Valuable strategies for taxpayers with substantial income and/or capital gains - by Michael Packman

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Michael Packman,
KNPRE

For years, the ownership and use of real estate in the United States has had tax advantages if you know what you are doing, and today is no different. I would like to share a couple of strategies that can be valuable to those taxpayers with substantial income and/or capital gains.

The first strategy can be valuable for the mitigation of either ordinary income or capital gains. It involves a little-known section of the tax code; 26 U.S. Code § 170(h) – "Qualified Conservation Contribution." Within this section, the Code defines "qualified conservation contribution" as a contribution of a "qualified real property interest" to a "qualified organization" exclusively for "conservation purposes." "Qualified real property interest" is defined as "any of the following interests in real property: (A) the entire interest of the donor other than a qualified mineral interest, (B) a remainder interest, and (C) a restriction (granted in perpetuity) on the use which may be made of the real property." With respect to subsection (C), the Code indicates that a conservation easement should constitute a "qualified real property interest." To effectuate the transfer of such a "qualified real property interest," the donor would draft, file, and record a deed that evidences the conservation easement as well as the legally binding restrictions with respect to the underlying real property enforceable by the "qualified organization," also known as the donee organization. But, how is this strategy valuable?
This first strategy is valuable because a proper "qualified conservation contribution" generates noncash charitable contribution deductions that can offset approximately 50% of an individual's adjusted gross income, which includes federal and, in some cases, state taxes as well as all types of income. However, the exact value of a proper "qualified conservation contribution" is subject to several factors, including the personal tax circumstances of the donor. With respect to the generation of deductions, the amount generated for the donor equals the difference between the value of the underlying real property before the charitable donation and after the charitable donation as determined by a "qualified appraiser." Thus, the ability to deduct up to half of your income sounds like a great advantage in connection with the ownership of real estate; especially if the value of the "qualified conservation contribution" in terms of deductions is substantially more than what was paid for the underlying real property, which sometimes is the case.

Yet, like with most government-incentivized programs, the grant of a "qualified conservation contribution" is susceptible to abuse and as such there are risks involved. The most prevalent risk in connection with a "qualified conservation contribution" is that of being audited. The Internal Revenue Service is afforded a three-year window, beginning on the date the tax return associated with the "qualified conservation contribution" is filed, to inform such donor that it is under audit. There are a number of outcomes that may arise following an audit; including, but not limited to, the complete disallowance of the entire requested deduction via challenge by the IRS, the reduction of the requested deduction via challenge by the IRS, or the allowance of the entire requested deduction by the IRS.

If you get audited, the IRS will most likely challenge the "qualified conservation contribution" on several grounds. First, the IRS may question whether is the underlying real property is worthy of conservation. To combat this challenge, the donor would need to make sure the requirements of Code § 170(h) are met. Second, the IRS may question the "qualified conservation contribution" on the basis of whether the technical requirements of Code § 170(h) were met. Here, it is crucial that all technical requirements were met. One such requirement is ensuring that the "highest and best use" of the underlying real property (used when determining the value of the underlying real property after the charitable donation) was "legally permissible," "physically possible," and "economically feasible" prior to donation. This can be done by engaging a relevant third-party expert to evaluate the underlying real property. Complying with all technical requirements also means making sure the necessary paperwork was filed and that the donation was recorded correctly. Therefore, if you are interested in making a "qualified conservation contribution," it is important to have the right advisors, attorneys, and appraisers as well as a charitable organization that constitutes a "qualified organization." Following this advice, can help you avoid making any missteps and ensure your proper compliance with Code § 170(h) as well as award you a feeling of pride and accomplishment for helping preserve our nation's dwindling environmentally significant habitats.

The second strategy that is valuable for certain taxpayers is a much newer addition to the code and one that the government is currently heavily promoting; "Opportunity Zones." The Opportunity Zone program was created by the Tax Cuts and Jobs Act of 2017 and meant to spur investment in undercapitalized communities. In essence, a taxpayer who deploys capital into a "Qualified Opportunity Zone," through a "Qualified Opportunity Fund," is afforded certain tax incentives for doing so. The reason the program has been given so much focus by the government is the impact the corresponding investments can have on impoverished areas and those affected by natural disasters, such as Puerto Rico and the U.S. Virgin Islands.

Unfortunately, this strategy cannot help mitigate ordinary income taxes, it only mitigates capital gains similar in some ways to that of a "1031 Exchange." Yet, unlike the first strategy, one of the many benefits of participating in an Opportunity Zone is that a taxpayer need only invest their capital gains and not the principal of any investment to defer certain taxes. The capital gains may be the as result of a sale of real property, stock, and/or a business. For example, if you were to sell your interest in a "Qualified Opportunity Fund" after five years, you would be afforded a stepped-up basis of 10% on the capital gains invested or, if you sold the same interest instead after seven years, then you would be afforded a stepped-up basis of 15%. Additionally, any gains generated by a "Qualified

Opportunity Fund" if you were to hold your investment for ten years or more are tax free after such period. However, there are certain disadvantages with an investment in an Opportunity Zone. As of now, one such disadvantage is that certain taxes must be paid by 2026, despite an interest in the "Qualified Opportunity Fund" potentially not being sold. Another disadvantage involves the stepped-up basis of 15%, which requires investment in an Opportunity Zone prior to the end of 2019.

When compared to other strategies, an investment in an Opportunity Zone does not require some of the tedious requirements that other strategies suffer from. For example, in a "1031 Exchange," real estate must be swapped in order to comply with that strategy's requirements. Further, Opportunity Zone investment offers a taxpayer more flexibility as it allows for them to dictate where their capital gains will go. Current investments that qualify for Opportunity Zone investment include commercial real estate developments, new businesses, expansion of existing businesses into Opportunity Zones, and/or the continued expansion of businesses already located inside Opportunity Zones. However, when compared to other strategies, the major downside of an investment in an Opportunity Zone is the lack of specific guidance and history that other strategies benefit from as until recently there was a significant lack of detailed information regarding Opportunity Zones. For example, a few months ago, the government published some comprehensive guidance that provides much needed clarity on several important items, but there is still the possibility that a taxpayer may run into an issue not yet addressed.

In summary, real estate can be an extremely tax efficient investment in the mitigation of both income tax and capital gains, but you must have the right advisors and team to make sure the complex rules and requirements of the code are satisfied.

Also, as demonstrated above, the ownership and use of real estate in a tax efficient manner has the added benefit of serving a highly important purpose other than saving money on taxes. With respect to the first strategy, this means preserving environmentally significant land and wildlife. With respect to the second strategy, this entails injecting much needed capital into impoverished areas and those affected by natural disasters to stimulate growth and development.

Michael Packman is a founder & principal of KNPRE, New York, N.Y.