COSTS OF THE EASEMENT PLANNING PROCESS: LANDOWNER BENEFITS AND LAND TRUST RISKS*

Nearly all conservation transactions involve substantial planning and execution costs. Some of those expenses may properly be assigned to the benefited party; for example, none of an attorney's fees should be considered to provide a benefit to other than his or her client. Other necessary costs may provide disparate benefits to the landowner and the land trust; appraisal fees are generally regarded as the landowner's responsibility, since a qualified appraisal is the quantitative foundation for the landowner's tax deduction, but it also serves the land trust in establishing its entitlement in the event of extinguishment or condemnation. As to certain other common costs – preparation of the baseline data comes to mind – it is difficult, if not impossible, to ascribe a primary benefit to either party.

The importance of an accurate assignment of financial responsibility for these various transactional expenses will have both economic and tax consequences for the landowner. On the land trust's side, there will often be a temptation to seek landowner contributions toward the cost of the project, and those contributions may be exacted in various ways – via services contracts, charitable pledges, or possibly as a nonitemized element in the computation of the expected stewardship endowment. This brief primer will attempt to provide some guidance as to the likely characterization of landowner-provided coverage of the expenses of a typical conservation-easement planning process.

Charitable contributions proceed, in the language of many cases, from "disinterested generosity." Whether the requisite generosity, or "giftiness," inheres in a particular case is an inescapably factual question, and the virtually endless variety of factual circumstances constitute a continuum, with "slam-dunk deductible" on one end and "not a snowball's chance" on the other. To illustrate, suppose we have an atypically solvent land trust able to bear all of the costs of the project except the landowner's attorney's fee and appraisal, and it does so. At the closing, the landowner is requested , but not required, to make a one-time charitable contribution designated as a "stewardship endowment." In arriving at the endowment number, the land trust amplifies that request by an amount representing its project costs, though the landowner is not privy to the computation. If, some weeks after the closing, the landowner makes a contribution in the amount of the request, it is inconceivable that such payment would not meet the "disinterested generosity" standard. (You will note here, that by the temporal disjunction between the easement conveyance and the stewardship gift, we have negated any contention that the creation of the endowment itself did not proceed from disinterested generosity.)

The foregoing example obviously assumes an immaculately trusting relationship (i.e., the "atypically solvent land trust"). In the existentially vexing world in which most land trusts actually live, their desire for a somewhat more binding expectation is entirely understandable, and often results in documentation (contracts, pledges, etc.) that will negate the landowner's charitable claim. Provided that the landowner has a firm understanding of the likely tax consequences at the inception of the process, the nondeductibility of amounts paid to cover the land trust's transaction costs under a services contract should not be a significant discouragement. As a matter of proper analysis, whether the landowner covers expenses which are the land trust's responsibility under a services contract or as an unstated element of a nonrequired endowment should not be decisive as to generosity, but it is always a Sisyphean prospect to argue against one's own paperwork.

Before turning to some frequently asked questions, let us examine the financial stakes of characterizing a landowner's payment as a charitable contribution, a transaction cost, or a tax-planning expense. If a charitable contribution, the tax benefit will be determined by multiplying the amount of the gift by the taxpayer's marginal rate (35% in the highest federal bracket; 26% or 28% if the alternative minimum tax applies). If the payment is not a gift but is attributable to services rendered in effecting a sale or bargain-sale transaction, the payment would offset the gain on the sale, which, for an individual taxpayer, would usually be taxed at a 15% (federal) capital gains rate. Finally, if the payment relates to the determination of tax liability, as some portion of attorneys' or accountants' fees is likely to do, it is considered a "miscellaneous itemized deduction," and applied against maximum-bracket income, but only to the extent that the aggregate of the taxpayer's miscellaneous itemized deductions exceeds 2% of adjusted gross income. The impetus for the landowner to achieve a charitable contribution should be obvious when the alternatives are fully comprehended.

Before considering several specific questions, let us make a few strategic observations. First, there is little reliable authority on some fairly basic issues. For example, may the expense of baseline data preparation be reasonably allocated between the parties? Under the Treasury regulations, the responsibility appears to rest with the landowner, but as a practical matter, the land trust is apt to be both more concerned with the baseline study and more reliant upon its future use (hence its more active role in production). Thus a reasonable allocation of costs, perhaps an even split, should be respected.

Second, if our aim is to maximize the landowner's tax benefits, then to the extent that certain costs can be agreed to be the land trust's responsibility, the land trust should not only pay those directly, but should avoid any understanding, contractual or implied, that would suggest that it will look to the landowner to cover its obligations. An attorney's fee, which will often be the land trust's most substantial cost item, may be expected to be recovered ultimately from the landowner's endowment gift, but the land trust attorney must not seek any formal assurance that the landowner will act as a surety. To do so will create the danger that the landowner's payment, intended as a charitable contribution, will be considered as made to the land trust as an agent for the land trust's attorney, and therefore nondeductible (charitable contributions must be paid to a charitable organization).

