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W. Eugene Seago

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THE EFFECTS OF THE VIRGINIA LAND PRESERVATION CREDIT ON FEDERAL TAXABLE INCOME: SHOULD THE RIGHT HAND TAKE FROM WHAT THE LEFT HAND GAVE?

W. EUGENE SEAGO, PH.D., J.D.*

INTRODUCTION

The federal government and the Commonwealth of Virginia provide tax incentives for landowners to create easements that will preserve the land from development.¹ Federal income tax law has permitted a charitable contribution deduction for conveying a conservation easement since 1964.² The Taxpayer Relief Act of 1997 provided new estate tax incentives for conservation easements.³ In 2006 Congress expanded the annual limitation on deductions for charitable contributions of conservation easements from thirty to fifty percent of adjusted gross income.⁴ Virginia allows the same charitable contribution as the federal government.⁵ In

* R.B. Pamplin Professor of Accounting, Virginia Polytechnic Institute and State University.

¹ See, e.g., Francine J. Lipman, *No More Parking Lots: How the Tax Code Keeps Trees Out of a Tree Museum and Paradise Unpaved*, 27 HARV. ENVTL. L. REV. 471 (2003); see also Charles Davenport, *Federal Taxes and Transferable State Tax Credits*, 101 TAX NOTES 1213 (2003); Charles Davenport & Philip M. Hocker, *Legislation Affecting Virginia Conservation Easement Tax Credits*, 42 ST. TAX NOTES 255 (2006), for an analysis of the Virginia credit.

² Pub. L. No. 88-272, § 209(f), 78 Stat. 19, 43-47 (1964) (codified as amended at I.R.C. § 170(f)(3) (West Supp. 2007)). The amendments to the Internal Revenue Code ("Code") in 1969, legitimized the Internal Revenue Service's ("IRS") holding in Revenue Ruling 64-205, 1964-2 C.B. 62, which permitted a deduction of the fair market value of a restrictive conservation easement.

³ Pub. L. No. 105-34, § 508, 120 Stat. 1068 (amending I.R.C. § 2031(c) (Supp. IV 2004)). See generally Karen M. White, Note, *"Extra" Tax Benefits for Conservation Easements: A Response to Urban Sprawl*, 18 VA. ENVTL. L. J. 103 (1999).

⁴ Pension Protection Act, Pub. L. No. 109-280, 120 Stat. 1068 (amending I.R.C. § 170(b)(1)(E) (West Supp. 2007)). In some cases, for corporate farmers, the limitation on deductions is 100% of taxable income for the year. I.R.C. § 170(b)(1)(E)(iv)(I) (West Supp. 2007). When either the 50% or 100% limitation applies the taxpayer is allowed a fifteen year carryover for excess contributions, rather than the five year carryover period generally allowed. *Id.* § 170(b)(1)(E)(ii).

⁵ Virginia indirectly allows the charitable contribution equal to the federal allowable deduction because the calculation of Virginia taxable income is the federal taxable income before certain adjustments, none of which pertain to charitable contributions. VA. CODE

addition, in 2000, Virginia began permitting a tax credit equal to fifty percent of the appraisal value of the easement.⁶ For contributions after December 31, 2006, the credit is limited to forty percent of the appraisal value of the easement.⁷ The credit used in any year cannot exceed the lesser of the tax for the year or \$100,000, with a ten year carryover for the unused credit.⁸ The combined federal and state income tax deductions and the state credit can be as much as seventy-two percent of the value of the contributed easement.⁹

Apparently, the deductions and credits are effective. During the period from 2000 to 2005, conservation easements were placed on over 200,000 acres of Virginia land.¹⁰ In 2005 the National Land Trust Alliance reported that Virginia was in the top ten states in terms of acreage subject to conservation easements.¹¹

Although the deductions and credit are lucrative for taxpayers in a high marginal tax bracket, frequently the land that could offer extraordinarily attractive open spaces benefits to the public is owned by individuals

ANN. § 58.1-322 (West 2007).

⁶ *Id.* § 58.1-512(A).

⁷ *Id.* For further discussion of the changes in the Virginia law, see Craig D. Bell, *Annual Survey 2006: Taxation*, 41 U. RICH. L. REV. 283 (2006). A tax credit may be thought of as a "deduction on steroids." A deduction reduces the tax liability by the amount of the deduction multiplied by the marginal tax rate, whereas a credit reduces the tax liability by the amount of the credit. Thus, in Virginia, a \$1.00 deduction is worth only \$1 x 0.0575 = \$.575, whereas a \$1 credit is worth \$1.

⁸ VA. CODE ANN. § 58.1-512(C).

⁹ The highest marginal federal and state rates are 35% and 5.75%, respectively. 41 C.F.R. § 302-17, app. A-B (2007) (noting the federal and state marginal tax rates for tax year 2006). The state income tax, however, is deductible in arriving at federal taxable income, unless the taxpayer is subject to the alternative minimum tax ("AMT"). Treas. Reg. § 1.164-1 (as amended in 1978); I.R.C. § 55 (West Supp. 2007). Therefore, for the taxpayer not subject to the AMT, the tax benefit of the deduction as a percent of its value is $(0.35 + 0.0575) + 0.40 - 0.35(0.0575 + 0.40) = 0.64378$. Because state income tax is not deductible for AMT purposes, and the AMT rate can be as high as 28%, I.R.C. § 55(b)(1)(A)(i)(II), the combined federal and Virginia tax benefits of the contribution may be as much as $0.28 + 0.0475 + 0.40 = 72.75\%$ of the value of the property. In addition, the donor may enjoy estate tax benefits under I.R.C. § 2031(c), and even state and local property tax benefits, through reduced valuation. Real estate taxes on the property are also reduced as a result of the easement. VA. CODE ANN. § 10.1-1011 (The value of the easement is removed from the land owner's property subject to tax.). The reduction in real estate taxes, however, is captured in the value of the property with the easement and, thus, the present value of the future taxes reduces the base for the credit and deduction.

¹⁰ Davenport & Hocker, *supra* note 1, at 256.

¹¹ See LAND TRUST ALLIANCE, 2005 NATIONAL LAND TRUST CENSUS REPORT 4 (2005), available at http://www.lta.org/census/2005_report.pdf.

who do not have significant amounts of income, and thus cannot utilize all of the deductions and credits.¹² To induce these taxpayers to convey a conservation easement, Virginia law allows the landowners to reap the benefits of the credits by selling or giving them to other taxpayers who are permitted to apply the credits against their Virginia income tax liability.¹³

The Virginia credit raises a host of federal income tax issues, but there is little in the way of authoritative pronouncements regarding the federal tax consequences of acquiring, using, selling or purchasing the credits.¹⁴ Moreover, alternative views of tax credit transactions for federal tax purposes that have not yet been pursued could produce taxable income from the transactions, and thereby reduce the net tax benefits of the state credit.¹⁵ But, whether to forgo federal revenues so that a state tax benefit can be enhanced is a decision that should be made by the legislature, rather than the administrative and judicial branches of the government.¹⁶

In particular, I believe that the transfer of an easement in exchange for a state tax credit is a property transaction that gives rise to income. The bargain sale to charity rules are applicable to these transactions. Under the bargain rules, if property is sold to a charity for less than its market value, the price of the sale less an allocated share of basis produces taxable gain.¹⁷ As will be seen, the credit received from the state for the easement is an amount realized from the transfer and, thus, the bargain sale rules are brought into play. When the bargain sale rules are applied, the analysis is very different from when those rules are not applicable. Moreover, the transfers create other controversial issues, in addition to the issue of the bargain sale. Therefore, Part I of this paper will address issues that emanate from the interplay between the federal and state laws, other than those issues associated with bargain sales to charity. The bargain sale to charity rules will be addressed in Part II.

¹² Nancy A. McLaughlin, *Increasing Tax Incentives for Conservation Easement Donations*, 31 ECOL. L.Q. 1, 16-17 (2004) (citing *Impact of Tax Law on Land Use: Hearing Before the Subcomm. On Oversight of the House Comm. on Ways and Means*, 104th Cong. 40-43 (1996)).

¹³ VA. CODE ANN. § 58.1-513(C)(1). It should be noted that a person with little income may not require the same amount of an incentive as a person with a high level of income because of a decreasing marginal utility for money as income rises.

¹⁴ McLaughlin, *supra* note 12, at 41 n.142 (citing I.R.S. C. Couns. Adv. Mem. 200238041 (Sept. 20, 2002)).

¹⁵ See C. Couns. Adv. Mem. 200238041 (Sept. 20, 2002). Colorado is one such state where the income generated by a transfer of tax credit is considered taxable income. *Id.*; COLORADO DEPT. OF REVENUE, TAXPAYER SERVICE DIVISION, FYT—GROSS CONSERVATION EASEMENT CREDIT 4 (April 2007), available at <http://www.revenue.state.co.us/fyi/pdf/income39.pdf>.

¹⁶ See *infra* p. 23.

¹⁷ I.R.C. § 1011(b) (2000); Treas. Reg. §§ 1.170A-4(b-c) (as amended in 1994).

The point of this Article is not that the Internal Revenue Service ("IRS") should pursue a more aggressive application of existing law to the recent advent of state environmental easement credits, such as in Virginia. Rather, the major point is that Congress should make the decision. If Congress would like the state and federal laws to act in tandem to encourage conservation easements, or if Congress believes that the combined state and federal benefits are more than are required to attain the goals of the program, Congress should speak to the issue. Otherwise, taxpayers must assign a discount for uncertainty of the possible tax benefits, thereby reducing the efficacy of the state and federal programs.

