# MINIMIZING RISKS IN ACCEPTING CHARITABLE GIFTS OF REAL ESTATE: THE "CHARITABLE PUT" AND OTHER TECHNIQUES

Emanuel J. Kallina II

Some prospective gifts of real estate may be simple, and a charity can easily determine that the benefits of accepting the asset exceed the burdens. But for some more complicated potential real estate gifts, the charity may conclude that further measures need to be taken to reduce risk in order arrive at a point where the reward to risk ratio is tolerable. In some of these situations, it may make sense to explore alternative ways of structuring the gift transaction to incorporate a "charitable put." In other situations, it may make sense to restructure the gift to allow the liquidated value of the gift to flow to the charity without the charity itself being in the chain of title.

These alternative structures are especially helpful in accepting gifts of real estate to fund charitable gift annuities ("CGAs") or in structuring bargain purchases of real estate. It is in these gift structures that nonprofit organizations are most often exposed to the risk of being required to make payments (either annuity payments or a bargain purchase price) before cash has been realized through the sale of the property. Charitable gift annuities funded with real estate are especially well-suited to donors wishing to make a gift while seeking steady, predictable income and wishing to avoid the legal costs and complexities of a charitable remainder trust ("CRT"). [Note: Among the respondents to the Northern California Planned Giving ("NCPG") Survey who reported substantial real estate gift activity, more than 40 percent reported that older donors seeking a life income arrangement were attracted to the simplicity and fixed rates of CGAs as opposed to CRTs.] Alternatively, bargain sale transactions can be very attractive to the donor who seeks to make a gift while also generating immediate cash for health needs, for travel, etc., or who would simply rather invest and manage proceeds from the sale himself rather than having another entity do so through a CGA or CRT. [Note: In the NCPG Survey, more than 60 percent of respondents from "successful" real estate gift programs reported use of bargain sale arrangements based on particular circumstances.]

For use in real estate-funded CGAs, bargain sales and other transactions, a range of gift-structuring alternatives can be quite helpful in minimizing or eliminating liquidity risk.

## The "Charitable Put"

The concept known as the "Charitable Put" emerged as a solution for problems associated with non-cash gifts, especially gifts of real estate. These problems arise in five major areas:

> Environmental and Other Risks: The first area, and usually the most important one from the charity's perspective, is the environmental risk associated with acquiring the property. These risks can include the cost associated with the clean up of contaminated soil or the cost of removing underground oil tanks. To that, one can add the danger of acquiring real estate, only to find out that there are obligations entitled with ownership, which are unexpected.
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> Carrying Costs: A second concern is the cost the charity incurs to receive, administer and liquidate the real estate. In today's world, charities are sensitive primarily to out-of-pocket expenses, but are becoming increasing aware that a planned gift/major donor officer cannot be raising money for the charity if she is busy administering and attempting to sell non-cash assets.

Lack of Return on Investment: A third problem is the charity's potential loss of return on investment during the period from the gift to its liquidation. Although this may not be an apparent concern, chief financial officers and treasurers of charities do include this factor in their thinking.

Delayed Fulfillment of Charitable Purposes: Fourth, the charity is worried about the lack of marketability and liquidity, which affect its ability to fulfill its charitable purposes.

Valuation Uncertainties and Adverse Fallout: Fifth, the charity is worried—or should be worried—about valuation uncertainties on the date of the gift; and closely connected to this, the charity desires to protect itself from the donor claiming a charitable deduction which is significantly greater than the value at which the charity can sell the real estate. The perceptions of the IRS, Congress (especially the Senate Finance Committee), and the public are important to the charity; its reputation can be severely damaged by the publicity surrounding a high profile donor who takes an excessively large deduction.

One of the obvious threads running through each of these potential problems is "liquidity." In other words, the charity can solve most of these problems, except perhaps the environmental one, by quickly disposing of the real estate upon receipt as a gift. We all know, however, this is easier said than done, because of a number of factors including the donor's tax situation and the real estate market in general.

Obviously, many of the charity's problems evaporate quickly if the donor transfers the real estate gift and attached to it is a contract for sale of the property to a legitimate, wealthy buyer. However, from the donor's perspective, this does not work because the IRS will treat the donor as having sold the real estate and gifted the sale proceeds to charity (see the discussion below). Historically, because of this dilemma, the charity is stuck with accepting a gift of real estate without a guaranteed buyer, along with the attendant problems discussed above.

The Charitable Put solves the charity's problems, while at the same time not jeopardizing the tax situation of the donor. At its simplest, with a Charitable Put, the charity enters into a contract with a third party—prior to receiving the gift—that gives the charity the right, upon receipt of a particular gift of real estate, to require the third party to purchase the real estate for a pre-arranged price, within a pre-determined period of time.

Suppose, for example, that donor (D) desires to give to charity Lorelei Heights, which consists of land and buildings in a major city, in exchange for a charitable gift annuity. Once the charity becomes aware of the gift, the charity obtains a real estate broker, who finds a third party buyer (B) to purchase Lorelei Heights. The charity will, before the gift occurs and before the gift annuity is finalized, enter into a legally binding contract with B where it (the charity) may require B to purchase Lorelei Heights within (for example) 10 days of the gift, for cash. Finally, the charity returns to D, letting him or her know that it is now ready to accept the gift of real estate and finalize the gift annuity contract.

