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BUILDING VALUE

Trusts Offer Tax Savings On Donated Properties

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Here's a way individual real-estate investors can give to their favorite charities -- as well as to themselves: charitable remainder trusts.

These trusts are tax-exempt entities that make it possible for investors to donate real estate to a charity of their choice and avoid hefty capital-gains and some other taxes triggered by property sales and even estate taxes.

The use of charitable remainder trusts are becoming more appealing these days as investment properties have appreciated in value in many markets, which can lead to higher capital-gains taxes. What's more, charities have recently been more accepting of real estate as a donation.

But there are some caveats. The trusts aren't exempt from all taxes. Also, they are irrevocable, meaning that once the trust is created, terms in it generally can't be changed -- though an investor can retain the right to change the charity if, for instance, he or she is displeased with the charity or if the charity changes its mission. In addition, there can be considerable fees in setting them up, including legal and administrative costs.

Charitable remainder trusts work like this: An investor transfers the property -- a building, a plot of land, a vacation home, a house being rented out or even a real-estate limited partnership interest -- to the trust. The investor then gets a charitable contribution deduction on his or her income-tax return that can be used for that year and carried forward for five years. The amount of the deduction depends on the estimated value of the real estate the charity will ultimately receive and the type of charity.

TRUSTING FAMILY MEMBERS

One disadvantage to using a charitable remainder trust is that what's left in it after the donor dies will go to the charity rather than the donor's family or children. A wealth replacement trust, a trust designed to purchase and continue paying premiums on a life insurance policy that will ultimately benefit the donor's heirs, can help overcome that disadvantage or at least lessen its impact. Here's how to combine a wealth replacement trust with a charitable remainder trust.

Step 1: Property is transferred to the charitable remainder trust.

Step 2: Charitable remainder trust sells the property.

Step 3: Proceeds from the sale go back into the trust for investment.

Step 4: The trust pays seller/donor the scheduled lifetime payments.

Step 5: The seller/donor funds a wealth replacement trust with a portion of the scheduled lifetime payments.

Step 6: On the death of the seller/donor, the charitable remainder trust pays the remaining assets to charity and the wealth replacement trust (life insurance) pays the heirs.

Source: "Selling Real Estate Without Paying Taxes," Dearborn Trade Publishing

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The trust then sells the property to a third party. (A trustee, who can either be the donor or someone the donor designates, signs any transaction documents on behalf of the trust.) After the sale, proceeds go back into the trust for investment. The trust can invest in stocks, bonds or real estate, among other things. When the trust sells the asset, there is no capital-gains tax because the trust is tax exempt.

The charitable remainder trust is then responsible for paying the seller/donor income generated from the trust -- for life. That amount is based on a fixed percentage rate that is determined when the seller/donor creates the trust. The Internal Revenue Service says that rate can't be less than 5% annually.

The distributions are, however, taxed as investors receive them. Still, some attorneys say the capital-gains tax savings more than offset that. After the donor's death, the remaining principal goes to the charity.

Charitable remainder trusts aren't limited to real estate; they can also have stocks and other kinds of assets. But Richard T. Williamson, a Long Beach, Calif.-based, estate and capital-gains tax planning attorney, says there's an especially compelling reason to use real estate: Under the tax code, when an owner sells a property, the IRS recaptures, through a tax, the deductions that the owner received for depreciation while he or she owned the property.

"With a charitable remainder trust, you avoid the capital-gains tax and the tax on recapture of depreciation," Mr. Williamson says.

But certain types of real estate can also have a distinct disadvantage. For instance, the IRS has taken the position that properties with mortgages on them don't qualify for charitable-remainder-trust treatment. That's, in part, because the investor/donor would no longer be responsible for the debt on the property, in effect receiving tax-free income -- the loan proceeds -- when donating.

For mortgaged real estate, Stephen D. Kirkland, a certified public accountant and a partner with Moore Kirkland & Beauston L.L.P. in West Columbia, S.C., suggests that investors put the property into a partnership where the partnership is liable for the debt and then donate the partnership interest to the trust.

Mr. Williamson adds that if the mortgage is small in relation to the value of the property, some charities are willing to pay off the mortgage for the donor prior to the donation being made.

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