

**Conservation Easement Tax Credit  
Department of Revenue  
Division of Real Estate**

**Performance Audit  
September 2012**



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Office of the State Auditor

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Dianne E. Ray, CPA  
State Auditor

September 21, 2012

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of Colorado's conservation easement tax credit. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The report presents our findings, conclusions, and recommendations, and the responses of the Department of Revenue, the Division of Real Estate, and the Conservation Easement Oversight Commission.

A handwritten signature in blue ink, appearing to read "Dianne E. Ray".



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## *Glossary of Abbreviations*

**BOREA** – Board of Real Estate Appraisers

**CEOC** – Conservation Easement Oversight Commission

**COMaP** – Colorado Ownership, Management, and Protection project

**DOR** – Department of Revenue

**DRE** – Division of Real Estate

**FMV** – fair market value

**GOCO** – Great Outdoors Colorado

**IRS** – U.S. Internal Revenue Service

**OIT** – Governor’s Office of Information Technology

**TABOR** – Taxpayer’s Bill of Rights

**TPS** – Taxpayer Service Division

**USPAP** – Uniform Standards of Professional Appraisal Practice



# CONSERVATION EASEMENT TAX CREDIT

Performance Audit, September 2012

## Report Highlights



Dianne E. Ray, CPA  
State Auditor

Department of Revenue  
Division of Real Estate

### PURPOSE

To determine whether there are effective internal controls in place at the Department of Revenue (DOR) and the Division of Real Estate (DRE) to ensure that conservation easement tax credits being claimed and used by taxpayers are valid.

### BACKGROUND

- A conservation easement is an interest in real property with the purpose of promoting land conservation. The restrictions on development and other land uses imposed by a conservation easement are intended to maintain the property in a relatively undeveloped state.
- Taxpayers may claim a state income tax credit for all or part of a conservation easement that is donated to a certified governmental entity or nonprofit organization.
- As of 2009, nearly \$640 million in tax credits had been claimed for about 3,200 conservation easements. In return, landowners restricted development rights and other land uses on about 925,000 acres of land.

### OUR RECOMMENDATIONS

- DOR should strengthen its conservation easement tax credit claim review process and improve its information management practices.
- DRE should strengthen its processes for reviewing conservation easement appraisals and certifying conservation easement holders.
- DOR, DRE, and the Conservation Easement Oversight Commission (CEOC) should ensure that the CEOC consultation process furthers the State's ability to determine the validity of conservation easement tax credit claims.
- DOR and DRE should evaluate options to better protect the State's investment of public resources in tax-credit-generating conservation easements.
- DOR, DRE, and the CEOC should work together to design a pre-approval process for reviewing and approving conservation easement tax credits.

DOR, DRE, and the CEOC agreed with our recommendations.

### AUDIT CONCERN

The State foregoes a significant amount of annual tax revenues to incentivize land conservation. House Bill 08-1353 was intended to try to curb historical abuses of the tax credit and help ensure the validity and proper valuation of tax-credit-generating conservation easements. However, our audit demonstrates that more changes need to be made to strengthen the administration of Colorado's conservation easement tax credit to ensure that tax credits being claimed and used by taxpayers are valid.

### KEY FACTS AND FINDINGS

- DOR's process for reviewing conservation easement tax credit claims and uses does not ensure coverage of a key requirement—the easement's conservation purpose—and other relevant risk factors.
- DOR's tax examiners do not sufficiently document their reviews of conservation easement tax credit claims and uses. Review documentation held little information about judgments made and conclusions reached.
- The CEOC consultation process is limited in its ability to help inform and facilitate DOR's decision making to allow or disallow tax credit claims. The CEOC tends to take a substantive compliance approach when reviewing conservation easement transactions that DOR refers for consultation, and the CEOC's deliberations tend to take on a landowner-centered perspective.
- DRE's appraisal review process is not sufficient to ensure that all appraisals of tax-credit-generating conservation easements undergo a desk review or that potential problems with appraisals are identified and referred for further investigation.
- DRE's certification process does not ensure that governmental entities and nonprofit organizations holding tax-credit-generating conservation easements continue to meet the minimum certification requirements.
- The State lacks adequate protections when governmental entities and nonprofit organizations that hold tax-credit-generating conservation easements are no longer certified.
- The State's current approach to administering the conservation easement tax credit creates uncertainty for the taxpayer and does not align review and decision-making responsibilities with those with the most appropriate and relevant expertise.
- Measuring the public cost of the conservation easement tax credit is generally straightforward. However, measuring the benefits the public has received in return is more difficult and limited because of a lack of available data.

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## RECOMMENDATION LOCATOR

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<b>Rec. No.</b>	<b>Page No.</b>	<b>Recommendation Summary</b>	<b>Agency Addressed</b>	<b>Agency Response</b>	<b>Implementation Date</b>
1	32	Strengthen the review of conservation easement tax credit claims to ensure coverage of key requirements and consideration of relevant risk factors by (a) including a basic review of the reported conservation purpose as part of a Level 1 review, and developing risk factors or other selection criteria that would require referral of the claim to the CEOC for a more complete assessment of the easement's conservation purpose as part of a Level 2 review; (b) expanding the current list of risk factors to include phased donations and donors with prior disallowed credit claims; and (c) evaluating and updating the list of risk factors on at least an annual basis.	Department of Revenue	Agree	March 2013
2	38	Ensure that the review of conservation easement tax credits claims is consistently applied and that the resulting decisions to allow or disallow claims are appropriate and substantiated by (a) developing and utilizing a standard work program or review tool to guide and document tax examiners' review of conservation easement tax credit claims; (b) developing more complete and detailed written policies and procedures for reviewing conservation easement tax credit claims, including how reviews should be documented; (c) instituting a quality review process whereby a supervisor and/or quality control staff routinely reviews a sample of conservation easement tax credit claim reviews completed by tax examiners. Supervisors and quality control staff performing the reviews should receive training to maintain at least a basic level of competency with the conservation easement tax credit and related issues.	Department of Revenue	Agree	July 2013

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## RECOMMENDATION LOCATOR

<b>Rec. No.</b>	<b>Page No.</b>	<b>Recommendation Summary</b>	<b>Agency Addressed</b>	<b>Agency Response</b>	<b>Implementation Date</b>
3	43	Ensure that electronic data and information management systems effectively support the administration of the conservation easement tax credit by (a) utilizing a relational database to manage data at the donation and taxpayer levels in a manner that captures the complexity of the tax credit claims and uses over time; (b) capturing data from Form DR 1305 for all conservation easement tax credit claims in the year in which the claim is made, regardless of when the use of the credit occurs; and (c) instituting appropriate data entry controls to help prevent data inaccuracies, and routine clean-up procedures to help identify and correct any data inaccuracies that do occur.	Department of Revenue	Agree	December 2013
4	50	Improve communication efforts and continue to build a common understanding about the purpose and goals of the consultation process. This should include using the consultation process to hold routine discussions about the general issues and trends being observed with conservation easement transactions associated with tax credit claims.	Department of Revenue  Division of Real Estate  Conservation Easement Oversight Commission	Agree  Agree  Agree	June 2012 and Ongoing  June 2012 and Ongoing  June 2012 and Ongoing
5	51	Provide the CEOC with more information, such as areas of concern or specific questions that need to be addressed, when referring individual conservation easement tax credit claims to the CEOC for consultation. DOR should also communicate its final decisions to allow or disallow tax credit claims that are referred for consultation.	Department of Revenue	Agree	December 2012

## RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
6	52	Revise the CEOC's written orientation manual to better address the CEOC's broader responsibility to the general taxpayer when defining "the public interest." The manual should explicitly recognize that the consultation process should further the State's ability to determine whether the landowner has complied with the statutory and regulatory requirements for claiming the conservation easement tax credit.	Division of Real Estate	Agree	March 2013
			Conservation Easement Oversight Commission	Agree	March 2013
7	61	Ensure that the conservation easement appraisal review process is effective at identifying and referring problematic appraisals for investigation before a tax credit is claimed by (a) performing a desk review of, at a minimum, all conservation easement appraisals for which a tax credit will be claimed; (b) developing standard operating procedures that outline the general parameters of the desk review, including the risk factors warranting a desk review and the required and/or significant attributes that should be examined on every desk review; (c) developing and utilizing a standard review template, or other similar tool, to ensure the consistency and completeness of the desk review and to document the significant judgments made, conclusions reached, and subsequent actions taken; and (d) working with the General Assembly to further clarify in statute the intended purpose and scope of the conservation easement appraisal review requirement.	Division of Real Estate	Agree	a. January 2013 b. January 2013 c. January 2013 d. July 2013
8	66	Strengthen the conservation easement holder certification process by formally establishing "conditional certification" in state rule. This should include specifying the appropriate purpose and use of conditional certification, what evaluation criteria would result in conditional certification versus full certification or denial of certification, and any other administrative requirements that are necessary to implement conditional certification.	Division of Real Estate	Agree	March 2013

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## RECOMMENDATION LOCATOR

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<b>Rec. No.</b>	<b>Page No.</b>	<b>Recommendation Summary</b>	<b>Agency Addressed</b>	<b>Agency Response</b>	<b>Implementation Date</b>
9	69	Strengthen the certification process to ensure that conservation easement holders continue to meet the certification requirements on an ongoing basis. At a minimum, DRE should periodically conduct an in-depth review of documentation for conservation easements that holders have accepted since their initial certification or most recent certification renewal.	Division of Real Estate	Agree	January 2013 and Ongoing
10	72	Evaluate options for protecting the State's investment of public resources in tax-credit-generating conservation easements when the conservation easement holder is no longer certified. Report back to the Legislative Audit Committee and the House and Senate Finance Committees by July 1, 2013, on viable options and pursue statutory and/or regulatory change, as appropriate. At a minimum, options that should be considered include (a) strengthening DRE's ability to investigate complaints against conservation easement holders that hold tax-credit-generating conservation easements, regardless of whether or not the holder is certified and (b) utilizing assignment clauses in the deeds for tax-credit-generating conservation easements that reserve the State's right to require the transfer of the easement to another certified conservation easement holder when the original holder ceases to exist; is no longer certified; or is unwilling, unable, or unqualified to enforce the terms and provisions of the easement.	Division of Real Estate	Agree	July 2013
			Department of Revenue	Agree	July 2013

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## RECOMMENDATION LOCATOR

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<b>Rec. No.</b>	<b>Page No.</b>	<b>Recommendation Summary</b>	<b>Agency Addressed</b>	<b>Agency Response</b>	<b>Implementation Date</b>
11	80	Work together to design a pre-approval process for reviewing and approving conservation easement tax credit claims prior to their use. Report to the Legislative Audit Committee and the House and Senate Finance Committees by July 1, 2013, on a proposed pre-approval process, including any statutory and regulatory changes that are necessary for implementation. At a minimum, the proposed pre-approval process should ensure that (a) the State has reasonable assurances that conservation easement tax credits being claimed by taxpayers are valid and comply with all statutory and regulatory requirements, (b) conservation easement tax credit claims are approved or denied separately from and prior to any uses of the tax credit, (c) all essential elements related to conservation easement tax credit claims are reviewed and approved by those with the most appropriate and relevant expertise, and (d) the review and approval of tax credit claims is timely.	Department of Revenue	Agree	July 2013
			Division of Real Estate	Agree	July 2013
			Conservation Easement Oversight Commission	Agree	July 2013
12	92	Help to ensure the State's ability to measure the public benefits of the conservation easement tax credit by: (a) Improving taxpayer forms to capture data in a format that facilitates aggregate analysis and reporting on the specific conservation purposes and land attributes that are being protected by conservation easements, (b) Ensuring that taxpayers donating tax-credit-generating conservation easements submit Form DR 1304, and (c) Eliminating unnecessary or duplicative data collection forms and consolidating public reports when possible.	Department of Revenue	Agree	July 2013

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# Overview of the Conservation Easement Tax Credit

## Chapter 1

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First established by state statute in 1976 (Section 38-30.5-102, C.R.S.), a conservation easement, also known as a conservation easement in gross, is a freely transferable interest in real property with the purpose of promoting land conservation. Specifically, a conservation easement is a right of the owner of the easement, also known as the conservation easement holder, to restrict the landowner from subdividing and building on the land or using the land in certain ways.

The restrictions imposed by a conservation easement are intended to maintain the property in a relatively undeveloped state, thereby preserving and protecting certain conservation purposes. Conservation easements typically afford the protection of fish, wildlife, and plant habitats, or the preservation of land areas for outdoor recreation, education, open space, or historical importance. As of September 2011, there were more than 4,300 conservation easements in Colorado covering approximately 1.6 million acres, or about 2.4 percent of the state's total land area. The map insert illustrates the location of conservation easements throughout the state.

The specific conservation purposes being protected and any restrictions on the landowner are contained in a legal document, called a deed of conservation easement, that is recorded in the local property records and becomes part of the chain of title for the property.

Conservation easements are generally seen as an attractive alternative to the acquisition of land as "fee title," which is the most complete ownership interest one can have in real property. Some potential advantages of conservation easements include:

- **Flexibility.** The terms of a conservation easement can often be tailored to meet the specific needs of both the landowner and the conservation easement holder while still ensuring the easement's conservation purpose.
- **Private Ownership.** Conservation easements are desirable because protecting and preserving natural habitat, open space, or other conservation purposes can be achieved without requiring the government

to acquire ownership of the land. With a conservation easement, the land is maintained under private ownership, which means that the landowner retains the ability to occupy the land, sell it, or pass it on to heirs. Depending on the terms of the conservation easement, traditional land uses such as livestock grazing or agricultural production may be allowed to continue on the property. The property also remains on the local tax rolls for property tax purposes.

- **Cost.** Conservation easements are less costly than a fee title acquisition because the holder is only paying the landowner for the development rights to the land and for other use restrictions, as opposed to the entire bundle of surface property rights. In general, the value of the development rights are the difference between the full market value of the land if left unencumbered and the full market value of the land with the conservation easement in place.

In addition to these considerations, tax policy at the federal and state levels gives landowners incentives to donate conservation easements instead of gifts of fee title.

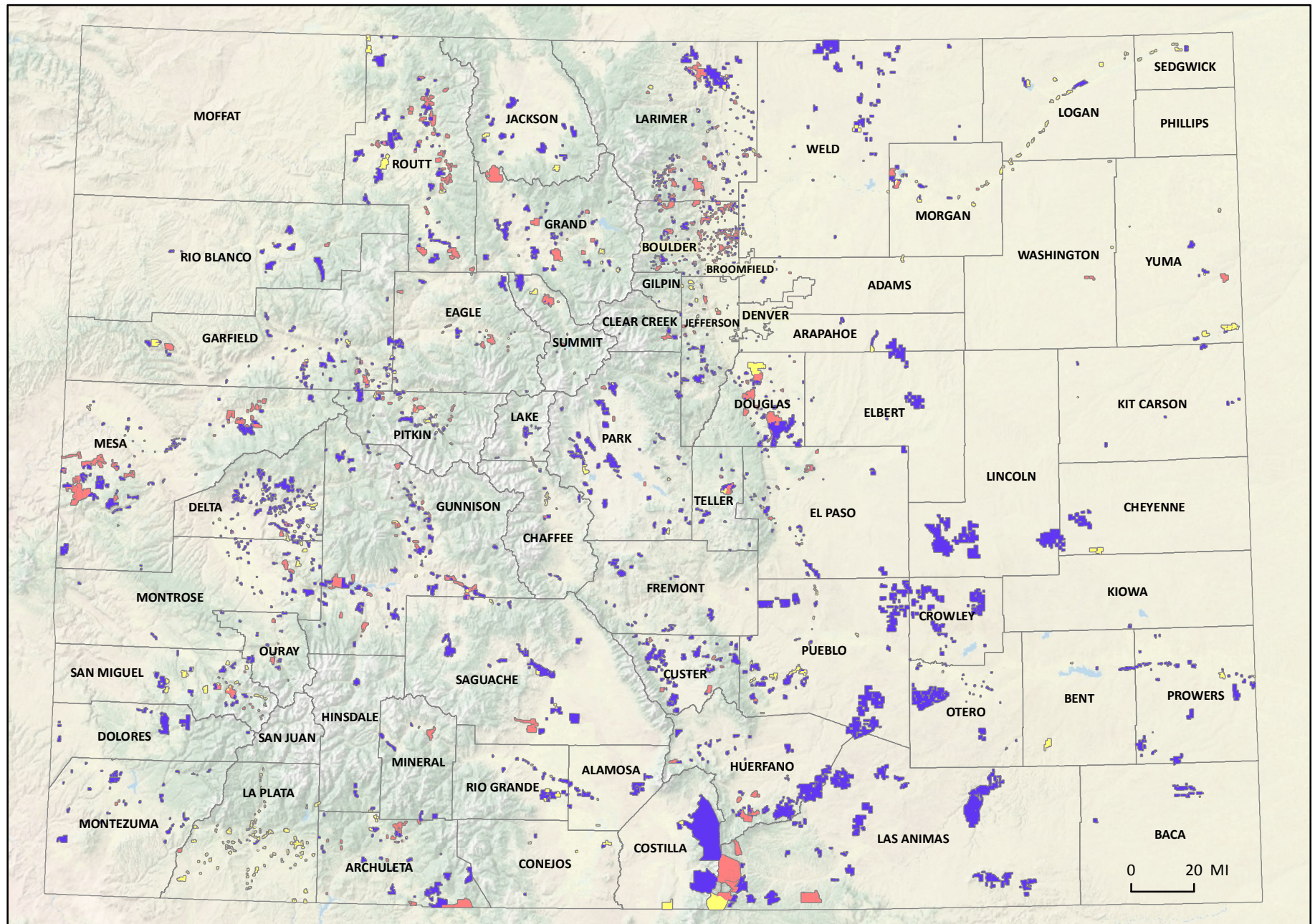
## Federal and State Tax Benefits

Landowners (i.e., taxpayers) who donate all or a portion of a conservation easement to a governmental entity or nonprofit organization may qualify for federal and state tax benefits. Federal law [26 USC 170(h)] allows taxpayers to claim a federal income tax deduction for all or part of a donated conservation easement, which the tax code refers to as a “qualified conservation contribution.” Taxpayers must meet the general requirements for a charitable contribution, as well as the specific requirements for conservation easement donations.

In addition to the federal tax deduction, 15 states, including Colorado, provide a state income tax credit to incentivize land protection through conservation easements. A tax credit, as distinguished from a tax deduction, is applied after the tax liability is calculated, and it results in a dollar-for-dollar reduction of the tax liability. The 15 states that provide a conservation easement tax credit have not followed a uniform model or approach in creating their credits. There is significant variation among the states on basic parameters, such as the maximum dollar amount of the credit allowed, which taxpayers may claim the credit, and whether the credit can be transferred to other taxpayers. We provide a comparison of states’ conservation easement income tax credits in Appendix A.



# Conservation Easements in Colorado



■ Conservation easements created in 2000 or later
 ■ Conservation easements created before 2000
 ■ Date established unknown

**Source:** Geospatial Centroid at Colorado State University with data provided from Colorado Ownership, Management, and Protection (COMaP) v9 Database.  
 Colorado State University, Fort Collins, CO. (September 2011).

## Colorado's Conservation Easement Tax Credit

For tax years beginning on or after January 1, 2000, state statute [Section 39-22-522(2), C.R.S.] allows taxpayers to claim a state income tax credit for all or part of a donated conservation easement. Throughout the report we refer to such conservation easements as tax-credit-generating easements. A taxpayer does not have to claim a federal tax deduction to claim the state tax credit. However, under state law, the state conservation easement tax credit is not allowed if the conservation easement donation does not qualify as a charitable conservation contribution in accordance with federal laws and regulations.

Specifically, to qualify for the state tax credit, the donated conservation easement must meet a number of minimum requirements, including the following:

- **Perpetuity.** The conservation easement must be perpetual in nature. For example, a deed of conservation easement that only imposes restrictions for a set period of time (e.g., 10 years) would not qualify for a tax credit because the easement is not held in perpetuity. The deed of conservation easement must ensure that the restrictions remain on the property forever, thereby creating an ongoing legal and financial obligation for current and future landowners to manage and maintain the property in accordance with the easement's terms and conditions. Because conservation easement holders do not occupy the land, they must have stewardship programs in place to ensure that landowners abide by the easement's terms and conditions, which can involve the easement holder's taking legal action against the landowner.
- **Conservation Purpose.** The conservation easement must be exclusively for one or more of the following conservation purposes:
  - The preservation of land areas for outdoor recreation by, or the education of, the general public.
  - The protection of a relatively natural habitat or ecosystem.
  - The preservation of open space (including farmland and forest land) where there is significant public benefit, and the preservation is (1) for the scenic enjoyment of the general public or (2) pursuant to a clearly delineated federal, state, or local governmental conservation policy.
  - The preservation of a historically important land area or a certified historical structure.

The deed of conservation easement must prohibit uses of the land that are inconsistent with the established conservation purpose. For example, a donated conservation easement would not qualify for a tax credit if the purpose of the easement is to protect habitat for a threatened bird species and the deed of conservation easement does not prevent the landowner from using pesticides that would eliminate the insects that are the natural food source for the bird species.

- **Qualified Organization.** The conservation easement must be donated to a qualified organization. State statute [Section 38-30.5-104(2), C.R.S.] requires the holder of a conservation easement to be a governmental entity or a nonprofit organization that is exempt under section 501(c)(3) of the federal Internal Revenue Code. Typically, nonprofit organizations that hold conservation easements are land trusts or other conservation organizations. Additionally, effective January 1, 2010, for nonprofit organizations and January 1, 2011, for governmental entities, if a tax credit will be claimed for a donated conservation easement, state statute [Section 12-61-720(8), C.R.S.] requires the governmental entity or nonprofit organization receiving the donation to be certified by the Division of Real Estate within the Colorado Department of Regulatory Agencies at the time of the donation. This certification process is intended, in part, to ensure that the conservation easement holder has a commitment to protect the conservation purposes of any conservation easement donations and has sufficient resources to enforce compliance with the easements' restrictions.
- **Qualified Appraisal and Appraiser.** The fair market value of the conservation easement donation must be established by a qualified appraisal completed by a qualified appraiser no more than 60 days prior to the donation and not later than the filing of the income tax return for the year of the donation. In Colorado, any individual who performs a conservation easement appraisal must be licensed as a certified general appraiser and comply with all state licensure and continuing education requirements established by the Board of Real Estate Appraisers. The appraisal must also be performed in accordance with Uniform Standards of Professional Appraisal Practice (USPAP). Appraisers must adhere to licensure, continuing education, and USPAP requirements for all conservation easement appraisals they perform, regardless of whether the easement is purchased or donated or a tax credit will be claimed. However, if a conservation easement appraisal will be used to claim a state tax credit, the appraiser must have completed a conservation easement appraiser update course once every 2 years.

