CLEAR AS MUD—TAXATION OF WETLAND MITIGATION BANKS

The receipt of mitigation credits should not be included in the gross income of the sponsor, but the Service has privately ruled that the creation of a mitigation bank is a sale for federal income tax purposes.

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The nation's clean water laws do more than set water pollution standards. They also require mitigation for the effects of development of wetlands. The legal complexity of the available routes for doing so is as great as the environmental complexity of the effects of development themselves.

One of these routes involves a concept known as mitigation banking. In addition to an intricate compliance process, it involves the creation of interests that raise difficult and as yet unresolved questions of real estate taxation.

Mitigation under the Clean Water Act

The objective of the Clean Water Act (CWA)[1] is to protect the integrity of the nation's waters. Section 404 of the CWA prohibits the disposal of dredge or fill materials in the navigable waters of the United States unless a permit is issued by the Corps of Engineers.[2] Any unavoidable impact must be minimized and compensated for. Under the CWA, such compensation comes in the form of compensatory mitigation, which is "a wetland, stream, or other aquatic resource area that has been restored, established, enhanced, or (in certain circumstances) preserved for the purpose of providing compensation for unavoidable impacts to aquatic resources permitted under Section 404 or a similar state or local wetland regulation."[3]

There are three categories of compensatory mitigation—mitigation banking, in-lieu fee mitigation, and permittee-responsible mitigation. The most favored is mitigation banking. Mitigation banks are funded in advance by private parties, referred to as sponsors, who secure a site and implement a mitigation plan. In exchange for creating a mitigation bank, the sponsor receives mitigation credits that can be used, sold, traded, exchanged, or held for investment.

In-lieu fee mitigation projects are similar to mitigation banks, except they are administered by government agencies or nonprofit organizations. In-lieu fee mitigation was almost eliminated in the Final Rule, but was retained for situations where mitigation banks were not practicable or economically viable. Unlike mitigation banks, in-lieu fee programs are not expected to be run as commercial ventures. Because these public interest projects do not have up-front financing, they are permitted to sell advance credits prior to securing a site and developing a mitigation plan.[4]

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The final type of compensatory mitigation is permittee-responsible mitigation. Permittee-responsible mitigation can be conducted on or off site. The permittee is responsible for the planning, implementation, and long-term success of the mitigation. The permittee-responsible mitigation sites are typically small, and the permittee often lacks the expertise required for long-term sustainability. As a result, permittee-responsible mitigation produces lackluster results, is the least favored type of compensatory mitigation, and is generally reserved for situations where mitigation banks or in-lieu fee mitigation are unavailable.

Mitigation banking under the final rule

The Environmental Protection Agency (EPA) and U.S. Army Corps of Engineers published the final compensatory mitigation rule (the "Final Rule") in the Federal Register on 4/10/08. The Final Rule, which became effective in June 2008, applies consistent standards to the three types of compensatory mitigation.

The Final Rule encourages the use of mitigation banks because they "generally involve less risk and uncertainty than in-lieu and permittee-responsible mitigation."[5] Such preference is based on administrative criteria, and is not a statement that mitigation banks are ecologically superior to the other forms of compensatory mitigation.

Mitigation banks are run as commercial ventures. As such, their proliferation depends on their economic viability. Beyond the direct scope of the Final Rule, but the focus of this article, is the impact of taxation on the economic viability of mitigation banks.

Mitigation banks are growing in number, but currently generate a modest percentage of all mitigation credits being used.[6] Given the preference in the final rule for mitigation banks, this number can be expected to rise substantially in the coming years.

Creating mitigation banks. Creating a mitigation bank is an administrative process. The first step for the sponsor is to create a mitigation bank prospectus. The prospectus provides an overview of the proposed mitigation bank, including the objectives, the service area, and the proposed ownership of the bank. The prospectus provides the basis for review and comment. The interagency review team (IRT) provides a preliminary review, and submits comments back to the sponsor within 30 days.[7] The IRT review is followed by notice to the public and a 30-day comment period. The district engineer will collect the comments and write an initial evaluation. If the district engineer concludes that the proposed bank has potential, it will notify the sponsor in writing, at which point the sponsor can begin preparing the draft mitigation bank instrument.

