# Charitable Dispositions and Receipts of Real Property Interests: A View from both the Individual Donor's and Charitable Donee's Perspective

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## Overview

It is often said that it is better to give than to receive. Of course that broad generalization may depend on one's point of view, especially where tax issues are involved. In the world of charitable giving donors and donees are constantly weaving through a maze of property and tax rules in an attempt to prove that giving and receiving are at least satisfactory to both donor and donee.

A full discussion of property rights is beyond the scope of this article; however, it is important to have a basic understanding of property rights to understand transfers of real property to charities by donors. First year law students are often confused by their professors' initial explanation of property as a 'bundle of rights', but as study of philosophy and the law reveal, a 'bundle of rights' is a fairly succinct definition. Suffice it to say that real property rights are determined by primarily state, but in some cases federal property laws. An owner of real property may have all of the rights generally associated real property (a fee simple interest) or some lesser interest (Life estate, remainder, easement, covenant or other interest). Each one of these separate rights is part of the entire bundle of rights we are speaking about. Our rights and abilities to acquire and dispose of property to charity under what became the common law of England can be traced back to at least to the 5th Century. The following passage provides a very brief overview of early writings which can be traced to our present traditions.

## An Historical Aside

Evidence of an exemption from taxation for charitable activities extends historically back to the writings of Saint Gregory of Tours in the 6th Century[2]. Saint Gregory chronicling a

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[2] In tracing English law to its roots, it is necessary to understand that the Roman law forming the basis of English law should be traced to the Visigothic Code adopted by the Franks and not the Code of Justinian which was the basis of Byzantine law. Both the Code of Justinian and the Visigothic Code trace their

5th Century encounter between King Clothar of the Franks and Bishop Martin[3] notes that King Clothar following an admonishment by Bishop Martin released the Church from its requirement to pay one-third of its collections to the fisc. There are other examples of the release of the clergy from taxation in Saint Gregory's writings[4]. These writings deal with Frankish and not English tradition which is primarily where our present concepts of charitable exemptions and deeds of real property to charity first arise.

## Grants of Tax Exempt Status by the King of England in the 10th Century

In pre-Conquest England under the Saxons one grant of a tax exemption to a monastery by King Edgar (10th Century) took the following form (Emphasis added):

> "In consequence, it seems proper that the church of the most blessed mother of God, the eternal Virgin Mary, of Glastonbury, inasmuch as it has always possessed the chief dignity in my kingdom, should be honoured by us with some especial and unusual privilege. Dunstan, therefore, and Oswald, archbishops of Canterbury and York, exhorting thereto, and Brithelm, bishop of Wells, and other bishops, abbots, and chiefs assenting and approving, ***I, Edgar, by the grace of God, King of the English***, and ruler and governor of the adjacent nations, in the name of the blessed Trinity, for the soul of my father who reposes there, and of my predecessors, ***do by this present privilege decree, appoint, and establish, that the aforesaid monastery and all its possessions shall remain free and exonerated from all payments to the Exchequer now and forever***: they shall have *soc and sac*, on *stronde and on wude, on felde, on grithbrice, on burghrice, hundredsetena, and mortheras, athas, and ordelas, ealle hordas bufan corthan, and beneothan: infangentheof, utfangentheof, flemenefertha, hamsocne, friderbrice, foresteal, toll and team*, just as free and peaceably as I have in my kingdom: let the same liberty and power also as I have in my own court, as well in forgiving as in punishing, and in every other matter, be possessed by the abbot, and monks of the aforesaid monastery within their court...."

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Roman roots to three prior Roman codes. It is these three prior Codes that were the law of the land at various times during the Roman occupation of England in the first few centuries of the first millennium.

[3] "King Clothar had ordered all the churches of his kingdom to pay into his treasury a third of their revenues. But when all the other bishops, though grudgingly, had agreed to this and signed their names, the blessed Injuriosus scorned the command and manfully refused to sign, saying, "If you attempt to take the things of God, the Lord will take away your kingdom speedily because it is wrong for your storehouses to be filled with the contributions of the poor whom you yourself ought to feed." He was irritated with the king and left his presence without saying farewell. Then the king was alarmed and being afraid of the power of the blessed Martin he sent after him with the gifts, praying for pardon and admitting the wrongfulness of what he had done, and asking also that the bishop avert from him by prayer the power of the blessed Martin." Book IV, Chapter 2

[4] *E.g.* "But in the same city [Clermont] King Childebert remitted all tribute both from the churches and from the monasteries and from the other clergy who seemed to belong to that diocese, as well as that from all those who held office in the diocese. For the collectors had already been reduced to penury in that, for a long time when land, through the succession of new generations, had been divided into many parts, they were scarcely able to collect this tribute. By the inspiration of God, the king commanded the collection of the tribute to be improved so that what was owing from the past to the fisc should not harm the collector of the tribute, or cause any churchman to be brought to account for tardiness in paying." Book 10, Chapter 7

# Example of Early Formalities of Grants of Land by Deed to Charity under Saxon Law

In 679 AD, King Hlothhere of Kent made the following deed to form a monastery (Emphasis Added):

> "In the name of our Lord, the Saviour Jesus Christ. ***I, Hlothhere, king of the dwellers in Kent***, for the salvation of my soul ***give the land in Thanet that is called Westana to you, Beorhtwald and to your monastery*** with all that belongs to it, fields, pastures, marshes, small woods, streams, fisheries, all, as has been said, belonging to this same land, just as has ever been possessed up until now, in conformity with its very well-known boundaries pointed out by me and by my *procuratores*. ***In the same way we grant to you and your monastery [that] you should hold [and] possess [it] and your successors warrant title to it in perpetuity, opposed by no one, with the agreement of Archbishop Theodore and Eadric, son of my brother, and also all the principes, just as it was given to you, so that you and your successors should hold [it].*** Should anyone attempt to contravene this gift, may he be separated from all Christendom and suspended from the body and blood of our Lord Jesus Christ. In order that this charter remain likewise in its steadfastness and as a confirmation, I have imprinted the mark of the holy cross with my own hand, and have asked that witnesses should subscribe [it]. Executed in the city of Rochester in the month of May, the seventh indiction.
>
> On the same aforementioned day I added another estate in Sturry nearby, the very well-known bounds being indicated by me and by my *procuratores* with fields and woods and meadows, just as we recounted the above-mentioned land earlier. May that [land] so given by me in the same way with all belonging to it into the power of the abbot in perpetuity be opposed by no one, God forbid!, neither by me nor by my parents nor by others. If anyone should do otherwise, let him know that he be damned by God, and let his soul render an account to God on the Day of Judgment."
>
> + Mark of the hand of ***Hlothhere, king, the donor***.
>
> (Witnesses)
>
> + Mark of the hand of Gumberht.
> + Mark of the hand of Gæbred.
> + Mark of the hand of Osfrith.
> + Mark of the hand of Eormenred.
> + Mark of the hand of Æthelmær.
> + Mark of the hand of Hagana.
> + Mark of the hand of Ealdred.
> + Mark of the hand of Ealdhad.
> + Mark of the hand of Guthheard.
> + Mark of the hand of Beornheard.
> + Mark of the hand of Welhisc.

Note that the requirements we presently have for deeds are little changed from the 7th Century. In the deed above, there is a Grantor, a grantee charity, a description of the land, warranties of title, signature by the grantor and witnesses to the grant.

# Basic Concepts

In discussing the disposition of all or any part of a bundle of rights to real property we hold we need to conceptualize the possibility that we may convey all or part of these rights to others in a variety of ways. For pedagogical purposes these rights are sometimes referred to as horizontal or vertical slices of property interests. A horizontal slice might be considered a fractional interest in property, for example: one half of black acre, 2/3rds of a lot, the south 300 feet of the tract five, etc. A vertical slice is something quite different; it would consist of mineral rights (below ground), air rights (above ground) or some restriction on the use of land. This is an important concept to understand when we discuss conservation easements later in the discussion. These horizontal and vertical interests are different than other present or future rights in real property, such as retained interest or future interest in property. OK, why do we care about this? The reason is that if we understand the rights in property being conveyed under state law, it will be much easier to determine why the Congress in its legislative grace permits or denies a deduction of a partial right in property; but let's move on, there is much to cover.

