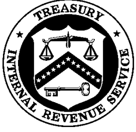

OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ASSISTANCE

MEMORANDUM FOR AREA COUNSEL,
SMALL BUSINESS/SELF-EMPLOYED, AREA 5

FROM: Associate Chief Counsel
(Income Tax and Accounting)

SUBJECT: Colorado Conservation Easement Credit
TL-N-130-01

This Chief Counsel Advice provides a partial response to your memorandum dated February 9, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

By a letter dated January 22, 2001, the Colorado Department of Revenue requested assistance from the Internal Revenue Service Governmental Liaison located in Denver, Colorado. Specifically, the Colorado Department of Revenue inquired about whether transferees of the Colorado conservation easement credit would qualify for a deduction under § 164 of the Code when applying the credit to their Colorado state income taxes. The Governmental Liaison requested assistance from your office. By a memorandum dated February 9, 2001, your office requested our assistance on the transferee issue as well as additional issues concerning transferors of the credit.

The following discussion provides an initial response covering only the transferee issue stated below; the remaining issues, including the effect of the state credit on a possible charitable deduction by the easement transferor under § 170, will be addressed in a supplemental technical assistance to be issued at a later date.

ISSUE

Is the transferee of a Colorado conservation easement credit entitled to a deduction for state taxes under § 164?

FACTS

<u>Summary</u>: Starting in 2000, Colorado provides a credit of up to $100,000 for the donation of a perpetual conservation easement to a government or § 501(c)(3) organization. An unused credit may be carried over up to 20 years. Unused credits are also refundable (subject to a cap and depending on the existence of a state surplus), and/or transferable (if above a certain amount) to other taxpayers, to use against their state tax liability.

<u>Conservation easement</u>: The real property laws concerning Colorado conservation easements are contained in Article 30.5 of Title 38 of the Colorado Revised Statutes. That article generally defines a "conservation easement in gross" as a right in the owner of the easement to prohibit or require certain acts with respect to a land or water area appropriate to maintaining such area in a manner that will preserve its value for recreation, education, habitat, open space, or historical importance. <u>See</u> Colo. Rev. Stat. § 38-30.5-102. A conservation easement in gross may only be created through a grant to a governmental entity or to a charitable organization exempt under Code § 501(c)(3) that was created at least two years prior to receipt of the conservation easement. § 38-30.5-104(2). The particular characteristics of a conservation easement in gross are those granted or specified in the instrument creating the easement. § 38-30.5-103(4). A conservation easement in gross is perpetual unless otherwise stated in the instrument creating it. § 38-30.5-103(3).

<u>Credit generally</u>: For tax years beginning on or after January 1, 2000, a Colorado state income tax credit is available for Colorado residents, and C corporations subject to Colorado tax, for the donation of all or part of the value of a perpetual conservation easement in gross. Colo. Rev. Stat. § 39-22-522; <u>see generally</u> Colorado Department of Revenue, <u>FYI -- Income 39 - Gross Conservation Easement Credit</u> (July 2000) ("State Explanation"). Nonresidents may not claim the credit. Part-year residents may claim the credit if the donation is made while they were residents. If a credit is claimed by a resident who moves to another state, any carryover can still be claimed if the taxpayer continues to have a Colorado tax liability.

<u>Passthroughs</u>: Trusts and estates may not claim the credit. If the credit is earned by a partnership, S Corporation, or similar pass-through entity, it is allocated pro rata to the partners or shareholders. Colo. Rev. Stat. § 39-22-522(4)(b). Any portion allocable to nonresidents is lost.

<u>Amount</u>: The credit is equal to the fair market value of the donated portion of a perpetual conservation easement in gross created upon real property located in Colorado. Colo. Rev. Stat. § 39-22-522(4)(a). However, the credit cannot exceed $100,000 for any donation. To support the valuation, the taxpayer must submit a qualified appraisal, as defined in 26 C.F.R. § 1.170A-13(c)(3) (1998). Colo. Rev. Stat. § 39-22-522(3). To the extent of a taxpayer's net income tax liability, a

taxpayer can always use the credit in full. If the credit exceeds the tax liability, there are three possibilities: carryover, refund, or transfer.

