Charity Begins at Home (or on the Farm):

Dealing with Remainder Interest Gifts

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I. What property can the donor give?

A. Personal Residence. Regulations and private rulings confirm that a “personal residence” need not be the donor’s principal residence; instead, a vacation retreat or other second residence can qualify. The term also can include the donor’s stock in a cooperative housing corporation, as well as a houseboat, mobile home or trailer.

1. The exact limits of the term are not set forth; but a helpful analogy may be found in IRC § 163, describing qualified personal residence trusts, which treats as a residence any facility that includes kitchen, toilet and sleeping accommodations. See generally, e.g., Priv. Ltr. Rul. 8015017.

2. The tax law might seem to allow a deduction for any residential property, as it refers to “a contribution of a remainder interest in a personal residence or farm”, without expressly requiring it to be the donor’s personal residence. IRC § 170(f)(3)(B)(ii). IRS regulations, however, require the property to be “used by the taxpayer [donor] as his personal residence”. Treas. Reg. § 1.170A-7(b)(3).

3. The donor and the donor’s family may not need to be the only users of the residence; instead, some public use may be permitted. See, e.g., Priv. Ltr. Rul. 9538040 (building in which donor lived qualified as a “personal residence” even though it also contained a research library open to the general public). Even renting part (but not all) of the property may be permissible. See, e.g., Priv. Ltr. Rul. 8711038 (property qualified as a “personal residence” even though the donor rented a portion to an unrelated third party).

4. Regulations also do not specify the amount of non-farm land that will be considered part of a personal residence.

B. Farm. A farm is any land that the donor or his tenant uses for “the production of crops, fruits, or other agricultural products or for the sustenance of livestock.”

1. A farm also includes the improvements to the land, such as houses, barns and silos.

2. “Livestock” includes “cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry.”

C. Tangible Personal Property. A gift of a remainder interest in a personal residence does not include related tangible personal property such as furniture. Likewise, a gift of a farm does not appear to include
any of the equipment or machinery used in the farming operation, except items that are considered “fixtures” and thus are treated as part of the land under state law.

D. **Remainder Interest.** The donated remainder may follow any interest recognized under state law, whether measured by the life of the donor or another individual, by a period of years or by a combination of those methods.

1. The measuring life need not be the donor’s or the life beneficiary’s. For example, a corporation could donate to charity a remainder interest in a farm, reserving the right to use it for the lives of individuals who were tenants on the farm. See Rev. Rul. 73-297, 1973-2 CB 67.

2. The entire remainder need not go to charity. For example, a deduction was allowed for 10% of a remainder in a residence that went to charity, where the other 90% went to an individual remainderman. See Rev. Rul. 87-37, 1987-1 CB 295.

3. The donor likewise need not give a remainder in the entire farm; instead, a deduction is available for contributing a remainder interest in a part of a farm. See Rev. Rul. 78-303, 1978-2 CB 122.

4. No deduction is allowed unless the charity has a remainder interest in the residence or farm itself and not just in sale proceeds. Compare Rev. Rul. 77-169, 1977-1 CB 286 (no estate tax deduction for a remainder interest in property devised to an individual for life, with directions to sell the property at the individual’s death and distribute the proceeds to charity) with Rev. Rul. 83-158, 1983-2 CB 159 (direction to the donor’s executor to sell the property at the surviving spouse’s death and distribute the proceeds to charity did not prevent the deduction because state law empowered the charity to take the residence itself rather than the sale proceeds).

II. **What are the tax consequences -- expected and unexpected?**

A. **Real Estate Transfer Taxes.** Some localities allow land to be transferred to charity without imposing any transfer taxes. Others, however, may impose transfer taxes based on the value of the property transferred and payable by the donor, the charity or both.

B. **Continuing Property Taxes.** A gift of a remainder interest to charity generally will not exempt the property from current real estate taxation; instead, the life tenants remain liable for as long as they have ownership rights.

C. **Remainder Interest Value.** The tax-deductible value of a remainder interest for federal tax purposes is determined under a complex formula that takes into account (I) the current market value of the property, (ii) the duration of the individual owners’ interests, (iii) the
current value of any improvements that are subject to depreciation and any natural resources that are subject to depletion, (iv) the estimated use for life of the improvements, (v) the salvage value of depreciable or depletable property at the end of its useful life and (vi) the Applicable Federal Midterm Rate. See Treas. Reg. § 1.170A-12.

1. Depreciation and depletion are computed using the straight-line method.

2. The estimated useful life may be based on an actual estimate by an appraiser, engineer or other authority; or it may be based on useful lives established for particular classes of property under federal income tax depreciation regulations. See Rev. Proc. 87-56, 1987-2 CB 674; IRS Publ. 946. These guidelines provide a range of useful lives for various types of improvements such as sidewalks, roads, landscaping and shrubbery (20 years), grain bins and farm fences (10 years) and residential rental property (40 years). They do not address the useful life of private residences, which are not generally depreciable; but examples in charitable gift regulations assume a 45-year useful life for residences.

3. The salvage value generally is based on an estimate from an appraiser or engineer.

4. As with other types of charitable gifts, the donor may choose to use the Applicable Federal Midterm Rate for the month of the gift or either of the two immediately preceding months.

