

Last Call

The new conservation tax incentives are huge. Individuals—and corporations—need to act immediately. It's almost too late

The Pension Protection Act (PPA) that President Bush signed on Aug. 17, 2006, includes the first major income tax incentives for land conservation since 1980. These breaks are huge, but they apply only to donations made in 2006 and 2007. Legislation has been introduced in Congress to extend the incentives, but of course, that might not happen.

I have been advising clients who think they might want to take advantage of these new incentives with conservation easement donations not to wait. A donor who starts now can pull the plug later if she changes her mind, or if the incentives become permanent and she wants to wait. But a donor who waits until the fall to start the complex and time-consuming process of donating a conservation easement might find it's too late to complete a gift this year.

Tell clients that it's smart to act quickly.

Donors who can take advantage of these incentives will realize very significant income tax savings. At the low end of what's possible, individuals can take a federal income tax deduction up to 50 percent of their adjusted gross income (AGI), up from 30 percent (in effect prior to the new incentives.) At the high end, both individuals and corporations qualifying under the new rules can take an income tax deduction up to

By **Stephen J. Small**,
Law Office of Stephen J.
Small, Esq., P.C.,
Boston

100 percent of their AGI.

For corporations, this represents an enormous leap. Generally, a charitable contribution by a corporation is deductible up to 10 percent of the corporation's taxable income,

Also striking is that these deductions are bankable and stackable. By "bankable," I mean that even if donors can't use the deduction this year, or next, they can take it later on. In fact, under the special PPA incentives, carryforwards for individuals and corporations jump from five years to a full 15 years. By "stackable," I mean that these donations can be taken into consideration after other donations have been taken.

Some aspects of the PPA incentives are still unclear. For example, the definition of "gross income" from farming activities is as yet unknown—as is whether, in the case of a partnership or limited liability company (LLC) or S corporation, the "qualified farmer or rancher" determination is made at the entity or the individual level.

PREVIOUSLY

Under the old law, an individual could deduct the value of a conservation easement donation generally up to 30 percent of the donor's "contribution base" for the year, with a five-year carryforward of any unused amount. "Contribution base" is AGI subject to certain adjustments. But because these adjustments are not relevant for most landowners, for shorthand, we simply say that the deduction for individuals could be taken up to 30 percent of AGI.

Also under the old law, a conservation easement donated by a corporation could be deducted only up to 10 percent 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. This very restrictive limitation on charitable contributions by corporate landowners has effectively killed countless potential conservation easement donations across the country.

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

NEW LAW

The PPA incentives apply to gifts of all "qualified conservation contributions." Under Internal

Revenue Code Section 170(h), "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. Let's focus primarily on conservation easement gifts.

The law includes two new major important incentives. First, any landowner (other than a corporate landowner) who donates a conservation easement can take the income tax deduction for the gift up to 50 percent of his 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 percent of AGI (for individuals), or up to 100 percent of taxable income (for corporations), also with a 15-year carryforward.

According to the new statute, "qualified farmer or rancher" means a taxpayer whose "gross income" from the business of farming (as defined under IRC Section 2032A(e)(5)) is greater than 50 percent 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 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" but only \$40,000 of that from ranching, is not. Landowners must check with their advisors about whether they are eligible to take advantage of the 100 percent incentive.

The second requirement to be eligible for the 100 percent incentive is that the conservation easement must include a restriction that the property remain available for agricultural purposes. It is not clear exactly what this means, but in the vast majority of farming and ranching situations it should be easy to satisfy the requirement with careful drafting in

A landowner who meets the new tests for "qualified farmer and ranchers" can take a deduction up to 100 percent of AGI or, for a corporation, taxable income.

SURPRISE

The total income tax savings from taking a deduction up to 50 percent of AGI in some cases may be higher than taking the deduction up to 100 percent

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 percent deduction, you’d also avoid paying tax on lower-taxed income. So if you look at the numbers, it certainly appears that at least in some situations the income tax savings from a donation are greater at the 50 percent of AGI limitation than at the 100 percent limitation!

Some simple examples, all assuming married filing jointly with two exemptions:

\$100,000 OF INCOME WITH...

