Allocating Charitable Conservation Easement Deductions to Equity Investors

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The real estate development industry has benefited from the investment tax credits in rehabilitation and development projects. However, to date, few developers have realized the benefits of donating conservation easements in their projects. As discussed in this article, the charitable deduction for donations of conservation easements can be used to attract equity investors to a commercial real estate project.

To illustrate how a conservation easement can be used in this manner, assume that “Owner LLC” owns an historic building located in a major urban center in the United States (the “Property”). Also assume that Owner LLC is a limited liability company that is classified as a partnership for federal income tax purposes. Owner LLC rehabilitated the Property without changing its historic features. In order to attract additional equity investment by “Investor LLC” to the project, Owner LLC proposes to donate a preservation and conservation easement on the Property and allocate all or a substantial portion of the resulting charitable deduction to Investor LLC. To this end, assume that Investor LLC is admitted as a member of Owner LLC with a five percent membership interest in return for a capital contribution to Owner LLC.

A conservation easement permanently restricts an owner’s ability (and the ability of future owners) to develop certain portions of the property and/or to make alterations to these special architectural features in any manner that adversely affects the historic or architectural elements of the property. The easement must be granted to a tax-exempt charitable organization that is organized and operated for the purpose of accepting, monitoring and enforcing conservation easements in the public interest. Further, the document creating the easement must contain specific provisions mandated by the Internal Revenue Service and must be recorded among the land records in the same way that a deed is recorded. To claim a charitable deduction, the value of the easement donation must be determined by independent qualified appraisal.

For purposes of the following discussion, assume that the value of the donated easement, determined by qualified appraisal, is $17 million and that Investor LLC makes a $4,250,000 capital contribution to Owner LLC. Also assume that the Property has a current fair market value of $130 million, has realized appreciation in value of $30 million over its adjusted cost basis of $100 million. Finally, assume that Owner LLC’s
operating agreement is amended to provide that the entire charitable deduction resulting from the conservation easement is allocated to Investor LLC. This article will examine the tax issues that are raised by this example.

The Charitable Deduction

If, prior to year-end, Owner LLC grants and records in the land records a conservation easement on the Property, and if the grantee of that easement is a tax-exempt organization, Owner LLC will be entitled to claim a charitable contribution deduction in accordance with § 170 of the Internal Revenue Code of 1986 (the “Code”). Subject to limitations discussed below, the amount of the allowable deduction will be equal to the fair market value of the easement at the time of the donation. Thus, if Owner LLC obtains an independent qualified appraisal of the conservation easement and otherwise complies with the requirements of Code § 170 and related regulations, Owner LLC should be allowed a charitable deduction equal to the fair market value of the easement donation. In this example, the allowable charitable deduction is $17 million.

Special Allocation Of Charitable Deduction To Investor LLC

In order to specially allocate the entire charitable deduction to Investor LLC, Owner LLC’s operating agreement must be amended to provide for that allocation. Subject to the proviso stated below, Investor LLC will be entitled to claim all of the charitable deduction allocated to it, notwithstanding the fact that the members of Owner LLC share all other profits, losses and deductions based their membership interests in Owner LLC. A special allocation will be effective, however, only if Owner LLC’s amended operating agreement is properly structured, requires strict adherence to the capital account maintenance rules of Code § 704 and regulations thereunder and satisfies the “substantial economic effect” test discussed below.

Substantial Economic Effect. While the terms of an operating agreement are generally controlling in deciding a member’s allocable share of an item of income, gain, deduction or loss, a special allocation of a tax item will not be permitted unless that allocation has substantial economic effect within the meaning of Code § 704(b) and regulations thereunder. If a special allocation does not have substantial economic effect, then it will be disregarded and the deduction in question will be reallocated among all of the members in accordance with each member’s interest in Owner LLC.