5. The highest deduction results from (i) allocating the largest reasonable portion of the total property value to the land and the salvage value of the house or other improvements, (ii) allocating the lowest reasonable current total value to the improvements, (iii) using the longest useful life and (iv) choosing the lowest available Applicable Federal Rate.

6. Note that a few states still have separate gift taxes. Valuation methods under those state systems may differ from the federal rules.

D. Measuring Term. Federal tax law imposes only two limits on the measuring term, which may be a lifetime, a fixed number of years, or a combination of the two. First, the individual whose life is the measuring term must be living at the time of the gift. Second, the life expectancy tables may not be used if the individual is terminally ill (suffering from an incurable illness or other deteriorating physical condition resulting in at least a 50% probability of death within one year) unless the individual actually lives for at least eighteen months after the gift.

E. Income Tax Deduction Limit. If the donor has owned the residence or farm for more than one year, the deduction for the remainder
interest value is subject to a limit of 30% of the donor’s contribution base if the charity recipient is a nonprivate foundation and 20% if the recipient is a private foundation. If the donor has owned the property for a year or less, the deduction will be limited the lesser of the remainder value or the donor’s cost basis. In either event, excess deductions may be carried over for up to five years. If the donor has claimed accelerated depreciation that would cause certain amounts to be recaptured as ordinary income if the property were sold, however, the donor’s deduction must be reduced by the amount subject to recapture.

F. **Appraisal Requirements.** A donor may claim a deduction exceeding $5,000 for the remainder value only if the claimed deduction is substantiated by a qualified appraisal that conforms to the formal and substantive requirements of Treas. Reg. § 1.170A-13(c).

1. Note that the regulations prohibit certain individuals from serving as appraisers regardless of their education or experience. Among those disqualified are (i) the donor, (ii) the donor’s spouse, (iii) the donor’s parents, children and grandchildren, siblings and their spouses, (iv) all parties to the transaction in which the donor acquired the gift property, (v) trusts, estates and businesses in which the foregoing individuals together own more than a 50% interest, (vi) the charity and its employees and (vii) an appraiser that performs a majority of its appraisals for any of the foregoing.

2. Newly-enacted legislation also requires the appraiser to demonstrate “verifiable education and experience in valuing the type of property”, IRC § 170(f)(11)(E)(iii)(I), and to have “earned an appraisal designation from a recognized professional appraiser organization or … otherwise met minimum education and experience requirements set forth in regulations” that have not yet been issued. IRC § 170(f)(11)(E)(ii)(I). These new requirements, enacted as part of H.R.4, the Pension Protection Act of 2006, are generally effective for appraisals prepared in connection with returns or other submissions after August 17, 2006.

G. **Gift Tax Consequences.** The present value of the remainder interest given to charity is deductible for federal gift tax purposes. Whether the value of the non-charitable interest is subject to gift tax will depend on the terms of the interest and the identity of the holder.

1. If the donor retains the only non-charitable interest in the property, no other taxable gift has been made.

2. A donor who conveys an interest to a spouse makes a gift of the actuarial value of that interest. The gift tax marital deduction may shelter its value from taxation, but only if the interest begins on the date of transfer and continues for the spouse’s lifetime. Note that, unlike the rules applicable to gift annuities and charitable remainder trusts, the marital deduction
will not be available for a remainder gift not in trust if the spouse’s interest does not begin immediately or if it lasts only for a term of years or until a specified event such as the spouse’s remarriage. Compare IRC § 2523(b) (general gift tax marital deduction rules applicable to life estates) with IRC § 2523(f)(6),(g) (special exceptions for spouse’s interests in gift annuities and remainder trusts) and IRC § 664(f) (“qualified contingency” rules for charitable remainder trust interests).

3. If the donor gives an interest to one or more third parties, the total actuarial value of those interests is subject to gift tax. Treasury regulations do not provide direct guidance on calculations for all possible combinations of terms, but various software providers and commentators have furnished examples of the most common variations.

4. For gift tax as well as income tax purposes, the value of the life tenants’ interests is determined by subtracting the charitable remainder value from the total value of the property. Unlike the income tax valuation formula, however, gift tax valuations do not take depreciation or depletion into account. See Rev. Rul. 76-473, 1976-2 CB 306. This results in higher charitable remainder values and thus in lower taxable gifts than the income tax valuation formula would yield.

5. If someone other than the donor’s spouse has an immediate interest in the property, up to $12,000 of the value of that interest can be sheltered by the donor’s annual gift tax exclusion. The donor’s spouse may consent to “split the gift”, providing another $12,000 of gift tax shelter. The value of a future interest that gives the beneficiary rights in the property only at a later date, however, does not qualify for the annual exclusion. Any additional value of a third party gift can be sheltered by the donor’s $1,000,000 lifetime gift tax credit (and by the spouse’s corresponding credit, if the gift is split).

6. A donor who reserves the right to revoke the future interest of another beneficiary will not be treated as having made a current taxable gift.

