Determining How and When to Gift Illiquid Assets

PEAK TRUST COMPANY
Elevated Trust & Wealth Management Solutions

Introduction

- Most gifts to charities are in the form of cash or marketable securities.
- Gifts of illiquid assets are a creative way to make large contributions with amazing benefits for the charity and donor.
- Gifting illiquid assets can be an effective way to fulfill a charitable goal.
- May allow the donor to use an asset that perhaps was once illiquid, was a non-producing asset or perhaps is expensive to maintain.
- They are considered a complex asset and will take careful planning to execute.
- Some examples of illiquid assets:
    - Real Estate
    - Artwork or other Collectibles
    - Private Company Stock
    - Private Entities (LLC, LP)
    - Life Insurance

Benefits for the Donor

- In most cases, the donor can contribute an appreciated asset and be able to deduct the value of the asset without having to report the appreciation as income.
- The charitable deduction is based on the current fair market value of the asset which is often considerably higher than the cost basis (original cost) of the unique asset.
- Normally, the donor can enjoy a charitable deduction that is equal to the current full fair market value of the gift, that as determined by a qualified appraiser.
- Donors can usually avoid capital gains taxes that would have been incurred if they would have sold the asset and then made the charitable gift.

Methods To Contribute

- Donate Directly to Charity
- Donor Advised Fund (DAF)
- Charitable Lead Trust - is an irrevocable **trust** designed to provide financial support to one or more **charities** for a period of time, with the remaining assets eventually going to family members or other beneficiaries
- Charitable Remainder Trust - is a tax-exempt irrevocable **trust** designed to reduce the taxable income of individuals by first dispersing income to the beneficiaries of the **trust** for a specified period of time and then donating the **remainder** of the **trust** to the designated **charity**.

How to Donate Specific Unique Assets

- Life Insurance
  - Two Ways to Consider Donating
    - Name the charity as both the policy's owner and beneficiary. If the donor wants to make current charitable gift of a life insurance policy, should do so irrevocably. By simply naming Charity as a beneficiary in a revocable beneficiary designation may not itself make a donor eligible for the income tax charitable deduction.

    - Name the organization as beneficiary of the policy. By doing this, the Donor can gift the policy's death benefit to the Charity and retain the right to change the beneficiary in the future if they so choose.

How to Donate Specific Unique Assets Continued

- Contact Life Insurance Company or Agent for required forms to transfer ownership or update beneficiary designation.
- Valuation of the policy
    - For income tax purposes, a gift of a life insurance policy is the donor’s basis in the policy (cost) or the policy’s value, whichever is less.
    - Caveat that the policy’s value will depend up on the situation
        - Paid-up Policy
            - Value is generally the cost that the donor would have to pay to replace the policy at the time of the gift.
        - Not fully Paid-Up Policy
            - Roughly equal to the policy’s cash value. This can be obtained from the insurance company.

How to Donate Specific Unique Assets Continued

Artwork/ Collectibles

- Often make up significant portion of donor’s estate.
- Determine Fair Market Value
  - Must be appraised by a qualified appraiser
  - Variety of factors determine value (i.e. item’s age, rarity, condition, brand name, market demand, etc.)

Artwork/Collectibles Continued

Donating to Charity

- Significant tax savings
  - Can avoid capital gains tax
- If charity uses the item in relation to its tax-exempt purpose, the donor is also entitled to a charitable income tax deduction equal to the property's FMV, up to 30% of donor's adjusted gross income (AGI). Otherwise the deduction may be limited to the cost basis (up to 50% of donor's AGI).
  - Example of "related to charity's purpose" – donate a painting to a museum for display or to an art school for use in one of its classes

- If charity sells the painting, it is not considered used for a related purpose and the deduction may be limited to donor's basis in the artwork.
- If collection is given away gradually and the value continues to appreciate, the deductions will grow with each donation. Giving away collectibles in this manner may also help avoid losing deductions that exceed the 30% AGI limit. However, excess deductions may be carried forward up to five years, the donor may lose the deductions permanently if a work or collection is of extreme value.

Artwork/Collectibles Continued

- If the donor wants to keep the collection intact and isn't ready to let it all go, they can give a fractional gift by donating an undivided percentage interest in the collection.
  - Example – donate 50% interest in art collection to art museum, the museum can display the art for six months yearly and donor then can deduct 50% of the collections FMV and have the benefit of enjoying the artwork the other 6 months of the year.
- Bargain Sale Option
  - Donor can sell appreciated property to a charity at a price that is lower the appraised FMV. This allows the donor to take a charitable deduction for the difference between the sale price and the FMV.
    - Donor must allocate the item's cost basis between the sale aspect and gift aspect. This must be based on the FMV each of these 2 parts. The donor will recognize a taxable gain on the difference between the sale price and costs basis allocated to the sale element but won't be taxed on the gain allocated to the gift aspect.