...no deductions:

AGI = \$100,000

Itemized Deductions = \$0

Federal Tax = \$14,300

...a \$500,000 easement deduction taken up to 30 percent of AGI:

AGI = \$100,000

Itemized Deductions = \$30,000

Federal Tax = \$8,698

Income Tax Savings (\$5,602 x 6) = \$33,612

...a \$500,000 easement deduction taken up to 50 percent of AGI:

AGI = \$100,000

Itemized Deductions = \$50,000

Federal Tax = \$5,698

Income Tax Savings (\$8,602 x 10) = \$86,020

...a \$500,000 deduction taken up to 100 percent of AGI:

AGI = \$100,000

Itemized Deductions = \$100,000

Federal Tax = \$0

Income Tax Savings (\$14,300 x 5) = \$71,500

Note how close the tax savings numbers are with a larger deduction:

...a \$1 million deduction taken up to 50 percent of AGI:

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

...a \$1 million deduction taken up to 100 percent of AGI:

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

\$200,000 OF INCOME WITH...

...no deductions:

AGI = \$200,000

Itemized Deductions = \$0

Federal Tax = \$43,550

...a \$500,000 easement deduction taken up to 30 percent of AGI:

AGI = \$200,000

Itemized Deductions = \$59,128

Federal Tax = \$32,133

Income Tax Savings (\$11,417 x 6) = \$68,502

... a \$500,000 easement deduction taken up to 50 percent of AGI:

AGI = \$200,000

Federal Tax = \$16,366

Income Tax Savings (\$ 27,184 x 5) = \$135,920

...a \$500,000 deduction taken up to 100 percent of AGI:

AGI = \$200,000

Itemized Deductions = \$199,010

Federal Tax = \$0

Income Tax Savings (\$87,100 plus \$27,184) = \$114,284

Notes:

- (1) The above examples 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.
- (2) In none of the deduction examples did the alternative minimum tax come up.
- (3) These examples do not address state income tax issues or corporate income tax situations.
- (4) With an elderly donor and a 15-year carryforward, the donor’s life expectancy may also be a consideration in long-term income tax planning. Any unused carryforward deduction 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.
- (5) Advisors must run the numbers for clients considering these donations!

—Stephen J. Small

the conservation easement.

For corporate donors, the only new incentive is the 100 percent incentive, 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 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 can still be taken up to 50 percent of AGI with a 15-year carryforward.

STACKING

The layering, stacking or timing of the income tax deductions from these gifts receive further favorable treatment. One question that often arises is what happens if an individual makes other charitable contributions, say a gift of stock to his 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 percent of AGI limitation.) Will they max out and be unable to take all their deductions in time? According to the report of the Joint Committee on Taxation, when the conservation contribution can be taken up to 50 percent of an individual’s AGI, here is how this provision works. This timing rule is technical but important: “[A]ssume 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.”

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.

When the conservation contribution can be taken up to 100 percent of an individual’s AGI, here is how this provision works. According to the Joint Committee report and following the methodology in our example, 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 percent limitation, of \$60. In this case, the donor may take \$50 of the non-conservation contributions (that is, up to 50 percent 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) five-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 time-limited! Although these incentives might be extended, they now apply only to easement gifts made in 2006 and 2007. It is critical to help a client understand that if she has maxed out her charitable gifts for this year and even the next, a conservation easement donation made in this two-year window will carry forward for 15 years. Certainly this is a great deal to grab while a client can.

In that regard, as is always the

case when doing income tax planning, it is important to sit down and “run the numbers” with up-to-date tax planning software. In fact, I’ve already found one surprise looking at these new incentives: In some cases, the total income tax savings from taking the deduction up to 50 percent of AGI may be higher than the total income tax savings from taking the deduction up to 100 percent of AGI. (See “Surprise,” p. CGS 4.)

UNCLEAR

Unfortunately, not everything in the PPA regarding conservation easements (and other charitable contributions) is clear. At first, it was thought that charitable contributions by S corporations also would receive more favorable income tax treatment under the new law. But experts are unsure about this point.

Previously, 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 S corporation stock. I know of many potential easement donations by land-owning S corporations that simply did not happen because of this rule.

Congress changed that rule with the PPA. Tax advisors and others who have followed this issue in the past thought that the policy behind the change was to allow a charitable contribution by an S corporation to flow through to shareholders, without the prior stock-basis limitation. But, after fairly extensive scrutiny of the law and the Joint Committee report, it is not clear either what Congress intended to do or what Congress did. This is a very complex rule, and some advisors believe that further technical changes should be made to the tax code to be certain to achieve a full pass-through of the deduction. **I**