7. Anyone who gives a remainder interest in a personal residence or farm to charity must file a federal gift tax return even if no tax is due. See Treas. Reg. § 25.2522(c)-3(c). Normal penalties for failure to file returns are based on the amount of tax due, so failure to file a return for a non-taxable gift would not generate any penalty. See generally IRC § 6651 (penalty is 5% of tax due for each month late, to a maximum of 25%). A separate criminal provision, however, classifies willful failure to file a return as a misdemeanor, punishable by a fine of up to $25,000, imprisonment for up to one year, or both. See IRC § 7203.
H. **Estate Tax Consequences.** The federal estate tax consequences of a remainder gift generally parallel the gift tax consequences.

1. If the donor gives a remainder interest to charity but reserves a life estate, the full property value is includable in the donor’s estate at his or her death. If there are no other non-charitable owners, however, the full value is eligible for the estate tax charitable contribution deduction, so the inclusion results in no estate tax liability.

2. If the donor’s surviving spouse was either a co-tenant with the donor or a successor tenant, the value of the spouse’s interest will be sheltered by the estate tax marital deduction and thus will not generate any estate tax liability.

3. If any third party has an interest that continues beyond the donor’s lifetime, the aggregate value of all such interests (including any interest of the donor’s surviving spouse) will be subject to estate tax (and the spouse’s interest will not be sheltered by the marital deduction).

4. Like the gift tax valuation rules, estate tax valuations are not required to take depreciation or depletion into account.

I. **Income Tax Basis.** If the donor transfers a remainder interest to charity during lifetime and transfers a life interest to another person, the donees’ tax basis generally will be the same as the donor’s, adjusted for any gift taxes paid, under normal rules for lifetime gifts. See IRC § 1015 (“carryover” basis). If the donor makes the transfers by will or makes a lifetime transfer to charity but reserves a life interest (so that, in either event, the property value is included in the donor’s gross estate for federal estate tax purposes), the donees’ tax basis usually will be the value shown on the donor’s estate tax return. See IRC § 1014 (“stepped-up” basis). Note that unless Congress acts to change the law, the basis step-up rules will change substantially after December 31, 2009. See IRC § 1022 (modified carryover basis).

1. Regardless of how the basis is established, the total initially will be apportioned between the individual life beneficiary and the charitable remainder beneficiary according to the actuarial values of their respective interests. As time passes, the life beneficiary’s basis continues to decrease and the charity’s basis continues to increase at the same rate as the values of their interests change. See Treas. Reg. §§ 1.1014-4 (property acquired at donor’s death); 1.1015-1(b) (property acquired by gift).

2. There is an important exception to the general rules of basis allocation. For purposes of calculating gain or loss if the term interest (whether for life or a number of years) is sold separately from the remainder interest, the individual beneficiary is treated as having a zero basis in the term interest. See IRC § 1001(e).
J. **Valuation of Fractional Remainders.** Donors giving fractional interests in property to relatives often seek to reduce their gift tax liability by claiming substantial valuation discounts, arguing that the property is a minority interest or is not readily marketable. A donor who gives charity a remainder interest in only a fraction or percentage of property may find that the IRS will use similar discount arguments to reduce the available charitable contribution deduction. See Rev. Rul. 87-37, 1987-1 CB 295. See generally, e.g. Priv. Ltr. Rul. 93366002 (value of one-half remainder interest discounted to reflect cost of partitioning).

K. **Valuation of Other Restricted Interests.** If the donor requires the charity to put the property to a use that arguably is not its “highest and best use” (e.g., to continue farming activities on property that could bring a higher price if converted to a housing development or shopping center), an appraiser would have to value the property with reference to its permitted use rather than other more profitable uses. If the charity is free to use the property for any purpose, however, the appraiser is not required to reduce its value estimate because the charity does not intend to use the property in the most profitable manner.

III. **How is the gift made?**

A. **Deed with Reservation.** A donor generally makes a lifetime gift of a remainder interest in a personal residence or farm by means of a deed sufficient to convey the interest under applicable state property law. Under general state law principles, the conveyance is effective when the deed is delivered to, and accepted by, the charity, even if it is not recorded in the local land records until a later date. Depending on local custom and practice, the deed may convey a remainder interest only, the entire ownership interest subject to a reserved life estate, or some other type of interest.

B. **Donor’s Will.** A donor may leave an interest in a personal residence or farm to someone else for life or a term of years, with remainder to charity, by means of a specific devise or the residuary clause of a will. The transfer generally will be effective as of the donor’s death, although state laws may vary as to who has title to the property before the will is admitted to probate.

C. **Not by Transfer in Trust.** To qualify for a tax deduction, the property interests must be transferred directly to one or more individuals and one or more charities and not to a trust for their benefit. See Rev. Rul. 76-357, 1976-2 CB 285 (a will provision leaving a residence to a trust for the decedent’s child’s life and directing the trustee to convey it to charity at the child’s death did not qualify for an estate tax charitable contribution deduction). Conveying property to a trust with a charitable remainder qualifies for a deduction only if the trust is a charitable remainder trust or a pooled income fund. See IRC §§ 170(f)(2), (3).
D. **Detailed Conveyance Agreement.** Sometimes donors do not involve their charities in planning for a remainder interest gift. When the charity is aware that such a gift is being contemplated, however, it should do all it can to ensure that the parties consider the full range of issues that could arise in the long and close relationship it and the life tenant will have as co-owners of the gift property. Understandings about those key points should be set forth in a written agreement signed by both the donor and the charity -- and perhaps also by any life tenants other than the donor.