## Other Requirements

The state conservation easement tax credit is available to Colorado resident individuals, C corporations, trusts, estates, and members of pass-through entities, such as partnerships, S corporations, and limited liability companies, that donate all or part of a perpetual conservation easement to a governmental entity or charitable organization.

The landowner donating a conservation easement must file a claim for the full value of the available tax credit in the tax year in which the easement is donated. A “tax year” is a period of 12 consecutive months that is covered by a particular tax return and used as a basis for calculating liabilities. For individuals, the tax year runs on a calendar-year basis, beginning January 1 and ending December 31. For example, an individual donating a conservation easement in June 2012 would claim the tax credit on his or her 2012 state income tax return (i.e., Tax Year 2012) that will be due in April 2013. For businesses, the tax year may run on either a calendar-year basis or the entity’s fiscal year.

When filing a tax return claiming a conservation easement tax credit, the landowner may use all or part of the credit in that same tax year depending on the amount of the landowner’s state income tax liability. If the landowner has a state income tax liability that is less than the value of the tax credit in the tax year in which the conservation easement is donated, the remaining value of the credit can be carried forward and used against income tax liabilities for up to 20 succeeding tax years. The credit cannot be applied to tax years prior to the donation.

House Bill 00-1348 made the conservation easement tax credit transferable. This means that landowners may sell all or a portion of their tax credit to another taxpayer, known as a transferee. The sales price of the credit depends upon the terms of the sales contract (e.g., buyers often only pay a percentage of the total value of the credit). Landowners can use the transferability of the conservation easement tax credit to gain a lump-sum payment versus realizing their credit’s full value over time. The transferability of the credit also makes the credit accessible to a broader range of taxpayers because, generally speaking, only those taxpayers who have a sufficient state income tax liability over a 20-year period are able to utilize the full value of their tax credits themselves. Financial gains from the sale of a conservation easement tax credit are taxed as ordinary income.

Only one conservation easement tax credit may be earned and claimed each year by the landowner donating a conservation easement. That is, multiple credits may not be earned in one year from multiple donations. Additionally, the full value of a credit must be used or abandoned by either the landowner or a transferee before the landowner can claim another credit for another donation.

## Tax Credit Calculation

Currently, for Tax Years 2007 and beyond, the total dollar amount of any single tax credit that can be claimed is equal to 50 percent of the donation's fair market value, up to a maximum of \$375,000. Thus, a taxpayer would reach the maximum credit allowed with a conservation easement donation that had a fair market value of \$750,000 or greater. The following table shows how the calculation of the tax credit's total dollar amount has changed since the credit first became available on January 1, 2000.

State Conservation Easement Tax Credit Calculated Credit Amounts and Maximums			
Tax Years	Calculated Credit Amount as a Percentage of the Donation's Fair Market Value (FMV)	Maximum Credit Allowed	Enabling/Amending Legislation
January 1, 2000– December 31, 2002	100% of FMV	\$100,000	House Bill 99-1155
January 1, 2003– December 31, 2006	100% of the first \$100,000 in FMV plus 40% of the FMV exceeding \$100,000	\$260,000 <sup>1</sup>	House Bill 01-1090
January 1, 2007– Present	50% of FMV	\$375,000 <sup>2</sup>	House Bill 06-1354
<b>Source:</b> Office of the State Auditor's analysis of the Colorado Revised Statutes and Session Laws.			
<sup>1</sup> This maximum would be reached by a conservation easement donation with a FMV of \$500,000 or greater.			
<sup>2</sup> This maximum would be reached by a conservation easement donation with a FMV of \$750,000 or greater.			

Although state statute limits the total dollar amount of any *single* tax credit, there is no permanent aggregate limit on the total dollar amount of conservation easement tax credits available for tax years ending prior to January 1, 2011. However, House Bill 10-1197 limited the total dollar amount available for new conservation easement tax credits to \$26 million for tax years beginning during calendar years 2011, 2012, and 2013. House Bill 11-1300 subsequently lowered this aggregate limit to \$22 million each for 2011 and 2012 and increased this aggregate limit to \$34 million for 2013. Taxpayers who wish to claim a conservation easement tax credit in any of these years must first obtain a credit certificate from the Division of Real Estate. The credit certificate reserves the taxpayer's right to claim a tax credit.

The Division of Real Estate distributes credit certificates on a first-come, first-served basis throughout the year. Once the total dollar value of issued certificates reaches the aggregate limit for a given calendar year, taxpayers requesting credit certificates are issued a certificate for a subsequent year. The following table shows the total dollar value of tax credit certificates issued by the Division of

Real Estate and the available balance under the aggregate limits as of August 17, 2012.

<b>Tax Credit Certificates Issued by the Division of Real Estate</b> <i>(As of August 17, 2012)</i>		
<b>Calendar Year</b>	<b>Dollar Value of Issued Certificates<sup>1</sup></b>	<b>Available Balance</b>
2011	\$22,000,000	\$0
2012	\$22,000,000	\$0
2013	\$2,362 <sup>2</sup>	\$33,997,638
<b>Total</b>	<b>\$44,002,362</b>	<b>\$33,997,638</b>
<b>Source:</b> Division of Real Estate. <sup>1</sup> The dollar value of the tax credit certificate corresponds to the dollar value of the tax credit that the taxpayer will claim. However, the final dollar value of the tax credit may be lower once it is reviewed by the Department of Revenue because of disallowances and adjustments. <sup>2</sup> The Division of Real Estate issued all of the certificates for credits available under the 2012 capped amount. Therefore, in accordance with state rules, it began issuing tax certificates for new tax credit claims that will count against the 2013 capped amount.		

In years that the State has surplus revenue under Article X, Section 20 to the Colorado Constitution, more commonly known as the Taxpayer's Bill of Rights (TABOR), taxpayers who donate conservation easements and whose available tax credit is larger than their tax liability are eligible for a tax refund of up to \$20,000 for tax years beginning January 1, 2000, through December 31, 2002, and up to \$50,000 for tax years beginning on or after January 1, 2003. Only the original donor of the conservation easement qualifies for a tax refund; refunds are not available to transferees. The State had a TABOR surplus and allowed for payment of the conservation easement tax credit as a refund in Tax Years 2000, 2001, and 2005.

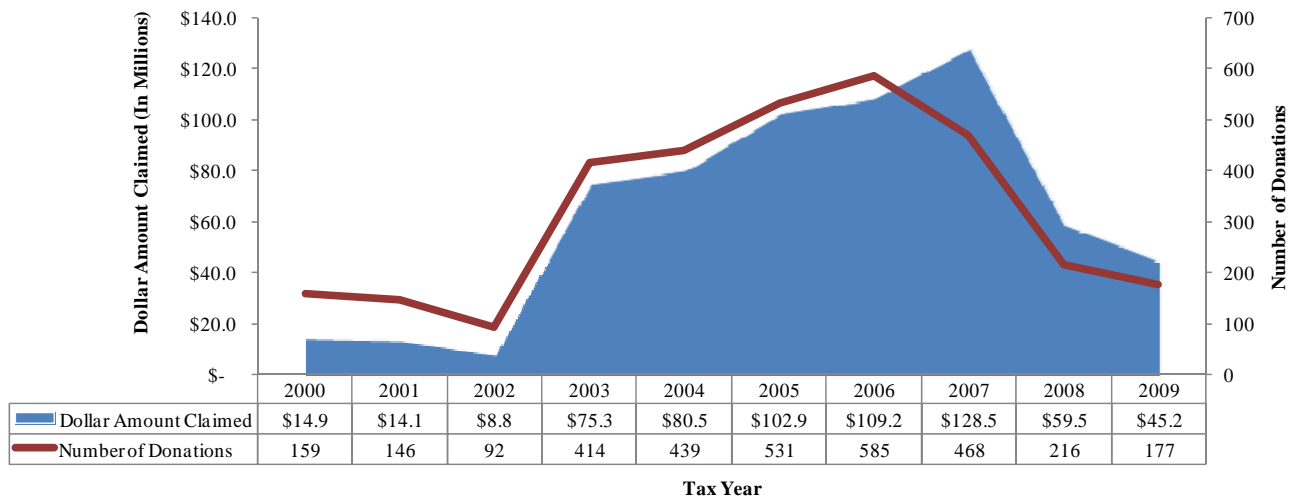
## Tax Credit Utilization

Similar to other tax credits, the State "pays" for the conservation easement tax credit by foregoing revenues from individual and corporate income taxes that it otherwise would have collected. Overall, for the 10-year period since the credit's inception in Tax Year 2000 through Tax Year 2009, taxpayers have claimed approximately \$639 million in tax credits resulting from approximately 3,200 conservation easement donations. As of the completion of our audit, the Department of Revenue had not completed its review and entry of the Tax Year 2010 and 2011 data. For purposes of illustrating overall trends, the following chart provides a compilation of data maintained by the Department of Revenue on conservation easement tax credits claimed for Tax Years 2000 through 2009.



### Conservation Easement Tax Credits Claimed Tax Years 2000 Through 2009

**Total Dollar Amount Claimed: \$638.9 Million**  
**Total Number of Donations: 3,227**



**Source:** Office of the State Auditor's analysis of Department of Revenue data.

The data show a significant increase in the dollar amount of credits claimed between Tax Years 2000 and 2007. The dollar amount of credits claimed increased by 762 percent over this period, with a high in Tax Year 2007 of approximately \$128.5 million in claims.

Subsequent to Tax Year 2007, the dollar amount of credits claimed fell by 65 percent to approximately \$45.2 million in Tax Year 2009. The trend line will fall again because of the aggregate limits in place for the tax credit for 2011, 2012, and 2013. Apart from trends in overall economic conditions, legislative changes are likely a key factor driving utilization of the conservation easement tax credit. For example, increases in the maximum dollar amount of the credit, as well as changes that made the credit transferrable to taxpayers other than the landowner, may have provided further incentives for landowners to donate a conservation easement and pursue the tax credit, thereby contributing to the increase in claims through Tax Year 2007. Legislative changes in 2008, which we discuss in the next section, put more safeguards in place to ensure the validity of the conservation easement donations being used to claim a tax credit. This additional scrutiny may have dissuaded some landowners from pursuing the tax credit.

## House Bill 08-1353

Discoveries of possible abuses of tax benefits associated with conservation easements resulted in the federal Internal Revenue Service (IRS) initiating audits of conservation easement transactions completed by Colorado taxpayers. DOR received information about these audits from the IRS in 2007, which triggered further audits and investigations by the Department of Revenue and the Division of Real Estate. Although the conservation purpose of some easements was questioned, the most common problems identified were violations of USPAP standards and misstatements of value by the appraisers conducting the appraisals. By overvaluing the land, the fair market value of the conservation easement donation was inflated, thereby inappropriately allowing the landowner to claim a larger tax credit.

In response to problems identified by the federal and state tax audits, the General Assembly "enacted "House" Bill "08-1353 "during "the 2008 Negislative Uession to j gr ""ensure "the "validity "and proper valuation of "conservation "easements"" yj cv"ctg""donated "by "landowners" and "used as the basis for claiming a tax credit. J qwug"Dkni08-1353 made the following significant changes:

- Established additional requirements for appraisers conducting conservation easement appraisals, including that a copy of the completed appraisal and an affidavit affirming several items (e.g., a statement specifying the value of the unencumbered property and the total value of the conservation easement along with details of the methods used to determine these values) be submitted to the Division of Real Estate within 30 days following the completion of the appraisal.
- Required the Division of Real Estate to review submitted conservation easement appraisals and corresponding affidavits for completeness and to track this information in an electronic database.
- Authorized the Division of Real Estate to investigate the activities of any appraiser who submits an appraisal of a conservation easement, including whether the appraiser complied with USPAP requirements or a substantial misstatement of value has occurred.
- Established a certification process at the Division of Real Estate whereby governmental entities and charitable organizations that hold tax-credit-generating conservation easements must meet certain minimum requirements.
- Established a nine-member Conservation Easement Oversight Commission to advise the Division of Real Estate and the Department of



Revenue regarding conservation easements for which a tax credit is claimed and to review applications for conservation easement holder certification.

- Required the Department of Revenue to consult with the Division of Real Estate and the Conservation Easement Oversight Commission to develop and implement a separate process for its review of conservation easement tax credit claims.

## Administration

There are a number of different actors involved in the creation and acquisition of conservation easements that are used as a basis for claiming a tax credit:

- **Landowner (Donor).** An individual or corporate taxpayer who owns the land that is subject to a conservation easement and who donates all or a portion of the easement to a governmental entity or nonprofit organization. The landowner uses the conservation easement tax credit to offset its state income tax liability or sells the credit to another taxpayer. Throughout the report we use the terms landowner and donor interchangeably.
- **Conservation Easement Holder.** A governmental entity or nonprofit organization that acquires a conservation easement through a donation from a landowner. The conservation easement holder is responsible for monitoring the land to ensure that the landowner abides by the easement's terms and conditions.
- **Appraiser.** A state-licensed real estate professional, typically hired by the landowner, who appraises conservation easements in accordance with established professional appraisal standards with the purpose of determining the conservation easement's fair market value.
- **Transferee.** An individual or corporate taxpayer who, generally with the assistance of a third-party broker, purchases a conservation easement tax credit from a landowner. The transferee uses the purchased tax credit to offset its own state income tax liability.

There are a number of different agencies that share responsibility for administering Colorado's conservation easement income tax credit:

- **Department of Revenue (DOR).** As the State's tax authority, DOR is responsible for administration, collection, audit, enforcement, and other activities pertaining to Colorado's tax laws. DOR's Taxpayer Service

Division (TPS) is responsible for processing tax filings, including all conservation easement tax credit claims. If a conservation easement tax credit claim does not comply with applicable laws and regulations, TPS staff disallow the taxpayer's use of the credit.

If TPS disallows the use of a credit, the taxpayer may either submit any missing documentation to resolve the issue without requesting a formal hearing or has 30 calendar days to protest the decision and request a formal administrative hearing with DOR's Executive Director. The taxpayer has the opportunity to hold a pre-hearing conference with DOR's Tax Conferee Section that works with the taxpayer to try to come to a final resolution on protested matters. If a pre-hearing conference with the Tax Conferee fails to achieve a successful resolution, then the matter proceeds to a formal administrative hearing. The taxpayer may appeal the Executive Director's final determination to the district court for the county where the taxpayer resides or has his or her principal place of business. Pursuant to House Bill 11-1300, certain taxpayers were provided the option to bypass DOR's administrative hearing process and take their protest directly to the district court of the county where the land encumbered by the conservation easement is located. We did not review DOR's Tax Conferee or administrative hearing processes as part of this performance audit.

- **Division of Real Estate (DRE).** DRE is organizationally located within the Department of Regulatory Agencies and is responsible for the regulation of real estate professionals (e.g., real estate brokers, real estate appraisers, mortgage loan originators) doing business in Colorado. DRE works with the Real Estate Commission and the Board of Real Estate Appraisers to administer licensing and continuing education requirements, investigate complaints, and take disciplinary action against licensees for noncompliance with applicable requirements.

With respect to conservation easement tax credits and the enactment of House Bill 08-1353, DRE receives copies of all conservation easement appraisals completed in Colorado. DRE also certifies those organizations that are qualified to hold conservation easements for which a tax credit will be claimed. Finally, starting January 1, 2011, DRE began issuing conservation easement tax credit certificates as a means of administering the aggregate caps on the total dollar amount of available conservation easement tax credits for calendar years 2011, 2012, and 2013.

- **Conservation Easement Oversight Commission (CEOC).** The nine-member CEOC is a Type 2 agency that, upon referral by DRE or DOR, reviews documents, such as a deed of conservation easement or an appraisal report, to provide advice regarding conservation easement

transactions for which a tax credit is claimed. The CEOC also reviews applications for certification from conservation easement holders and makes recommendations to the DRE Division Director to approve or deny certification.

The CEOC members represent a number of different stakeholder interests. By statute, the Great Outdoors Colorado Trust Fund, the Department of Agriculture, and the Department of Natural Resources each have a permanent member on the CEOC, and the Governor appoints the remaining six members for a 3-year term. (Three of the initial appointments were for a 2-year term.) The six gubernatorial appointments must represent a local land trust, a state or national land trust, a local government open space or state conservation agency, a historic preservation organization, a certified general appraiser with conservation easement appraisal experience, and a landowner who has donated a conservation easement in Colorado. No more than three of the Governor's appointees serving at the same time may be from the same political party.

- **Board of Real Estate Appraisers (BOREA).** This seven-member board is a Type 1 agency with jurisdiction over all real estate appraisers in Colorado, including those who appraise conservation easements. BOREA makes policy decisions and establishes rules regarding licensure, continuing education, and experience requirements; reviews complaints; and takes disciplinary action against appraisers. BOREA's membership comprises three licensed appraisers, one county assessor, one banker with experience in mortgage lending, and two members of the general public. All members are appointed by the Governor with confirmation by the State Senate for a 3-year term.

## Audit Purpose, Scope, and Methodology

We conducted this performance audit in response to a legislative request. Audit work was performed from December 2011 through September 2012. We acknowledge the cooperation and assistance provided by management and staff at the Department of Revenue and the Division of Real Estate, the members of the Conservation Easement Oversight Commission, and staff affiliated with the COMaP (Colorado Ownership, Management, and Protection) project at Colorado State University.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the

evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The overall objective of this audit was to determine whether there are effective internal controls in place at both the Department of Revenue and the Division of Real Estate to ensure that conservation easement tax credits being claimed and used by taxpayers are valid. We planned our audit work to assess the effectiveness of those internal controls that were significant to our audit objectives. Our conclusions on the effectiveness of those internal controls are described in the audit findings and recommendations.

Because of the significant legislative changes that occurred in 2008, our audit focused on requirements and processes in place for the conservation easement tax credit since the enactment of House Bill 08-1353. Specifically, we evaluated:

- Whether processes for reviewing conservation easement appraisals are sufficient to ensure that the appraisal is performed by a qualified appraiser and that any material violations of professional standards, substantial misstatements of value, or other relevant matters are identified and communicated to DOR.
- Whether processes for certifying and renewing certification for conservation easement holders are sufficient to ensure that only qualified entities are being certified to hold conservation easements for which state tax credits will be claimed.
- Whether processes for reviewing conservation easement tax credit claims are sufficient to ensure that unqualified tax credit claims are denied and qualified tax credit claims are not denied.
- Whether all essential elements related to conservation easement tax credit claims are reviewed at the most effective and efficient point in the process.
- The conservation easement tax credit program's overall value and effectiveness.

We planned our audit work to assess the effectiveness of those internal controls that were significant to our audit objectives. Our conclusions on the effectiveness of those controls are described in the audit findings and recommendations.

To accomplish our audit objectives, we:

- Researched federal and state laws, rules, and regulations pertaining to the federal conservation easement tax deduction and Colorado's state conservation easement tax credit.
- Reviewed DOR and DRE policies and procedures for administering Colorado's conservation easement tax credit.
- Interviewed DOR and DRE management and staff and other stakeholders, including all members of the CEOC.
- Reviewed and analyzed documentation and data on conservation easement tax credit claims, conservation easement appraisals, and conservation easement holder certification applications.
- Gathered and analyzed information on general trends in conservation easements in Colorado.
- Compared and contrasted Colorado's conservation easement tax credit with similar programs in other states.

We relied on sampling techniques to support our audit work in three specific areas:

- We selected a nonstatistical judgmental sample of 10 conservation easement tax credit donor claims and associated supporting documentation filed in Tax Years 2009 and 2010. We selected our sample items to provide representation of credit claims that were allowed and disallowed, credit claims of varying dollar amounts, credit claims from individual and corporate taxpayers and pass-through entities (e.g., nonprofits or limited liability companies), conservation easements held by different conservation easement holders, conservation easements in different areas of the state, and conservation easement donations made by the same donor over time. We designed our sample to help provide sufficient, appropriate evidence for the purpose of evaluating DOR's process for reviewing tax credit claims based on our audit objectives.
- We selected a nonstatistical judgmental sample of 25 of the 46 organizations that had applied for certification as a conservation easement holder as of March 2012. We selected our sample items to provide representation of approved and denied applications, governmental entities and nonprofit organizations, different sized organizations, and organizations located in different areas of the state. We did not select any organizations that were accredited by the Land Trust Alliance because certification applications from these organizations receive expedited

approval by DRE. We designed our sample to help provide sufficient, appropriate evidence for the purpose of evaluating DRE's certification process based on our audit objectives.

- We selected a nonstatistical judgmental sample of 10 of the 330 conservation easement appraisals that had been submitted to DRE as of February 2012 and were specifically related to a conservation easement tax credit claim filed in Tax Years 2009 or 2010. We selected our sample items to provide representation of conservation easement appraisals that DRE subjected to a desk review, as well as conservation easement appraisals that DRE did not subject to a desk review. We designed our sample to help provide sufficient, appropriate evidence for the purpose of evaluating DRE's conservation easement appraisal review process based on our audit objectives.

Specific details about the audit work supporting our findings, conclusions, and recommendations are described in the body of the report.

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# Administration of the Conservation Easement Tax Credit

## Chapter 2

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The General Assembly created the conservation easement tax credit in 1999 partly in response to the rapid population growth that Colorado was undergoing. About one million new residents came to the state in the 1990s, increasing the population by about 31 percent. Residential and commercial land development boomed during this time, especially in rural areas where land was quickly being converted from agricultural uses. In this context, the conservation easement tax credit was proposed as a way to limit the spread of new development and to protect swaths of land that are considered valuable for conservation. Additionally, lawmakers recognized that the tax credit might provide a much-needed lifeline to some farmers and ranchers who were facing increasing economic pressure and were looking for additional ways to monetize their land holdings, short of selling to developers.