If B cannot pay cash, then the contract can provide for alternate financing that is acceptable to the charity. Obviously, the Charitable Put technique requires someone such as the treasurer or a finance officer to thoroughly vet the financial capabilities of B, to make certain that the transaction actually does happen. Other than having a buyer with sufficient cash in the checking account, this could be done with an irrevocable letter of credit, bank loan, or similar banking technique.

The idea of the Charitable Put is appealing from the charity's standpoint:

- There is certainty as to sales price and timing of the sale.
- The environmental risks are reduced, as well as other liabilities, if the period the charity holds the real estate is very brief.
- The carrying costs are minimal and definable (read into this, you have a happy finance office).
- There is no lack of return on investment.
- There is no delay in fulfilling the charitable purpose.
- Valuation uncertainties are eliminated, as well as any adverse publicity risk.

**Legal Analysis – From the Donor' Perspective**

Obviously, the Charitable Put works for the charity, but does it work from the donor's perspective? Remember, the donor needs to be assured he will not be taxed on the inherent appreciation in the real estate gift. Although the following discussion is highly technical, it is essential a planned or major gifts officer understands the tax and legal issues, and is able to communicate them to the donor's tax counsel in a fashion that the donor and his or her advisers are confident the gift can take place as desired and intended.

In general, under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any gain realized from it, if the taxpayer has the right to receive the income or if, based on the realities and substance of the events, the receipt of the income is practically certain to occur (whether the right basically has become a fixed right), even if the taxpayer transfers the right before receiving the income.[1] In contrast, the mere anticipation or expectation of the receipt of income is insufficient to conclude that a fixed right to income exists.[2]

In Revenue Ruling 78-197, the Service announced that it will treat the proceeds of a redemption of stock as income to the donor ***only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption***.[3] The Tax Court has characterized the "legally bound" standard in Revenue Ruling 78-197 as a "bright line" test for determining if a contribution of stock to a charity followed by a redemption of that stock from the charity should be respected in form, or recharacterized as a redemption of the stock from the donor followed by a contribution of the proceeds by the donor to the charity.[4]

In the *Palmer* case[5], a shareholder, in control of a corporation, gifted stock of that corporation to a charitable foundation also controlled by the donor. Subsequent to the gift, and as part of the same plan, the shareholder caused the corporation to redeem the gifted stock from the donee foundation the next day. The Tax Court respected the form of the transaction and did not recharacterize the transaction as a redemption of the stock by the donor shareholder followed by a gift of the redemption proceeds to the charitable foundation, because it found that a gift of stock had, in fact, been made to the foundation and the foundation was not legally obligated to redeem the stock at the time it received title to the shares. In reaching its decision the court noted: "there were two paths which the [donor] could have taken—he could have had the stock redeemed and then made a contribution of the [proceeds], or he could have contributed the stock and let the donee arrange for the redemption. The tax consequences to the donor turn on which path he chooses, and so long as there is substance to what he does, there is no requirement that he choose the more expensive way."[6]

In *Blake v. Commissioner*[7], the court held that an expectation and advance understanding between a donor and a charity that appreciated stock contributed by the donor would be sold by the charity and the proceeds used to purchase the shareholder's yacht was enough, under the step transaction doctrine, to re-structure the transaction. The Tax Court treated the shareholder as selling the stock realizing gain, and then transferring the sale proceeds to the charity. Further, the Tax Court found that the donee was legally bound to purchase the yacht under a theory of promissory estoppel. Consequently, the taxpayer was taxed on the gain from the charity's sale of stock, and his charitable deduction was allowed only for the value of yacht. On appeal, the appellate court stated:

> "…whether or not the 'understanding' the Tax Court found here was legally enforceable under state law, we hold that where there is an understanding that a contribution of appreciated property will be utilized by the donee charity for the purpose of purchasing an asset of the contributor, the transaction will be viewed as a matter of tax law as a contribution of the asset -- at whatever its then value is -- with the charity acting as a conduit of the proceeds from the sale of stock. This makes the taxpayer/putative donor taxable on the gain of the stock … Where there is, as here, an expectation on the part of the donor that is reasonable, with an advance understanding that the donee charity will purchase the asset with the proceeds of the donated stock, the transaction will be looked at as a unitary one."[8]

Despite the apparent inconsistencies between *Palmer*, Revenue Ruling 78-197, and *Blake*, there are logical interpretations of these and other relevant cases and rulings. *Blake* dealt solely with a situation in which there was a gift of an appreciated asset to charity, *so that the charity in turn could purchase an asset from the donor*. In effect, there was a *quid pro quo* required by the donor, in order for the donor to make such a substantial gift. The donor admitted this in court. In fact, viewed in its entirety, *Blake* involved a taxpayer who received a charitable deduction of $700,000 for a boat that was really worth $200,000, as evidenced by the sales price months later. If a situation does not involve a *quid pro quo*, or if it does not involve a scheme to obtain an inflated tax deduction, the legal test in *Palmer* and Revenue Ruling 78-197 applies, namely that there must be a legal obligation on the part of the donees if the donor is to be subject to tax on the resulting gain. This departure from the legal standard of *Palmer* and Revenue Ruling 78-197 to the one espoused in *Blake* is justified only where a *quid pro quo* exists; this conclusion is supported by the Second Circuit's later decision in *Greene v. United States*, discussed next.

