

THE NEW CONSERVATION TAX INCENTIVES – SOME THINGS WE KNOW AND SOME THINGS WE DON'T KNOW

By

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

There are some very important things we do know about the new law, and there are some things we do not know about the new rules. This article is not legal advice. It is commentary on the new incentives. Landowners contemplating conservation donations must consult with their own counsel on these issues.

First, some quick background to set the stage.

BACKGROUND

Under the “old” law, 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.”**

Also under the old law, a conservation easement donated by a corporation could be deducted **only up to 10% of the corporation’s taxable income for the year** (that is, of course, taxable income before 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.**

Gifts 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.

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THE NEW LAW – SOME THINGS WE KNOW

1. **The new incentives expire at the end of next year!!** Pay attention!! If you might have a conservation gift in mind, and if these new incentives are important to you, it is not too early to start work on your transaction, or at least begin thinking about it seriously. The new incentives apply to gifts made in 2006 and 2007. It is possible that Congress might extend these incentives, but it is also possible that will not happen.

2. **The incentives apply to gifts of “qualified conservation contributions”.** By the terms of the new 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; 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.

3. **The law includes two new major important incentives.** 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**.

A “qualified farmer or rancher” is generally defined under the new law as an individual (or a corporation) whose income from farming or ranching is greater than 50% of his total AGI. According to the **new 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**. This definition applies to individuals and to corporations. 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, is a “qualified farmer or rancher.” A landowner with \$200,000 of “gross income,” \$40,000 of which is from ranching, is not. 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. Because this particular requirement was added to the statute late in the deliberations, *it only applies to conservation easements donated after the date the statute becomes law.*

In other words, easements by “qualified farmers or ranchers” donated after December 31, 2005, and before August 17, 2006, apparently do not need to include this specific language to be eligible for the 100% deduction (although they almost certainly will include such language if the landowner plans to continue farming activities!!). At this early 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 corporate donors, the “only” new incentive is the 100% incentive, and apparently both the “qualified farmer and rancher” and the “remain available for agriculture” requirements must be met. Apparently, however, if an individual 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 could still be taken up to 50% of AGI with a 15-year carryforward.

4. **The income tax deductions from these gifts receive further favorable treatment.** 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 alma mater, 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 in prior years are still subject to the 30% of AGI limitation). **According to the 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.*” (emphasis added)

Put another way, if a donor has made contributions other than these new conservation contributions during the year, those contributions are “used up” first against

the existing limitations. *After* those contributions are used to the maximum allowable extent, *then* the conservation contributions are taken into account.

Here is another example. Say an individual has AGI of \$100, writes a check to the local land trust for \$40, and donates a conservation easement with a value of \$80. First the \$40 contribution is used up, then \$10 of the \$80 easement contribution is used up, for a total of \$50, that is, 50% of the individual's AGI. There is a carryforward, for up to 15 years, of \$70 of the conservation easement contribution.

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 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 AGI), 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.

Or, assume an individual with \$100 of AGI writes a check to the alma mater for \$30, and donates a conservation easement with a value of \$100. The donor first deducts the \$30 contribution, then \$70 of the easement donation (up to a total of 100% of AGI). There is a \$30 carryforward, for up to 15 years, from the conservation easement donation.

This tax savings opportunity may be limited!! Once again, although these incentives might be extended, they now apply only to easement gifts made in 2006 and 2007. 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.

5. **Bottom line about what we know: the income tax savings from these new incentives can be significant and substantial.** See the spreadsheets at the end of this article.

At the same time, note these two very important observations.

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

THE NEW LAW – SOME THINGS WE DON'T KNOW

1. **Do the new incentives really apply to all “qualified conservation contribution” gifts??** 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)? 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.

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? If the statute means what it says, the answer to that question is also yes. However, there are also very technical tax rules having to do with “partial interest” gifts that could be applied by the IRS in an attempt to deny such a deduction.

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 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. **Do we know how “qualified conservation contributions” other than conservation easement gifts might work out in fact??** This is a current matter of continuing discussion in the land trust community and there are few clear answers.

Assume that a landowner has land that has important conservation values, and some subsurface mineral deposits with more than a nominal value. A “simple” gift of the fee interest with a reservation of the right to oil, gas, and subsurface minerals meets the requirements of the new statute. Assuming a gift to the local land trust of a conservation easement on the land meets all of the Section 170(h) requirements, that donation would also be eligible for the new incentives.

What if the landowner first donated that conservation easement, then, a few months later, reserved the right to extract subsurface minerals and donated the fee interest (subject to the earlier conservation easement) to the town, so the property could be used as a park? Would that gift be eligible for the new increased incentives? **It certainly seems so.**

Do the results change if there are no known mineral deposits, but the landowner structured the transaction this way to take advantage of the new incentives? I do not think the answer is clear although these gifts seem to be in compliance with the language of the statute. However, as noted above, the technical partial interest rules might be applied to deny a deduction. There is no official guidance from the IRS on this point at this time.

Honest and informed people can disagree about these questions and these answers. I hope that as time goes by we can provide answers with more certainty. Stay tuned.

One other important issue has surfaced. As noted above, under the tax code rules, to qualify for an income tax deduction the landowner’s gift must meet one of the conservation purposes tests under section 170(h). A further requirement under section 170(h) is that the conservation purposes must be enforceable in perpetuity. In the case of a conservation easement, this means at least two things: the easement be perpetual, and the restrictions imposed by the easement must actually protect the conservation values of the property. In other words, Aunt Sally may have a beautiful 200-acre farm, with important open space, habitat, and agricultural values, but if the conservation easement allows Aunt Sally to create twenty 10-acre house lots on the property, the conservation

values will be destroyed and the conservation easement will not qualify under the tax rules.

