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“Doing well by doing good:” Taking the concept to another level - by Michael Packman and Brian Sidman

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“Doing well by doing good.” Fortunately, this concept is referred to more and more lately and one that has always resonated with our real estate firm. Having run businesses for over fifteen years, I have always noticed that the best deals are done when all parties best interest are taken into account and all feel the deal is fair. So, what if the concept is taken to another level? What if in addition to being economically beneficial, it also accomplished something beneficial for the planet as a whole? That sounded like a great concept to me.

Over three years ago, I was introduced to one such concept. At first, it seemed too good to be true, but after extensive due diligence I came to find a niche industry, conservation easements. Internal Revenue Code (IRC) § 170(h) states that a qualified conservation contribution is a contribution of a qualified real property interest (i.e., a restriction granted in perpetuity on the use which may be made of the real property) to a qualified organization exclusively for conservation purposes. “Conservation easement” is the generic term for easements granted for preservation of land areas and section 170(h) of the tax code allows for four types of conservation contributions. The preservation of land areas for outdoor recreation by, or the education of, the general public. For the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem. The preservation of open space (including farmland and forest land). And lastly, preservation of a historically important land area or a certified historic structure. Conservation easements permanently restrict how land or buildings are used. The “deed of conservation easement” describes the conservation purpose(s), the restrictions and the permissible uses of the property. The deed must be recorded in the public record and must contain legally binding restrictions enforceable by the donee organization.

So what are some of the benefits to contributing a property as opposed to developing it? The “value” of an easement is the difference between the value of the land before the easement and the value of the land after the easement. Once the easement is donated to the land trust it is qualified as a charitable donation for the amount equal to the “value” of the easement. Individuals can deduct up to 50% of their adjusted gross income as of December 2015. Deductions offset both federal and state taxes, can be used against all types of income and can offset quarterly payments.

Investment in land that may be used for conservation easement has been a great way for individual landowners to conserve property while reaping tax benefits noted. About ten years ago, the syndication of conservation easements was introduced. The syndicated model has allowed high-income earners to participate in this process and reap the rewards as well. However, after years of investors reaping the benefits of the transactions while staying under the radar, the IRS has started to look into them. Last year, they declared conservation easements to be a listed transaction, which has scared away sponsors along with some of the potential investors. Our belief is the declaration is positive for the industry. As with any industry when it picks up a head of steam, you have people without much experience that cut corners and look to make a quick profit. With the new scrutiny, many of these poorly run or overly aggressive sponsors have exited the space. On the other hand, congress back in July gave instructions to the IRS in their budget proposal that no new funding is to be spent on easement enforcement. It is apparent, that while the IRS has a close eye on the industry, there are plenty in the government that see the value for investors and the planet thus desiring for industry to continue its growth.

Let’s dive into the potential benefits and risks that an investor takes when getting involved in a transaction with an easement option. For purposes of this exercise we will outline an easement with a 4 to 1 deduction. An individual with an annual income of $1 million, makes a $125,000 investment, assuming 39.6% federal and 6% state tax, he would receive a $500,000 write off against ordinary income which equates to $228,000 in tax savings. Sounds great right? Now, it is important to review the risks. The major risk is if the transaction gets audited, which the IRS has a three-year statute of limitations to inform a partnership of an audit from the date the easement is filed. If the transaction was found not to be acceptable, the entire deduction would be disallowed, if it is deemed acceptable, but the valuation of the appraisal is found to be too high, the amount of the deduction may be reduced.

There are a few key components to these transactions. First and most importantly, the offering cannot be sold as an easement transaction. The transaction must be a development project of some fashion that has the option for an easement. Once a transaction is fully funded, the limited partners (investors) vote, and as long as a majority votes for the easement, it is filed. Secondly, the deduction should be in the 4 to 1 or 5 to 1 range (in the past certain transactions were 8 or even 10 to 1). The sponsor of the transaction should have sufficient experience in the area and have a viable project. The sponsor should allocate a sufficient amount in reserves for audit defense. We believe it should be in excess of $500,000. This is a rough estimate of the amount needed in the case of an audit. Lastly, and most importantly, there should be two appraisals done by reputable appraisers with the lowest one used for the project. As an added layer of protection, a handful of sponsors have found international insurance companies to insure the principal of the transaction should there be an audit. This has become an interesting space and one we have spent several years doing substantial due diligence on and have deemed that with a well put together transaction and team behind the transaction, it holds a value for the right investor.

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