Because the state law generally "piggybacks" on the federal law in regard to whether the taxpayer has made a valid transfer of a conservation easement¹⁸ and to the value of the transfer,¹⁹ these issues will not be addressed.²⁰ To summarize the federal requirements, the taxpayer must transfer an interest in real property to a "qualified organization" for "conservation purposes."²¹ A qualified organization is a governmental unit or a section 501(c)(3) not-for-profit organization.²² "Conservation purposes" means the preservation of land for outdoor recreation, the preservation of open space, the protection of fish, wildlife, or plants or the preservation of land with historical importance.²³

I. THE APPLICATION OF GENERAL CONCEPTS OF GROSS INCOME TO DONOR'S CREDIT

A. *The Donor's Receipt of the State Income Tax Credit*

When the landowner-donor conveys an easement and receives a credit from the state, the donor has given up an interest in real property.²⁴ The transfer of property is a condition to receiving the credit. If the donor is unable to use the credit, or would rather someone else use the credit, the donor can transfer (sell or give) the credit to a Virginia taxpayer.²⁵ The

¹⁸ VA. CODE ANN. § 58.1-512(D)(2) (West 2007).

¹⁹ *Id.* § 58.1-512(B).

²⁰ For a discussion of the federal requirements for the deduction under I.R.C. § 170(h), see generally Lipman, *supra* note 1.

²¹ I.R.C. § 170(h)(1) (West Supp. 2007).

²² *Id.* § 170(h)(3).

²³ *Id.* § 170(h)(4) (A). For a detailed discussion of the valuation of conservation easements, see Ryan J. Padden, Note, *Valuing Perpetual Conservation Easements for Purposes of Section 170: Browning v. Commissioner*, 52 TAX L. 209 (2006).

²⁴ See, e.g., Rev. Rul. 59-121, 1959-1 C.B. 212.

²⁵ VA. CODE ANN. § 58.1-513(C)(1) (West 2007).

law permits the transferee to apply the credit against his or her Virginia income tax.²⁶ Although the purpose of the deductions and credits are to motivate the donation, whether the donor would have made the contribution absent the tax benefits is not important in determining whether income is realized from the transaction, according to general income tax principles.²⁷ The important point is that the credit increased the donor's wealth as compared to if the credit were not permitted.²⁸ On the other hand, it is apparent that the tax benefits that are granted generally to motivate behavior would be diminished if the same jurisdiction taxed the benefits as income, thereby taking in one hand what it has given in another. Thus, the transaction should not be deemed a transaction that is taxed by the jurisdiction granting the credit.²⁹ This line of reasoning, however, does not mandate that the federal income tax system ignore the state tax benefit accompanying a transfer. Thus, in Revenue Ruling 85-39, the IRS concluded that the State of Alaska's distribution of oil revenues to its citizens, which reduced the population turnover of the state, was federal taxable income to the recipients.³⁰ The ruling distinguished the payments from gifts because of the State's motive for the payments³¹—to reduce population turnover—and applied the broad federal concept of gross income.³²

It is submitted that tax credits awarded by Virginia to encourage land preservation differ little from the Alaska dividend in terms of form and motivation. In both cases, the specific motives are economic rewards, which removes the credits from the gift classification. The forms differ, a cash payment versus a tax credit, but ultimately, both programs increase the recipient's wealth. Thus, my position is that the IRS has the authority

²⁶ *Id.* § 58.1-512(D)(5)(b).

²⁷ See *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960).

²⁸ See *Diedrich v. Comm'r*, 457 U.S. 191, 194-200 (1982) (holding that the taxpayer realized income from making a gift where the donee paid the donor's gift tax, which was greater than the donor's basis in the property); see also *id.* at 200-01 (Rehnquist, J. dissenting) (denying the majority's conclusion that the taxpayer had income from a transaction in which the value of the property transferred was greater than the donor's assumed liability).

²⁹ This was the result in *Browning v. Comm'r*, 109 T.C. 303, 324-25 (1997) (holding that the tax benefits received from the conveyance of an easement did not decrease the amount of the charitable contribution).

³⁰ Rev. Rul. 85-39, 1985-1 C.B. 21; see also *Griesen v. United States*, 831 F.2d 916, 920 (9th Cir. 1987), *aff'g* 635 F. Supp. 481 (D. Alaska 1986).

³¹ See *Duberstein*, 363 U.S. at 285.

³² Rev. Rul. 85-39, 1985-1 C.B. 21; I.R.C. § 61 (2000) (defining "gross income"); see *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955) (holding that the definition of gross income. See generally *Eisner v. Macomber*, 252 U.S. 189 (1920) (holding that a stock dividend was not taxable income).

to treat the state conservation easement credit as a variable in the calculation of taxable income.

The United States Supreme Court has repeatedly ruled that the income tax formula treats all increases in wealth that are realized as "gross income," unless specifically excluded by law.³³ Certain deductions unrelated to earning income are allowed to reduce taxable income.³⁴ Charitable contributions³⁵ and state income taxes³⁶ are among those deductions. Charitable contributions are voluntary reductions in wealth³⁷ and to allow a deduction for the value of the property, without taking into account the offsetting economic benefit received from the tax benefits, is an incomplete analysis of the events.

It should also be noted that to conclude that the Virginia conservation easement credit should be reflected in federal taxable income is not to say that all state income tax benefits (e.g., a deduction allowed in computing taxable income) produce federal taxable income. The conservation credit can be distinguished from the benefits of deductions that reduce state income taxes in that the credit is received in return for a property transfer to the state; a deduction may be based on the perceived ability to pay,³⁸ some other equity concern,³⁹ or for a hoped for effect on behavior.⁴⁰

1. The Application of a Credit Received in a Non-taxable Event

If the conservation easement credit is not deemed to have been received in a taxable transaction,⁴¹ the taxpayer has no basis in the credit.⁴²

³³ See, e.g., *Glenshaw Glass Co.*, 348 U.S. at 432 (Punitive damages are gross income.); *Comm'r v. Banks*, 543 U.S. 426, 438-39 (2005) (Court rewards used to pay contingency fee to attorneys are not taxable income.); *United States v. Burke*, 504 U.S. 229, 245 (1992) (Back pay award in Title VII actions is taxable income.); *Dickman v. United States*, 465 U.S. 330, 333-35 (1984) (The transfer of property can be a gift.); *Comm'r v. Kowalski*, 434 U.S. 77, 82-84 (1977) (Medical allowance payments are taxable income.).

³⁴ I.R.C. § 161 (2000).

³⁵ I.R.C. § 170 (West Supp. 2007).

³⁶ *Id.* §§ 164(a)(1)-(2).

³⁷ See *id.* § 170(c).

³⁸ See Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 132 (1989) (noting that the theoretical underpinning for a deduction for individuals with dependents is the individual's ability to pay).

³⁹ See Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. Rev. 443, 528-29 (2007) (noting that cost of living deductions are based on equity concerns).

⁴⁰ See generally Stephanie Stern, *Encouraging Conservation On Private Lands: A Behavioral Analysis Of Financial Incentive*, 48 ARIZ. L. REV. 541 (2006).

⁴¹ The credit could be deemed received by a cash basis taxpayer in a taxable transaction, but the amount of the credit is incapable of valuation because it is subject to contingencies.

Therefore, anything received for the credit is taxable income. The taxpayer has no basis because the original basis in the land does not transfer to the credit. This is because, in effect, the basis in the easement was stepped up⁴³ (without the recognition of gain) at the time of the contribution to create a deduction equal to the fair market value of the property.⁴⁴ The issue becomes whether the donor should recognize gain from the use of the credit to reduce the tax liability, such as when appreciated property is used to satisfy a liability.⁴⁵

In 2002, in an advisory memo regarding Colorado's easement credit, the IRS Chief Counsel dismissed the idea of recognizing gain from the use of the conservation easement credit.⁴⁶ To the Chief Counsel this seemed a wasted motion because if the income was recognized, concomitantly the donor would enhance the deductible state tax expense by the amount of the gain.⁴⁷ Therefore, if the liability was \$10,000 and the credit with a zero

See Treas. Reg. § 1.461-1(a)(1) (2007). In the case of an accrual basis taxpayer, one could reason that no income should be recognized at the time of the transfer because the all-events test was not satisfied. This is because its use is contingent upon the taxpayer having an actual liability for the ongoing tax year. *See id.* § 1.461-1(a)(2). The fact that the credit is transferable would counter the all-events test argument.

⁴² The IRS agrees with this conclusion. *See* I.R.S. C. Couns. Adv. Mem. 200211042 (Mar. 15, 2002). The donee could realize expenses of transferring the property, which should be deemed his or her basis in the credit. Expenses to satisfy the requirements for the deduction and credit (e.g., appraisal fees) should be treated as deductible expenses under I.R.C. § 212 to determine the donor's tax liability (subject to the 2% of adjusted gross income threshold of I.R.C. § 67).

⁴³ The stepped up basis of property is the value placed on it when it is sold. *See* I.R.C. § 1012 (2000) (defining basis as cost); BLACK'S LAW DICTIONARY 152 (6th ed. 1990). For example, when property is inherited, the inheritance value of the property is "stepped up" to the fair market value at the time of the donor's death. *See* I.R.C. § 1014; BLACK'S LAW DICTIONARY 152 (6th ed. 1990).

⁴⁴ I.R.C. § 170(e) (West Supp. 2007). Assuming the property was held for investment or used in the trade or business, rather than held by a dealer in real estate, then the seller's gain from a sale would be ordinary income and the deduction for a charitable contribution of ordinary income property is limited to his or her basis in the property. *Id.* § 170(e)(1)(A).

