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Tax Credit Update—The Tempel Case and Its Implications

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Background

As many in Colorado's conservation community are aware, there are a significant number of IRS audits of Colorado Conservation easement donations that are presently in litigation in U.S. Tax Court. The principal issue in most of these cases is the appraisal valuation. In a number of cases, however, the IRS has also brought up the question of how the proceeds of an easement credit sale will be characterized for tax purposes (e.g., ordinary income, capital gain, etc.). Recently in the Tempel case (136 T.C. No. 15) the Tax Court issued an opinion which, for the first time, addresses the issue of characterization of income. Use this link if you wish to see the full Tempel opinion: <http://www.ustaxcourt.gov/InOpHistoric/Tempel.TC.WPD.pdf>.

The Holding in Tempel

In short, and after considerable analysis, the court in Tempel held that the proceeds from the sale of Colorado conservation easement tax credits were capital gains with a basis of \$0. Further, on the important question of whether the capital gains were short-term or long-term, the court said:

"The sale of capital assets held for more than 1 year will result in long-term capital gain or loss...petitioners' holding period in their credits began at the time the credits were granted and ended when petitioners sold them. Since petitioners sold their State tax credits in the same month in which they received them, the capital gains from the sale of the credits are short-term."

Therefore, the strict holding by the court was that the proceeds of the tax credit sale were short-term capital gain, but the implication was that had the credits been held for one year after they were granted, and then sold, the proceeds would have been long-term capital gain.



The Conservation Resource Center is a nonprofit land conservation organization that specializes in policy, research, outreach and education. In addition to its pioneering Tax Credit Exchange Program, the conservation attorneys at the Center work to advance land conservation in Colorado and throughout the nation. As part of our research and outreach work, CRC periodically sends updates on conservation news, policy and legislation.

Implications of Tempel

Under the current tax structure, long-term capital gains are taxed at the federal level at the rate of 15%. Short-term capital gains are taxed at the ordinary income rate for the taxpayer involved. Most taxpayers selling conservation easement credits will have substantial income (due, most likely, to the sale of the tax credits), and so their federal ordinary tax rate will often be 30%+. Thus, following the implication of the Tempel holding, many easement donors may decide to hold their credits for at least one year before they sell them to attempt to cause the income to be characterized as long-term capital gain.

Further considerations

Since the Tempel case was only recently decided, there has been limited discussion and debate about it, and thus all of the issues related to it have yet to be fully flushed out. Below are some of the issues that have been identified:

Ruling Not Final:

The ruling of a court is not considered final until the appeals period for the ruling has expired. In Tempel the court issued its ruling as a partial summary judgment. The period for appeal does not begin to run until a final ruling has been issued in the full case (in Tempel that means a determination of the appraised value of the donation). That final ruling might not occur for some time, and even when it does occur, one or both parties might choose to appeal the court's determination regarding capital gain. Consequently, it may be a long time before the ruling in Tempel becomes final, and taxpayers may be reluctant to rely on the ruling during that time.

Non-specific holding:

As noted above, the court in Tempel did not hold that easement credits that have been held for a year generate long-term capital gain. Rather, it said the opposite: that credits held for less than a year generate short-term capital gain. Although it might seem obvious that the inverse is true, the IRS could take a narrow reading of Tempel and assert that Tempel does not constitute authority regarding credits held for more than a year.

When are Credits "Granted"?:

The ruling in Tempel did not address the issue of precisely when easement credits are "granted," and thus when the holding period begins to run. There are several possible answers: when the easement is granted, when the credits are registered, etc. Ambiguity over this will likely not be resolved for a considerable time.

Tax Rate Issues:

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The donation of a qualified conservation easement generates federal charitable deductions and, in Colorado, state tax credits. In most cases donors who sell the state tax credits and incur taxable income will be able to use their charitable deduction to off-set some portion of that income (in the case of qualifying farmers, they can use the deduction to off-set up to 100% of their income). The court in Tempel also cited recent guidance issued by the IRS (201105010) that seems to indicate that receiving or selling state tax credits does not offset or reduce a taxpayer's related charitable deductions.

Thus, because of the typically large size of these federal charitable deductions, the practical difference between the long-term capital gain rate and the ordinary income rate may be mitigated or eliminated by the use of the tax deduction. Additionally, tax rates are subject to change — particularly with the current budget discussions in Congress. If a donor elects to hold tax credits for a year before selling them, the income will be subject to any changes that occur in the capital gain rate during that time.

Personal & Financial Considerations:

Considerations other than tax rates may affect decisions regarding the timing of credits sales. In some cases easement donors are phasing their easement donations over a number of years. In Colorado, an easement donor cannot earn additional tax credits until all previous credits have been utilized. In such cases an easement donor may not wish to miss an entire year in the phasing cycle due to a one-year holding period.

Similarly, in some cases donors have been able to delay the payment of certain easement expenses (such as an endowment contribution) until their credits are sold. Service providers or land trusts may not be willing to wait an additional year to receive their payments. In these situations, donors may opt to sell some of the credits right away, and sell the remainder after the one year holding period.

Finally, for many easement donors, the proceeds from the sale of the tax credits are a very large factor in their financial and cash flow planning. It simply may not be an option to wait a full year for the proceeds from the sale of the tax credits as their financial needs might be more imminent.

Conclusion:

Given the numerous issues raised by the Tempel decision, it is clear that easement donors face challenging decisions regarding the timing of the sale of their tax credits. Each easement donor's situation is necessarily unique and there are no obvious

the timing of the sale of their tax credits. Each easement donor's situation is necessarily unique and there are no obvious answers. Careful planning and early consultation with tax and legal professionals are even more critical now in light of the Tempel decision.

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