

**B12. Tax Issues in
Conservation Easements;
Decades of Experience in 90
Minutes ^(CLE)**

Friday, October 12 | 1:30 p.m. - 3 p.m.

Room 317/318

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Rally 2018: The National Land Conservation Conference
Pittsburgh, PA



Tax Issues in Conservation Easements: Decades of Experience in 90 Minutes
Rally 2018 Presentation Outline

Section 1

What property to appraise and what to analyze for enhancement?

- Introduction; Relevant Statutes and Regulations
 - Qualified Conservation Contributions (Treas. Reg. § 1.170A-14(a))
 - QCC is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes to be protected in perpetuity. These contributions are deductible under IRC § 170.
 - Valuation (Treas. Reg. § 1.170A-14(h))
 - Treas. Reg. § 1.170A-14(h)(1): the value of the contribution is computed as the fair market value of the surface rights in the property contributed.
 - Treas. Reg. § 1.170A-14(h)(3):
 - Contiguous Parcel Rule
 - The amount of the deduction for the conservation easement in the case of a charitable contribution of a perpetual conservation restriction **covering a portion of the contiguous property owned by a donor and the donor's family** is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction.
 - "Family" is defined in the same way as under IRC § 267(c)(4): "The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."
 - Family does not include an entity, such as a corporation or partnership, that is classified as separate from its owner under the entity classification rules.
 - CFOP – Contiguous Family-Owned Property
 - Enhancement Rule
 - If the granting of a perpetual conservation restriction increases the value of **any other property owned by the donor or a related person**, the amount of the deduction for the conservation contribution shall be reduced by the amount of the increase in the value of the other property, **whether or not such property is contiguous**.
 - For the purposes of this rule, "related person" has the same meaning as either in IRC § 267(b) or IRC § 707(b)

- A four-lane paved road?
- Colorado Division of Real Estate 4 C.C.R. 725-4:1.19 (Repealed 6/30/18)
 - “For purposes of section 12-61-727, C.R.S., contiguous means physically touching, sharing an edge, boundary, or corner. Contiguity will not be broken by a natural or artificial waterway. Lands separated by a right-of-way dedicated in fee simple will not be considered contiguous.”
 - Sometimes unclear, but if not contiguous, likely related party property.
 - Appraiser should provide a solid rationale for the approach taken.
 - Appraiser can include a memo from lawyer on what to appraise.
- Even if not owned by “family,” are other properties, even non-contiguous tracts, owned by “related parties”?
 - If yes, will those properties’ values be enhanced?
 - If yes, the amount of the deduction for the conservation contribution is reduced by the amount of the increase in the value of the other property.

Section 2

Basis limitations and allocations

- What is Basis?
 - “Basis is, essentially, what the taxpayer paid for the underlying property plus the cost of any improvements made to the property (see Code section 1012[-1(a)])” TIMOTHY LINDSTROM, A TAX GUIDE TO CONSERVATION EASEMENTS 176 (2016).
 - “A taxpayer’s basis in a conservation easement is not the same as the taxpayer’s basis in the underlying property. Treas. Reg. § 1.170A-14(h)(3)(iii) provides that...to calculate the basis in a conservation easement, a taxpayer needs two pieces of information: (1) their basis in the underlying property and (2) the percentage by which the conservation easement reduced the value of the underlying property according to the easement appraisal. To obtain the basis in the easement the taxpayer multiplies one by two.” *Id.* at 176-77.
- Background – Taxing as Ordinary Income vs. Capital Gain
 - If a taxpayer owns an asset for longer than one year, she pays taxes at the long-term capital gains rate. In 2018 there are three rates - 0%, 15% and 20% - depending on your tax bracket.
 - On the other hand, if a taxpayer owns an asset for less than one year, she pays taxes at the short-term capital gains rate, which is the ordinary income tax rate of the taxpayer based on her yearly income. If she is in the 37% tax bracket, this means that whatever profit she made in the sale above the original purchase price, she has to pay 37% of that in taxes.
- Two Sides of the Coin
 - The determination of whether the donation of a conservation easement is limited to basis is the same determination of whether the sale of the underlying land would give rise to ordinary income or capital gains. The two basis limitations we are concerned with here are the one-year holding period and dealer status. Through the tacking rules discussed below, it is possible to add a prior holding period for a one-year hold.
- 1-Year Holding Rule
 - Plain English
 - “Conservation easements contributed over land the donor has owned for one year or less are considered contributions of ordinary income property. Deductions for such contributions cannot exceed the donor’s basis in the conservation easement.” LINDSTROM, *supra*, at 175.
 - Statutory and Regulatory Language
 - **IRC § 170(e)(1)**: General rule. The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of—(A) the amount of gain which would not have been long-term capital gain...if the property contributed had been sold by the taxpayer at its fair market value.