⁴⁵ Treas. Reg. § 1.1001-2(a) (as amended in 1980). In I.R.S. Priv. Ltr. Rul. 2003-48-002 (Aug. 28, 2003), the IRS took the position that the purchaser of a state tax credit must recognize gain when the credit is used to reduce tax due by more than the purchaser's cost of the credit.

⁴⁶ I.R.S. C. Couns. Adv. Mem. 200238041 (Sept. 20, 2002); *see also* I.R.S. C. Couns. Adv. Mem. 200211042 (Mar. 15, 2002) (advising that the portion of a tax credit received as a result of remediating contaminated property which is applied to reduce tax is not treated as a state payment or taxable income).

⁴⁷ I.R.S. C. Couns. Adv. Mem. 200238041 (Sept. 20, 2002).

basis was for \$10,000, the credit would offset the liability and the taxpayer would have neither taxable gain nor deductible state income tax.

Also, in 2007, the Chief Counsel found that Alaska's income tax credit permitted for members of the United States military should be excluded from income and classified as a reduction in taxes.⁴⁸ The application of the state tax credit reduces the amount of state tax available as a deduction under Internal Revenue Code ("I.R.C.") section 164(a)(3).⁴⁹ Any additional credit not used to reduce taxes could be excluded as a gift. The Chief Counsel interpreted the Alaska statute and its legislative purpose for conveying a refund of unused tax credit as satisfying the "donative intent" requirement for the "gift" classification under I.R.C. section 102.⁵⁰ Aside from the fact that often the income and expense cannot be matched, as will be discussed below, the military credit differs from the environmental easement in that the taxpayer receives the credit for the transfer of the property to the state (or its agent), whereas the military service credit is not received for services rendered to Alaska. Thus, the Alaska credit is eligible for gift treatment.

Absent from the Chief Counsel's analysis was the possibility that the donor may not be allowed a deduction for the state income tax, as when the donor is subject to the alternative minimum tax⁵¹ or the taxpayer did not itemize his or her deductions.⁵² Also, the Chief Counsel did not consider the fact that excluding the gain from income will affect adjusted gross income, which, in turn, can affect other elements of the taxable income formula (e.g., exemptions⁵³ and deductions phase-out,⁵⁴ charitable contributions,⁵⁵ medical expense deduction⁵⁶ and other deductions subject to the two percent of adjusted gross income limitation⁵⁷). Therefore, simply excluding the income and deduction does not always yield the same taxable income when taking into account both the positive and the negative amounts.

The Chief Counsel's authority for treating the use of the credit as a "nonevent" was Revenue Ruling 79-315 and the Sixth Circuit decision

⁴⁸ I.R.S. C. Couns. Adv. Mem. 200708003 (Feb. 23, 2007).

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ I.R.C. § 56(b)(1)(A) (West Supp. 2007).

⁵² I.R.C. § 161 (2000).

⁵³ *Id.* § 151(d)(3) (2000).

⁵⁴ I.R.C. § 68 (West Supp. 2007).

⁵⁵ *Id.* § 170(b).

⁵⁶ *Id.* § 213(a).

⁵⁷ I.R.C. § 67 (2000).

in *Snyder v. United States*.⁵⁸ Neither authority was on point. In Revenue Ruling 79-315, the Iowa legislature granted a rebate of 1978 state income taxes paid. The statute was enacted in 1979 and the rebates were paid that year. The ruling concluded that taxpayers who paid the tax in 1978 but did not claim it as an itemized deduction were not required to include the rebate in gross income.⁵⁹ This is a clear application of the tax benefit rule, but Revenue Ruling 79-315 says nothing about the case of the taxpayer using an asset with no basis to pay an expense that may (or may not) be deductible.⁶⁰ In *Snyder*, the accrual basis taxpayer received a state tax credit (that was to be applied to taxes on gross receipts) for making improvements to its property.⁶¹ The IRS argued that the credit should be included in income when the improvements were made, rather than when the credit was applied to the gross receipts tax due.⁶² Although the Tax Court agreed with the IRS,⁶³ on appeal the IRS conceded that under the all-events test applicable to the accrual basis taxpayer the credit should not be recognized until the gross receipts against which the credit could be applied were actually earned.⁶⁴ Whether income from the use of the credit should be recognized was not at issue, and thus was not decided in *Snyder*.

Although the Chief Counsel concluded (incorrectly in my opinion) that no federal gross income and nor expense should be recognized from the use of the credit, the IRS has held that federal taxable income must be recognized from a sale of the credit.⁶⁵ In both the application and sale of credits the taxpayer has disposed of an asset. The only difference between the two situations is that with the application of the credit the taxpayer's cash payment for tax is reduced, whereas cash is actually received in the case of the sale. Treating these two similar situations differently matters, though, because of the structure of the tax formula, as discussed above.⁶⁶

⁵⁸ I.R.S. C. Couns. Adv. Mem. 200211042 (Mar. 15, 2002); see Rev. Rul. 79-315, 1979-2 C.B. 27; *Snyder v. United States*, No. 89-1276, 1990 U.S. App. LEXIS 1603 (6th Cir. Feb. 1, 1990).

⁵⁹ Rev. Rul. 79-315, 1979-2 C.B. 27.

⁶⁰ I.R.C. § 111 (2000); see *Dobson v. Comm'r*, 320 U.S. 489, 506 (1943) (discussing the exclusionary component of the tax benefit rule).

⁶¹ *Snyder*, 1990 U.S. App. LEXIS 1603 at *8.

⁶² *Id.* at *9.

⁶³ *Snyder v. Comm'r*, 54 T.C.M. (CCH) 953 (1987).

⁶⁴ Treas. Reg. § 1.451-1(a) (as amended in 2007); see *Snyder*, 1990 U.S. App. LEXIS 1603 at *9.

⁶⁵ I.R.S. C. Couns. Adv. Mem. 200211042 (Mar. 15, 2002).

⁶⁶ See *supra* notes 53-57 and accompanying text.

2. Refunds, Credit Carryovers and the Tax Benefit Rule

The tax benefit rule requires that a taxpayer who receives a refund in one year of state income taxes that was deducted in a previous year must include the refund in gross income, to the extent the taxpayer received a tax benefit from deducting the tax in the previous year.⁶⁷ As illustrated in the following example, both the conservation easement credit and payments on taxes during the year are combined to determine whether a state income tax refund is due. Under Virginia law, the credit is applied against the tax imposed for the year.⁶⁸ The credit can only reduce the tax for the year to zero (i.e., the credit is nonrefundable).⁶⁹ Any unused credit can be carried forward for ten years.⁷⁰ When the taxpayer has state taxes withheld, or has paid on an estimate for the year in which a credit is created, issues arise about the order in which the payments and credit are used, as is illustrated below.

Assume that in 2007 the cash basis taxpayer had \$4,000 of tax withheld and contributed a conservation easement with a value of \$25,000, which generated a \$10,000 credit. The total Virginia income tax for 2007, as determined in 2008, was \$11,000. If the \$4,000 payment was applied before the credit, the taxpayer would not receive a refund; rather, the taxpayer would have no tax due and a \$3,000 credit carryforward. On the other hand, if the credit is applied before the payments, the taxpayer would receive a \$3,000 refund and no credit carryforward. These two situations are depicted in the table below.

	Withheld in 2007	Credit Allowable in 2008	Total Tax	Refund Received in 2008	2008 Tax Benefit Rule Income	Credit Carryover
1. Credit applied before payments	\$4,000	\$10,000	\$11,000	\$3,000	\$3,000	\$0
2. Payment applied before credit	\$4,000	\$10,000	\$11,000	\$0	\$0	\$3,000

⁶⁷ I.R.C. § 111(a) (2000).

⁶⁸ VA. CODE ANN. § 58.1-512(A) (West 2007).

⁶⁹ *Id.* § 58.1-512(C)(1).

⁷⁰ *Id.* § 58.1-512(C)(1), (D)(5)(b).

Although the Virginia Code does not specifically address the ordering issue, the language of the statute, “there shall be allowed as a credit against the tax liability imposed,”⁷¹ indicates that the credit is applied before the payments.

Also, as discussed above, if the application of the \$10,000 credit were treated as a payment, in addition to the \$3,000 income under the tax benefit rule, the cash basis taxpayer would have \$10,000 gross income and tax expense in 2008.

3. The Credit as a Reduction in the Charitable Contribution

The tax benefit from the conservation easement credit could possibly find its way into taxable income as a reduction in the amount of the charitable contribution deduction. As will be further discussed below, in *Browning v. Commissioner*, a bargain sale case, the Tax Court rejected the IRS’s attempt to treat the donor’s federal tax benefits as a reduction in the amount of the charitable contribution.⁷² Judge Halpern dismissed, without discussion, the reduction in charitable contribution argument, ruling that the transaction was a bargain sale that must be governed by section 1001(b).⁷³ Section 1001(b) provides that the amount realized from a sale or disposition of property is the “sum of any money received plus the fair market value of the property (other than money) received.”⁷⁴ Judge Halpern ruled that the federal tax benefits were not an amount realized under I.R.C. sections 1001(b) and 1011(b).⁷⁵ This is a sensible result because, as discussed above, it would make no sense for the federal government to promise a tax benefit for the contributions but then take back the benefit it had promised.⁷⁶ This would be a case of giving with the left and taking back with the right hand. The opinion, however, did not foreclose the possibility that a state tax credit could be part of the consideration received in the bargain sale. As will also be discussed below, the bargain sale rules in section 1011, if applicable, treat an amount realized as consideration from a sale, rather than a direct reduction in the amount of the charitable contribution.⁷⁷

⁷¹ *Id.* § 58.1-512(A).

