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The Case for Tax Clarification for Mitigation Banks

Public Value of Private Investment in Conservation Land

As a result of aquatic resource mitigation rules adopted by the U.S. Army Corps of Engineers (the "Corps") and U.S. Environmental Protection Agency (the "EPA") in 2008 (the "2008 Rules"), substantial private investment capital is currently available to protect and maintain ecologically significant conservation lands. These rules enacted under the Clean Water Act set standards for wetland and stream mitigation banks (collectively, "mitigation banks") to offset unavoidable adverse impacts from development of public and private infrastructure. Private investment capital, including private equity and pension funds, has been increasing investment in mitigation banks since standards were clarified with adoption of the 2008 Rules.

Traditionally, the government and conservation non-profits have been the primary proponents of conservation land, and funding has been limited to agency budgets and charitable contributions. Meanwhile private and public infrastructure development has enjoyed much greater funding and development pressures have outpaced land conservation. Loss of wetlands is the foremost issue, because wetlands protect and modulate flows in our rivers and streams. Our national "no net loss" goal for wetlands is difficult to achieve when development funding overwhelms conservation funding. The availability of private investment capital for land conservation, without importantly either the land or its long-term care becoming a burden on taxpayers, works to relieve this disparity and achieve our national goal. Private investment capital builds mitigation banks, and mitigation banks are how developments can pay their own way to offset their wetland and stream impacts. Private investment has the *potential* to supplant government subsidized mitigation on a variety of fronts (e.g., wetlands, endangered species, and water quality), closing the loop, so to speak, for private capital to fund both economic development *and* the necessary mitigation of impacts.

*How a **Mitigation** Bank Works*

Private owners of *ecologically significant, but partially degraded, land* work with investors to protect, restore, and maintain the land in perpetuity under the 2008 federal wetland mitigation banking program. Mitigation "credits" are awarded based on achieving ecological benefits from restoration activities on the land. These *credits are released over time as the restoration project proves successful*, making the credits "advance mitigation" for impacts yet to occur under future Corps permits. Then, if within the service area of the mitigation bank (usually the same watershed), the Corps later decides to allow wetland impacts for a proposed project (e.g. roads, schools, or housing), that project can purchase the mitigation credits from the mitigation bank with Corps approval to offset impacts. Credit purchase satisfies mitigation requirements because the credits are already verified as *successful, proven results and backed by financial assurance instruments* for perpetual protection and regular maintenance of the ecologically significant land.

The combination of private land and private investment capital coming together under the regulation of the Corps to provide advance mitigation for unavoidable wetland impacts is a stellar example of how proper incentives can be used by government to achieve public purposes. Not surprisingly, perhaps, there are still a few hitches, and a troublesome one is **tax treatment of mitigation bank credit sales**.

Tax Clarification Needed

An obstacle to private capital investment is ambiguity about the tax treatment of mitigation bank credits sales. In most cases when a landowner sells land, the sale is treated as sale of a capital asset, rather than as ordinary income, and income is recognized (and taxed) when actually received. The same landowner, however, who would conserve the land through mitigation banking, receives wetland mitigation *credits,* instead of a monetary settlement, and under theories advanced in IRS Private Letter Rulings (PLRs), taxes may be due at this point, even before any revenue is received from credit sales. Recognition of income before any revenue is received is an unusual burden on any investment, and is particularly burdensome for mitigation bank investments that may take many years to break even.

Another tax impediment to mitigation banking is treatment of credit sales as ordinary income. A private landowner of a wetland mitigation bank may have owned the land for years and will have invested or partnered with investors to create the mitigation bank as described in the side bar, but in return he receives wetland mitigation credits *over tim*e, as the mitigation bank proves successful. He sells these credits (typically in small batches) *over time* to satisfy the mitigation needs of Corps-approved projects. The tax issue arises from two necessary elements of the mitigation banking regulations: 1) credits are only released as, and to the extent, the mitigation project meets its success criteria; and, importantly, 2) credits can only be sold as and when the Corps approves wetland losses in development projects proposed by others. This gradual release and sale of credits can cause the mitigation banker to resemble a *dealer*, rather than an *investor*, and triggers the capital asset exception in IRC Section 1221 for "property held by the taxpayer for sale to customers in the ordinary course of his trade or business."

A corollary impediment is the treatment of mitigation credit income as ordinary income under the Substitution of Income Doctrine. An asset considered a *right to earned income* rather than a *right to earn income*, it is typically taxed as ordinary income.[1] The specific characteristics of mitigation bank credits would argue in favor of their being a right to earn income and, therefore taxed as a capital asset, but this ambiguity remains a deterrent to investment.