In *Greene v. United States*[9], the taxpayer contributed futures contracts[10] to a Section 501(c)(3) private operating foundation which he founded in the early 1970s. In 1974, the taxpayer obtained a private letter ruling from the Service indicating that he would be entitled to an income tax charitable deduction in an amount equal to the FMV of the contracts on the date of gift, and that there would be no gain recognized to him when the charity subsequently sold the futures contracts. In 1981, IRC §1256 was amended to provide that 60 percent of the gain on futures contracts would be long-term capital gain, and the balance would be treated as short-term capital gain regardless of the holding period.

In 1982, Greene donated the 60 percent long-term capital gain portion to the charity, taking a full deduction. According to the court, the fact that the donor could reasonably anticipate at the time of the contribution that the donee would immediately sell the donated property does not necessarily convert the donation into an anticipatory assignment of income. On the other hand, where there is merely anticipation or expectation, rather than a certainty, of income, there is no assignment of income. On appeal, the court stated that the assignment of income doctrine applies to cases where the donor retains sufficient power and control over the donated property or the receipt of income so as to make it reasonable to treat the donor as the recipient of income.[11] However, the court went on to affirm summary judgment for the donor taxpayers. The court held that the donors could not be deemed to have realized income on the contracts under the anticipatory assignment of income doctrine after they were sold by the charity because the donors had no control over the sale. Distinguishing the case from Blake, the Second Circuit also ruled that the interdependence test was not met, and the step transaction doctrine was inapplicable.

In *Ferguson v. Commissioner*[12], three individuals donated appreciated stock to charitable organizations immediately before their corporation was sold to another in a tender offer. The Tax Court held that the taxpayers were taxable on the gain in the stock transferred under the anticipatory assignment of income doctrine. The taxpayers and their children owned 18.8 percent of the stock of American Health Companies Inc. (AHC). In July of 1988, AHC entered into a merger agreement with two acquiring corporations (X). Under the agreement, X was to purchase AHC's stock in a tender offer and then merge into AHC. On August 3rd, AHC's board voted on a tender offer made by X. The taxpayers abstained from voting, as board members, on the tender offer. Nonetheless, the offer was approved. Between August 15th and 21st, the taxpayers executed "donation-in-kind" records stating their collective intention to donate 61,111 shares of AHC stock to the charities. The taxpayers' stockbroker (Broker) helped the taxpayers create separate accounts for all of their respective stockholdings. On August 26, the charities were formed. As of August 30th, more than 50 percent of AHC's outstanding shares had been tendered or guaranteed. On September 8th, the Broker transferred the shares to the newly formed charities, at which time more than 95 percent of the outstanding shares of AHC stock had been tendered or guaranteed.

On September 9, the merger took place, with AHC stock being traded for X stock. The Service determined that the taxpayers were taxable on the gain attributable to the AHC shares that were donated to the charities. The court held that Broker was not an agent of the charities, but instead an agent of the taxpayers, and stated the taxpayers "have failed to explain how the gifts to the charitable foundations occurred on August 15, 1988, and August 21, 1988, respectively, when the [charitable] foundations were formed on or about August 26, 1988." The Court held that there was no unconditional delivery of stock to charities or to their agents as required under Section 1.170A-1(b) of the Income Tax Regulations, until September 9, 1988, when the taxpayers relinquished control. When the taxpayers relinquished control on September 9th, more than 95 percent of the outstanding shares of AHC stock had been tendered or guaranteed, meaning that the taxpayers and the charity had no ability to prevent X from completing the transaction. The court said:

> "We do not believe that application of the anticipatory assignment of income doctrine is conditioned on the occurrence of a formal shareholder vote. We believe, instead, that when more than 50 percent of the outstanding shares of AHC stock had been tendered or guaranteed, which in effect was an approval of the merger agreement, and the Charities could not vitiate the intention of the shareholders, who had tendered or guaranteed a majority of AHC stock, of the [taxpayers], and of [X], the right to merger proceeds matured. When the Charities received AHC stock on September 9, 1988, payment in exchange for those shares pursuant to the tender offer was imminent (i.e., four days from the date of the gifts). Moreover, the Charities did not even need to tender their shares, but would have received $22.50 a share in cash because the merger agreement provided that shares outstanding after the tender offer would be converted into the right to receive $22.50 in cash. The fact that AHC shareholders may not have had a legal right to the merger proceeds prior to acceptance of the tendered or guaranteed shares by [X] does not change our conclusion. **The Court of Appeals for the Eighth Circuit in Hudspeth v. United States...rejected the taxpayer's contention that the gifts preceded the time when an enforceable right to the liquidation proceeds accrued and focused, instead,**

> **on the fact that the donees could not change the future course of events; i.e., the liquidation of the corporation**."[13]

In effect, the court held that the strong likelihood of something happening was the legal equivalent of the event actually taking place. Thus, the *Ferguson* decision clouded the bright lines of *Palmer* and Revenue Ruling 78-197 regarding the donee's legal obligation to proceed with the transaction. On appeal, the appellate court noted that "once a right to receive income has 'ripened' for tax purposes, the taxpayer who earned or otherwise created that right, will be taxed on any gain realized from it, notwithstanding the fact that the taxpayer has transferred the right before actually receiving the income."[14]

That court also stated that "to determine whether a right has 'ripened' for tax purposes, a court must consider the realities and substance of events to determine whether the receipt of income was practically certain to occur." In fact, "…the Tax Court could have relied on the way things were going, not merely how things were."[15] The holding of the 9th Circuit affirmed the Tax Court in its choice of August 30th, days before the tender offer actually became final, and not September 9th, the day the tender offer actually became final (when 85 percent of the outstanding AHC shares had been tendered or guaranteed as required by the tender offer and merger agreement), from a factual and legal standpoint.