- 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;
 - 4. The extent of subdividing, developing, and advertising to increase 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.
 - LINDSTROM, *supra*, at 182-83.
 - Statutory and Regulatory Language
 - Treas. Reg. § 1.170A-4(b)(1): see above.
 - IRC § 170(e)(1): see above.
- Tacking Safe Harbor
 - Plain English
 - In certain instances, if the landowner acquired the property from an affiliate she may be able to succeed to the long-term capital gain holding period of its affiliate through tacking of the holding period.
 - Statutory and Regulatory Language
 - IRC § 735 Character of Gain or Loss on Disposition of Distributed Property:
 - “(b) Holding period for distributed property. In determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of subsection (a)(2)), there shall be included the holding period of the partnership, as determined under section 1223, with respect to such property.”
 - IRC § 1223 Holding Period of Property (Contribution to Partnership):
 - “(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.”
 - IRC § 723 Basis of Property Contributed to Partnership:
 - “The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) [26 USCS § 721(b)] to the contributing partner at such time.”

- Basis Allocation
 - Plain English
 - “The donor of a conservation easement is required to reduce their basis in land subject to an easement...Because a conservation easement represents an interest in land, when that interest is removed a portion of the land’s value has also been removed...Therefore, [the Regulations] require that a donor’s basis in land subject to a conservation easement be reduced by an amount equal to the proportionate reduction in the value of the land resulting from the easement as reflected in the easement appraisal.” LINDSTROM, *supra*, at 180.
 - “Basis reduction is required whether or not a donor contributed, sold for full fair market value or sold an easement for a bargain price...the adjustment is entirely dictated by the appraised value of the easement.” *Id.*
 - Statutory and Regulatory Language
 - Treas. Reg. § 1.170A-14(h)(3)(iii):
 - “Allocation of basis. In the case of the donation of a qualified real property interest for conservation purposes, the basis of the property retained by the donor must be adjusted by the elimination of that part of the total basis of the property that is properly allocable to the qualified real property interest granted. The amount of the basis that is allocable to the qualified real property interest shall bear the same ratio to the total basis of the property as the fair market value of the qualified real property interest bears to the fair market value of the property before the granting of the qualified real property interest. When a taxpayer donates to a qualifying conservation organization an easement on a structure with respect to which deductions are taken for depreciation, the reduction required by this paragraph (h)(3)(ii) in the basis of the property retained by the taxpayer must be allocated between the structure and the underlying land.”
 - The basis of the conservation easement must be reported on the IRS Form 8283, although it appears that reporting the basis of the underlying property may be substituted for the basis of the conservation easement.