Each ambiguous issue is explained in more detail below.

Recognition of Income

Two PLRs[2] have concluded that the placement of a conservation easement on mitigation bank property, which resulted in the award of mitigation credits, constituted a sale of the land and triggered recognition of revenue. In both cases, the petitioners argued their particular facts and circumstances *for* income recognition when the conservation easement was granted and IRS agreed with their arguments. Tax

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[1] See *Lattera v. Commissioner*

[2] PLR 9612009 and PLR 201222004

commentary[3] has been critical of the logic of these rulings, arguing that settled tax law has not viewed the creation of property rights under federal, state, or local licensing and other regulatory schemes as causing the recipient of such rights to be in receipt of gross income. Nevertheless, the fact that two these PLRs exist for mitigation banks hangs like the sword of Damocles over private investment.

Ordinary Income vs. Sale of a Capital Asset

The tax courts have generally confirmed that credits are capital assets, but even capital assets held for more than a year may be taxed as ordinary income if the mitigation banker is considered a *dealer* in mitigation bank credits. Mitigation bankers may resemble dealers because the credits are awarded incrementally *over time* and sold to proposed projects *over time* in small batches. Given the large disparity between tax rates for gains on capital assets and ordinary income, this tax treatment creates a disincentive for landowners to conserve ecologically significant land as a wetland mitigation bank. Simply said, they may be better off financially by selling their land for development than participating in the Corps' mitigation bank program.

In defining the term "capital asset," IRC Sec. 1221(a)(1) expressly *excludes inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business*. Multiple factors have been used to decide if the taxpayer is a dealer subject to ordinary income, but in 2004 the Tax Court[4] observed that *the frequency and substantiality of sales is the most important factor* to be considered. Thus, automobile dealer sales, subdivision lot sales, and retail store sales are not treated as capital assets when sold by their owners in the ordinary course of trade or business. Because of the required incremental release and sale of credits over time, mitigation banks can be caught in this fact pattern defining a dealer. Thus, landowners and investors in mitigation banks may have a disincentive to conserve some of the best ecological land in the nation under a program developed, sanctioned, and regulated by federal agencies.

Finally, the 2008 Rules do not allow for separation of the mitigation bank credits from the mitigation bank sponsor and its responsibility to the Corps. Thus, the mitigation bank cannot be construed as a producer, similar to a manufacturer, who then sells credits to an actual dealer. While conservation-minded landowners may enter into varied arrangements with private investors to develop a mitigation bank, these arrangements may fail to solve the landowner's tax dilemma because of ambiguity surrounding dealer status. For example, IRC Sec. 707(b)(2) provides that if a controlling partner or member of related person sell capital gain property, directly or indirectly, to a partnership or LLC, *any gain recognized is ordinary income to the extent their property is ordinary income property in the hands of the partnership or LLC*. Thus, if the mitigation bank partnership or LLC is a deemed a dealer, the landowner's sale of property to the partnership may be ordinary income, instead of capital gains.

Under the Substitution of Income Doctrine the sale of certain kinds of "credits" may be taxed as ordinary income, even if the mitigation banker has avoided the dealer classification issue explained above. If the

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[3] See *Clear as Mud – Taxation of Wetland Mitigation Banks* by Andrew F. Dana in *Real Estate Taxation*, 4th Qtr. 2008

[4] See *Phelan, et ux. v. Commissioner*

IRS finds that mitigation credits represent earned income yet to be received, as opposed to a right to earn income, the sale would be taxed as ordinary income. Mitigation bankers can claim that to receive income from the sale of credits, they have to continually invest in the maintenance of the mitigation bank and that the sale of their credits is subject to market risk. Investors and landowners need more certainty than just knowing they have good arguments, however, and without clarification this ambiguity takes its toll on investment interest in mitigation banking.

Relief Sought by Legislation

The clarifications sought by the National Mitigation Banking Association are simple: *The grant of a property interest as a condition of establishing a mitigation bank is not a taxable event and the gain or loss attributable to the sale or exchange of a mitigation bank credit by the sponsor of the mitigation bank who earned such a credit would be considered the sale or exchange of a capital asset held for more than 1 year and not substitution of income.*

The proposed change would:

1. Clarify that the regulatory requirement of a grant of property interest to create a mitigation bank is not the sale of an asset and, thus, not taxable at that event;
2. Settle the dealer classification issue in favor of investment in mitigation banks;
3. Allow the sale of conservation land to a mitigation bank partnership in which the landowner has a majority interest to be taxed as capital gains; and
4. For a land sale as described in (3) above, allow the use of installment reporting, which is currently prohibited by the dealer status.