IV. **What are the parties’ basic rights and obligations if the gift documents are silent?**

A. **Sources of Authority.** Although remainder interest gifts are creatures of federal tax law, many of the rights and obligations of the individual and charitable owners are defined by various state laws, including property and conveyance rules, principal and income statutes, mortmain laws and state and local tax statutes.

B. **Transfer Taxes and Fees.** Some states waive conveyance and recordation taxes on any transfer to a charity, while others provide exemptions only if the charity is the sole owner or if the charity is of a certain type, e.g., a church, school or hospital. These amounts can be unexpected additions to the donor’s out-of-pocket cost of making the gift.

C. **Regularly Recurring Expenses.** State principal and income rules generally make the life tenant responsible for regularly recurring expenses such as property taxes, insurance premiums and routine maintenance and repairs.

D. **Larger Repairs and Capital Improvements.** Principal and income rules generally divide the cost of larger repairs (e.g., a new roof or furnace) and capital improvements (e.g., an added room or patio) between the life tenant and remainder owner in proportion to the actuarial values of their respective ownership interests. In many states these values are derived from actuarial tables that are based on different interest assumptions and mortality data than IRS valuation tables.

E. **Duty to Preserve and Repair.** Property laws in most states require the life tenant to keep property in good repair and not allow it to deteriorate beyond reasonable wear and tear. The scope of this duty and of the concept of “waste”, however, often is not defined by statute but instead is described only in court opinions.

F. **Inspections.** Statutes or judge-made law in many states may require the life tenant to let the remainder owner inspect the property at reasonable intervals and reasonable times to ensure that it is being properly cared for. In other states, however, a remainder owner may have no such rights unless it has reason to believe that the life tenant is committing waste.
G. **Remedies.** State law may impose various obligations on life tenants; but a charitable remainder owner often can enforce them only through a proceeding in the local courts, or in the case of certain taxes or expenses advanced by the charity, in a claim against the life tenant’s estate. State laws generally do not allow either party to compel the other to give up its interest involuntarily, either by dividing ("partitioning") the property into separate parcels for the life beneficiary and the charity or by holding a court-ordered sale and dividing the proceeds.

H. **Permissible Uses.** The parties to such a gift may assume that residential property will always be the life tenant’s residence or that farm property will continue to be used for agricultural purposes. Absent a contrary provision in the deed or will, however, state law generally will not prevent the life tenant from sharing the residence with others, renting it to third parties or operating a business on the premises. Likewise it may not restrict the charity’s use of the property after the life tenancy ends.

I. **Tenant’s Incapacity.** State law usually does not provide a satisfactory means of dealing with property of an owner who has become temporarily or permanently incapacitated. Unless the life tenant has previously executed a durable power of attorney, the only option in many states is to begin a slow, costly and public court proceeding for appointment of a guardian or conservator to handle the property of the incapacitated tenant.

J. **Loss or Condemnation.** If the property is damaged or destroyed by fire, storm or other casualty or if it is taken by government in the exercise of eminent domain power, the terms of the applicable casualty insurance policy or of the state condemnation law will determine how the proceeds are to be paid. Those rules, however, will not specify what the parties must do with the proceeds or what they are entitled to do with any remaining portion of the property itself.

K. **Estate Taxes.** If the donor’s will or other testamentary document does not specify the fund from which state and federal estate taxes, if any, are to be paid, a "boilerplate" provision in the documents or a default provision of state law may allocate part of the tax liability to the charity or a successor life tenant.

L. **Charity Ownership Limits.** Statutes in some states restrict the type or amount of real estate that certain types of charities can own. Others, sometimes called “mortmain” statutes, limit the amount of time a charity can hold property received by gift or bequest.

V. **What topics should a conveyance agreement address?**

If the donor and the charity both are involved in designing a remainder interest gift, the documentation should include a detailed conveyance agreement that sets forth each party’s rights and responsibilities as to the property. The topics will vary according to the law of the applicable state, but a typical conveyance agreement will address most or all of the following issues:
A. **Property Conveyed.** If the agreement is made before, rather than concurrently with, the actual conveyance, it should include a specific legal description of the land and improvements being conveyed, the duration of the reserved rights, and the person(s) to whom they are reserved. Often a draft of the actual deed will be attached to the agreement as an exhibit.

B. **Prerequisites to Closing.** The agreement should clearly list any steps that each party must take and any conditions that must be satisfied before closing. These typically might include surveys, title searches, appraisals, environmental reviews, and inspections.

C. **Conveyance Details.** The document should specify when the closing will take place, what documents each party will be required to provide, and how taxes, recordation fees and other costs will be allocated between the donor and the charity.

D. **Extent of Retained Interest.** The agreement should specify whether an interest in the residence or farm is being retained for one or more lifetimes, a specific period of years or some combination of a lifetime and a term of years. Equally important, it should specify whether the donor is retaining the interest or granting it to an identified third party and, in the case of multiple beneficiaries, whether they are to enjoy their interests concurrently or consecutively.