Once complete, the draft instrument is submitted to the IRT for additional review and is subject to a 30-day comment period. After the IRT review is complete, the district engineer has 90 days to instruct the sponsor on whether the initial draft is acceptable, and if not, what changes need to be made. The final step, assuming there are no objections raised by members of the IRT, is the preparation of the final mitigation banking instrument (MBI). The timeline for the above process varies, however. The Final Rule indicates that approval of a mitigation bank should occur within one year after the sponsor submits a complete prospectus for the project.

The MBI will include the 12 fundamental components of a compensatory mitigation program: objectives, site selection criteria, site protection instruments, baseline information, credit determination, mitigation work plan, maintenance plan, ecological performance standards, monitoring requirements, long-term management plan, adaptive management plan, and financial assurances.

A few components of the MBI are of particular importance for tax purposes, including the financial assurances, the site protection instrument, and credit determination. Finan-

UNDER THE CLEAN WATER ACT, COMPENSATION FOR DEVELOPMENT COMES IN THE FORM OF MITIGATION.

1 33 U.S.C. 1251 *et seq.*

2 The U.S. Army Corps of Engineers has had a regulatory role in protecting waters and wetlands since the Harbors and Rivers Act of 1899 (30 Stat. 1151). See 33 USC section 1362(7) for the definition of navigable waters.

3 Compensatory Mitigation Fact Sheet, www.epa.gov/owow/wetlands/pdf/CMitigation.pdf.

4 73 Fed. Reg. 19605 at 19671 (4/10/08). Advance credits are "credits of an approved in-lieu fee program that are available for sale prior to being fulfilled in accordance with an approved mitigation project plan."

5 73 Fed. Reg. 19605 (4/10/08).

6 Shabman and Scodari, "Past, Present, and Future of Wetlands Credit Sales," Resources for the Future Discussion Paper 04-48 (Dec. 2004) (stating that mitigation credits generate 10%-20% of credits used).

7 73 Fed. Reg. 19605 at 19671 (4/10/08). The IRT is "an interagency group of federal, tribal, state, and/or local regulatory and resource agency representatives that reviews documentation for, and advises the district engineer on, the establishment and management of a mitigation bank or an in-lieu fee program."

cial assurances reflect the projected costs of implementing the mitigation plan and ensuring its economic and ecological long-term sustainability. Such costs are capitalized into the basis of the mitigation credits, and will thus affect the tax consequences of the later sale of such credits.[8]

THE THRESHOLD ISSUE FOR DETERMINING PROPER TAXATION IS WHETHER MITIGATION CREDITS ARE INCLUDED IN THE SPONSOR'S GROSS INCOME.

The site protection instrument is the legal instrument that the sponsor uses to permanently protect the mitigation site. These instruments are most commonly conservation easements, but may also be title transfers.[9] Because an easement or title transfer is required under the MBI in order to receive a return benefit in the form of mitigation credits, a contribution to a tax-exempt entity (either state agency or land trust) does not qualify for the charitable income tax deduction under Section 170. It is well settled that "if a payment proceeds primarily from the incentive of anticipated benefit to the payor beyond the satisfaction which flows from the performance of a generous act, it is not a 'gift' that may be classified as a charitable contribution."[10] Under this rule, the contribution required by the MBI lacks the requisite detached and disinterested generosity that is required for a contribution to an exempt organization to be deductible.

Most importantly, the MBI will determine the amount and describe the type of credits that will be received by the sponsor following the successful implementation of the mitigation plan. A credit is "[a] unit of measure ... representing the accrual or attainment of aquatic functions at a compensatory mitigation site; the measure of function is typically indexed to the number of wetland acres restored, created, enhanced or preserved."[11] The character and quantity of credits are based on the acreage and aquatic function that they represent. The Final Rule places greater reliance on functional and condition assessments in determining credits rather than acreage and linear feet.

The MBI sets out the total type and number of mitigation credits that will be issued to the sponsor; however, such credits are not immediately released to the sponsor. Instead, the release of credits is tied to the achievement of performance standards and level of aquatic functions attained at the mitigation bank.[12] Assuming the bank has a high likelihood of success, a limited portion of credits may be eligible for release after the MBI is approved, a protection instrument secures the site, and financial assurances are established.