⁷² *Browning v. Comm’r*, 109 T.C. 303, 325 (1997).

⁷³ *Id.*

⁷⁴ See I.R.C. § 1001(b) (2000).

⁷⁵ *Browning*, 109 T.C. at 325.

⁷⁶ *Supra* p. 8.

⁷⁷ See I.R.C. § 1011(b) (2000).

B. Sale of the Credit

1. Calculating the Gain

The Virginia credit is non-refundable; that is, the credit can only be used to reduce a tax liability.⁷⁸ If the credit exceeds the contributor's tax for the year of the contribution, the tax paid will be refunded and the remaining credit can be carried forward and used against the income tax in the ten subsequent years.⁷⁹ Many landowners have potential easement credits in excess of their current and anticipated tax liabilities in future years because of a combination of factors. For example, the land may be the owner's major asset, but the land is not productive and the owner may have a short life expectancy.⁸⁰ To provide an incentive to these and other "land rich but cash poor" property owners, the Virginia statute permits the donor to transfer his or her credit. The transferee is then permitted to apply the credit against his or her tax liability within the same ten year carry-forward period as was permitted the transferor.⁸¹ Furthermore, Virginia law specifically excludes from the donor's Virginia taxable income any proceeds from the sale of the credit.⁸²

The transfer of a credit for consideration is clearly an increase in wealth realized and, thus, is a taxable event under federal law.⁸³ The donor must compare the amount realized from the transfer with his or her basis in the credit to determine the taxable gain.⁸⁴ The character of the gain must also be determined.

As discussed above, the owner should have no basis in the credit if it is deemed received in a nontaxable event.⁸⁵ This is true because the credit was received in exchange for the easement, whose basis (as well as the appreciation) was deducted as a charitable contribution. Allowing a deduction for the contribution and a basis in the credit would be double-counting the donor's investment. Beginning in 2007, however, Virginia

⁷⁸ But, a good case can be made for making the credit refundable. See Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006).

⁷⁹ VA. CODE ANN. §§ 58.1-512(D)(5)(b), 58.1-513(C)(1) (West 2007).

⁸⁰ The unused credit can not pass to the donor's estate. See Va. Dept. Tax, Tax Comm'r Rul., 2005 Va. Tax LEXIS 189, at *3-4 (Dec. 5, 2005).

⁸¹ VA. CODE ANN. § 58.1-512(C)(5).

⁸² *Id.* § 58.1-513(E).

⁸³ Of course, the credit can only be applied against Virginia income tax.

⁸⁴ I.R.C. § 1001(a) (2000).

⁸⁵ I.R.C. C. Couns. Adv. Mem. 200211042 (Mar. 15, 2002).

charges a transfer fee for transferring the credit.⁸⁶ The fee is the lesser of (1) two percent of the value of the donated interest or (2) \$10,000.⁸⁷ The statute is not clear as to who is to bear the burden of the fee.⁸⁸ But, if the fee is paid by the transferor (donor), the fee should be treated as a reduction in the amount realized from the sale of the credit, as a selling expense, thus reducing the gain on the sale.⁸⁹ If the transferee pays the fee, either the transferor will report the selling price plus the fee as the amount realized and treat the fee as a cost of the credit, or the transferor will simply report the net amount as gain. The net effect on the transferor is the same with either approach.

2. The Character of the Gain

It would seem that if the credit is viewed as not received in a property transaction, the character of the donated property that produced the credit will not determine the character of the income realized from the sale of the credit. Thus, the character of the income would be determined by the general definition of a capital asset.⁹⁰ Because income tax credits are not on the list of what is not a capital asset, according to I.R.C. section 1221, one might conclude that the credit is a capital asset. If this is correct it would mean that the person who uses the credit reduces an expense that would otherwise be deducted against ordinary income, thereby increasing ordinary taxable income, but a person who sells his or her credit will have capital gain. Such incongruity should not exist. Perhaps it can be avoided with the application of the reasoning applied in *P.G. Lake*⁹¹ and *Corn Products*⁹² to a deduction.⁹³ In *Commissioner v. P.G. Lake*, the Court held that the amount received for an assignment of ordinary income was not

⁸⁶ S.B. 5019A, 2006 Gen. Assem., Sp. Sess 1 (Va. 2006) (enacted).

⁸⁷ VA. CODE ANN. § 58.1-513(C)(2). The fee also applies to the distribution of the credit to partners, shareholders in a corporation and beneficiaries of a trust or estate. *Id.*

⁸⁸ The statute states, "A fee . . . shall be imposed upon any transfer arising from the sale by any taxpayer of credits under this article . . ." *Id.*

⁸⁹ *Union Bag-Camp Paper Corp. v. United States*, 325 F.2d 730, 742 (Cl. Ct. 1963) (holding that taxes paid by lessee as a condition of rental of timberland were deductible as business expenses).

⁹⁰ I.R.C. § 1221(a) (West Supp. 2007) (defining "capital asset" as "property held by the taxpayer").

⁹¹ *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260 (1958).

⁹² *Corn Products Refining Co. v. Comm'r*, 350 U.S. 46 (1955).

⁹³ The *P.G. Lake* theory was suggested by Charles Davenport.

the proceeds from the sale of a capital asset.⁹⁴ In *Corn Products Refining Company v. Commissioner*, the Court concluded that the taxpayer's gains or losses were not "capital" because the contracts entered into as hedges against price increases for its raw materials were ordinary income property.⁹⁵ The Court ruled that to conclude otherwise would require taxpayers to report capital gains and losses from the cost of insuring against inventory losses.⁹⁶ Likewise, if the taxpayer were permitted capital gain on the sale of its state tax credits, a taxpayer with a capital loss carryforward could sell his or her tax credits and create capital gains that are offset by the capital loss carryforward, and then take the itemized deduction for the state income tax paid.⁹⁷ Relating the character of the income to the character of the expense the credit was intended to reduce will yield the correct result.

If, contrary to the above conclusion, it should ultimately be determined that the credit is a capital asset, whether the gain from the transfer is a long-term or short-term capital gain will depend upon whether the credit has been in existence for more than twelve months.⁹⁸ That is, if the credit suddenly springs into existence (contrary to the bargain sale treatment discussed below)⁹⁹ rather than being derived from the investment in the land, the date the credit was acquired must be the date the credit was issued by the state.¹⁰⁰ Long-term gain status would be achieved if the transfer occurred more than one year from the issuance date.¹⁰¹

3. The Purchaser-Transferee

The purchaser of the credit acquires an asset whose basis is equal to the cost. The use of the credit is a taxable disposition resulting in gain or loss equal to the difference between the purchaser's basis in the credit

⁹⁴ *P.G. Lake*, 356 U.S. at 264.

⁹⁵ *Corn Products Refining*, 350 U.S. at 50.

⁹⁶ *Id.* at 53-54.

⁹⁷ In Chief Counsel Advisory Memo 200211042, the IRS presented a variety of arguments to support its conclusion that the credit was not a capital asset. Among those arguments was that the credit might be property for some purposes, but a much more narrow definition of property should be applied for capital gains purposes. I.R.C. C. Couns. Adv. Mem. 200211042 (Mar. 15, 2002).

⁹⁸ See I.R.C. § 1222(1)(2000) (defining "short-term capital gain"); *id.* § 1222(3) (defining "long-term capital gain").

⁹⁹ *Infra* Part II.

¹⁰⁰ I.R.C. § 1223 (West Supp. 2007) (stating that the holding period of property is the time which the taxpayer possessed the property as a capital asset).

¹⁰¹ I.R.C. § 1222(3) (2000).

and the amount of the reduction in tax (i.e., the face amount of the credit). The purchaser is permitted a deduction for state income taxes paid equal to the amount of the tax due before the application of the credit.¹⁰² Thus, if the purchaser paid \$7,500 for a \$10,000 state tax credit when the tax return was filed and the credit was applied, the purchaser would recognize \$2,500 gain and a deduction for \$10,000 in state income tax paid.¹⁰³ The taxpayer who is subject to the alternative minimum tax, however, will recognize \$2,500 gain but will have no deduction for state income taxes paid.¹⁰⁴

The gain from the use of the credit should be treated as ordinary income because, even if the credit could be deemed a capital asset, the gain is not from a "sale or exchange," a requirement for capital gain treatment.¹⁰⁵ The transaction is a redemption and not a sale or exchange because the state receives no property in return for the credit.¹⁰⁶ Moreover, the credit was purchased to satisfy the specific obligation for which it was used. This is not a case of purchasing property, allowing it to appreciate and then using it to satisfy an unrelated obligation, the type of situation intended for the special capital gains treatment.¹⁰⁷

In regard to the timing of income and deductions, according to the IRS Chief Counsel, the purchase of the credit is not the payment of the state tax liability. Rather, the taxable disposition and tax expense are recognized when the tax return is filed.¹⁰⁸ Thus, if the credit is purchased in 2007, and is applied to that year's tax return that is filed in 2008, the income and deduction are recognized in 2008.

Although the Chief Counsel's advisory memo does not mention the taxpayer's accounting method, it appears the advisory is directed at a cash basis taxpayer. For the accrual basis taxpayer that has elected to use the recurring item exception to the economic performance requirement, the income tax expense would accrue the last day of the year in which the income is earned, regardless of whether any of the tax had been paid.¹⁰⁹ But,

¹⁰² See I.R.S. C. Couns. Adv. Mem. 200126005 (June 29, 2001).

