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MEMORANDUM

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July 23 , 2010

TO: Interested Persons

FROM: Ron Kirk, Economist, 303-866-4785

SUBJECT: Colorado's Conservation Easement State Income Tax Credit

This memorandum updates information that was first provided to members of the General Assembly in April 2007 regarding federal and state conservation easement tax incentives. This research is presented as follows: a background section; a section on Colorado's conservation easement tax credit; a section on legislation affecting appraisals; and a section on Colorado Department of Revenue audits. The conclusion looks at the future trend for conservation easement donations given the passage of **House Bill 10-1197**.

Summary

Taxpayers who create conservation easements can gain a federal and state tax advantage by using the easement as a charitable conservation contribution at the federal level. At the state level, Colorado allows a tax credit for conservation easements. This credit piggybacks on the federal law that allows for the federal tax deduction. Thus, the Colorado income tax credit must adhere to the guidelines and purpose for which a conservation easement is created. Credits claimed under the Colorado conservation easement tax credit program has increased since it was initially made available in FY 2000-01. Total credits claimed from FY 2000-01 through FY 2008-09 were \$427.8 million. The increase in credits claimed is likely the result of legislative changes that expanded the credit and made it transferable.

Summary (continued)

The Internal Revenue Service, the Colorado Department of Revenue, and the Colorado Division of Real Estate have taken an aggressive stance through a collaborative effort to identify taxpayers who appear to be using inflated appraisal values for easements. Audits by the Internal Revenue Service and the Colorado Department of Revenue have resulted in the denial of nearly 340 of 2,500 donations (14 percent) used to garner a tax benefit in tax years 2003 thru 2007. Through tax year 2007, denials were valued at a total of \$87.1 million, 19 percent of all tax credits claimed.

Currently, there are approximately 500 claims for conservation easements that the department either has disputed or is in the process of disputing. To address the backlog of disputed claims, the legislature appropriated \$1.1 million during the 2010 session. The department estimates that this funding will increase General Fund revenue by \$4.1 million per year over five years. The department's goal is to process and offer mediation to all disputed cases within a five-year period.

What is a Conservation Easement

Background. A conservation easement is a voluntary legal agreement between a landowner and a charitable organization or government entity that permanently preserves scenic or agricultural open space, natural habitat, or recreational areas for the benefit of the public. These agreements can be individually suited to preserve the specific qualities tied to the property, allowing it to remain under private ownership and control. For example, an agreement may preserve traditional land uses such as family ranching or farming and may or may not allow public access to the property protected by the easement.

Federal conservation easement tax incentives. Federal tax laws allow taxpayers to make a charitable donation for qualifying conservation easements. This donation can be deducted from federal income taxes and can result in substantial income and estate tax savings. Federal law requires that conservation easements meet a conservation purpose such as:

- the preservation of land areas for outdoor recreation by, or the education of, the general public;
- the protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem; or
- the preservation of open space (including farmland and ranch land).

Mainly, the above preservation purposes must be for the scenic enjoyment of the general public that results in a significant public benefit (Section 170 (4) (A), IRC).

Colorado's Conservation Easement Tax Credit

Colorado offers a state income tax credit for conservation easements that qualify as a charitable contribution under federal law. If a charitable contribution is not allowed because the donation does not meet the requirements under federal law, then the Colorado state income tax credit is not allowed for the donation of the easement. Thus, the state credit piggybacks on the federal law.

Colorado's conservation easement tax credit was first effective for tax year 2000 and was available to Colorado resident individuals, C Corporations, trusts, and estates who donate all or part of a perpetual conservation easement to a governmental entity or to a 501(c)(3) charitable organization. State law defines a conservation easement as a right of the owner of the easement to prohibit certain acts with respect to the property in order to maintain the property in a manner that will preserve its value for recreation, education, habitat, open space, or historical importance (Section 38-30.5-102, C.R.S.). A Colorado taxpayer can claim state income tax credits for the tax year that the easement is donated. The following changes that were made to the credit, only apply to the *given year that the donation was made*.

Initial credit and transferability — tax years 2000 thru 2002. Colorado's conservation easement tax credit was initially equal to the fair market value (FMV) of the donation when it was created. For donations made after January 1, 2000, through December 31, 2002, the credit was capped at \$100,000, and equal to 100 percent of the first \$100,000 of the conservation easement's FMV.