Private Letter rulings in 2001 and 2002[16] gave practitioners hope that the *Ferguson* cases were just an aberration in thinking, and that the Service would not continue to litigate this point. This idea was shattered by *Rauenhorst v. Commissioner*, where the Service argued that a gift of warrants to four charities was an anticipatory assignment of income.[17] The Tax Court, in this case, however, took a totally different view than it did in *Ferguson* and publicly reprimanded the Service for ignoring Revenue Ruling 78-197 and the *Palmer* case, demanding that the Service live within the constraints of its own published rulings. The impact of Judge Ruwe's decision was felt so widely within the Service that IRS chief (legal) counsel felt obligated to publicly announce the Service "would never again argue that the IRS is not bound by its own revenue rulings."[18]

*Rauenhorst* was followed by PLR 200321010, regarding a gift of stock to a charitable remainder trust, where the stock was subject to a restriction on transfer. Here, the Service reasoned that the CRT was not legally bound under Revenue Ruling 78-197 and *Palmer* to sell the stock, and thus the stock restriction, which was tantamount to a first right of refusal, would not cause the donors to be taxable when the CRT sold the gifted stock.

Very little activity has occurred at the IRS level regarding pre-arranged sales and assignment of income since Rauenhorst, despite the fact these legal concepts are omnipresent in most transactions. That being said, in late May of 2008, the Service issued PLR 200821024, dealing with a pre-arranged sale and repurchase from a donor advised fund ("DAF"). In that ruling, the Service declared that the possible purchase by a donor (via a trust of which he is the trustee) of stock contributed by him to a DAF would not constitute an anticipatory assignment of income.

The investment policies of the community foundation that maintained the DAF require that the foundation's investments be diversified. Under the facts as represented, the foundation has indicated an intention to sell and will seek to find prospective buyers. The donor through a related entity may purchase a portion of the gifted shares, if the foundation offers the shares for sale. The remaining shares owned by the foundation may be purchased by others, who are unrelated to the donor.

The donor represented that none of the shares are "subject to any condition or legally binding obligation requiring Y [the foundation] to sell the shares, or offer them for sale. The contributed shares will not be subject to any option or right by any person to acquire them from Y. Y has the sole discretion regarding whether or when to sell the contributed shares and to whom those shares may be sold. Further, [the donor] will not retain any rights or interest in the contributed shares."

The Service determined that under *Palmer v. Commissioner*[19]and Rev. Rul. 78-197, the proposed transaction would not be treated as a direct purchase of the stock by the trust. This ruling shows a maturation in the willingness of the IRS to consent to a pre-arranged sale, where there is no legally binding obligation to sell on the part of the charity. This type of ruling has been requested from the Service on a number of occasions, but to-date the Service has refused to consider a gift/repurchase arrangement. As long as there is no excess benefit to the donor, and everything is transparent, the IRS should not have a problem with this type of transaction.

Being able to have an outlet for re-selling the stock is in the best interests of the charity, the donor, and the government. It would be helpful if the Service would turn this PLR into a Revenue Ruling, since we cannot rely upon the former, but can do so with the latter.

In summary, other than *Ferguson*, unless there is a *quid pro quo* arrangement (as in *Blake*), the Service and the courts apply the rule “legally bound” standard of *Palmer* and Revenue Ruling 78-197. The Service’s latest pronouncement in this area, although it cannot be relied upon by other taxpayers, certainly indicates a favorable attitude towards an arrangement that does not have a Charitable Put, but does have a re-sale to the very donor who gifted the asset.

Applying the law of assignment of income and the pre-arranged sale to our Charitable Put technique, it is clear the charity is under no legal obligation to sell the real estate to the third party buyer. The charity has an option (a “put”) it can exercise within its discretion, not an obligation. In conclusion, because there is no *quid pro quo* and the charity will not be legally bound to sell the real estate, gain on the sale to the third party cannot be attributed to the donor.

**“Excess Benefit,” “Private Benefit” and Policy Concerns**

As is always the case with an innovative strategy involving charity and private individuals, one must ask if there is an “excess benefit” or “private benefit” being enjoyed by the donor or the third party. In our hypothetical, the Charitable Put primarily benefits the charity, not the donor, and the third party is really irrelevant to the analysis. The technique allows the charity to force a third party to buy the real estate at fair market value (“FMV”), within a time-frame acceptable to the charity. The Charitable Put could be beneficial to the donor, from one perspective, because it might reduce the cost of an appraisal, since the appraiser merely needs to document FMV , rather than spending a great deal of time investigating land records. I have yet, however, to encounter an appraiser who would reduce fees because of this set of facts.

