Tax Tip

Update of the Tax Consequences of the Formation and Operation of a Mitigation Bank

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In a previous column that appeared in this publication in 2009,[1] authors Charles H. Egerton and Christine L. Weingart addressed the tax consequences arising from the grant of a conservation easement in exchange for mitigation credits, as well as the tax consequences from the sale of the mitigation credits themselves. This column will serve to both update and expand on the discussion in the previous column relating to the tax consequences associated with the formation and operation of a mitigation bank.

As was explained in the previous column, 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.[2] The value of a particular mitigation bank lies in the number of mitigation credits identified with the mitigation banking permit and the market value of these credits. The resultant credits may then be purchased by landowners and/or developers in order to offset the negative wetland impacts of new development projects on their land.

Mitigation banks are created when an eligible property owner grants a conservation easement over all or a portion of its property to a particular state entity, such as a water management district or a forestry commission. The property owner simultaneously contractually obligates itself to restore the property to its original wetlands condition (or enhance, establish or preserve the wetlands) in accordance with the specific requirements imposed in a mitigation bank agreement entered into with a state and/or federal agency. In many, if not 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 state or federal agency a mitigation banking permit that grants a specified number of mitigation credits. Generally, only a portion of the granted mitigation credits is 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.

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Once released, the mitigation credits may be traded within a market established by the government agencies. 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 benefit of the water source upon which the development encroaches.

Tax Consequences of Forming a Mitigation Bank

At the time the 2009 column was published, the only published guidance addressing the grant of a conservation easement in exchange for the issuance of a mitigation banking permit was a private letter ruling issued in 1996. In LTR 9612009,[3] the taxpayer, a public utility, intended to establish a mitigation bank on a certain portion of its real property. Over the years, the taxpayer considered several uses for the property, but because of environmental and regulatory constraints, the property was never used and was considered surplus property. The taxpayer proposed to establish a mitigation bank on the surplus property. This entailed the grant of a perpetual conservation easement on the surplus property in exchange for mitigation credits. The taxpayer represented that it intended to use some of the credits to offset adverse impacts of future projects that it intended to undertake on its own properties, but also stated that it might sell some of the excess credits to third parties or exchange some of the excess credits for other credits.

The value of a particular mitigation bank lies in the number of mitigation credits identified with the mitigation banking permit and the market value of these credits.

Based upon these facts, the IRS ruled that the grant of the perpetual conservation easement by the taxpayer to the water management district in exchange for mitigation credits was to be treated for federal income tax purposes as a taxable sale or exchange of the property. The analysis set forth in the ruling to explain its conclusion is likely correct. Code Sec. 61(a)(3) requires inclusion in gross income of gains derived from the sale or exchange of property. Code Sec. 1001(a) provides 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 excluded under another provision of Subtitle A of the Code. The grant of a perpetual conservation easement that results in the retention of bare legal title to the affected property by the taxpayer but deprives it of all or substantially all of the beneficial use of the property (which is almost always the case with the creation of a mitigation bank) is treated as equivalent to a complete disposition of the property.[4] Thus, the taxpayer will be treated as having transferred its property *via* the grant of the perpetual conservation easement in exchange for marketable mitigation credits in a fully taxable transaction under Code Secs. 61(a)(3) and 1001 unless such gain is excludible under another provision of the Code.[5]

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 under Code Sec. 1001(b). The taxpayer's adjusted tax basis in the property upon which the conservation easement was granted would then be offset against this amount to determine the amount of taxable gain.

There have been two new IRS pronouncements addressing mitigation banks since the 2009 column. First, in 2012, the IRS issued LTR 201222004.[6] In that ruling, the taxpayer-owned ranchland which it had held for five years and which it acquired for the purpose of development, but had not engaged in any physical development activities on any part of the ranch. The taxpayer negotiated a mitigation bank agreement with a governmental agency pursuant to which the taxpayer would grant a perpetual conservation easement to the agency and would receive mitigation credits in exchange. As was the case in LTR 9612009, the IRS concluded that the conveyance of the conservation easement in exchange for mitigation credits was a taxable sale or exchange of property under Code Sec. 1001 for federal income tax purposes.

