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Mitigating Tax Consequences for the Mitigation Banker

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As environmental issues move to the forefront of concerns to be addressed in property transactions, state and local governments, with some involvement from the federal level, have created numerous mechanisms to alleviate the impact of development on the environment. One popular, well-established system for offsetting the impact of development on wetlands is that of the mitigation bank.

A mitigation bank is a wetland resource area that has been restored, enhanced, established, or preserved for the purpose of providing offsets for impacts to water resources within the same geographic area.[i] The value of the bank lies in the number of mitigation credits identified with the mitigation banking permit. These credits may be purchased by developers in order to offset the negative wetland impacts of new development.

Procedurally, a mitigation bank is created when an eligible property owner grants a conservation easement over all or a portion of his property to the relevant state entity, such as a water management district or forestry commission. The property owner simultaneously contractually obligates himself to restore the property to its original wetlands condition (or enhance, establish or preserve the wetlands) in accordance with specific instructions from the local authority. In most cases the property owner must also set aside money in a trust fund to provide for the future maintenance of the property in perpetuity.

In exchange for the conservation easement and related commitments, the property owner receives from the local or federal authority a mitigation banking permit which grants a specified number of mitigation credits. Generally, only a portion of the granted mitigation credits are available for withdrawal at the time the permit is issued. The remainder of the mitigation credits are released and made available in stages as restoration work is completed and the set aside of funds is accomplished.

Once released, the mitigation credits may be traded within a market established by the government authorities. Generally, mitigation credits may only be purchased by landowners within the specific geographic area where the mitigation bank exists, so that the mitigation benefits inure to the water source upon which the development encroaches.

Tax Consequences from the Grant of the Conservation Easement in Exchange for Mitigation Credits.

There is very little formal guidance regarding the tax consequences of the grant of a conservation easement in exchange for the issuance of a mitigation banking permit. The only guidance directly on point is a Private Letter Ruling issued by the National Office of the Internal Revenue Service in 1996.

LTR 9612009 deals with a public utility company which owned real property adjacent to its plant for over 20 years. Although the taxpayer had considered several different uses for the property, due to environmental and regulatory constraints, the taxpayer was unable to develop or otherwise use the property for any of its intended purposes. The taxpayer proposed to establish a mitigation bank using the excess real property. This entailed the grant of conservation easements on the property in exchange for the mitigation credits. It was represented that the taxpayer intended to use some of the mitigation credits to offset adverse impacts on future projects. It was also represented that the taxpayer might sell some of the excess credits or exchange the excess credits for other mitigation credits.

Based upon these facts the Service ruled that the grant of the perpetual conservation easement by the taxpayer to the water management district in exchange for mitigation credits will be treated for federal income tax purposes as a taxable sale of the property. Although the letter ruling did not address the computation of the amount of gain to be recognized, it is clear from the discussion that the "sale price" of the property would be equal to the value of the mitigation credits received. The taxpayer's adjusted tax basis in the property with respect to which the conservation easement was granted would then be offset against this amount to determine the amount of taxable gain.

The analysis in the Private Letter Ruling is likely correct (with one exception noted below) based upon a review of basic tax principles applicable to sales or exchanges of property. Code Sec. 61(a)(3) requires inclusion in gross income of gains derived from dealings in property unless specifically excluded by another provision of Subtitle A of the Code. Code Sec. 1001(a) provides, in pertinent part, that "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis [of such property]." Code Sec. 1001(b) provides that the "amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." Most importantly, Code Sec. 1001(c) provides that the entire amount of the gain realized on the sale or exchange of property shall be recognized unless a specific exception for such transaction is provided in the Code. It is clear from reading Code Sec. 1001 in its entirety that the disposition of the property by granting the conservation easement in exchange for the marketable mitigation credits is a taxable event, barring the application of a non-recognition provision.