In our discussion we are concerned with the transfer of all or part of a bundle of real property to an organization or trust which qualifies for exemption from federal income tax under §501(c)(3) of the Internal Revenue Code of 1986 as amended ("Code"). We will take a cursory look at transfers of such real property interests from both the donor's and donee's perspective. The format of this article is intended to provide basic information to the donor of the donee's needs and desires and likewise the donee of the donor's needs and desires. Hopefully at the end of this discussion both the donor and the donee will be able to come to the conclusion that it is better to both give and receive.

***Gifts Generally***

The starting point for understanding the tax effects of a charitable transfer is state law. An important principle of tax law espoused by the courts is that we first look to state law to determine what property rights are involved in a transaction and next to federal tax law to determine the taxation of those exchanges of property rights. Here we are dealing with gifts of property.

For a person to make a gift of property to another person under state law, three specific events must occur: (i) the intent by the donor to make a gift; (ii) the delivery of that gift to the intended donee; and (iii) the acceptance of that gift by the donee. The absence of any one of these requirements will void the gift or render it incomplete. This is an important concept to understand from both the donor's and the donee's perspective. Tax literature is replete with instances of failed gifts that could not qualify for charitable deductions. The inattention to detail, interference or inaction of either donor or donee in a charitable transfer can diminish or void the benefits each party expects in the completion of a gift.

### *Making Gifts of Real Property-the Requirement of a Deed executed with the Proper Formalities*

Florida Statues require that in most instances real property must be made by a written instrument commonly known as a deed[5]. Typically, deeds must be signed by the grantor of the interest in real property in the presence of two subscribing witnesses[6]. The requirement of a writing is imposed by the Statute of Frauds as it exists in Florida[7]. Under the Statute of Frauds, oral contracts for real property are unenforceable. Thus an oral promise to make a gift of land to a charity, without a writing is not enforceable. How does this compare to the 7th Century deed above?

### *Promises to make a Gift of Real Property-Enforcement by Estoppel*

What if a donor makes a pledge to transfer land and reneges on the gift? In Florida, charitable pledges may be enforceable where they are stated with particularity under a theory of *Promissory Estoppel*[8]. In order for a charity to recover it will need a written pledge agreement which may be required to be signed by the same formalities necessary to convey real property.

### *Basic Tax Principles Applicable to Charitable Transfers*

The Federal Income Tax and the Federal Gift Tax are very different taxes and follow very different principles. The Federal Income tax is a tax on accessions to wealth and is imposed annual on the net income earned by a taxpayer. The Federal Gift and Estate tax is an excise tax on the right to transfer property and is accessed at the moment of transfer at the fair market value of the transfer.

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[5] **Fla. Stat. §689.01** States the following: **"**No estate or interest of freehold, or for a term of more than 1 year, or any uncertain interest of, in or out of any messuages, lands, tenements or hereditaments shall be created, made, granted, transferred or released in any other manner than by instrument in writing, signed in the presence of two subscribing witnesses by the party creating, making, granting, conveying, transferring or releasing such estate, interest, or term of more than 1 year, or by the party's lawfully authorized agent, unless by will and testament, or other testamentary appointment, duly made according to law; and no estate or interest, either of freehold, or of term of more than 1 year, or any uncertain interest of, in, to, or out of any messuages, lands, tenements or hereditaments, shall be assigned or surrendered unless it be by instrument signed in the presence of two subscribing witnesses by the party so assigning or surrendering, or by the party's lawfully authorized agent, or by the act and operation of law. No seal shall be necessary to give validity to any instrument executed in conformity with this section. Corporations may execute any and all conveyances in accordance with the provisions of this section or ss. 692.01 and 692.02." Similarly, **Fla. Stat. §689.06** states: "All grants, conveyances, or assignments of trust or confidence of or in any lands, tenements, or hereditaments, or of any estate or interest therein, shall be by deed signed and delivered, in the presence of two subscribing witnesses, by the party granting, conveying, or assigning, or by the party's attorney or agent thereunto lawfully authorized, or by last will and testament duly made and executed, or else the same shall be void and of no effect."

[6] Id.

[7] See **Fla. Stat. § 725.01 "***No action shall be brought whereby to charge … any person upon any agreement …made … upon any contract for the sale of lands, tenements or hereditaments, or of any uncertain interest in or concerning them, or for any lease thereof for a period longer than 1 year … unless the agreement or promise upon which such action shall be brought, or some note or memorandum thereof shall be in writing and signed by the party to be charged therewith or by some other person by her or him thereunto lawfully authorized."*

[8] See, Mount Sinai Hospital vs. Jordan, 290 So. 2d 484 (1974). A full discussion of promissory estoppel is beyond the scope of these materials. This cite will give you a good starting point if you have a further interest in this topic.

### *Income Tax Principles*

From an income tax perspective the principal elements of a gift are: (1) An intention on the part of the donor to absolutely and irrevocably divest himself of the title, dominion and control of the subject at the very time he undertakes to make the gift; (2) the irrevocable transfer of the present title, dominion and control of the thing given by the donor; and (3) the delivery, by the donor to the donee, of the subject of the gift or of the most effectual means of commanding the dominion of it[9]. While this definition is close to the previously stated Intent delivery and acceptance standard, note the additional language related to "*dominion and control*." The donor must irrevocable part with the party conveyed for a gift to occur. No part of the bundle of rights may be retained as to the portion of the property conveyed. If rights in property are retained the gift may not be complete and may still be considered owned by the donor. For example, the loan of a painting to an art museum for ten years does not constitute the complete divestment of title and dominion by the donor.

The seminal income tax case is ***Commissioner v. Duberstein***[10]. The Supreme Court in ***Duberstein*** espoused a number of very important Income Tax principles. First, a transfer is not a gift if transfer occurred due to some form of incentive or economic benefit. Second, a transfer is not a gift if it proceeded as a result of coercion or a moral or legal duty. Instead for a gift to be present the donor must make the transfer to the done out of a sense of a detached and disinterested generosity which resulted from impulses of charity, affection, respect, admiration or like impulses; in essence expecting nothing in return. In construing gifts from an income tax perspective courts look to the Donor's primary or dominant intent in making the transfer.

### *Gift Tax Principles*

The existence of a gift for gift tax purposes is wholly different. Under the Gift Tax rules, the donor's intent is irrelevant. The Gift tax taxes all transfers made by a donor for less than full and adequate consideration. The value of the property rights conveyed at the time of the release of dominion and control over property is what controls. Since value is involved, the starting point in determining a gift is measuring the consideration, if any, that is received in a transfer. If full and adequate consideration is received in a conveyance of property, there is no gift; however, once a transfer is made for less than full and adequate consideration we begin to measure a gift. The gift is measured by the difference between what has been conveyed and what has been received. Where the value of the property received exceeds the consideration exchanged, if any, the result is a gift.

### *Summary*

To summarize, in analyzing transfers of real property to charity we need to recognize the bundle of rights which is being transferred. We must pay careful attention to whether we are transferring horizontal or vertical slices of property. We must look at the formalities

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[9] **Allen-West Commission Co. v.Grumbles**, 129 Fed. 287
[10] 363 US 278 (1960).

of the transfer, for example whether a properly executed deed has been made. In addition, we must look at the donor's intent and the value of the consideration exchanged in the transaction. We must ensure that the donor has relinquished full dominion and control over the rights conveyed. Finally, we must determine the tax effects of the transfer.

## Basic Charitable Transfers of Real Property Outright

The simplest transfer to consider is a conveyance of all of the donor's right, title and interest (the entire bundle) to an organization exempt from income taxation pursuant to §501(c)(3).[11] If the transfer is a lifetime conveyance it must be done by a deed executed with the formalities required by the state in which the property is located. It is also important to have a well drafted grant agreement between the donor and donee organization. If the transfer is testamentary, a well drafted will or trust document is required. The deed is still required but will come from a personal representative or trustee. If a testamentary transfer is contemplated, make sure that the language of the testamentary charitable transfer is check by a qualified Estate planning attorney. Failing to do so can result in a costly reformation action in the court or a loss of the deduction.

