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USING A DONOR ADVISED FUND TO TAX-EFFICIENTLY MONETIZE REAL ESTATE

Wealthy individuals often have the bulk of their net worth tied up in highly-appreciated, illiquid assets such as real estate or privately-held businesses. This lack of liquidity can make charitable planning quite challenging, as few charities are adequately prepared to accept donations of such illiquid assets directly, and if the donor chooses to sell the often highly-appreciated asset in order to donate the sale proceeds, the gift is significantly diminished by the steep tax rate these low-basis assets are subject to.

Fortunately, there are a variety of tools and techniques that enable real estate investors to tax-efficiently monetize their business and real estate holdings, and one that can be particularly useful when an individual is charitably inclined: a donor advised fund.

From a tax perspective, the strategy allows for a realization event (the asset is ultimately sold) that is a non-recognition event (no taxable event is triggered on the sale). The strategy allows real estate and interests in limited partnerships to be sold tax-free with 100% of the sales proceeds re-invested in publicly-traded securities within the DAF where those proceeds can grow tax-free for years.

The donor also qualifies for an immediate charitable contribution deduction for the fair market value of the asset (worth 35% at today's top marginal tax rate) that can be carried forward for an additional five years, irrespective of when the actual grant is made which may be years after the contribution of the real estate to the DAF.

Finally, many wealthy investors consider the possibility of creating their own private foundation which qualifies as a charity if certain conditions are met. It's worth noting that if appreciated real estate is contributed to a private foundation the investor qualifies for a charitable deduction equal to the tax cost basis (not fair market value) of the property which is typically very low.

Furthermore, there is no requirement that the donor make a minimum annual grant (such as required of private foundations). The proceeds in the account can grow tax-free for years before any grant is made.

For all of these reasons, if a client would like to build a significant endowment fund over the next few years and allow the assets to grow tax-free until grants are made, but has the bulk of their net worth tied up in real estate or a privately-held business, the client might consider contributing all or a portion of these illiquid assets to a donor advised fund (DAF) account.

Case Study: Bill is a wealth manager. Tony, age 55, is one of Bill's clients. Bill oversees Tony's liquid assets which are worth about $5 million. Tony owns and manages his own business, which is currently worth $30 million. Tony also owns a real estate investment, a rental property, worth $2 million.

Tony is at that point in his life when he feels the need to "give back" and is doing some planning with Bill to facilitate his future charitable endeavors.

- Tony does not wish to make grants today. Rather, he wishes to endow a professorship at the university from which he graduated several years from now. The amount needed to fund the endowment is $3 million.
- In 2008 Tony's real estate investment decreased in value by one-third from $3 million to $2 million and has not increased in value since then, and the prospects for significant price appreciation are not compelling. Tony decides to "earmark" this property to fund his future charitable endeavors.

- During the same period Tony's account that Bill manages more than doubled in value. Tony concludes it would be more prudent to have the assets earmarked for charitable giving purposes professionally managed by Bill and invested in a diversified portfolio of publicly-traded securities rather than a direct investment in a single commercial property.
- The rental property is currently worth $2 million and has a very low tax basis due to previous tax depreciation deductions, so even though the value of the property has decreased significantly, an outright sale would trigger a current taxable event and significantly reduce the amount of earmarked assets available to invest.
- Tony wishes to invest and grow the earmarked assets as tax-efficiently as possible so as to reach the $3 million growth target as soon as possible so that he is in a position to endow the university chair.
- Tony earns over $1 million of salary income from his business each year all of which is taxed at the highest ordinary rate (which is currently 35%) and he expects this income stream to continue for the next several years. Tony would like to currently benefit from a charitable contribution deduction. That is, he does not want to wait until the grant is actually made, which could be years from now, in order to qualify for a tax deduction.
- Bill has done a terrific job for Tony over the years, and it's imperative that Bill be able to oversee/manage the assets earmarked to fund Tony's charitable endeavors.

First Option: The first option considered was simply to sell the real estate and have Bill manage the earmarked after-tax proceeds in Tony's existing account.

Tony paid $1 million to acquire the rental property in 1989. For tax purposes the property qualified for a depreciation deduction $31,750 per year for an aggregate of $730,000 through 2012. As a result, the tax basis of the property has been adjusted downward and is currently $270,000. The results of an outright sale would be as follows:

$2,000,000 amount realized (sales proceeds)

<u>less</u>

$270,000 adjusted tax basis (purchase price less accumulated depreciation)

<u>equals</u>

$1,730,000 capital gain broken down as follows:

$730,000 "unrecaptured section 1250 gain" taxed at the 25% rate ($182,500 of tax)

$1,000,000 taxed at long-term capital gain rate of 15% ($150,000 of tax)

Total tax = $332,500

Blended federal tax rate = 16 5/8%

After-tax proceeds = $1,667,500

Second Option: Instead of simply earmarking the after-tax proceeds of the sale in Tony's existing account with Bill, if Tony contributed the $1,667,500 after-tax cash proceeds to a DAF account, he would qualify for an immediate charitable contribution deduction equal to that amount with a potential tax benefit of about $580,000. Although there are some limitations, because Bill earns a considerable salary from his company which he expects to continue indefinitely, it would appear that this tax benefit should be used over the next few years. There are DAFs that would allow Bill to oversee the proceeds.

Third Option: Instead of selling the property and incurring the $332,500 federal tax, the property could be contributed directly to a DAF. If the property is then sold by the DAF, there will not be an immediate taxable event. The appreciation forever escapes taxation. Nor is the accumulated depreciation deduction ever "recaptured".

Therefore, the full $2 million would be available for Bill to invest and manage. Importantly, those proceeds grow tax-free because they are growing within a charitable organization (i.e., the DAF qualifies as a charitable organization). In addition, Tony would qualify for a $2 million charitable contribution deduction with a potential benefit of $700,000.

Below is a summary of the three options that Tony and Bill considered:

1. Sell the real estate outright and have Bill manage the after-tax proceeds in Tony's existing account.
   - $332,500 tax incurred.
   - $1,667,500 after-tax proceeds that do not grow tax-free.
   - No current charitable deduction.
2. Sell the real estate outright and then contribute the proceeds to a DAF and have Bill manage the proceeds.
   - $332,500 tax incurred.
   - $1,667,500 after-tax proceeds that grow tax-free.
   - Current charitable deduction with potential tax benefit of $580,000.
3. Contribute the property to a DAF which then sells the property and have Bill manage the proceeds.
   - No current taxable event.
   - $2,000,000 after-tax proceeds that grow tax-free.
   - Current charitable deduction with potential tax benefit of $700,000.

For good reason, Tony decides to proceed with the third option. There is no obligation for Tony to make a minimum annual grant. The plan is to have the proceeds remain invested in the DAF account and grow tax-free under Bill's oversight/management until the target of $3 million is reached. At that point Tony plans to make a recommendation to the DAF to fund the endowment of the chair at his alma mater.

Sell $2M Real Estate Outright	**Sell $2M Real Estate Outright Contribute the Proceeds to DAF**	**Contribute $2M Property to DAF DAF Sells Property**
• $332, 500 tax incurred	• $332, 500 tax incurred	• No current taxable event
• $1,667,500 after-tax proceeds that do NOT grow tax-free	• $1,667,500 after-tax proceeds that grow tax-free	• $2,000,000 after-tax proceeds that grow tax-free
• No current charitable deduction	• Current charitable deduction with potential tax benefit of $580,000	• Current charitable deduction with potential tax benefit of $700,000

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