To calculate the gain to be recognized under Code Sec. 1001 on the exchange, the selling price of the taxpayer's property will be the fair market value of the mitigation credits issued in exchange for the conservation easement.[ii] If the taxpayer grants a perpetual easement over its land and retains no beneficial interest, then the sale is treated, for federal income tax purposes, as a sale of the entire property. Revenue Ruling 72-255. Therefore, if the taxpayer retains no

significant beneficial interest, then his entire adjusted basis in the property upon which the conservation easement is granted may be used for purposes of calculating the gain.

In the Private Letter Ruling, the Service ruled that the expenditures made by the taxpayer to "restore" the property over which it granted a perpetual conservation easement to a wetlands status would be added to the tax basis of the mitigation credits. That is, those expenses could not be used to offset any gain from the initial receipt of the mitigation credits, but, rather, would reduce the amount of gain when the mitigation credits were ultimately sold. However, there is authority that the seller's estimated costs of meeting the contractual obligations imposed by the buyer should be included in the basis of the property sold for the purposes of computing the amount of gain realized on the sale.[iii] Based upon this authority (and contrary to the position taken by the Service in the Private Letter Ruling), the cost basis of the property over which the conservation easement is granted should be increased by the reasonable estimate of the amount of his contractually obligated costs for purposes of computing gain or loss on the grant of the conservation easement.

If, under state law, the conservation easement and the mitigation credits are deemed to be interests in real property, then the exchange may qualify as a like-kind exchange under Code Sec. 1031 if all of the other elements of a Code Sec. 1031 exchange are present. Although a survey of all the states is beyond the scope of this article, in Florida, for example, the mitigation credits will most likely not be classified as interests in real property.[iv] Therefore, at least in Florida, the exchange is not likely to qualify for non-recognition under Code Sec. 1031. However, if the circumstances warrant and the grant of the conservation easement is an involuntary event, Code Sec. 1033 might be available to allow non-recognition.

Based upon the analysis of the Private Letter Ruling as discussed above, which would treat the receipt of mitigation credits in exchange for the grant of a conservation easement as a full recognition event, the taxpayer must face the unwelcome prospect of receiving "phantom income" in the form of recognized gain with no matching cash consideration that can be applied to pay tax liabilities. If the taxpayer is fortunate enough to have sales of the mitigation credits lined up that can be closed in the same taxable year or within the succeeding taxable year but before the taxes must be paid, this prospect is not as daunting. The mitigation credits received by the taxpayer will have a cost basis in the hands of the taxpayer under Code Sec. 1012 equal to the value of such credits at the time of receipt, which will either eliminate or substantially minimize gains from subsequent sales of the credits.

Additional relief from the possible phantom income problem may also be afforded by the manner in which mitigation credits are typically awarded. A specific number of credits will initially be awarded but only a small portion of this number will be issued at the time the conservation easement is granted. In most situations, the balance of the credits will be issued in increments as the taxpayer completes his remediation requirements and contributes monies to a trust fund to maintain the property in perpetuity. Thus, the bulk of the credits that are ultimately to be awarded are beyond the taxpayer's reach until he has completed the various phases of restoration. If one or more of these "payments" in the form of issuance of mitigation credits will occur in a subsequent taxable year, the taxpayer may be entitled to report his gain on the installment method under Code Sec. 453. However, the exact value of the credits that will be received in future installments generally cannot be determined until the mitigation credits are actually

released because the value of the credits is so dependent upon market conditions. Therefore, the contingent price sales rules under Reg. § 15A.453-1(c) will most likely apply for allocating basis recovery as mitigation credits are received.

In most instances with which the authors are familiar, the remaining credits will be issued in accordance with a fixed time schedule which is tied to the time frame in which the taxpayer is required to perform his contractual commitments to obtain the credits. In such a case, Reg. § 15A.453-1(c)(3) holds that the basis shall be allocated to the taxable years in which payment may be received in equal annual increments. Alternatively, under such regulations, the property owner may ask the Commissioner to agree to another reasonable method of recovery. For instance, because the exact number of credits to be received is known, the property owner might ask to allocate the basis ratably to each credit, which may alleviate the burden of having the basis allocated over such a long period of time.

Most deferred awards of mitigation credits do not bear interest; as a result, if installment reporting is utilized, the original issue discount rules of Code Secs. 1272 through 1275 will apply. In addition, the property owner must consider whether the toll charge under Code Sec. 453A will apply.