¹⁰³ See *id.*

¹⁰⁴ I.R.C. § 56(b)(1) (West Supp. 2007).

¹⁰⁵ I.R.C. § 1222(1),(3)(2000) (defining both "long-term" and "short-term" capital gain, in part, as "the sale or exchange of a capital asset"); see, e.g., *Fairbanks v. United States*, 306 U.S. 436 (1939) (holding that the redemption of a corporate bond was not a sale or exchange).

¹⁰⁶ *Fairbanks*, 306 U.S. at 437. But see *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir. 1940) (holding that the distribution of securities constituted a taxable "sale or exchange").

¹⁰⁷ Compare *Kenan*, 114 F.2d at 220, with *Hudson v. Comm'r*, 20 T.C. 734, 737 (1953) (holding that money received from a settlement of a judgment is taxable as ordinary income and is not capital gain).

¹⁰⁸ See I.R.S. C. Couns. Adv. Mem. 200126005 (June 29, 2001).

¹⁰⁹ See I.R.C. § 461(h) (West Supp. 2007).

the credit may not be deemed utilized until the tax return was filed, after the close of the year. This is true because filing the return and claiming the credit is a condition precedent to receiving the benefit of the credit.¹¹⁰ Thus, the accrual basis taxpayer's tax expense and gain from using the credit to pay the liability would be recognized in different tax years.

4. The Donor Transfers the Credit as a Gift

The donor who cannot utilize the credit may transfer the credit by gift. If one concluded that the donor received the credit in a non-taxable event, the donee's basis would be the same as the donor,¹¹¹ which as discussed above would be zero. Thus, the donee would have a gain equal to the face amount of the credit and an income tax expense for the same amount, when the credit is applied, for no net change in taxable income.¹¹² Consequentially, the donee's cash flow will be increased by the amount of the reduction in state taxes that did not require a cash payment.

If, on the other hand (as argued above),¹¹³ the donor would have income from the utilization of the credit under general principles of gross income, the transfer of the credit would be an assignment of the donor's income.¹¹⁴ Thus, when the donee utilizes the credit, the donor will recognize income. It follows that the donee would not have income, but would have an itemized deduction for the tax expense paid with the credit. In most circumstances, where the credit would be suitable property for a gift, the donor has no remaining tax to be absorbed by the credit, and the recognition of gain would result in little or no tax. But, the donee does have a tax liability. Therefore, if the donee's utilization of the credit creates taxable income for the donor, and a deduction for a donee without the utilization of cash, the gift is tax efficient; that is, the gift of the credit preserved the combined cash of the donor and donee.

In summary, under the general principles of gross income, the person who transfers a conservation easement and receives a Virginia tax credit has experienced an increase in wealth and should recognize income. A number of different scenarios as to when and how much income

¹¹⁰ See *General Dynamics v. United States*, 481 U.S. 239, 245-46 (1987) (holding that employee medical expenses are not deductible by the employer until claims are actually filed); *Doyle, Dane, Bernbach, Inc. v. Comm'r*, 79 T.C. 101, 106-07 (1982) (finding that company could not deduct as a capital loss expected loss from a probable loan default).

¹¹¹ I.R.C. § 1015(a) (2000).

¹¹² This assumes that the donee is not subject to the AMT.

¹¹³ *Supra* p. 9.

¹¹⁴ *Helvering v. Horst*, 311 U.S. 112, 118 (1940).

should be recognized were discussed above.¹¹⁵ In my opinion, however, the better chartered approach to the income issue is provided in the bargain sale to charity rules, discussed below.

II. BARGAIN SALE TO CHARITY

A. *The Credit as Sales Proceeds*

As stated in *Grodts & McKay Realty, Inc. v. Commissioner*, “[t]he term ‘sale’ is given its ordinary meaning for [f]ederal income tax purposes and is generally defined as a transfer of property for money or a promise to pay money.”¹¹⁶ The transferor of the easement receives a tax credit from the transferee.¹¹⁷ If the credit is deemed to be a promise to pay the transferor, then the special rules in the I.R.C. for bargain sales to charities apply. These rules require the taxpayer to partition the transaction, allocating basis between the amounts deemed sold and deemed donated.¹¹⁸ The consideration received (i.e., the tax credit) is matched with the basis in the portion deemed sold and gain or loss must be recognized.¹¹⁹

The bargain sale to charity rules were added to the I.R.C. in 1969, along with other changes to the charitable contributions rules.¹²⁰ These changes, in the aggregate, substantially reduced the tax benefits from charitable contributions of appreciated property. The House Committee on Ways and Means explained the underlying philosophy of the changes as follows:

Your committee does not believe the charitable contributions deduction was intended to provide greater—or even nearly as great—tax benefits in the case of gifts of property than

¹¹⁵ *Supra* Part I.

¹¹⁶ 77 T.C. 1221, 1237 (1981) (citing *Comm’r v. Brown*, 380 U.S. 563, 570-71 (1965)). *See also* *State of Iowa v. McFarland*, 110 U.S. 471, 478-79 (1884) (distinguishing a property for property transaction, a sale or exchange, from a property for services transaction).

¹¹⁷ The transfer may be to the Commonwealth of Virginia or to an organization described in I.R.C. § 501(c)(3). VA. CODE ANN. § 58.1-512(C)(4) (West 2007). If the transfer is to a § 501(c) organization, the agency is, in essence, the agent for its principal, the Commonwealth of Virginia.

¹¹⁸ I.R.C. § 1011(b) (2000).

¹¹⁹ The I.R.C. does not require the donor to allocate the expenses associated with the transfer between the portion sold and donated. The expenses paid by the donor are treated as cash contributions and, thus, do not enter into the basis allocations. *See* Rev. Rul. 74-477, 1974-2 C.B. 116 (holding that a corporation’s expenses incurred in connection with the transfer of property from a taxpayer paid by the taxpayer are treated as a cash contribution).

¹²⁰ Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(c), 83 Stat. 549, 564.

would be realized if the property were sold and the proceeds were retained by the taxpayer. In cases where the tax saving is so large, it is not clear how much charitable motivation actually remains.¹²¹

Although the major culprit of the prior law was the ability to deduct as a charitable contribution the fair market value of ordinary income property, Congress perceived the bargain sale to charity rules as overly generous.¹²² Before the 1969 changes, a taxpayer could sell property to a charity for an amount equal to or less than the seller's basis, reporting no gain on the sale, while deducting a charitable contribution equal to the fair market value of the property, less the bargain sales proceeds.¹²³ The net result was that none of the appreciation in the value of the property was included in income but was all deducted. For example, assume the donor sells a capital asset to the charity for \$8,000, the donor's basis, when the fair market value of the property is \$20,000. Before the 1969 Tax Act the donor would report a charitable contribution of \$20,000 – \$8,000 = \$12,000, and no gain would be recognized.¹²⁴

Under the 1969 amendments,¹²⁵ the donor-seller must treat the bargain sale price as an amount realized and must allocate his or her total basis to the portion deemed sold as follows:

(Selling price/fair market value) x Donor's basis in the property.

The donor's gain recognized is thus:

Amount realized – Basis in the portion sold = Taxable gain.

It is only in the context of a bargain sale to a charity that the transactions are partitioned between sale and gift.¹²⁶ This is deliberate on the part of Congress. Treasury Regulation § 1.1001-1(e), which applies to bargain sales in the context of non-charitable gifts, treats the sales proceeds as a recovery of basis and gain is only recognized if the proceeds exceed the

¹²¹ H.R. REP. NO. 91-413, at 54 (1969).

¹²² *See id.*

¹²³ *See id.* § 201(c), 83 Stat. at 564.

¹²⁴ Treas. Reg. § 1.1001-1(e) (as amended in 2007).

¹²⁵ I.R.C. §1011(b) (2000).

¹²⁶ *Id.*

total basis in the property.¹²⁷ This regulation was in existence when the bargain sale to charity rules were enacted and still applies to bargain sales other than bargain sales to charity, which are subject to the new rules.¹²⁸

The bargain sale formula denies the seller-donor a deduction for the appreciation in the portion of the asset deemed sold. Under current law, the seller will report a gain of \$4,800, calculated as follows:

$$\begin{aligned} \$8,000 - [(\$8,000/\$20,000) \times \$8,000] &= \$8,000 - \$3,200 = \\ \$4,800. &^{129} \end{aligned}$$

The donor will also be allowed a charitable contribution deduction of $\$20,000 - \$8,000 = \$12,000$.¹³⁰ The net effect of the transactions on taxable income is $-\$12,000 + \$4,800 = -\$7,200$.¹³¹ As discussed above, under prior law, the donor was simply allowed a charitable contribution deduction of $\$20,000$ fair market value $-\$8,000$ basis $= \$12,000$. Thus, the change in the law increased the donor's capital gain but leaves the itemized deductions unaffected.

In the above example, the taxpayer received a direct \$8,000 cash payment from the charity. With a conservation easement valued at \$20,000, but no direct payment of cash, Virginia would award the donor with an \$8,000 tax credit ($40\% \times \$20,000$). In substance, the credit is the same as a cash payment. Thus, the federal tax effects of receiving the credit would be the same as the above example, in which the donor actually received cash from the charity.

Virginia taxable income could also be affected. Under the general Virginia taxable income formula, the characterization of the state credit

¹²⁷ Treas. Reg. § 1.1001-1(e).

