Colorado
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Staff

Room 029 State Capitol, Denver, CO 80203-1784
(303) 866-3521 FAX: 866-3855 TDD: 866-3472

MEMORANDUM

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March 17, 2008

TO: Interested Persons

FROM: Ron Kirk, Economics Section, 303-866-4785

SUBJECT: Conservation Easement Tax Credit

This memorandum provides information on the federal and state conservation easement tax incentives. The research includes information on the evolution of the state credit, the amount of credits claimed, and some issues that the Internal Revenue Service and the Colorado Department of Revenue are evaluating in regard to taxpayer audits for persons who claim the federal deduction or the state income tax credit.

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, a tax credit is available. The amount of credits claimed under the Colorado conservation easement tax credit has increased since it was initially made available in FY 2000-01. The total credits claimed from FY 2000-01 through the present amount to about $274.2 million. The increase in credits claimed is likely resulting from changes to the legislation that initially created the credit which enlarged the credit, and made it refundable and transferable.

After identifying certain taxpayer misuses of federal and state laws, the Internal Revenue Service and the Colorado Department of Revenue have taken an aggressive stance by auditing taxpayers who appear to be using inflated values for easements or creating easements that have little to no public benefit. Currently, the Internal Revenue Service is auditing over 300 Colorado taxpayers who have been referred to the service for auditing purposes by the Colorado Department of Revenue.

Summary (continued)

In addition, the Division of Real Estate is working together with the Department of Revenue to gain information about appraisals that may have been overvalued. Recently, the division has issued 30 subpoenas as part of a statewide investigation into Colorado's conservation easement program. To facilitate the auditing process tied to conservation easement donations, the General Assembly is debating House Bill 08-1353. The bill contains requirements that allow state agencies to work together to verify the validity of appraisals that are used for purposes of claiming the state income tax credit for conservation easement donations.

Conservation Easement Tax Credit

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.

Persons who create a conservation easement can gain a federal and state tax benefit. For example, the voluntary donation of a ***qualifying*** conservation easement can result in substantial income and estate tax savings as a "charitable conservation contribution" when *recognized* as such by the Internal Revenue Service and the Colorado Department of Revenue.

Federal tax law. Federal tax laws primarily govern taxpayers that claim a charitable contribution for conservation easements. 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).

Federal tax deduction. In recognition of preserving our heritage, Congress allows a deduction for owners of qualifying property who give up certain rights of ownership, for example, development rights, to preserve their land (or buildings) for future generations. This deduction is commonly referred to as the "charitable conservation contribution" (conservation easement donation). Deductions reduce federal taxable income and thus, reduce the amount of federal taxes owed from their income taxes.

Colorado's Conservation Easement Tax Credit

In 1999, House Bill 99-1155 created Colorado's conservation easement tax credit (Section 39-22-122, C.R.S.). The credit became effective on and after January 1, 2000, and was available to Colorado resident individuals, C Corporations, trusts, and estates who donate all or part of a perpetual conservation easement in gross to a governmental entity or to a 501(c)(3) charitable organization.

Colorado's conservation easement tax credit piggybacks on the federal credit requiring land donations to qualify as a charitable contribution for federal income tax purposes (Section 170 (4) (A), IRC). 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.).

Qualifying appraisal. When claiming the credit, the taxpayer must file a summary of the appraisal for the conservation easement with the Department of Revenue that was prepared when the conservation easement was created (26 CFR 1.170A-13 (c) (4) (1998). However, the department may require the taxpayer to submit the actual appraisal to the department.

Changes to the state tax credit. When initially established in 1999, Colorado's conservation easement tax credit was 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 fair market value. 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 utilize the credit.

During the 2008 session, the General Assembly is debating House Bill 08-1353 that is intended to facilitate the administration of the conservation easement tax credit. The bill authorizes the Department of Revenue to share certain appraisal and tax information on conservation easement donations with the Division of Real Estate in the Department of Regulatory Agencies. The bill also creates a certification process for qualified conservation easement holders and places certain requirements on appraisers who appraise conservation easements. Table 1 provides information on changes to the credit from 2000 through the present.