A typical release schedule provides for a percentage of total credits to be released after the completion of specified annual tasks, and may span five years. By way of an example, a recently created mitigation bank provides that 15% of the total mitigation credits will be released after execution of the MBI, contribution and recording of a conservation easement, and provision of financial assurances. Every year thereafter, for a period of four years, 10% to 15% of the credits will be released upon completion of all annual tasks and activities required under the plan. The final 20% will be released at the end of year five if the sponsor has achieved all ecological performance standards set out in the MBI.

The above overview is a condensed analysis of the creation and operation of a mitigation bank under the Final Rule. It is intended to provide a background for the taxation discussion that follows. The issues that are addressed below include whether the creation of a mitigation bank is a realization event, and if so, issues related to taxation of mitigation bank creation.

Realization event?

The threshold issue for determining the proper taxation of the creation of a mitigation bank is whether mitigation credits are included in the sponsor's gross income. Although no general provision excludes the receipt of governmental benefits from taxation, the Service recognizes that "the creation of property rights under federal, state, and local licensing and other regulatory schemes does not cause the recipient of such rights to be in receipt of gross income."[13] This nonrecognition treatment specifically applies to licenses and permits that are transferable to third parties.[14]

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8 Ltr. Rul. 9612009.

9 73 Fed. Reg. 19605 at 19671 (4/10/08).

10 DeJong, 36 TC 896, 899 (1961), *aff'd* 309 F.2d 373, 10 AFTR2d 5863 (CA-9, 1962).

11 73 Fed. Reg. 19605 at 19671 (4/10/08).

12 *Id.*

13 Postlewaite, Cameron and Kittle-Kamp, "Federal Income Taxation of Intellectual Properties and Intangible Assets (Warren Gorham & Lamont, 1997), § 9.02.

14 GCM 39606, 2/8/87), citing Rev. Rul. 70-644, 1970-2 CB 167, *mod. by* Rev. Rul. 72-384, 1972-2 CB 479, *clarified by* Rev. Rul. 73-429, 1972-2 CB 479, *revoked in narrow circumstances by* Rev. Rul. 75-466, 1975-2 CB 74.

In the context of transferable rights, the nonrecognition rule applies to the original grantee.[15] The original grantee will recognize gain or loss only on the later sale to a third party.[16] The Service has consistently applied this tax treatment to the original grantees of clean air emission allowances,[17] peanut quotas,[18] tobacco quotas,[19] television broadcast licenses,[20] city liquor licenses,[21] cattle grazing permits,[22] oil and gas leases,[23] and federal upland cotton acreage allotments,[24] to state only a few examples of government benefits excluded from gross income. Whether mitigation credits are within this category of government issued permits and licenses that are excluded from gross income will have a profound effect on the economic viability of mitigation banks.

The primary guidance that addresses the taxation of the receipt of mitigation credits by the sponsor is Ltr. Rul. 9612009. The facts of this ruling involve a public utility that held certain real property for future development as a power plant. The utility changed its intent with regard to the property and decided instead to establish a mitigation bank on the site. The utility sought a ruling that the contribution of a perpetual conservation easement in exchange for mitigation credits is a sale or exchange of the easement, and that the easement is treated as the entire interest in the underlying real property.

The Service ruled that because the perpetual easement deprived the public utility of "practically all beneficial interest in the land," the easement is treated for federal income tax purposes as the fee interest in the underlying land.[25] It held that "the conveyance of the perpetual conservation easement by Company to obtain mitigation credits will be treated, for federal income tax purposes, as a sale of the property." The Service misplaces reliance on Rev. Rul. 72-255[26] to stand for the proposition that the transfer of a perpetual easement, when only bare legal title is retained, is a sale for federal income tax purposes.[27] In a series of inartfully worded guidance documents, the Service makes statements such as "a grant of a perpetual or indefinite easement, by which the owner is deprived of practically all beneficial interest therein and is merely the holder of bare legal title, is considered a sale of an interest in real property."[28] Such statements confuse the fact that it is the nature of the consideration received, not the nature of the property granted, that dictates whether the transfer is taxable. The grant of an easement or a grant of the underlying land in exchange for a government benefit that is excluded from gross income is not properly treated as a sale for federal income tax purposes.[29]

In reaching the holding of Ltr. Rul. 9612009, the Service borrowed directly and heavily from the more abundant guidance issued for clean air emission allowances. Ltr. Rul. 9612009 indicates that clean air emission allowances are sufficiently similar to mitigation credits to warrant the application of the guidance issued for one as guidance controlling for the other. As such, an analysis of clean air emission allowances will be an integral part of determining the proper taxation of mitigation credits.