## Effects on the Donor

When a donor makes a life time (*inter vivos)* transfer of real property to qualified charity we need to consider both the Income tax and Gift tax consequences of the transfer. From an income tax perspective, there is a lot of information to gather. We need to know the original cost basis of the property, analyze additions or subtractions from basis since acquisition, whether the land is subject to any third party rights such as a mortgage or other lien or other rights such as easements, covenants or other restrictions. We should check if there are any potential environmental liabilities associated with the land. We should know whether the land being transferred is considered capital gain or ordinary income property in the hands of the donor and whether the donor used the property in a trade or business[12]. We will need to have the property appraised by a qualified appraiser to determine its fair market value. We also need to know the donors adjusted gross

[11] An organization described in §501(c)(3) of the Code is any [c]orporation, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

[12] In part, IRC §1231(b) states: The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year…

income and the type of charity the donor is donating to, in order to determine the amount of the deduction available[13].

Once this information is in hand we can calculate the tax effects for the donor. Generally, a donor is entitled to an income tax charitable deduction equal to the fair market value[14] of the property transferred. This is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts[15]. In order to receive a charitable deduction, the donor will have to substantiate the deduction. This means that the donor will have to get an appraisal to determine the fair market value of the property transferred.

***Percentage Limitations***

Knowing the fair market value of the property, we can determine the value of the charitable deduction available for the transfer of the real property. To get to the correct answer, we need to look at the percentage limitations on the deduction for the donor.

***Organizational Limitations***

The Internal Revenue Code creates two primary deduction classes. The first is the 50% limitation class ("50% Charities") which available for transfers to charities identified in §170(b)(1)(A)(i) through (viii). These categories include:

1. Churches.
2. Educational Institutions
3. Hospitals and medical research institutions
4. Governments and governmental organizations
5. Publically Supported Organizations
6. Private Operating Foundations

The second class of organizations so-called 30% organizations ("30% Charities") includes anything which is not a 50% organization, most significantly private foundations.

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[13] Donations of appreciated property are subject to certain deduction percentage limitations depending on the type of property transferred and the type of organization receiving the donation. See explanation at ___ below.

[14] Treas. Reg. § 1.170A-1(c)(1). The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, but if he sells only at retail the usual market consists of his retail customers.

[15] Id.

### *Limitations on Transfer of Capital Gain Property*

Real property may be classified as either ordinary income property or capital gain property depending on the use of the property by the owner of the property. For example a developer or dealer in real property may be required to treat real property owned or constructed as inventory because it is sold to customers in the ordinary course of a trade or business. If the property is held for investment or used in a trade or business, other than as inventory[16] then the property may qualify for capital gain treatment[17].

### *Gifts to 50% Charities*

If the property transferred by the donor *to charity* is considered long term capital gain property (held for more than one year), and the gift is made to a 50% Charity as defined above, then the total deduction available for these gifts is limited to 30% of the contribution base. Amounts disallowed by the 30% limitation may be carried forward for a period of five years. Gifts to charity in excess of the 30% limitation will lapse on a FIFO basis if the donor is unable to use the total deductions for the property contributed.

In addition to the 30% limitation and carry-over phase out rules there is a further ordering principal to consider. Where a donor's total charitable gifts to 50% Charities exceed the 50% threshold it is the gifts of capital gain property that are disallowed first.

**EXAMPLE**

Donor A's who has a contribution base of $200,000 gives $120,000 of cash and real property to 50% charities. $90,000 of these donations consist of real property classified as capital gain property for federal income tax purposes. The remaining $30,000 of these donations is in cash. Donor A's ability to take a deduction is first limited by the 50% ceiling. The 50% ceiling caps the available deduction for A at $100,000 ($200,000 x 50%). Due to the ordering principles, the cash ($30,000) will be considered donated first. The result is that only $70,000 of the $90,000 of real property donated will be permitted as a deduction. However, there is a further 30% limitation on the amount of capital gain property that can be donated to a 50% charity. Thus only $60,000 (30% of the $200,000 contribution base) is permitted. In total then, Donor A is permitted a deduction of $90,000 consisting of $30,000 in cash and $60,000 in capital gain property leaving $30,000 in deductions which may carry over on a FIFO basis to future tax years. The $30,000 carried over consists of $10,000 carried over due to the 30% limitation and $20,000 due to the 50% limitation.

In cases where the unrealized gain on capital gain property is relatively small the donor may wish to consider a special tax election which effectively eliminates the 30% ceiling. By electing to reduce the value of the deduction to adjusted basis, the donor's deduction is limited only by the 50% of contribution base ceiling. Due to the recent collapse in real estate this option should at least be explored by donors who are considering a transfer of real property to charity. However, in reviewing the benefits of this election it is necessary to consider other issues such as market timing and time value of money in the determining whether to donate.

[16] See §1221 of the Code.
[17] See §1231(b) of the Code.

***Gifts of property for the use of 50% Charities or for the use of 30% Charities***

Not all donations to a 50% Charity qualify for the 50% deduction limitation. Significantly, donations of real property to a 50% charity which is made ***for the use*** of 50 percent charities ***or to or for the use*** of 30 percent charities will not qualify for the 50% limitation instead the deduction for these gifts is limited to the lesser of (i) 20% of the contribution base or (ii) the amount in excess of the 30% contribution base over the aggregate of the gifts of capital gain property made to 50% Charities. The excess is carried forward for 5 years.

So just what is the distinction that could cause a donor to lose a rather healthy portion of a donation? Perhaps the easiest way to visualize the distinction is to try to find an intermediary between the donor and the ultimate recipient of the funds. If the transfer is a direct transfer of cash or other property to the 50% Charity then it likely qualifies as a transfer “to” charity and as a result qualifies for 50% limitations. If the donor first transfers the charity to a trust which in turn transfers the property to a charity, then the transfer is “for the use of” a charity and qualify for only the 30% limitations. This is perhaps a simplistic explanation but sufficient for our purposes. An exception to this rule would be a transfer of remainder interest that becomes a possessory interest of a charity after the expiration of a term interest, think charitable remainder trust.

Taxpayers must report noncash charitable contributions on Form 8283.

## Recapture on later Disposed Donated Property

Some coordination is necessary to ensure that the donor’s and donee’s purposes are aligned in the gift of real property. Prior to making a gift of real property to a charity, the donor should discuss the gift with Charity, its usefulness and acceptability to the Charity and the terms of the gift. A written grant agreement is the best course of action.

It is possible that the donor’s intentions and anticipated tax deductions can be thwarted by the inability or lack of desire of the charity to hold or use the real property contributed. This can occur if property received by a charity for an exempt use in excess of $5,000 is sold or otherwise transferred by the donee charity before the end of the tax year in which the property is received. In such cases, unless the charity provides the donor with a written receipt or certification that states that either (i) the real property was related to the recipient's exempt purposes and describes how the property was used and how such use furthers the organization's exempt purposes or (ii) describes the intended use of the property by the recipient organization and states that the intended use has become impossible implement. Without this certification the donor’s deduction will be limited to his or her basis. Further, if contributed exempt use property is disposed of by the recipient charity (i) within 3 years of contribution and (ii) after the close of the taxable year in which the contribution is made, the donor is required to include in income in the

year of disposition the amount by which the charitable deduction allowed exceeds the donor's basis in the property.

## CONTRIBUTIONS OF HORIZONTAL SLICES – ONLY AN UNDIVIDED PORTION OF THE DONOR'S ENTIRE PROPERTY INTEREST QUALIFIES

Partial interests in property (less than the full bundle of rights) are normally not deductible. For example, a mere non-exclusive right to enter property or to use property is not deductible. However, if a donor transfers an undivided portion of the donor's entire interest in property a deduction is available, provided the contribution is not in trust[18]. To qualify the undivided portion of the donor's interest must be the entire term of the donor's interest[19]. Thus an individual who owns fee title to land cannot convey a joint interest for a term of years to charity and receive a charitable deduction. However, an individual who owns a remainder interest in real property who contributes one-half of his remainder interest to charity can receive a charitable deduction[20].

## RECEIPT OF A REAL PROPERTY BY A CHARITY

While charities are normally thankful for any donation that comes their way, the receipt of real property by gift or bequest is often perplexing to a board of directors of a charity who are much more adept at dealing with gifts of securities or cash. This concern is not unfounded. Charities must think long and hard prior to receiving a gift of real property. A great deal of due diligence (read consulting on the acquisition with lawyers, accountants, appraisers, architects, environmental engineers, et. al.) is required if directors are to faithfully discharge their duties to the charity. For example, accepting environmentally compromised real property can mean that a charity has accepted a liability in excess of the value of the property received.