Section 3

Issues with land trusts or third parties paying for appraisals, baseline reports, or other transactional costs

- Introduction
 - Private inurement
 - The doctrine of private inurement is the fundamental distinction between a nonprofit organization and a for-profit organization. It is a statutory criterion for federal income tax exemption for nine types of exempt organizations.
 - Requires that a tax-exempt organization be organized and operated so that “no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual.”
 - Generally understood as providing unjust enrichment from the organization’s gross or net earnings to another party.
 - Analysis
 - Is the transaction benefitting an insider?
 - Founders, managers, officers, directors, trustees, substantial contributors, owners of more than 20%, members of the families of these individuals, and certain entities controlled by them.
 - If yes, sales of assets to insider not prohibited as long as the terms and conditions of the sale are reasonable, not providing an unreasonable excessive benefit.
 - Private benefit
 - Different than (although it subsumes) the private inurement doctrine. Applicable only to charitable organizations.
 - Derives from the requirement under section 501(c)(3) of IRC that an organization be organized exclusively and operated primarily for one or more qualifying exempt purposes.
 - Not defined explicitly in statute, but an organization fails this requirement when it confers private benefits upon an individual that are more than incidental, quantitatively and qualitatively, to the furthering of its exempt purposes.
 - Incidental private benefit. Must be:
 - Qualitatively incidental
 - Must parallel the exempt activity, in that the exempt objectives cannot be achieved without necessarily benefitting certain individuals privately. *See* Revenue Ruling 70-186, 1970-1 C.B. 128.
 - Quantitatively incidental
 - Must be insubstantial when measured in the context of the overall tax-exempt benefit conferred by the activity. *See*

Revenue Ruling 75-286 1975-2 C.B. 201 and Revenue Ruling 68-14, 1968-1 C.B. 243.

- Facts and circumstances
 - Motivation
 - Control
 - Financial integration
 - Number of persons benefiting
- Notes on what is or is not a private benefit
 - Not limited to monetary benefits
 - May confer benefits to individuals as members of a charitable class (e.g., individuals receiving food and shelter at a homeless shelter).
 - May not confer benefits to a single person or certain designated individuals, even if a part of a designated charitable class.
- Differences:
 - Broader in reach—private benefit applies to any person, private inurement only applies to private shareholders or individual, defined by the Treasury Regulations as “person having a personal and private interest in the activities of the organization.”
 - Restriction on inurement absolute, while restriction on private benefit allows for incidental benefit.
- **Violators** lose tax exempt status (death penalty) or are subject to an excise tax
- Avoiding fraudulent or abusive transactions
 - Land Trust Alliance standards on syndications
 - When engaging in transactions with pass-through entities of unrelated parties, particularly those offered or assembled by a third party or described as a syndication by the IRS,
 - a. Require a copy of the appraisal prior to closing
 - b. Decline to participate in the transaction if the appraisal indicates an increase in value of more than 2.5 times the basis in the property within 36 months of the pass-through entity’s acquisition of the property, the value of the donation is \$1 million or greater and the terms of the transaction do not satisfy the Land Trust Alliance Tax Shelter Advisor.
- Land trusts or third parties paying for appraisals, baseline reports, or other transactional costs
 - **Baseline report:** record of the property’s condition and conservation or preservation values at the time the easement is transferred
 - Assists in future monitoring and enforcement
 - IRS requirement for any deductible easement in which the donor retains rights that, if exercised, could impair the conservation values of that property.

- IRS places responsibility for preparing documentation on the donor, but a third party or land trust typically performs this task because it has the expertise and will want to ensure that the documentation adequately identifies the property's values. (Conservation Easement Handbook Chapter 4)
 - **Appraisals** are generally the landowner's responsibility, according to Treasury Regulations.
 - Other transaction costs can include survey, title, environmental assessments, mineral reports, and legal and estate planning fees
 - If a third party or land trust pays for the donor's appraisal costs, or other transaction costs, the IRS may require that this payment be considered as income to the donor, turning the charitable gift into a bargain sale.
- The IRC § 170(f)(8) Letter (contemporaneous written acknowledgement) - Did the organization provide any "goods or services in consideration in whole or in part" for the contribution of the property.
- Avoid converting a charitable donation or bargain sale into a non-deductible conveyance by making the conveyance not voluntary.

Always remember the intelligence of the Appraiser, Accountant, and Attorney's dogs – Valuation, 1040, and Res Ipsa Loquitur