Under the regulations for Code § 704(b), a special allocation of a deduction can have substantial economic effect only if, throughout the term of the limited liability company, the operating agreement provides:

(i) for the determination and maintenance of the members’ capital accounts strictly in accordance with a detailed set of rules set forth in the regulations;

(ii) that, upon liquidation of the limited liability company, liquidating distributions will be made in accordance with the (properly maintained) positive capital account balance of the members, taking into account all necessary adjustments to the members’ capital accounts for the taxable year of such liquidation; and

(iii) that any member with a deficit capital account balance following such liquidation is unconditionally obligated to restore that deficit balance. Specifically with respect to the requirements for making liquidating distributions and for making contributions to restore deficit capital account balances following a liquidation, the regulations require that these events occur by the earlier of 90 days after the date of such liquidation and the last day of the limited liability company’s taxable year in which liquidation occurs.

Therefore, provided that Owner LLC’s amended operating agreement includes each of these required elements, the special allocation of the charitable easement deduction solely to Investor LLC should be considered to have substantial economic effect and should be respected by the Internal Revenue Service.

Book-Up Rules. Owner LLC’s amended operating agreement should also provide that each of the members’ capital accounts may be increased to reflect a revaluation or “book-up” of the Property to reflect current fair market value in connection with the occurrence of certain specific events. For example, under the partnership tax regulations, a book-up is permitted when a new or existing member contributes money or other property to the limited liability company. Here, Investor LLC’s cash capital contribution to Owner LLC in exchange for its membership interest triggers a book-up of capital accounts. By way of illustration, Owner LLC has a basis cost of $100 million, which has appreciated to $130 million. When Investor LLC is admitted as a member of Owner LLC in exchange for a cash capital contribution, the book value of the Property should be restated for capital account purposes and the unrealized gain with respect to the Property should be allocated to the developer member’s capital account, as if the Property were sold for fair market value in a taxable transaction. Note, however, that the book-up rules do not create any actual gain or loss for the members at the time of the revaluation, but instead preserve future allocation of the built-in gain or loss.

This revaluation may cause a disparity between the developer member’s capital account and Owner LLC’s adjusted tax basis in the Property. As a result, future allocations of depreciation, depletion, amortization and gain or loss must be computed, for capital account purposes, based on such adjusted book value, and the
members’ distributive shares of the corresponding tax items must be determined in a manner that takes into account such disparity.

Limitations On The Charitable Deduction

There are numerous limitations on the ability to deduct charitable contributions.

Basis. As a general rule for entities taxed as partnerships, a member’s ability to deduct limited liability company losses is limited by its adjusted basis in its membership interest. However, this limitation does not apply to a member’s ability to deduct its share of the limited liability company’s charitable contributions. This is because the partnership tax rules provide that a limited liability company, in computing its net income or net loss, does not take into account charitable deductions. Instead, each member is required to take into account separately its distributive share of the limited liability company’s charitable deductions. Thus, a member of a limited liability company, having an operating agreement that satisfies the substantial economic effect rules, may deduct its share of the charitable deduction made by a limited liability company in an amount that exceeds the adjusted basis of its membership interest. Here, for example, Owner LLC will allocate a $17 million charitable deduction to Investor LLC at the time when Investor LLC’s basis in its membership interest will be $4.25 million (the amount of its capital contribution). Notwithstanding its lower basis, Investor LLC will be entitled to deduct the full amount allocated to it, provided that the other limitations on deduction, discussed below, are satisfied.

Appreciated Property. For purposes of this example, it is assumed that the fair market value of the conservation easement is $17 million, based on a valuation of the Property as a whole of $130 million. Since Owner LLC’s adjusted basis in the Property is $100 million and since that basis will be allocated to all elements, components or rights comprising the Property in proportion to their respective values, the basis of the conservation easement will be approximately $13,076,923 million (adjusted basis of property multiplied by the quotient of the fair market value of the easement divided by the fair market value of the Property).