One the one hand, real property is an asset which will improve the charity's balance sheet. On the other, immediately following the receipt of real property, the charity must establish a number of expense and liability accounts, among them, maintenance, repairs, utilities and taxes (if not able to qualify for an exemption). Administration costs of the organization will increase due to the need to deal with the real property on a continuing basis.

Even if due diligence dictates that the property is an acceptable donation, the question is what will the charity due with the property if it receives it. Understanding the capital gain property limitations described earlier it may be wise have the donor discuss with his or her advisers whether it is not better to sell the property and donate the cash proceeds to the charity. Another option might be to have the donor could assign rights to a contract

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[18] IRC§170(f)(3)(B)(ii).
[19] Treas. Regs § 1.170A-7(b)(1)(i) .
[20] Reg § 1.170A-7(b)(1)(i); Rev. Rul. 79-295, 1979-2 CB 349.

for the sale of real property to the charity once it has been entered into. This would reduce the costs to the charity of dealing with the costs of transferring real property.

However, for our purposes we want to discuss those situations where the charity actually wants the property. The charity may want land to build a church, school or headquarters for its own use. It may want to create housing for indigent or special needs individuals. If it is a hospital it may want to build offices for physicians and rent them.

## BOOKING THE DONATION- UNUSUAL GRANT?

A receipt of real estate is typically a large and unusual grant for a standard charity. So from an accounting perspective do we merely credit donations of real property on our income statement and debit our fixed assets on the balance sheet or are there other factors to consider? Well the answer is that we need to look at the possibility of treating the contribution as and unusual grant. If we don't, we may see a skewing of our support fractions and an abnormal increase in income which could lead to questions from the IRS about our sources of support and from potential future donors about the charity's need for funding.

Without going through a discussion of the support fractions, let's just say that the both the IRS and donors look to certain fundraising and financial guideposts in determining whether a charity is operating as a charity. Often large unusual contributions can knock those fractions out of whack. Thus, our Congress in its infinite wisdom determined that there would be certain times when large and infrequent grants could be excluded from the calculation of these support fractions. Such large and unusual donations are known as "Unusual Grants."

In general Unusual Grants are substantial lifetime contributions or bequests from disinterested persons (e.g. no directors or disqualified persons) who are attracted to the publicly supported nature of the organization and as a result make an unusual or unexpectedly large donation, which by reason of its size affects the broad publically supported status of the Charity[21].

What constitutes an Unusual Grant is a question of fact[22]. As such It will be incumbent on the Board and development staff of the charity to determine prior to the acceptance of a large gift such as one of real property to determine whether an Unusual Grant is being made and if not, under the facts, what effect the receipt of the real property will have on the charity's support fractions.

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[21] Treas. Regs. § 1.509(a)-3(c)(3).
[22] Treas. Reg § 1.170A-9(e)(6)(iii).

# TRANSFERS OF PERSONAL RESIDENCES TO CHARITY

A transfer of a personal residence to charity would seem straight forward. As we have seen, the entire interest in real property transferred to charity is deductible[23]. In addition, transfers of real property encumbered by a mortgage are treated as partly a sale and partly a gift. However there are some rules to keep in mind if a donor desires to transfer a personal residence to charity in any manner other than outright

***Non-trust remainder interests or tenancies in common.***

If a donor reserves a life interest in property constituting a personal residence, farm[24] or vacation property and conveys a remainder interest to charity, the transfer will qualify for a charitable deduction[25]. In like manner, if the decedent provides an undivided portion of his entire interest in real property to his wife and two charity as tenants in common, whereby the charity is given the right, as a tenant in common with the decedent's wife to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property the transfer will be deductible[26].

If the donor conveys to charity a remainder interest in a farm or personal residence the donor’s deduction is determined using the IRS’s actuarial tables[27]. In addition consistent with the rules for additions to charitable remainder unitrusts, a donor’s subsequent improvement of a personal residence or farm will permit the donor to take an additional ratable deduction, provided the improvements become a fixture or real property on completion[28].

***No deduction for transfers of non-qualifying remainder interests in trust***

No charitable deduction is permitted if the remainder interest in the residence comes to the charity through a trust[29]. Both Treas. Reg. § 1.170A-7(b)(4) and Treas. Reg. §20.2055-2(e)(2)(ii) contain the not in trust prohibition. A good explanation for the

[23] Treas. Reg. §20.2055-2(e)(2)(i) states that A deductible interest for purposes of §20.2055-2(e)(1) is a charitable interest in property where the charitable interest is an undivided portion, not in trust, of the decedent's entire interest in property. An undivided portion of a decedent's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the decedent in such property and must extend over the entire term of the decedent's interest in such property and in other property into which such property is converted.

[24] Treas. Reg. § 1.170A-7(b)(4). States that a deduction is allowed under section 170 for the value of a charitable contribution *not in trust* of an irrevocable remainder interest in a farm which is not the donor's entire interest in such property. Thus, for example, if a taxpayer contributes not in trust to an organization described in section 170(c) a remainder interest in a farm and retains an estate in such farm for life or for a term of years, a deduction is allowed under section 170 for the value of such remainder interest not transferred in trust. For purposes of section 170(f)(3)(B)(i) and this subparagraph, the term “farm” means any land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. The term “livestock” includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. A farm includes the improvement thereon.

[25] IRC § 170(f)(3)(D)(i).

[26] *See,* Treas. Reg. §20.2055-2(e)(2)(i).

[27] IRC § 170(f)(4); Treas. Reg. § 1.170A-12(b)(2).

[28] PLR8529014 (Apr. 16, 1985).

[29] Ellis First National Bank of Bradenton, exr (Est Kerr) v. U.S., 550 F2d 9 (1977, Ct Cl).

reasoning behind the prohibition is found in Ellis First National Bank of Bradenton, as Executor of the Estate of Kerr v. U.S. In that case, the Claims Court stated in dicta that,

> "[S]ection 2055(e) was amended to eliminate possible abuses in the administration of trusts which might operate to deprive the charity of the future remainder interest for which the estate has been credited with a deduction. This concern is no less present with respect to personal residences which pass first through a trust not approved by the Act. Unlike an outright gift of a remainder interest in a residence where the charity is guaranteed the eventual deed upon the termination of the life estate, a remainder interest which passes through a trust and is subject to the trustee's exercise of discretionary powers, is not certain to be realized by the charity. The potential for abuse is dramatically evident in the trust established by the will of John A. Kerr:
>
> 1. I direct that my Trustee shall provide to my sister, Hazel C. Kerr, the use of my real estate in Sun City Center, Florida, and New Richmond, Quebec, Canada, during her lifetime without charges of any nature and all expenses of maintaining said property shall be paid out of the net income of this Trust. *Either or both of said properties may be sold during my sister's lifetime only upon receipt of the written consent thereto of my said sister or her legal guardian.* [Emphasis added.]"

As the Claims Court notes in its holding:

> "It is clear that the above-quoted language authorizes the trustee, upon the application or with the consent of the life beneficiary, to liquidate the two residences without the consent of any of the charities entitled to the remainder interest. Such action, if taken by the trustees, would deprive the charities of the certainty of receiving deeds to the properties; the proceeds from the sale could be mingled with the other trust assets and such assets could be administered in a manner which would deplete the value of the interest of the charities. The fact that none of these things was done in this case does not affect the result we have reached. It is the possibility for abuse which the Act sought to remove by limiting the kinds of trusts in which deductions may be taken for remainder interests bequeathed to charities."

Note that there are certain exceptions to this rule. Treas. Reg. §20.2055-2(e)(2)(ii) clearly provides that a transfer of a life estate in a residence to a surviving spouse with a remainder to charity can qualify for a deduction under §2055. This result must be contrasted with Rev. Rul. 76-357[30], where no charitable deduction was permitted for the bequest of a remainder interest in a decedent's personal residence passing to charity upon the death of the decedent's child for whom the residence was held in a testamentary trust[31]. Perhaps the result is based on the fact that a life interest conveyed to a spouse with remainder to charity is a deferral of receipt at the same level as the decedent transferor.

**30** 1976-2 CB 285.

31 From the Ruling: "*In the present case, the decedent bequeathed the personal residence to a trustee and directed that the decedent's child have a lifetime right to occupy the premises before the property is to be conveyed to charity. The statutory exception in section 2055(e)(2) of the Code for remainder interests in personal residences is thus not applicable to the decedent's residence because it was placed in trust*."

