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Sale of State conservation easement income tax credits resulted in short term capital gains

Tempel (2011), 136 TC No. 15

The Tax Court has held that transferable State conservation easement income tax credits that taxpayers received as a result of their charitable contribution donation and then sold were capital assets. However, the Court also concluded that the taxpayers had neither a basis nor a long-term holding period in these State tax credits. As a result, the taxpayers recognized short term capital gains on the sale.

Background. Under the "substitute for ordinary income doctrine," the Supreme Court has concluded that capital gain treatment is not available where the substance of what is sold is the right to receive future ordinary income and the substance of what is received is the present value of ordinary income which the seller would otherwise receive in the future. Instead, there is ordinary income rather than capital gain since consideration is paid for the right to receive future income, not for an increase in the value of the income-producing property. (Com. v. Lake Inc, P.G., (1958, S Ct) 1 AFTR 2d 1394)

Facts. In 2004, George and Georgetta Tempel donated a qualified conservation easement to a qualified charitable organization. As a result, the Tempels received conservation easement income tax credits from the State of Colorado. These credits were transferable to other taxpayers. In 2004, the Tempels sold a portion of these credits in the month that they received them.

The Tempels reported short-term capital gains from the sales of the State credits. They claimed an allocated portion of the professional fees they incurred to complete the conservation easement donation as their adjusted basis in the State tax credits they sold.

On audit, IRS determined that the State income tax credits that the Tempels sold were not capital assets and that they had no adjusted basis in the credits. The Tempels sought relief in Tax Court.

In Tax Court, IRS filed a motion for partial summary judgment. The Tempels filed a cross-motion in which they claimed that the proceeds from their sales of State tax credits should have been reported as long-term capital gains.

IRS's position. IRS argued that taxpayers' gains from the sales of their State tax credits were ordinary because they were merely a substitute for ordinary income, i.e., a substitute for a refund from Colorado that would have been ordinary income. IRS also argued that to the extent a taxpayer could use a credit to reduce a State tax liability but instead sold that credit, that taxpayer had the economic equivalent of ordinary income.

Court's conclusion. The Tax Court held that the State tax credits that the Tempels sold were capital assets, rejecting IRS's contention that they should be treated as ordinary income. Since the State tax credits that were sold didn't represent a right to income, the substitute for ordinary income doctrine was inapplicable.

The Tempels sold $110,000 and gave away $10,000 of their $260,000 of State tax credits, leaving them with $140,000 of State tax credits to use. However, Colorado taxpayers have been able to receive a refund for their conservation easement credits only in 2005. The Court determined that there was no evidence (and IRS didn't assert any) that they sold credits that they could have otherwise used to receive a refund. Accordingly, the Tempels' proceeds from the sale of their credits weren't a substitute for a tax refund.

The Court further stated that it knew of no authority (and IRS failed to cited any) for the proposition that a State income tax credit resulted in ordinary income upon its later sale. On the contrary, courts and IRS rulings frequently treat government-granted rights as capital assets.

The Tax Court concluded that it was apparent that the transferred State tax credits never represented a right to receive income from the State. They merely represented the right to reduce a taxpayer's State tax liability. The Court found that it was clear that a government's decision to tax one taxpayer at a lower rate than another taxpayer was not income to the taxpayer who paid lower taxes. A lesser tax detriment to a taxpayer was not an accession to wealth and so did not give rise to income. The Tempels never possessed a right to income from the receipt of the credits. They did not sell a right either to earned income or to earn income.

Basis. The Court held that the Tempels didn't have any basis in their State tax credits based on the professional fees they incurred in connection with establishing and donating the conservation easement. Rather, an individual may deduct ordinary and necessary expenses incurred in connection with the determination, collection, or refund of any tax as an itemized deduction under Code Sec. 211 and Code Sec. 212 . Appraisal fees and other ordinary and necessary expenses to determine a taxpayer's tax liability as the result of a charitable contribution may be deductible under Code Sec. 212(3) .

In addition, under Code Sec. 1012 , cost basis generally is what a taxpayer paid to acquire an asset. Here, the Tempels paid transaction fees to establish a conservation easement that they donated to an unrelated third party. They did not acquire the State tax credits by purchase.

Further, the Court found no support in the Code or the regs to justify allocating the taxpayers' basis in their land to the State tax credits.

Holding period. The Court also held that the Tempels' holding period in their State tax credits was insufficient to qualify for long-term capital gain treatment. The Court concluded that the taxpayers' holding period in their credits began at the time the credits were granted and ended when they sold them, i.e., the same month in which they received them. The capital gains from the sale of the credits were short term.

The Court rejected the taxpayers' contention that their holding periods in their land and State tax credits were one and the same because they were both part of the bundle of their real property rights. It reasoned that a Colorado taxpayer had no property rights in a conservation easement contribution State tax credit until the donation was complete and the credits were granted. The credits never were, nor did they become, part of the taxpayers' real property rights.

References: For distinguishing between capital asset and right to receive income, see FTC 2d/FIN ¶ I-6824 ; United States Tax Reporter ¶ 12,214.65 ; TaxDesk ¶ 223,013 ; TG ¶ 10775 .