Overall, the various requirements and processes in place for administering the conservation easement tax credit are intended to accomplish land conservation goals while ensuring that the State is not foregoing more revenue than it should. Having strong administrative processes to determine whether a tax credit claim should be allowed or disallowed is important for protecting the broader taxpayer interests because foregone tax revenues cannot be used to fund state services and programs, such as education, transportation, or unemployment benefits.

As of 2009, nearly \$640 million in tax credits had been claimed on about 3,200 easements since the credit was first made available in 2000, although this total may end up being lower because some claims have been disallowed and are in various stages of dispute resolution. In return, landowners preserved about 925,000 acres of land in a predominantly natural, scenic, or open condition. Despite these positive aspects, however, the conservation easement tax credit has also fallen subject to abuse by some developers, landowners, and appraisers who misrepresented properties' conservation or financial values to obtain undue financial benefits. New requirements were put in place in 2008 through the enactment of House Bill 08-1353 to try to curb these types of abuses.

The State took an important step forward in its administration of the conservation easement tax credit with the enactment of House Bill 08-1353. However, our audit demonstrates that more changes need to be made to strengthen the



administration of Colorado's conservation easement tax credit to ensure that tax credits being claimed and used by taxpayers are valid.

Colorado's conservation easement tax credit is administered through a series of interrelated processes performed by the Department of Revenue (DOR), the Division of Real Estate (DRE), and the Conservation Easement Oversight Commission (CEOC). As discussed in this chapter, our audit findings suggest two different, but not mutually exclusive, directions for strengthening the State's administration of the conservation easement tax credit. One direction is to improve each of the individual processes. Throughout this chapter we make a number of recommendations to DOR, DRE, and the CEOC for improving reviews of tax credit claims, reviews of conservation easement appraisals, and the certification of conservation easement holders. A second direction, which we discuss at the end of this chapter, is to fundamentally shift the manner in which the tax credit is administered by moving to a pre-approval process. We believe that such a move could hold a number of important benefits for the State and its taxpayers and is worthy of further study by DOR, DRE, and the CEOC and consideration by the General Assembly.

If the State moves forward with and adopts a pre-approval process, DOR, DRE, and the CEOC will likely need to adjust their implementation of the other recommendations contained in this report. Conversely, if a pre-approval process is not ultimately adopted, it will be important that DOR, DRE, and the CEOC fully implement the remaining audit recommendations to strengthen the individual processes for administering the conservation easement tax credit.

## **Review of Tax Credit Claims**

DOR is responsible for the administration, collection, audit, enforcement, and other activities pertaining to Colorado's tax laws. Thus, DOR is the decision maker and accountable party when it comes to determining whether taxpayers meet the legal and regulatory requirements to qualify for a conservation easement tax credit, and it has the authority to disallow claims when these requirements are not met. We detail the various requirements to qualify for a conservation easement tax credit in Chapter 1.

One of the objectives of our audit was to determine whether DOR's review process is sufficient to ensure consistent and appropriate treatment of conservation easement tax credit claims. To address this objective, we reviewed applicable statutes, rules and regulations, and DOR policies and procedures. We also conducted numerous interviews with DOR management and staff who perform and oversee the tax credit claim review process. Finally, we reviewed hard-copy and electronic file documentation for a nonstatistical judgmental sample of 10 conservation easement tax credits claimed in Tax Years 2009 and 2010. We selected our sample to include coverage of areas important for

evaluating the overall tax credit review process, such as credit claims that were allowed and disallowed, were made by the same donor, were forwarded to DRE and the CEOC for consultation, were of varying dollar amounts, and were from individual and corporate taxpayers and pass-through entities (e.g., partnerships, S corporations, and limited liability companies).

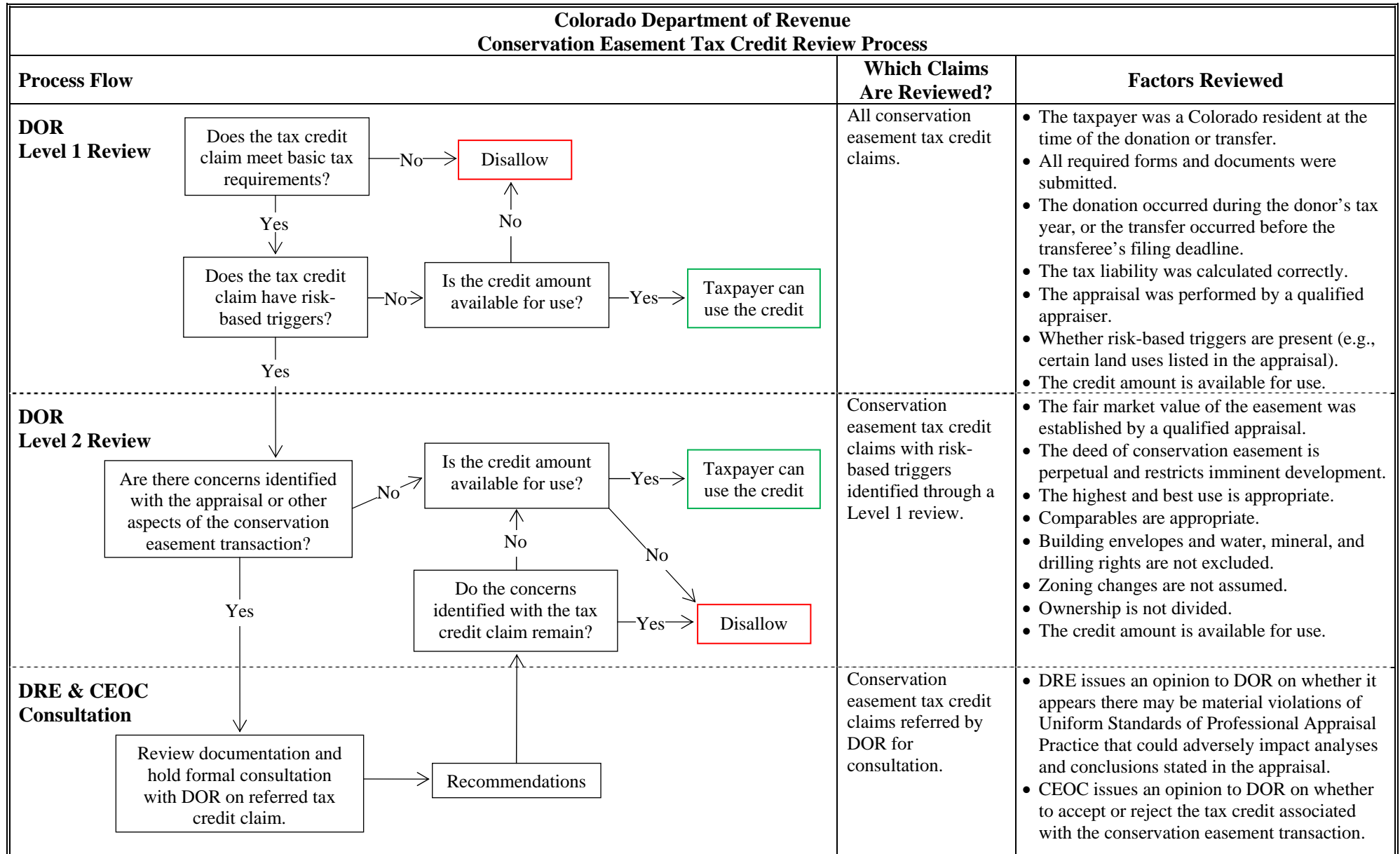
As described in Recommendation Nos. 1 through 3, we found that DOR's review of conservation easement tax credit claims needs attention in three areas. Specifically, the scope of DOR's review does not ensure coverage of key requirements and relevant risk areas, tax examiners do not sufficiently document their reviews of conservation easement tax credit claims and uses, and there are concerns about the completeness and accuracy of tax credit data maintained in DOR's database.

## Scope of Review

DOR's Taxpayer Service Division (TPS) is responsible for reviewing tax filings, including all conservation easement tax credit claims. Two TPS tax examiners are assigned to review conservation easement tax credit claims and supporting documentation to determine whether the tax credits being claimed and used by taxpayers are valid. TPS's review of conservation easement tax credit claims is *the* primary control for ensuring that the State does not (1) lose tax revenues by allowing unqualified tax credit claims or (2) over-collect tax revenues by disallowing qualified tax credit claims.

Generally speaking, TPS utilizes a risk-based approach when reviewing conservation easement tax credit claims, which means that not every statutory and regulatory requirement is examined on every claim. Additionally, similar to other tax administration processes, when tax examiners review a tax credit claim, they do not technically "approve" the claim. Rather, they do not disallow the claim. A tax credit claim can be disallowed at several different points during the review process, and credit claims that are not disallowed are available for use by the taxpayer. As described in Chapter 1, the landowner (i.e., donor) must file a claim for the tax credit in the tax year in which the easement is donated, regardless of whether the credit is used to offset a tax liability in that year. However, in terms of the timing of TPS's review, tax examiners only review tax credit claims once a taxpayer (either the donor or a transferee) files a tax return *using* the credit. That is, if a credit claim is filed in 2010 but is not used to offset a tax liability until 2012, then TPS's review would not occur until 2012. (We discuss some problems caused by this timing issue later in Recommendation Nos. 3 and 11.)

The following table provides a summary of TPS's process for reviewing conservation easement tax credit claims, as well as the different factors that are examined at each level of the review process.



**Source:** Colorado Office of the State Auditor's interviews with Department of Revenue staff and review of available procedural documentation.

All conservation easement tax credits undergo a Level 1 review, during which a tax examiner determines compliance with basic tax requirements. The tax examiner also determines whether certain risk factors or “triggers” are present, thereby warranting a more in-depth Level 2 review by another tax examiner. Examples of risk factors include appraisers or conservation easement holders with past problems or issues and appraisals that list gravel mining as the highest and best use (i.e., the category of possible use that would give the land the most value without an easement). During a Level 2 review, a more experienced tax examiner reviews the deed of conservation easement, the appraisal, and other documentation substantiating the tax credit claim. Concerns identified through a Level 2 review that relate to the appraisal or other aspects of the conservation easement transaction (e.g., conservation purpose) are referred for a formal consultation with DRE and the CEOC. Generally, after receiving input from DRE and the CEOC, DOR makes the final decision to allow or disallow the tax credit claim. The tax examiner working the claim also determines whether the credit amount being used is available (e.g., the donor has not claimed or used more than one conservation easement tax credit for the same tax year or the total amount of the credit used by donors and transferees does not exceed the total credit amount allowed).

## **Conservation Purpose**

To qualify for a tax credit, state statute [Section 39-22-522(2), C.R.S.] requires donated easements to meet one or more federally recognized conservation purposes—preservation of land areas for outdoor recreation; protection of fish, wildlife, or plant habitat; preservation of open space; or preservation of a historically important land area. Ensuring the appropriateness of an easement’s conservation purpose is one of the cornerstones to the tax credit.

As shown in the previous table, there are a number of factors that TPS staff examine during their review process. These review factors are generally aligned with the various statutory and regulatory requirements that must be met in order to claim the conservation easement tax credit. However, we found that conservation purpose receives little to no coverage by TPS’s tax examiners during their reviews of tax credit claims. This is a concern, given the legal and substantive significance of an easement’s conservation purpose for qualifying for a tax credit.

Specifically, we found that conservation purpose is not one of the factors that TPS’s tax examiners review during either a Level 1 or a Level 2 review of the tax credit claim. During a Level 1 review, TPS staff do not perform a basic verification that the conservation purpose reported by the landowner is consistent with one or more of the four allowable conservation purposes. (We discuss problems related to landowner reporting on conservation purposes in Chapter 3.)

During a Level 2 review, TPS staff review the appraisal and the deed of conservation easement; however, the Level 2 review focuses primarily on the appraisal methodology and does not include a review of conservation purpose. We found no evidence that DOR had reviewed the conservation purpose for the 10 tax credit claims we sampled.

We recognize that fully validating an easement's conservation purpose may require careful review of the deed of conservation easement, the appraisal, and other documentation, such as a baseline report that documents the property's present condition. Additionally, as discussed later in Recommendation No. 11, tax examiners may lack the expertise necessary to fully evaluate an easement's conservation purpose. Nonetheless, the lack of consideration of the conservation purpose underlying conservation easement tax credit claims represents a significant gap in DOR's current Level 1 and Level 2 review processes that needs to be addressed. DOR should include at least a basic review of the conservation purpose reported by the taxpayer as part of a Level 1 review. State statute [Section 12-61-721(3)(a), C.R.S.] states that at the request of DOR, the CEOC shall advise DOR regarding conservation values. Thus, DOR should refer questionable claims to the CEOC for a more complete assessment of the easement's conservation purpose as part of a Level 2 review. Ultimately, if the conservation easement restricting the land being put under easement does not meet one of the legally recognized purposes, there is no reason for the State to be foregoing revenues to help protect it.

## Risk Factors

As discussed previously, TPS utilizes a risk-based approach when reviewing conservation easement tax credit claims. Specifically, during a Level 1 review, tax credit claims are reviewed to determine whether certain risk-based triggers are present, thereby warranting a Level 2 review. Utilizing a risk-based approach can be a cost-effective way for DOR to target its staff resources when reviewing tax credit claims. However, risk-based approaches are only effective to the extent that relevant risk factors are properly identified and considered during the initial review. Although TPS has developed a list of risk factors to help target tax examiners' review activities, the list is incomplete in two key areas:

- **Phased Donations.** "Phasing" is a legal way for landowners to increase their tax benefits by donating conservation easements on different portions of a larger parcel of property or giving up additional development rights for the same parcel of land over time. In both cases, the new easement counts as a separate donation and may be eligible to receive a separate tax credit. During our file review, we identified five claims in our sample that appeared to be phased donations. Although phased donations are not necessarily problematic, according to DRE's staff appraiser and the

member of the CEOC who is an appraiser, special attention should be paid to appraisals of phased donations. The appraisal methodology can be complicated and, if not performed well, increases the risk of an incorrect valuation. Establishing the conservation purpose also becomes more complicated with phased donations because the conservation purposes cited for each donation need to be supported by the specific characteristics of that portion of the property. Currently, TPS does not include phased donations on its list of risk factors that escalate tax credit claims to a Level 2 review.

- **Donors with Prior Disallowed Claims.** During our file review, we identified one tax credit claim in our sample for Tax Year 2010 that was filed by a group of donors whose prior year claims had been disallowed. We inquired with TPS staff why these prior claims had been disallowed and whether those problems could be of concern for the 2010 claim. TPS staff reported that although the prior year disallowances were due to problems with the appraisals, the Level 1 review of the 2010 claim did not identify any triggers warranting a more in-depth review of the appraisal. We understand that each donation is a separate transaction, but it is reasonable to consider taxpayers who have had prior disallowances to be a higher risk group. The fact that the donors in the sampled case we reviewed had prior disallowances due to problems with the appraisals should have triggered the appraisal associated with the 2010 claim for additional review. Historical problems with taxpayers' tax credit claims are a reasonable risk indicator of problems with current claims that should be considered. TPS already takes this approach with respect to appraisers and conservation easement holders; tax credit claims that are associated with appraisers and conservation easement holders with known historical problems receive a more in-depth Level 2 review as a result.

By not specifically including phased donations or donors with prior disallowed claims on its "trigger list" for a Level 2 review, DOR is missing coverage of important risk areas. DOR does not follow a set schedule for evaluating and updating its list of risk factors. Some of the historical abuses of the tax credit were related to conservation easements on land for which the highest and best use was reported as gravel mining. Gravel mining continues to be a risk factor on TPS's list of risk factors; however, other risk factors have emerged and will continue to emerge as the tax credit evolves over time. Evaluating and updating the list of risk factors at least annually would ensure that the list is kept current and remains relevant to the tax credit claims being reviewed. In addition, DOR should use DRE and the CEOC to help identify new risks related to conservation easement transactions.

## **Recommendation No. 1:**

The Department of Revenue (DOR) should strengthen its review of conservation easement tax credit claims to ensure coverage of key requirements and consideration of relevant risk factors by:

- a. Including a basic review of the reported conservation purpose as part of a Level 1 review, and developing risk factors or other criteria that would require referral of the claim to the Conservation Easement Oversight Commission (CEOC) for a more complete assessment of the easement's conservation purpose as part of a Level 2 review.
- b. Expanding the current list of risk factors to include phased donations and donors with prior disallowed credit claims.
- c. Evaluating and updating the list of risk factors on at least an annual basis. DOR should consult with the Division of Real Estate (DRE) and the CEOC during this process.

## **Department of Revenue Response:**

- a. Agree. Implementation date: March 2013.

DOR will include a basic review of the reported conservation purpose in its Level 1 review of conservation easement tax credit claims. In addition, as part of its on-going discussions with the Division of Real Estate (DRE) and the CEOC about improving the consultation process, DOR will develop risk factors to be considered as part of the Level 2 review of conservation easement tax credits which will include provisions for when the conservation purpose of an easement should be reviewed by the CEOC.

- b. Agree. Implementation date: March 2013.

DOR will expand its current list of risk factors to explicitly include all phased donations and prior disallowed credit claims. In addition, as part of its ongoing discussions with DRE and the CEOC about improving the consultation process, DOR will ask for input about its current list of risk factors which are used during the Level 1 and Level 2 reviews in order to determine more specific risk factors related to phased donations which may need to be addressed.

- c. Agree. Implementation date: March 2013.

DOR currently updates its list of risk factors as it learns of new risks and will continue to do so. In addition, DOR will review its list of risk factors with DRE and the CEOC at the beginning of each fiscal year.

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## Review Documentation

Conservation easement transactions can be complex, and there are a number of requirements that the taxpayer must adhere to when claiming the tax credit. DOR's tax examiners must also rely on their professional experience and judgment when applying the tax laws and regulations and determining whether to allow or disallow a tax credit claim. Because of these characteristics, complete documentation of the review is important for ensuring that all required attributes are examined and that the resulting decisions to allow or disallow claims are appropriate and substantiated.

We found that TPS's tax examiners do not sufficiently document their reviews of conservation easement tax credit claims and uses. Tax examiners' notes were typically spread across various hard-copy documentation (e.g., letters, memos, tax returns, sticky notes) and electronic systems. More importantly, we found that the review documentation held little information about judgments made and conclusions reached by the tax examiners performing the review, including whether and which risk-based factors were present in the claim warranting a Level 2 review. As a result of these underlying documentation issues, we were limited in our ability to independently verify whether tax examiners reviewed key requirements that must be met for a conservation easement donation to qualify for a tax credit. The following bullet points highlight the specific documentation problems we encountered for the 10 sampled tax credit claims we examined.

- **Qualified Appraisal.** The appraisal establishes the fair market value of a conservation easement donation, which directly affects the amount of the tax credit that can be claimed. As discussed previously, conservation easement appraisals undergo a more in-depth Level 2 review only when certain risk-based factors are identified during a Level 1 review. We identified concerns related to reviews of appraisals for five of our 10 sampled claims. Specifically, for four of the claims, there was no documentation to indicate that the tax examiner had considered risk factors during the Level 1 review and that no risk factors were identified, thereby supporting the decision not to elevate the appraisals for these four tax credit claims to a Level 2 review. For the fifth claim, TPS reported that it eventually performed a Level 2 review and examined the appraisal when the taxpayer submitted required documentation after the claim was



disallowed. However, the only evidence of a Level 2 review we found was a number of blank sticky notes attached to the appraisal report, possibly as placeholders for the different sections that were examined. The tax examiner made no written notes on what was examined or the conclusions that were reached. This differed from two other claims in our sample for which the tax examiner documented that he or she had examined the appraisal during a Level 2 review as well as the issues or concerns identified during the review.

- **Qualified Appraiser.** Conservation easement appraisals supporting a tax credit claim must be conducted by an appraiser who is licensed by DRE as a certified general appraiser. For seven of our 10 sampled claims, there was no documentation indicating that the tax examiner had verified the appraiser was licensed by DRE. We noted that the appraiser associated with one of these claims was listed on TPS's list of risk factors, but it was unclear from the file documentation whether this was one of the reasons why the claim had a Level 2 review. We verified that the six appraisers who conducted the conservation easement appraisals associated with these seven sampled tax credit claims were licensed by DRE. For the three remaining claims in our sample (two were disallowed and one was allowed), neither we nor DOR could verify the appraiser's licensure status because the taxpayers did not submit some or all of the required documentation (e.g., appraisal report, appraiser affidavit) necessary to identify the appraiser completing the conservation easement appraisal.
- **Qualified Organization.** Entities holding tax-credit-generating conservation easements must be a governmental entity or a nonprofit organization and be certified by DRE. For two claims in our sample for which the certification requirement was applicable, there was no documentation indicating that the tax examiner had verified the conservation easement holders were certified by DRE. We verified that both holders associated with these two tax credit claims were certified by DRE. For six claims in our sample, the certification requirement was not applicable because the donations were made in 2009, before the certification requirement took effect. For the remaining two claims in our sample, neither we nor DOR could verify the conservation easement holder's certification status because the taxpayers did not submit some or all of the required documentation (e.g., tax forms, appraisal report) necessary to identify the governmental entity or nonprofit organization holding the donated conservation easement.

As discussed previously, we were generally limited in our ability to trace tax examiners' decisions to allow or disallow claims back to the underlying review documentation. Despite these limitations, however, for four of our sampled claims

our own review of the taxpayer's documentation revealed problems with the claim. Specifically, we found claims that should have been disallowed as well as problems on both allowed and disallowed claims that were not identified through the tax examiner's review. When combined with the lack of sufficient review documentation, these additional issues elevate the risk that DOR's decisions to allow or disallow conservation easement tax credit claims may not be appropriate and substantiated.