Transferability — tax years 2000 and afterwards. In addition, the credit became transferable, allowing a taxpayer to transfer all or a portion of the credit to another taxpayer in increments of not less than \$20,000. Thus, a taxpayer who does not have a tax liability to fully use the credits (see the following discussion on the 20-year carry forward period), could potentially sell their credits to a taxpayer who has the tax liability and receive an up-front payment. This money may be discounted depending upon the contract for sale of the credits but amounts to a "lump-sum" payment to the taxpayer who otherwise might have to wait years to benefit from the tax incentive tied to the conservation easement.

Carry forward period or refund — tax years 2000 and afterwards. In years that the state did not have a TABOR surplus, the credit could be carried forward and applied against the income tax due for up to 20 succeeding income tax years if the taxpayer did not have the tax liability to fully use the credit. The credit can not be carried back to a prior tax year.

In years that the state had a TABOR surplus, up to \$20,000 was refundable. Thus, if a taxpayer owed no taxes to the state, the taxpayer would be given a state income tax refund of up to \$20,000. For tax years 2003 and afterwards, the refundable credit was increased from \$20,000 to up to \$50,000. The state allowed for a refundable credit in tax years 2000, 2001, and 2005. The credit was not refundable for tax years 2002 through 2004 and 2006 through 2010. It is important to note that taxpayers who created the conservation easement and made the initial donation, and **not transferees** of such credits, only qualify for the refundable credit for those years that the state had a TABOR surplus.

Expanding the credit — tax years 2003 and afterwards. Effective for tax years beginning 2003 thru 2006, the credit was expanded to equal 100 percent of the first \$100,000 of the FMV plus 40 percent of the donation capped at \$260,000. Thus, the maximum credit was capped for a donation that had a \$500,000 FMV.

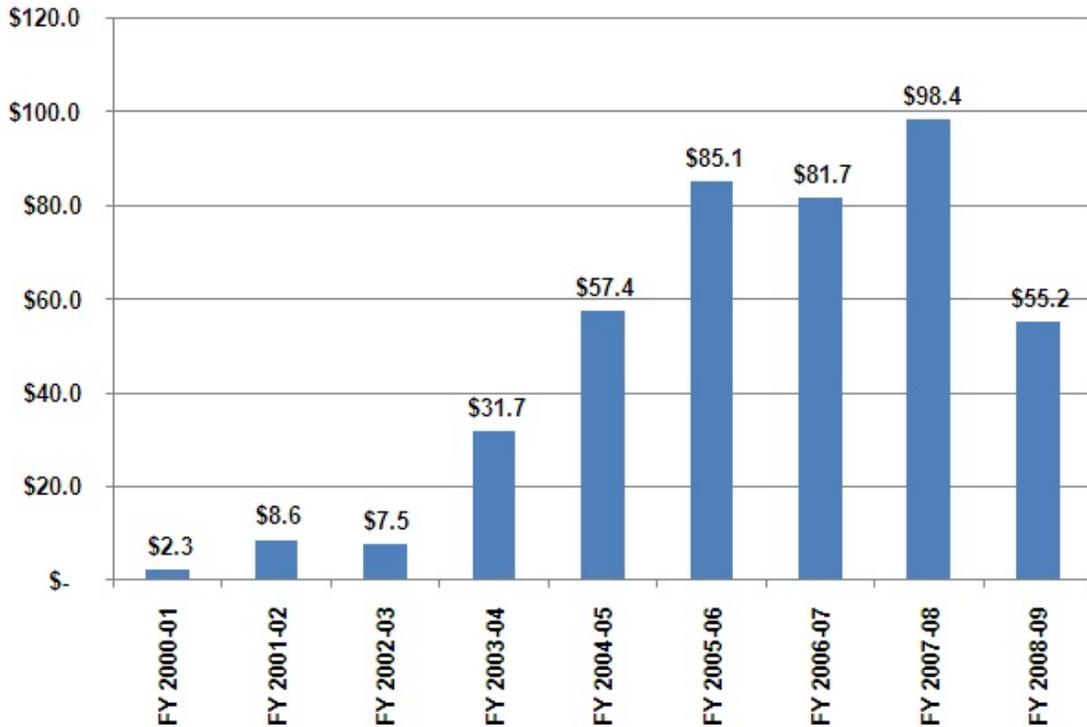
Effective tax years beginning 2007, the credit was changed to equal 50 percent of the donation capped at \$375,000. Thus, the maximum credit was capped for a donation that had a FMV of \$750,000. Table 1 summarizes changes to the credit by tax year.