The character of any gain the taxpayer will be required to recognize from the taxable exchange of a perpetual conservation easement for mitigation credits will generally be dependent upon the character of the wetlands property in the taxpayer's hands. If the property has been held by the taxpayer for an extended period of time either for investment purposes or for use in his trade of business, the gains will likely qualify for long term capital gain treatment. On the other hand, if the taxpayer has a track record of acquiring real property to create mitigation banks and selling mitigation credits to developers, and commences the process of creating a mitigation bank promptly after the property was acquired, the Service may argue that the taxpayer is a dealer in such properties and that the gain should be taxed as ordinary income. Moreover, even if the property is either investment property or Code Sec. 1231 property in the taxpayer's hands, Code Sec. 1257 may apply to recharacterize any gain from the disposition of converted wetlands (i.e., areas that once were wetlands but were subsequently converted into farmland) as ordinary gain. Generally, Code Sec. 1257 will not apply to any plantings that preceded its effective date of March 1, 1986, and will only apply to plantings after that date if such property was not planted with other crops prior to the effective date.

Tax Consequences from the Sale of the Mitigation Credits.

Generally, taxpayers who receive mitigation credits in connection with the creation of a mitigation bank do so with the expectation that such credits will be resold to developers and do not hold the credits for a significant period of time. In addition to failing to meet the holding period requirements for long-term capital gain treatment, if a property owner enters into multiple sales transactions instead of one bulk sale, it is likely that the property owner will be deemed a dealer with respect to the credits, causing the credits to be treated as inventory with any gain from their sale as ordinary.

Conclusion.

Other than general statutory, administrative, and judicially created rules governing sales and exchanges of property, there is no definitive guidance upon which a taxpayer may rely to determine the tax consequences arising from the issuance of a mitigation banking permit in exchange for the grant of a perpetual conservation easement, together with acceptance of contractual commitments to remediate and restore property. Although none of the issues identified in this article are novel, the volume of these transactions is growing and the resolution of each of these issues within the context of such an exchange are perhaps sufficiently unique to warrant guidance (other than a private letter ruling, which of course cannot be relied upon) from the Service.

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Charles H. Egerton and Christine L. Weingart are members of Dean Mead's Tax Department. Mr. Egerton has been named an Outstanding Tax Attorney by *The Best Lawyers in America*, *Chambers USA - America's Leading Business Lawyers* and *Florida Trend Magazine*. He is a recipient of the Gerald T. Hart Award, which honors the Outstanding Tax Attorney in the State of Florida by The Florida Bar Tax Section.

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[i] U.S. Environmental Protection Agency Mitigation Banking Factsheet available at http://www.epa.gov/owow/wetlands/facts/facts16.html

[ii] Code Sec. 1001(b).

[iii] *Herzog Building Corp. v. Comm'r*, 44 T.C. 694 (1965); *Bryce's Mountain Resort, Inc. v. Comm'r*, 50 TCM 164 (1985); Rev. Proc. 92-29, 1992-1 C.B. 748.

[iv] "Mitigation credits" in Florida are defined in Section 373.403 of the Florida Statutes as "... a standard unit of measure which represents the increase in ecological value resulting from restoration, enhancement, preservation or creation activities." The only evidence/record of the mitigation credits is the mitigation bank permit which the water management district grants the property owner. As credits are used or transferred, this is recorded by changing the number of credits left on the permit. This is in distinct contrast to interests in real property, which are recorded on property records. Additionally, Section 62-341.215 of the Florida Administrative Code, which deals with environmental resource permits granted for improvements to land which do not rise to the level requiring mitigation, specifically provides that the general permit granted does not convey to the permittee or create in the permittee any property right, or any interest in real property. Although this section of the Florida Administrative Code does not apply specifically to mitigation credits, the general permits to which it does apply are analogous to the mitigation bank permit which authorizes mitigation credits, both being permits issued pursuant to the authority of the Department of Environmental protection, and both being permits with development of lands subject to wetland restrictions.