Table 1: Legislation Authorizing Conservation Easement Tax Credit

<table>
<tr><th>Bill</th><th>State Credit</th><th>Refundable</th><th>Transferable</th></tr>
<tr><td>HB 99-1155</td><td rowspan="2">100% of the first $100,000 of fair market value (FMV)</td><td>No</td><td>No</td></tr>
<tr><td>HB 00-1348</td><td>Yes, but conditional. Up to $20,000 if there was a TABOR surplus.</td><td>Yes. The bill allowed a taxpayer to transfer all or a portion of the tax credit to another taxpayer in increments of not less than $20,000. Transferees are not eligible for a refundable credit.</td></tr>
<tr><td>HB 01-1090</td><td>Effective 01/01/03, 100% of the first $100,000, plus 40% of the donation in excess of $100,000 capped at $260,000. (Maximum credit is captured at $500,000 FMV.)</td><td rowspan="3">HB 01-1090 increased the credit from $100,000 to $260,000 and raised the refundable amount from $20,000 to $50,000 per year beginning in 2003 for years in which there was excess TABOR revenue (but not as a TABOR refund mechanism). The state had a TABOR surplus in FY 2004-05. Thus, the tax credit was last refundable for the 2005 tax year.</td><td rowspan="3">Yes. In terms of transferability, HB 01-1090 made technical changes for tax year 2003 that made the transferable credit apply more generally to land donations. The bill also increased the refundable portion of the credit for years in which the state had a TABOR surplus. These changes made the transferability of the credit more attractive to taxpayers.</td></tr>
<tr><td>HB 05-1244</td><td>HB 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.</td></tr>
<tr><td>HB 06-1354</td><td>Effective 01/01/07, 50% of the donation capped at $375,000 for the credit. The cap on the tax credit is reached for a donation valued at $750,000 FMV. HB 06-1354 did not enlarge the credit but was a revenue neutral change to accommodate a federal guideline by the IRS that questioned whether a donation that was valued at 100 percent (state law) was a charitable contribution.</td></tr>
<tr><td>HB 08-1353 (This bill has not been adopted by the General Assembly at this time.)</td><td colspan="3">Effective 07/01/08 the bill provides additional requirements to verify the validity of a state income tax credit claimed by a taxpayer for donating a conservation easement. The bill:

• creates a nine-member Conservation Easement Oversight Commission in the Division of Real Estate;
• creates a certification program for qualified conservation easement holders; and
• requires any appraiser who conducts an appraisal for a conservation easement to submit a copy of the completed appraisal to the Division of Real Estate within 30 days following completion of the appraisal. The bill also places additional requirements on appraisers who appraise conservation easements in terms of fees and additional classroom education and experience requirements.</td></tr>
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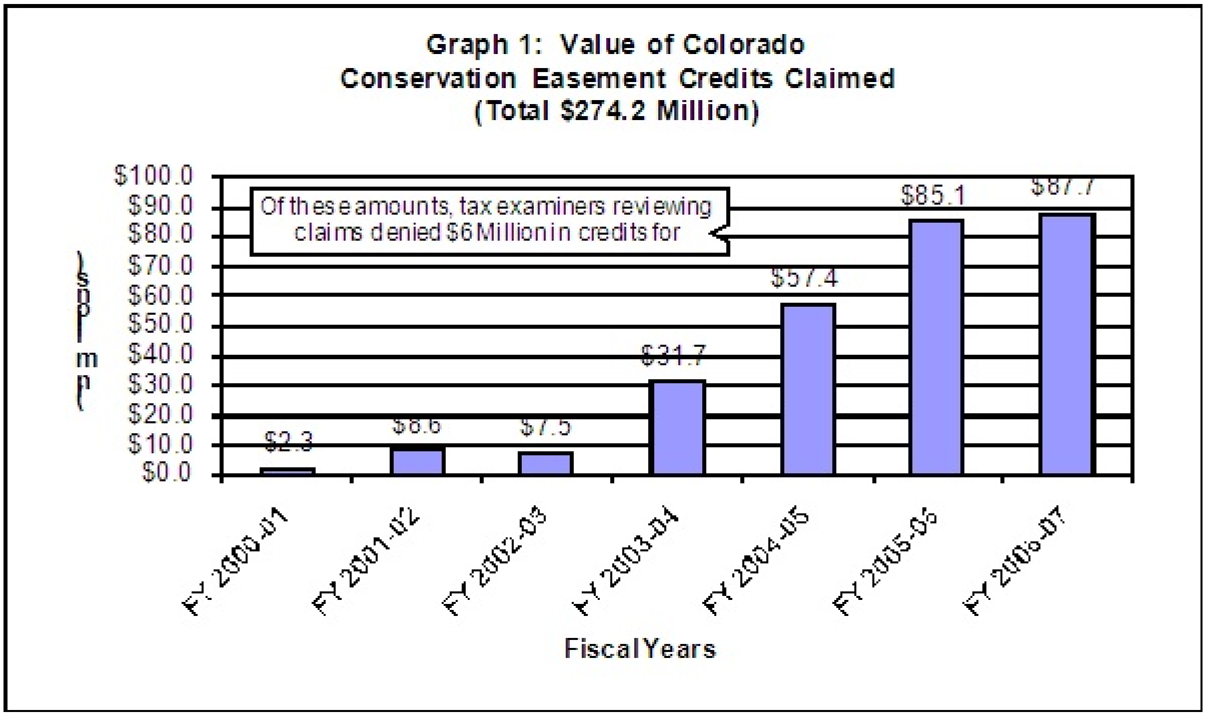
Credits claimed. The amount of credits claimed under the Colorado conservation easement tax credit has increased since it was initially made available in FY 2000-01. The total credits claimed ranged from $2.3 million in FY 2000-01 to a high of $87.7 million in FY 2006-07. However, during FY 2006-07, through an ongoing auditing process of conservation easement donations made prior to FY 2006-07, the department denied about $6 million in tax credits claimed prior to FY 2006-07. Given this adjustment, total credits claimed by taxpayers for the Colorado conservation easement credit were $274.2 million through FY 2006-07. Graph 1 shows annual conservation easement credits claimed from FY 2000-01 through FY 2006-07.



