Land Trust Alliance
Together, conserving the places you love

Practical Pointers for Balancing Risk on Deductions of State Tax Credits for Conservation Following the Treasury Regulations Issued in June 2019

This is not legal advice; consult an experienced tax attorney.

In June 2019, the IRS issued a final regulation regarding contributions in exchange for state and local tax credits (SALT). The regulation intends to prevent states from bypassing a cap on the federal deduction for state and local taxes included in the tax bill signed into law in December 2017. It also affects other tax credits, including those for conservation, and erodes tax incentives for donors of land or conservation easements. The Land Trust Alliance is pursuing new legislation in Congress to exempt conservation tax credits from these new regulations.

What is the issue?

Our analysis shows the regulation may, to varying degrees, impact conservation donors in Arkansas, California[1], Colorado[2], Delaware, Florida[3], Georgia, Iowa, Maryland[4], Massachusetts, Mississippi, New Mexico, New York[5], South Carolina, Virginia[6] and the Commonwealth of Puerto Rico[7]. The new regulation applies to contributions made after August 27, 2018.

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[1] Conservation transactions in California do not qualify for a state tax credit unless the taxpayer submits an application under the Natural Heritage Preservation Tax Credit Act to the Wildlife Conservation Board and a funding source has been committed to reimburse the General Fund for the tax credit amount *prior to the grant and recording of a conservation easement*. If the grantor has not submitted such an application *and* a funding source has not been committed *first*, some California attorneys suggest that a disclaimer is not necessary since the project will not qualify for a state tax credit. The SALT regulations apply where a taxpayer "receives or expects to receive" a state tax credit and the taxpayer, the attorneys argue, does not "expect to receive" a tax credit in California unless it has been applied for and approved prior to closing. A conservative approach may be to assume that the IRS will adhere to its statements that it will count the mere existence of a tax credit against the taxpayer. See the Federal Register Section 8, which appears to support the inapplicability argument.

[2] Colorado has a similar statute to California, as both require pre-approval before a state tax credit is issued, with the one critical difference being that California requires credit approval *before* the grant of the conservation easement. Colorado requires approval *after* the grant. Colorado's conservation tax credit appears to be subject to SALT because most donors likely granted an easement with the expectation of receiving a tax credit.

[3] A conservative interpretation of the Florida property tax exemption statute is to treat it as a tax credit subject to SALT. Some Florida practitioners assess that this is an unlikely result. Whether the lack of reference to a "tax credit" in the statute is sufficient to remove this from SALT is unknown.

[4] Maryland has state and county property tax credits and a state income tax credit, all of which are subject to SALT.

[5] Some New York attorneys assess that Comment 5, titled *Conservation Easement Contributions* in the preface to the new regulations, includes the possibility of a "good faith valuation" of a perpetual tax credit. The Code and Treasury Regulations have many long-standing valuation methods that could be applied if the IRS is willing to accept that. The statement does not give any approved formula so this approach is also risky even though it is quantitative. At the same time, Comment 8, titled *Disclaiming the Tax Credit* in the preface to the new Regulations, does not give the form of disclaimer, so that this approach also has risk. However, the new regulation 170A-1(h)(3)(ii) suggests that the IRS expects a disclaimer.

[6] Virginia has a 40% state tax credit, which may significantly reduce the federal deduction, depending on the facts.

[7] SALT does not apply to residents of an exempt territory who do not pay federal taxes. Puerto Rico citizens, as residents of an incorporated territory, do not pay federal taxes. Donors who are citizens residing in states, however,

Now that the regulation is permanent, how exactly will it affect people?
Under the new regulation, a donor who takes a federal tax deduction for the value of the gift and receives a state or territory (hereafter collectively referred to as "state") tax credit now has to reduce the federal tax deduction by the amount of the state credit. The impact of the regulation will vary depending on the state or local tax credit. For example, the tax credit in Virginia is very generous, so after running all the numbers and consulting tax experts, a taxpayer may decide it is preferable to accept the state tax credit and forego the federal deduction, if that is what the tax expert running the numbers concludes. In which case, the taxpayer would not use a disclaimer. Note that the regulation does not affect federal wetland or mitigation credits; SALT solely focuses on state and local tax credits.

What are the exceptions?
If the total amount of the state and local tax credits received, or expected to be received, by the donor is 15% or less of the fair market value of the conservation easement transferred (or other property contributed or bargain sold), then the new regulation disregards the state tax credit. Thus the taxpayer need not offset the allowable deduction. Note that in the case of a bargain sale, the value of the "transfer" is the full fair market value of the property, not just the contributed portion.