It is unlikely that even the IRS would categorize this indirect and speculative benefit to the donor as something worth the effort to quantify. This is particularly true since the technique prevents the donor from “gaming” the system by claiming a much higher value than the market supports in reality. Given the current IRS concern with valuation issues, and the amount of time it wastes on such matters, and given Congress’ push to eliminate valuation issues, the Charitable Put should be viewed as a very favorable technique by those in authority.

**The DAF Automatic Excess Benefit Rule**

On a more technical front, a number of charities either have a DAF or use a supporting organization ("SO") to receive gifts of real estate. Further, some of these charities may consider selling the asset back to the donor, as in PLR 200821024. Assuming this to be the case, one must ask if the "automatic benefit rules" of the Pension Protect Act of 2006, passed August 17, 2007 (Act) will impact such a resale.

The Act defines a DAF as: (1) a fund or account which is separately identified by reference to contributions of a donor; and (2) which is owned or controlled by a sponsoring organization; and (3) which a donor has or reasonably expects to have certain advisory rights or privileges with respect to the distribution or investment of the assets.[20]

The Act defines a sponsoring organization as a Section 170(c) charity (e.g., religious, charitable, scientific, literary, educational, etc.) which is not a governmental entity or a private foundation and which maintains one or more DAFs.[21]

The Act also explains that for any transaction involving a DAF, the definition of a disqualified person includes:

(1) the donor (or the donor's designated person) who has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts in the donor advised fund because of the donor's status as a donor;
(2) such a donor's family member; or
(3) an entity of which such a donor, or his/her family member, owns more than 35 percent of the total combined voting power.[22]

The Act states that an excess benefit transaction will automatically include any grant, loan, compensation, or "other similar payment" from such fund to a person described in Act Section 1232(a)(2) with respect to such fund. "Other similar payment" is not clarified further in the Act itself.[23]

According to the staff of the Joint Committee on Taxation (JCT), "other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as expense reimbursement.[24] JCT further explains that "other similar payments" do not include, for example, a payment pursuant to a bona fide sale or lease of property, which would instead be subject to general excess benefit rules of Section 4958 of the Code. Further, JCT provides an example:

> ". . . if a donor to a donor advised fund purchased securities from the fund, the purchase is subject to the rules of section 4958 because, under the provision, the donor is a disqualified person with respect to the fund."

If the charity exercises a "put" back to the donor, then the donor must purchase the real estate from the charity at FMV through a bona fide sale. Since a payment pursuant to a bona fide sale will not be an "other similar payment" subject to Act Section 1232(b), the charity's "put" should not be a violation of the DAF Automatic Excess Benefit Rule.

**The SO Automatic Excess Benefit Rule**

The same rationale applies to an SO as follows. An SO is a public charity under Section 509(a)(3) provided that:

(1) it is organized, and at all times thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in Section 509(a)(1) or Section 509(a)(2);

(2) per Act Section 1241(a)'s amendment to Section 509(a)(3)(B), it is:

a. operated, supervised, or controlled by one or more organizations described in Section 509(a)(1) or Section 509(a)(2); or
b. supervised or controlled in connection with one or more such organizations; or
c. operated in connection with one or more such organizations; and

(3) it is not controlled directly or indirectly by one or more disqualified persons (as defined in Section 4946) other than foundation managers and other than one or more organizations described in Section 509(a)(1) or Section 509(a)(2).

The Act defines "substantial contributor" as any person who contributed or bequeathed an aggregate amount of more than $5,000 to the organization, if such amount is more than 2 percent of the total contributions and bequests received by the organization before the close of the taxable year of the organization in which the contribution or bequest is received by the organization from such person.[25]

Section 4958(f) of the Code explains that the term "disqualified person" means, with respect to any transaction, any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization.

The Act states that any grant, loan, compensation, or "other similar payment" is prohibited from a Section 509(a)(3) SO to a substantial contributor. "Other similar payment" is not clarified further in the Act itself.[26]

According to the JCT, "other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as expense reimbursement.[27] As with the DAF Automatic Excess Benefit Rule, the JCT further explains that "other similar payments" for purposes of the SO Automatic Excess Benefit Rule do not include, for example, a payment pursuant to a bona fide sale or lease of property, which would instead be subject to Section 4958(c)(1)(A) of the Code.

Assuming the donor is a "substantial contributor" to the SO, and assuming further the charity sells the real estate back to the donor, then the donor must repurchase the real estate from the charity at fair market value through a bona fide sale. Since a payment received in a bona fide sale will not be an "other similar payment" subject to Act Section 1242(b), the charity's "put" will not result in a violation of the SO Automatic Excess Benefit Rule. The JCT's discussion of the SO Automatic Excess Benefit Rule does not offer an example, as with their discussion concerning the DAF Automatic Excess Benefit Rule. However, it is inescapable that the example applies equally to the SO Automatic Excess Benefit Rule, and that the exercise of the "put" should not be an "other similar payment."

**The Excess Benefit Rule**

Section 4958(c)(1)(A) of the Code provides, in part that the term "excess benefit transaction" means any transaction in which an economic benefit is provided by a tax-exempt organization under Section 501(c)(3) of the Code that is not a private foundation, directly or indirectly, to or for the use of, any disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including performance of services) received for providing such benefit.