¹²⁸ See I.R.S. Gen. Couns. Mem. 36,642 (March 23, 1976) (reaching the conclusion that the split transaction approach to charitable transfers should not be applied to non-charitable bargain sales).

¹²⁹ See Treas. Reg. § 1.1011-2(c) (as amended in 1994).

¹³⁰ See *id.* If the donor in the above example received \$4,000, he or she would recognize gain of \$2,400 [$\$4,000 - (4/20)(\$8,000) = \$2,400$] and would have a charitable contribution deduction of \$16,000 [$\$20,000 - \$4,000 = \$16,000$], for a net effect on taxable income of $\$2,400 - \$16,000 = -\$13,600$.

¹³¹ See *id.* The reduction in tax will not be the decrease in taxable income multiplied by the marginal tax rate because the gain may be "capital" although the deduction is ordinary. See *supra* note 7 (discussing the relationship between the marginal tax rate and deductions). Also, including the gain in gross income may affect other deductions that are affected by adjusted gross income (e.g., medical expenses, exemptions and itemized deductions subject to phase-out). See *supra* notes 53-57 and accompanying text.

as sales proceeds from a bargain sale could increase state taxable income by the amount of the bargain sale gain. This is true because the calculation of Virginia taxable income is generally based on federal taxable income.¹³² If the state credit is sales proceeds and, therefore, reduces the federal charitable contribution, the state charitable contribution will likewise be reduced. Virginia laws, however, exclude from income any federal taxable income resulting from the conservation easement.¹³³ Thus, if the bargain sale rules would create a federal gain, the gain is not included in Virginia taxable income. The legislature may have provided for this variance because of the uncertainty regarding the federal law in regard to bargain sales and the state credit. Although the Virginia statute excludes from Virginia taxable income the gain that would arise from treating the credit as bargain sale proceeds, the statute does not restore to the charitable contribution deduction the amount of the credit. Thus, in the above example, the Virginia taxable income would not include the \$4,800 gain, but the charitable contribution deduction would be \$12,000, rather than the \$20,000 value of the property.

Continuing the above example, assume the taxpayer's state income tax before the credit is \$10,000 and the environmental credit is allowed for 40% of the value of the property, or $.40 \times \$20,000 = \$8,000$. Treating the credit as bargain sale proceeds, rather than a reduction in state income taxes, means that the state taxes paid are \$10,000, rather than $\$10,000 - \$8,000$ credit = \$2,000. If the bargain sale rules are not invoked, the taxpayer would reduce federal taxable income by the value of the easement, \$20,000, and take a \$2,000 deduction for state taxes paid. Also, when the charitable contribution is reduced by \$8,000 as bargain sale proceeds, the taxpayer's Virginia taxable income will increase by \$8,000.

	Bargain Sale	No Bargain Sale
Charitable contribution (ordinary deduction)	(\$12,000)	(\$20,000)
Taxable gain	\$4,800	\$0
Federal deduction for state taxes paid	(\$10,000)	(\$2,000)
Net effect on federal taxable income	(\$17,200)	(\$22,000)

¹³² VA. CODE ANN. § 58.1-322 (West 2007).

¹³³ *Id.* 58.1-513(D).

It should be noted that the differences in the tax effects of applying the bargain sale rules is much more dramatic if the taxpayer is subject to the alternative minimum tax ("AMT"). This is true because the state income tax is not deductible in arriving at alternative minimum taxable income.¹³⁴ Thus, if the transaction in the above example is applied to a taxpayer subject to the AMT, the bargain sale results in a \$7,200 net reduction in taxable income.¹³⁵ Without the bargain sale rules applied to the charitable contribution, the net effect on taxable income is a \$20,000 reduction.

1. Should the Bargain Sale Rules Be Applied to the Receipt of the Virginia Credit?

As suggested above, in determining the federal tax consequences of the state tax credit, to ignore the credit is an incomplete application of the income tax system. The taxable income formula begins with the objective of taxing increases in wealth that have been realized, unless the income is specifically excluded or deductions are permitted.¹³⁶ The law then provides for deductions, including charitable transfers, in arriving at taxable income. But, the charitable transfer brings with it an offsetting increase in wealth as state taxes are reduced, and this reduction would not have occurred "but for" the transfer. To take into account the negative effects on wealth of the transfer without accounting for the positive effects of the same transaction is an incomplete analysis of the events.¹³⁷ That is not to say that all deductions allowed for state tax purposes produce federal taxable income. Rather, the Virginia credit is extended to persons who transfer property to the Commonwealth (or in trust for the benefit of the state), bringing the transactions into an exchange of values.¹³⁸

The bargain sale approach is defensible when the taxpayer receives more than incidental state tax benefits from the conservation easement. By "more than incidental" it is meant that the additional revenue is worth the additional cost of compliance and enforcement. From a technical point of view, the donor has transferred property and has received consideration for the transfer, thus satisfying the sale or exchange requirement that was discussed above.¹³⁹ Moreover, Congress has not provided an exclusion from

¹³⁴ I.R.C. §56(b)(1) (West Supp. 2007).

¹³⁵ \$4,800 (taxable gain) – \$12,000 (charitable contribution deduction) = –\$7,200.

¹³⁶ See *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1954).

¹³⁷ See *Diedrich v. Comm'r*, 457 U.S. 191, 196-98 (1982).

¹³⁸ See VA. CODE ANN. § 58.1-512(A) (West 2007).

¹³⁹ See *supra* notes 105-107 and accompanying text.

the bargain sale rules in the case of sales to a state government.¹⁴⁰ From the point of view of horizontal equity, a donor in Virginia is better able to pay his or her tax after making a charitable contribution of a conservation easement than a person who has identical tax attributes, unless he or she resides in a state that does not provide a credit for the charitable transfer.

a. Are the State Credit Proceeds from a Sale or Other Disposition?

Applying general principles of tax accounting, the grant of an easement is a transfer of an interest in real property.¹⁴¹ A sale of real property is a transfer for cash or a promise to pay cash.¹⁴² It follows that if the state tax credit received for granting the easement is "cash or a promise to pay cash," the transfer of the easement is a sale of an interest in real property. As discussed above, the donor receives the payment in the form of a reduction in state income tax. If the donor owes state taxes equal to or greater than the credit, the donor can be viewed as paying the tax with the proceeds from the sale of the easement. If the donor does not owe state taxes, he or she can assign the credit (by gift, sale or exchange) to someone who can use it.¹⁴³ In the latter case, if the donor received cash from the state for the assignment of his or her promise, the donor may have gain from this transaction, as will be discussed below.

The credit, or payment from the state, is deferred from income until the taxpayer files a return and utilizes the credit.¹⁴⁴ Moreover, the payment is contingent upon the taxpayer having a tax liability. Thus, the transaction is an installment sale with a contingent selling price.¹⁴⁵ If the donor sells his or her credit, the disposition of an installment obligation rules are applicable.¹⁴⁶

If one cannot accept the tax credit as the Commonwealth's promise to pay because of its contingent nature, the credit is, nevertheless, property received in exchange for the easement. The credit contains rights

¹⁴⁰ See I.R.C. § 1011 (2000); Treas. Reg. § 1.1001-1 (as amended in 2007).

¹⁴¹ See, e.g., Rev. Rul. 59-121, 1959-1 C.B. 212.

¹⁴² "A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent." *Comm'r v. Brown*, 380 U.S. 563, 570 (1965) (quoting *Iowa v. McFarland*, 110 U.S. 471, 478 (1884)).

¹⁴³ VA. CODE ANN. § 58.1-513(c)(1) (West 2007). See *supra* note 13 and accompanying text.

¹⁴⁴ See *supra* note 108 and accompanying text.

¹⁴⁵ See Treas. Reg. § 15a.453-1(c)(1) (as amended in 1994).

¹⁴⁶ See I.R.C. § 453(I) (West Supp. 2007).

protected by the Commonwealth, with value that can be sold or exchanged.¹⁴⁷ Moreover, the IRS has ruled that a conservation easement credit is property for purposes of the like-kind exchange rules.¹⁴⁸

Finally, one logical hurdle with regard to characterizing the credit as sales proceeds, as discussed above, is that the transfer is often to a trustee while the payment is received from the state. The trustee arrangement, however, is used to relieve the state of the burden of enforcing the easement for which the state is making the payment. In substance, the payment is made by the state for its own benefit and the trust arrangement is a matter of form. Also, in at least one case, in determining whether a transfer for consideration had occurred, the United States Court of Claims ruled that the benefit received by the transferor need not come from the donee-transferee.¹⁴⁹

b. The Service's Current Inclination

As discussed above, at the time of this writing, the IRS had not endorsed the bargain sale in the context of a state credit. In fact, the IRS seems to be leaning toward not applying bargain sale reasoning.¹⁵⁰ The authority for the IRS's preliminary position, however, is not "on point" and, as demonstrated above, there is substantial authority for applying the bargain sale rules to the Virginia "property for tax credit" exchanges.¹⁵¹

Whether, as a matter of policy, the IRS should exercise that authority is another matter. If there is any validity to the underlying assumption that the size of a tax benefit will influence property owners' decisions to make the contributions, reducing the benefit (through the application of the bargain sale rules) would obviously impact some donors' decisions, and thus reduce the number of acres of land preserved. If the goals of the state and the federal government seem to be in congruence, and the budget considerations are also in harmony, then the IRS should not pursue a change in the rules. That is, the IRS should wait for Congress to speak, and Congress should speak.

