THE "NEW" CONSERVATION TAX INCENTIVES

By

Stephen J. Small, Esq. (10/14/08)

On August 17, 2006, the President signed into law the Pension Protection Act of 2006. That law included the first major new income tax incentives for land conservation since 1980.

The new incentives applied to donations made before December 31, 2007. The new incentives expired at the end of the year last year. This past summer, Congress extended the incentives and they apply to donations made this year (2008) and next year (2009).

What follows is essentially the article I wrote last year on the incentives. It appears that the provisions of the original incentives will be extended in their entirety.

This article is not legal advice. It is commentary on the new incentives. Landowners contemplating conservation donations must consult with their own advisors on these issues. The IRS has also issued important guidance on these incentives; see IRS Notice 2007-50 (you can get that from the IRS web site at www.irs.gov).

First, some quick background to set the stage.

BACKGROUND

Under the "old" law, for gifts prior to 2006, an individual could deduct the value of a conservation easement donation generally up to 30% of the donor's "contribution base" for the year, with a five-year carryforward of any unused amount. "Contribution base" is a technical tax term that means **adjusted gross income subject to certain adjustments** (which adjustments are not relevant for most landowners). So for shorthand we simply say **the deduction for individuals could be taken up to 30% of "adjusted gross income," or "AGI."**

 Portions of this article have been taken from earlier articles I have written on the new tax incentives.

Gifts to "public" charities by cash or check by individuals are deductible up to 50% of the donor's AGI. This provision has not been changed by the new incentives.

Also under the old law, a conservation easement donated by a <u>corporation</u> could be deducted **only up to 10% of the corporation's <u>taxable</u> income for the year** (that is, of course, taxable income <u>before</u> taking the deduction), again with a five-year carryforward. **In particular, this very restrictive limitation on charitable contributions by corporate landowners has effectively "killed" countless potential conservation easement donations across the country**.

<u>THE NEW INCENTIVES – SOME THINGS WE KNOW</u>

1. **<u>The incentives apply to gifts of "qualified conservation contributions"</u>**. By the terms of the statute, the incentives apply to gifts of all "qualified conservation contributions". Under Section 170(h) of the tax code, **"qualified conservation contributions"** include (1) the gift of a remainder interest in land for conservation purposes; (2) a gift of the fee interest in real estate for conservation purposes with a reserved right to extract oil, gas, and subsurface minerals; and (3) the gift of a "qualified real property interest," including a conservation easement. **Most of this summary will focus on conservation easement gifts**, but see the discussion below (under "SOME THINGS WE DON'T KNOW") about other qualified conservation contributions.

2. **<u>The law includes two new major important incentives</u>**. First, any landowner who donates a conservation easement can take the income tax deduction for the gift **up to 50% of the landowner's AGI for the year, with a 15-year carryforward of any unused deduction**. This new incentive is clear, there are no new "tests," and there appear to be no "open issues" in the new statute on this particular point.

Second, a landowner who meets the new tests for "qualified farmers and ranchers" can take the **deduction up to 100% of AGI (for individuals), or up to 100% of taxable income (for corporations), also with a 15-year carryforward**.

According to the **statute**, "qualified farmer or rancher" means a taxpayer whose "gross income" from the business of farming (as defined under Section 2032A(e)(5) of the tax code) is greater than **50% of the taxpayer's "gross income" for the taxable year in which the conservation easement is donated**. <u>This definition applies to individuals and to corporations</u>. For purposes of this incentive, farming, ranching, other kinds of agricultural activities, and forestry use will satisfy the requirements of the statute; I use the term "farming" here to cover all of these activities.

As one example, a landowner (individual or corporate) who has $50,000 of "gross income," all of which comes from the business of farming, *<u>is</u>* a "qualified farmer or rancher." A landowner with $200,000 of "gross income," and only $40,000 of "gross income" from ranching, *<u>is not</u>*. Again, landowners must check with their own advisors about whether or not they are eligible to take advantage of the 100% incentive. (One of the things we do not know is precisely how "gross income" is defined; see below.)

The second requirement to be eligible for the 100% incentive is that the conservation easement must include a restriction that the property remain available for agricultural purposes. It is not 100% clear what this means, but there is some guidance on this point. See the discussion below. At this point, all of the ramifications of this requirement are not clear, but in the vast majority of farming and ranching situations it *should be easy* to satisfy this requirement with careful drafting in the conservation easement.

For <u>*corporate*</u> donors, <u>the "only" new incentive is the 100% incentive</u>, and apparently both the "qualified farmer and rancher" and the "remain available for agriculture" requirements must be met. On the other hand, it appears that if <u>*an individual*</u> who is a "qualified farmer or rancher" donates a conservation easement that does not include this reserved right for continuing agricultural activities, the easement donation <u>could still be taken up to 50% of the individual's AGI with a 15-year carryforward</u>.

