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January 28, 2008

RE: Update on Conservation Easement Audits

We hope that the New Year finds you well and enjoying this truly wintry weather. As you are most likely aware, December saw several articles in the Denver-area newspapers about audits of conservation easements by the Internal Revenue Service and related enforcement actions by the Colorado Division of Real Estate against appraisers who have been allegedly overstating the value of conservation easement donations. We at Aspen Valley Land Trust (AVLT) have carefully followed these developments and have been deeply involved in drafting legislative responses to the audits as well as new conservation law. This letter is intended to summarize and bring you up to date on the situation, and let you know how you may track the issues as they progress.

Background on conservation organizations and the Conservation Tax Credit Program

Entities qualified to accept and hold conservation easements are limited to certain non-profit organizations and governments charged with a mission to conserve land for qualified conservation purposes, who have the resources to enforce such restrictions. AVLT is a qualified tax-exempt organization under this requirement in accordance with Section 170(h) and Section 501(c)(3) of the Internal Revenue Code. AVLT also meets requirements of Colorado law as a qualified organization under C.R.S. Section 38-30.5-104.

AVLT is a member in good standing of the Land Trust Alliance (LTA), a non-profit, national advocacy association that acts as the primary convener, strategist and representative for more than 1,600 qualified land trusts across North America. LTA pioneered the use of conservation easements for private land conservation, and developed the *Land Trust Standards and Practices* to guide the ethical performance of land trusts. AVLT has adopted these *Standards and Practices* to guide its operating procedures.

AVLT is also a member of the Colorado Coalition of Land Trusts (CCLT), a statewide non-profit association of land trusts charged with assisting land trusts and municipal open space programs across Colorado with education, advocacy, and the guiding and tracking of legislation that impacts land conservation. AVLT's Executive Director, Martha Cochran, is currently on the CCLT Board of Directors.

CCLT has been particularly instrumental in enacting, overseeing, and expanding Colorado's outstanding and unique conservation tax credit program. This program, now being copied by other states, provides the most generous conservation tax incentives in the nation in the form of valuable, *transferable* tax credits for qualified easement donations. This program has been an overwhelming success, far outpacing expectations, and causing exponential growth in the land conservation movement since its inception in 2000.

A brief history of the IRS and state inquiry into conservation easements

In 2003, the Washington Post ran a series of articles regarding questionable conservation deals intended to take advantage of federal tax benefits that sparked a Congressional hearing on conservation easements. Among other abuses, Congress found that over half of all conservation easements in one eastern state protected golf courses, while many "façade" easements (easements designed to preserve the character of historic structures) were being claimed on buildings that were already protected by other government programs. As a result, Congress pressed the IRS to take a closer look at the conservation easement tax deduction.

Subsequently, and as a result of the IRS review, Colorado's conservation community, led by CCLT, became aware of two new "rogue" land trusts seeking to capitalize on Colorado's generous tax incentives by promoting conservation easement transactions designed to attract multiple investors and maximize tax credit benefits. These land trusts, which are not members of CCLT, have been completing an unusually high number of valuable easement transactions and appear to be operating outside the guidelines of the LTA *Standards and Practices*. In response, CCLT urged the Colorado Department of Revenue (DOR), which previously had not delved deeply into tax returns involving conservation tax credits, to investigate. The DOR quickly found that it didn't have the resources for such task, and requested the IRS to conduct its own review in Colorado.

What began as a legitimate investigation by the IRS quickly grew to ensnare the donors of sound easements to reputable land trusts. Since 2004, the IRS has conducted roughly 600 audits of conservation easements nationwide, with approximately half targeting easement donations made in Colorado between 2003 and 2004 (the high number of audits in Colorado is due directly to the State's request for IRS assistance, as well as to the popularity and number of easements completed in Colorado). Of Colorado's estimated 300 audits, over 100 involve easements donated to member organizations of CCLT. (Most of the member organizations of CCLT have at least one easement donor under audit and some have as many as twelve. AVLT has four.) The remaining donations were made to city or county governments, many of which (including Pitkin County and the City of Aspen) have legitimate, dedicated conservation programs, or to questionable land trusts or organizations operating outside the recognized conservation community.

