms of income taxes, you might be better off with a Roth IRA if you expect to be in a higher tax bracket when you reach retirement age.

And from an estate planning perspective, a Roth IRA is usually preferable because it allows your savings to continue growing and compounding beyond age 70½, leaving more of your wealth for future generations. Unlike a traditional IRA, a Roth IRA doesn't require you to begin taking distributions at age 70½, and it allows you to continue making contributions beyond that age. And though your heirs will be required to take distributions after they inherit the Roth IRA, the distributions will not be considered taxable income except in very limited circumstances.

Now or later

For income tax purposes, a Roth conversion is treated as if you had withdrawn the funds from the traditional IRA in a taxable (but penalty free) distribution and reinvested them in a Roth IRA. If the value of your IRA investments has taken a beating in the current

economy, making the conversion now may allow you to minimize the tax hit.

On the other hand, under current law, if you do the conversion in 2010 you can spread the taxable income over the *following* two years. That is, you report no income in 2010, 50% in 2011 and 50% in 2012. However, you can opt out of this option and report all of the income in 2010. Of course, if you wait until next year, the value of your IRA investments may recover and a conversion may result in greater taxable income. To determine the optimal timing, you need to weigh the tax cost of converting and reporting the income this year against the expected tax cost of converting next year and being able to defer the income to subsequent years.

Another option is to do the conversion in stages over two or more years to minimize the tax hit in any one year. This strategy may avoid pushing your income into a higher tax bracket or triggering other unfavorable tax consequences (such as itemized deduction phaseouts) that kick in once your income reaches a certain level.

Income limitations

Depending on your income level, the question of whether to convert a traditional IRA into a Roth IRA this year may be moot. Currently, you're only eligible for a conversion if your modified adjusted gross income (MAGI) — not counting income generated by the conversion itself — is $100,000 or less. Married individuals filing separate returns are ineligible regardless of their income.

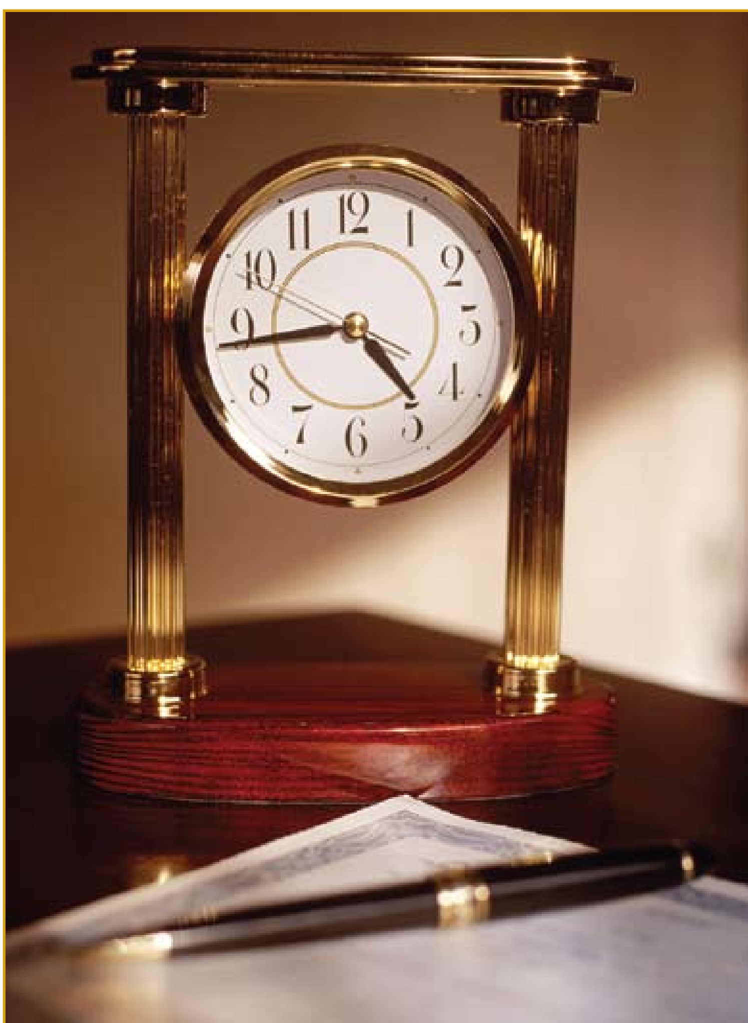
But this income limitation is scheduled to disappear in 2010, allowing taxpayers at any income level to convert a traditional IRA into a Roth IRA. Notably, this is true even of people who would be ineligible to make *contributions* to a Roth IRA.

This year, for example, Roth IRA eligibility is phased out beginning when adjusted gross income (AGI) reaches $105,000 ($166,000 for married couples filing a joint return) and eliminated once AGI reaches $120,000 ($176,000 for joint filers). But taxpayers whose income exceeds those levels can still convert a traditional IRA into a Roth IRA starting next year.