Under Code § 170(e)(1)(A), the amount of the deduction for a charitable contribution of appreciated property must be reduced by the amount of gain that would not have been long-term capital gain if the contributed property had been sold by the taxpayer at its fair market value (determined at the time of the contribution). For contributions of an interest in real property such as the conservation easement, this limitation comes into play in two circumstances: first, if the Property is not a “capital asset,” or second, if the holding period of the Property is less than one year.

Regarding the first condition, the Property in the example should qualify as a capital asset. Because Owner LLC does not hold the Property for sale in the ordinary course of business, the Property is not inventory and should qualify as a capital asset.8

As to the second circumstance, Owner LLC must have held the Property for more than one year at the time of the easement donation in order for the inherent gain to qualify as long-term capital gain. Importantly, the holding period of property is tested at the entity, not the member, level. Thus, so long as Owner LLC’s holding period for the Property exceeds one year, as is the case in the hypothetical, the conservation easement will not be treated as ordinary income property—even though the resulting deduction is allocated to a member (Investor LLC) who has been a member of Owner LLC for less than a year.4 Accordingly, if Owner LLC’s holding period for the Property exceeds one year (and if it has not claimed accelerated depreciation with respect to the improvements), Owner LLC would recognize only long-term capital gain on a sale of the Property and the reduction of the charitable contribution deduction provided by Code § 170(e)(1)(A) would not apply.

Percentage Limitations. Code § 170(b)(1)(C) provides that a non-corporate taxpayer’s charitable deduction for the donation of a conservation easement to a publicly-supported charitable organization for any taxable year cannot exceed 30 percent of its adjusted gross income, computed without regard to any net operating loss carryback. Such charitable contributions made by a non-corporate taxpayer in excess of the 30 percent of adjusted gross income limitation may be carried forward and deducted in the five succeeding taxable years.

Code § 170(b)(2) provides that a corporation’s total charitable deduction for any taxable year cannot exceed 10 percent of its taxable income, computed without regard to any net operating loss carryback, any capital loss carryback, certain special deductions allowed to corporations and before taking the charitable deduction into account. Charitable contributions made by a corporate taxpayer in excess of the 10 percent limitation may be carried forward and deducted in the five succeeding taxable years.

Impact Of Charitable Deduction On Investor LLC’s Basis

Investor LLC’s adjusted basis in its membership interest in Owner LLC will initially equal its cash capital contribution to Owner LLC increased by its distributive share of the nonrecourse liabilities of the Owner LLC, if any. That basis will then be reduced to reflect the allowance of the charitable deduction for the conservation easement and its allocation to Investor LLC. Pursuant to the partnership tax regulations, a member’s basis is reduced (but not below zero) by its distributive share of limited liability company expenditures which are not deductible in computing limited liability company taxable income or loss and which are not
capital expenditures. If a partnership makes a charitable contribution of appreciated property, a partner’s basis in its partnership interest is reduced by the basis, not the fair market value, of the contributed appreciated property. Here, if the basis of the conservation easement is approximately $13 million and the resulting deduction is allocated solely to Investor LLC, its basis in its membership interest in Owner LLC will be reduced by the lesser of $13 million or its capital contribution of $4.25 million.

The impact of this rule is to make permanent Investor LLC’s tax savings resulting from the charitable deduction. There is, in effect, no basis reduction for the appreciation component of the conservation easement. Upon a sale or liquidation of Investor LLC’s interest in Owner LLC, there will be no “recapture” of the additional deduction representing the appreciation in the easement’s value in relation to Investor LLC’s basis in its membership interest.

Impact Of Charitable Deduction On Investor LLC’s Capital Account

As indicated above, one of the conditions to the Internal Revenue Service’s respecting the allocation of the charitable deduction is the requirement that the operating agreement governing Owner LLC provide for the creation and maintenance of its members’ capital accounts in accordance with Code § 704. This requirement, in turn, raises the question of how Investor LLC’s capital account should be adjusted to reflect the allocation of the charitable deduction to it.

