CONSERVATION FRONTIERS

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The Dana Point Preserve, Orange County, CA, is owned and managed by the Center for Natural Lands Management. The Preserve's habitat is the increasingly rare coastal sage scrub which supports the federally endangered Pacific pocket mouse and the federally threatened Coastal California gnatcatcher.

PHOTO COURTESY OF LEE ANN CARRANZA, CNLM

This Issue

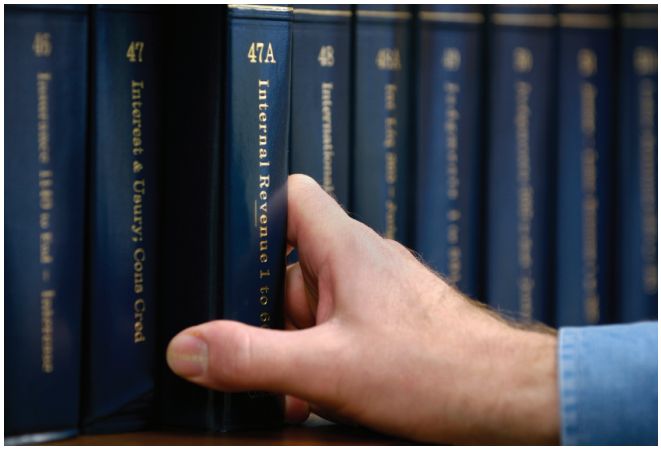
Mitigation and Tax Deductions: Where Angels Fear to Tread

by LUCINDA CALVO

Land trusts sometimes receive land from developers who are required to perform mitigation to obtain development approvals or to comply with federal, state, or local laws. Generally, no income tax deduction is available to developers for such land transfers. But what happens when a developer claims that the land transfer exceeds the mitigation requirement and attempts to claim a charitable tax deduction for the so-called excess? What duties and risks does a land trust encounter in this scenario? This edition of Conservation Frontiers *reviews how land trusts can recognize these situations when they arise, increases understanding of the basic tax law underlying such transactions, and suggests actions that protect both the individual land trust's interests and the reputation and future of land trusts in general.*

Introduction

In a typical mitigation land transaction, a developer transfers a property right to a land trust in the form of a conservation easement or fee title without claiming an income tax deduction. However, on rare occasions, a developer may attempt to claim a charitable income tax deduction and may ask the land trust to cooperate in fulfilling IRS substantiation requirements, such as requesting that the land trust supply a donee acknowledgment letter and sign the Donee Acknowledgment portion of IRS Form 8283. Land trusts mindful of their tax-exempt status, as well as of their reputation and the reputation of the land trust movement, would do well to develop a basic familiarity with the tax law concerning developer mitigation property transfers.



Determining Charitable Intent: Quid Pro Quo and Dual Character Transactions

A general principle of federal tax law is that charitable donations require charitable intent (also known as donative intent) in order to be tax deductible. Thus, when a taxpayer makes a payment or contributes property in exchange for some benefit, the payment is generally not deductible. This "something for something" exchange is known in the law by the Latin phrase quid pro quo. For example, if a taxpayer buys a ticket to a raffle organized to raise funds for a charity, the taxpayer may not claim the ticket price as a charitable deduction. Even though the taxpayer may have purchased the ticket because the transaction would benefit the charity, the taxpayer also benefits personally by acquiring a chance to win the drawing. Similarly, if a developer transfers a property right to a land trust in order to perform mitigation required by law, or to fulfill a legal agreement that allows the developer to proceed with a project, the property transfer is not deductible. The transfer is characterized as a quid pro quo transaction because the developer has given something (a land right) to get something (government approval for development).

How does this simple, tit-for-tat rule apply when a taxpayer's transfer to a charity exceeds the benefit the taxpayer receives in return? In this situation, a taxpayer may be allowed to claim a tax deduction for the excess amount. For example, if a charity arranged for a benefit symphony concert, and clearly advertised that an additional $10 charitable donation amount would be added to the established ticket prices for that particular symphony, then that $10 excess amount could be claimed as a tax-deductible charitable contribution. In tax law nomenclature, this is sometimes called a "dual character" transaction because the payment has a two-fold aspect: partly a purchase and partly a contribution. In the conservation context, the same rule applies. Treasury regulations and IRS guidance specify that if the transferor of a perpetual conservation restriction can clearly demonstrate that the transfer's value to the public is greater than the financial or economic benefit to the transferor–taxpayer, then the excess may be deducted, if it was purposely contributed with the intent to make a charitable gift.

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However, a developer mitigation land transfer is a much more complicated, multi-layered transaction than the symphony concert ticket example. The analysis of whether an excess amount was actually contributed becomes correspondingly more complicated. There are many ways developers benefit from mitigation land transfers, and many ways in which related tax deductions are limited, which typically wipes out any excess value claimed.