In summary, based on existing law, a transferable conservation easement credit is property received in exchange for an interest in the

¹⁴⁷ See BLACK'S LAW DICTIONARY 1252 (8th ed. 2004) (defining the word "property").

¹⁴⁸ See I.R.S. Priv. Ltr. Rul. 06-51-025 (Dec. 12, 2006).

¹⁴⁹ See *Singer Co. v. United States*, 449 F.2d 413, 421 (Cl. Ct. 1971).

¹⁵⁰ See *supra* pp. 7-9.

¹⁵¹ See discussion *supra* p. 9.

real estate. Because the amount of the credit is only forty percent of the value of the easement, the transaction is part sale and part charitable contribution. The portion deemed sold and the resulting taxable gain are determined by the bargain sale to charity rules.¹⁵²

2. Should the Bargain Sales Proceeds Reduce the Base for the Credit?

In the above example, if the Virginia credit was treated as sales proceeds, the federal charitable contribution was reduced. If the federal charitable contribution is reduced, does this reduce the base for the credit? In the example, if the credit is forty percent of the \$20,000 value, does this mean the credit is permitted on only \$12,000 [\$20,000 – \$8,000 sales proceeds]? According to the Virginia statute, the credit is forty percent of the fair market value of the conveyance (\$20,000 in the example) and the federal bargain sale rules are not mentioned.¹⁵³ But, the Virginia statute also provides that “[t]he value of the donated interest in land that qualifies for credit under this section, as determined according to appropriate federal law and regulations, shall be subject to the limits established by I.R.C. section 170(e).”¹⁵⁴ The latter section sets forth the adjusted gross income limitations for various types of property, the value of which are otherwise deductible.¹⁵⁵ When these sections of the Virginia Code are considered in light of another Virginia Code section that excludes from Virginia taxable income any federal income resulting from the charitable contributions, it appears that the Virginia statutes are intended to allow the credit on the value of the property before the application of the bargain sale rules.¹⁵⁶

But, the Virginia statute could also be read more narrowly to mean that the base for the Virginia credit must be the same amount as the deduction allowed for federal income tax purposes.¹⁵⁷ If this is correct, the application of the bargain sale rules to the credit situation will create more complex calculations (because of the interdependent variables), as well as reducing the base for the credit. Recognizing these interrelationships,

¹⁵² See Treas. Reg. § 1.1001-1(e) (as amended in 2007); I.R.C. § 1011(b) (2000).

¹⁵³ VA. CODE ANN. § 58.1-512(A) (West 2007).

¹⁵⁴ *Id.* § 58.1-512(B).

¹⁵⁵ *Id.*

¹⁵⁶ See *id.* § 58.1-513(D).

¹⁵⁷ See *id.*

the charitable contribution portion of the bargain sale transaction can be determined by using basic algebra as follows:

$$X = \text{FMV} - CX,$$

where “X” is the charitable contribution portion of the transaction, “FMV” is the fair market value of the property and “C” is the state credit as a proportion of the charitable contribution portion. Thus, as in the above example, where FMV = \$20,000, the charitable contribution portion is \$14,286 and the sales proceeds equal \$5,714, as calculated below.

$$\begin{aligned} X &= \$20,000 - .4X \\ 1.4X &= \$20,000 \\ X &= \$14,286 \\ \$20,000 - \$14,286 &= \$5,714. \end{aligned}$$

As discussed above, the Virginia statutes appear to be tailored to limit the effects of federal action that would reduce state tax benefits from the credit. Thus, the sensible interpretation of the Virginia statute is that if the state credit triggers the federal bargain sale rules, the Virginia credit is, nevertheless, based on the value of the conservation easement without reduction for the state credit.¹⁵⁸ Therefore, the bargain sales proceeds in the above example should simply be 40% of the fair market value of the easement, but this is only the present author’s “filling the blanks” in statutes that should be clarified.

3. Does the Charitable Contribution Deduction Create Sales Proceeds?

In addition to the credit, Virginia permits the taxpayer a charitable contribution deduction equal to the deduction allowed on the federal return.¹⁵⁹ If the state tax credit is received in a bargain sale transaction, it seems to follow that the reductions in state taxes from the charitable contribution deduction are also received as proceeds from a bargain sale. The intuitively correct answer regarding the credit is that it is an amount realized—it is substantial consideration for relinquishing property rights,

¹⁵⁸ See VA. CODE ANN. § 58.1-513(D) (West 2007).

¹⁵⁹ See *id.* §§ 58.1-322(A), 402(A). This result is accomplished indirectly under Virginia law by using federal taxable income as a starting point for calculating Virginia taxable income.

a *quid pro quo*. The state credit is a payment for certain behavior. Once we begin down this path of treating the state credit as an amount realized, the reduction in state taxes as a result of the charitable contribution deduction should likewise be an amount realized: the same events create both the credit and the deduction. That is not to say that every deduction permitted on a state return creates federal gross income. The bargain sale to charity is a special case of creating a "sale" where, under the general rules of taxation, the transaction is not partitioned into part sale and part gift.¹⁶⁰ Although there may be valid economic arguments for generally treating the state tax savings from a deduction as federal taxable income, this has never been done, perhaps because of political or administrative considerations.¹⁶¹ Thus, a charitable contribution of cash produces a state tax benefit not included in federal taxable income under, perhaps, a common law of taxation.

The bargain sale to charity, however, is a special case that Congress has addressed.¹⁶² In non-charitable bargain sales (usually between family members), the total basis in the property is matched with the sales proceeds.¹⁶³ Before the 1969 amendments to the Code, bargain sales in non-charitable situations where there was an excess of the value of the property sold over the total sales proceeds were charitable contributions. But, Congress deliberately singled out the bargain sale to charity for bifurcation of the transaction in the 1969 legislation.¹⁶⁴ If the credit is an amount realized from a bargain sale, the state tax savings from the deduction is, likewise, an amount realized.

The previous example is extended to include a state income tax deduction of .0575% of the value of the easement. The first column shows the results if the reduction in the state income tax as a result of the charitable contribution deduction is included in the amount realized from the bargain sale:

¹⁶⁰ Compare Treas. Reg. § 1.1001-1(e)(2) (as amended in 1996), with Treas. Reg. §§ 1.1011-2(b)-(c) (as amended in 1994).

¹⁶¹ If the formula for computing state taxable income begins with federal taxable income, the federal taxable and state taxable income formulas become circular: a state deduction increases federal taxable income, which, in turn, increases state taxable income.

¹⁶² See I.R.C. § 1011(b) (2000).

¹⁶³ See *Diedrich v. Comm'r*, 457 U.S. 191, 198-99 (1982). See, e.g., *Mason v. United States*, 513 F.2d 25, 29 (6th Cir. 1975); *Singer Co. v. United States*, 449 F.2d 413, 418 (Cl. Ct. 1971).

¹⁶⁴ See I.R.C. § 1011(b).

	Bargain Sale, State Deduction as Proceeds	Bargain Sale, No State Deduction as Proceeds	Difference	No Bargain Sale
Charitable contribution (ordinary deduction)	(\$11,348)	(\$12,000)	\$652	(\$20,000)
Taxable gain	\$5,191	\$4,800	\$391	\$0
Federal deduction for state taxes paid	(\$10,000)	(\$10,000)	0	(\$2,000)
Net effect on Federal taxable income	(\$16,157)	(\$17,200)	\$1,043	(\$22,000)

The charitable contribution when the state deduction is not treated as sales proceeds is the \$20,000 fair market value of the property, less the \$8,000 state credit.¹⁶⁵ To compute the amount of the charitable contribution when the deduction is treated as sale proceeds, \$12,000 must be divided by 1 plus the donor's marginal tax rate ($\$12,000 / (1 + 0.0575)$) which equals \$11,348. In the example, the state deduction for the charitable deduction of the easement reduced the state income tax by \$652. This means that \$652 of the purchase price should be allocated to the bargain sale, rather than the charitable contribution.¹⁶⁶ Thus, the charitable contribution was reduced by \$652. When the additional \$652 was allocated to the bargain sale, this increased the taxable gain by \$391.¹⁶⁷ ($\$652 \times \$12,000 / \$20,000$).

It should be noted that, in the example, the federal deduction for state taxes paid was not changed. The state income tax did not change because, under the Virginia statute, Virginia taxable income will not include any gain or income recognized under federal income tax from the use or sale of the credit.¹⁶⁸

In my opinion, a court would be reluctant to require a donor to include the reduction in state taxes in the bargain sale proceeds. To do so could raise the issue of whether any deductions on a state return would always yield federal taxable income. Although that line of reasoning does not have general merit, it does have merit in the context of the bargain sale to charity situation, even though the consequences of its implementation would be very unpopular. Thus, before the issue raises its unpleasant head, it should be addressed in a statute.

¹⁶⁵ See *supra* p. 25.

¹⁶⁶ See *Estate of Bullard v. Comm'r*, 87 T.C. 261, 294-95 (1986).

¹⁶⁷ See I.R.C. § 1011(b) (2000).

¹⁶⁸ VA. CODE ANN. § 58.1-513(D) (West 2007).