E. **Parties’ Continuing Financial Obligations.** The agreement should allocate the continuing expenses of the property between the individual tenant(s) and the charity. As noted above, state law generally makes the life tenant responsible for regularly recurring expenses such as real estate taxes, property insurance premiums, maintenance expenses and ordinary repairs. Some donors are not aware of this rule, so stating it specifically in the conveyance agreement can avoid surprises or misunderstandings later. If the parties agree to shift some of the expense burden to the charity, the extent of the charity’s obligation should be clearly stated. Note that the charity’s payment of a donor’s legal obligation is a quid pro quo that the charity must disclose on its gift receipt.

F. **Major Repairs and Improvements.** State law generally treats additions, major improvements and capital expenditures differently from regularly recurring expenses. The cost of such major items is allocated actuarially between the life tenant and the charity based on the expected useful life and the values of the parties’ respective property interests. The agreement also should address whether either party can undertake, or incur expenses for, such major items without the permission of the other.

G. **Permitted Uses.** State law generally allows life tenants to use property for any lawful purpose so long as the use does not substantially impair the overall value of the property. The agreement should specify whether the life tenants can use the property as anything other than their personal residence or as a farm (e.g., renting it to third parties or converting it to other business or
commercial use) and, if so, whether the charity must approve the change. The agreement also should state any restrictions on the charity’s permitted uses after the tenancy ends. Note that any use restrictions that apply to either party’s interest generally should be reflected in the deed or will as well.

H. **Permitted Encumbrances.** The agreement should obligate the life tenants not to place any new liens, mortgages or other encumbrances on the property or to increase any existing encumbrance without the charity’s consent.

I. **Insurance and Maintenance.** State law generally requires life tenants to maintain the property and preserve its value. The agreement should require the life tenants to carry appropriate levels of property and casualty insurance, naming the charity as a co-beneficiary in proportion to its interest. Many agreements also allow charities to conduct reasonable inspections of the property and take steps to correct any hazards or problems that may appear, if the life tenant does not correct them after proper notice.

J. **Advancements and Recovery.** If the life tenants fail to pay any expenses or other charges that are their responsibility, the agreement should allow the charity to pay those amounts in order to avoid, for example, interest charges, lapse of insurance coverage, tax liens or other adverse consequences. In that event the agreement also should allow the charity to recover those amounts (including any interest or penalties that were incurred) from the life tenants or their estates.

K. **Insurance or Condemnation Proceeds.** The agreement should specify the disposition of proceeds payable if the property is damaged, destroyed or taken. Options may include repairing or rebuilding, investing in other property subject to the same restrictions, distributing the proceeds to the parties in proportion to their respective interests, investing the proceeds to produce income in lieu of the use of the property, or some combination of those methods.

L. **Designation of Attorney-in-Fact.** The agreement should obligate each life tenant to keep a durable power of attorney in force so that the charity can deal with an authorized representative if the life tenant becomes disabled. Agreements sometimes designate an official of the charity to serve as attorney-in-fact if the life tenant has failed to name anyone else.

M. **Effect of Vacancy.** The agreement should address the possibility that the life tenant will cease to occupy the property. The parties first should consider what type and length of absence will constitute a vacancy. Options in that event may include leasing the property to a third party who pays rent to the life tenant or cooperating in a sale of the property, with the sale proceeds treated in the same manner as insurance or condemnation proceeds under the agreement. Whether the property is to be rented or sold, the agreement should assign responsibility for managing and maintaining it and for paying the attendant costs.
N. **Potential Sale Scenarios.** At some point either the life tenant or the charity may wish to sell its interest. The charity might be able to sell a remainder interest alone, and a tenant for a fixed term of years likewise may be able to sell only that relatively certain interest. A tenant for life, however, is unlikely to be able to sell just that interest, because a buyer could not be certain how long the interest might last. Even if a life interest could be sold separately, a buyer is unlikely to pay the full fraction of the total property value; instead the buyer probably would insist on a substantial discount to reflect duration risk and lack of marketability. In most states, neither a life tenant nor a remainder owner can compel the other to sell its interest. The agreement therefore should address when, if ever, one party may compel the other to join in a sale. Note that, as explained below, giving the donor this right will render the gift non-deductible.

O. **Governing Law.** Certain issues relating to the property will be governed by the law of the state where it is located but the parties are free to specify what law governs other issues. This is especially important when the charity is located in a different state from the donor, the life tenant or the property.

P. **Valuation Issues.** In states that have separate statutory tables for valuing property interests, the parties may wish to specify whether, for example, sale, insurance or condemnation proceeds are to be divided actuarially according to state valuation tables or the corresponding IRS tables. Note that IRS tables will determine whether the division results in a further gift by the life tenants (e.g., when state property tables would have allocated to the life tenants a greater portion of the value than they actually receive) or in some extra benefit to the life tenants (e.g., when IRS tables say they are entitled to more than the state tables entitle them to receive).

VI. **What related planning issues may arise?**

A. **Effect of Sale Requirement.** Donors may want assurances that the property can be sold if they are no longer able to live there or wish to move to a smaller or more convenient residence or to another city. The IRS has ruled, however, that a charity’s obligation to sell its interest if the donors wish to sell the property will render the gift non-deductible even if the proceeds are divided actuarially between the parties. See Rev. Rul. 77-305, 1977-2 CB 72.