For example, if a landowner sells a conservation easement valued at $1 million for $700,000, so that the charitable contribution is $300,000, and receives a tax credit equal to 40% of the contribution amount ($120,000), the credit will be only 12% of the value of the property transferred and can be disregarded.

Might the state tax credit be more valuable than the federal deduction?
Yes, so you must run the numbers with your expert tax advisors. Be certain that any tax software you are using actually incorporates the SALT calculation; some do not. Many states, but not all, with an income tax allow deductions for any charitable contribution recognized by the federal government. *States often use tax credits as incentives because a credit is much more valuable than a deduction*: A deduction saves the taxpayer the tax rate times the deduction, and state and local tax rates together top out at about 15%.

SALT does not affect state deductions or credits that are 15% or less of the value of the donation (the contribution in the above example). If a state were to give a deduction for three times the value of the donation, that would be treated as a credit under the new regulation and would have to be offset against the federal deduction, provided that it exceeded 15% of the value of the donation.

Is a disclaimer of the state or local tax credit permitted?
A taxpayer may disclaim the use of a state tax credit and take the full federal deduction without an offset. Paragraph 8 of the explanation of § 1.170A-1(h)(3) by the Department of the Treasury

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do pay federal taxes. The SALT regulations will apply in cases where the donors of a conservation easement on land in Puerto Rico are citizens residing in a state, subject to paying federal taxes.

states, “If a taxpayer properly declines receipt of a benefit, the taxpayer will not be treated as receiving or expecting to receive the benefit, and the charitable contribution deduction will not be reduced by the amount of the benefit” and cites Rev. Rul. 67-246, 1967-2 C.B, 104, 108, Example 3.

Neither the Service nor the Treasury has issued or plans to issue further guidance in the near future (as of November 2019) on how and when to disclaim and decline receipt of a state tax credit. The Federal Register; however, published a notice regarding the new rule:

> 8. Disclaiming the Tax Credit. …
> Although not specifically stated in the regulations, taxpayers who prefer to claim an unreduced [federal] charitable contribution deduction **have the option of not applying for a state or local income tax credit where such an application is required in order to receive the credit**. Alternatively, taxpayers may apply for a lesser amount of the credit. The Treasury Department and the IRS request comments as to how taxpayers may decline state or local tax credits in **other** situations. [FR Doc No: 2019-12418] *(Emphasis and clarification added)*

What is the *quid pro quo* issue discussed in the introduction to the regulation?
Quid pro quo involves a **bargained-for** exchange of property or cash for property, or *vice versa*. The IRS and Treasury argue that a state tax credit is one such bargained for or expected exchange. The Alliance and others argue that the unilateral conferral of a tax benefit by a state for the unilateral charitable contribution of a conservation easement to a third party is **not** a *quid pro quo* transaction. The donor has no legal right to compel the state to grant the credit, and so, according to United States Tax Court, does not meet the test for *quid pro quo.* (See, *Tempel v. Commissioner* 136 T.C. 341 (2011), *aff'd sub nom, Esgar Corp. v Commissioner*, 744 F.3d 648 (10th Cir. 2014) (a consolidated appeal of *Tempel* and *Esgar*, T.C. Memo. 2012-35), upheld on appeal by the 10th Circuit and followed by the Tax Court in *Route 231, LLC v. Commissioner*, T.C. Memo. 2014-30, *aff'd*, 810 F. 3d 247 4th Cir. 2016); and *SWF Real Estate LLC v. Commissioner*, T.C. Memo. 2015-63.)

If the state, as it has every right to do, terminates the credit after the taxpayer has contributed the easement, the taxpayer has no legal claim against the state. As the Tax Court pointed out in *Tempel*, the taxpayer has no property right in a credit until the state issues the credit. That only occurs after the taxpayer's position changes unilaterally by contributing a perpetual conservation easement, which the taxpayer cannot retract, and only if the state has not changed its credit policy. While other types of *cash* tax credits may or may not be *quid pro quo*, given prior court rulings, the in-kind tax credit for a conservation easement donation is most certainly not.

Do you have an example of a disclaimer?
The following is one example – for illustration purposes only – of a Tax Credit Disclaimer. *Please note that each disclaimer will be specific to state law. You must **consult a competent tax professional licensed in your state** to evaluate this example under your state laws*.

Please assess the various risk-balancing judgement calls embedded in this example. The example flags various such judgment calls with footnotes. Please examine carefully to address your risk tolerance in various other drafting decisions that may not be indicated by a footnote. If you decide to move forward, your own individual tax expert must advise you on a proper and unique disclaimer.[8]

Did the IRS approve this example?