Practical Obstacles to Developer Dual Character Transactions

Although treasury regulations allow for the tax deductibility of some dual character conservation transactions, many legal commentators speak discouragingly of the prospects for tax deductibility when a developer claims to be a donor. This skepticism is based on several types of issues that arise in developer conservation transactions: the substantial benefit problem, valuation/appraisal issues, and the operation of other tax rules.

Substantial Benefit

In determining whether a transaction is a non-deductible quid pro quo transaction or a partly deductible dual character transaction, tax courts and the IRS look to whether the taxpayer expects a substantial benefit in return for the property transferred, or whether the benefit is merely incidental. To be substantial, a benefit need not be strictly quantifiable or immediate. Examples of this kind of benefit include situations in which the so-called donation cultivates a future customer base, bolsters the developer's marketing pitch, or enhances the value of a real estate development. Determination of whether a benefit is substantial or incidental is made based on the individual facts and circumstances of a transaction, and a developer should seek the advice of an attorney familiar with conservation transaction case law and IRS guidance.

Valuation and Appraisal Issues

Even if the "substantial benefit" hurdle can be overcome, the developer still must prove that the total value of the benefit the developer confers exceeds that received. This calculation involves a number of complex valuation issues. For example, valuing the benefits to the developer must include: enhancements to the value of a development plan or other property owned by the developer or by related persons, services the land trust provides to facilitate the transfer, and the value of the mitigation requirement (often difficult since the requirement is typically expressed as a percentage of a property or particular portion of the property rather than a dollar value).

The transferred property right itself must also be appraised (whether fee title or easement). Tax regulations make clear that for a tax deduction to occur, there must be surrender of genuine development value: a developer "must take into account not only the current use of the property but also…the likelihood…that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict" the property's development or economic value. (26 C.F.R. § 1.170A-14 (h)(3)(ii).) A developer must also be careful to select an appraiser and an attorney experienced in the particular IRS appraisal and substantiation requirements for conservation transactions. Several recent tax cases arose from appraisals of conservation easements that failed to meet the basic requirements of IRS law in this specialized area. The size or prominence of a law firm does not guarantee expertise: in one case, a prominent national law firm representing a developer in negotiations with a municipality and a land trust failed to be aware of the requirement to file Form 8283.

Operation of Other Tax Rules

Other tax rules also limit the likelihood that a developer will be able to obtain a tax deduction for a mitigation transfer, or at least limit the profitability of a deduction. A full discussion is beyond the scope of this article, but two key issues are the basis allocation rule and the distinction between inventory and a capital asset, both contained in treasury regulations on qualified conservation contributions. Under the basis allocation rule, the tax basis of the property retained by the donor is reduced by an amount equal to the ratio between the fair market value of the donation and fair market value of the property. For instance, if a donated easement reduces the value of the remaining property by one-third, then one-third of the basis is subtracted from the tax basis of the rest of the property. What this means is that for income tax purposes, if a donor sells the remaining property, such as by carving a parcel into lots, the donor will have more taxable gain, as if the donor had paid less for the property to begin with. The tax deduction might be trimmed even more if the donated prop-

Tax Law of Quid Pro Quo Transactions

KEY CASE LAW:

- *United States v. American Bar Endowment*, 477 U.S. 105 (1986).
  The definitive case on quid pro quo and dual character transactions in charitable tax law.
- *Singer Co. v. U.S.*, 449 F.2d 413 (Ct. Cl. 1971).
  A major case defining the issue of substantial benefit/expectation of future benefit.
- *Headlands Reserve v. Center for Natural Lands Management*, 523 F. Supp. 2d 1113 (C.D. Cal. 2007).
  This case presents a helpful real-life case study of a dispute between a developer and a land trust over the tax treatment of a quid pro quo land transfer. The federal court upheld the land trust's refusal to sign Form 8283. The case also underscores the importance of seeking legal counsel versed in tax aspects of conservation transactions.

IRS MATERIALS:

- Treasury Regulation § 1.170A-14(h)(3).
  A fundamental regulation detailing the valuation of a perpetual conservation restriction (such as a conservation easement).
- Revenue Ruling 67-246, 1967-2 Cum. Bull. 104, *available at* http://www.irs.gov/pub/irs-tege/rr_67_246.pdf.
  This IRS guidance describes the income tax treatment of dual character transactions and provides helpful examples.
- Notice 2004-41, I.R.B. 2004-28, p. 31, *available at* http://www.irs.gov/pub/irs-irbs/irb04-28.pdf.
  This IRS guidance discusses conservation easements and questionable "conservation buyer" transactions in particular, and in general serves as a cautionary tale on shaky conservation transactions.
- Conservation Easement Issue Identification Worksheet, http://www.irs.gov/businesses/small/article/0,,id=249135,00.html#_Toc286.
  Produced by the IRS for use by its auditors, this chart summarizes many issues that may arise in a conservation transaction and includes references to related IRS code and regulations. A similar, more printer-friendly worksheet is available at the Land Trust Alliance website at http://www.landtrustalliance.org/land-trusts/resources-1/resolveuid/556268132be5e28e569dd00aa08a5cd6.
- Stephen J. Small, *Proper–and Improper–Deductions for Conservation Easement Donations, Including Developer Donations*, 105 TAX NOTES 217 (Oct. 11, 2004).
  This article, written by an attorney formerly at the IRS Office of Chief Counsel, provides an excellent, accessible overview.
- Land Trust Alliance, "Practical Pointers Series: Form 8283" (Mar. 11, 2011) *available at*: www.landtrustalliance.org/land-trusts/resources-1/8283%20Practical%20Pointers.doc.
  This fact sheet provides a short survey of best practices regarding Form 8283, along with a list of resources for further learning.