In any event, the problem for any conveyance of a personal residence in trust is the rule that no charitable remainder trust can qualify for a charitable deduction for its remainder unless it is drafted in the form of a charitable remainder annuity trust or a charitable remainder unitrust. Note that the trust to the son for life and then to charity in the Revenue Ruling is not in proper form.

One additional thought is that if a charity receives a non-qualifying transfer of a remainder interest in a personal residence or farm, in trust, from a decedent, the charity and the life beneficiaries should determine whether there is a possibility of reforming the trust or immediately dividing the trust with the assistance of the courts into charitable and non-charitable interests. This may be difficult to do when the property is a personal residence or farm as the interest may not be reformable[32] or where the termination and distribution of the property do not meet the required formalities.

# RECEIPTS OF REAL PROPERTY SUBJECT TO INDEBTEDNESS

If a charity receives real property from a donor which is subject to a mortgage or other indebtedness, or if the charity assumes indebtedness associated with real property, the transaction is treated as a sale. This is not surprising. In such cases the donor is relieved of an obligation and thus his net worth increases. Since §61 of the Code describes income as all accessions to wealth and §108 specifically mentions discharges of indebtedness logically a decrease in a liability can be considered income is many cases.

Where a sale is indicated through the donation of property subject to indebtedness, the rules of §1011(b) must be followed. The following example is an illustration of the result.

**EXAMPLE:** Donor A transfers land with a fair market value of $100,000 and an adjusted basis of $50,000 to Charity B. The land is subject to a mortgage of $70,000. The transaction is treated as a sale to the charity for $70,000. There is a gift of $30,000 ($100,000-$70,000). 70% of the adjusted basis or $35,000 is allocated to the sale and $15,000 is allocated to the gift. Gain of $35,000 ($70,000-35,000) is recognized.

### *Holding and Use of Real Property by a Charity*

Now that the charity has received real property, the question is what to do with it. Rent it, sell it, develop it, hold it for investment. There are a number of options. Whatever the decision, the charity will need to consider whether the choice made runs afoul of the unrelated business taxable income rules.

The granting of an exemption from federal income taxation by the Internal Revenue Service acts as only a partial relief from the federal income tax. The relief is applicable only in those situations where the not for profit enterprise is operating within the scope its charitable exemption. When exempt organizations engage in trade or business activities

[32] Private Letter Ruling 8110016 (11/26/1981).

which are *unrelated* to their exempt purpose[33] they will be subject to federal income taxation unless an exemption or exclusion applies[34]. The tax is technically referred to as the unrelated business income tax ("UBIT")[35]. This tax can be a problem for any charitable organization because the receipt of excess amounts of unrelated business taxable income ("UBTI") can place the exempt status of the organization in jeopardy.

### *Unrelated Business Taxable Income ("UBTI"), Generally*

The term "Unrelated Business Taxable Income"[36], is defined in the Internal Revenue Code ("Code"), as any gross income derived by an organization from *any unrelated trade or business regularly carried on by it*[37], less deductions allowed which are directly connected with the carrying on of such trade or business.

The Code classifies a number of activities as being excluded from the calculation of UBTI. For example, gains realized on capital gain property (gains or losses from the sale, exchange, or other disposition of property other than inventory) are exempted[38]. If a charity receives land, uses it for its purposes or holds for investment and then sells the land the gain will not be subject to the UBTI rules.

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[33] **IRC §513(a)** of the Code generally defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable or other purpose or function constitution the basis for its exemption under §501.

[34] **IRC §501(b) TAX ON UNRELATED BUSINESS INCOME AND CERTAIN OTHER ACTIVITIES**. An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in parts II, III, and VI of this subchapter, but (notwithstanding parts II, III and VI of this subchapter) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[35] **IRC § 511(a)(1) IMPOSITION OF TAX. --**There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every [Exempt Organization] a tax computed as provided in section 11 [relating to Corporations]. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

[36] **IRC §512(a)(1) GENERAL RULE. --**Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

[37] Treas. Reg. §1.513-1(c)(1). In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

[38] **IRC §512(b)(5)** There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than §**512(b)(5)(A)** stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

**512(b)(5)(B)** property held primarily for sale to customers in the ordinary course of the trade or business.

There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organization's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

***Debt Financed Income***

An ancillary issue for our consideration is the UBTI rules related to debt financing income. Under the debt financing rules of IRC §514[39], an exempt organization is required to take into UBTI a percentage of the income generated by the debt financed property[40]. The percentage of income to be included in UBTI is based on the average amount of acquisition indebtedness an organization has on its books at any time during the tax year (or during the preceding 12 months, if the property is disposed of during the year). Debt financed property is generally defined as any property acquired to produce income which is subject to acquisition indebtedness. It is important to note that debt financed property ***does not*** include property whose primary use is substantially related to the exercise or performance by the organization of its charitable purpose[41].

If the donation to the organization is free and clear of mortgages, liens and encumbrances, it is hard to envision the application of the debt financing rules to the receipt of real property. However, if the charity acquires real property in a bargain sale to charity and the property is subject to acquisition indebtedness, then there is a strong likelihood that the rules under §514 may apply.

# RECEIPT OR REAL PROPERTY WHICH IS SUBSTANTIALLY RELATED TO THE CHARITY'S EXEMPT PURPOSE

First, let's look at the use of the real property in a purpose related to the charities exempt purpose. In these circumstances, even if the property is leased to for profit persons, UBTI will not be generated.

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[39] **IRC §514(a) UNRELATED DEBT-FINANCED INCOME AND DEDUCTIONS. --**In computing under section 512 the unrelated business taxable income for any taxable year --
**514(a)(1) PERCENTAGE OF INCOME TAKEN INTO ACCOUNT. --**There shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness (as defined in subsection (c)(7)) for the taxable year with respect to the property is of (B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of such property during the period it is held by the organization during such taxable year.
**514(a)(2) PERCENTAGE OF DEDUCTIONS TAKEN INTO ACCOUNT. --**There shall be allowed as a deduction with respect to each debt-financed property an amount determined by applying (except as provided in the last sentence of this paragraph) the percentage derived under paragraph (1) to the sum determined under paragraph (3). The percentage derived under this paragraph shall not be applied with respect to the deduction of any capital loss resulting from the carryback or carryover of net capital losses under section 1212.
**514(a)(3) DEDUCTIONS ALLOWABLE. --**The sum referred to in paragraph (2) is the sum of the deductions under this chapter which are directly connected with the debt-financed property or the income therefrom, except that if the debt-financed property is of a character which is subject to the allowance for depreciation provided in section 167, the allowance shall be computed only by use of the straight-line method.

[40] **IRC §514(b)(1) IN GENERAL. --**For purposes of this section, the term "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).

[41] I**.R.C. §514(b)(1)(A).**

One good example of "related purposes" can be found in PLR 9750056[42]. In that ruling a Hospital was consolidating a number of activities. The IRS held that the operation of a fitness center, physical therapy center, wellness program and like activities did not generate "unrelated" business taxable income because the relationship between the business activities generating the income in question and the accomplishment of the health care purposes of the organization were substantial[43]. Thus lease income from the activity to the parent or receipt of dividends from subsidiaries will not be considered UBTI because of the relationship of the income generated to the parent organization's exemption.

# RENTING REAL PROPERTY

### When rent qualifies for an exemption

It is possible for a charity to rent the property received, but there are some limitations. In many, but not all circumstances the rental of real property by a charity qualifies for an exclusion from the UBTI rules. The exclusions are found in §512(b)(3)(A) of the Code. This section of the Code states that in most cases rent from real property will be excluded from the calculation of an organization's UBTI. Further, the rules also state that incidental rental of personal property associated with the real property will also be excluded from the calculation of UBTI if the rent from personal property is less than 10% of total rents[44].

For example, rents from banquet facilities received by a §501(c)(2)[45] title holding subsidiary of another exempt organization have been held to be exempt from UBTI[46]. Thus an exempt organization can create a subsidiary title holding company rent out the real property and collect rent on the property without jeopardizing its exemption.

### When rent does not qualify for an exemption

There are two primary circumstances when rent will not qualify for an exemption from the UBTI rules. In the first instance, where the total rent received under a lease consists of more than 50% rent received from personal property rather real property UBTI is present[47]. Logically, the charity is engaging in the rental of personal property and not real property. Remember the 10% limitation above.