No. The IRS has not reviewed or approved this or any other example, nor issued its own form or guidance on the disclaimer. Therefore, anyone using this or any disclaimer, or any good faith valuation method, ***is doing so at the person's own risk entirely***.

EXAMPLE OF A POSSIBLE TAX CREDIT DISCLAIMER[9]

This Tax Credit Disclaimer ("Disclaimer") is made this ___ day of _______, 2019 by ____ ("_____________").

RECITALS

1. [Insert name(s) of donors[10], their status and taxpayer ID number] ("Donor(s)") is/are the owner(s) of certain real property located in ________________________________, having an address of _________________ and being identified as Tax Parcel _____________________ containing approximately _______ acres (the "Property").

2. The ___________ Land Trust (the "Trust") is a __________ not-for-profit corporation, having an address at ______________________________, and is a "qualified organization" within the meaning of § 170(h)(3) of the Internal Revenue Code of 1986 as amended.

3. Donor(s) intend(s) to make a charitable contribution of a conservation easement over the Property to the Trust.

4. [Insert citation for state statutory provision allowing credit] provides a credit against [insert type of tax] in exchange for the [insert wording consistent with state statute] of a conservation easement. The credit is available to the donor of a conservation easement on land located in the State of __________. [Insert reference to state agency or other local or state authority that has oversight and insert references to applicable forms.]

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[8] Each grantor's own tax attorney should also determine the state specific document type for a complying disclaimer. For example, an affidavit form might be more preferable in some states.

[9] The most conservative approach is to sign and *record* the Disclaimer *prior* to contribution of the conservation easement so that the disclaimer is automatically available once the easement goes to record. This is a risk decision based on state law and IRS preferences, so the donor's attorney should thoroughly examine the decision.

[10] If the donor is a pass-through entity, all members of the entity should sign individually as well as having the entity sign.

5. § 1.170A-1(h)(3) of the United States Treasury Regulations ("Regulations") requires that the deduction for any charitable contribution in exchange for which a state or local tax credit is allowed must be offset by the maximum amount of said credit.

6. Paragraph number 8 of the explanation of § 1.170A-1(h)(3) by the Department of the Treasury issued with publication of said section in its final form, is titled "Disclaiming the Tax Credit." It states, "If a taxpayer properly declines receipt of a benefit, the taxpayer will not be treated as receiving or expecting to receive the benefit, and the charitable contribution deduction will not be reduced by the amount of the benefit" and cites Rev. Rul. 67-246, 1967-2 C.B, 104, 108, Example 3.

7. Donor(s) desire(s) to avoid reduction of any deduction allowed to him/her/it/them as a result of the [insert appropriate state law consistent word] of the conservation easement as required in § 1.170A-1(h)(3) of the Regulations and hereby make this disclaimer [insert state or local statute references].

DISCLAIMER

In consideration of the Recitals Donor(s) hereby DECLINE, DISCLAIM and RENOUNCE any tax credit available to him/her/it/them, or any of them, their heirs [if applicable], successors[11] and assigns, pursuant to [statutory citation], or pursuant to any other law of the State of ____________ or any locality thereof, as a result of the contribution of a conservation easement on the Property by them or any of them. Donor(s) bind themselves hereby to file no application for any such tax credit and to refuse to in any other manner claim, transfer, assign, sell, convey or use such tax credit.

WITNESS the following signatures:

_________________________________, LLC
By: ___________________________________
____________________, Manager/ Member

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________________________, Individually

[11] This is the most conservative posture for this disclaimer. It is debatable whether a donor may disclaim a tax credit for the donor's successors if such tax credit could be available to the donor's successor owners. Please consider this matter in light of your state laws with your own attorney.

[INSERT STATE-SPECIFIC NOTARY ACKNOWLEDGMENT][12]

STATE OF _____________)
) SS.:
COUNTY OF ___________)

On this ___ day of _________________, 2019, before me personally appeared ___________________, to me known and known to me to be the same person described in and who executed the within instrument, and him/her/it/them duly acknowledged that him/her/it/them executed the same on behalf of _________________________, LLC [if applicable] and individually.

____
Notary Public
SEAL My Commission expires: ____________________

QUESTIONS?
Please call or write to Leslie Ratley-Beach, Conservation Defense Director, at 802-262-6051 or Lori Faeth, Director of Government Relations, at 202-800-2230.

CAVEAT
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[12] The form of notary acknowledgment is state-specific. Any users of this form should attach the correct acknowledgment.