The Clean Air Act is designed to limit sulfur dioxide emissions from fossil-fuel-powered combustion devices owned by utilities. Each allowance permits the holder to emit one ton of sulfur dioxide without penalty. The allowances issued may be "(1) applied against sulfur dioxide emissions occurring in the year to which it has been allocated by the EPA, (2) transferred, (3) sold or exchanged, or (4) held for and applied against sulfur dioxide emissions occurring in a future year."[30] On the issue of whether the receipt of clean air emission allowances is taxable, Rev. Rul. 92-16, 1992-1 CB 15, holds without analysis, that "[t]he allocation of emission allowances by the Environmental Protection Agency and their receipt

THE HOLDER OF A CLEAN AIR EMISSION ALLOWANCE WILL RECOVER ITS BASIS UNDER SECTION 1001 AND RECOGNIZE TAXABLE GAIN OR LOSS UPON A LATER SALE OR EXCHANGE OF THE ALLOWANCES.

15 *Id.*

16 Reg. 1.61-2.

17 Rev. Rul. 92-16, 1992-1 CB 15; Rev. Proc. 92-10, 1992-1 CB 661.

18 Notice 2002-67, 2002-2 CB 715.

19 Notice 2005-51, 2005-2 CB 74.

20 Richmond Television Corp., 345 F.2d 901, 15 AFTR2d 880 (CA-4, 1965), *vac'd and rem'd*, 382 US 68, 16 AFTR2d 5858 (1965).

21 Nachman, 191 F2d 934 (CA-5, 1951).

22 U.P. Shufflebarger, 24 TC 980 (1955).

23 Rev. Rul. 83-137, 1983-2 CB 41.

24 Rev. Rul. 66-58, 1966-1 CB 186.

25 See also Rev. Rul. 72-225, 1972-1 CB 59.

26 1972-1 CB 59.

27 Rev. Rul. 72-255 stands for the limited proposition that the transfer of a perpetual easement, when the taxpayer retains bare legal title, is treated as a transfer of the underlying land.

28 GCM 38073; see also Rev. Rul. 59-121, 1959-1 CB 212; Rev. Rul. 68-291, 1968-1 CB 351

29 Stubbs, 428 F.2d 885, 26 AFTR2d 70-5010 (CA-9, 1970). Taxpayers deeded a portion of their property for dedication as a public road in exchange for upzoning. While no charitable income tax deduction was available, the grant of the underlying land was not a realization event.

30 Rev. Proc. 92-91, 1992-2 CB 503.

by a utility ... does not cause the utility to realize gross income under section 61 of the Internal Revenue Code."

Rev. Proc. 92-10, 1992-1 CB 661, restates and expands this rule, providing that "[t]he allocation of emission allowances by the EPA to a utility does not cause a utility to realize gross income under section 61 of the Internal Revenue Code. Accordingly, a utility's basis in those emission allowances is not measured by reference to the fair market value of the allowances."

THE SERVICE TREATED THE SPONSOR'S RECEIPT OF MITIGATION CREDITS AS A SALE FOR FEDERAL INCOME TAX PURPOSES.

Rev. Proc. 92-10 states that the holder of a clean air emission allowance will recover its basis under Section 1001 and will recognize taxable gain or loss upon a later sale or exchange of the allowances.[31] It provides specifically that "costs incurred to acquire or hold an emission allowance must be capitalized.... These costs, including amounts paid to acquire or hold an allowance (such as the purchase price and any properly allocable legal, accounting, and engineering fees), constitute the holder's tax basis in an emission allowance under § 1012 of the Code."[32] Ltr. Rul. 9612009 cites Rev. Proc. 92-10 to establish that the basis rules applied to clean air emission allowances also apply to mitigation credits. Under such rules, the basis of mitigation credits includes all costs to acquire and construct the mitigation bank, costs to achieve the ecological conditions required under the MBI, and costs to provide for long-term stewardship of the site.