Credits claimed in FY 2002-03 were $7.5 million and more than tripled in FY 2003-04 to $31.7 million. Three changes were made by the General Assembly that may have led to the 322.7 percent increase (from tax year 2002 to tax year 2003). First, House Bill 01-1090 increased the credit amount from $100,000 to $260,000 per donation. Second, aside from increasing the credit, two bills, House Bill 00-1348 and House Bill 01-1090 made technical changes for tax year 2003 that enhanced the value of the credit by increasing the refundable portion of the credit for years in which the state had a TABOR surplus. Table 2 provides data for corporate, individual, and fiduciary filers.

Table 2: Conservation Easement Tax Credits Claimed

(in millions)

Year	Corporate Credits	Individual & Fiduciary Credits	Total Credits Claimed	Annual % Change
FY 2000-01	$0.0	$2.3	$2.3	N/A
FY 2001-02	$0.8	$7.8	$8.6	269.1%
FY 2002-03**	($0.3)	$7.8	$7.5	-12.8%
FY 2003-04**	$1.3	$30.4	$31.7	322.7%
FY 2004-05	$5.8	$51.6	$57.4	81.1%
FY 2005-06	$8.4	$76.7	$85.1	48.3%
FY 2006-07*	$10.1	$77.6	$87.7*	3.0%
Totals	**$26.1**	**$248.2**	**$274.2**	**N/A**

**Tax examiners denied $6 million in tax credits claimed on donations made prior to FY2006-07.*

Taxpayer Audits

Recent discoveries of misuse of the deduction for conservation easements has resulted in about 300 taxpayers in Colorado being audited by the federal Internal Revenue Service (IRS). The misuse has also resulted in the IRS briefing Congress on this tax issue and a heightened concern by the agency to curb the abuse of tax advantages tied to conservation easements. The most common misuses include the determination of whether certain easements meet the federal guidelines that pertain to conservation purpose and whether easements meet the goals that are tied to a public benefit.

Other concerns include appraisers who overvalue easements and other potential abuses that are tied to the transferability of credits. Similar to the IRS, the Colorado Department of Revenue has audited a number of taxpayers who benefit from the state tax advantages tied to conservation easements.

Colorado Department of Revenue audits. Since Colorado's income tax liability is calculated by using federal taxable income as the starting point, deductions that reduce federal taxes reduce the amount of state taxes owed to Colorado. Thus, the state has an interest in whether the federal tax advantages tied to conservation easements are administered fairly and accurately.

In an attempt to stop taxpayers who appear to be gaming the system through conservation easements, the department has referred hundreds of taxpayer returns claiming benefits from conservation easements to the federal IRS for audits. These audits are conducted by the federal IRS and are not duplicated by the state Department of Revenue. Many of the audits that were referred by the department were flagged because they were identified as conservation easements that may not be following the federal guidelines that apply to either conservation purposes or public benefit. For example, some easements have been created from green-belt areas in metro areas that *were never intended* to be developed or were created from rural parcels of land that are not visible or accessible to the public.

The department is also engaging in its own audits apart from the IRS. For donations made prior to FY 2006-07, the department denied an estimated $6 million in conservation easement tax credits. These audits are part of an ongoing process that is evaluating whether land values for conservation easements are accurate. However, limited resources are making it difficult for the department to audit and verify appraised values for conservation easements. The department also noted that it does not have the resources or expertise to verify and re-appraise values for conservation easements. As an example, the department reported that the verification and auditing of appraisal values for some conservation easements can cost up to $25,000 per easement.