- **Missing Taxpayer Documentation.** We identified three claims for which taxpayers did not submit all documentation required by statute or rule, yet tax examiners allowed these taxpayers to use the tax credit. For two claims, the taxpayers did not submit the required tax forms and other supporting documentation, such as the appraisal, the appraiser affidavit, and the deed of conservation easement. These documents are key to substantiating that the donation meets requirements for claiming the tax credit. TPS staff confirmed that these two credits should have been disallowed because of the missing documentation. Finally, for the third claim, the taxpayer did not submit a copy of the appraiser affidavit. TPS staff stated that although the tax examiner should have obtained this document before allowing the credit, there was sufficient information from the other documentation on file to check the validity of the credit without subjecting the taxpayer to further requests. This course of action may have minimized some burden on the taxpayer, but statute requires that the appraiser affidavit accompany conservation easement appraisals. It is part of the supporting documentation for tax credit claims that is required to be submitted to DOR. Making an exception in this case is unfair to other taxpayers claiming the credit who submitted the required appraiser affidavit.
- **Credit Use and Carry-Forward Amounts.** We identified one claim for which the tax examiner did not properly verify the credit amounts being used and carried forward. The taxpayer mistakenly entered a \$6,000 use of the credit on their e-filed return, despite having a tax liability of only \$3,891. The taxpayer did not get more of a financial benefit than they were entitled to. However, the tax examiner should have caught this mistake and corrected the return appropriately. Additionally, the tax examiner's notes in DOR's electronic databases indicated that the taxpayer had used the full \$6,000 credit even though the taxpayer had a carry-forward of \$2,109 (the \$6,000 incorrectly noted on the tax return minus the \$3,891 use of the credit to offset the taxpayer's tax liability). This inaccurate accounting for the carry-forward amount in DOR's databases could cause confusion when the taxpayer tries to use the remainder of the tax credit in future tax years.

- **Claiming New Credits.** We identified one claim for which the donor tried to claim a new credit in 2009, despite not having fully used the carry-forward from their 2008 credit. State statute [Section 39-22-522(6), C.R.S.] restricts donors from claiming or using more than one conservation easement tax credit in the same tax year. Any previous credits claimed must be entirely used up or the remaining amounts abandoned by both donors and transferees before the donor can claim or use a new credit. DOR ultimately denied the tax credit claim for other reasons; however, we could not determine based on the available review documentation whether the tax examiner had also identified this problem.

## Lack of Controls

Overall, DOR lacks sufficient controls over the review of conservation easement tax credit claims in three key areas. All of these controls are important for ensuring that decisions to allow or disallow credit claims are appropriate and substantiated. First, TPS's tax examiners do not use a standard work program or review tool to guide and document their review of conservation easement tax credit claims. As discussed previously, a key problem we identified through our audit was insufficient documentation of the tax examiners' reviews, which made it difficult to verify which items were reviewed on each tax credit claim and the resulting judgments made, conclusions reached, and subsequent actions taken. Use of a standard work program would help to ensure that all required aspects of a credit claim are examined consistently and provide tax examiners a means of documenting their reviews in a straightforward and consolidated manner. Standard work programs and checklists would also help DOR ensure that it has received all required supporting documentation and tax forms from taxpayers before starting its review.

Second, although TPS has established an overall work flow, it lacks detailed written policies and procedures for reviewing conservation easement tax credit claims. Currently, the written guidance for tax examiners performing the tax credit reviews consists of a couple of process flowcharts, a list of triggers that warrant a Level 2 review, and a somewhat abstract list of considerations that the tax examiner uses during a Level 2 review to identify problems or concerns with conservation easement appraisals. For example, the written guidance does not detail (1) the statutory, regulatory, and other tax requirements that must be reviewed on each claim during a Level 1 or Level 2 review; (2) how tax examiners' reviews should be documented; and (3) how exceptions should be handled. Written policies and procedures are an important control; they help management establish and communicate key expectations and requirements, and they provide structure and guidance to staff when performing their work. Formulating written policies and procedures also helps agencies institutionalize existing staff knowledge, which is important for training new staff and mitigating

the loss of knowledge that occurs when experienced staff retire or leave the agency.

Finally, the two tax examiners assigned to review conservation easement tax credit claims generally have little substantive oversight of their work by their immediate supervisors or TPS's quality control staff. These two tax examiners have three different individuals in their direct reporting line to the TPS Division Director. DOR also has a staff person from its investigations unit assigned to perform quality control reviews of tax examiners' work. However, none of these individuals reviews, even on a sample basis, the work supporting the tax examiners' decisions to allow or disallow conservation easement tax credit claims. When needed, the tax examiners typically seek guidance and input directly from the TPS Division Director or staff in DOR's Tax Conferee Section.

DOR reported that other TPS staff, including immediate supervisors, do not have sufficient expertise to review the more specialized work performed for the conservation easement tax credit. We understand that tax returns with conservation easement tax credit claims may be more complicated than a review of the typical tax return. However, supervisors and quality control staff should have a basic level of competency with the work being performed by TPS's tax examiners. Moreover, the complexity of the credit, as well as the large dollar amount of the credits being claimed, increases the risk of errors, fraud, and abuse occurring and, therefore, increases the need for adequate supervisory or quality control review. Routine review by supervisors and/or quality control staff of at least a sample of completed conservation easement tax credit reviews each year is an important control for identifying problems with supporting documentation and conclusions reached or other errors that may have occurred during the review process. Supervisory review is also a direct means of providing important feedback to staff about their work performance.

DOR reported that it relies on taxpayers' protests of disallowed credits and the subsequent review of the disallowed credits by staff in the Tax Conferee Section to ensure that TPS's tax examiners have appropriately identified all issues. Relying on taxpayer protests is not an adequate or sufficient control to ensure quality in DOR's decision making. In particular, not every taxpayer whose credit may have been inappropriately disallowed will spend the additional time and money to protest the disallowance. Moreover, taxpayers are unlikely to protest a tax credit claim that may have been inappropriately allowed in their favor. DOR has a responsibility to implement controls to ensure a complete, accurate, and consistent review and appropriate decision making on all claims.

## **Recommendation No. 2:**

The Department of Revenue (DOR) should ensure that its review of conservation easement tax credits claims is consistently applied and that the resulting decisions to allow or disallow claims are appropriate and substantiated by:

- a. Developing and utilizing a standard work program or review tool to guide and document tax examiners' review of conservation easement tax credit claims.
- b. Developing more complete and detailed written policies and procedures for reviewing conservation easement tax credit claims, including how reviews should be documented.
- c. Instituting a quality review process whereby a supervisor and/or quality control staff routinely reviews a sample of conservation easement tax credit claim reviews completed by tax examiners. Supervisors and quality control staff performing the reviews should receive training to maintain at least a basic level of competency with the conservation easement tax credit and related issues.

## **Department of Revenue Response:**

- a. Agree. Implementation date: July 2013.

DOR has further developed its checklists for employees to use as part of the Level 1 and Level 2 reviews of conservation easement tax credits and is currently updating these checklists to ensure that Recommendation No. 1 of the State Auditor's report be included.

- b. Agree. Implementation date: July 2013.

DOR will develop more complete and detailed written policies and procedures for reviewing conservation easement tax credit claims which will reference the checklists and their use as well as any additional documentation requirements.

- c. Agree. Implementation date: July 2013.

DOR currently sends cases with which it has concerns to the Division of Real Estate and the Conservation Easement Oversight Commission as part of its quality review process and will continue to do so. In addition, DOR will review its current staffing assignment of tax

examiners and identify changes to be made which will result in routine supervisory reviews of tax credits which have been both disallowed and not disallowed.

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## Information Management

Information management represents the ability to routinely compile, track, analyze, and report on key programmatic data in a manner that informs decision making, facilitates reporting to stakeholders and policy makers, enables internal and external monitoring and evaluation, and supports the achievement of program goals and objectives. Good information management practices are critical for the effective administration of the conservation easement tax credit.

In 2007, TPS developed an internal database where information related to conservation easement tax credit claims, uses, and transfers is kept. The TPS database is a primary resource for tax examiners' review of tax credit claims and for compiling, tracking, and reporting on credit availability and use on a taxpayer-specific basis and in the aggregate. DOR also works with the Governor's Office of Information Technology (OIT) to administer and oversee GenTax, which is the State's tax processing system for income and business taxes.

The TPS database consists of one large data table and is therefore more similar to a spreadsheet than a relational database. (A relational database stores and organizes data across multiple data tables that allow data to be linked, accessed, or queried in many different ways without having to reorganize or sort the underlying data.) Each time a donor or transferee uses a tax credit, a separate record is entered into the TPS database with the associated tax year. Thus, a single tax credit claim could have multiple records in the database. As of March 2012, the TPS database included approximately 21,460 individual records. To identify which credit is being used, each taxpayer record includes a donation number that identifies a specific conservation easement tax credit. However, the database does not have separate records or data tables for tax-credit-specific information, such as the total credit amount, donation date, donated value, county, parcel location, or conservation easement holder. Because the database is structured in this way, TPS staff must follow specific procedures when entering data. Tax-credit-specific information is included as part of the donor record for the year in which the tax credit was claimed.

The purpose of our audit was not to assess controls over DOR's information technology systems. Thus, we did not perform comprehensive testing of the TPS database or information in GenTax. However, we obtained and analyzed data from the TPS database to report background information on basic trends in conservation easement tax credit claims (see Chapter 1). As discussed earlier in

this chapter, we also conducted a file review for 10 sampled conservation easement tax credit claims, which required us to work with information maintained in the TPS database and GenTax. Overall, through our audit work in these areas, we identified concerns related to the completeness and accuracy of tax credit data maintained in the TPS database.

## Incomplete Data

We found that data on conservation easement donations and tax credits are likely to be incomplete because of delays entering information into the TPS database. First, the list of donations and credits claimed are not up to date. The tax credit must always be claimed by the landowner in the tax year in which the donation is made. Specifically, Form DR1305 must be attached to any Colorado income tax return that claims or uses a conservation easement tax credit. However, DOR's current process does not capture data from Form DR1305 for entry into the TPS database if there is no corresponding *use* of the credit in that same year by either the donor or a transferee. For example, DOR may receive a claim from a donor for Tax Year 2010. Yet if the donor does not use the credit to offset a tax liability until Tax Year 2012, the claim would not be entered into the TPS database until the donor's 2012 tax return is processed.

Second, we found that even when the tax credit is used to offset a tax liability, the use is not entered timely. At the beginning of our audit fieldwork, in February 2012, TPS staff reported having completed all reviews for Tax Year 2010; however, staff estimated that they had only entered approximately one-third to one-half of the conservation easement credits and associated taxpayer information into the TPS database.

## Inaccurate Data

As mentioned previously, we did not perform comprehensive testing of all records in the TPS database. However, while working with the TPS database to pull our sample of 10 tax credit claims and conduct our file review, we found several examples of inaccurate data in the database.

- **Donation Numbers.** The donation number should be a unique identifier for each conservation easement tax credit so that all taxpayer records associated with a single credit can be sorted and grouped together. However, we identified 171 records in the database for donors and transferees that had a donation number of "0"; 11 donations that were incorrectly assigned the donation number for another donation; and six donations that were entered more than once under a different donation number.

- **Total Credit Amounts.** Because the TPS database does not have any tax-credit-specific records and there are multiple donor and transferee records, TPS's procedures require that tax-credit-specific information, such as the total credit amount, be entered only once into the donor record for the year in which the tax credit was claimed. However, we identified seven donations for which the total credit amount was entered in both donor and transferee records. For two of these donations, the credit amount in the transferee record was different from the credit amount in the donor record. As a result of these duplicate and erroneous entries, a report on the total credit amount across these seven donations could be overstated by as much as \$3 million. We identified two additional credits for which the total credit amount was entered for the wrong tax year.
- **Dates.** Credit claims for donations are supposed to be submitted in the tax year in which the conservation easement donations occurred and should be accurately reflected in the database. We found three donations for which the donation year and tax year for the claim did not match. These errors may have resulted from data entry errors and/or tax examiners not catching taxpayer errors, such as taxpayers mistakenly submitting the claim in the wrong tax year or incorrectly filling out their forms. In the first case, the donation was made in 2008 but was entered in Tax Year 2009 in the database. In the second case, the donation date was entered incorrectly in the database. In the third case, the same 2009 donation was entered in both Tax Years 2009 and 2010 and under different donation numbers.
- **Social Security Numbers/Account Identifiers.** Social security numbers or other account identifiers (e.g., Colorado Account Number) are used to uniquely identify individual and corporate taxpayers, which is important when matching taxpayer records between the TPS database and other systems such as GenTax. However, in working with OIT to pull information from GenTax, OIT informed us that some of the social security numbers and account identifiers from the TPS database appeared to be missing the leading zero (e.g., 012-34567 would be listed as 12-34567). Missing the leading zero can create mismatched records when trying to match or merge data across separate systems. We also found 45 records in the TPS database that had no social security number or account identifier (i.e., the field was blank), and one record for which this field was entered as "0."

Incomplete and inaccurate data in the TPS database could have negative effects in a couple of different ways. First, these issues add to the risk that DOR could inappropriately allow or disallow uses of the conservation easement tax credit.



Specifically, TPS's tax examiners rely on information in the database to evaluate compliance with various requirements, including that (1) donors do not claim more than one conservation easement tax credit at a time, (2) uses of the tax credit by donors and transferees do not exceed the total amount of the credit claim for the donation, and (3) all uses of the tax credit by donors and transferees are disallowed when the credit is disallowed.

Second, incomplete and inaccurate data limit DOR's ability to report aggregate information about conservation easement tax credits to the General Assembly and the public effectively. As a result of the delays entering data into the TPS database, DOR does not have a complete record of those tax credits that have been claimed but not used. However, having a current record of all conservation easement tax credits that have been claimed is important for establishing the total amount of state income tax revenues that could be foregone over the life of the credits, the amount already used, and the amount potentially still outstanding. Information in the TPS database also supports some of DOR's other statutory reporting requirements to the Joint Budget Committee and the House and Senate Finance Committees.

## **Controls Over Data**

Overall, DOR has not created and maintained a database or system that effectively supports its administration of the conservation easement tax credit. First, the TPS database is not structured or designed properly to ensure the accuracy and integrity of information about the conservation easement donations and tax credits. As described earlier, the database structure is one large data table listing donors' and transferees' *uses* of the credits by tax year. There are no separate records or data tables for tax-credit-specific information. At a minimum, designing the database as a relational database with separate data tables for recording certain classes of information (e.g., tax-credit-level, taxpayer-level, credit-transaction-level information) could have helped prevent the data accuracy problems we found.

Second, DOR's data entry procedures do not ensure that the data are complete and as up-to-date as possible. As discussed previously, DOR does not capture tax credit claim information for entry into the TPS database when donors file a claim for the credit without a corresponding use of the credit by either the donor or a transferee. Also, TPS's tax examiners do not enter information into the TPS database as they are performing their reviews; rather, staff wait until all of the reviews are completed and then go back and perform data entry as they have time.

Third, TPS lacks sufficient data entry controls, which are important for preventing data inaccuracies from being introduced into the database in the first place. For example, if the tax credit is new and has not already been entered into the

database, TPS staff have to manually assign a new donation number to each claim and associated donor and transferee records. However, the problems we found with donation numbers suggest that DOR needs to provide more guidance and training to staff on how to identify whether or not a tax credit claim is already in the database, ensure that donation numbers are included with each record, and prevent assignment of the same donation number to different tax credit claims. Additionally, the TPS database does not require staff to enter information into certain fields or include other built-in edit checks to ensure that dates and other numeric fields are entered properly.

Finally, TPS does not regularly examine and clean its data. Data cleanup procedures that help with identifying and correcting data inaccuracies could include reviewing a sample of files entered into the database as well as running queries and reports to identify data anomalies, such as blank fields, out-of-range dates, data inconsistencies (e.g., donation year and tax year for the claim do not match), credits claimed that exceed allowable amounts, and duplicate donation numbers.

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### **Recommendation No. 3:**

The Department of Revenue (DOR) should ensure that its electronic data and information management systems effectively support the administration of the conservation easement tax credit by:

- a. Utilizing a relational database to manage data at the donation and taxpayer levels in a manner that captures the complexity of the tax credit claims and uses over time. As part of this process, DOR should migrate the existing TPS data to a relational database.
- b. Capturing data from Form DR1305 for all conservation easement tax credit claims in the year in which the claim is made, regardless of when the use of the credit occurs. Tax examiners should enter data on uses of the tax credit as they perform their reviews.
- c. Instituting appropriate data entry controls to help prevent data inaccuracies, and routine cleanup procedures to help identify and correct any data inaccuracies that do occur.

## **Department of Revenue Response:**

- a. Agree. Implementation date: December 2013.

DOR will determine the options available with the primary focus being on incorporating the TPS database into our existing tax system, GenTax. Once all feasible options are determined, they will be reviewed and the most cost-effective option will be implemented.

- b. Agree. Implementation date: December 2013.

DOR will enter information from Form DR1305 into the applicable database as identified in subpart (a) of this recommendation at the time returns are received from taxpayers, which will ensure data are captured more quickly and will eliminate the need for tax examiners to perform data-entry functions to any separate database.

- c. Agree. Implementation date: December 2013.

Because DOR will change how and when data are entered into the applicable database as identified in subparts (a) and (b) of this recommendation, existing data-entry controls instituted by its data entry unit within the Central Department Operations Division will help prevent data inaccuracies. In addition, DOR will review data entered on a quarterly basis as reports are generated from the applicable database as identified in subpart (a) of this recommendation to be used in preparing statutorily required reports.

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## **CEOC Consultations**

State statute establishes the nine-member CEOC as part of an overall administrative process for ensuring the validity of conservation easement tax credits claimed by taxpayers. Specifically, Section 12-61-721(3)(a), C.R.S., states:

“The [CEOC] shall advise [DRE and DOR] regarding conservation easements for which a state income tax credit is claimed pursuant to section 39-22-522, C.R.S. At the request of [DRE or DOR], the [CEOC] shall review conservation easement transactions, applications, and other documents and advise [DRE and DOR] regarding conservation values consistent with section 170(h) of the federal ‘Internal Revenue Code of 1986,’ as amended, the

capacity of conservation easement holders, and the integrity and accuracy of conservation easement transactions related to the tax credits.”

Additionally, Section 39-22-522(3.5)(a), C.R.S., states:

“In resolving disputes regarding the validity or the amount of a credit..., including the value of the conservation easement for which the credit is granted, the [DOR] executive director shall have the authority, for good cause shown and in consultation with [DRE] and the [CEOC]..., to review and accept or reject, in whole or in part, the appraisal value of the easement, the amount of the credit, and the validity of the credit based upon the internal revenue code and federal regulations in effect at the time of the donation.”

The CEOC meets on at least a quarterly basis, and its meeting agendas typically include conservation easement transactions that are the basis for a tax credit claim and for which DOR has requested a consultation. As of January 2012, there were a total of 668 formal consultations between DOR and the CEOC. Of these 668 consultations, 41 (6 percent) consultations involved conservation easement transactions that occurred in 2008 or later. For these 41 consultations, our analysis showed that the CEOC recommended rejecting the tax credit claims for 20 transactions (49 percent) and accepting the tax credit claims for 19 transactions (46 percent). In the remaining two transactions (5 percent), the CEOC did not make a formal recommendation to accept or reject the associated tax credit claims.

During the consultation process, DOR provides available documentation, such as the appraisal report and deed of conservation easement, to the CEOC members in advance of the meeting. Because of confidentiality requirements for individual tax matters, the CEOC meets in executive session to discuss the specifics of each referred case, which may include issues regarding the appraisal methodology and valuation or the legitimacy of the donation’s conservation purpose. The CEOC votes in open meeting to recommend that DOR accept or reject the credit claim. DOR is under no obligation to adhere to the CEOC’s recommendations. In addition to the CEOC’s review, DRE’s staff appraiser conducts a separate review of the appraisal for each conservation easement transaction that DOR refers for consultation to determine whether there appear to be material violations of the Uniform Standards of Professional Appraisal Practice (USPAP) that could adversely impact the appraiser’s analyses and conclusions and, therefore, the valuation of the land being donated.

One of the objectives of our audit was to determine whether DOR’s consultation with DRE and the CEOC provide adequate support for decision making about conservation easement tax credit claims. To address this objective, we observed two CEOC meetings and listened to audio recordings of one additional CEOC

meeting related to our sampled tax credit claims. We also reviewed the CEOC's written orientation manual and interviewed all members of the CEOC as well as DRE and DOR management and staff about the CEOC's advisory role and the consultation process. Finally, we compiled and analyzed data on the CEOC's recommendations regarding the 41 conservation easement transactions occurring since 2008 that DOR referred for consultation as of January 2012.

Conservation easement transactions can be complex and nuanced. Overall, we found that the CEOC plays an important role in providing necessary expertise and stakeholder perspectives when scrutinizing conservation easement transactions for which tax credits are claimed. However, as described in the following sections, in practice, there is a misalignment in two key areas that we believe limits the CEOC's ability to effectively fulfill the purpose for which it was created, which is to help inform and facilitate DOR's decision making to allow or disallow tax credit claims.

## **Substantive Versus Strict Compliance**

CEOC members differ from one another on what motivates their individual votes. However, we found that the CEOC as a whole tends to take a *substantive* compliance approach when reviewing conservation easement transactions that DOR refers for consultation. That is, when making recommendations to DOR, the CEOC's collective vote is generally more reflective of whether the conservation easement transaction overall is legitimate (e.g., the easement has a valid conservation purpose, the appraisal does not appear to be grossly inaccurate or purposefully misleading, the holder is a qualified organization) and the landowner has made a good faith effort to comply with applicable requirements, rather than whether the landowner has complied with each specific statutory and regulatory requirement. Overall, the CEOC appears to prefer the substantive compliance approach when reviewing appraisals.

Our analysis showed that the CEOC recommended approving the tax credit claim for 19 (46 percent) of the 41 conservation easement transactions occurring since 2008 that DOR referred for consultation as of January 2012. However, for 8 (42 percent) of these 19 transactions, the CEOC recommended accepting the tax credit claim despite DRE's opinion that there appeared to be material USPAP violations in the appraisal that could affect the valuation of the land being donated. For example:

- In one of our sampled cases, DRE's staff appraiser reported to the CEOC that there may be material USPAP violations in the appraisal. Specifically, the appraisal did not mention a number of other conservation easements in the area that could have been used to help establish the value opinion, the appraisal did not consistently adjust the value of comparable properties for

improvements on those properties, and the appraiser did not obtain title documentation for the property to determine whether there were any other encumbrances on the property, such as mineral rights or grazing leases. DRE's staff appraiser reported that these steps are standard practice for conservation easement appraisals and their omission could affect the value opinion. During the discussion, CEOC members voiced their opinions that the appraised value seemed reasonable and that this was a great piece of land that would be good to conserve. The CEOC voted unanimously to recommend approval of the tax credit. DOR ultimately denied this tax credit claim, citing problems with the appraisal.

