

PLEASE NOTE: A prior version of this memorandum contained an erroneous interpretation of the S corporation amendment (item 2). We recited what we believed Congress intended to do—permit a pass-through of a corporate contribution of appreciated property, limited only if the shareholder’s stock basis was exceeded by his pro rata share of the corporation’s basis in the contributed property. But the amended statute does not achieve that result; a further technical correction (to IRC § 1367) will be required to do so. Such a correction would presumably relate back to the effective date of the Pension Protection Act, but any plan to make an S corporation contribution based on the presumptive Congressional intent should not be executed until the statutory correction has been made. The Land Trust Alliance, and others concerned with this important issue, will be working to effect that correction.

Pension Protection Act of 2006

Summary of Certain Charitable Giving Incentives

On August 17, 2006, the President signed into law the Pension Protection Act of 2006, marking the culmination of many years of diligent efforts of the Land Trust Alliance, land trusts nationwide, and countless others. These changes to the tax code provide tremendous new incentives that enhance the benefits available from conservation easement transactions, especially for those property owners who qualify as farmers or ranchers in the year of the donation. This summary discusses those changes related to land conservation transactions, and includes as well a brief explanation of new rules related to donations of IRA assets to qualified nonprofit organizations, including most land trusts and certain other public charities. Finally, the summary briefly mentions new penalty provisions that seek to further curtail abuses relating to overvaluation of easement donations and other misstatements of tax liability.

1. Conservation Easement Incentives

Generally, a qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. One such qualified real property interest includes a restriction granted in perpetuity on the use that may be made of real property, or, in the usual parlance, a conservation easement. Under former law, contributions of conservation easements on capital gain property were subject to the same limitations and carryover rules as other charitable contributions of capital gain property, namely, a deduction at the property’s fair market value up to 30% of the taxpayer’s adjusted gross income (“AGI”), with a five-year carryover of any excess. Capital gain property means any capital asset or property used in the taxpayer’s trade or business which, if sold, would result in long-term capital gain.

Example 1: Zane Sturdley, whose AGI is \$200,000 this year, donates a conservation easement with a fair market value of \$600,000. Under former law, in the year of the donation, Zane would be allowed a deduction of \$60,000 for the

conservation easement donation in the year of the gift, and the additional \$540,000 could be carried over for up to five additional years, or until fully utilized, subject to the 30% limitation. Thus, if Zane's AGI remained at \$200,000 throughout the carryover period, \$240,000 of his contribution would be wasted.

Under the new provision, the 30% AGI limitation on contributions of capital gain property by individuals does not apply to conservation easements. Instead, the donor may deduct the fair market value of the conservation easement to the extent of the excess of 50% of the taxpayer's AGI over the amount of all other allowable charitable contributions. Moreover, individuals are allowed to carry over any qualified conservation contribution that exceeds the 50% limitation for up to fifteen years rather than the previous five-year carryover period.

Example 2: In the example above, under the new law Zane would be allowed a deduction of \$100,000 for the conservation easement donation and may carry over the excess \$500,000 for up to fifteen years, subject to the 50% limitation.

Example 3: In the year of the conservation easement donation, had Zane also made a cash contribution to the land trust of \$25,000 (which is also subject to a 50% limitation), Zane would first take into account the \$25,000 donation to the land trust. Then, he would be allowed to deduct \$75,000 of the conservation easement gift, bringing him to the overall 50%-of-AGI limitation. Zane may carry over the remaining \$525,000 of the easement donation for up to fifteen years, subject to the 50% limitation.

a. Farmers and Ranchers

In the case of an individual who is a qualified farmer or rancher for the taxable year in which a conservation easement is donated, the conservation easement deduction is allowed up to 100% of the excess of the taxpayer's AGI over the amount of all other allowable charitable contributions. Similarly, in the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the conservation easement is donated, the conservation easement deduction is allowed up to 100% of the excess of the corporation's taxable income over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to fifteen years, subject to the 100% limitation.

Example 4: Taking the facts from Example 3 above, if Zane is a farmer or rancher, in addition to the \$25,000 non-easement deduction, he would be able to deduct \$175,000 of the easement gift in the year of the donation, thus eliminating entirely his federal income tax liability, and could then carry over the remaining \$425,000 for up to fifteen years.

In order to qualify for the 100% limitation, the conservation easement must provide that the property will remain generally available for agricultural production. There is no requirement that the property actually be put to agricultural use, simply that it remain available for such

purposes. A qualified farmer or rancher means a taxpayer whose gross income from the business of farming is greater than 50% of the taxpayer's total gross income for the taxable year of the donation. (Many high-income individuals who own and operate agricultural properties may be able to arrange their financial affairs so as to meet this gross-income requirement.) Farming is defined in the Code as cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including animals) on a farm; handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the farm regularly produces more than one-half of the commodity so treated; and the planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market.