What does this mean when there is a gift of the fee interest, for conservation purposes, with a reservation of the rights to oil, gas, and subsurface minerals? The law is not abundantly clear on this point, and in fact there is very little guidance from the IRS on how this happens. What it seems to mean is that the deed of gift (gifting the fee and reserving the mineral interests) must include at least some of the restrictions that are substantially similar to restrictions imposed by a conservation easement, such as prohibiting industrial activities or other activities that would destroy the habitat or other conservation values, and including limitations on the permitted oil and gas operations. At least in theory, including such restrictions in the deed of gift potentially raises questions about enforceability and valuation. Once again, stay tuned.

3. **In connection with the 100% incentive, what does “gross income from the trade or business of farming” mean?** There is no guidance on this term. If you think you might qualify for this benefit, consult with your advisors.

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 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 INCOME TAX SAVINGS CAN BE SUBSTANTIAL, BUT RUN THE NUMBERS!!!

See the 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 scenarios below has the Alternative Minimum Tax (“AMT”) come up.

These spreadsheets do not address state income tax issues. Also, new software is not yet available for the new conservation donation tax incentives, so I had to improvise a bit here and there to adapt. I believe these calculations are correct, however. The spreadsheets do not address corporate income tax situations.

Here is a sneak preview of the important surprise. In many of the following situations (see \$100,000 of AGI, \$200,000 of AGI), 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. With an elderly donor (my definition of elderly goes up a little bit each year) and a 15-year carryforward, long-term income tax planning also might want to think a bit about life expectancy.

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 spreadsheets begin on the next page.

This first set of calculations has no surprises. Compare the income tax savings under the “old” law (deduction up to 30% of AGI) and the new law, both with the 50% incentive and the 100% incentive.

Here is \$50,000 of income, no deductions:

Adjusted Gross Income	50,000
Itemized Deductions	0
Federal Tax	4,210

Here is \$50,000 of income and a \$500,000 easement donation taken up to 30% of AGI:

Adjusted Gross Income	50,000
Itemized Deductions	15,000
Federal Tax	3,505
Income Tax Savings (\$705 x 6)	4,230

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

Adjusted Gross Income	50,000
Itemized Deductions	25,000
Federal Tax	2,005
Income Tax Savings (\$2,205 x 16)	35,580

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

Adjusted Gross Income	50,000
Itemized Deductions	50,000
Federal Tax	0
Income Tax Savings (\$4,210 x 10)	42,100

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

Adjusted Gross Income	100,000
Itemized Deductions	0
Federal Tax	13,890

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	8,965
Income Tax Savings (\$4,925 x 6)	29,550

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	5,755
Income Tax Savings (\$8,135 x 10)	81,350

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 (\$13,890 x 5)	69,450

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 (\$8,135 x 16)	130,160
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Here is \$100,000 of income, with a \$1,000,000 deduction taken up to 100% of AGI:

Income Tax Savings (\$13,890 x 10)	138,900
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Here is \$200,000 of income, no deductions:

Adjusted Gross Income	200,000
Itemized Deductions	0
Federal Tax	40,672

Here is \$200,000 of income, with a \$500,000 easement donation taken up to 30% of AGI:

Adjusted Gross Income	200,000
Itemized Deductions	59,010
Federal Tax	27,033
Income Tax Savings (\$13,639 x 6)	81,834

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

Adjusted Gross Income	200,000
Federal Tax	16,713
Income Tax Savings (\$23,959 x 5)	119,795

Here is \$200,000 of income, with a \$500,000 deduction taken up to 100% of AGI:

Adjusted Gross Income	200,000
Itemized Deductions	199,010
Federal Tax	0
Income Tax Savings (\$81,344 plus \$23,959)	105,303

Here is \$500,000 of income, no deductions:

Adjusted Gross Income	500,000
Itemized Deductions	0
Federal Tax	143,876

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

Adjusted Gross Income	500,000
Itemized Deductions	143,010
Income Tax Savings	154,782

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

Adjusted Gross Income	500,000
Itemized Deductions	243,010
Federal Tax	64,062
Income Tax Savings (\$79,814 x 2)	159,628

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

Adjusted Gross Income	500,000
Itemized Deductions	493,010
Federal Tax	479
Income Tax Savings	143,397

Here is \$1,000,000 of income, no deductions:

Adjusted Gross Income	1,000,000
Itemized Deductions	0
Federal Tax	318,876

Here is \$1,000,000 of income, with a \$500,000 easement donation taken up to 30% of AGI:

Adjusted Gross Income	1,000,000
Itemized Deductions	283,010
Income Tax Savings	155,898

Here is \$1,000,000 of income, with a \$500,000 easement donation taken up to 50% of AGI:

Adjusted Gross Income	1,000,000
Itemized Deductions	483,010
Federal Tax	153,427
Income Tax Savings	165,449

Compare this result with the one following. Here is \$1,000,000 of income, with a \$1,000,000 deduction taken up to 50% of AGI:

Adjusted Gross Income	1,000,000
Itemized Deductions	483,010
Federal Tax	153,427
Income Tax Savings (\$165,449 x 2)	330,898

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

Adjusted Gross Income	1,000,000
Itemized Deductions	983,010
Federal Tax	1,479
Income Tax Savings	317,397