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[42] (December 12, 1997).
[43] *See* Treas. Reg. §1.513-1(d)(2).
[44] *See*, Treas. Reg §1.512(b)-1(c)(2)(ii).
[45] Section 501(c)(2) and 501(c )(25) organizations are granted exemptions from federal income tax provided their sole purpose is to hold title to property, collect the income thereon, and turn over the entire amount, less expenses, to another exempt organization.
[46] PLR9605001 (2/2/1996).
[47] IRC §512(b)(3)(B)(i).

In the second instance, where the total lease payment depends in part on the income or profits of the lessee, the lease income will not be exempt[48]. This prohibition should not be confused with rents based on gross receipts or a percentage of sales. Rents with features related to gross receipts or percentages of sales, if properly written will be exempt from the UBTI rules. Rev. Rul. 80-297[49] is instructive in this instance. In that ruling, the IRS stated that an educational institutions rental of its tennis facilities to an unrelated third party for a fixed fee resulted in an exclusion of the rents from the UBTI calculation for the organization.

## Sales of Real Property by a Charity

If a Charity receives property and holds it for investment or uses it within its purposes then the later disposition of that real property should be exempt from the UBTI calculation. The general rule is that gains or losses from the sale or exchange of property will be excluded from UBTI under §512(b)(5)[50]. The primary exceptions to this rule are inventory and dealer property. For Charities, this rule means that any decision to develop real property owned by the Charity should be carefully scrutinized.

## Development Activity

***Can a charity engage in development activity*?**

In limited circumstances, the answer is yes. For example in PLR9128030, the IRS ruled that a school which had received a bequest and held the real property for investment could maintain control over the development of the land. Here the control over development was not control in the sense of guiding the day to day construction activities and marketing of the project. Instead the control maintained was over environmental concerns and maintaining a natural setting.

***Dispositions of Land Previously Used by a Charity in Support of its Exempt Purposes***

In **PLR 200242041[51],** a monastery and school acquired property over a 45 year period. A portion of the property acquired was deemed not suitable for use by the charity in the accomplishment of its exempt purposes. After consultations with an advisory

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[48] IRC §512(b)(3)(B)(ii).

[49] 1980-2 CB 196.

[50] IRC §512(b)(5) states, There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than— (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c) ) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organization's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of § 631, as a sale or exchange of such timber.

[51] July 9, 2002; see also See also IRS Letter Ruling 200510029 (Dec. 16, 2004) which uses a similar legal analysis and results in an exclusion from UBTI under §512(b)(5).

board, the charity decided to sell the property for its highest and best use which was residential construction. The charity had never before sold or subdivided any of its land and according to the facts had no intention of acquiring additional land for subdivision and development.

In order to obtain its goal of selling the land for residential construction purposes, the charity was required by the local government to enter into a subdivision agreement, which required the charity to construct certain improvements to the land, primarily the installation of roadways and utilities providing access and services to the land. In addition, the local government required the charity to install drainage and landscaping, construct a pedestrian/equestrian trail across the lots, and grant the local government an open space easement over part of the land. The charity was also required to post a bond to guaranty the charity would make the required improvements.

The analysis in **PLR 200242041** applies the foregoing facts to a discussion of the meaning of the "property held primarily for sale to customers in the ordinary course of the trade or business" prong of §512(b)(5). The ruling initially focuses on the principles of ***Malat v. Riddel***[52], which defines "primarily" as "of first importance." Although not stated in the ruling, the general rule is that "the *dominant* purpose during the period prior to sale controls, and in real estate cases the purpose or intention must be determined with respect to each transaction and each tract of land since the purpose may vary with respect to *each transaction or each tract* [53]." The facts of the ruling do not indicate that sales of land was a primary purpose of the charity.

The ruling next turns to what some tax practitioners in the 5th and 11th Federal Circuits refer to as the ***Winthrop*** factors[54]. These factors are commonly used to distinguish between investment intent and the intention to engage in the trade or business of development of real property for sale to the general public. The relevant difference for investors in real property is that investors are permitted capital gains treatment for their sales while developers or dealers are not. Similarly, for exempt organizations, a finding of investment intent will result in an exclusion from UBTI under §512(b)(5), while a finding of development intent will result in UBTI.

The following factors are mentioned in ***Winthrop*** and other cases[55] as important to a determination of investment rather than development intent: (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales. No one particular factor is determinative and

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[52]. 383 U. S. 569 (1966).

[53] Tibbals v. United States, 176 Ct. Cl. 196, 206, 362 F. 2d 266, 271 (1966).

[54] . US v. Winthrop, 417 F2d 905, (CA 5 1969).

[55] See e.g. Adam v. Commissioner, 60 T.C. 996, 999 (1973); Houston Endowment, Inc. v. United States, 606 F.2d 77 (5th Cir. 1979); Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976); and Buono v. Commissioner, 74 T.C. 187 (1980).

courts generally look at the facts of each case objectively in light of the factors to determine intent[56].

To further assist readers of the ruling in distinguishing between investor and development intent, the ruling discusses the result in **Rev. Rul. 55-449[57].** In that Ruling, the IRS held that a foundation which was deriving income from the sale of over 80 houses over an 18 month period was engaged in an unrelated trade or business.

The ruling weaves through the ***Winthrop*** factors in finding investment rather than development intent and an exclusion under §512(b)(5). Specifically, (i) the charity acquired the property by gift and had held it for many years; (ii) the charity had made no attempt to sell the property; (iii) the charity had no plans to market the property; (iv) the charity intended to hire a third party to complete the improvements and sell the property; and (v) the charity had no business office to sell or market the property. As a result, the IRS held that the facts indicated that the property was not held primarily for sale to customers in the ordinary course of the charity's trade or business, rather the land had the characteristics of investment property. The charity qualified for a §512(b)(5) exclusion.

***Charity Approached by Developer to Develop, Market and Sell***

***Advance and Payment of Development Costs by Charity***

Another charity avoided UBTI treatment in **PLR9017058[58]** under slightly different facts**.** In that private letter ruling, a developer approached the charity and proposed a plan where the developer would arrange for all of the improvements, zoning and other requirements and sell the lots, if the charity would provide the land and the necessary funds. The land was the only parcel that the Charity owned and the land had been used in the furtherance of exempt activities. Under the terms of the contract, the developer was provided with the authority to undertake or supervise all of the necessary improvements and to coordinate the improvements with local authorities. The developer also agreed to market and sell the properties on a commission basis. The development work undertaken by the contractor included grading and layout of roadways, installation of sewer, water, and utility mains, (but not individual lot hook-ups), and stake-up of individual lots. The Charity provided all of the funding but did not borrow any of the funds. The Charity used the proceeds to fund its retirement plan.

In **PLR9017058,** the IRS held that since the development activities involved were all undertaken by the developer and not the Charity, the sales qualified for an exclusion from UBTI as they were not considered a trade or business activity of the Charity.

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[56] Adam v. Commissioner, 60 T.C. 996 (1973).

[57] 1955-5 C.B. 599. see also **Rev. Rul. 59-91**, 1959-1 C.B. 215, describes a corporation that sold a portion of its property it held as an investment. The property sold was subdivided into residential lots, graded, the streets surfaced, and the required drainage installed. In holding the gains realized from the sales of the lots constituted ordinary income, the ruling implies the sizeable improvements made in order to facilitate the sales led to the conclusion the property was held primarily for sale to customers.

[58] January 31, 1990

*Charity Assumes Risks of Development*

The result in **PLR9017058 s**hould be contracted with the result in **PLR8950072[59].** In one of the alternatives proposed in **PLR8950072**, the charity assumed the risks of management and development of land previously used in its exempt function. There the charity intended to carry out the subdivision, development and sale activities. The IRS likened the activities to those in Brown v. Commissioner[60]. As a result, the IRS held that the activities were held not to be casual or isolated sales. Rather they rose to the level of a trade or business. Accordingly, no exclusion under §512(b)(5) was available. Interestingly, the IRS commented on the effect of charity's exemption if it decided to go forward with its development alternative. The IRS stated that under Treas. Regs. §section 1.501(c)(3)-1(e)(1) an exempt organization may operate a trade or business as long as operation of that trade or business is not its primary purpose. Therefore, as long as real estate development and sales activities were not its primary purpose, its exemption would be unaffected. Of course the charity would be taxable on any UBTI at corporate rates.