3. **<u>The layering, stacking, or timing of the income tax deductions from these gifts receive further favorable treatment</u>**. One question that is likely to come up is what happens if an individual makes other charitable contributions, say a gift of stock to the <u>alma</u> <u>mater</u>, or has made other conservation easement donations in the past, and the individual is carrying forward the deductions from those gifts (such carryforward deductions from gifts before 2006 are still subject to the 30% of AGI limitation). **According to both the IRS Notice and the 2007 report of the Joint Committee on Taxation, when the conservation contribution can be taken up to 50% of an individual's AGI, here is how this provision works. This "timing" rule is technical but important:**

"…assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50% limitation of $60. The individual is allowed a deduction of $50 in the current year for the non-conservation contributions (50% of the $100 contribution base) and *is allowed to carryover the excess $10 for up to 5 years*. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution *may be carried forward for up to 15 years*." (from the 2007 Joint Committee report; emphasis added)

Put another way, if a donor has made contributions <u>other than</u> these new conservation contributions during the year, those contributions are "used up" first against the existing limitations. <u>*After*</u> those contributions are used to the maximum allowable extent, <u>*then*</u> the conservation contributions are taken into account.

When the conservation contribution can be taken up to 100% of an individual's AGI, here is how this provision works, again according to the IRS Notice and the 2007 Joint Committee report:

Assume that a donor with a contribution base of $100 makes a qualified conservation contribution with a value of $80 and has made other cash or check contributions, subject to the existing 50% limitation, of $60. In this case, the donor may take $50 of the non-conservation contributions (that is, up to 50% of the contribution base), plus $50 of the conservation contribution. The remaining $10 of non-conservation contributions is available, subject to the old (and existing) 5-year carryforward rules, and $30 of the conservation contribution ($80 minus $50) is subject to the 15-year carryforward rule.

This tax savings opportunity may be limited!! Although these incentives might be extended once again, they now apply only to easement gifts through the end of 2009. Once again, this is important: a philanthropic donor should understand that even if she has "maxed out" her charitable gifts for this year, and even next year, a conservation easement donation made in this two-year window will carry forward for 15 years!! This opportunity might not be available in the future.

4. **<u>Charitable contributions by S corporations will now receive more favorable income tax treatment under other changes in the law</u>**. Prior to 2006, when an S corporation made a charitable contribution, the deduction "flowed through" to the shareholders, but only to the extent each shareholder had "basis" in his or her S corporation stock. I know of many potential easement donations by landowning S corporations that simply did not happen because of this rule.

In 2006 and 2007, Congress made some changes in these rules, but those changes expired at the end of 2007. Now, in the huge "bailout" legislation Congress passed in October of this year, Congress has fixed this rule one more time. To make a long and technical story very short, now, <u>in almost every case</u> when an S corporation makes a charitable contribution, that deduction will flow through to the shareholder or shareholders regardless of their stock basis. I say "in almost every case" because the new rule does not simply say that the deduction flows through without regard to basis, so there could be some particular situations in which the full deduction does not in fact flow through. Just as one example, it appears that the entire deduction will not flow through to shareholders if the *basis of the donated asset is greater than the shareholders' stock basis.* This might happen, for example, if an S corporation owns a ranch or a farm and depreciation and/or operating losses over time had lowered stock basis. If this rule is important for you, check with your advisor about its status and applicability.

In any case, it is absolutely clear that with the new enhanced income tax incentives for conservation easement donations, in effect for donations this year and next year, a conservation easement donation that flows through an S corporation to its shareholders can be used by each shareholder up to 50% of his or her adjusted gross income for the year, with a fifteen-year carryforward, and possibly, if the shareholder is a "qualified farmer or rancher" under the new incentives, up to 100% of adjusted gross income with a fifteen-year carryforward!!

5. **<u>Bottom line about what we know: the income tax savings from these new incentives can be significant and substantial</u>**. Note these two very important observations.

First, as always, any potential donor should consult with his or her own experienced tax advisor, who can "run the numbers" for any particular situation. Second, as you will see from the simple spreadsheets that follow, there is at least one very surprising result: in some cases, the <u>total</u> income tax savings from taking the deduction up to 50% of AGI may be higher than the <u>total</u> income tax savings from taking the deduction up to 100% of AGI.

<u>GUIDANCE FROM THE IRS</u>

Early in 2007, the Land Trust Alliance ("LTA") submitted a letter to the Treasury Department with comments on the issues that follow and other questions that come up under the new incentives. The Land Trust Alliance, as the national convenor, strategist, and representative of more than 1,600 land trusts across the country, lobbied hard for these new tax incentives and for their extension. The IRS responded to the letter and other comments with a discussion of many of these issues in Notice 2007-50.