Carryover: Any unused portion of the credit may be carried forward for up to 20 years. Colo. Rev. Stat. § 39-22-522(5)(a). Only one credit may be claimed each year. § 39-22-522(6). Additional credits may not be earned during any year to which a prior conservation easement credit is being carried forward, either by the taxpayer or by another taxpayer who has received a transferred credit from that taxpayer.

Refund: Refundability of the credit will depend on whether there are excess state revenues in the prior year that must be refunded to Colorado taxpayers under the state constitution.[1] If there is no surplus, the credit is not refundable. If there is a surplus, at the election of the taxpayer the credit can exceed the amount of the net tax liability, with the balance being refunded to the taxpayer. However, in such a case the total credit for the year, including the nonrefundable and refundable portions, cannot exceed $20,000. Colo. Rev. Stat. § 39-22-522(5)(b)(III).

Transfer: A Colorado resident or C corporation may transfer all or a part of the unused portion of a credit to another Colorado resident or C corporation.[2] Colo. Rev. Stat. § 39-22-522(7). The credit may be transferred to more than one transferee. The minimum amount of unclaimed credit that can be transferred to any one transferee is $20,000. Both the transferor and the transferee must include on their returns, for the year the transfer is made, a written statement that specifies the fact and amount of the transfer. Transferred credits are always nonrefundable for the transferee, although they may be carried over. It appears that a transferee may not transfer the credit.[3]

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[1] Under section 20(7) of Article X of the Colorado constitution, this surplus is based on spending limits determined by factors such as inflation, population growth, voter authorization, etc. The determination of whether there is a surplus is announced around October of the following year. It is our understanding that the State of Colorado expects to have surpluses for the next several years.

[2] A state non-profit organization will act as a clearinghouse for the transfer of these credits. Donors will register with this organization to sell their credits for a specified percentage of face value (e.g., 80%), buyers will sign a letter of intent to pay a specified percentage of face value (e.g., 90%), and the difference goes to the organization to cover its costs.

[3] With respect to legislative purpose, Colorado Governor Owens, commenting on the legislation that made the credit refundable and transferable, stated: "Tax credits provide little incentive for farmers and ranchers with little to no tax liability ... [the legislation] offers a way for agricultural landowners to leverage their stewardship into a valuable asset rather than selling out to developers."

LAW AND ANALYSIS

The January 22 letter from the Colorado Department of Revenue expresses concern that a transferee will not be able to claim a deduction under § 164 when the transferred credit is used to “pay” a state tax liability. Section 164(a) specifically allows a deduction for state income taxes in the taxable year in which paid or accrued. This deduction is allowed regardless of whether the taxpayer is carrying on a trade or business or an activity described in § 212 (relating to expenses for the production of income).

In the instant case, the transferee will use its purchased credit to “pay” its state income tax liability. Thus, the issue raised is whether the purchase of the credit, in itself, serves to extinguish or reduce the transferee’s state tax liability. If so, the transferee would not have a tax liability to “pay” and, therefore, would not be entitled to a deduction.

We think that the purchase of a credit, in itself, does not serve to extinguish the transferee’s existing state tax liability. The transferee must take specific action to apply the credit to its tax liability. The transferee must include on its state income tax return the amount of the credit. That amount is then applied to reduce the amount of the transferee’s net tax liability. Thus, the purchase of the credit, without the transferee including the amount of the credit on its state income tax return, does not alone reduce or extinguish the transferee’s state tax liability. Further, this transaction is analogous to a taxpayer being permitted to pay its state tax liability by transferring property to the state, rather than money. In this case, the transferee transfers property (the credit) to the state in satisfaction of its tax liability. This “payment” of property is a payment of tax that is generally deductible under § 164.

Please call if you have any further questions about this issue.

Associate Chief Counsel
(Income Tax and Accounting)
By Michael D. Finley
Chief, Branch 3