We inquired with CEOC members about how they approach the consultation process in this type of situation. During our interviews, none of the CEOC members disputed the importance of the appraisal for substantiating the conservation easement transaction and the value of the tax credit. However, four CEOC members specifically reported that if the conservation purpose is sound, DOR should not disallow tax credit claims based on a problematic appraisal when a revised appraisal likely would not bring the fair market value of the donated easement low enough to reduce the amount of the credit claim. For example, in the case of an appraisal with apparent USPAP violations that values a conservation easement donation at \$2 million, the total tax credit the landowner could claim is \$375,000. Even if the landowner obtains a second appraisal without apparent USPAP violations that reduced the fair market value of the conservation easement donation by half to \$1 million, the total tax credit the landowner could claim would still be \$375,000. Thus, the position of these four CEOC members is that there is no net benefit to the State in disallowing the credit and requiring a second appraisal in such a case.

We understand the logic of the argument advanced by some of the CEOC members. However, we find the argument to be problematic because, in effect, it holds appraisals of higher-value donations to a lesser standard and fundamentally does not help to address the issue of overvalued conservation easement appraisals that House Bill 08-1353 was intended to fix. To ensure consistent application of the tax laws, conservation easement appraisals must be held to the same standards regardless of the value of the donation or the resulting tax credit. Additionally, it is important to recognize that valuation problems with a conservation easement appraisal could have a secondary negative effect if the appraisal is subsequently included in a comparable sales analysis as part of an appraisal of another property.

Although a particular piece of land may be desirable for a conservation easement, this does not mean that the transaction qualifies for claiming a tax credit. It is not necessarily problematic that the CEOC considers substantive aspects of conservation easement transactions as part of the consultation process. However, when making recommendations to accept or reject a tax credit claim, the CEOC

needs to understand that DOR, as the agency responsible for administering Colorado's tax laws, must apply the tax code consistently for all taxpayers and follow a *strict* compliance approach when determining whether taxpayers meet the statutory and regulatory requirements for claiming and using the credit. To do otherwise would undermine the assurances and safeguards that these requirements are intended to provide.

## **Landowner Versus General Taxpayer Perspective**

As noted previously, CEOC members differ from one another on what motivates their individual votes. However, we found that the overall tenor of the CEOC's deliberations tends to focus more on the landowner's perspective than on its broader responsibility to the general taxpayer, which is to help ensure that conservation easement tax credits claimed are valid. Specifically, we found that this landowner-centered perspective was prevalent during the CEOC meetings we observed and the audio recordings of meetings we listened to, as well as during our interviews with some of the CEOC members. Additionally, DRE and the CEOC created a written orientation manual to help CEOC members understand their roles and responsibilities as well as other administrative processes. The manual states: "In all decisions [the CEOC] makes, the interest of the public should be paramount. *In particular, the Colorado landowner who wishes to preserve a piece of their land in a sound and secure conservation easement*" (emphasis added).

By statute, the CEOC membership is structured to include a number of different stakeholders (e.g., local land trust, state or national land trust, local government open space or state conservation agency, historic preservation organization, a landowner). At the CEOC's June 2012 meeting, the CEOC members spent time describing their organizations. During this discussion, one of the CEOC members described how their organization assisted landowners with conservation easement transactions, including the need to "protect landowners from DOR." This member was not speaking about the CEOC's official role when making this comment, nor is it necessarily indicative of all CEOC members' perspectives. Nonetheless, it is concerning that a member of the CEOC brings such a perspective to a consultation process that, by its very design, is intended to inform and facilitate DOR's decision making about tax credit claims. It is reasonable that the landowner perspective be considered when evaluating conservation easement tax credit claims referred for consultation. However, statute does not establish the CEOC as a landowner advocate.

## **Improving Communication and Common Understanding**

All of the CEOC members acknowledged that the CEOC's role is advisory. However, the problems we identified are the result of an overall lack of

communication and common understanding about the purpose and goals of the consultation process. Ultimately, the consultation process should further the State's ability to determine whether landowners have complied with the statutory and regulatory requirements for claiming a conservation easement tax credit.

The CEOC held its first meeting in September 2008, and formal consultations with DOR began in October 2010. During our audit, DOR and DRE staff and CEOC members reported that communication between DOR and the CEOC has been strained for a number of years. CEOC members generally reported that DOR does not have an understanding and appreciation for the substantive aspects of conservation easement transactions or the landowner's perspective. DOR management and staff reported that the CEOC does not have an understanding and appreciation for the compliance requirements that DOR must strictly apply and adhere to when reviewing tax credit claims.

Recently, at the CEOC's June 2012 meeting, DOR and the CEOC began to address the lack of common understanding about the purpose and goals of the consultation process by directly communicating with one another about their respective roles and responsibilities. In particular, at this meeting, DOR staff explained internal procedures for processing taxes, including the need to take a strict compliance approach when reviewing tax credit claims. CEOC members provided information about the organizations they represent and their individual areas of expertise related to conservation easements. This level of communication has been lacking in the past and needs to continue.

In addition to communicating about processes, roles, and responsibilities, more communication is needed with respect to the tax credit claims that are referred to the CEOC for consultation. Currently, DOR does not detail why it refers tax credit claims to the CEOC. Thus, CEOC members do not always have a clear understanding about DOR's concerns with the transaction. CEOC members reported that knowing the basis for the consultation would help target their review efforts and ensure that DOR gets what it needs from the consultation. CEOC members also reported it would be beneficial to learn about the outcomes of the consultations (i.e., whether DOR allowed or disallowed the tax credit claim) as a means of improving the advice the CEOC provides to DOR. Additionally, we noted that there is little routine discussion among DOR, DRE, and the CEOC about the overall trends and issues being seen with conservation purposes, conservation easement appraisals, and landowner compliance with the statutory and regulatory requirements for claiming the conservation easement tax credit. This type of broader discussion can be helpful for informing discussions about specific tax credit claims.

Finally, the characterization of "the public interest" as it is currently outlined in the CEOC's written orientation manual falls too much on the side of the



landowner and lacks proper balance with the CEOC's broader responsibility to help ensure the validity of conservation easement tax credits being claimed by landowners. Also absent from the orientation manual is a specific acknowledgment that the CEOC's consultations are intended to help determine whether landowners have complied with the statutory and regulatory requirements for claiming the conservation easement tax credit and, therefore, inform and facilitate DOR's decision to allow or disallow tax credit claims.

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### **Recommendation No. 4:**

The Department of Revenue (DOR), the Division of Real Estate (DRE), and the Conservation Easement Oversight Commission (CEOC) should improve communication efforts and continue to build a common understanding about the purpose and goals of the consultation process. This should include using the consultation process to hold routine discussions about the general issues and trends being observed with conservation easement transactions associated with tax credit claims.

#### **Department of Revenue Response:**

Agree. Implementation date: June 2012 and Ongoing.

DOR is currently working on improving its communication with DRE and the CEOC. DOR, DRE, and the CEOC will continue this effort by changing and formalizing the consultation process to be more useful to DOR and to better utilize the expertise of DRE and the CEOC in determining whether taxpayers have complied with the requirements for claiming a conservation easement tax credit.

#### **Division of Real Estate Response:**

Agree. Implementation date: June 2012 and Ongoing.

DRE has worked over the past two years to improve communication, understanding, and cooperation between DOR and the CEOC. These efforts have proven fruitful and will continue through informal discussions between staff and at CEOC meetings. Specifically, DRE will work with DOR staff to identify a process in which the two agencies will routinely discuss issues. Issues will then be brought to the CEOC for input at regularly scheduled meetings. DRE will work with DOR and the CEOC to increase the effectiveness and efficiency of the consultation process.

## **Conservation Easement Oversight Commission Response:**

Agree. Implementation date: June 2012 and Ongoing.

The CEOC is committed to continuing to work to improve communication with DOR and DRE to build a common understanding about the purpose and goals of the consultation process. Discussions about conservation issues and trends should include concerns identified by the CEOC, including the cost to the State of legal expenses and staff time pursuing tax credit claims that the CEOC believes are appropriate. The CEOC has recommended disallowance of more than 600 conservation easement tax credits and strongly supports disallowances where parties have abused the law. However, the CEOC strongly believes that sound, legitimate conservation easement tax credit claims are being disallowed based upon strict and perhaps unrealistic standards. Finding a way to address this concern as the consultation process moves forward will be an important part of the CEOC's ongoing communication efforts with DOR and DRE.

### ***Auditor's Addendum***

*Some of the views expressed by the CEOC in its response, such as the need to review State legal expenses and staff time related to the review of conservation easement tax credit claims and to address the CEOC's perception that legitimate tax credit claims are being disallowed based on strict and unrealistic standards, go beyond the scope of the CEOC's statutory responsibilities. Section 12-61-721(3)(a), C.R.S., states:*

*"At the request of [DRE] or [DOR], the [CEOC] shall...advise [DRE] and [DOR] regarding conservation values..., the capacity of conservation easement holders, and the integrity and accuracy of conservation easement transactions related to the tax credits."*

*The requirements for claiming a conservation easement tax credit are clearly established in federal and state statutes and regulations, and legitimate conservation easement tax credit claims are those that comply with these statutory and regulatory requirements.*

### **Recommendation No. 5:**

The Department of Revenue (DOR) should provide the Conservation Easement Oversight Commission (CEOC) with more information, such as areas of concern or specific questions that need to be addressed, when referring individual

conservation easement tax credit claims to the CEOC for consultation. DOR should also communicate its final decisions to allow or disallow tax credit claims that are referred for consultation.

### **Department of Revenue Response:**

Agree. Implementation date: December 2012.

DOR will provide more information to the Division of Real Estate (DRE) and the CEOC regarding DOR's specific questions and concerns about appraisals and/or deeds submitted for consultation. DOR will also provide information on a quarterly basis to DRE and the CEOC about DOR's actions on cases previously submitted for consultation.

### **Recommendation No. 6:**

The Division of Real Estate (DRE) and the Conservation Easement Oversight Commission (CEOC) should revise the CEOC's written orientation manual to better address the CEOC's broader responsibility to the general taxpayer when defining "the public interest." The manual should explicitly recognize that the consultation process should further the State's ability to determine whether the landowner has complied with the statutory and regulatory requirements for claiming the conservation easement tax credit.

### **Division of Real Estate Response:**

Agree. Implementation date: March 2013.

DRE will work with the CEOC to review and revise the written orientation manual to further define the responsibility that CEOC members have to the general taxpayers as part of the duty to protect the public interest. Revisions will include a discussion of the role the CEOC plays in the consultation process and how the CEOC will further the State's ability to determine compliance with statutory and regulatory requirements. DRE staff will prepare recommended changes for discussion at the December 3, 2012 CEOC meeting. Additionally, DRE staff and the CEOC's legal counsel will review the responsibilities and roles of CEOC members at the yearly CEOC retreat taking place in the first quarter of 2013.

## **Conservation Easement Oversight Commission Response:**

Agree. Implementation date: March 2013.

The CEOC will revise the written orientation manual, which was written prior to consultation with DOR, to address the CEOC's role in the consultation process. The CEOC was created by statute to advise DRE and DOR on conservation easement transactions. When advising these agencies the CEOC tries to protect the financial interest of all taxpayers, including those who donate conservation easements. A designated seat on the CEOC for a landowner/donor supports the CEOC's position that part of its responsibility is to consider the landowner perspective. The CEOC represents various stakeholders with significant expertise on conservation easement transactions, and its members believe it is appropriate for the CEOC, in its advisory capacity, to question the basis for DOR's and DRE's decisions and to ensure that all perspectives are considered. The CEOC will continue to use its diverse expertise and the various member perspectives (e.g., state agencies, a local government, land trusts, and a landowner) to advise both the DOR and DRE on all aspects of conservation easement transactions associated with tax credit claims.

### ***Auditor's Addendum:***

*Some of the views expressed by the CEOC in its response, such as questioning the basis for DOR's and DRE's decisions, go beyond the scope of the CEOC's statutory responsibilities. Section 12-61-721(3)(a), C.R.S., states:*

*"At the request of [DRE] or [DOR], the [CEOC] shall...advise [DRE] and [DOR] regarding conservation values..., the capacity of conservation easement holders, and the integrity and accuracy of conservation easement transactions related to the tax credits."*

*We acknowledge that CEOC members represent a number of different interests, including landowners donating conservation easements. However, none of these interests should take priority over the CEOC's broader responsibility to help ensure the integrity and accuracy of conservation easement transactions related to tax credits being claimed by taxpayers.*

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## Review of Conservation Easement Appraisals

To claim a conservation easement tax credit, the fair market value of the conservation easement donation must be established by a qualified appraisal completed by a qualified appraiser no more than 60 days prior to the donation and no later than the due date of the donor's tax return. Fundamentally, the fair market value of a conservation easement is what drives (1) the financial benefit the taxpayer receives by claiming the tax credit and (2) the corresponding loss in tax revenue for the State. Thus, without an appraisal that uses a sound methodology in accordance with applicable professional standards, the State lacks assurances that the dollar value of any tax credit claimed by the taxpayer is reasonable and appropriate.

As discussed in Chapter 1, the General Assembly enacted House Bill 08-1353 during the 2008 legislative session, in part to help ensure the validity and accuracy of valuation of conservation easements that are donated by landowners and used as the basis for claiming a tax credit. Specifically:

- Section 12-61-719(1), C.R.S., requires any appraiser who conducts an appraisal for a conservation easement to submit a copy of the completed appraisal to DRE within 30 days following the completion of the appraisal. Conservation easement appraisal reports must be submitted to DRE regardless of whether a tax credit will be claimed. The appraiser also must complete and submit an affidavit that (1) attests to certain specific appraisal values (e.g., the unencumbered land value, the total easement value, values for minerals), (2) describes the ownership of nearby land parcels, and (3) provides details of the appraiser's licensure status and compliance with continuing education requirements.
- Section 12-61-719(3), C.R.S., requires DRE to review submitted conservation easement appraisals and corresponding affidavits for completeness and to track the affidavit information in an electronic database. As mentioned previously, DRE conducts a separate review of the appraisal for each conservation easement transaction that DOR refers to the CEOC for consultation.

The General Assembly also authorized DRE to charge an administrative fee, thereby providing a dedicated revenue source to cover the cost of DRE's appraisal review activities. The amount of the fee is determined by DRE. Currently, appraisers pay a \$265 fee for each conservation easement appraisal they submit to DRE.

## Appraisal Review Process

DRE has established a review process for the conservation easement appraisals it receives. First, DRE staff review the appraisal and corresponding affidavit to ensure they are complete and enter basic information, such as the names of the appraiser and the conservation easement holder, the county of the donation, and the easement's acreage and fair market value, into a spreadsheet. At this point, DRE staff verify that the appraiser is licensed and has attested to completing the continuing education requirements. DRE also retains an electronic copy of the appraisal report and completed affidavit.

Second, DRE staff select some conservation easement appraisals to undergo a more in-depth desk review by DRE's staff appraiser. Appraisals are selected for desk review based on several different risk factors, including whether the appraisal will be used to substantiate a tax credit claim, the appraiser has had practice problems in the past, or the conservation easement donation is part of a phased transaction. It is important to note that appraisals are only opinions of value and that values may vary depending on the appraiser and his or her methodology. DRE's staff appraiser reviews the appraisal *methodology* but does not determine whether the appraiser's value opinion is "correct." To do so would require another independent appraisal for the property. Examples of potential USPAP violations and other concerns that have been identified through DRE's desk review include failing to take into account an adjacent property; evaluating the wrong property; using inappropriate comparable properties to establish a possible sale value; failing to take into account the zoning uses for the property; and inflating the value of the property resources, such as gravel and water, without taking into account the cost and likelihood of extracting these resources.

Finally, if DRE's staff appraiser identifies any significant concerns with a conservation easement appraisal, such as a potential licensure or USPAP violation, the matter is referred as a complaint to DRE's enforcement section for investigation. DRE enforcement staff conduct an investigation and present the findings and conclusions to the Board of Real Estate Appraisers (BOREA), which has the authority to take disciplinary action against the appraiser. If, as the result of an investigation, BOREA determines that a material USPAP violation or a substantial misstatement of value has occurred, Section 12-61-719(5), C.R.S., requires that DOR be notified and provided with a copy of the conservation easement appraisal and a summary of findings.

One of the objectives of our audit was to determine whether DRE's process for reviewing conservation easement appraisals is sufficient to ensure that appraisals used to substantiate tax credit claims are performed by licensed appraisers and adhere to applicable professional standards and that any violations are communicated to DOR. To address this objective, we analyzed data on all

conservation easement appraisals submitted to DRE since 2008. We also reviewed a nonstatistical judgmental sample of 10 conservation easement appraisals and related documentation that were submitted to DRE between April 2009 and December 2010 and were specifically related to a conservation easement tax credit claim filed in Tax Years 2009 or 2010. We selected our sample items to provide representation of conservation easement appraisals that DRE subjected to a desk review, as well as conservation easement appraisals that DRE did not subject to a desk review.

DRE reported that its appraisal review process is intended to try to identify and address problematic conservation easement appraisals before a tax credit is claimed. However, we identified problems with DRE's review process that limit DRE's ability to accomplish this goal effectively.

- **Not all conservation easement appraisals undergo a desk review.** Although all conservation easement appraisals submitted to DRE undergo a basic review for completeness to ensure that all of the necessary documents are submitted, we found that not all conservation easement appraisals undergo a more in-depth desk review by DRE's staff appraiser. Specifically, only 286 (31 percent) of 919 conservation easement appraisals have had a desk review since DRE started receiving conservation easement appraisals in July 2008. The percentage of conservation easement appraisals undergoing a desk review also varies significantly from year to year, ranging from a low of 17 percent in 2009 to a high of 42 percent in 2011.

<b>Conservation Easement Appraisals Received and Reviewed by the Division of Real Estate</b> <i>(As of July 31, 2012)</i>			
Calendar Year <sup>1</sup>	Conservation Easement Appraisals Received <sup>2</sup>	Desk Review Performed	
		Count	Percent of Total
2008	105	41	39%
2009	253	44	17%
2010	243	73	30%
2011	224	93	42%
2012	94	35	37%
<b>Total</b>	<b>919</b>	<b>286</b>	<b>31%</b>
<b>Source:</b> Office of the State Auditor's analysis of the Division of Real Estate's conservation easement appraisal log.			
<sup>1</sup> Only partial year data are reflected for 2008 and 2012. The Division of Real Estate started receiving conservation easement appraisals effective July 1, 2008, and we pulled data from the Division of Real Estate's appraisal log through July 31, 2012.			
<sup>2</sup> Not all conservation easement appraisals received by the Division of Real Estate were related to a potential tax credit claim.			

DRE reported that it attempts to conduct a desk review of as many conservation easement appraisals as possible and that in recent years it has prioritized its review efforts on appraisals supporting tax-credit-generating conservation easements. Starting in February 2009, DRE began identifying which conservation easement appraisals were likely to support a tax credit claim and the estimated tax year of the claim.

To provide an analysis of DRE's prioritization efforts, we limited our analysis to those conservation easement appraisals that DRE determined would likely be used to substantiate a tax credit claim. We also grouped the data based on the estimated tax year for the claims as determined by DRE. This analysis shows that only 223 (46 percent) of 483 tax-credit-generating conservation easement appraisals had a desk review, with the year-to-year percentages varying significantly from a low of 26 percent in 2010 to a high of 95 percent in 2011.

<b>Tax-Credit-Generating Conservation Easement Appraisals Received and Reviewed by the Division of Real Estate</b> <i>(As of July 31, 2012)</i>			
Estimated Tax Year <sup>1</sup>	Conservation Easement Appraisals Received <sup>1</sup>	Desk Review Performed	
		Count	Percent of Total
2009	175	73	42%
2010	155	41	26%
2011	78	74	95%
2012	75	35	47%
<b>Total</b>	<b>483</b>	<b>223</b>	<b>46%</b>
<b>Source:</b> Office of the State Auditor's analysis of the Division of Real Estate's conservation easement appraisal log. <sup>1</sup> This is the Division of Real Estate's estimate of the tax year for which a tax credit supported by the conservation easement appraisal will be claimed. Figures for 2012 are based on partial year data; we pulled data from the Division of Real Estate's appraisal log through July 31, 2012.			

Both of our analyses demonstrate that DRE's coverage of conservation easement appraisals through desk reviews could be improved. Increased coverage is important if DRE's review process is to be effective at identifying and addressing problematic conservation easement appraisals before a tax credit is claimed. For example, we identified one conservation easement appraisal in our sample that did not receive a desk review at the time DRE received the appraisal. However, DOR discovered problems with the appraisal when it reviewed the tax credit claim and requested a review by DRE. DRE conducted an investigation and concluded that "the value opinion may not be appropriate or adequately supported given the



data and analysis presented” and that “the appraisal may not meet the requirements defined in the Internal Revenue Code.” DRE took disciplinary action against the appraiser, including requiring the appraiser to re-perform and resubmit the appraisals at his own cost. This case also illustrates the efficiencies that could potentially be gained through an up-front desk review by DRE. It is likely that the issues with this appraisal could have been identified and resolved sooner had DRE performed a desk review, as opposed to waiting for DOR to receive a tax credit claim and raise concerns at that point in the process.

- **Not all problems are identified through desk reviews.** As discussed previously, the intent of DRE’s appraisal review process is to try to identify and address problematic conservation easement appraisals before a tax credit is claimed. However, even when DRE performs a desk review, we found that not all problematic issues are identified. Of the eight conservation easement appraisals in our sample that underwent a desk review, there was one in which DRE’s staff appraiser did not identify any issues warranting further investigation, although it was noted that some information was omitted from the appraisal report. Upon receiving a tax credit claim supported by this appraisal, DOR raised questions about the appraisal and requested a consultation with DRE and the CEOC. During the consultation, DRE’s staff appraiser stated that the information omitted from the appraisal report should have been included to support the value conclusions and that the appraisal may have had material USPAP violations. DOR subsequently denied the tax credit, citing problems with the appraisal. The landowner has since protested the denial, and the case is currently with DOR’s Tax Conferee.