The second ruling, LTR 201408031,[7] did not address tax issues associated with formation of a mitigation bank. Rather, in that ruling the taxpayer, a tax-exempt charitable organization, requested a ruling as to whether its activities in making numerous sales of mitigation credits to third

parties would result in unrelated business taxable income under Code Sec. 512(a)(1). The IRS ruled that the tax-exempt entity's activities in making numerous sales of credits over an extended period of time constituted the active conduct of a trade or business of selling mitigation credits, but also determined that this business was directly related to the entity's exempt purposes and, thus, did not result in unrelated business taxable income.

Neither LTR 201222004 nor LTR 201408031 contradict the conclusions set forth in the 2009 column that the issuance of a mitigation banking permit in exchange for the grant of a perpetual conservation easement is a taxable event. Accordingly, for the reasons cited in our 2009 column and those set forth above, we reaffirm that conclusion. Note that 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.

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 property in the taxpayer's hands. If the property on which the mitigation bank will be created is a capital asset or a Code Sec. 1231 asset (property used in a trade or business) which has been held by the taxpayer for over one year, the taxable gain from the exchange of the conservation easement will be long-term capital gain.[8] One would ordinarily assume that a taxable disposition of a large parcel of undeveloped land that has been held for more than one year would be eligible for treatment as long-term capital gain. However, consider a situation in which a taxpayer who has formed one or more mitigation banks in the past and who is treated as having been regularly engaged in the trade or business of selling mitigation credits owns other property that would lend itself to the creation of an additional mitigation bank. In such a case, it might be determined that the taxpayer's principal purpose in acquiring and holding such property was to create a new mitigation bank and acquire additional mitigation credits that it could sell in the ordinary course of its trade or business of selling mitigation credits. If so, the character of gain on the taxable exchange of a perpetual conservation easement for mitigation credits would more likely be ordinary, rather than capital, in nature.

Although a taxpayer may be regarded as being engaged in the trade or business of selling mitigation credits to customers, its status as such is not necessarily determinative of the characterization of other property owned by the taxpayer on which a mitigation bank may be placed. Several court decisions have held that even a dealer in real property can hold other properties for investment purposes and enjoy the benefit of long-term capital gain treatment for any gains from the disposition of such properties.[9] Even though these cases hold out the possibility that a taxpayer who is a dealer in properties may hold other property for investment, there is a heavy burden on the taxpayer to establish that its investment motives with respect to such properties were predominant.[10] If there is credible evidence that a particular piece of property was set aside by a taxpayer for an investment purpose that will withstand the "heavy burden" test mentioned above, the character of gain on the exchange of a perpetual conservation easement for mitigation credits may be capital. However, in the absence of any such evidence, any taxable gain resulting from the exchange of the perpetual conservation easement on such property for mitigation credits may result in ordinary income.

To calculate the gain recognized on the exchange under Code Sec. 1001, the amount realized (the "selling price") of the property will be the fair market value of the mitigation credits issued in exchange for the conservation easement under Code Sec. 1001(b). Assuming that the taxpayer grants a perpetual conservation easement over the property and retains no beneficial interest with significant value in such property, the exchange will be treated for federal income tax purposes as a taxable disposition of the entire property with respect to which the conservation easement was granted.[11] Thus, the taxpayer's entire adjusted basis in such property (possibly increased in the manner discussed below) may be used for purposes of calculating gain.

As noted in the preceding paragraph, the gain on the taxable exchange is measured by the excess of the amount realized over the adjusted tax basis of the property that was exchanged, as required under Code Sec. 1001(a). There are two planning tools that may be potentially helpful in this regard.