It is curious that, despite drawing from the clean air emission allowance guidance to determine the computation of the basis of mitigation credits in the hands of the mitigation bank sponsor, the Service departs from the same guidance on the issue of whether the receipt of mitigation credits is included in gross income. Note that if a sale for federal income tax purposes occurs, the sponsor will have a tax cost basis in the mitigation credits equal to their fair market value. The sponsor's basis will be increased by subsequent financial outlays used to attain the ecological standards required under the MBI.

The Service, by treating the sponsor's receipt of mitigation credits as a sale for federal income tax purposes, implicitly distinguishes such credits from other permits, licenses, and rights issued by the government that are not taxable. The position of the Service on this point is in direct conflict with Rev. Rul. 92-16 and Rev. Proc. 92-10, which the Service deems controlling for other issues related to mitigation credits.

Consistent application of both Rev. Rul. 92-16 and Rev. Proc. 92-10, and the larger body of law related to government created rights, requires that no gain be recognized on the initial mitigation bank transaction. The adjusted basis of the conservation easement should be capitalized as an acquisition expense, together with the other acquisition and restoration expenses, and be used to compute the basis of the mitigation credits. The Service, by failing to issue a ruling to this effect, produces a private letter ruling with an internal inconsistency that operates to confuse practitioners who strive to properly report the initial mitigation bank transaction for tax purposes.

The scarcity of guidance, and inconsistencies in what guidance does exist, creates a difficult setting in which practitioners must plan. The law related to government-issued allowances, licenses, and other comparable rights supports the position that the receipt of mitigation credits by the original grantee should not be included in gross income. Ltr. Rul. 9612009, which is not precedential authority, states otherwise. In the author's opinion, the Service's position that mitigation credits are includible in gross income is incorrect and based on an unsupportable interpretation of available guidance. Given the uncertainty, it is advantageous for practitioners to structure the mitigation banking transaction in a manner that defers taxation if the Service asserts that receipt of the credits is a realization event.

Structuring mitigation banks amidst uncertainty

As discussed above, the sponsor's receipt of mitigation credits should not be included in gross income. Because the Service, despite a clear body of law to the contrary, privately ruled that the receipt of credits is a sale for federal income tax purposes, prudent practitioners must structure mitigation bank transactions to minimize any immediate taxation. Set out below is a discussion of issues for tax practitioners to be aware of when structuring a mit-

[31] Rev. Proc. 92-10, Q&A 4-5. Such gain or loss will be capital, unless the allowances are held primarily for sale to customers in the ordinary course of a trade or business, in which case any gain or loss will be ordinary.

[32] Rev. Proc. 92-10, 1992-1 CB 661; Ltr. Rul. 9612009.

igation bank transaction in the context of a sale for federal income tax purposes.

Adjusted basis of conservation easement. A preliminary issue for the sponsor is whether the disposition of the easement is treated as a sale of the underlying property, or of just the easement. The determination of whether the easement or underlying property is sold is important for purposes of determining the adjusted basis of the property sold. Ltr. Rul. 9612009 states that "[i]f taxpayer sells a perpetual easement to a portion of its land and retains no beneficial interest in such portion, the sale is treated, for federal income tax purposes as a sale of the land."[33] In that factual scenario, the easement left the taxpayer with bare legal title. The sale was deemed to be one of the underlying property and the taxpayer could offset the amount realized by the entire basis in the underlying property.[34]

The ruling leaves open the issue of what occurs, for federal income tax purposes, when the sponsor retains some beneficial enjoyment of the land in excess of bare legal title. While the facts of the proposed transaction in Ltr. Rul. 9612009 stated that all beneficial interests were transferred, it is unlikely in most situations that the sponsor granting the conservation easement will truly retain only bare legal title. As a result, it will be a transfer of the easement, not the underlying land. If still treated as a sale for federal income tax purposes, the sponsor must apportion his or her basis. The likely outcome is that the sponsor will be required to equitably apportion the basis of the property between the easement and the fee pursuant to Reg. 1.61-6(a).[35] If the sponsor can establish that the apportionment of basis to the easement is impossible or impracticable, he or she may be permitted to defer realization of gain in favor of a tax-free recovery of basis.[36] If the amount realized exceeds the basis of the property, the tax-free recovery of basis will be immediately exhausted and therefore provide a marginal benefit. Note that if the contribution of the easement is treated as a sale of the underlying property, the subsequent disposition of the underlying fee subject to the easement will be a non-event for tax purposes.[37]