Gifting to Heirs

Accomplished by:

- Including specific bequest in will or trust
  - If collectibles are transferred through residual gifting, as in part of the property that is left after other beneficiaries receive their bequests, the heir may be faced with a tax liability.
    - Example – heir could become accountable to the donor’s estate for taxes applicable to the item.
- Transfer collections during donor’s lifetime.
  - Use annual gift tax exclusion. Gifts of collectibles can qualify for the $15,000 (2019) per beneficiary annual gift tax exclusion ($30,000 for married couples). Collectibles gifts in this manner are entirely removed from donor’s estate.
  - Use Lifetime Gift Tax Exemption. If the annual exclusion for a beneficiary has already been used or donor wants to make a gift in excess of the exclusion amount, they can use their $11.4 million lifetime gift tax exemption ($22.8 million for married couples), to make gifts of collectibles without incurring federal gift tax.
- Real Estate
  - Your donations qualify for an income tax deduction equal to the fair market value or the cost basis of the property.
  - The amount of your deduction generally depends on whether the real estate is a short-term asset (held one year or less) or a long-term asset (held more than one year).

How To Donate

1. **Direct Gift**

- A direct gift is the simplest method of donating real estate. The deed or title is transferred from the donor to the charity.
- As the donor, you generally receive a tax deduction equal to the fair market value of the property and that deduction may be carried forward for five years. You also avoid paying the capital gains tax that would otherwise accrue as a result of the sale of the property.

2. Charitable Remainder Trust (CRUT)

- The use of a CRUT is a great way for donors with highly appreciated property to accomplish their philanthropic goals while also preserving income for future generations. This trust is tax exempt, so it is not taxed when it sells property and all the proceeds from the sale can be fully reinvested.
- Distributions from the CRUT to its beneficiaries are determined annually based on a fixed percentage (at least five percent) of the value of the CRUT’s assets. At the end of the CRUT’s life, the remaining assets are distributed to designated charitable organizations.
- Contributing real estate to a CRUT provides the donor with an immediate charitable deduction (equal to the present value of the remainder interest that will ultimately pass to charity) and provides future cash flows to the beneficiaries.
- There are several factors to consider when contributing real estate to a CRUT, so it is important to seek legal and financial advice prior to using this vehicle for donating property.

How To Donate Continued

3. Bargain Sale

- In a bargain sale, the donor sells property to a charity for less than the property's fair market value.

- As the donor, you are taxed on your gain, which is the selling price less a pro-rata share of the cost or basis of the property. In this case, your basis in the property is allocated between sale and gift portions of the transaction.

- You may claim a tax deduction equal to difference between the property's fair market value and its selling price.

What to be Aware of When Donating Real Estate

As donations of appreciated property are subject to greater scrutiny from the IRS, it is important to consult with a tax advisor before donating real estate. Below are several situations to consider:

1. *Charitable Substantiation Requirements*

- To prevent over-valuation, real estate donations over $5,000 require a qualified appraisal of the property, performed by a qualified appraiser. If the value of the real estate you donate is $500,000 or more, the appraisal must be attached to your tax filing.
- Your deduction may be disallowed if you don't have the appropriate documentation.

2. Prearranged Sale

- If you, as donor, enter into a binding contract/agreement to sell a piece of property, you may not subsequently donate that property (prior to completion of the contract) in order to avoid capital gain taxes.
- Since the contract exists, you are deemed to have sold the property. When the charity subsequently sells this property, you are still responsible for paying capital gain taxes as if you had sold the property yourself.

What to be Aware of When Donating Real Estate

3. Depreciation

- If you have claimed accelerated depreciation on the property you donate, your tax deduction will be reduced by the amount of depreciation you've taken that exceeds the depreciation allowed under the straight-line method.
- This concept is similar to the ordinary income recapture that occurs on a gain from the sale of property where accelerated depreciation was claimed.

4. Bargain Sale

  - It is important that you clearly identify the donation element of the sale when entering into a bargain sale transaction with a charity.

  - If the donation element is not clearly stated at the time of the sale, you can lose the tax deduction. You will not have an opportunity to identify the donation element at a later date.

What to be Aware of When Donating Real Estate

5. Mortgaged Property

- Donating property that is subject to a mortgage may cause recognition of income to you, as donor. Bargain sale rules apply, as the property is treated as if it were sold for the balance outstanding on the mortgage.

- The fact that you are still responsible for making mortgage payments after the donation does not preclude the recognition of taxable income.

Often the Charity will want to evaluate the gift of real estate as there are liability concerns that need to be addressed.

Conclusion

More important factor for donor to remember is to effectively gift a unique asset, a qualified appraisal at Fair Market value as of the date of donation is a must.

Gifting illiquid assets seems intimidating versus gifting cash or marketable securities, but the upside is it can provide incredible benefits to the Charity and a great way to fulfill philanthropic goals.