erty is considered inventory, such as lots a developer holds for sale, rather than capital gain property. A deduction for donated inventory property typically is limited to the dealer's cost or basis.

Given the myriad practical pitfalls a developer may encounter in attempting to structure a dual character conservation transaction, a prudent developer should see to it that the appraisal and other tax documentation is prepared with IRS review in mind. Because deductions for conservation restrictions tend to be larger than other charitable deductions, and because they have been subject to abuse in the past, developers face a greater chance of winning the "audit lottery."

Land trusts can take a number of actions to be diligent – in fact, reading this article is a first step. Other steps include:

- Because of the high potential for difficulties, land trusts should not seek out these types of donations.
- If approached, the land trust should be clear from the outset and throughout the process that:
  - the land trust is not dispensing tax advice;
  - qualified conservation transactions have unique, particularized legal requirements;
  - the developer should engage not simply a tax attorney, but legal counsel specially experienced in tax aspects of conservation transactions.
- The land trust should obtain its own, completely separate and independent attorney.
- The source of funds to retain counsel should also be considered: using charitable funds on a developer mitigation transaction may be ethically questionable. Also, using funds from the developer to hire counsel means that the land trust might not receive fully independent legal advice.
- Follow Land Trust Alliance (LTA) guidance not to sign a questionable Form 8283, especially if it does not list a deduction amount.

Finally, the land trust must look at the big picture: does the entire deal advance the mission of the land trust? On one hand, making a substantial land acquisition may appear enticing, but if legal trouble ensues, the situation could become an albatross that drains financial and human resources, compromising the land trust's ability to protect its other holdings.

Risks for Land Trusts

Some may question the dire tone of the warnings above. After all, land trusts are not meant to be tax advisors; rather they are charged with the mission of protecting conservation values by acquiring, holding, and stewarding land. Turning away land deals may seem counterproductive. However, the existence of the qualified conservation tax deduction means that land trusts are involved with the federal income taxation process by association: the donee acknowledgment letter and a signature on the Donee Acknowledgment portion of IRS Form 8283 are required for substantiation of noncash contributions over $500.

Although the donee organization's signature on IRS Form 8283 merely "acknowledges that it…received the donated property as described" from the donor, statements by Congress and by IRS officials indicate that the federal government expects land trusts to act as gatekeepers and not accept contributions wearing a legal blindfold. IRS notices and pronouncements by IRS officials warn that questionable transactions may lead to a challenge of an organization's tax-exempt status, as well as increased IRS scrutiny of conservation donations in general. Given that the IRS is already devoting additional resources to conservation donations due to previous abuses, it is even conceivable that a pattern of shaky conservation tax deals could lead Congress to reconsider or even revoke the tax deduction for qualified conservation contributions. As IRS Commissioner Steven T. Miller stated about abusive easement contributions, "if we do not work together on this, the congressionally provided deductibility for gifts of easements may be at risk." Also, negative publicity may affect public perceptions of the credibility of land trusts and conservation easements. Donors may hesitate to contribute to a land trust involved in a tax controversy.

Conclusion

Considering the difficulties of evaluating, documenting, and proving a dual character developer charitable conservation contribution, only a highly motivated aspiring donor-developer, with genuine donative intent, a truly substantial land donation, a meticulously detailed appraisal, and painstaking adherence to conservation tax donation law, should attempt to claim a deduction. As for land trusts, only those with the resources to seek legal counsel and thoroughly vet the transaction should contemplate involvement in a dual character deal. In other words, while dual character developer conservation transactions are theoretically possible under the rule stated in *American Bar Endowment*, such transactions are likely to be practically and legally beyond the capacity of many land trusts to properly evaluate, and should be approached with great caution, if at all. ■

Conservation Frontiers is published by California Council of Land Trusts.

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The statewide voice for more than 150 land trusts, the California Council of Land Trusts is a collaboration of land trusts delivering policy solutions and speaking for the conservation of special lands and waters throughout California.

The Council helps land trusts protect the natural areas and farmlands important to the state and local communities by increasing the resources and tool available to conserve and steward land.

We leverage our expertise in policy and stewardship to advocate for the most effective ways to ensure that local places of value and importance are protected and stay protected for the benefit and enjoyment of Californians.

We work to inspire awareness, vision and commitment among California's leaders and communities to protect the Golden State's natural heritage.

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