In the context of a sale for federal income tax purposes, the sponsor should prefer to treat the conservation easement for federal income tax purposes as a sale of the underlying property and be able to use his or her adjusted basis of the entire property to offset the amount realized. Query, however, whether retaining more than bare legal title brings the transaction outside of the scope of Ltr. Rul. 9612009 and protects against the Service asserting that it is a sale for federal income tax purposes.

Amount realized. The Service has aptly observed that the open transaction doctrine, which defers taxation of property with no ascertainable value, has been in large part eroded in recent years.[38] It is unlikely that mitigation credits lack an ascertainable fair market value. Therefore, attempting to fashion the initial mitigation bank transaction as an open transaction in an attempt to defer gain until later disposition is ill advised. Credits are capable of valuation by relation to comparable sales by other operating mitigation banks or by state pricing guidelines.

The amount realized will be the fair market value of the mitigation credits received. To the extent the MBI is a binding contract right to receive credits, the fair market value of the credits should be determined on the date the MBI is executed and not the date of receipt of each round of credits. It is likely that the fair market value of the credits on the date of execution of the MBI is susceptible to valuation discounts because the credits are not marketable until released by the IRT and authorized for use. Recall that such authorization is based on whether ecological performance criteria are met for each given year. Until such criteria are met, the credits are subject to risk of forfeiture, and thus properly discounted because a willing buyer would not pay full value to a willing seller given the risk that the credits will never be authorized for use.

Obtaining a discounted value for the credits is advantageous to the sponsor because it reduces the amount realized, and thus reduces the taxable gain. The Service may challenge such discounts. Where available, comparable sales of unreleased, unauthorized credits should be sought and an appraisal report prepared by a

THE OPEN TRANSACTION DOCTRINE HAS BEEN IN LARGE PART ERODED IN RECENT YEARS.

[33] Ltr. Rul. 9612009, citing Rev. Rul. 72-255, 1971-1 CB 221.

[34] *Id.*

[35] Rev. Rul. 68-291, 1968-1 CB 351 (Service applied basis allocation to determine gain on the sale of an easement that affects only a specific portion of a larger tract).

[36] Inaja Land Co., 9 TC 727 (1947).

[37] Ltr. Rul. 9612009.

[38] IRS News Release IR-2006-161 (10/17/06); see also Reg. 1.1001-1(a)(1) (amount realized on an exchange includes the FMV of any property received; only in rare and extraordinary cases will property be considered to have no FMV).

THE PRUDENT PRACTITIONER SHOULD STRUCTURE THE INITIAL MITIGATION BANK TRANSACTION TO MITIGATE IMMEDIATE TAXATION.

third-party qualified appraiser to support any discounts taken by the sponsor.

Installment sale. The timing of receipt of the amount realized raises issues and planning opportunities in the context of a taxable sale for federal income tax purposes. Under most MBIs, the mitigation credits are released over a period of five years, resulting in a "disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs."[39] This is an installment sale for federal income tax purposes. Provided that the property disposed of is not dealer property, installment reporting will apply to the sale unless an affirmative election out is made.[40]

This deferral opportunity is attractive because it reduces the hardship of being immediately taxed in year one when only 15% of the credits are made available for sale. There are issues, however, to be aware of. First, a portion of each payment of mitigation credits that occurs in a later year will be recharacterized as interest under the original issue discount rules.[41] The interest component will be taxed at ordinary income rates, which in most cases will convert gain that would have been taxed at preferential capital gain rates to income taxed at higher ordinary income rates.