The new provisions generally apply to contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008. However, the available-for-agriculture restriction that must be contained in the conservation easement document itself pertains only to easements that are donated after the date of enactment, August 17, 2006.

b. Conservation Easements on Historic Property

Under former law, a conservation easement on an historic property qualified for deductibility if it preserved an historically important land area or a certified historic structure. A certified historic structure means any building, structure, or land which is (1) listed in the National Register or (2) located in a registered historic district and is certified by the Secretary of the Interior as being of historic significance to that district.

Under the Pension Protection Act, a charitable deduction is no longer allowable with respect to a structure or land area located in a registered historic district simply by virtue of the structure or land area's location in such district. A charitable deduction will continue to be allowed with respect to an historic district building certified as being of historic significance to the district, but the easement must preserve the exterior of the building, including the space above the building, the sides, the rear, and the front of the building. In addition, the easement must provide that no portion of the exterior of the building may be changed in a manner inconsistent with its historical character. Note that these rules do not affect the deductibility of easements on National Register properties.

For any contribution of a conservation easement relating to a structure located in a registered historic district, the taxpayer now must include with the return a qualified appraisal of the conservation easement donation, together with photographs of the entire exterior of the building and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. The taxpayer will not be allowed the deduction if the taxpayer fails to obtain and attach such appraisal. The donor and donee must also enter into a written agreement certifying that the donee is a qualified organization whose purpose is to preserve the environment, open space, or historic resources. Further, if a taxpayer is claiming a deduction in excess of \$10,000 for a donation of a conservation easement related to the exterior of a building located in a registered historic district, the taxpayer must pay a \$500 fee

to the IRS in order to qualify for the deduction, and such fee is required to be dedicated to the IRS for enforcement of the conservation-easement qualification requirements (presumably, to defray costs of auditing easement deductions).

c. Deduction Limitation for Property Subject to Rehabilitation Credits

Under present law, a taxpayer is allowed a tax credit for a taxable year in which the taxpayer places in service a rehabilitated historic structure. The Pension Protection Acts provides that, as to the donation of a conservation easement on an historic building, the amount of the deduction is reduced by an amount that bears the same ratio to the fair market value of the contribution as the sum of the rehabilitation credits allowed for such structure for the preceding five taxable years bears to the fair market value of the building on the date of the contribution. In other words, if a taxpayer donates a conservation easement on a building for which the taxpayer has claimed a rehabilitation credit in any of the five taxable years preceding the year of the easement donation, the taxpayer must reduce the amount of the easement contribution deduction proportionately.

Example 5: If the aggregate amount of credits claimed by a taxpayer within the five years preceding a conservation easement donation is \$100,000, and the fair market value of the building with respect to which the donation is made is \$1,000,000, the taxpayer must reduce the amount of the easement deduction by 10%.

The provisions relating to deductions for conservation easements on historic structures and land areas and to the rehabilitation credit are effective for contributions made after the date of enactment of the provision (August 17, 2006). The filing fee requirement is effective for contributions made 180 days after the date of enactment and thereafter.

2. Charitable Giving Incentives for S Corporations (Good Intentions, Gone Awry)

If an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the corporation's contribution in determining his or her personal income tax liability. The deduction that a shareholder may take, however, is limited to the amount of that shareholder's stock basis in the corporation. And, under former law, an S corporation shareholder would have also been required to reduce the basis of his or her stock of the S corporation by the amount of the charitable contribution that flowed through to that shareholder.

Example 6: Beezley, Inc., an S corporation with two equal shareholders, A and B, donates a conservation easement on land owned by the corporation. The easement has an allocated adjusted basis of \$10,000 and a fair market value (under the usual "before and after" appraisal method) of \$100,000. A's stock basis is \$10,000; B's basis is \$50,000. Thus, although each shareholder would be allocated half of the corporation's contribution (\$50,000), A's charitable deduction would be limited to \$10,000 (stock basis), while B would enjoy the full

\$50,000 deduction. Both shareholders would have then reduced their respective bases to zero.

The Pension Protection Act changes current law by providing that the amount a shareholder must reduce his or her basis in the S corporation stock by reason of a charitable contribution is the amount of the shareholder's pro rata share of the adjusted basis of the *contributed property in the hands of the corporation*. Nonetheless, because Congress did not amend the basis limitation on the allowable pass-through deduction, the shareholder's ability to utilize the deduction is still constrained by the amount of his or her stock basis.

Example 7: Taking the facts from the example above, although A and B may still only deduct \$10,000 and \$50,000 respectively (subject to the new 50%-of-AGI limitation, of course), they will only reduce their respective bases of the S corporation stock by \$5,000 each (the pro rata share of the corporation's adjusted basis in the donated property). Thus, A's basis will be reduced to \$5,000 and B's basis will become \$45,000.