First, the "amount realized" will be the current fair market value of any mitigation credits received at the time of delivery of the perpetual conservation easement, plus the present value of mitigation credits that will be received in the future.[12] It is advisable that a taxpayer retains the services of a qualified appraiser who has worked extensively in the mitigation banking area and has first-hand knowledge of the market for these mitigation credits to establish the fair market value of the credits. Mitigation credits that are committed to be delivered in the future have a number of variables that will most likely affect their current fair market value, including: (i) the required actions that must be completed by the taxpayer as a condition to receiving such additional credits and

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any uncertainties that may exist with respect to when or whether such additional credits will be received and (ii) if the credits will most likely be received over several years in the future, there are uncertainties as to what the market will be for these mitigation credits and even whether there will be any market for them at all (such as occurred in the 2008–2011 timeframe when development work virtually came to a standstill during the Great Recession and the market for these credits was almost non-existent). A knowledgeable and experienced appraiser who works with mitigation bankers will likely significantly discount the value of these deferred mitigation credits because of these uncertainties. This, in turn, will reduce the "amount realized" by the taxpayer in computing the amount of its gain on the taxable exchange.

We would also expand this observation to include the need for guidance related to the capitalization of expenditures made in compliance with a mitigation bank agreement to restore or preserve property, as well as guidance with respect to the classification of mitigation credits held by a taxpayer as either dealer or investor property.

If, however, the property upon which the taxpayer grants a perpetual conservation easement was either a capital asset or a Code Sec. 1231 asset, and if under the mitigation bank agreement the mitigation credits will be received by the taxpayer over two or more of its taxable years, the taxpayer may report its gain on the installment basis under Code Sec. 453.[13] Because the fair market value of the mitigation credits to be received in future years most likely cannot be definitively determined as of the date of the grant of the conservation easement and receipt of the mitigation bank permit, the transaction will most likely be treated as a contingent price sale under Reg. §15A.453-1(c) and will be subject to the basis recovery rules under that Regulation. In most instances, the taxpayer will receive an initial allotment of mitigation credits upon filing of the conservation easement and the issuance of the mitigation bank permit, and the balance of the mitigation credits will either be issued over a fixed time schedule (usually tied to the times for completion of specified tasks to be performed by the taxpayer under the mitigation bank agreement) or by an outside date. In such a case, Reg. §15A.453-1(c)(3)(i) provides that the taxpayer's basis must be prorated in equal annual increments over the maximum pay-out period. Alternatively, the taxpayer may apply for a ruling under Reg. §15A.453-(1)(c)(7) requesting an alternative approach for basis recovery if it can establish to the satisfaction of the IRS that the general rule would substantially and inappropriately defer recovery, of the taxpayer's basis. In this regard, it may be cogently argued that, because the exact number of mitigation credits to be received is known at the outset, the taxpayer should be able to allocate its basis ratably to each of the credits to be received. If agreed upon by the IRS, this approach would alleviate the possibility of an unwarranted deferral of basis recovery if the credits are released earlier.

Most deferred issuances of mitigation credit arrangements make no provision for the payment of interest. Consequently, if installment reporting is utilized, the original issue discount rules of Code Secs. 1272 through 1275 will apply. In addition, the taxpayer should also determine whether the toll charges imposed under Code Sec. 453A will apply.

Secondly, in computing the taxpayer's adjusted tax basis in the property for purposes of measuring the gain from the taxable exchange under Code Sec. 1001(a), the authors believe that the taxpayer may be able to increase its tax basis in such property by the reasonably estimated costs of restoring and maintaining the property that the taxpayer is contractually required to incur under the mitigation bank agreement in order to receive the deferred mitigation credits. Although this is contrary to the position taken by the IRS in LTR 9612009, it is directly supported by *Herzog Building Corp.*,[14] *Bryce's Mountain Resort, Inc.*,[15] and Rev. Proc. 92-29.[16] The IRS concluded in LTR 9612009 that these costs should be added to the tax basis of the mitigation credits received by the taxpayer (rather than to the basis of the property with respect to which the perpetual conservation easement was granted). The letter ruling, however, does not discuss *Herzog*, *Bryce's Mountain Resort* or Rev. Proc. 92-29. The authors believe that a taxpayer has a very strong argument (and certainly a reasonable basis to assert) that it is entitled to increase its tax basis in the entire property by such reasonably estimated expenses for purposes of computing the amount of its taxable gain on the exchange based upon the authorities cited above. This would further reduce the amount of the taxpayer's taxable gain required to be reported from such a transaction.[17]

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Tax Consequences of Operating a Mitigation Bank

The primary issues associated with operating a mitigation bank are (1) whether costs associated with the mitigation credits, such as additional expenditures made to prepare and conserve the property covered by the perpetual conservation easement, are required to be capitalized into the cost of such credits, and (2) whether the character of gain on the sale of the mitigation credits is capital or ordinary in nature.