We recognize that a desk review is limited only to the information contained in the appraisal report. It is also reasonable that additional questions and concerns may be raised through subsequent reviews and scrutiny by DOR and/or the CEOC that were not initially considered during DRE’s desk review. However, at a minimum, the scope of DRE’s desk review should be rigorous enough to provide reasonable assurance that it is effectively identifying and referring potential problems for further investigation. Identifying and referring potential problems for further investigation is important because the investigation process is the only means by which DRE and BOREA are able to officially conclude that a material USPAP violation or a substantial misstatement of value has occurred in a conservation easement appraisal.

The fact that not all conservation easement appraisals undergo a desk review and that not all problems with conservation easement appraisals are identified through desk reviews are the result of several factors:

- **Resources.** Despite year-to-year fluctuations in the number of conservation easement appraisals being submitted, DRE only has one staff appraiser assigned to perform desk reviews. From a risk perspective, it is reasonable for DRE to focus its desk reviews on appraisals of tax-credit-generating conservation easements. However, DRE has not obtained or allocated additional resources to perform desk reviews of such appraisals when demand increases. For example, our earlier analysis showed that DRE reviewed about 95 percent of all tax-credit-generating conservation easement appraisals for Tax Year 2011. However, DRE's ability to achieve this higher coverage was largely because its workload decreased. Only about half as many tax-credit-generating conservation easement appraisals were submitted for Tax Year 2011 (78 appraisals) as in the previous two years (155 appraisals in 2010 and 175 appraisals in 2009). Although DRE has had more coverage in recent years, the number of conservation easement appraisals supporting tax credit claims will likely increase once the aggregate cap on the total dollar amount of credits available expires in 2013.

During our audit, DRE reported that a primary factor affecting its resources and ability to conduct desk reviews of *new* conservation easement appraisals was that, historically, a significant portion of its staff appraiser's time has been spent conducting desk reviews of appraisals referred by DOR. However, as discussed in Recommendation No. 4, as of January 2012, there were a total of 668 formal consultations between DOR and the CEOC and DRE, only 41 (6 percent) of which involved conservation easement transactions that occurred since 2008. Thus, the demand on the DRE staff appraiser's time related to DOR referrals may not be as significant going forward.

As noted earlier, the General Assembly provided a dedicated source of fee revenue to cover the cost of DRE's appraisal review activities. DRE reported a desire to keep administrative fees as low as possible. We recognize the need to keep fees low; however, DRE should ensure that, at a minimum, all conservation easement appraisals expected to be used to substantiate a tax credit claim undergo a desk review. This may require that DRE adjust administrative fees and work through the state budget process to obtain the additional staff resources necessary (e.g., hiring additional in-house staff appraisers or contracting for appraisal review services) as workload demands change.

- **Formal Procedures.** DRE's conservation easement appraisal review process lacks formal procedural definition. As discussed previously, DRE staff consider a number of different risk factors when selecting appraisals for further desk review, including whether the appraisal will be used to

substantiate a tax credit claim, the appraiser has had practice problems in the past, or the conservation easement is part of a phased transaction. However, none of these risk factors is formally established in policies and procedures. Additionally, DRE does not use a standard review template when it conducts the desk reviews. Thus, it is unclear what attributes of each appraisal should be and are examined during the desk review; the review process is generally only defined by the DRE staff appraiser's individual work practices. Review templates are a basic control for ensuring a consistent review and that all required and/or significant attributes are examined. Review templates also help to document the relevant judgments made and conclusions reached during the review, as well as any subsequent actions taken as a result of the review.

- **Statutory Intent.** State statute is not entirely clear regarding the intended purpose and scope of DRE's review of conservation easement appraisals. In the legislative declaration to House Bill 08-1353, the General Assembly stated its intent that the desired results and benefits of the new requirements were, in part, "to have the division of real estate *review* appraisals of conservation easement and affidavits of appraisers submitted to the division and maintain the information in an electronic database" (emphasis added). Given the issues that precipitated House Bill 08-1353, it appears that the General Assembly intended for DRE to establish a review process that is rigorous enough to identify potential problems with conservation easement appraisals before a tax credit is claimed. However, DRE indicated that the specific requirement put in place by House Bill 08-1353 suggests that the General Assembly intended for DRE's review to be more limited in scope. Specifically, Section 12-61-719(3), C.R.S., states that "[DRE] shall *review* the information submitted...*to ensure that it is complete* and shall record and maintain the information submitted as part of the affidavit in an electronic database" (emphasis added). During our audit, DRE reported that statutory clarification on this issue is important for ensuring that its reviews and resources are aligned with what was intended by the General Assembly.

An up-front desk review of conservation easement appraisals can be an effective and efficient means of identifying and addressing problematic appraisals before a tax credit is claimed. Ensuring that sufficient staff resources are available, review processes are formalized, and the intended purpose and scope of the reviews are clearly defined are all critical to strengthening DRE's conservation easement appraisal review process and gaining the level of assurance over conservation easement appraisals that we believe the General Assembly envisioned by enacting House Bill 08-1353.

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**Recommendation No. 7:**

The Division of Real Estate (DRE) should ensure that the conservation easement appraisal review process is effective at identifying and referring problematic appraisals for investigation before a tax credit is claimed by:

- a. Performing a desk review of, at a minimum, all conservation easement appraisals for which a tax credit will be claimed.
- b. Developing standard operating procedures that outline the general parameters of the desk review, including the risk factors warranting a desk review and the required and/or significant attributes that should be examined on every desk review.
- c. Developing and utilizing a standard review template, or other similar tool, to ensure the consistency and completeness of the desk review and to document the significant judgments made, conclusions reached, and subsequent actions taken.
- d. Working with the General Assembly to further clarify in statute the intended purpose and scope of the conservation easement appraisal review requirement.

**Division of Real Estate Response:**

- a. Agree. Implementation date: January 2013.

DRE staff will identify and review all appraisals used to substantiate a tax credit claim. DRE's continued goal is to complete a review of conservation easement appraisals used as substantiation for tax credit claims within the calendar year the appraisal is received by DRE. The ability to accomplish this goal is complicated by limited staff resources, fiscal constraints, difficulties predicting the number of appraisals that must be reviewed, and the additional workload resulting from the consultation process. Despite these complications, DRE has reviewed 95 percent of all appraisals for tax-credit-generating easements in 2011 and has since completed reviews of the remaining four appraisals. DRE will ensure resources are available to effectively administer reviews of all conservation easement appraisals substantiating conservation easement tax credit claims.

b. Agree. Implementation date: January 2013.

DRE will formalize risk factors used to prioritize reviews of conservation easement appraisals. Staff will also develop a procedure that identifies attributes of the appraisal that must be reviewed in every case as well as unique circumstances that require further review. The process will address situations where additional information should be sought as well as the process for referring problematic appraisals for investigation.

c. Agree. Implementation date: January 2013.

DRE will create a new review template allowing for consistent documentation and reporting of review findings. The template will be used in all reviews to ensure the consistency and completeness of reviews and to document conclusions and subsequent actions taken by DRE. It will also allow flexibility in cases where staff reviewers identify unique issues that require additional review or information.

d. Agree. Implementation date: July 2013.

DRE will work with the General Assembly as appropriate to clarify the desired scope and purpose of conservation easement appraisal reviews. Any additional level of review beyond what is recommended in this audit report likely will require the allocation of additional resources. DRE will also address the scope and purpose of appraisal reviews as part of our report to the General Assembly requested in Recommendation No. 11.

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## **Certification of Conservation Easement Holders**

As discussed in Chapter 1, state statute requires the holder of a conservation easement to be a governmental entity or a nonprofit organization. Additionally, if a tax credit will be claimed for a donated conservation easement, state statute requires the governmental entity or nonprofit organization receiving the donation to be certified by DRE. The purpose of the certification requirement is to establish minimum qualifications for organizations that hold conservation easements to encourage professionalism and stability and to identify fraudulent or unqualified applicants. Certification, which must be renewed annually, is a key control for ensuring that tax-credit-generating conservation easements are donated to qualified organizations.

As of March 2012, DRE had received a total of 46 completed applications for certification (31 applications from nonprofits and 15 applications from governmental entities); however, only 43 applications were complete. Of the 43 completed applications, DRE certified 37 applicants through its standard certification process. DRE certified the remaining six applicants based on their accreditation by the Land Trust Alliance, which is a national nonprofit land conservation organization that has established standards and practices widely accepted in the conservation and land trust community for the responsible operation of a land trust. State statute [Section 12-61-720(5), C.R.S.] allows for expedited certification of nonprofits and quasigovernmental land conservation entities that are accredited by national land conservation organizations. Currently, there are 42 certified conservation easement holders in Colorado. With the exception of one nonprofit organization that allowed its certification to expire, all other certified holders renewed their certifications for 2012.

## **Certification Process**

State statute [Section 12-61-720(1), C.R.S.] charges DRE with establishing and administering a certification program for organizations that accept tax-credit-generating conservation easement donations. DRE has the authority to (1) determine whether an applicant possesses the necessary qualifications for certification and (2) deny certification or the renewal of a certification if it determines that an applicant does not possess the applicable qualifications for certification or that the applicant has violated any provisions of statute or rules.

Governmental entities and nonprofit organizations applying for certification submit an organizational profile, which includes basic documents about the entity, proof of nonprofit status if the applicant is not a governmental organization, and a list of the conservation easements held by the organization. DRE staff perform a preliminary review of this information to determine whether the applicant generally appears to be eligible for certification. Once the applicant is determined to be generally eligible for certification, DRE staff conduct an in-depth review of a sample of three to five conservation easements held by the organization. Applicants provide DRE with additional documentation for the sampled conservation easements, including appraisal reports, internal checklists, monitoring dates and reports for the previous 3 years, and any known violations of the easements' terms and conditions. Applicants also submit more detailed information about the organization, such as stewardship and selection practices, conflict of interest policies, and other internal policies and procedures.

DRE staff review the application materials and assign one of four ratings—strong response, area for improvement, concern, or critical concern—to 25 different evaluation factors. Staff prepare an evaluation report and submit it to the CEOC and the DRE Division Director. The purpose of the staff evaluation report is to

inform the CEOC and the DRE Division Director about those areas in which the applicant may not be meeting the minimum qualifications. The CEOC reviews and discusses the staff evaluation report before making a recommendation to the DRE Division Director, who makes the final decision to grant or deny certification.

One of the objectives of our audit was to determine whether DRE's process for certifying conservation easement holders is sufficient to ensure that only qualified entities are certified to accept tax-credit-generating conservation easement donations. To address this objective, we reviewed the CEOC's recommendations and the DRE Division Director's certification decisions for all 46 organizations that had applied for certification as of March 2012. We compiled and analyzed DRE staff ratings from all 37 summary evaluation reports (evaluation reports were not completed for the six organizations that received an expedited review). Finally, we conducted a detailed file review of a nonstatistical judgmental sample of 25 certification applications and related documentation. We selected our sample items to provide representation of approved and denied applications, governmental entities and nonprofit organizations, different sized organizations, and organizations located in different areas of the state.

Overall, we found that DRE has an extensive and systematic process for reviewing and evaluating certification applications based on broad principles and best practices that are well established within the land trust community for effective conservation easement stewardship. DRE staff and CEOC members reported that the certification requirements have been effective at eliminating the systematic abuses of the tax credit that existed prior to 2008.

## Conditional Certification

DRE's certification process can generally be relied upon to provide positive assurance that the applicant has met all applicable requirements established in statute and rules. In particular, the process appears to be effective at indicating when applicants clearly meet or clearly do not meet the minimum qualifications for certification. However, some applicants fall into a gray area. Historically, DRE has taken one of two approaches to certification in these situations:

- **Certification with Concerns.** According to DRE's rating criteria, a "concern" rating means that DRE staff determined the organization may not be in compliance with a particular certification requirement (e.g., lack of a required policy or failure to implement or follow the policy). Of the 37 organizations DRE certified, we found that 14 received a "concern" rating on at least one of the 25 different evaluation factors. In these cases, DRE fully certified the organizations but required them to provide a detailed description of how each area of concern was addressed—

including all actions taken, by whom, and on what date—before DRE *renewed* the certification. All 11 organizations in our sample that were certified with a “concern” rating responded to the concerns with their subsequent renewal applications.

- **Conditional Certification.** For two applicants in 2010 and one applicant in 2011, DRE denied certification because the organizations had not met the minimum qualifications. For each of these three applicants, DRE staff assigned “concern” and “critical concern” ratings in several areas, and the CEOC also expressed concerns during its discussions that these three organizations were not meeting minimum requirements. These three organizations subsequently reapplied for certification and provided additional information to DRE demonstrating changes they had made, such as new policies and procedures and staff education and training efforts. However, instead of fully certifying these organizations, DRE granted a *conditional* certification and imposed additional requirements for the applicants to achieve full certification. One organization must provide detailed project documentation for the next four conservation easements it accepts, and the easements must be co-held with another certified organization of DRE’s choosing. The remaining two organizations must provide detailed project documentation for the next three conservation easements they accept. DRE reported that each of the applicants had policies and procedures that met the minimum qualifications for certification. However, DRE also wanted more assurance that the organizations would be complying with these policies and procedures for new easements.

When a conservation easement holder is certified, DRE is providing positive assurance that the holder has met all applicable requirements established in statute and rules. Although the staff-assigned ratings do not necessarily dictate the final certification decision, on its face it is problematic when DRE fully certifies organizations when the staff-assigned “concern” ratings indicate that minimum requirements may not have been met. DRE is also exposed to criticism that not all applicants are being held to the same certification standards.

The use of conditional certification provides DRE with a more straightforward and effective means of certifying organizations when the minimum requirements may not have been met. In particular, conditional certification is easily distinguished from full certification and clearly indicates there are additional requirements that must be satisfied before the applicant can achieve full certification. However, DRE has not formally established “conditional certification” in rule. Consequently, DRE lacks sufficient authority to set additional requirements on applicants as a condition for certification. Additionally, without establishing conditional certification in rule, it is not



transparent to organizations applying for certification or other agencies, such as DOR, what conditional certification means or those situations or circumstances in which conditional certification is appropriate.

Reviewing an organization's capacity to hold conservation easements is complicated and nuanced. Conditional certification reasonably allows organizations to be certified to accept tax-credit-generating conservation easements while putting additional requirements in place to address those areas where the State needs additional assurance. DRE already uses conditional or probationary licensure in other areas of its regulatory responsibilities (e.g., real estate brokers).

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## **Recommendation No. 8:**

The Division of Real Estate (DRE) should strengthen the conservation easement holder certification process by formally establishing "conditional certification" in state rule. This should include specifying the appropriate purpose and use of conditional certification, what evaluation criteria would result in conditional certification versus full certification or denial of certification, and any other administrative requirements that are necessary to implement conditional certification.

### **Division of Real Estate Response:**

Agree. Implementation date: March 2013.

Conditional certification is a useful tool that DRE will work towards formalizing through rule. It provides an additional safeguard ensuring that organizations continue to meet the minimum requirements for certification. DRE will specify criteria used to determine which organizations qualify for conditional certification and any additional requirements they must adhere to. The formalized rule will allow DRE to apply requirements consistently but maintain the flexibility necessary to address the specific concerns identified. Staff drafted a conditional certification rule prior to the initiation of the audit with the intention of formalizing conditional certification. DRE will move forward with adoption of a conditional certification rule in the first quarter of 2013.

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## Ensuring Long-Term Value and Benefits

According to state statute [Section 39-22-522(2), C.R.S.], the conservation easement tax credit is only allowed for donations that meet the requirements for a qualified conservation contribution under federal laws and regulations. One such requirement is that the donated conservation easement must be perpetual in nature, which is important for protecting and preserving the conservation easement's value and benefit over the long term.

The requirement that conservation easements be perpetual in nature places certain responsibilities on the landowner and the conservation easement holder. Current and future landowners have a responsibility to manage and maintain the property in accordance with the easement's terms and conditions. Conservation easement holders have a responsibility to ensure that landowners abide by the easement's terms and conditions.

State statute [Section 12-61-720(8), C.R.S.] also requires governmental entities and nonprofit organizations accepting conservation easement donations for which tax credits will be claimed to be a certified conservation easement holder at the time of the donation. This certification requirement is intended, in part, to ensure that the governmental entities and nonprofit organizations have strong conservation easement stewardship practices and the capacity (e.g., financial and nonfinancial resources) to maintain, monitor, and defend the purposes of the easements in perpetuity. Thus, the certification requirement is important for protecting the "investment" of public funds in tax-credit-generating conservation easements.

We reviewed the conservation easement holder certification requirements and process and identified two concerns contributing to a lack of assurance that conservation easements will continue to be protected over the long term should the holder no longer be able to meet its responsibilities or remain certified. As discussed in the following sections, we found that (1) DRE's current certification renewal process is insufficient to ensure that conservation easement holders continue to meet certification requirements and (2) the State lacks adequate protections when governmental entities and nonprofit organizations holding tax-credit-generating conservation easements are no longer certified.

## Certification Renewal

Governmental entities and nonprofit organizations that wish to continue to accept new conservation easements for which tax credits will be claimed must renew their certification annually. In accordance with state rules (4 C.C.R., 725-4, A-2), certification expires on December 31 following the date of issuance. Certified

holders submit a renewal application to DRE, including a list of any new conservation easements accepted during the previous year, and pay a renewal application fee of \$740. As mentioned previously, all but one of the 43 originally certified holders renewed their certifications for 2012.

We reviewed all renewal applications for the 22 certified conservation easement holders in our sample that had applied for recertification as of April 2012. Because of the timing when DRE implemented the certification process, the nonprofit organizations in our sample generally had renewals for 2011 and 2012, and the governmental entities in our sample had renewals for 2012. Overall, we found that the current renewal process is not adequate to ensure that governmental entities and nonprofit organizations that hold tax-credit-generating conservation easements continue to meet the certification requirements. Specifically, DRE does not perform any review of documentation for new conservation easement donations the holder has accepted since being certified.

DRE's lack of a documentation review was of particular concern for those circumstances in which DRE's initial certification review only encompassed conservation easement holders' policies and procedures. State rules require that conservation easement holders must have *and follow* reasonable policies and procedures to ensure compliance with the different certification requirements. However, for 11 of the 22 applicants in our sample with a completed application, the applicants had policies and procedures at the time of initial certification that met the certification requirements, yet the applicants could not demonstrate to DRE that these policies and procedures were being followed. For example, state rules require conservation easement holders to have and follow policies and procedures to receive and review a copy of the appraisal that is used to determine the fair market value of each property. One applicant in our sample had a policy governing the receipt and review of documentation, including the appraisal, supporting each donation. However, the organization was unable to demonstrate its compliance with this policy to DRE at the time of certification. DRE certified this applicant for 2010 but did not verify that the organization had followed its policy for newly accepted conservation easements when the organization renewed its certification for 2011 and 2012. This organization accepted three new tax-credit-generating conservation easements in 2010 (the year leading up to its 2011 renewal) and four new tax-credit-generating conservation easements in 2011 (the year leading up to its 2012 renewal). Without a more in-depth review of documentation for new conservation easements as part of the certification renewal process, DRE is unable to verify that organizations such as the one on our example are actually following their policies and procedures, as required by state rules.

DRE's annual certification renewal process does not provide meaningful monitoring of conservation easement holders on an ongoing basis. Thus, the renewal process is little more than a mechanism to obtain an updated list of

conservation easements and collect a fee. During our interviews with CEOC members, four members specifically stated that there should be a more stringent renewal process or other periodic review by DRE to ensure that conservation easement holders are maintaining the level of diligence that they were required to display at the time of their initial certification. To minimize the burden that a more in-depth review would have on DRE staff and conservation easement holders, DRE could stagger and cycle the reviews such that each certified conservation easement holder undergoes such a review at least once every two or three years. Alternatively, DRE could take more of a risk-based approach and target its reviews to more problematic conservation easement holders with some holders still being randomly selected to ensure coverage. Consistent with its approach to the initial certification review, DRE could select the specific conservation easement projects for review on a sample basis.

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### **Recommendation No. 9:**

The Division of Real Estate (DRE) should strengthen the certification process to ensure that conservation easement holders continue to meet the certification requirements on an ongoing basis. At a minimum, DRE should periodically conduct an in-depth review of documentation for conservation easements that holders have accepted since their initial certification or most recent certification renewal.

### **Division of Real Estate Response:**

Agree. Implementation date: January 2013 and Ongoing.

DRE staff will implement a schedule for reviewing conservation easement project documentation as a requirement of certification. The process will ensure projects from all certified conservation easement holders are reviewed on a periodic basis. DRE will identify risk factors that will trigger automatic project reviews as well as conduct random reviews. Staff review of project documentation will be similar to that conducted during the initial certification process. Project documentation reviews will occur throughout the year.

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## **Statutory and Regulatory Framework**

Conservation easement holders that accept tax-credit-generating conservation easement donations must be certified by DRE at the time of the donation. However, as discussed in this section, the statutory and regulatory framework for Colorado's conservation easement tax credit does not adequately protect the State

in those situations and circumstances in which governmental entities and nonprofit organizations holding tax-credit-generating conservation easements are no longer certified.

The certification requirement places a number of requirements on conservation easement holders at the time of the donation. However, once the donation has been made, the certification requirement technically no longer applies. Conservation easement holders may choose not to renew their certification. DRE may also suspend or revoke certification for cause (e.g., the holder no longer meets the minimum requirements for certification), although this has not happened since the certification requirement was put in place in 2008. When a conservation easement holder is no longer certified, current laws and rules would prevent the organization from accepting any *new* conservation easement donations for which tax credits will be claimed. However, the holders are allowed to continue to hold *existing* easements for which tax credits have already been claimed.

We are concerned that allowing uncertified holders to hold easements for which tax credits have already been claimed undermines the purpose of the certification requirement and potentially places the State's investment of public resources in existing easements at risk. First, when a conservation easement holder is no longer certified, the State effectively loses its ability to ensure the holder's ability to maintain, monitor, and defend the purposes of the tax-credit-generating conservation easements in perpetuity. Specifically:

- Notwithstanding efforts to strengthen the certification renewal process (see Recommendation No. 9), unless a conservation easement holder remains certified, DRE has no authority to continue to oversee the organization. For example, DRE would be unable to obtain and review documentation from the holder to ensure that the holder monitors tax-credit-generating conservation easements on at least an annual basis and that any potential violations of the easement's terms and conditions are followed up on and resolved in a timely manner. One nonprofit organization did not renew its certification for 2012. This organization did not hold any tax-credit-generating conservation easements; however, it is highly likely that, as time progresses, other governmental entities and nonprofit organizations holding tax-credit-generating conservation easements will not renew their certifications. Since tax credits can be carried forward for up to 20 years, it is possible that, in some cases, credits could be used for many years after the conservation easement holder is no longer certified. Additionally, because easements are to be maintained in perpetuity, it is possible that the State will be relying on noncertified holders to maintain easements that were supported by tax credits.