1. **<u>Do the new incentives really apply to all "qualified conservation contribution" gifts</u>**?? As noted above, under the terms of the statute, the new incentives apply to gifts of all "qualified conservation contributions". Under Section 170(h) of the tax code, **"qualified conservation contributions"** include (1) the gift of a remainder interest in land for conservation purposes; (2) a gift of the fee interest in real estate for conservation purposes with a reserved right to extract oil, gas, and subsurface minerals (so-called "qualified mineral interest" gifts); and (3) the gift of a "qualified real property interest," including a conservation easement.

Does the new statute mean what it says? Did Congress really intend to apply these important new incentives to qualified mineral interest gifts?

Does this all mean that a landowner who donates her property, outright, in fee, to the local land trust will only be able to take an income tax deduction for the value of the gift up to 30% of her AGI for the year, with a five-year carryforward (the "old" and continuing law for most charitable gifts of property)? According to the IRS, it appears so.

Does this also mean that if the same landowner reserves the right to extract oil, gas, and subsurface minerals and then donates the fee to the land trust she can take a deduction up to 50% of her AGI with a 15-year carryforward? Yes; that is in fact what the plain language of the statute says, and the Notice confirms that.

In short, this is an unusual situation. Congress seems to have given higher tax incentives to certain gifts of "partial interests" in property than to gifts of the entire property. But this is a policy decision that Congress has made and this is what the law says.

What if there are no known oil, gas, or subsurface mineral deposits when the landowner makes this donation? Are the new incentives still available? The IRS appears to take the position that on these facts the new incentives are not available.

It is important to keep in mind that the "conservation purposes" tests under Section 170(h) apply to all qualified conservation contributions, not just to conservation easements. A charitable gift of property with no conservation values, no matter how it is structured, will not be eligible for the new incentives. Under Section 170(h) of the tax code, every qualified conservation contribution must meet one (although of course may meet more than one) of these "conservation purposes" tests:

1. the preservation of land areas for outdoor recreation by, or the education of, the general public;
2. the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
3. the preservation of open space for the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental policy, which will yield a significant public benefit; and
4. the preservation of an historically important land area or a certified historic structure.

2. **If a partnership, or LLC, or S corporation is the donor of the conservation easement, is the "qualified farmer or rancher" determination made at the entity level or at the individual partner, or member, or shareholder level**?

Generally, as the LTA letter to Treasury noted, since the law refers to a qualified farmer or rancher as "a taxpayer," it seems correct to assume that for S corporations, partnerships, and other pass-through entities that own and operate farm businesses, each individual taxpayer who is a stockholder or partner in the pass-through entity must make the determination whether he or she is a "qualified farmer or rancher." In other words, the income of the ownership entity itself is irrelevant to this determination. According to the Notice, this is the rule that will apply.

This application of the rule might mean that some family members of a family-owned farm organized as an S corporation or partnership would not qualify for the 100%-of-AGI deduction limit, by virtue of having sufficient outside income, while other stockholders or partners do qualify. However, as noted above, an individual who does not qualify as a "qualified farmer or rancher" may still take the deduction up to 50% of AGI with the 15-year carryforward.

An alternative reading of the rule could lead to a 100%-of-AGI deduction for a partner or stockholder whose income is not primarily from farming. This result appeared to be inconsistent with the intent of the statute, and the IRS agreed.

3. **In connection with the 100% incentive, what does "gross income from the trade or business of farming" mean**? The Notice goes into some detail on this issue. If you are interested, see the Notice.

4. **In connection with the 100% incentive, how does the landowner make certain that "the property remain available" for agriculture and farming purposes**? According to the 2007 Joint Committee report, "There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes." (emphasis added) In other words, it appears that the conservation easement does not have to require that the property stay forever in agricultural use, but must include such agricultural activity as a reserved right. The Notice is consistent with this reading, but includes a longer discussion on related matters. If you think that you (or a corporation in which you are a shareholder) might be eligible for the 100%-of-AGI incentive, you must pay particular attention to the discussion in the Notice about these issues.

FOUR VERY IMPORTANT POINTS

1. **Huge**. These new incentives are huge. Donors who can take advantage of the new incentives can realize very significant income tax savings.

2. **"Stacking" or layering or timing**. The sequencing of various charitable income tax deductions for philanthropic taxpayers is important in tax planning. As discussed above, the statute and the 2007 Joint Committee report treat these deductions favorably, in that they are taken into consideration after other donations, and that increases the likelihood of a carryforward being available. This dovetails nicely with the concept of "banking" a large deduction to be used against future income events.