According to the JCT, "other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as expense reimbursement.[28] The JCT further explains that "other similar payments" do not include, for example, a payment pursuant to a bona fide sale or lease of property which would instead be subject to general Section 4958(c)(1)(A). This example is provided:

> ". . . if a donor to a donor advised fund purchased securities from the fund, the purchase is subject to the rules of section 4958 because, under the provision, the donor is a disqualified person with respect to the fund. Thus, if as a result of the purchase, the donor receives an excess benefit as defined under generally applicable section 4958 rules, then the donor is subject to tax under such rules. If as generally would be the case, the purchase was of securities that were contributed by the donor, a factor that may indicate the presence of an excess benefit is if the amount paid by the donor to acquire the securities is less than the amount the donor claimed the securities were worth for purposes of any charitable contribution deduction of the donor."

Again, in light of the above discussion of DAF and SO automatic benefit rules, and assuming that the JCT's example for DAFs is applicable to SOs, then exercise of the put by the charity will not cause the donor to engage in an automatic excess benefit under either Act Section 1232 or Act Section 1242. However, the general excess benefit rules of Section 4958 will apply, especially (according to the above quoted language discussing the example) if the purchase price of the real estate is less than the charitable contribution taken by the donor.

In our case, the donor will pay FMV for the real estate. In other words, assuming a repurchase of the real estate for FMV (which should not be less than the Form 8283 amount reported by the donor), the donor will not receive an excess benefit under Section 4958.

**Managing Donor Expectations**

Needless to say, the charity needs to manage donor expectations as it implements the Charitable Put. For example, the charity needs to make sure the donor understands the concept, her tax advisers are comfortable with the technique, and she is aware of the identity of the potential third party buyer and the price at which the real estate is to be sold. Obviously, it is imperative the charity work with its donor on the sales price, since the donor already has her own perception of value and how much of an income tax deduction is available.

**Private Letter Ruling Request?**

This concept has been informally presented to the IRS, and discussed in some depth with various high-level IRS agents, all of whom are staff and not the decision makers. These individuals were skeptical at first, but as the discussions proceeded, they seemed less and less concerned. They were careful to say they could not approve the technique without significant in-house study and analysis, but were quite surprised to learn that the technique was being widely used by sophisticated tax practitioners in the field.

Even though this technique has been used frequently and is becoming more prevalent, without a definitive Revenue Ruling, legal counsel for donors may find it advisable to seek a Private Letter Ruling when using the Charitable Put technique. When the Charitable Put was presented to the Service two years ago, they discouraged a formal PLR request. In late May of this year, however, the IRS published PLR 200821024, which is closely aligned in spirit with the Charitable Put. Perhaps the time is ripe for another run at the IRS!

**Two Alternatives: Nominees, Agents and Trustees**

There are two prime alternatives to consider, in lieu of using the Charitable Put.

In *Guest v. Commissioner*[29], the taxpayer made a charitable contribution of non-recourse, debt-encumbered real estate to his temple. The temple directed Guest to deed the property to third party buyers lined up by the charity, instead of directly to the temple. The opinion of the court quoted a letter from the charity and went on to say:

> "'We accept this gift, and hope to use it in a manner worthy of the spirit in which it was given.' The temple, however, requested petitioner to retain title to the properties as its nominee until it completed negotiations to sell the properties. This arrangement saved significant transfer taxes."

The IRS challenged whether or not a gift had, in fact, been made. The court recited the requirements for having a completed gift as being (1) a competent donor, (2) a donee (charity) capable of accepting the gift, (3) "a clear and unmistakable intention …to absolutely and irrevocably divest himself of title, dominion, and control" of the property, (4) the irrevocable transfer of present legal title to the donee, so that the donor cannot exercise any dominion or control over the property, (5) delivery by the donor to the donee of the gift, and (6) acceptance of the gift by the donee.

The Service claimed that the issuance of the deed to the charity's designee was not adequate delivery, but the Tax Court disagreed, ruling that once the donor had parted with control by deeding the properties to the third parties, he had fulfilled the requirements of delivery and making a gift. The court specifically noted that there was no transfer of legal title, and so there was and could be no trust arrangement. Nevertheless, the court found that the facts of the case were analogous to cases involving the donor as an agent of or trustee for the donee charity.

It is unclear exactly what the *Guest* court decided in terms of the relationship of the donor and the donee, but it is clear that there was no trust. Logically speaking, this had to be a nominee or agency relationship, but the court refused to use a label to identify the nature of the transaction.

It is interesting to note that the Government never argued the "pre-arranged sale" and never attempted to tax the donor on the inherent gain. Perhaps the Service was still smarting from *Palmer* and its begrudging concession in Revenue Ruling 78-197.

A second alternative to the Charitable Put is an "escrow" arrangement, where the charity works with the donor to acquire a third party buyer and simultaneously closes on two transactions, one being the gift to the charity and the other being the sale to the third party. Consider this alternative within the context of debt-encumbered property, where the charity wants to make certain that the debt is not assumed by the charity. Here, the charity would hold the deed from the donor to the charity in escrow until the buyer is ready to proceed, then the buyer would transfer the purchase price to the agent, then the mortgage would be paid off and discharged, and finally the net proceeds would be turned over to the charity.