B. **Effect of Condition Subsequent.** If the donor or other individuals would be entitled to reclaim the property if the charity changes the use of the property or violates some other condition, the remainder gift value will be non-deductible unless the likelihood that the condition will be violated is “so remote as to be negligible.” See Treas. Reg. § 1.170A-1(e); Rev. Rul. 85-23, 1985-1 CB 327 (remainder non-deductible when left to charity only if one named child did not survive the other). In contrast, if the charity’s violation of such a condition would cause the remainder interest to pass to another qualified charity, the remainder gift should be deductible despite the condition. See Priv. Ltr. Rul. 9436039.
C. **Effect of Existing Lease.** If a remainder interest in farm property is transferred subject to an existing lease, IRS may seek to deny any charitable contribution unless the parties’ agreement guarantees that the charity will receive its prorated portion of any rent prepaid during the year of the life tenant’s death. See Priv. Ltr. Rul. 9714017.

D. **Effect of Existing Mortgage.** If the property being transferred is encumbered by a pre-existing debt, the gift may be subject to the bargain sale rule, which treats a donor who has been relieved of a debt obligation as if he or she had received an equal amount of cash. If the property has appreciated in value, however, the donor must recognize gain only in the ratio that the debt bears to the total property value. The IRS has not officially applied these rules to a remainder interest gift. In ruling privately on a transfer where the donor remained liable for the mortgage payments, however, IRS concluded that (i) the remainder value should be based only on the donor’s equity in the property, (ii) the donor would receive additional deductions for the principal value of each future mortgage payment attributable to the remainder interest, (iii) the remainder value of any future improvements that constitute real estate under local law will be deductible as additional charitable contributions and (iv) the donor would have to take the full mortgage value into account in determining whether the transaction generated any taxable gain or loss. See Priv. Ltr. Rul. 9329017. The first three conclusions comport with general rules of taxation, but the fourth seems inconsistent with the normal application of the bargain sale rule, which would treat only a proportionate share of the total mortgage value as generating gain or loss.

E. **Transfer for Charitable Gift Annuity.** Some charitably motivated donors may want to reserve lifetime rights to a residence or farm and also to have access to part of the remainder value to help offset their expenses. Investing the tax savings generated by the gift deduction might create a fund for future expenses if (i) the donors have enough other income to use most or all of the deduction currently and (ii) they have both the liquidity and the self-discipline to invest, rather than spend, the resulting tax savings. Where state law allows, a better approach may be to convey the remainder interest to charity in return for a charitable gift annuity, resulting in a smaller income tax deduction but also a lifetime stream of income.

1. The annuity amount must be based on the actuarial value of the remainder interest, not on the full value of the property. The charity will have to pay the annuity from other resources, as it will not have access to the value of the property until the donors’ interests end or they relinquish those interests.

2. Gift annuity payments must continue for one or two lifetimes and cannot be limited to a fixed number of years. If the charity thinks it appropriate to offer an annuity rate above American Council on Gift Annuities recommendations, it should be sure that the actuarial present value of the annuity payments does not exceed 90% of the remainder value, as a larger percentage
would subject the charity to tax under the unrelated business taxable income rules for debt-financed property. The annuity also must be non-assignable (except to the charity) and must be the only consideration that the charity gives in return for the remainder interest. See Treas. Reg. § 1.514(c)-1(e).

3. Gift annuity payments will be subject to tax in accordance with normal bargain sale rules, although IRC § 121 may shelter some capital gain from tax if the property is the donor's principal residence.

4. The IRS has approved similar arrangements in several individual cases. See, e.g., Priv. Ltr. Ruls. 8120089, 8305060, 8305075, and 8806042. If time and budgets permit, however, cautious donors and charities may consider requesting their own rulings, because the prior rulings only show how the IRS has viewed such arrangements in the past; they do not bind the IRS to reach the same result in other instances, no matter how similar.

5. IRS considerations aside, the charitable gift annuity rules of certain states may effectively prohibit charities from accepting remainder interests in return for annuities. Some states forbid charities to issue gift annuities to their residents for real estate; and a few purport to extend that prohibition to all annuities of charities that issue gift annuities in those states, even when the charity, the donor, the annuity and the real estate are elsewhere. Still others require charities to fund segregated reserves for their gift annuity obligations but say that real estate is not an appropriate investment for such funds, forcing the charity to set aside cash or securities instead.

F. **Transfer for Other Payments.** If concerns about federal tax consequences or state law limitations make a charitable gift annuity unattractive, the donors still may capture some of the remainder value through other forms of bargain sale. For example, they could convey the remainder in return for a lump sum or a series of payments not tied to the donors’ life expectancies. Arguably such arrangements are not subject to the same restrictions as gift annuities. The charity, however should carefully analyze any arrangement involving installment payments to confirm the extent, if any, to which it would trigger the unrelated business taxable income rules.

G. **Planning for Vacancy.** The parties should not simply assume that the donor or other life tenant will be willing and able to reside in the property (or use it for farming purposes) for the entire term. A tenant’s health or financial situation may dictate a move to more accommodating or more affordable surroundings, or a change in family situation or retirement plans may encourage a move to another locality. The parties may have several options for dealing with the property in that case, depending on the terms of their conveyance agreement, if any, and the applicable state law. They include:
1. Cooperating in renting the property to a third party and agreeing that the rent, net of related expenses, would be payable to the life tenant in lieu of the tenant’s right to use the property.