*Loans to Developers for Development Costs*

One of the issues that will arise in the relationship between the Church and any future developer is funding. In one of the rulings analyzed above, the charity fronted all costs of obtaining entitlements and creating the required infrastructure. No mention is made of whether the payment of the costs came directly from the charity or were the result of loans against the property or to the developer. As intimated above debt financing can be an issue in the disposition of property by a charity. If borrowing is required by the Church to make the proposed plan viable, it is important to know if this could affect the exclusion under §512(b)(5).

This question was partially answered in **PLR200119061**[61]. In that ruling a large religious organization had a land purchase program pursuant to which it acquired land in the path of growth and development for the purpose of buying land for schools, churches and community outreach programs at a relatively low land cost. Quite understandably, the charity did not need all of the land for its exempt purchases and engaged in sales of surplus land.

One part of the ruling describes a transaction in which the charity purchased land from a landholder and financed part of the sale through an equity participation loan. The charity financed a portion of the sale on surplus land to a developer through a separate subordinated promissory note and deed of trust. Under the subordinated promissory note, the developer was required to pay principal and interest to the charity. These financing

[59] (Sep. 21, 1989).
[60] Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), the taxpayer owned 500 acres of unimproved land used for grazing purposes. He decided to sell the land and subdivided it into lots, cut in streets, installed storm sewers, constructed gas and electric lines and other activities of the kind usually carried out by a real estate company. Each year 20 to 30 lots were sold. The court held that the taxpayer was holding lots for sale to customers in the regular course of business. The fact that he did not buy additional land did not prevent the sales activities from being a business as he had enough land for a business without buying more.
[61] (Feb. 14, 2001)

arrangements permitted the charity to fund the required infrastructure improvements, *e.g.* roads and sewers. The charity deemed this to be a significant benefit to the charity's purposes of building churches and schools and reduced the overall costs to the charity. Another portion of the ruling deals with a commercial loan to a developer to finance infrastructure necessary to sell surplus land.

The relevant portion of the ruling, deals with the characterization of the notes. As with other rulings, **PLR200119061** whether the acquisition and intended future disposition of the land was considered land held for investment or development at the time of its disposition[62]. The charity for its part requested the following rulings from the IRS related to the surplus property:

1. The sale of H surplus land did not result in unrelated business taxable income; and

2. The use of a subordinated promissory note with deferred interest with respect to the sale of H surplus land did not result in unrelated business taxable income.

In its analysis of these issues, the IRS first stated the general rule that for an activity to avoid characterization as an unrelated trade or business, it must be "substantially related" to the achievement of the organization's exempt purposes[63]. With regard to the loan of funds to the developers, the IRS could not reconcile the loan of funds to a developers of land to the accomplishment of the charity's exempt purposes. As such, the loans generated interest that was considered UBTI.

***Participation in the Earnings of the Developer***

Another important question is the potential effect of an agreement to participate in the earnings of the developer, post sale. This question was discussed in **PLR200237027[64].** In that ruling a religious organization which had a church and a school, (subject to a mortgage) contracted to sell a portion of its land to raise funds needed for the construction of a gymnasium. The religious organization had owned the land since its original organization. According to the facts the religious organization had already borrowed funds to assist in the construction of the gymnasium, however, it appears that additional funding was required for completion. Accordingly, the religious organization entered into a contract of sale of a portion of its land with a third party

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[62] **Treas. Reg. §1.513-1(a)**states, in part, that unless one of the specific exceptions of §§512 or 513applies, the gross income of an exempt organization subject to the §511 tax is includible in the computation of unrelated business taxable income if, 1) it is income from a trade or business, 2) such trade or business is not regularly carried on by the organization, and 3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions. **Treas. Reg. §Section 1.513-1(b)** provides in part that the term 'trade or business' has the same meaning as in §162 of the Code, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

[63] **Treas. Regs. §1.513-1(d)(2**) states that a trade or business is 'related to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is substantially related' for purposes of §513 , only if the causal relationship is a substantial one. ***Notice that in this ruling, the property was neither acquired nor used to further the exempt purposes of the charity. It was designated as surplus land.***

[64] **June 18, 2002**

developer Under the terms of the contract with the developer, the religious organization received (i) Cash; (ii) non-interest bearing notes secured by a mortgage on the property sold; and (iii) 42% of the profits earned by the developer on the sale of the improvements. Using arguments similar to those expressed in prior rulings, the IRS stated that the cash and promissory notes received would not result in the recognition of UBTI. However, it withheld any opinion regarding the receipt of the 42% profits interest. As to the debt financing issue mentioned in the facts[65], the IRS found none because the indebtedness was related to the construction of the gymnasium[66]. This was seen as substantially related to the religious organization's and school's exemption.

In another ruling, **PLR9340062[67],** a charitable trust classified as a private foundation, desired to liquidate its real estate holdings. It entered into an option agreement involving a complex transaction with a third party developer to accomplish the liquidation. The result of the transaction was that the developer would acquire the charitable trust's land in return for a sales price which included both non-contingent and contingent amounts. The non-contingent portion of the purchase price was based on the fair market value of the property on the date of acquisition by the developer. The contingent portion was based on the gross sales proceeds of the sale of the land. Note that the charitable trust is not participating in the net profits of the developer. According to the ruling, the contingent component reflects consideration for the favorable terms of an option agreement between the charitable trust and the developer.

The IRS approved the transaction because the facts demonstrated that the charitable trust was not engaged in a continuing business with the developer, instead the charitable trust was cashing out of an investment. No comments, positive or negative were made relating to the contingent consideration.

## QUALIFIED CONSERVATION EASEMENTS AND CONTRIBUTIONS[68]

It is possible to donate certain vertical and horizontal slices of real property rights to a qualifying organization and obtain in return receive a charitable deduction for the

[65] §514(b)(1)(A) of the Code defines the term "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness, other than any property substantially all the use of which is substantially related to the exercise or performance by such organization of its charitable, educational or other exempt purpose.
§514(c)(1)(A) of the Code defines the term "acquisition indebtedness" as the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property.

[66] §512(b)(4) of the Code provides, in part, that notwithstanding §512(b)(5), in the case of debt-financed property (as defined in §514 ) there shall be included as an item of gross income derived from an unrelated trade or business, the amount ascertained under §514(a)(1). §514(a)(1) of the Code provides, in part, that in computing under §512 the unrelated business taxable income, there shall be included a certain percentage of income with respect to each debt-financed property.

[67] **July 16, 1993**

[68] The Conservation easement has its origins in the 1960s and the construction of the Blue Ridge Parkway ***see*** **Rev. Rul. 64-205**, 1964-2 C.B. 62 and predates the enactment of section 170(h).

conveyance[69]. Here we are focused on the conservation easement[70] which is a restrictive real property right recognized by state law. Restrictive easements are valuable real property rights created by a grantor for the benefit of and in favor of a grantee, which are enforceable by the grantee. The primary tax law governing conservation easements are found in §170(h) of the Code and §1.170A-14 of the Treasury Regulations. The Code recognizes two distinct classes of qualified conservation easements. The first is the qualified conservation *contribution* found in §170(h). This section of the code deals with the income tax principles covering conservation easements. The rules governing qualified conservation *easements* for estate tax purposes are found at §2055[71] and those for the gift tax at §2522(d). All of these sections rely on the principle of §170(h) for their substance.

The Code defines a qualified conservation contribution as a gift[72]of *qualified real property,* made to a *qualified organization*[73], which uses the gift *exclusively for conservation purposes*[74]. This is the same definition applied by §§2055 and 2522(d).

### *Is Perpetual really Perpetual?*

Editorial Commentary- In the beginning of this discussion we noted that a King of England conveyed land to the Church forever and that if anyone interfered with that conveyance they did so in pain of their mortal soul. Well, as fate would have it a later King of England, one Henry VIII, would strip the church of their property, destroy the Catholic Church in England and sent tens of thousands to their deaths. That by some measure might be considered interference. Henry of course had 6 wives, two of whom he beheaded on the Tower green. As to his progeny, Mary Tudor daughter of Catherine of Aragon in an attempt to restore the Church killed perhaps as many as her father and earned the name "Bloody Mary." Her half-sister, Elizabeth succeeded her, eliminated or so she thought the "Stuart" Claim to the throne by executing Mary Stuart, reigned for many years and died childless. That was the end of the Tudor line. The next King was James I, a Stuart.