Table 1: Colorado Conservation Easement Tax Credit Legislation

Tax Year	Legislation
2000	HB 99-1155 established the credit at 100% of the first \$100,000 of fair market value (FMV). HB 00-1348 made the credit transferable; the bill also made it refundable up to \$20,000 if there was a TABOR surplus.
2003	HB 01-1090 expanded the credit to equal 100% of the first \$100,000, plus 40% of the donation in excess of \$100,000, capped at \$260,000. This bill also increased the refundable portion of the credit up to \$20,000 to \$50,000.
2007	HB 06-1354 changed the calculation of the credit to equal 50% of the donation capped at \$375,000. The cap on the tax credit is reached for a donation valued at \$750,000 FMV.

History of credits claimed. The amount of credits claimed under the Colorado conservation easement tax credit program has increased from \$2.3 million in FY 2000-01 to a high of \$98.4 million in FY 2007-08, before falling to \$55.2 million in FY 2008-09. The increase in credits claimed was likely due to the transferability and refundability of the credit. The decline in FY 2008-09 to \$55.2 million is likely due to legislative changes affecting appraisals (see the following section). Since the credit's inception in FY 2000-01, total credits paid out by the state were \$427.8 million. Figure 1 illustrates credits processed by the Department of Revenue since FY 2000-01.

Figure 1
Conservation Easement Credits Claimed
FY 2000-01 thru FY 2008-09: \$427.8 Million



Source: Colorado Department of Revenue Annual Reports.

Legislative Changes Affecting Appraisals

Discoveries of misuse of the federal deduction for conservation easements resulted in over 250 taxpayers in Colorado being audited by the federal Internal Revenue Service (IRS). The federal audits triggered audits by the Colorado Department of Revenue (see next section). The most common misuses include overvalued appraisals. In response to these audits, the General Assembly enacted legislation that affected appraisals that were used to value conservation easements in Colorado.

Program changes. During the 2005, 2007, 2008, and 2009 sessions, the legislature adopted bills that made changes to the conservation easement program to ensure that the validity of conservation easement donations met the federal requirements that were tied to the federal deduction and the state income tax credit.

In 2005, House Bill 05-1244 authorized the Department of Revenue to review and evaluate the appraisal value of the easement and the amount and validity of the credit. In 2007 and 2008, House Bill 07-1361 and House Bill 08-1353 set forth additional requirements to verify the validity of donations that were used for purposes of the state income tax credit.

2008 and 2009 legislation. House Bill 08-1353 created a nine-member Conservation Easement Oversight Commission in the Division of Real Estate charged with advising the Division of Real Estate and the Department of Revenue on values related to the conservation easement state income tax credit. The bill also established a certification for the purpose of establishing minimum qualifications for certifying organizations that hold conservation easements. The Board of Real Estate Appraisers was also affected by the legislation. Under the legislation, the Board is authorized to investigate a written complaint concerning the activities of any appraiser who submits information regarding an appraisal of a conservation easement.

The legislation also required the Department of Revenue to develop and implement a separate process for the review of easements in consultation with the Division of Real Estate and the Conservation Easement Oversight Commission. The legislation also established fees to implement the provisions of the bill. The fee was capped at \$600 on appraisers who submit a conservation easement appraisal to the Division of Real Estate; a fee of up to \$5,810 per applicant was set for a conservation easement certificate. In 2009, House Bill 09-1014 eliminated the fee caps in HB 08-1353 and allowed the division to set the annual fees.

Colorado Department of Revenue Audits

Similar to the IRS, the Colorado Department of Revenue audited a number of taxpayers who have claimed state income tax credits. Many of these audits were triggered by the federal audits and focused on inflated appraisals. To date, most of these audits affected donations that were used to claim state income tax credits in tax years 2003 through 2007. The department is beginning its audit process on 2008 donations.

Parties affected by audits. There are two groups of taxpayers affected by audits. The first group is made up of taxpayers who claim state income tax credits because they made the donation. This group is the initial donor of the easement. The second group of taxpayers are "transferees" who are users of the credit. This is the group of taxpayers who purchased the credits from the taxpayer who created the easement (donor). As mentioned in Table 1, the conservation easement credit became a transferable credit that allowed a taxpayer to transfer all or a portion of the credit to another taxpayer. For each taxpayer who transfers credits under the transferability provisions of state law, on average, there are four transferees that purchase credits from each donor.