Initially, ignoring 29 years of conservation easement case law and best practices, the IRS began a new legal challenge of the conservation purposes of donated easements (legal cases it lost) before eventually focusing its efforts on fraudulent appraisals. After preliminary examinations, the IRS determined that in more than 95 percent of its cases, the easement in question did not decrease the value of the land it covered at all, and therefore should not have

resulted in tax benefits to the donors. Oddly enough, many easements for which this determination was made were purchased, at least in part, with funds from Great Outdoors Colorado, the U.S. Department of Agriculture, Colorado Division of Wildlife, U.S. Fish and Wildlife Service and/or other governmental agencies, all of which required extensive review of such easements and their appraisals prior to funding the transactions.

While the folly of the “zero value” determination was apparent to almost everyone else, the IRS appears to be slow to respond and slower to adjust its thinking. Finally, almost two years after initiating the first audits, the IRS (in response to legislative and political pressure) began sending out settlement offers to many landowners under audit. The offers gave landowners the opportunity to “settle” for 25 percent, 60 percent or 75 percent of the value of their easement donation, but were made without a substantiating appraisal or reference to any specific criteria. As of the end of 2007, more than 90 percent of Colorado landowners receiving such offers have decided to challenge the IRS and decline settlement. It looks probable that the IRS will have to reissue many of these settlements anyway, as it is illegal to offer a settlement amount that has not been substantiated by appraisal or other suitable criteria.

What happens now?

Fortunately, Sen. Allard and Sen. Salazar have been heavily involved in pressing the IRS to re-focus its inquiry toward fraud and to recognize the legitimacy of valid easements donated to compliant organizations. In December 2007, the Senators issued a joint press release citing a letter they had written to the IRS Commissioner which stated that the Senators:

- *strongly support the effort to identify and deal with abusive conservation easement transactions and with those who promote them; and*
- *desire to see a swift and just resolution to the majority of the pending investigations into conservation easement donations in Colorado.*

We are hopeful that the continuing pressure from the Senators and the fact that the IRS has recently lost several significant court cases involving conservation easements audits will result in a quick and fair resolution to these unfair audits.

Recent developments in Colorado’s conservation easement investigations

The popularity of Colorado’s generous tax credit program represents a large financial commitment in Colorado’s already over-burdened state budget. Even avid supporters of the conservation program admit that the amount of money involved, almost \$80 million in 2006, makes the program more expensive than previously thought. For this reason, the state – and the conservation community – cannot tolerate fraudulent tax claims and is instituting its own actions to root out impropriety.

As a first step, House Bill 1361 was enacted during the last legislative session calling for stricter appraisal requirements, increased reporting by the organizations that hold conservation easements, and increased oversight by the DOR. You can learn more about this bill on the CCLT website, www.cclt.org.

Taking things a step further, the Colorado Division of Real Estate (DORA) has now entered into the easement investigations, with the specific goal of eliminating over-stated appraisals and non-qualified easement-holding organizations. The DORA has stated that it supports the State's conservation easement program, and hopes to improve the program by removing opportunities for fraud. To this end, the DORA has taken action against two suspect land trusts, one in southeast Colorado and one in the Greeley area, and recently suspended two appraisers over issues related to work for the land trust in southeast Colorado. To our knowledge, none of the DORA investigations involve any land trusts belonging to CCLT.

Task Force Recommendations

In addition, Sen. Isgar and Rep. Alice Madden last fall convened a Conservation Tax Credit Task Force to look at additional legislation that might help prevent fraud and protect the state's tax credit program. The Task Force included state government department heads, legislators, representatives from the governor's office, and members of the land trust community (including Martha Cochran). The Task Force issued several recommendations expected to be introduced in legislation this session, including:

- Conservation easement appraisals be submitted to the state DORA as well as the DOR;
- Oversight of appraisers be increased by the DORA; and
- All organizations holding conservation easements be registered with the State.