The taxpayer's initial basis in each mitigation credit received is the value of such credit that is included in the amount realized by the taxpayer in the taxable exchange of a conservation easement for mitigation credits.[18] If the mitigation credits received by the taxpayer are properly treated as capital assets, any expenditures made by the taxpayer pursuant to the mitigation bank agreement to restore the property, or to enhance, establish or preserve wetlands on the property, will be treated as properly chargeable to capital and added to the taxpayer's basis under Code Sec. 1016.[19] If, on the other hand, the taxpayer is deemed to be engaged in the trade or business of selling mitigation credits to customers in the ordinary course of its trade or business, such expenditures must be capitalized and added to the taxpayer's basis in its mitigation credits under Code Sec. 263A.[20]

The primary issue faced by mitigation bankers subsequent to the formation of their mitigation banks is whether they will be treated as either dealers or investors with respect to the mitigation credits held by them. An in-depth examination of the case law related to this issue is beyond the scope of this column, but the test for making this determination is relatively easy to articulate. Code Sec. 1221(1) excludes from the definition of a capital asset "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Such property is commonly referred to as "dealer property." A number of courts have developed factors to be applied in determining whether property is dealer property in the hands of the taxpayer.[21] In one frequently cited case, the court stated that, among these judicially created factors, the most significant are (1) the number, extent, continuity and substantiality of sales and (2) the extent and nature of the taxpayer's efforts to sell the property.[22] Applying this analysis in the mitigation bank arena, if the taxpayer utilizes the mitigation credits it receives in connection with one or more developments undertaken by it and/or bulk sells the credits to one or a very small number of buyers and the sales are infrequent, the mitigation credits will likely be treated as capital assets in the hands of the taxpayer. If the mitigation credits that are sold or exchanged are held by the taxpayer for a period in excess of one year, any gains derived from such sales will likely qualify for long-term capital gain treatment under Code Sec. 1222(3). On the other hand, if the taxpayer engages in numerous sales of the mitigation credits on a continuous basis to a large number of buyers, and if such sales continue over an extended period of time, it is highly likely that these will be treated as sales of dealer property with the result that any gains from such sales will be treated as ordinary income.[23]

Conclusion

In the conclusion to our 2009 column on the topic of tax issues related to mitigation banks we observed that, other than general statutory, administrative and judicially created rules governing sales and exchanges of property, there is no definitive guidance upon which a taxpayer can rely to determine the tax consequences arising from the issuance of mitigation credits in exchange for grant of a perpetual conservation easement. Unfortunately, the absence of definitive guidance on this issue has continued for the nine years since publication of our prior column. We would also expand this observation to include the need for guidance related to the capitalization of expenditures made in compliance with a mitigation bank agreement to restore or preserve property, as well as guidance with respect to the classification of mitigation credits held by a taxpayer as either dealer or investor property. Although none of these issues are novel, the number of mitigation banks in the United States has grown significantly and the resolution of these issues within the context of mitigation banking arrangements is sufficiently unique to warrant guidance (other than the issuance of private letter rulings which cannot be relied upon) from Treasury or the IRS.

ENDNOTES

1. Charles H. Egerton & Christine L. Weingart, *Tax Tip, Mitigating Tax Consequences for the Mitigation Banker*, J. PASSTHROUGH ENTITIES, Jan.–Feb. 2009.
2. U.S. Environmental Protection Agency Mitigation Banking Factsheet available at *www.epa.gov/cwa-404/mitigation-banking-factsheet*.
3. LTR 9612009 (Dec. 18, 1995).
4. *Scales*, 10 BTA 1024 (1928); Rev. Rul. 54-575, 1954-2 CB 145, as modified by Rev. Rul. 72-433, 1972-2 CB 470.
5. If under state law the conservation easement and the mitigation credits are treated as interests in real property, the exchange might qualify as a like-kind exchange under Code Sec. 1031, if all of the other elements of a Code Sec. 1031 exchange are present. It should be noted, however, that if the taxpayer obtains such mitigation

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credits for resale to third parties, the mitigation credits may not be eligible replacement property under Code Sec. 1031(a)(2)(A).