Disputed credits. For tax years 2003 thru 2007, audits by the Colorado Department of Revenue have resulted in the denial of nearly 340 of 2,500 donations (14 percent).¹ Of total credits claimed during this period, the denials accounted for 19 percent of total credits, valued at \$87.1 million.

Currently, there are approximately 500 claims for conservation easements that the department either has disputed or is in the process of disputing. These claims date from tax years 2001 through 2008, most of which occurred between 2002 and 2007. Department data through

¹ Department audits have resulted from a collaborative effort of the Colorado Department of Revenue, the Internal Revenue Service, and the Colorado Division of Real Estate.

December 31, 2009 value these claims at \$121.2 million, excluding penalties and interest. Note that credits claimed in Figure 1 include **net credits** that were paid out by the state in each fiscal year and incorporate the disallowed credits that have resulted from audits.

Backlog of cases. The department has a significant backlog of cases in its Taxpayer Service Division and the Tax Conferee in FY 2010-11 related to audits of taxpayers. The department has resolved eight of 340 cases in which the denial was protested.

Department proposal. To resolve the backlog in conservation easement disputed claims, the department requested 3.7 FTE and \$1.1 million from the legislature. The department's goal is to process and offer mediation to all disputed cases within a five-year period.

During the 2010 session, the legislature responded by appropriating \$1.1 million of General Fund money to address the backlog. The department estimates that this funding will result in an increase in General Fund revenue of approximately \$4.1 million per year over five years.

Recovery of money from audits. Under the current process, the state may not recover the full amount of money owed by taxpayers when an audit results in the denial of tax credits. In many cases, most of the denied credits were sold by the easement donors to transferees. In this instance, if the credit is denied, the donor is liable. In addition, for those credits that are sold by donors to transferees, the department disallows the credits that are claimed by transferees. But in terms of recovery, the donor in most cases is the party held liable for money owed to the state.

For most taxpayers who owe back money to the state, there is a good chance that individuals who sold credits may have already spent the money they were paid for the use of their credits by transferees. Thus, to the extent that this money may have already been spent, the amount of recoverable money in future settlements may be much less than the full amount owed to the state.

Future Trends for Conservation Easement Donations

During the 2010 session, the General Assembly adopted **House Bill 10-1197** concerning conservation easements. The legislation caps the aggregate amount of credits for tax years 2011, 2012, and 2013, at \$26 million in each of these years.

Revenue impacts. Based on the most recent data, the state is expected to provide \$63 million in new conservation easement tax credits for the current FY 2009-10.² This includes \$43 million in new tax credits claimed on income tax schedules already processed by the Department of Revenue; \$5 million in credits claimed on schedules received by the department, but not yet processed; and \$15 million in credits related to documentation received by the Division of Real Estate that have not yet been claimed for income tax purposes.

² This estimate is based on the tax year estimate for 2008 and the resulting impacts identified in the staff fiscal note for HB 10-1197. However, the General Fund revenue impact in FY 1214-15 may be considerably higher than the \$174 million estimate in Figure 2 should planned donations over the three-year cap period be larger than the \$63 million annual estimate.

However, before the \$26 million cap in HB 11-1197 is imposed, taxpayer behavior may be affected both before and after the limit is imposed. For example, the number and value of conservation easement donations in the current 2010 income tax year may be higher than expected as donors attempt to have their conservation easements approved prior to the \$26 million cap being put in place on January 1, 2011. Similarly, beginning January 1, 2014, when the cap is removed, the number and value of conservation easements claimed will likely be much higher than the current \$63 million level.

For example, if \$63 million in credits would have been planned in each of the three years that a cap of \$26 million is in place, and deferred until FY 2014-15, about \$37 million in donations for each of the three years may be delayed and not claimed until the cap is no longer in place in FY 2014-15. Thus, the total credits claimed could be as much as \$174 million in FY 2014-15 (\$37 million + \$37 million + \$37 million + \$63 million). Figure 2 illustrates this future trend for conservation easement donations.

Figure 2
Future Trends for Conservation Easement Donations
(FY 2009-10 thru FY 2014-15)