2. Agreeing that the charity will buy the life tenant’s remaining interest for its actuarial present value, ending their co-ownership relationship.

3. Cooperating in selling their respective interests in the property to a third party and agreeing to divide the proceeds, net of selling expenses, in proportion to the actuarial values of interests, ending their relationship.

4. Selling the property and reinvesting the net proceeds in suitable replacement property titled in the same manner, continuing their relationship on the same terms. If the replacement property were less expensive, they could reinvest part of the proceeds and divide the rest actuarially.

5. Selling the property and allocating all or some portion of the life tenants’ share of proceeds to the charity as an additional charitable contribution.

6. Some commentators suggest that the parties also could sell the property and invest the proceeds in another form, such as an income-producing trust. Before agreeing to such an arrangement as part of the gift terms, however, both parties should carefully analyze the potential tax consequences, including the deductibility of the initial contribution, the taxability of income and any private inurement risk to the charity’s tax-exempt status.

H. **Release of Life Interest as Additional Gift.** Donors or other life tenants who no longer need to use the property or are no longer able to do so and who do not need rental income from it may choose to transfer their remaining rights to the charity. In that event they are entitled to additional deductions based on their life expectancies (or the duration of the term of years), the current value of the property and current IRS interest rates.

I. **Improvements as Additional Gifts.** If the donor, as life tenant, pays for subsequent major improvements that local law treats as fixtures (and thus as part of the property), the donor may claim an additional deduction for the market value of a remainder interest in those fixtures. See, e.g., Priv. Ltr. Rul. 9329017 (value of future improvements that are treated as part of farm real estate); Priv. Ltr. Rul. 8529014 (value of remainder interest in central heating and air conditioning system). Note that the deduction is based on the value of the improvements and not on the donor’s cost.

J. **Effects of Joint Sale.** If the donor retains a life interest and/or provides a life interest for the donor’s spouse, the donor or spouse
may realize capital gain if the property subsequently is sold and the proceeds divided between the life tenant(s) and the charity. If the property qualifies as the donor’s principal residence [and not merely as a personal residence] at the time of the sale, however, the donor should be able to shelter up to $250,000 ($500,000 for a married couple) of gain from income tax under normal rules for sale of a principal residence. See IRC § 121; Treas. Reg. § 1.121-4(e)(1). Note that the special basis allocation rules described above may affect the calculation of gain or loss.

K. Sale to Family Members. A donor who wants to transfer particular property to family members may do so by giving part of the remainder interest to those relatives and part to charity. The charitable contribution deduction will generate an income tax saving that the donor can transfer to the relatives directly or through the purchase of life insurance. The relatives can buy the charity’s partial remainder interest, either at the donor’s death or before, for whatever price the parties can agree on, leaving them as the outright owners at the donor’s death and providing the charity with a ready means of converting the property value into liquid form.

L. Combined Fractional and Remainder Gifts. A donor who wants to use property, such as a vacation home, for only part of each year may reserve a partial life estate and claim a deduction for two separate gift elements – a gift of an undivided fractional interest that corresponds to the portion of the year for which the donor has not reserved rights to use the property and a second gift of a remainder interest in the remaining fraction in which the donor has reserved those rights. See Rev. Rul. 75-420, 1975-2 CB 78. This option will not be affected by the newly-enacted rules on partial interest gifts, which apply only to tangible personal property. See generally new IRC § 170(o) enacted in H.R.4, the Pension Protection Act of 2006, and effective as of August 17, 2006.

M. Other Tools for Other Goals. No other non-trust form of charitable gift or other partial interest conveyance can generate an immediate charitable contribution deduction while giving the donor or another individual beneficiary continuing rights that closely resemble outright ownership for a period of time -- and in some cases lifetime income as well. Other arrangements involving trusts may approximate those benefits, but with important differences.

1. Charitable remainder trusts can generate comparable tax deductions and a stream of future income; but the self-dealing rules will prevent the donor or any family member from using the property. Unlike an outright remainder interest gift, the spouse’s interest can terminate on the happening of a “qualified contingency” such as the spouse’s remarriage. An annuity trust or straight unitrust is not an appropriate recipient of a real estate gift because of the possibility that it would have to begin payments before the property could be rented or sold. Even a flip unitrust or one of the net-income variations generally could not be funded solely with real estate, as it would need cash to
pay carrying costs until the property could produce revenue.

2. Pooled income funds can generate tax deductions and income streams, but most will not accept real estate contributions at all. A contribution of a remainder interest would be especially problematic because it would produce no immediate income for the fund beneficiaries.

3. Qualified terminal interest property (QTIP) trusts provide no income tax benefits, but they do allow a donor’s spouse to have lifetime rights to use a residence or farm property. A QTIP trust, however, cannot be established for any term other than the spouse’s lifetime.

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Charity Begins at Home 
(or on the Farm): 
Dealing with Remainder Interest Gifts

NCPG Virtual Seminar 
May 16, 2007

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Richmond, VA

Dealing with Remainder Interest Gifts

Scope of This Afternoon’s Topic --

• What property can the donor give?
• What are the tax consequences?
• How is the gift made?
• Basic rights and obligations
• Topics for discussion with donor
• Related planning issues
Dealing with Remainder Interest Gifts

One simple phrase . . .