It is likely, however, that Congress intended for the S corporation shareholders to enjoy a pass-through deduction for the full fair market value of the contribution in the example above. In order for that result to obtain, it will be necessary to enact curative legislation (affecting IRC § 1367) that lifts the basis limitation for the pass-through deduction. We understand that the Land Trust Alliance will be actively advocating such a statutory correction.

This provision applies to contributions made in taxable years beginning after December 31, 2005, and taxable years beginning before January 1, 2008.

3. Charitable Gifts from Individual Retirement Accounts

Prior to enactment of the Pension Protection Act of 2006, an amount withdrawn from a traditional Individual Retirement Account ("IRA") or a Roth IRA was subject to income tax, and then, if those post-tax dollars were contributed to a charitable organization, the contribution was subject to the normally applicable limitations on deductibility. As a general matter, withdrawals from IRAs are includable in taxable income to the extent that the amount withdrawn represents a return of those contributions that were previously deducted by the taxpayer. In turn, if cash is donated to a public charity, for example, the amount deductible is limited to 50% of the taxpayer's AGI for that year, with the remaining amount carried over for five additional years.

Example 8: Fern Dwyer, a 72-year-old taxpayer with an AGI of \$40,000, owns an IRA worth \$100,000. Fern has decided to withdraw the entire amount of her IRA and donate it to the local Humane Society. Under the former law, first the \$100,000 withdrawal would increase Fern's current-year AGI to \$140,000. Then, the donation of \$100,000 to the Humane Society would entitle Fern to a \$70,000 deduction in the year of the gift (50% of \$140,000), with the remaining \$30,000 carried over for five additional years. Thus, assuming Fern is subject to a 25% effective federal income tax rate and has no other deductions, she would have a

current-year tax liability of \$17,500 (25% of \$70,000) rather than \$10,000 (25% of \$40,000) as a result of the inclusion of the IRA withdrawal in her taxable income.

Under the Pension Protection Act of 2006, a previously taxable IRA distribution is now excluded from gross income if the amount is then the subject of a “qualified charitable distribution,” i.e., any distribution from an IRA directly by the IRA trustee to a public charity described in IRC Section 170(b)(1)(A) (other than a supporting organization or a donor-advised fund).

Example 9: Under the new law, if Fern wishes to contribute her \$100,000 IRA to the Humane Society, the entire amount would be excluded from gross income in the year of the withdrawal/donation. Although Fern would not be allowed a charitable deduction for the gift to the Humane Society, she would not be liable for any additional tax as a result of her gift of the IRA to the public charity.

Note that the exclusion may not exceed \$100,000 per taxpayer per taxable year, and distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½. Further, the exclusion applies only if the charitable contribution would otherwise be entirely deductible, determined without regard to the AGI-related limitations. For example, if the deductible amount is reduced because the taxpayer received some sort of benefit in the exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is also not available with respect to the IRA distribution.

4. Substantial and Gross Overstatements of Valuations of Property

The Tax Code imposes penalties on taxpayers for substantial and gross misstatements resulting in an underpayment of income tax. Under former law, a substantial misstatement was a value claimed that was at least twice (200% or more) the amount determined to be correct, and a gross misstatement was at least four times (400% or more) of the correct value. The penalty for a substantial misstatement is 20% of the underpayment of tax, and 40% of the underpayment for a gross misstatement. However, no penalty is imposed unless the portion attributable to the misstatement exceeds \$5,000. Moreover, a taxpayer will not be subject to any penalty if (1) the value claimed on the return is supported by substantial authority; (2) the facts involved are disclosed on the taxpayer’s return and there is a reasonable basis for the claimed value; or (3) the taxpayer can show that there was a reasonable cause for the undervaluation and the taxpayer acted in good faith.

The Pension Act changes the current law by lowering the threshold for the degree of misstatement that invokes the penalties. Now, a substantial misstatement means one that is 150% or more of the amount determined to be correct, and a gross valuation misstatement means that the claimed value is at least 200% of the correct value. Further, the reasonable cause exception does not relieve a taxpayer from penalties in cases of gross misstatements of value. The penalties provision is effective for returns filed after the date of enactment (August 17, 2006).

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Coblentz, Patch, Duffy & Bass, LLP, offers a wide range of legal services related to conservation transactions, including tax planning for individuals, families, and business entities, conservation easement drafting and negotiation, as well as non-profit governance matters. The firm's land conservation and business attorneys would be glad to provide guidance on the myriad opportunities available under the Pension Protection Act and are especially equipped to assist small corporate clients take full advantage of the greatly enhanced tax benefits for contributions of appreciated property from closely-held corporations, including C corporations that may be qualified to elect to be treated as S corporations next year. Please contact Bill Hutton at the number listed below for more information.

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