For many people, a Roth IRA offers distinct advantages over a traditional IRA.

Keep an eye on Congress

As you weigh your options, be sure to consider the possibility that Congress will increase taxes or change the rules regarding Roth IRA conversions next year. Given this uncertainty, it may make sense to do a Roth conversion this year, if you're eligible. ✤



It's *intentionally* defective?

How an IDGT can benefit your estate plan

If you're talking to your estate planning advisor and he or she says a defective trust may be right for you, don't be alarmed. In fact, you should thank him or her, because an intentionally defective grantor trust (IDGT) can be an effective estate planning technique for minimizing taxes in large estates.

Multiple advantages

Combining the estate tax benefits of an irrevocable trust with the income tax advantages of a grantor trust, IDGTs offer intriguing estate planning opportunities. Irrevocable trusts can allow you to freeze the value of assets for transfer tax purposes. When you contribute property to an irrevocable trust, you're subject to gift tax on its current fair market value, but all future appreciation in value passes to your beneficiaries tax free.

An IDGT (also referred to as an intentionally defective irrevocable trust, or IDIT) behaves like other irrevocable trusts for estate tax purposes. But by retaining certain powers over the trust (such as the right to reacquire trust assets by substituting other property of equal value), you can make it "defective" for income tax purposes. In other words, the assets are removed from your estate, but the IDGT is treated as a grantor trust for income tax purposes.

Because you're treated as the owner of a grantor trust, you report the trust's net income on your individual tax return. Why is that a good thing? Because paying the trust's income taxes allows you to substantially increase the amount of wealth your beneficiaries receive without triggering additional gift or estate taxes.

Ordinarily, an irrevocable trust is responsible for its own taxes, which consume a portion of its assets. By structuring the trust as a grantor trust for income tax purposes, however, you achieve the equivalent of an additional tax-free gift to your beneficiaries: Your income tax payments reduce the size of your estate while increasing the trust's value by the amount of income taxes the trust would otherwise have paid.

The IRS has acquiesced with respect to the validity of this technique, ruling that a grantor's payment of taxes for a properly structured grantor trust doesn't constitute a gift to the trust's beneficiaries.

Appreciated-asset selling vehicle

An IDGT can be an ideal vehicle for selling assets that have appreciated in value and are expected to continue appreciating. In a typical transaction, you make a taxable gift of seed money — say, 10% of the purchase price — to the trust. Next, you sell property to the trust in exchange for a promissory note.

Because a grantor trust is treated as the grantor's alter ego for income tax purposes, a sale to an IDGT is essentially a sale to yourself. So you won't recognize any capital gain or loss on the sale, nor will you owe any taxes on the note payments. You will, of course, pay taxes on the trust's net income.

The property sold to the IDGT — along with all future appreciation — is removed from your taxable estate. In addition, so long as the purchase price is equal to the property's fair market value and the note bears adequate interest at the applicable federal rate (AFR), there's no gift tax on the transaction. To the extent that the trust's earnings and appreciation top the AFR, the excess is transferred to your beneficiaries tax free.

Funny name, valuable tool

Despite its somewhat odd sounding name, an IDGT can help you realize significant gift and estate tax savings. Plus, it has the flexibility to solve a variety of estate planning problems. So if your estate planning advisor mentions a defective trust, don't laugh — just ask him or her for more details. ✤

Estate Planning Red Flag

Your child is on the title to your home or other assets

One of the most common, and costly, estate planning mistakes is to own property jointly with your child. Many people hold property — such as homes, bank accounts, investments or automobiles — with their children as joint tenants with right of survivorship. Their goal is to avoid probate and to ensure that when they die the property is transferred to their children automatically without the need for a trust or other estate planning vehicle.

There are several problems with this approach:

- Unless you purchase the property together with your child, adding his or her name to the title is considered an immediate taxable gift of half of the property's value.
- As soon as your child becomes a joint owner, the property is exposed to claims by his or her creditors.
- Your child gains access to certain assets, such as bank or investment accounts, and can dispose of them without your consent or knowledge.
- For other assets, such as real estate, you may not be able to sell or borrow against them without your child's signature.
- Your child receives the property immediately when you die, even if he or she lacks the maturity to manage it.
- When you die, your share of the property's value will be included in your taxable estate.
- Your child can step up the basis on only the portion of the property that is included in your estate. The portion that is deemed to be your child's share would not be subject to step-up.

Another potential problem with joint tenancy is that you may unintentionally disinherit a family member. Suppose, for example, that you and your spouse each have one child and several grandchildren from previous marriages. After you die, your spouse adds both children to the title to the family home as joint tenants. If your child dies before your spouse's child, the latter will become sole owner of the home when your spouse dies, effectively disinheriting your grandchildren.

All of the problems previously discussed can be avoided with one or more properly drafted trusts.

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