Governor Bill Ritter, Rep. Kathleen Curry and Sen. Gail Schwartz have also been very supportive of reforms needed to assure that the conservation tax credit program continues and that potential tax fraud associated with this program be eliminated. In his State of the State address January 10, 2008, Governor Ritter made this statement regarding proposed conservation legislation:

"I appreciate the good work Representative Madden and the Department of Revenue and regulatory agencies have done to address abuses of the state's conservation easement program. Last year I signed HB 1361, and this year I look forward to additional legislation that will stem fraud and protect this important conservation tool."

What's the future of the tax credit?

On the federal level, it is hoped that the IRS, with encouragement from Colorado's Senators, will act to clear legitimate conservation easement donors and pursue potential abusers of the laws. Two years ago, Congress increased the federal tax benefits for conservation easement donors by raising the amount that donors may deduct annually from their adjusted gross income from 30 to 50 percent (and 100 percent for qualifying farmers and ranchers). That provision is expected to be renewed in 2008, retroactive to the first of the year, demonstrating continued congressional support for the program.

On the state level, Governor Ritter has been extremely supportive of the conservation easement program, agreeing with Senators that regulation is necessary but insisting the program as a whole not be harmed. The maximum Colorado conservation tax credit that may

be claimed per year was raised in 2007 from \$260,000 to \$375,000, demonstrating state lawmaker's support for the program, even amidst concerns of fraud. In 2008, we expect the state to increase oversight of both appraisers and land trusts, while protecting the \$375,000 maximum tax credit amount.

How have the IRS and State actions impacted AVLT?

Despite all of this uncertainty, AVLT helped landowners conserve more acres in 2007 than in any other year of its history, including some of the area's richest ranchlands and most unique high mountain habitats. For the most part landowners, though concerned about the potential for audit, have been very brave and committed to seeing their land conserved for future generations. Most are confident that they are doing the right thing by acting in good faith to follow laws enacted to encourage conservation. To our knowledge, very few landowners have backed away from plans to conserve their property for fear of a possible audit.

In addition, the entities and individuals who have purchased tax credits from our conservation easement donors in the past are again planning to purchase credits as a way to support conservation in our region.

AVLT continues to be a leader in the conservation community, and to help shape the changing topography of the land conservation movement. In 2005, AVLT was a test case for developing national land trust accreditation standards through the Land Trust Alliance, and in the coming months we will be among the first land trusts in the U.S. to participate in LTA's official accreditation process. In addition, we were one of the first organizations to prescreen conservation easement appraisers, and we continue to work diligently to see that our transactions adhere to all IRS and Treasury regulations, as well as to *Land Trust Standards and Practices*. As a result, we feel confident in the quality and execution of our conservation easements, and believe them to be compliant with both the letter and spirit of conservation law.

How to stay informed

First, we want to be very clear that there is fraud in the Colorado conservation easement program, and the press about it is likely to get worse before it gets better. However, the conservation community widely agrees that people unfairly claiming Colorado tax credits, and the promoters encouraging such abuse, must be caught and stopped.

The Colorado Coalition of Land Trust's website has regular updates on the audits, legislative updates and links to news stories. Their website is www.cclt.org. In addition, the Land Trust Alliance follows policy and other issues nationally on their website, www.lta.org.

And as always, please feel free to contact us if you have questions or would like to discuss any concerns, or if you receive any notices from the IRS or the State pertaining to your conservation easement. The audits have been a heavy burden on the landowners and families who are unfairly entangled in this web, and we, along with CCLT, LTA and other members of

the land conservation community, will continue to work toward a fair and rapid conclusion to this unfortunate situation.

We are very proud to be the stewards of the important lands which you all have worked so hard to conserve, and we continue to be in awe of you generous, dedicated landowners who give so graciously so that the future of our valleys may be filled with wildlife, ranches and the open spaces that we all treasure.

Sincerely,

A handwritten signature in cursive script that reads "Martha Cochran".

Martha Cochran
Executive Director