- State statute [Section 12-61-720(11), C.R.S.] only grants DRE the authority to investigate complaints or take disciplinary action against governmental entities and nonprofit organizations that are required to be certified. Thus, if the conservation easement holder is no longer certified, DRE no longer has the authority to investigate complaints against the holder, even if it continues to hold tax-credit-generating conservation easements. As of August 2012, DRE had received five complaints about conservation easement holders but did not have the jurisdiction to investigate four of these complaints because the conservation easement holders were not certified. We confirmed that two of these four conservation easement holders held tax-credit-generating easements that were donated in Tax Years 2000 through 2006 and 2001 through 2008, respectively, prior to the certification requirement taking effect. DRE's lack of authority to investigate complaints against uncertified conservation easement holders that continue to hold tax-credit-generating easements is a large gap in the State's ability to identify when the holders are no longer providing appropriate stewardship of their easements for the public's long-term benefit.

Second, the State currently does not have the ability to require an uncertified conservation easement holder to transfer tax-credit-generating conservation easements to a certified holder. Assignment clauses outline the terms of reassignment or transfer of a conservation easement to another qualified organization and are included in deeds of conservation easement to provide a backup or contingency in the event that the governmental entity or nonprofit organization holding the easement is dissolved or is unable to meet its ongoing stewardship responsibilities. For example, the Great Outdoors Colorado Trust Fund (GOCO) helps governmental entities and nonprofit organizations fund the acquisition of conservation easements throughout Colorado. To protect its investment of funds, GOCO requires that an assignment clause be included in the deed of conservation easement. Specifically, the assignment clause reserves GOCO's right to require transfer of the easement to a different organization if the original conservation easement holder (1) ceases to exist; (2) is unwilling, unable, or unqualified to enforce the terms and provisions of the easement; or (3) is unwilling or unable to effectively monitor the property for compliance with the easement on at least an annual basis. GOCO has never had to use this provision, but it provides strong protections for GOCO and a means of ensuring the long-term value and benefit of the conservation easements that GOCO helps to fund.

Conservation easement holders may include an assignment clause in their deeds of conservation easement as a matter of their own organizations' policies or based on established best practices in the land trust community. However, currently, state statute and rules governing the conservation easement tax credit do not require that assignment clauses be included in deeds of conservation easement.

Moreover, there is no requirement that assignment clauses, when used, reserve the State's right to require that tax-credit-generating conservation easements be transferred to another certified holder when the original holder is no longer certified. When a tax credit is claimed on a donated conservation easement, the State, by virtue of foregoing tax revenue, in essence becomes a funding agency for the acquisition. Thus, we believe that DOR and DRE should consider adopting GOCO's approach.

The statutory and regulatory environment surrounding conservation easements is complex. In addition to the issues we identified related to uncertified conservation easement holders, staff at the Office of the Attorney General reported that efforts by some landowners and conservation easement holders (even those that are certified) to subsequently amend or dissolve conservation easements pose additional risks. It is a challenge to provide the assurances necessary to protect the public interest in what is essentially a private transaction between the landowner and the organization acquiring the easement. Nonetheless, given the significant investment of public resources in conservation easements through tax credits, we believe it is prudent that the State identify and pursue solutions that help ensure the easements' value and benefit over the long term.

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### **Recommendation No. 10:**

The Division of Real Estate (DRE) and the Department of Revenue (DOR) should evaluate options for protecting the State's investment of public resources in tax-credit-generating conservation easements when the conservation easement holder is no longer certified. DRE and DOR should report back to the Legislative Audit Committee and the House and Senate Finance Committees by July 1, 2013, on viable options and pursue statutory and/or regulatory change, as appropriate.

At a minimum, options that should be considered include:

- a. Strengthening DRE's ability to investigate complaints against conservation easement holders that hold tax-credit-generating conservation easements, regardless of whether or not the holder is certified.
- b. Utilizing assignment clauses in the deeds for tax-credit-generating conservation easements that reserve the State's right to require the transfer of the easement to another certified conservation easement holder when the original holder ceases to exist; is no longer certified; or is unwilling, unable, or unqualified to enforce the terms and provisions of the easement.

## **Division of Real Estate Response:**

- a. Agree. Implementation date: July 2013.

DRE will explore options allowing for the investigation and enforcement of regulatory or statutory requirements for non-certified conservation easement holders. Regulatory programs do not typically have jurisdiction over entities that are not required to be certified or licensed. Creating a framework allowing DRE to investigate and enforce regulations for non-certified conservation easement holders will require statutory changes providing the required jurisdiction and resources. DRE will explore statutory and regulatory options and report back to the General Assembly as requested.

- b. Agree. Implementation date: July 2013.

DRE has met with staff at the Great Outdoors Colorado" (GOCO)" to discuss the assignment clause required for conservation easements utilizing GOCO funds. DRE staff will continue to investigate appropriate conservation easement language and other options to ensure conservation easements are appropriately managed and enforced in perpetuity. DRE will work with DOR to identify practical options for reserving the State's right to require the transfer of tax credit generating easements to another holder. DRE is committed to ensuring the long-term management of conservation easements involving the state tax credit and will work to identify and report back to the General Assembly on a viable process that further protects the State's investment of public resources in tax-credit-generating conservation easements.

## **Department of Revenue Response:**

- a. Agree. Implementation date: July 2013.

DOR will meet with DRE to discuss options for strengthening DRE's ability to investigate complaints against conservation easement holders and, in conjunction with DRE, will report back to the General Assembly.

- b. Agree. Implementation date: July 2013.

DOR will meet with DRE to discuss options for addressing the issues related to conservation easement holders' failures or refusals to



enforce the terms and provisions of a conservation easement and, in conjunction with DRE, will report back to the General Assembly.

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## Pre-Approval of Tax Credit Claims

Taxpayers claiming the conservation easement tax credit often receive substantial reductions in their income tax obligations, and the State foregoes a significant amount of general fund revenues in return for assurances that lands will be conserved and protected in perpetuity. Given the tax credit's significant financial impact on the State's revenues (i.e., \$639 million foregone through 2009), it is important that the State have the appropriate mechanisms in place to ensure that conservation easement tax credits are supported by qualified conservation easement transactions. Throughout this chapter, we have made a number of recommendations to ensure that conservation easement tax credits being claimed by taxpayers comply with applicable statutory and regulatory requirements and are supported by land donations that have valid conservation purposes, are properly valued, and are donated to organizations that have the capacity to maintain, monitor, and defend the purposes of the easements in perpetuity.

Colorado's conservation easement tax credit is administered through a series of interrelated processes performed by DOR, DRE, and the CEOC, many of which were established through the enactment of House Bill 08-1353. Improving each of these individual processes will strengthen the State's administration of the conservation easement tax credit. However, as discussed in this final section of the chapter, we also believe that the State should fundamentally shift the manner in which the conservation easement tax credit is administered by adopting a pre-approval process.

## Audit-Based Approach for Reviewing Tax Credit Claims

Currently, DOR's review of conservation easement tax credit claims occurs only *after* taxpayers (donors or transferees) file a tax return that uses the credit to offset their tax liabilities. Use of the tax credit is allowed unless a subsequent review or audit of the taxpayer's tax return and supporting documentation disallows the credit. This is often referred to as an "audit-based" approach because there is no prior approval by the State of the tax credit claim. The State's review occurs entirely after the fact.

In many ways, an audit-based approach to the conservation easement tax credit is advantageous for the State because it relies on tax administration infrastructure and processes that already exist within DOR. However, based on our audit work,

including interviews with management and staff at DOR and DRE and the members of the CEOC, we identified two key disadvantages to this type of approach to administering the conservation easement tax credit.

- **Uncertainty for the Taxpayer.** One disadvantage of Colorado’s audit-based approach is that DOR does not technically “approve” conservation easement tax credit claims. Rather, credit claims are not disallowed. This lack of a positive approval of the tax credit creates uncertainty for donors and transferees attempting to use the credit because DOR could disallow the credit after the tax return is filed. The timing of DOR’s review adds to the overall uncertainty taxpayers experience. As discussed earlier in this chapter, DOR does not review a conservation easement tax credit claim until the credit is used to offset a tax liability. Thus, a taxpayer filing a credit claim in 2010 may not find out there are problems with the claim until 2012. During our interviews, several CEOC members reported that landowners and the conservation easement holders are often caught off guard when the tax credit claim for a conservation easement donation is disallowed several years after the donation took place. Moreover, in the meantime, landowners may have sold the credit to a transferee, which results in additional tax returns that are called into question if the credit is disallowed.

Donors make significant financial decisions when entering into a conservation easement agreement. These decisions may be based, in part, on the expected availability of the tax credit. Donors are giving up valuable development rights on their land in exchange for the ability to offset up to \$375,000 in tax liabilities over 20 years, or for income from the sale of the tax credit to transferees. Similarly, when buying credits, transferees are expecting to gain a financial benefit by using the credit to offset their tax liabilities. However, it is important to note that (1) these financial benefits are only gained if the tax credit is allowed and (2) the disallowance of a tax credit does not have any impact on the easement agreement itself. Therefore, when a credit is subsequently disallowed, landowners are faced with the situation in which the conservation easement and its restrictions remain in place, yet the expected financial benefits no longer exist. As a result, it is possible that the State could be losing the benefit of legitimate conservation easement donations because landowners are unwilling to enter into a complex financial transaction for fear that their tax credit claim could be disallowed at some future date.

- **Decision Making Authority Is Not Well Aligned with Areas of Expertise.** A second disadvantage of Colorado’s audit-based approach is that although the decision-making authority to allow or disallow conservation easement tax credit claims rests with DOR, the expertise

necessary to review certain aspects of conservation easement tax credit claims currently rests outside DOR. Both DRE and the CEOC operate in an advisory position to DOR regarding conservation easement tax credit claims. For example, DRE has a fully licensed appraiser on staff who conducts desk reviews of conservation easement appraisals and reviews appraisals referred by DOR; however, DRE does not make the determination that appraisals supporting conservation easement tax credits comply with the minimum requirements for a qualified appraisal completed by a qualified appraiser. Similarly, the CEOC members collectively possess sufficient expertise to assess and evaluate an easement's conservation purpose; however, the CEOC does not make the determination that the conservation purpose complies with the statutorily allowable purposes for claiming a tax credit.

We question whether the current process provides for the most efficient and effective decision making. DOR's tax examiners are skilled and trained in the application of tax laws and regulations when reviewing conservation easement tax credit claims. However, they are not licensed appraisers nor do they currently assess or evaluate some of the more substantive aspects of conservation easement transactions, such as conservation purposes and the easements' terms and conditions to ensure that these purposes will be safeguarded (e.g., no inconsistent land uses are allowed). As discussed earlier in this chapter (see Recommendation Nos. 1 and 7), conservation purpose and appraisals are two areas in which the State needs better review coverage to ensure taxpayers' compliance with minimum requirements.

## **Adopting a Pre-Approval Process**

The primary alternative to an audit-based approach that some other states use involves the certification or pre-approval of conservation easement tax credit claims. Under this approach, states have processes to certify or approve conservation easement tax credit claims *before* the taxpayers are allowed to file a tax return using the credits. For example, although the specific requirements vary for each state, of the 14 other states that offer tax credits for conservation easement donations, we identified 10 states that have application and approval processes that must occur before a taxpayer can use the credit in a tax return filing. These states include Arkansas, California, Delaware, Georgia, Maryland, Massachusetts, Mississippi, New Mexico, North Carolina, and Virginia.

We believe that adopting a pre-approval process would provide the State with stronger assurances that conservation easement tax credits are supported by qualified transactions while also yielding increased efficiencies and more certainty for the taxpayers when claiming and using the tax credits. Adopting a

pre-approval process will require statutory change as well as a realignment of resources. Therefore, DOR, DRE, and the CEOC will need to work with the General Assembly and affected stakeholders to consider a number of factors, as discussed in the following section.

### **Goals for the Pre-Approval Process**

One clear advantage of a pre-approval process is that the State would issue an approval or denial of the tax credit claim before a donor or transferee files a tax return to use the associated credit. Having a positive approval (as opposed to the lack of a disallowance under the current process) provides more certainty to donors about the validity of their tax credits. Additionally, the State would have stronger assurances that conservation easement tax credit claims are valid before they are used because the State's approval would be based on a review of all conservation easement tax credit claims for compliance with all minimum requirements, including easements' conservation purposes. Ultimately, the State's goals for the pre-approval process will dictate the scope of the review of conservation easement tax credit claims. For example:

- If the goal of the pre-approval process is to identify and reject clearly abusive transactions (e.g., those that lack any real conservation values, have overinflated appraised values, or have unqualified entities accepting the donation), the State could adopt a more limited review of taxpayer documentation.
- If the goal of the pre-approval process is to ensure that only the highest-quality transactions qualify for the tax credit, the State's review would have to be much more thorough. For example, for each claim, the State might need to conduct a detailed examination of (1) the deed of conservation easement and the baseline report (i.e., documentation of the present condition of the property) to ensure that conservation purposes are sound and (2) the appraisal to ensure that the fair market value of the donation is determined based on a solid appraisal methodology in accordance with professional standards.

The solution likely rests between these two ends of the spectrum. Ideally, the pre-approval process would provide a more detailed review of conservation easement donations and taxpayers' compliance with minimum requirements than what currently exists without the process being too onerous for the taxpayer or requiring extensive review time frames to complete.

## Decision Making

House Bill 08-1353 took an important step forward by including more perspectives and expertise into the process for evaluating conservation easement tax credit claims. However, these perspectives and expertise are generally only advisory. One advantage to a pre-approval process is that it could allow the State to assign decision-making responsibilities for approving the different components of conservation easement tax credit claims to those with the appropriate expertise. For example:

- DRE could have the responsibility for determining whether appraisals supporting conservation easement tax credits comply with the minimum requirements for a qualified appraisal completed by a qualified appraiser. This responsibility could include determining whether the appraisals have methodological issues that could affect the valuation of the land being donated. House Bill 08-1353 started to move in this direction by at least requiring that all conservation easement appraisals be submitted to DRE.
- The CEOC could have the responsibility for assessing and evaluating the quality of conservation easement transactions, including determining whether easements associated with tax credit claims are for qualified conservation purposes and whether the easements' terms and conditions sufficiently protect these conservation purposes. The makeup of the CEOC could also be adjusted as necessary. If DRE is responsible for reviewing appraisals, we are uncertain whether there would be a need for a licensed appraiser on the CEOC. Also, the CEOC does not presently include an individual with expertise in tax matters; having someone with this expertise could be beneficial when determining whether conservation purposes associated with tax-credit-generating easements comply with the tax code.
- DRE, with input from the CEOC would retain responsibility for certifying conservation easement holders. DOR already relies on the certification process established in accordance with House Bill 08-1353 to ensure that conservation easement holders have the capacity to maintain, monitor, and defend the purposes of tax-credit-generating easements.
- DOR would retain responsibility for ensuring compliance with all other tax-related statutory and regulatory requirements for claiming and using the tax credit, such as ensuring that the donation occurred before the end of the donor's tax year, all forms and documents required to substantiate the credit claim have been submitted, and the donor has not claimed or used more than one conservation easement tax credit for the same tax year. DOR would also retain responsibility for reviewing uses of approved

credits on filed tax returns, such as ensuring that the taxpayer has a tax liability to offset, the total amount of the credit used by donors and transferees does not exceed the total credit amount allowed, and the amount being used does not exceed any carry-forward amounts.

Because this is a tax credit, as the State's tax agency, DOR should still retain the final sign-off on conservation easement tax credits under a pre-approval process. Substantively, however, DOR could rely on the decisions and approvals provided by DRE and the CEOC regarding conservation easement appraisals, conservation purposes, and the certification of conservation easement holders. Additionally, because decision making would be shared among several agencies, avenues for appealing decisions made during the pre-approval process should be clearly established and communicated to the taxpayer. Finally, it may also be important for taxpayers to understand that the pre-approval process would not limit the State's ability to audit the transaction at a later date if the taxpayer is selected for audit through DOR's routine audit processes for individual and corporate taxpayers.

## **Timeliness**

One common criticism of pre-approval processes is that they often add to the length of time for claiming tax credits. For example, many conservation easement transactions are supported by complex and sophisticated appraisals, and an in-depth review of such appraisal documentation would require time to complete. In adopting a pre-approval process, the State will need to determine how best to maintain a timely decision-making process. For example, Georgia tries to achieve a 90-day turnaround from the time donors file a tax credit claim to the time the claim is approved or denied. However, to make this work, Georgia requires donors to provide all documentation by October so that decisions can be made in time for donors or transferees to use the tax credits when filing their tax returns in April of the following year.

Adopting a pre-approval process comes with its own challenges, and we do not presume that it will, by itself, correct all of the existing problems with the State's administration of the conservation easement tax credit. However, in conjunction with the improvements recommended throughout the rest of this report, pre-approval should provide for a more effective and efficient administrative process that provides more certainty for donors and transferees while maintaining the necessary protections for the State. We recognize that DOR, DRE, and the CEOC may need to adjust their implementation of the other recommendations contained in this report if the State adopts a pre-approval process.

**Recommendation No. 11:**

The Department of Revenue (DOR), the Division of Real Estate (DRE), and the Conservation Easement Oversight Commission (CEOC) should work together to design a pre-approval process for reviewing and approving conservation easement tax credit claims. These agencies should report to the Legislative Audit Committee and the House and Senate Finance Committees by July 1, 2013, on a proposed pre-approval process, including any statutory and regulatory changes that are necessary for implementation.

At a minimum, the proposed pre-approval process should ensure that:

- a. The State has reasonable assurances that conservation easement tax credits being claimed by taxpayers are valid and comply with all statutory and regulatory requirements.
- b. Conservation easement tax credit claims are approved or denied separately from and prior to any uses of the tax credit. Avenues for appealing decisions made during the pre-approval process should be clearly established and communicated to the taxpayer.
- c. All essential elements related to conservation easement tax credit claims are reviewed and approved by those with the most appropriate and relevant expertise.
- d. The review and approval of tax credit claims is timely.

**Department of Revenue Response:**

Agree. Implementation date: July 2013.

DOR will meet with DRE and the CEOC to discuss and provide options for designing a pre-approval process for reviewing and approving conservation tax credits and report back to the General Assembly. The discussion will include the issues raised in the State Auditor's report and in Recommendation No. 10 subparts (a) through (d).

## **Division of Real Estate Response:**

Agree. Implementation date: July 2013.

DRE will work with DOR and the CEOC to explore processes by which the State would approve conservation easement tax credit claims prior to the tax credit being used. There are likely many viable options for implementing an approval process that meets the minimum requirements of this recommendation. DRE will work to ensure proposals are aligned with the expertise of DRE, DOR, and the CEOC. A report outlining the identified options for a pre-approval process will be provided to General Assembly as requested.

## **Conservation Easement Oversight Commission Response:**

Agree. Implementation date: July 2013.

The CEOC is committed to working with DRE and DOR to develop a process that provides certainty to landowners who do qualified transactions with licensed appraisers and certified conservation easement holders, and which provides reasonable assurances to the State that the credits claimed comply with statutory and regulatory requirements. It is the consensus of the CEOC's members that, while HB 08-1353 eliminated the occurrence of fraudulent tax credit claims and unqualified easement holders, the current process fails to provide a clear path for legitimate conservation easement tax credit claims to move forward. It is the CEOC's opinion that, as stated in the audit, the review and decision-making processes should be reassigned to those agencies with appropriate expertise. The CEOC members believe it is necessary for all parties to fully participate in the design of a process that accomplishes these goals and that the process must provide for a binding decision-making process not subject to administrative discretion.

### ***Auditor's Addendum***

*Some of the specific items expressed in the CEOC's response, such as reassigning review and decision-making responsibilities and the extent to which such decisions are binding, should be considered and evaluated in collaboration with DOR and DRE as part of the implementation of this recommendation.*

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# Effectiveness of the Conservation Easement Tax Credit

## Chapter 3

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Colorado uses tax policy as a means of incentivizing land conservation. As recently as the 2011 Legislative Session, the General Assembly has affirmed its policy commitment to the conservation easement tax credit. Specifically, the legislative declaration to House Bill 11-1300 made the following statements:

- Colorado’s conservation easement tax credit is an important preservation tool used to balance economic needs with natural resources, such as land and water preservation.
- Colorado’s conservation easement tax credit and the federal tax deduction have allowed many farmers and ranchers the opportunity to donate their development rights to preserve a legacy of open spaces in Colorado for wildlife, agriculture, and ranching.
- Citizens throughout Colorado believe good, sound conservation practices are important to Colorado’s quality of life, agriculture, and wildlife heritage.

One of the objectives of our audit was to assess the conservation easement tax credit’s overall effectiveness. To address this question, we gathered and analyzed information on general trends in conservation easements in Colorado, compared and contrasted Colorado’s conservation easement tax credit with similar programs in other states, reviewed various reports and research on conservation easement tax credits more generally, and interviewed DOR and DRE management and staff and members of the CEOC.