The escrow arrangement, much like the *Guest* case, describes an agency relationship, and for purposes of accuracy and clarity, both should be labeled as such. It is not dissimilar to a scenario where a donor transfers marketable securities to his broker, and the question is whether or not delivery has taken place. In other words, does the broker represent the charity or the donor? If the former, and assuming the donor has no authority to retract his gift, then delivery has occurred and the gift is complete. If the latter, no delivery has taken place, and no gift has occurred until the securities are re-titled in the name of the charity.

**Using an LLC to Make the Gift of Real Estate**

According to the NCPG Survey, only three percent of respondents reported requiring use of a limited liability company (LLC) (and only one percent of "successful programs"), and only 12 percent had a separate/support organization for receipt of real estate gifts (17 percent for "successful programs).

We suggest that for more complex real estate gift transactions, an LLC is a wonderful vehicle for conveying real estate to charity, because it can significantly limit the charity's liabilities and costs:

- **Environmental Issues**: An LLC can limit the charity's exposure to environmental issues, since the LLC is the legal owner, and is a distinct entity from the charity itself. Further, the charity is not directly responsible for ongoing environmental concerns, such as the dumping of hazardous substances (see the comments below).
- **Transfer Taxes and Other Fees**: If the donor makes a gift to an LLC, the charity can avoid a second round of transfer taxes when the real property is sold. This is a significant issue, since transfer taxes and documentary stamps and fees can approach 2.5 percent of the property's FMV in many counties and states.
- **Liability as Direct Owner**: The charity is insulated from direct liability for carry costs, since the LLC is the legal owner.
- **No Management Responsibility for the Charity**: The charity can request that the donor act as the "managing manager" of the LLC, and thereby avoid ongoing environmental issues and property management issues. Even if the donor's motivation for the gift, in part, is to jettison the management albatross, most donors with strong donative intent will be willing to continue to manage the property until a sale can take place within, e.g., for 30 days.

Whether the donor is making a gift of 100 percent of his interest in real estate, is giving an undivided partial interest, is entering into a bargain sale, or is gifting the property in exchange for a charitable gift annuity, the charity should consider having the donor create an LLC and gift the LLC interest to the charity. Assuming that the LLC is a single-member LLC (SMLLC), and assuming that the donor is the manager of the LLC (technically, under most state statutes the "managing manager"), the charity should be able to mitigate its exposure to environmental concerns. Furthermore, any contracts or agreements affecting the real estate would not be binding on the charity, since it does not own the real estate, but instead the LLC does.

A number of questions have arisen from the charity's perspective on whether or not an SMLLC interest is ignored for tax purposes. The law seems clear in this regard.[30] The facts are as follows:

- A business entity that is not classified as a corporation (an eligible entity) can elect its classification for federal tax purposes.
- An eligible entity with at least two members can elect to be classified as either an association or a partnership; an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.
- Unless a domestic eligible entity elects otherwise, the entity is disregarded as an entity separate from its owner if it has a single owner.

An eligible entity that has been determined to be, or claims to be, exempt from taxation under Section 501(a) is treated as having made an election to be classified as an association. Such election will be effective as of the first day for which the exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain, in effect, unless an election is made under Section 301.7701-3(c)(1)(i) of the Procedure and Administration Regulations after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

An announcement in 1999[31] stated that an owner exempt from taxation under Section 501(a) must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return, because the regulations under Section 7701 provide that an entity wholly owned by a single owner may be disregarded as an entity separate from its owner (when the entity is disregarded as separate, its operations are treated as a branch or division of the owner). Additionally, this Announcement was cited in support of a recent Information Letter stating that a limited liability company that did not elect to be treated as a corporation or partnership separate from its sole member, a Section 501(c)(3) organization, is disregarded and treated as a component of the organization (LTR 200634015). A number of additional private letter rulings have been issued since this Announcement, all of which are consistent with this same tax treatment of ignoring the SMLLC as an entity (absent an election to the contrary).[32]

Thus, before and after the gift of the real estate through a SMLLC, the entity is ignored for tax purposes. The donor could make additional gifts to the SMLLC, if it chose, and the gifts should be tax deductible, and the charity will not need to file under Section 508 of the Code to qualify the SMLLC as a tax-exempt subsidiary of the charity. Despite this rather compelling authority, note the IRS has NOT specifically approved in writing that a donor to a SMLLC owned by a charity is entitled to a deduction under Section 170.

**Using an SO (Trust) to Receive the Gift of Real Estate**

One last innovative technique worthy of consideration is the creation of an SO, formed as a trust, to receive gifts of real estate (even if a SMLLC is used). Many pieces of real estate are encumbered, and because of this the real estate constitutes debt encumbered property under Sections 514 and 512. As such, a sale of this real estate would result in unrelated business taxable income ("UBTI"), and thus a reduced gift to charity.

Perhaps an example would serve to illustrate this point. Suppose our donor gives Lorelei Heights through a SMLLC to charity. The property is worth $400, and has a basis of $200 and a mortgage of $200. When the SMLLC interest is sold (or the underlying real estate itself), the charity will have $100 of UBTI. Assuming the charity is a corporation, and it has to pay a blended federal and state tax at the rate of 40 percent, the charity will have to pay $40 of taxes.