Like-kind exchange. To the extent mitigation credits are classified as interests in real property, which itself is a debatable issue beyond the scope of this article, nonrecognition may be achieved through application of Section 1031. The basic requirements of Section 1031 are that the property be held for productive use in a trade or business or investment, that it be exchanged with property of a like kind, that exchange property be identified within 45 days, and that the exchange completed within 180 days.[42]

Whether property is of like kind depends on kind or class, but not grade or quality.[43] In the context of real property interests, the like-kind requirement has been satisfied in a broad spectrum of exchanges. Such transactions include the exchange of water rights for a fee interest in real estate,[44] a leasehold interest (in a producing oil lease until the deposit is exhausted) in exchange for a ranch,[45] an easement in exchange for an apartment building,[46] and a conservation easement in exchange for a fee interest in a farm.[47]

In Rev. Proc. 92-10, Q&A-4 and 5 state that for purposes of Section 1031 non-recognition, clean air emission allowances are treated as like-kind property, resulting in the exchange of clean air emission allowances being eligible for Section 1031 non-recognition if all other requirements of Section 1031 are fulfilled. Ltr. Rul. 9612009, again establishing that guidance for clean air emission allowances is guidance for mitigation credits, provides that:

> The statements in Q & A-4 and 5 of Rev. Proc. 92-10 are applicable to a [mitigation] credit because each credit is property and represents a legal entitlement to the holder of the credit equivalent to an ecological value. Thus, the underlying properties to which the credits relate are the same. Therefore, the exchange of credits is an exchange of like-kind property that qualifies for nonrecognition treatment under § 1031 of the Code, provided that the requirements of that section are otherwise satisfied.[48]

This establishes, at a minimum, that mitigation credits are within the scope of Section 1031. To the extent mitigation credits are properly classified as interests in real property, the door is open to the exchange of a conservation easement, itself an interest in real property, for mitigation credits to qualify as a valid Section 1031 exchange.

To meet the simultaneousness requirement of Section 1031, the standard credit release schedule should be amended so that all mitigation credits are received at the time of the initial mitigation bank transaction. The IRT is unlikely to enter into an MBI that authorizes immediate release of all credits for sale because authorization for use must be tied to achievement of aquatic functions. Thus, there is tension between the sponsor desiring to have the credits received in the beginning for tax purposes, and the IRT requiring that credit not be released until ecological performance criteria are met.

The planning opportunity here is not to negotiate with the IRT for the early authorization for use, but rather to modify the accounting procedure to distinguish between the receipt of credits and the authorization

39 Section 453(b).
40 Section 453(d).
41 Section 1273.
42 Section 1031.
43 Reg. 1.1031(a)-1(b).
44 Rev. Rul. 55-749, 1955-2 CB 295.
45 Rev. Rul. 68-331, 1968-1 CB 352.
46 Rev. Rul. 72-549, 1972-2 CB 472.
47 Ltr. Rul. 9851039.
48 Ltr. Rul. 9612009.

of such credits for use. In other words, all credits will be received at the time the MBI is executed, but the credits will not be authorized for use until the performance criteria are met for each given year. The IRT should be indifferent as long as the credits are not used before the mitigation bank meets the ecological criteria required by the MBI. The above-contemplated modification in no way accelerates the authorization schedule. Such accounting change clearly brings the timing of the receipt of the credits within the parameters required by Section 1031. Note, however, that such modification is mutually exclusive to the structure required for installment sales discussed above.

Conclusion

A mitigation bank transaction is complex, and many aspects related to the taxation of the transaction lack consistent guidance. The Final Rule both encourages and depends on mitigation banks for the success of compensatory mitigation. Mitigation banks are run as commercial ventures, and as a result they will flourish as long as they are economically viable. In order to ensure economic viability, there is a pressing need to resolve the uncertainty surrounding the taxation of mitigation banks. Taxing the value of all of the mitigation credits in year one is most likely an economic deathblow to the viability of mitigation banks.

According to the body of law related to government issued licenses, the receipt of mitigation credits should not be included in the gross income of the sponsor. This outcome encourages compensatory mitigation because it results in no immediate taxation, which in turn increases the economic viability of mitigation banks.

The Service has privately ruled, however, that the creation of a mitigation bank is a sale for federal income tax purposes. This analysis implicitly presumes that the credits themselves are a property right that is taxable when received, and not a type of non-taxable government issued license.

Although Ltr. Rul. 9612009 is not precedential authority, the prudent practitioner should structure the initial mitigation bank transaction to mitigate immediate taxation in the event the Service asserts that the transaction is taxable. Such structure may include either an installment sale, or a like-kind exchange under Section 1031. ■