There are no statewide land conservation or conservation-easement-specific plans against which we could measure the effectiveness of Colorado’s conservation easement tax credit program. Therefore, in this chapter, we have developed three different measures of effectiveness as a way to frame the discussion about the tax credit. Based on our first measure, the tax credit appears to be effective as a general incentive for protecting land and spurring conservation activity. Based on our second measure, the tax credit appears to be effective at reducing the average tax liability of those taxpayers claiming the credit. However, when we consider our third measure—an assessment of costs and benefits—we are left in a more

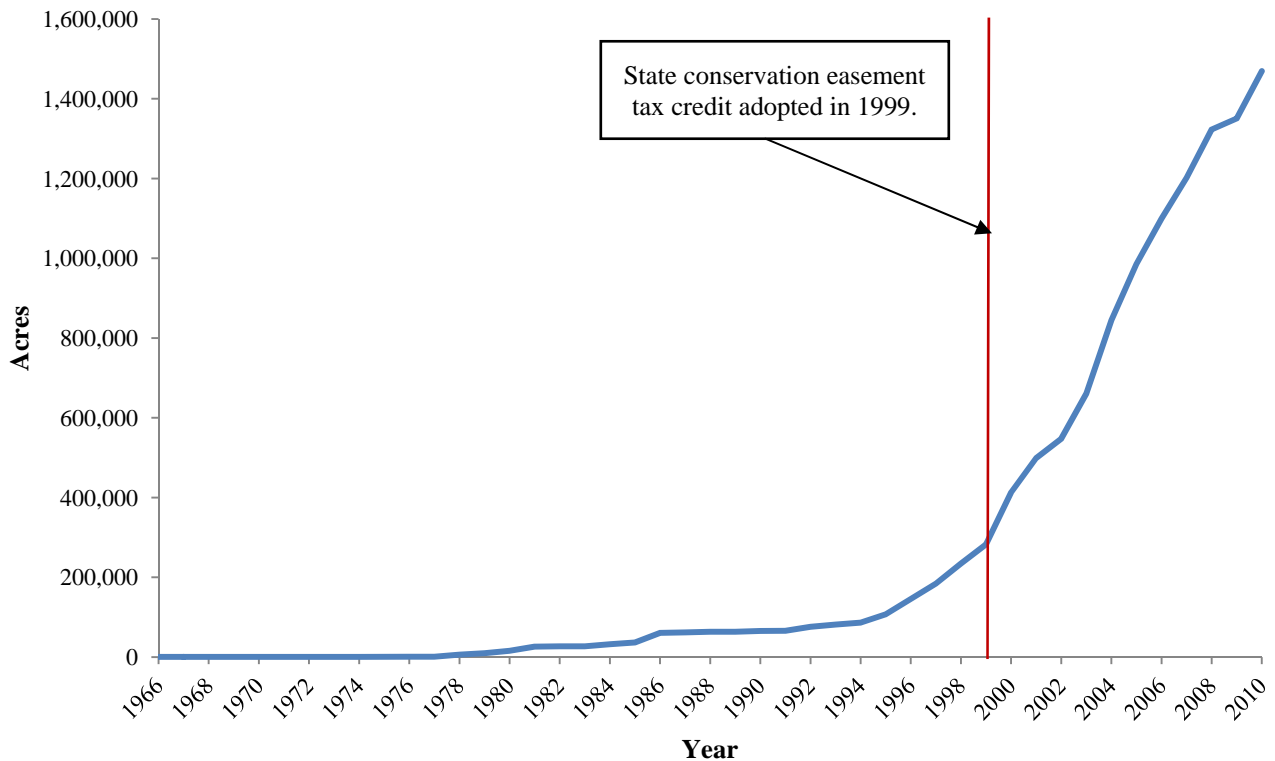
tenuous position as to the tax credit's effectiveness because the costs are generally easily quantified, but quantifying the benefits is more elusive.

## **Effectiveness Measure 1: The Conservation Easement Tax Credit Appears to Encourage Additional Land Protection**

One measure of the conservation easement tax credit's effectiveness is whether it results in more acres of land being protected through conservation easements. Through our interviews with various agencies and stakeholders, we learned that the most comprehensive source of data on protected lands in Colorado is the Colorado Ownership, Management, and Protection (COMaP) project at Colorado State University. The COMaP database is a standardized geographic information systems database and set of core attributes based on primary data obtained from a number of federal, state, and local government agencies, as well as nonprofit land trusts and other nongovernmental organizations.

We worked with COMaP project staff to obtain and understand general trend data on conservation easements in Colorado. The following chart shows the cumulative conservation easement acreage by year for calendar years 1966 through 2010.

### Cumulative Conservation Easement Acreage In Colorado Calendar Years 1966-2010



**Source:** Colorado Ownership, Management, and Protection (COMaP) v9 Database, Colorado State University, Fort Collins, CO (September 2011).

**Note:** COMaP includes an additional 125,000 acres of conservation easements with unknown dates of establishment that are not reflected in this chart.

Overall, it appears that the tax credit has been effective at encouraging conservation activity in Colorado. Specifically, the total acres of land protected through conservation easements increased by about 430 percent since the tax credit was made available. In 1999, land trusts and governmental agencies reported holding conservation easements on about 283,000 acres of land in Colorado. By 2010 the total acreage of reported conservation easements jumped to about 1.5 million acres. (These figures do not include the 125,000 acres of conservation easements for which the date of establishment is unknown, as noted in the previous chart.) We cannot conclusively state that these lands would not have been preserved had the tax credit not been available, nor can we attribute all of this increase solely to the existence of the tax credit. Nonetheless, the data show a compelling trend. Similar analyses performed by audit and evaluation offices in Montana and Virginia show upward trends in the number of acres under

conservation easement subsequent to those states' adoption of a conservation easement tax credit.

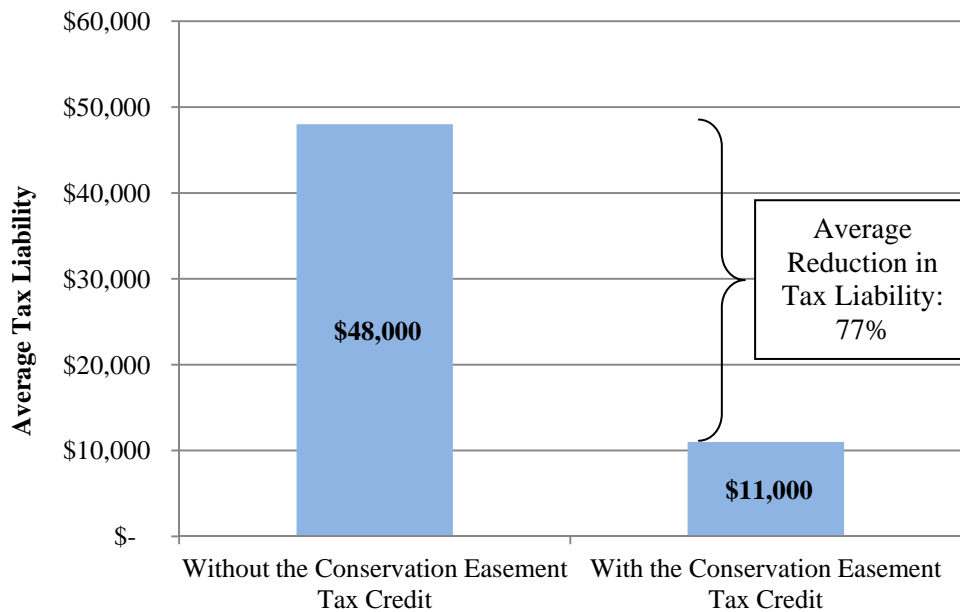
## **Effectiveness Measure 2: The Conservation Easement Tax Credit Allows Taxpayers to Reduce Their Tax Burden**

The conservation easement tax credit seeks to incentivize land conservation efforts by allowing taxpayers to reduce their tax burden. Therefore, a second way to measure the effectiveness of the tax credit is from the perspective of taxpayers using the credit, including both easement donors and transferees who purchase tax credits on the secondary market. That is, the tax credit is effective if taxpayers are actually taking advantage of it to reduce their taxes.

We analyzed tax return data from DOR's GenTax system for all 910 taxpayers (donors and transferees) that used the tax credit to offset a tax liability in Tax Year 2010. Overall, we found that these 910 taxpayers lowered their tax burden by a total of about \$33.3 million through the conservation easement tax credit. The following chart represents the difference in the average tax liability before and after applying the conservation easement tax credit for these 910 taxpayers. Our analysis shows that in Tax Year 2010, the tax credit lowered the average state income tax liability for those taxpayers who used the credit from about \$48,000 to about \$11,000 (77 percent reduction), resulting in an average tax savings of about \$37,000.

### Average State Income Tax Liability Among Taxpayers Who Used the Conservation Easement Tax Credit

*Tax Year 2010*



**Source:** Office of the State Auditor's analysis of Department of Revenue data.

Overall, our analysis demonstrates that the conservation easement tax credit provides donors and transferees with a substantial financial benefit. However, we are limited in our ability to further evaluate the average tax savings represented in the chart above. Although the data show that the tax credit is working to reduce tax liabilities for those taxpayers who are able to use it, determining whether this average percentage reduction in tax liabilities should be higher or lower is a policy matter that is beyond the scope of our audit. It is also important to note that the average percentage reduction in tax liability could fluctuate over time as a result of various factors, such as the number and value of conservation easements being donated and changes in the demand for tax credits among potential transferees in the secondary market.

## **Effectiveness Measure 3: It Is Unclear Whether the Conservation Easement Tax Credit Protects Conservation Values at a Reasonable Cost**

The State is foregoing a significant amount of annual tax revenues to incentivize land conservation. Therefore, a final measure of the conservation easement tax credit's effectiveness would be to determine whether its public benefits outweigh its costs.

### **Quantifying Costs**

Unlike other state programs and services where cost is typically measured in terms of expenditures, the public cost of the conservation easement tax credit is an opportunity cost—the revenues the State would have otherwise collected and used to fund state programs and services.

According to data from DOR, as of Tax Year 2009, landowners had claimed about \$639 million worth of tax credits for donated conservation easements since the credit was first made available for Tax Years beginning on or after January 1, 2000. This total includes credit amounts used by landowners or transferees, as well as credit balances that may be used in future tax years (e.g., carry-forward amounts). The actual final cost to the State for these credits may be less, however, since some claims have been denied by DOR and are in various stages of dispute resolution. It is also possible that some donors will not use or transfer the full value of their credit before the 20-year carry-forward period expires.

As of the conclusion of our audit work, DOR had not finished processing new conservation easement tax credit claims that occurred in Tax Year 2010; therefore, data on the “costs” added in 2010 were not available. For tax years beginning in calendar years 2011 through 2013, the General Assembly limited the total dollar amount available for new conservation easement tax credits to \$78 million. As of August 17, 2012, DRE had issued tax certificates for about \$44 million (56 percent) of the \$78 million available.

### **Quantifying Benefits**

Although measuring the public cost of the conservation easement tax credit is generally straightforward, measuring and demonstrating the aggregate benefit the public has received in return is more difficult and limited because of a lack of available data. We attempted to quantify the public benefit of the conservation easement tax credit using two separate measures: (1) the fair market value of the conservation easements for which tax credits have been claimed and (2) the specific conservation purposes that have been protected.

- **Fair Market Values.** Tax-credit-generating conservation easements are primarily held by other parties and cannot be considered financial assets of the State. However, the State and its taxpayers are receiving the benefit of protecting land at a cost that is significantly less than what the State would pay to directly reimburse landowners for the full fair market value of their easements. We examined data that DOR has collected from taxpayers since 2007 for public reporting purposes pursuant to state statute [Section 39-22-522(3), C.R.S.]. These data consistently show a 3:1 ratio between the appraised value of the conservation easements and the tax credit amounts claimed. That is, the fair market value of tax-credit-generating conservation easements tends to be about three times the amount the State foregoes in the form of tax credits for those easements. We found this ratio to be consistent with other data that DRE has collected from landowners since 2011 as part of its management of the tax credit cap.
- **Conservation Purposes.** One of the advantages of Colorado's conservation easement tax credit is that each of the four allowable conservation purposes is defined broadly to include a wide variety of lands and values (i.e., public benefits) for which land may be protected and a tax credit claimed. However, given limitations in available data, which we describe in more detail later in this section, it is not possible to quantify specifically how much land has been protected for each of the allowable conservation purposes. For example, it is not possible to determine how many of the 925,000 acres associated with tax-credit-generating conservation easements are for open space preservation versus habitat protection. Without the ability to associate acreage statistics with conservation purposes in this manner, quantifying the public benefits of the conservation easement tax credit is limited significantly.

Despite efforts by the General Assembly to obtain information from landowners about their conservation easement donations, currently, neither DOR nor DRE collect data from landowners in a manner that permits the type of aggregate analysis of the conservation purposes associated with tax-credit-generating conservation easements that could be useful for measuring and demonstrating the public benefits of the conservation easement tax credit. Moreover, as discussed in Chapter 2, DOR does not currently examine an easement's conservation purpose as part of the tax credit claim review process.

In 2007, the General Assembly attempted to provide the public with information about the conservation purposes that landowners cite when claiming tax credits on their conservation easement donations through a reporting provision included in House Bill 07-1361. Codified in Section 39-22-522(3)(c), C.R.S., this provision explicitly requires each landowner donating a tax-credit-generating easement to report to DOR information about the conservation purposes that are protected by



the easement. The landowner must also report information about the county, township, and range where the easement is located; the number of acres subject to the easement; the amount of the tax credit claimed; and the name of the organization holding the easement. Statute further requires DOR to make all of this landowner-reported information publicly available. To implement the reporting provisions of House Bill 07-1361, DOR promulgated rules that require landowners to file Form DR1304, which can be completed either online or in hard-copy format. This form allows landowners to report all statutorily required information about their conservation easements, including the easements' conservation purposes. DOR provides a compilation report of this landowner-reported information on its website.

During our audit, we analyzed Form DR1304, as well as the resulting compilation report available on DOR's website that is based on DR1304 forms completed by landowners, and found this current reporting mechanism to be limited in three ways. First, descriptions of conservation purposes are captured only in text format. As a result, there is very little consistency among the entries—landowners have written as little as two words and as much as a paragraph of more than 300 words to describe their easements. Although this may be sufficient for analyzing conservation easement donations on a case-by-case basis, it does not allow the data to be quickly aggregated and grouped according to common conservation purposes. For example, Form DR1304 does not provide check boxes that allow the landowner completing the form to select the allowable conservation purposes applying to the easement. The form also does not include check boxes to capture more detail on the specific land attributes supporting the conservation purposes, such as the types of wildlife habitats that are being protected or the types of public recreational opportunities that are present.

Second, landowners claiming conservation easement tax credits do not always file Form DR1304. Specifically, we estimated that DOR received the form for only about 70 percent of the conservation easement tax credits that were claimed between Tax Years 2007 and 2009. Consequently, the reports DOR has made publicly available on its website do not exhibit all the conservation easement tax credits that were claimed during this period. Although landowners are required to submit Form DR1304, DOR staff reported that they do not disallow credit claims solely for failure to submit the form. Additionally, current rules require taxpayers to file Form DR1304 separately from the other documentation that must be submitted as part of the tax credit claim.

Finally, we believe there are opportunities for DOR to streamline the collection and reporting of data on conservation easement tax credit claims. For example, in addition to requiring landowners to submit Form DR1304, DOR also requires conservation easement holders to complete Form DR1299, which must be submitted to both DOR and DRE. However, through our discussions with staff from both agencies, we found that DOR and DRE do not actually use Form

DR1299, and information on the form (e.g., list of all currently held conservation easements and acreage) is duplicative of information that is already submitted through the conservation easement holder certification process. Additionally, DOR maintains two separate public reports on its website that both derive from the same core data, but each report contains information that is not included in the other. We believe DOR can fulfill its reporting requirements through a single, consolidated report that would ultimately prove more useful to the public.

## **Ensuring Public Benefits**

The specific public benefits derived from the conservation easement tax credit may be difficult to quantify. However, there are indicators that tax-credit-generating conservation easements are providing benefits that are important to the public. We interviewed all members of the CEOC, who represent different stakeholder interests. When we asked about the benefits of the tax credit, each member reported that there have been important conservation benefits achieved and that the tax credit is accomplishing what it was intended to do, such as preserving scenic corridors and open space while maintaining ranching and other agricultural uses of the land, providing outdoor recreational opportunities for the public, and protecting important fish and wildlife habitats.

We found there are some general requirements the public can rely on to provide at least a minimum level of assurance that donated lands hold value and benefits for the public. Specifically, in order to be certified by DRE to accept tax-credit-generating conservation easements, governmental entities and nonprofit organizations must have a process for reviewing, selecting, and approving any potential conservation easements, including processes to identify and document the conservation values and the public benefits achieved by protecting those values prior to accepting the conservation easement. DRE staff and CEOC members reported that many conservation easement holders will not accept donations that do not meet the organization's conservation standards or further their organization's mission.

We compiled and analyzed the mission statements and other related information from the application materials for the 42 governmental entities and nonprofit organizations that were certified conservation easement holders as of June 30, 2012. The following table shows a breakdown of how these conservation easement holders' mission statements generally relate to the four conservation purposes outlined in the Internal Revenue Code and regulations. The most common conservation purpose cited in holders' mission statements and application materials referenced the preservation of open space as one of the goals driving their land conservation efforts. Many mission statements referred to more than one conservation purpose.

<b>Analysis of Mission Statements for Certified Conservation Easement Holders</b> <i>(As of June 30, 2012)</i>		
<b>General Conservation Purpose</b>	<b>Count of Certified Conservation Easement Holders*</b>	<b>Percent of Total Certified Conservation Easement Holders*</b>
Open Space	37	88.1%
Fish, Wildlife, Plants, or Similar Ecosystem	24	57.1%
Outdoor Recreation and Education	11	26.2%
Historically Important Land Area or Structure	6	14.3%
<b>Source:</b> Office of the State Auditor's analysis of conservation easement holder certification application materials provided by the Division of Real Estate. * There were a total of 42 certified conservation easement holders, 25 of which had mission statements that referred to more than one conservation purpose.		

Finally, we reviewed the results of the January 2012 "Conservation in the West Survey," which is a bipartisan poll of 2,400 registered voters in six western states (Arizona, Colorado, Montana, New Mexico, Utah, Wyoming) commissioned by the State of the Rockies Project at Colorado College. The survey data show that 86 percent of Colorado respondents agreed or strongly agreed with the statement that "even with state budget problems, we should still find money to protect Colorado's land, water, and wildlife." These general attitudes about conservation indicate that Coloradoans may see an overall public benefit from the conservation easement tax credit that is worth the cost.

## **Recommendation No. 12:**

The Department of Revenue (DOR) should help ensure the State's ability to measure the public benefits of the conservation easement tax credit by:

- a. Improving taxpayer forms to capture data in a format that facilitates aggregate analysis and reporting on the specific conservation purposes and land attributes that are being protected by conservation easements.
- b. Ensuring that taxpayers donating tax-credit-generating conservation easements submit Form DR1304.
- c. Eliminating unnecessary or duplicative data collection forms and consolidating public reports when possible.

## **Department of Revenue Response:**

- a. Agree. Implementation date: July 2013.

DOR will help ensure the State's ability to measure the public benefits of the conservation easement tax credit by improving required forms used to capture data about conservation easements and the associated tax credits.

- b. Agree. Implementation date: July 2013.

DOR will review its procedures in obtaining Form DR1304 from taxpayers and make changes to ensure the form is submitted.

- c. Agree. Implementation date: July 2013.

DOR will review the forms associated with conservation easement tax credits and eliminate any unnecessary or duplicative data requests that are not statutorily required and consider options for consolidating public reports. In addition, DOR will review its publication of information on its website to ensure it is easily accessible.

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# Appendix

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## Appendix A

### Conservation Easement Income Tax Credit Incentives by State

State	How Is the Credit Calculated?	Credit Claim Limits	Annual Usage Limits	Statewide Credit Caps	Maximum Carry-forward Period	Transferable to Other Taxpayers?
Arkansas	50% of the donation's fair market value	\$50,000 maximum per donation; 1 donation per taxpayer per year	Up to \$5,000 may be used per year.	Credits will cease being available one year after the end of the calendar year in which the total of credits used exceeds \$500,000.	9 years	No
California	55% of the donation's fair market value	None	None	\$100 million total	8 years	No
Colorado	50% of the donation's fair market value	\$375,000 maximum per donation; 1 donation per taxpayer per year	None	None, except for 2011, 2012, and 2013 (\$22 million for 2011 and 2012, \$34 million for 2013)	20 years	Yes
Connecticut	50% of the donation's fair market value	None; only available to corporations	None	None	25 years	No
Delaware	40% of the donation's fair market value	\$50,000 maximum per taxpayer per year	None	\$1 million per year; \$10 million total	5 years	No
Georgia	25% of the donation's fair market value	\$250,000 maximum per year for individuals, \$500,000 for corporations and partnerships	None	None	10 years	Yes
Iowa	50% of the donation's fair market value	\$100,000 maximum per taxpayer per year	None	None	20 years	No
Maryland	100% of the donation's fair market value	\$80,000 maximum per taxpayer per year	Up to \$5,000 may be used per year.	None	15 years	No
	100% of local property taxes paid each year on conserved land	None	None	None	This credit may be claimed annually for 15 years following an easement donation.	No
Massachusetts	50% of the donation's fair market value	\$50,000 maximum per donation; taxpayers must allow 3 years to elapse between donations	None	\$2 million per year	Carry forward not allowed. Credit in excess of tax liability is refundable.	No



## Appendix A

### Conservation Easement Income Tax Credit Incentives by State

State	How Is the Credit Calculated?	Credit Claim Limits	Annual Usage Limits	Statewide Credit Caps	Maximum Carry-forward Period	Transferable to Other Taxpayers?
Mississippi	50% of allowable transaction costs such as for appraisals, baseline inspections, and surveying and legal fees.	Lifetime maximum of \$10,000	None	None	10 years	No
	\$5.50 per acre on land allowed to be used as a natural preserve; wildlife refuge, habitat, or management area; or for public recreation.	None	None	None	Credit may be claimed annually. Unused credits may be carried forward for 5 years from the year in which the land was approved for use.	No
New Mexico	50% of the donation's fair market value	\$250,000 maximum per donation; 1 donation per taxpayer per year	None	None	20 years	Yes
New York	25% of local property taxes paid each year on conserved land	\$5,000 per taxpayer per year	Up to \$5,000 may be used per year.	None	Carry forward not allowed. Credit in excess of tax liability is refundable.	No
North Carolina	25% of the donation's fair market value	\$250,000 maximum per year for individuals, \$500,000 for corporations, pass-through entities, and joint filers	None	None	5 years	No
South Carolina	25% of the donation's fair market value	No maximum per taxpayer; \$250 maximum per acre	Up to \$52,500 may be used per year.	None	Indefinite	Yes
Virginia	40% of the donation's fair market value	None	Up to \$100,000 may be used per year.	\$100 million per year (inflation adjusted after 2008)	10 years	Yes
<b>Source:</b> Office of the State Auditor's analysis of statutes and regulations in states that offer income tax credit incentives for conservation easement donations.						

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