Most of the difficult judgments involved in resolving fact-based questions, like the extent of a landowner's responsibility to cover certain expenses, will involve drawing a line on the continuum of possibilities. It may be virtually impossible to know with certainty that the taxpayer's advisor has drawn the line in exactly the right place, but if it falls within a range of reasonableness, it stands a good chance of acceptance, or of at least serving as the starting point for a readjustment. To illustrate, with respect to the expenses of developing baseline data, the overly aggressive taxpayer's counsel might suggest a 90% allocation of costs to the land trust, on the premise that nearly all of the assembled data will benefit the land trust in discharging its monitoring responsibilities. The overly conservative advisor, with an eye to the misguided regulations, which seem to assign the responsibility of preparation to the landowner, might advise that no charitable contribution is allowable if the landowner assumes full responsibility to cover the baseline data preparation expenses. In our view, both positions fall outside the range of reasonableness, which, taking all relevant facts into account, might range from, say, 35% (landowner's responsibility) to 65%. (And by the way, in our experience the advice of counsel on an issue like this will by no means always land on the overly aggressive end of the continuum; taxpayers are often induced to assume unnecessarily conservative reporting positions through counsel's failure to find comforting direct authority or because of irrational fears of an IRS audit.)

Now, with those cautions in mind, on to your frequently asked questions…

1. <u>If the landowner is expected to "reimburse" the land trust for its properly allocable process costs, and to provide a stewardship endowment as well, and if it is unlikely that the transaction will move forward without the landowner's commitment to underwrite those costs, can they be deductible charitable contributions at all?</u>

It should be obvious by now that calling a transfer of money or property a "gift" or a "contribution" doesn't make it one. So there is no categorical answer here; it comes down to drawing the appropriate line on the disinterested-generosity continuum. If the circumstances are as set forth in the third paragraph of this article, we shall have no difficulty in finding the requisite "giftiness." On the other hand, if the landowner is informed that the easement cannot be accepted without coverage of costs and an accompanying cash endowment, we are at the "probable denial" end of the scale. Recent IRS audit experience suggests that a commitment (by services contract, for example) will place those payments on the wrong end of the giftiness continuum. But expectation is not commitment, and in planning to broach the subjects of cost reimbursement and the endowment need, the land trust should be prepared to weigh its desire for certain payment against the landowner's tax disadvantages. (And don't be deluded into thinking that the avoidance of putting the demand in writing will prevent nondeductibility. Recollections of oral communications will be relevant, and possibly demanded under oath, should the audit come to a judicial process.)

2. <u>May the execution of a pledge letter, whereby the landowner commits to make a stewardship contribution, make the contribution nondeductible?</u>

There is ample authority to support the deductibility of amounts paid to satisfy charitable pledges. In this context, however, deductibility would not extend to any portion of the pledged amount that will serve to satisfy an obligation of the pledgor (landowner). So if the pledged amount includes full coverage of the baseline data costs, it would be naïve to think that subsuming that element in the pledged amount will make it deductible.

As to the land trust's comfort in the pledge strategy, under virtually universal state statutes or common law, reliance on a pledge will make it enforceable. That reliance (devoting significant staff time, mounting a capital campaign, etc.) need not match in cost, time or trouble the pledged amount, and the landowner should be notified in writing of the land trust's intention to rely on the pledge at the time it is made.

3. <u>If the land trust charges for its staff time and project-related disbursements, may the landowner's contractually required payments be deductible?</u>

From a tax perspective, we believe that the services-contract approach is almost always disadvantageous to the landowner. In the absence of such a contract, it is certain that a substantial part of such costs – those which in an arm's length negotiation would be the clear responsibility of the buyer or donee – could be rolled into the stewardship endowment --- and thus the services contract probably consigns those cost elements to a less-favored category of tax benefit (either transaction costs, as to a bargain sale, or miscellaneous itemized deductions, which often means no tax benefit at all, because of the 2%-of-adjusted-gross-income threshold). This is not to suggest that the landowner's tax objectives should be decisive; in many cases the land trust's financial objectives will demand the assuance provided by contract.

4. <u>If the land trust insures the recovery of its costs through a payment-for-services contract, might that jeopardize the charitable deduction attributable to the transfer of the easement?</u>

There is no reason to believe that the land trust cannot act in both the capacity of a services provider and that of a donee (though we acknowledge that it seems intuitively strange that a putative donee should be compensated for its costs in arranging for a donative transfer). Nothing in the services contract should suggest or imply that the easement transfer is linked to the planning process, however; the best practice would make it clear that the choice of donee would be left to the landowner at the end of that process. (If the land trust has been fully compensated for its costs and services, it should have little reason to complain that the donative transfer of the easement to it remains an expectation.)

It should be abundantly clear by now that in establishing the financial understanding between landowners and land trust prior to the planning process for a conservation transaction, there is likely to be an inescapable tension. Providing the land trust with comfortable assurance that it will emerge from that process financially whole will nearly always compromise the landowner's optimum tax-planning objectives. Before demanding a payment that may jeopardize the landowner's legitimate charitable objectives, careful consideration should be given to other factors that may provide noncontractual comfort, including the landowner's standing in the community, his or her history with the land trust, and the actual probability of the landowner's failure to meet the land trust's expectation of disinterested generosity. (In our experience, such disappointments are exceedingly rare.)

Bill Hutton, Partner
Coblentz, Patch, Duffy & Bass LLP
(415) 772-5701
wth@cpdb.com