". . . remainder interest in a personal residence or farm . . ." 

-- IRC 170(f)(1)(B)(i)
Dealing with Remainder Interest Gifts

One simple phrase . . .

". . . remainder interest in a personal residence or farm . . ."

-- IRC 170(f)(1)(B)(i)
Dealing with Remainder Interest Gifts

Defining Terms

• “Residence” defined broadly
  - Includes some surrounding land
• “Personal” implies use by donor
  - Need not be principal
  - Need not be exclusive
• “Farm” - agricultural products or livestock

Defining Terms - “Remainder Interest”

• Must be valid under state law
• Preceding term can be for years or lives
• Partial remainder will qualify
• Sale proceeds alone will not qualify
Dealing with Remainder Interest Gifts

State Tax Consequences

• Conveyance and recordation taxes
• Continuing property tax liability
• Federal income and transfer tax conformity?

Federal Income Tax Consequences

• Deduction for remainder value
  - Based on property values, duration of life interest, useful life and salvage value of depreciable or depletable components, and federal interest rate assumptions
  - Usual annual percentage limits apply
  - Recaptured depreciation reduces deduction
Federal Income Tax Consequences (Continued)

• Qualified appraisal required
  - Some individuals automatically “disqualified”
  - PPA 2006 restrictions apply to all new gifts
    (and perhaps those in 2005 and 2006, as well)
• “Highest and Best Use”

Federal Income Tax Consequences (Continued)

• Fractional remainders may require discounting
• Basis: carried over or stepped up?
  - Uniform basis rules
  - Separate sale exception
Dealing with Remainder Interest Gifts

Federal Gift Tax Consequences
• Deduction for remainder value
• No gift tax on:
  - Donor’s retained interest
  - Immediate life interest of donor’s spouse
  - Interests the donor can revoke
• Other interests taxable (not depreciated)
• Gift tax return required

Dealing with Remainder Interest Gifts

Federal Estate Tax Consequences
• Deduction for remainder value
• No estate tax on:
  - Donor’s retained interest (no further value)
  - Spouse’s current or successor interest if no other non-charitable interests continue
• Tax on all continuing interests – including spouse’s – if any other individual has a continuing interest (not depreciated)
To ask a question:
Press *1 on your touch-tone phone
(Please note that *1 will not work if you are using a speaker phone -- pick up the hand set before selecting *1.)

- or -

Type your question into the box in the lower right corner of your screen and click “Send”

Dealing with Remainder Interest Gifts

How is the gift made?

- **Deed** effective under state law
- **Will** valid in situs state
- **Not** by transfer in trust
How complicated can it be?

- Eight little words
- “Short” doesn’t mean “simple”

\[
\left(1 + \frac{i}{2} \sum_{t=0}^{n-1} \left[ \frac{l_{x+t+1}}{l_x} \left(1 - \frac{l_{y+t+1}}{l_y} \right) - \left(1 - \frac{l_{y+t}}{l_y} \right) \right]\right) \left(1 - \frac{1}{2n} - \frac{t}{n}\right)
\]
“Default” rights and duties under state law

- Costs of conveyance
- Regularly recurring expenses
- Larger repairs and capital improvements
- Duty to preserve and repair
  - Duty ill-defined
  - Right of inspection
- No limits on permissible uses

Dealing with Remainder Interest Gifts

“Default” rights and duties under state law

- Dealing with incapacity issues
- Uses of insurance or condemnation proceeds
- Means of enforcing parties’ rights
- Allocation of estate tax liability
- Charity ownership limits
Dealing with Remainder Interest Gifts

Topics for Written Agreement
- Property Conveyed
- Prerequisites to Closing
- Conveyance Details
- Extent of Retained Interest

Dealing with Remainder Interest Gifts

Topics for Written Agreement (Continued)
- Parties’ Continuing Financial Obligations
- Major Repairs and Improvements
- Permitted Uses
- Permitted Encumbrances
Dealing with Remainder Interest Gifts

Topics for Written Agreement (Continued)
• Insurance and Maintenance
• Advancements and Recovery
• Insurance or Condemnation Proceeds
• Designation of Attorney-in-Fact

Dealing with Remainder Interest Gifts

Topics for Written Agreement (Continued)
• Effect of Vacancy
• Potential Sale Scenarios
• Governing Law
• Valuation Issues
Dealing with Remainder Interest Gifts

Related Planning Issues
- Requirement to Join in Sale
- Reversions and Conditions
- Pre-existing Leases
- Property Subject to Mortgage

Dealing with Remainder Interest Gifts

Related Planning Issues (Continued)
- Transfer for Charitable Gift Annuity
- Transfer for Other Payments
- Effect of Joint Sale
- Sale to Family Members
Dealing with Remainder Interest Gifts

Related Planning Issues (Continued)

• Planning for Vacancy
• Release of Interest as Additional Gift
• Improvements as Additional Gifts
• Combined Fractional and Remainder Gifts
• Other Tools for Other Goals

Time for Q&A...

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Thank you for joining us today!

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