[6] LTR 201222004 (Nov. 29, 2011).

[7] LTR 201408031 (Nov. 27, 2013).

[8] Caveat: Code Sec. 1257 may apply to recharacterize any gain that would otherwise be taxed as long-term capital gain from the disposition of converted wetlands (*i.e.,* areas that once were wetlands but were subsequently converted into farmland) as ordinary income. 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 such effective date.

[9] *See, e.g., O.M. Fraley,* 66 TCM 100, Dec. 49,146(M), TC Memo. 1993-304; *D.R. Cottle,* 89 TC 467, Dec. 44,175 (1987); and *Maddux Construction Co.,* 54 TC 1278, Dec. 30,174 (1970).

[10] *See, R.L. Graves,* CA-4, 89-1 USTC ¶9170, 867 F2d 199; and *Slappey Drive Industrial Park,* CA-5, 77-2 USTC ¶9696, 561 F2d 572. *See, also,* Charles H. Egerton & Edward A. Waters, *Tax Tip, May Dealers in Real Property Hold Some Properties for Investment,* J. PASSTHROUGH ENTITIES, Jan.–Feb. 2016.

[11] *Supra* note 4.

[12] Code Sec. 1001(b).

[13] If, on the other hand, such property is dealer property, installment reporting will not be available. Code Secs. 453(b)(2)(A) and 453(l).

[14] *Herzog Building Corp.*, 44 TC 694, Dec. 27,509 (1965).

[15] *Bryce's Mountain Resort, Inc.*, 50 TCM 164, Dec. 42,164(M), TC Memo. 1985-293.

[16] Rev. Proc. 92-29, 1992 CB 748.

[17] If the taxpayer's taxable gain upon the grant of the conservation easement in exchange for mitigation credits will be treated as long-term capital gain, and if the taxpayer anticipates that it will market the mitigation credits in such a manner that it will likely be deemed to be engaged as a dealer in the sale of such credits, thus producing ordinary income from such sales, it may be more advantageous for the taxpayer not to attempt to reduce its gain from the deemed sale on the initial exchange for its reasonably estimated costs of compliance with the mitigation bank agreement. It might instead adopt the approach set forth in LTR 9612009 and allow the basis of the mitigation credits to be increased for these expenditures, thus minimizing ordinary income rather than long-term capital gains. Of course, the time value of money should also be considered in making this decision.

[18] Code Sec. 1012.

[19] If the taxpayer included the estimated amount of these costs in the tax basis of its property for purposes of computing its gain from the exchange of the conservation easement for mitigation credits under the authority of *Herzog Building Corp.* (*infra* note 13), it will not be able to include these amounts again in the tax basis of the mitigation credits. *Cf.,* Code Secs. 1311 and 1312(7).

[20] *Id.*

[21] *See, e.g., Winthrop,* CA-5, 69-2 USTC ¶9686, 417 F2d 905.

[22] *Biedenharn Realty Co.,* CA-5, 76-1 USTC ¶9194, 526 F2d 409, *cert. denied* 97 SCt 64. The court in *Biedenharn* also included a third factor, which was the degree of improvements made by the taxpayer to the property, but this factor relates to a parcel of real property and is not relevant to mitigation credits.

[23] In an analogous situation, LTR 201408031, which is discussed earlier in this column, involved a tax-exempt organization that proposed to engage in numerous sales of mitigation credits to a large number of buyers and such sales would continue for a number of years. The LTR cited Reg. §1.513-1(c)(1) (dealing with unrelated business taxable income) in support of its determination that the frequency and continuity of the tax-exempt entity's sales of mitigation credits was indicative of a trade or business regularly carried on with respect to the sale of these credits. The tax-exempt organization was ultimately found not to have unrelated trade or business income for the sole reason that its activities in the sale of mitigation credits were directly related to its tax-exempt purpose.

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