If, instead, the SMLLC interest were given to an SO which is a trust under state law that does not tax UBIT and has no personal income tax, the SO will be taxed as if it is an individual under federal law. Since the maximum federal rate is 35 percent, and the SO can obtain an income tax deduction (just as an individual) for 50 percent of its cash gifts to a public charity, instead of having $100 of UBTI, the SO trust would only have $50 of UBTI, and at a 35 percent rate, would only pay $17.50. This effectively reduces the tax rate by 43.75 percent of what it otherwise would have been. Although this may not seem significant with a $400 gift of real estate, if the gift instead were much larger and the basis in the asset was much lower, the tax savings would be truly significant.

**Conclusion**

The importance, nationwide, of real estate as an asset, and the success of growing numbers of charities in attracting major gifts through real estate transfers of various sorts, should motivate more and more charities to reexamine their reluctance (or refusal) to accept real estate gifts. In taking a fresh look at the trade-offs between the risk in real estate gift acceptance and the returns from such gifts, charities should consider that adherence to proven due diligence procedures can, in many cases, largely eliminate potential environmental liability, transfer cost, lack of liquidity, carrying costs and other risks and expenses. In the case of more complicated gifts, and/or where the institution seeks additional protections from risk, a variety of creative structuring alternatives can be used with great success. Chief among these are the Charitable Put—which can be especially useful in charitable gift annuity and bargain sale gifts where the charity needs assurances regarding the timing of the sale and the price of the sale—and the use of a SMLLC as an alternative to a charity directly taking title to the gift property.

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[1] Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999); Jones v. United States, 531 F.2d 1343, 1346 (6th Cir. 1976); Kinsey v. Commissioner, 477 F.2d 1058, 1063 (2d Cir. 1973); Hudspeth v. United States, 471 F.2d 275, 280 (8th Cir. 1972); Estate of Applestein v. Commissioner, 80 T.C. 331 (1983); Lucas v. Earl, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731 (1930).

[2] S.C. Johnson & Son, Inc. v. Commissioner, 63 T.C. 778, 787-88 (1975).

[3] under facts similar to those in Palmer v. Commissioner, 62 T.C. 684 (1974), aff'd on another grounds, 523 F. 2d 1308 (8th Cir. 1975).

[4] *See,* Rauenhorst v. Commissioner 119 T.C. 157 (October 7, 2002), at 165.

[5] Palmer, *supra*

[6] Palmer, *supra*, at 693.

[7] Blake v. Commissioner, 42 T.C.M. 1336 (1981)

[8] Blake v. Commissioner 697 F.2d 473 (2d Cir. 1982) at 480.

[9] Greene v. United States, 806 F. Supp. 1165 (S.D.N.Y. 1992)

[10] According to Wikipedia, a "futures contract" is a "standardized contract, traded on a futuresexchange, to buy or sell a certain underlying instrument at a certain date in the future, at a specified price."

[11] Greene v. United States 13 F. 3d 577 (2d Cir. N.Y. 1994)

[12] Ferguson v. Commissioner 108 T.C. 244 (1997)

[13] Ferguson, *supra*, at 263-264 [emphasis added].

[14] Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999) at 1003.

[15] *Id* at 1003-1004.

[16] PLRs 20010719, 200117016, 200205008, 200232004

[17] Rauenhorst v. Commissioner 119 T.C. 157 (October 7, 2002)

[18] fn. Tax Analysts Reference 2002 TNT 205-1 (22 Oct 2002)

[19] Palmer v. Commissioner 62 T.C. 684 (1974), *aff'd on other grounds*, 523 F.2d 1308 (8th Cir. 1975), *acq.*, 1978-1 C.B. 2

[20] Act Section 1231, which creates Section 4966(d)(2) of the Code.

[21] Act Section 1231, which creates Section 4966(d)(1) of the Code.

[22] Act Section 1232(a)(2)which amends Section 4958(f) of the Code by adding subsection (7).
[23] Act Section 1232(b), which amends Section 4958(c)(2)(A) of the Code.
[24] Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," as passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, JCX-38-06, p. 347.
[25] Act Section 1242(b), which amends Section 4958 of the Code.
[26] Act Section 1242(b), which amends Section 4958(c)(3) of the Code.
[27] Joint Committee on Taxation, op. cit., p. 358.
[28] Joint Committee on Taxation, op. cit., p. 347.
[29] Guest v. Commissioner 77 T.C. 9 (1981)
[30] See Section 301.7701-3 of the Procedure and Administration Regulations.
[31] Announcement 99-102, 1999-43 I.R.B. 545 (Oct. 14, 1999)
[32] It may be important to determine under prevailing state law whether or not an LLC must be created "for profit" or can be created for non-profit purposes. If the state law follows the uniform law draft in this area, the LLC need not be a "for profit" entity. The National Conference of Commissioners on Uniform State Laws, in their Summary of the Uniform Limited Liability Company Act (http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-ullca.asp), takes the position that an LLC can be either "for profit" or "not-for-profit":

> Three things should be noted about forming a limited liability company under the Uniform Act. Unlike a partnership, but like a corporation, one person can organize a limited liability company. It is possible to organize a not-for-profit limited liability company under the Uniform Act. There is no limitation to businesses for profit. The Uniform Act also does not restrict the types of business or profession that may organize limited liability companies. Thus, doctors and lawyers may organize limited liability companies. Professionals, generally, have not been able to form business corporations, and have historically organized as partnerships."

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