3. **Banking a large deduction**. Many donors may not be able to "use up" a large income tax deduction currently. Many donors with varied interests may anticipate, or be planning for, a large income realization event say at some point five to ten years out, such as the sale of a business, or the sale of appreciated investment real estate or other assets, or a large distribution from a retirement plan. A charitable contribution now, to lock in the 15-year carryforward to use against an anticipated income event say ten years from now, seems to me to be an interesting long-term income tax planning concept the likes of which we simply have not seen before!! Of course, a lot of assumptions need to be made as part of such planning, but it is an intriguing thought.

4. **Timing**. I have advised clients who think they might want to donate conservation easements this year not to wait. This can be a complex and time-consuming process. A donor who starts the process now has the option to pull the plug later in the year if she changes her mind. A donor who waits until the fall to start the process may find that is too late to complete a gift this year.

SPREADSHEETS

See the two spreadsheets that follow. Note that these are "simple" examples and do not include a lot of the other usual items that show up on individual income tax returns, such as mortgage interest, capital gains and losses, etc.

In none of the deduction scenarios below did the Alternative Minimum Tax ("AMT") come up.

These spreadsheets do not address state income tax issues or corporate income tax situations. Also, the spreadsheets were prepared in 2007 using 2007 tax tables.

Here is a sneak preview of the important surprise. In the two spreadsheets that follow, when the entire deduction is "used up" before the carryforward period runs out, the income tax savings appear to be higher when the deduction is taken up to 50% of AGI each year instead of up to 100% of AGI each year. This may be because of the "progressive" income tax: the more income you have, the higher the tax rate. When only the "top half" of your income is sheltered by a deduction, that is your higher-taxed income. By eliminating all taxable income with a 100% deduction, you are also avoiding paying tax on lower-taxed income. This is all food for thought.

In addition, note that with an elderly donor (my definition of elderly goes up a little bit each year) and a 15-year carryforward, the donor's life expectancy may also be a consideration in long-term income tax planning.

In that regard there is one other related issue. Any unused carryforward deduction (in the case of any charitable gift) "expires" with the death of the donor. Married couples that own land and want to take advantage of this extended carryforward should consult with their advisors about structuring their land ownership, and easement donation, to take this issue into consideration.

Finally, the calculations are not intended to prove any particular point other than the fact that each donor must get his or her own tax and legal advice. It is often not prudent to generalize about income tax consequences.

The examples that follow are all married filing jointly with two exemptions.

Here is $100,000 of income, no deductions:

Adjusted Gross Income	100,000
Itemized Deductions	0
Federal Tax	**14,300**

Here is $100,000 of income, with a $500,000 easement deduction taken up to 30% of AGI

Adjusted Gross Income	100,000
Itemized Deductions	30,000
Federal Tax	**8,698**
Income Tax Savings ($5,602 x 6)	**33,612**

Here is $100,000 of income, with a $500,000 easement deduction taken up to 50% of AGI:

Adjusted Gross Income	100,000
Itemized Deductions	50,000
Federal Tax	**5,698**
Income Tax Savings ($8,602 x 10)	**86,020**

Here is $100,000 of income, with a $500,000 deduction taken up to 100% of AGI:

Adjusted Gross Income	100,000
Itemized Deductions	100,000
Federal Tax	**0**
Income Tax Savings ($14,300 x 5)	**71,500**

Note, also, how close the tax savings numbers are with a larger deduction. Here is $100,000 of income, with a $1,000,000 deduction taken up to 50% of AGI:

Income Tax Savings ($8,602 x 16)	**137,632**

Here is $100,000 of income, with a $1,000,000 deduction taken up to 100% of AGI:

Income Tax Savings ($14,300 x 10)	**143,000**

<u>Here is $200,000 of income, no deductions</u>:

Adjusted Gross Income	200,000
Itemized Deductions	0
Federal Tax	**43,550**

<u>Here is $200,000 of income, with a $500,000 easement deduction taken up to 30% of AGI</u>:

Adjusted Gross Income	200,000
Itemized Deductions	59,128
Federal Tax	**32,133**
Income Tax Savings ($11,417 x 6)	**68,502**

<u>Here is $200,000 of income, with a $500,000 easement deduction taken up to 50% of AGI</u>:

Adjusted Gross Income	200,000
Federal Tax	**16,366**
Income Tax Savings ($27,184 x 5)	**135,920**

<u>Here is $200,000 of income, with a $500,000 deduction taken up to 100% of AGI</u>:

Adjusted Gross Income	200,000
Itemized Deductions	199,128
Federal Tax	**0**
Income Tax Savings ($87,100 plus $27,184)	**114,284**

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