B. The Character of the Gain from the Bargain Sale

As discussed above, if the bargain sales rules apply, the donor must recognize gain from the deemed sale of the asset.¹⁶⁹ The character of the gain should be determined by the character of the property deemed sold. The easement is an interest in real property.¹⁷⁰ Therefore, the gain is "capital" if the property was held as an investment or personal use or is section 1231 gain if the land is used in a trade or business.¹⁷¹ In the case of farm land, ordinary income recapture of soil and water conservation expenses apparently do not apply.¹⁷²

C. The Use of the Credit

The performance of the necessary acts to receive the credit is not a taxable event for the cash or accrual basis taxpayer.¹⁷³ This is true because the actual receipt of the cash is generally deferred until the tax return is filed, and thus the installment sale rules defer the gain recognition until the proceeds are collected, if the bargain sale rules are applied.¹⁷⁴ When the tax return is filed, and the credit is utilized, the installment sale gain is recognized. The cash basis taxpayer will recognize the income from the bargain sale and the tax expense (deemed paid with the credit) in the same year.¹⁷⁵ The accrual basis taxpayer would accrue the income tax as of the end of the year, based on the income earned (assuming the recurring items exception to the economic performance test can be utilized), but the gain will not be recognized until the return is filed and the taxpayer is deemed to collect on the installment obligation.¹⁷⁶ If the bargain sale rules are not applied to the accrual basis taxpayer, and the recurring items exception to section 461(h) applies, the income tax net of the available credit will accrue as of the end of the tax year.¹⁷⁷

¹⁶⁹ See *supra* note 167 and accompanying text.

¹⁷⁰ See, e.g., Rev. Rul. 72-549, 1972-2 C.B. 472.

¹⁷¹ See I.R.C. § 1231 (2000).

¹⁷² See I.R.C. §§ 175, 1252 (2000). If the easement prevented use of the property for farming, perhaps this would be a disposition under section 1252.

¹⁷³ See *supra* note 119 and accompanying text.

¹⁷⁴ See I.R.C. § 453(c) (2000).

¹⁷⁵ See *id.* § 461(a).

¹⁷⁶ See *id.* § 461(h)(3).

¹⁷⁷ See Treas. Reg. §§ 1.461-4(g) (as amended in 1999), 1.461-5 (as amended in 1995).

The cash basis taxpayer applying the bargain sale rules will recognize the gain from the bargain sale in the same year as the return is filed applying the credit against the tax due.¹⁷⁸ At the same time, the deduction for the state tax expense will be the amount of the tax before the credit.¹⁷⁹ If the bargain sale rules are not applicable, the cash basis taxpayer recognizes no gain and the taxes actually paid (net of credits) are deducted when paid.

D. Transfers of Credits

1. Sale of the Credit

As discussed above, donors who do not expect to be able to utilize the credit because of insufficient Virginia taxable income can sell and thereby receive monetary benefits from the contribution of the easement.¹⁸⁰ The transfer of a credit for consideration is clearly an increase in wealth realized and, thus, is a taxable event.¹⁸¹ The donor must compare the amount realized from the transfer with his or her basis in the credit. Furthermore, the character of the gain must be determined.

Under the bargain sale rules, the basis in the property deemed sold must be computed. The total basis in the fee simple interest must be allocated between the easement and the remaining interest in the property. The basis in the easement must be further allocated between the portion deemed sold and the contributed portion.¹⁸² The bargain sale transaction (easement for a tax credit) is an installment sale. An installment sale is "a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs."¹⁸³ The application of the credit to the tax liability is a "payment" and, generally, the credit will not be applied until the tax return is filed after the close of the year in which the transfer occurs. The right to receive the credit is an "installment obligation." Therefore, the donor-credit-seller's basis in the portion of the easement becomes his or her basis in the installment

¹⁷⁸ I.R.C. § 461(a).

¹⁷⁹ See Treas. Reg. § 1.164-1 (as amended in 1978) (noting that federal income tax allows a deduction for state and local taxes levied, not paid).

¹⁸⁰ Of course, the credit can only be applied against Virginia income tax.

¹⁸¹ *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

¹⁸² See I.R.C. § 1011(b) (2000).

¹⁸³ *Id.* § 453(b)(1). See Treas. Reg. § 15a.453-1(b)(1) (as amended in 1994).

obligation.¹⁸⁴ The difference between the seller's basis in the installment obligation and the proceeds from the sale is taxable gain.¹⁸⁵ If the easement for a tax credit transaction is not considered a bargain sale, the donor has no basis in the credit. Therefore, the entire sales proceeds is taxable gain.¹⁸⁶ The above example has been extended by assuming that the donor sold the \$8,000 state tax credit for \$6,000.

	Bargain Sale	No Bargain Sale
Charitable contribution (ordinary deduction)	(\$12,000)	(\$20,000)
Basis in credit	\$3,200	\$0
Sales proceeds from credit (75% of face)	\$6,000	\$6,000
Taxable gain from sale of credit	\$2,800	\$6,000
Net effect on federal taxable income	(\$9,200)	(\$14,000)

The difference between the two options is the appreciation in the portion of the asset deemed sold under the bargain sale rules:

$$(\$8,000 \text{ sales price} / \$20,000 \text{ basis}) \times (\$20,000 \text{ value} - \$8,000 \text{ total basis}) = \$4,800.$$

As the example indicates, whether the bargain sale rules apply can have significant tax effects on the taxpayer who sells his or her credit. In reality, however, this difference may be irrelevant because the taxpayers who sell credits generally are doing so because they have no state tax liability.¹⁸⁷ Further, because Virginia taxable income is based on federal taxable income (with adjustments), there is no federal tax liability.¹⁸⁸ For these taxpayers the incentive provided by the tax law is simply the amount he or she receives from the sale of the credit, which is unaffected by the outcome of the bargain sale issue.

¹⁸⁴ Treas. Reg. § 1.453-9(b) (as amended in 1995).

¹⁸⁵ *Id.* § 1.453-9(b)(1)(I).

¹⁸⁶ *Id.* § 1.453-9(b)(1)(ii).

¹⁸⁷ See Op. Va. Att'y Gen. No. 02-094 (Nov. 19, 2002) (opining that a person only has to be subject to taxation in Virginia and does not have to have paid Virginia income taxes to receive income tax credits that can be transferred).

¹⁸⁸ VA. CODE ANN. § 58.1-322 (West 2007).

As discussed above, the sale of the credit is the sale of an installment receivable when the bargain sale rules are applied.¹⁸⁹ Thus, the character of the gain is determined by the character of the property deemed sold in the bargain sale transaction. Moreover, whether the gain is long-term is determined by the holding period of the land from which the basis in the easement was derived.¹⁹⁰

2. The Credit Purchaser

The purchaser of the credit acquires a basis equal to his or her cost. A Chief Counsel Memorandum took the position that the use of the credit is a taxable disposition resulting in gain or loss equal to the difference between the purchaser's basis in the credit and the amount of the deduction in tax (i.e., the face amount of the credit) and that the purchaser is permitted a deduction for state income taxes paid for the amount of the tax due before the application of the credit.¹⁹¹ Thus, if the purchaser paid \$7,500 for a \$10,000 state tax credit, when the tax return was filed and the credit was applied, the purchaser would recognize \$2,500 gain and a deduction for \$10,000 in state income tax paid. Under this approach, however, the taxpayer who is subject to the alternative minimum tax will recognize \$2,500 gain but will have no deduction for state income taxes paid.¹⁹²

3. Gift of the Credit

As illustrated above, under the bargain sale rules, the donor receives an installment obligation with a basis determined by his or her basis in the easement.¹⁹³ The gift of the credit is a disposition of the installment obligation. Under Section 453 of the I.R.C., the disposition is a taxable event to the donor, who must recognize gain equal to the difference between his or her basis in the obligation and its fair market value.¹⁹⁴ The donee, thus, obtains a basis equal to the fair market value of the obligation and will recognize gain when the credit is utilized equal to the difference between

¹⁸⁹ *Supra* Part II.A.1.a

¹⁹⁰ *Supra* note 98 and accompanying text.

¹⁹¹ See I.R.S. C. Couns. Adv. Mem. 0238041 (Sept. 20, 2002).

¹⁹² See I.R.C. § 56(b)(1) (West Supp. 2007).

¹⁹³ See I.R.S. C. Couns. Adv. Mem. 200126005 (June 29, 2001).

¹⁹⁴ See I.R.C. § 453(b)(2)(B) (2000).

the amount of the credit and the donee's basis.¹⁹⁵ Thus, the bargain sale rules shifts income back to the donor and away from the donee.

E. Other Bargain Sale Applications

The donor transfers the easement with the expectation of a positive cash flow from reduction in a tax liability, or proceeds from the sale of the credit. The donor, however, may be required to make substantial payments to create and transfer the easement. When the transfer is to a I.R.C. Section 501(c)(3) organization, rather than the Commonwealth of Virginia, the tax-exempt organization may be willing to pay the donor's expenses associated with the transfer and obtaining approval for the credit.¹⁹⁶ When this is done, it seems clear that the bargain sale rules apply, regardless of whether the bargain sale rules apply to the receipt of the credit. That is, the donor is receiving proceeds from the donee in a charitable contribution setting, which fits the terms of section 1011(b).¹⁹⁷

CONCLUSIONS

Uncertainty regarding the federal tax benefits of state conservation easement credits may cause the donors to discount the expected benefits from the transfers. The reduced expected benefits will cause some potential donors to decide to permit development, thus reducing the effectiveness of state law. Congress should speak so as to remove doubt about whether the state income tax credits for the environmental easements create federal taxable income to the donor under general concepts of gross income or under the bargain sale to charity rules. Further, Congress should address the issue of whether applying the existing tax laws, which create federal taxable income from the environmental easement transfers, is contrary to federal environmental policy.

¹⁹⁵ See *id.*

¹⁹⁶ See I.R.C. § 501(c)(3) (West Supp. 2007).

¹⁹⁷ See I.R.C. § 1011(b) (2000).