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[69] Normally, §170 would deny a deduction for a charitable contribution of any interest in property that consists of less than the donor's entire interest in the property other than certain transfers in trust***. see*** §1.170A-6 relating to charitable contributions in trust and §1.170A-7 relating to contributions not in trust of partial interests in property.

[70] A conservation easement is similar to a scenic easement. They differ primarily in the purposes that they serve, a conservation easement being more broadly defined than a scenic easement. The burden of an appurtenant conservation easement will run with the servient land if the instrument creating it is properly recorded. If the requirements of the local recording statute are satisfied, a legal negative easement, such as a conservation easement, will be protected against interference by both legal and equitable remedies. ***See sectio*n 414(5) 3 POWELL ON REAL PROPERTY** (1979).

[71] §2055(f) states that "[a] deduction shall be allowed under [§2055(a)] in respect of any transfer of a qualified real property interest (as defined in §170(h)(2)(C) ) which meets the requirements of §170(h) (without regard to paragraph (4)(A) thereof ). §2522(d) contains identical language.

[72] Note the transfer must be gratuitous in the "*Duberstein*" sense. Deductions will be denied if the donor excepts to receive an economic benefit from the conveyance. See, ***Louisville & Nashville R. R. Co v Comm'r***, *(1976) 66 TC 962 (1976),* ***affd in part, revd in part without discussion of this issue****, 641 F2d 435( 6th DCA 1981).*

[73] The term "Qualified Organization is defined in Section 170(h)(3) generally qualifying public charities. Generally, A governmental unit described in section 170(b)(1)(A)(v); an organization described in section 170(b)(1)(A)(vi);A charitable organization described in section 501(c)(3) that meets the public support test of section 509(a)(2); or A charitable organization described in section 501(c)(3) that meets the requirements of section 509(a)(3) and is controlled by a qualifying organization.

[74] §170(h)(1) of the Code. Under §170(h)(4)(A)(iii) of the Code, the term "*conservation purpose*" includes the preservation of open space (including farmland and forest land) if such preservation is pursuant to a clearly delineated state or local governmental conservation policy and will yield a significant public benefit.

The lesson could be don't interfere with perpetual easements as Henry VIII in the end lost all, his life and his line. Or perhaps that when drafting conservation easements religious references may be helpful in punishing defilers of the donor's intent. Of course the real point is that the term perpetual is really limited to what a government will or will not permit or enforce. Thus, the easement is only as good as the government in place and the promises it intends to keep.

For the purposes of the Code and regulations, perpetual takes on the following meaning. To qualify for a charitable deduction the instrument of conveyance from the donor prohibits the donee from subsequently transferring the easement (or, in the case of a remainder interest or the reservation of a qualified mineral interest, the property), whether or not for consideration, unless the donee organization, as a condition of the subsequent transfer, requires that the conservation purposes which the contribution was originally intended to advance continue to be carried out. Moreover, subsequent transfers must be restricted to organizations qualifying, at the time of the subsequent transfer, as an eligible donee. When a later unexpected change in the conditions surrounding the property that is the subject of a donation makes impossible or impractical the continued use of the property for conservation purposes, the requirement of this paragraph will be met if the property is sold or exchanged and any proceeds are used by the donee organization in a manner consistent with the conservation purposes of the original contribution. Clearly perpetual is not forever.

### ***Qualified Real Property***

The statute identifies three distinct forms of qualifying conveyances, (i) *the entire interest of the donor other than a qualified mineral interest*[75], *(ii) a remainder interest*[76] and (iii) *a perpetual restriction on the use of property*[77].

#### ***The Donor's Entire Interest***

A donor may convey all of his interest in real property and obtain a deduction as a specific carve out, the same donor may retain a Qualified Mineral Interest[78] in the property transferred and still qualify for a deduction. This is the classic horizontal slice of real property.

Where a donor transfers his entire interest he is permitted to take a charitable deduction for a conservation contribution equal to the fair market value of the rights contributed[79]. If a qualified mineral interest is reserved, the value of the reserved interest is subtracted from the value of the interest conveyed.

#### ***A Remainder Interest***

A qualified remainder interest in real property can qualify for a charitable deduction. The deduction available for a conveyance of a remainder interest in property is equal to its fair market value at the time of contribution. In determining fair market value the donor is

[75] §170(h)(2)(A) of the Code.
[76] §170(h)(2)(B) of the Code.
[77] §170(h)(2)(C) of the Code.
[78] Means subsurface oil, gas, or other minerals, and the right to access to such minerals.

permitted to take into consideration depreciation, depletion and easements, covenants and other rights of record under state law[80].

### *A Perpetual Restriction on the use of property*

In the case of a perpetual restriction, such as an easement or a covenant running with the land, the donor is permitted a deduction equal to the fair market value of the easement, based on the sale of comparable easements, provided that comparables are available. Where there are no comparables an appraiser would be permitted to determine the fair market value of the deduction as the difference between the value of the property before the granting of the perpetual restriction and the value after the perpetual restriction is granted[81]

**Rev. Rul. 76-376**[82], provides that if a taxpayer grants an easement in land and owns adjoining land in which an easement was not granted, the fair market value of the easement granted is the difference between the fair market value of the entire tract of land before and after the granting of the easement.

One subset of restricted use property is historic structures. The Code permits a deduction for conveyances such as facades, building shells and similar historic transfers provided that (i) the restriction preserves the entire exterior of the building, and (ii) prohibits any change to the exterior which would negatively affect its historical character. To obtain a deduction the donor and donee must enter into a written agreement certifying that the donee is a qualified organization which has as one or more of its purposes, environmental protection, land conservation, open space preservation, or historic preservation, and has the resources to manage and enforce the restriction and a commitment to do so, and in the case of any contribution made in a taxable year beginning after the date of the enactment of this subparagraph, the taxpayer includes with the taxpayer's return for the taxable year of the contribution a qualified appraisal of the qualified property interest, photographs of the entire exterior of the building, and a description of all restrictions on the development of the building.

### *Examples Permitted by Statute*

#### *Recreation or Education*

Donor’s may convey an easement to preserve land for recreation, or educational interests and receive a charitable deduction. The easement must permit substantial and regular us by the general public. Examples would be hiking trails, boating or fishing on lakes and in some cases golf courses.

#### *Protection of Environmental Systems*

Protecting ecosystems or habitats are qualifying purposes. Significant habitats and ecosystems include, but are not limited to, habitats for rare, endangered, or threatened species of animal, fish, or plants; natural areas that represent high quality examples of a terrestrial community or aquatic community, such as islands that are undeveloped or not

[80] Treas. Reg. § 1.170A-14(h)(2).

[81] Treas. Reg. § 1.170A-14(h)(3)(i); see also ***Stanley Works and Subs.v.Comm’r***, *87 TC 389 (1986).*

[82] 1976-2 C.B. 53.

intensely developed where the coastal ecosystem is relatively intact; and natural areas which are included in, or which contribute to, the ecological viability of a local, state, or national park, nature preserve, wildlife refuge, wilderness area, or other similar conservation area. Under this form of donation, it is possible to restrict public access in order to preserve the environment.

### *Preservation of Scenic Enjoyment and Open Spaces*

Preservation of land may be for the scenic enjoyment of the general public if development of the property would impair the scenic character of the local rural or urban landscape or would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, waterbody, trail, or historic structure or land area, and such area or transportation way is open to, or utilized by, the public. "Scenic enjoyment" will be evaluated by considering all pertinent facts and circumstances germane to the contribution.

### *Mortgaged Property*

No deduction is permitted for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity. The requirement of section 170(h)(5)(A) is satisfied in the case of mortgaged property (with respect to which the mortgagee has not subordinated its rights) only if the donor can demonstrate that the conservation purpose is protected in perpetuity without subordination of the mortgagee's rights.

## Conclusion

This brief discussion has covered some of the important topics which can be found in the area of law and taxation covering charitable transfers of land by donors to qualifying charities. The field is much wider than what has been covered. Hopefully the reader has been alerted to important issues that must be resolved for both the donor and donee to have a successful donation.