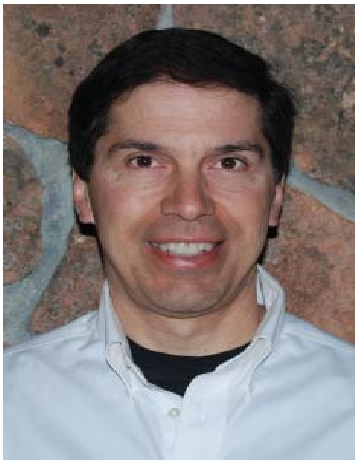
Conservation Easement tax Credits:
Now A Smart Move for Your Clients?



Many CPAs and financial advisors have found themselves in the same position: the taxable year is over, the client is looking at a substantial tax bill and asking if anything can be done at this late date to lower it.

One answer has been for them to buy Colorado Conservation Easement Tax Credits (CE Credits). Depending on the discount involved, this can immediately result in an approximately 15 percent saving on Colorado income taxes. Additionally, if the financial advisor had time to plan in advance, the client could have also avoided paying Colorado estimated tax payments throughout the previous year, providing even more savings and cash flow flexibility to the client. However, buying CE Credits has not been without risk, and recent stories in the press have made many wary of utilizing these Credits. The purpose of this article is to provide a brief overview of the situation, and some tangible guidance for those who wish to buy CE Credits.

How CE Credits are transferred

Before looking at the current situation regarding CE Credits it is useful to understand how the Credits are transferred. There is little regulatory or statutory guidance regarding how the market functions; however, the following is a brief guide:

1. Typically a facilitator acts as a middle man in transferring the CE Credits. There are no requirements or qualifications to be a facilitator.
2. In a sale of CE Credits, the easement donor/seller receives about 80 percent of the face value of the credits involved, the buyer pays about 85 percent, and the facilitator retains about 5 percent. Flawed CE Credits transfer at lower rates.
3. The seller indemnifies the buyer against denial or reduction of the CE Credits, but the indemnity is typically limited to what the buyer paid for the CE Credits plus penalties and interest.
4. Buyers must obtain the CE Credits by no later than the time their taxes are due for the tax year involved, without extension (typically April 15th).

Background and controversy

When a land owner donates a conservation easement to a qualified recipient (assuming various conditions are met), that donor earns a federal charitable deduction pursuant to IRS 170(h). The amount of the deduction is the value of the easement, as determined by a qualified appraisal. Typically, the appraiser reaches that value by determining how much the land was worth without the easement, and then how much it was worth after the imposition of the easement; the difference between the two being the value of the easement.

Easement donations often result in very large charitable deductions. While those large deductions are useful to high-income land owners, they offer very little incentive to most real farmer/ranchers, who rarely have high income tax liabilities. To address this situation, in 2000, Colorado adopted state income tax credits that were earned by easement donations. Colorado took the additional significant step of making those CE Credits directly transferable. This created a powerful new incentive for easement donations, and multiplied the number of Colorado easement donations many fold. It also set the table for a series of events that few anticipated.

At the same time that easement donations were ramping up, unrelated events were occurring on the national level. In early 2002, the *Washing Post* ran a series of articles critical of the practices of the Nature Conservancy, and questioning the oversight of easement donations in general. These articles attracted the attention of Congress, which quickly refocused its attention on the IRS. Congress essentially told the IRS it had been applying too little scrutiny to CE donations, and suggested that IRS step up its enforcement efforts.

While attention was focused on CE donations on the national level, red flags were going up in Colorado. Members of the conservation community had learned that some new nonprofits had entered the scene, and had been generating a large number of easement donations. Many of these CEs were on Colorado's eastern plains, an area that had not previously been attractive for CE donations. The Colorado Department of Revenue (DOR) also became aware of the situation, and began looking for a way to address it. As one potential solution, the DOR suggested that the IRS might want to scrutinize some of Colorado's easement donations. The timing of this suggestion happened to be just right, as the IRS was looking for a way to assert itself into CE oversight. The IRS set out on a path that eventually resulted in its auditing nearly 300 Colorado CE donations. Almost all of the audits were from the tax year 2003 and related phased transactions that occurred in subsequent years.