The regulations do not explicitly address the treatment of charitable contributions, particularly contributions of appreciated property. The § 704 regulations require that a partner’s capital account must be decreased by allocations made to such partner of partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures, including the charitable contribution deduction.

The amount of the required capital contribution adjustment is uncertain. One possibility is that, by analogy to the comparable basis adjustment for an appreciated property contribution, Investor LLC’s capital account should be adjusted, not below zero, by the adjusted basis of the contributed property.

Alternatively, the transaction could be analogized to a non-liquidating in-kind distribution of the conservation easement to Investor LLC, followed by its contribution of the easement to the charitable donee. The partnership tax regulations require that a partner’s capital account be decreased by the fair market value of the property distributed by the partnership. At the same time, these regulations require (and permit the partnership agreement expressly to provide) that the capital accounts of the partners be adjusted to reflect the manner that the unrealized gain inherent in the distributed property would be allocated among the partners if there were a taxable disposition of the distributed property on the date of distribution. Owner LLC’s operating agreement could therefore provide that, on an in-kind distribution, the distributee member’s capital account should be booked-up to reflect the unrealized appreciation, if any, in the distributed property. As a result, Investor LLC’s capital account could first be increased by any appreciation arising after Investor LLC is admitted as a member of Owner LLC and then reduced by $17 million, the fair market value of the easement.

It should be noted here that whenever a new member is admitted to the limited liability company in exchange for more than a de minimis capital contribution, the other members’ capital accounts will be booked up to reflect any appreciation in the company’s assets pursuant to the partnership tax regulations. As such, once the charitable donation occurs there may be only a small amount of appreciation, or none, in the company’s assets to allocate to Investor LLC. Thus, Investor LLC could end up with a sizeable negative capital account, although there are several ways to mitigate against this.

One approach would have Investor LLC join Owner LLC at the early stage of the project when little to no appreciation has occurred. Another approach would be to properly time Investor LLC’s investment so as not to trigger the book-up when Investor LLC is admitted as a member, but rather delay the book-up until the contribution is made. At that time, the book-up could be allocated entirely to Investor LLC pursuant to the partnership tax regulations.

Note that these issues relating to the treatment of capital accounts are more complex than they may appear. All of the issues discussed herein should be fully explored by competent tax professionals before proceeding with any transaction.

Other Considerations

There are a number of other considerations to keep in mind, including abusive partnership regulations and tax shelter reporting issues.

Abusive Partnership Regulations. In May 1994, the Treasury promulgated Regulations under Code § 701 to prevent abuses involving partnerships. These regulations have an extremely broad application and should be thoroughly examined before proceeding with any transaction. However, detailed discussion of these issues is beyond the scope of this article.

Tax Shelter Reporting. Finally, while the proposed transaction has characteristics of a “tax shelter,” if the arrangement is properly structured and if Investor LLC has a genuine and meaningful ownership interest in the Property, Owner LLC may not be required to register as a tax shelter under Code § 6111(a) or comply with the disclosure requirements under Code § 6011(a).
Further consideration of these issues is beyond the scope of this article, but these reporting and disclosure issues should be reviewed before embarking on a similar transaction.

**Conclusion**

If a conservation easement transaction with investors is properly structured, the charitable deduction resulting from the donation of the conservation easement may be specially allocated entirely to the investor member.

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1 If the Property has been the subject of a qualified rehabilitation, there are other considerations to be taken into account regarding the impact on any investment tax credits taken.

2 Assume for purposes of the example discussed herein that there is no debt on the Property.

3 Note, however, that if Owner LLC claims accelerated depreciation with respect to the Property, the amount of depreciation claimed in excess of straight-line depreciation will be classified as an "unrealized receivable" and would be treated, to the extent of the additional depreciation claimed, as ordinary income property. The allowable charitable deduction would be reduced to the extent of any ordinary income inherent in the Property and properly allocable to the conservation easement.


6 See Revenue Ruling 96-11, supra.