The existence of all of these audits began to cast a pale over the purchase and sale of CE Credits. In the fall of 2007, a task force was convened to suggest changes to Colorado's easement credit legislation to tighten up the CE Credit program. More fuel was added to the fire in early 2008, when an investigative report by the *Rocky Mountain News* resulted in a series of articles critical of Colorado's CE practices. All of this conspired to make accountants and other financial advisors increasingly reluctant to recommend the purchase of CE Credits to their clients.

Colorado's legislative response

As noted above, in the fall of 2007, a task force met to consider modifications of the CE Credit program to address perceived deficiencies. The resulting legislation was considered and variously amended throughout the legislative season, and was signed into law by the Governor on June 1, 2008 (effective on July 1, 2008). While the new legislation contains considerable detail, its principal elements are:

1. **Appraisal Review**: When an appraiser completes a CE appraisal, the appraiser is now required to submit a full copy of the appraisal and certain related materials to the Colorado Division of Real Estate. If the Division believes there are problems with the appraisal it can notify the Department of Revenue, and the Real Estate Board can investigate and discipline the appraiser involved. It has yet to be determined whether this process also might provide feedback to the appraiser and/or provide an opportunity for the appraiser to address deficiencies.
2. **Certification of Easement Recipients**: Governments and nonprofits that accept CE donations must now be certified by the state before the resulting CE Credits can be used. Land trusts must be certified by no later than Jan. 1, 2010, and governmental open space programs must be certified by no later than Jan. 1, 2011.
3. **Oversight Board:** The legislation created a new Conservation Easement Oversight Board (Oversight Board). It is responsible for establishing the standards for land trust/government certification (see number 2 immediately above). It also can provide input to the Department of Revenue and Real Estate Board, if so requested.

It was the opinion of the task force and the legislature that the above steps (together with a number of more minor modifications,) would stabilize Colorado's CE Credit program and stem the abuses that had been previously observed.

Practical steps to assure CE Credit quality

The new legislation, and the general attention and greater scrutiny to CE Credits, should go a long way toward reducing the risks associated with purchasing CE Credits. In addition to that, practitioners may also want to consider the following:

1. **Obtain CE Credits from a Reliable Source**. Most CE Credits are transferred via facilitators who, as noted above, are completely unregulated. Good facilitators scrutinize the CE Credits involved, and will not sell Credits that do not meet their standards. The experience of good facilitators has been very positive, with virtually no reports of their credit buyers

losing money (e.g. either the CE Credits have been good, or the indemnity has covered any shortfall).

2. **Buy New CE Credits**. As noted above, the protections of the new legislation took effect beginning July 1, 2008. By buying CE Credits originating after that date, you obtain the additional protections offered by the legislation.
3. **Avoid Bargain Priced CE Credits**. Good facilitators selling good CE Credits all charge virtually the same price. If a seller is willing to sell CE Credits at a lower price, there is almost always something wrong with those CE Credits.
4. **Pay attention to Indemnity/Bonding**. A seller almost always indemnifies the buyer if the CE Credits go bad. A practitioner may wish to conduct some due diligence into the strength of that indemnity. If the indemnity is questionable, the buyer may want to ask for additional protection. Beginning in 2007, bonding agents were willing to bond CE Credits for a payment of about 2 percent of their face amount.

CE Credits remain one of the few tools that can be used to immediately and substantially lower a Colorado taxpayer's tax obligations. A savvy practitioner can help assure that any such tax savings are permanent, and will not later be lost in an audit or other adjustment.

Michael D. Strugar, Director, Strugar Conservation Services, LLC. Mr. Strugar established the Conservation Resource Center, a nonprofit organization dedicated to helping communities and governmental entities deal with matters involving land conservation. Working in Colorado, he developed the nation's first functioning exchange for transferring Conservation Tax Credits.