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

OFFICE OF
CHIEF COUNSEL

July 24, 2002

Number: **200238041** CC:ITA:B1
Release Date: 9/20/2002 PRESP-152782-01
UILC: 170.14-00; 170.12-07; 164.03-00; 162.05-15; 1001.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

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

FROM: Associate Chief Counsel
(Income Tax and Accounting)

SUBJECT: Colorado Conservation Easement Credit
PRESP-152782-01

This memorandum responds to your request for advice. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

Previously, by a memorandum dated May 31, 2001, we provided Chief Counsel Advice to your office on a related matter . At that time, we concluded that the transferee of a Colorado conservation easement credit is entitled to a federal tax deduction when using the credit to reduce state taxes. We also stated that we would provide a supplemental response on issues affecting the original recipient of the credit.

After consideration, we have determined that these issues, along with certain other issues raised in connection with the federal tax treatment of state tax credits, would be best addressed in official published guidance. This will allow full consideration of concerns we have identified with respect to the tax treatment of these and other refundable and transferable state tax credits, and help ensure uniform treatment of taxpayers. In addition, we will be able to take into account the interplay of the issues you raised with certain legislation concerning the tax treatment of conservation easements now pending in Congress. Accordingly, our office will recommend that the treatment of state tax credits, including credits such as the Colorado conservation easement credit, be addressed in published guidance. Please be aware that the decision to issue published guidance must be approved at higher levels.

Pending resolution of these issues, we cannot furnish definitive advice on the questions you raised. However, we are providing an updated summary of the facts and a brief discussion of the two key questions concerning the tax treatment of the original recipient of the conservation easement credit, and some of the concerns

and considerations that will need to be taken into account in answering those questions.

FACTS

For tax years beginning on or after January 1, 2000, a Colorado state income tax credit is available for the donation of all or part of the value of a perpetual conservation easement in gross by resident individuals, C corporations, partnerships, S corporations, other similar pass-through entities, estates, and trusts. Colo. Rev. Stat. § 39-22-522 (2001); see generally Colorado Department of Revenue, FYI -- Income 39 - Gross Conservation Easement Credit (December 2001) ("State Explanation"). If a charitable deduction is claimed on the federal income tax return for any donation subject to the credit, the amount deducted from federal taxable income must be added back to determine the taxpayer's Colorado taxable income. Colo. Rev. Stat. §§ 39-22-104(3)(g) and 39-22-304(2)(f) (2001). However, if the federal deduction exceeds the amount of the credit created by the donation, then the "addback" is only the amount equal to the credit, including any credit carried forward to future tax years. See State Explanation p. 2.

Amount: For tax years beginning on or after January 1, 2000, but before January 1, 2003, 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, but the credit cannot exceed $100,000 for any donation. For tax years beginning on or after January 1, 2003, the credit is equal to 100% of the first $100,000 of the fair market value of the donated portion of such conservation easement when created, and 40% of all amounts of the donation in excess of $100,000, except that the credit cannot exceed $260,000 per donation. Colo. Rev. Stat. § 39-22-522(4)(a). 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 by the taxpayer for up to 20 years. Colo. Rev. Stat. § 39-22-522(5)(a). Only one credit may be claimed each year. Section 39-22-522(6). Additional credits may not be earned by the taxpayer 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. Id. (A taxpayer is not permitted to carry back the credit to years prior to the donation of the easement.)

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

[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 in October or November of the following year. It is our understanding that the State of Colorado had surpluses for the past few years and does not expect to have surpluses

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 for donations made during tax years beginning on or after January 1, 2000, but before January 1, 2003, the total credit for the year, including the nonrefundable and refundable portions, cannot exceed $20,000. For donations made during tax years beginning on or after January 1, 2003, the amount is $50,000. Colo. Rev. Stat. § 39-22-522(5)(b)(III).

Transfer: A taxpayer may transfer all or a part of the unused portion of the credit to a transferee who meets the definition of a taxpayer who can claim the credit.[2] Colo. Rev. Stat. § 39-22-522(7). The credit may be transferred to more than one transferee. For donations made during tax years beginning on or after January 1, 2000, but before January 1, 2003, the minimum amount of unclaimed credit that can be transferred to any one transferee is $20,000. For donations made during tax years beginning on or after January 1, 2003, there is no minimum amount. Transferred credits are always nonrefundable for the transferee, although they may be carried over. A transferee may not transfer the credit to another.

DISCUSSION

I. Major issues

The key feature that raises the two primary issues in this fact pattern is the fact that the transfer of the conservation easement—which is generally appreciated property—entitles the taxpayer to a substantial financial benefit for up to the full fair market value of the easement.

The first major issue this raises is whether, to the extent a taxpayer is effectively reimbursed for the transfer of the easement through the use, refund, or transfer of the credit, that benefit is a *quid pro quo* that reduces or eliminates a charitable contribution deduction under § 170. (A subsidiary issue is whether, when the benefit takes the form of a reduction in state tax liability, disallowing a deduction under § 170 entitles the taxpayer to an equivalent deduction for a deemed payment of state tax under § 164 or § 162.)

The other major question is whether the benefit of the state conservation easement credit is, in substance, an amount realized from the transfer of the easement under § 1001, generally resulting in taxable capital gain. Although there may be authority to defer recognition of that gain until the benefit is actually realized through use,

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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 will go to the organization to cover its costs.

refund, or transfer of the credit, failure to tax that gain altogether is arguably unfair to taxpayers who sell conservation easements or other appreciated property and receive cash.

To take a simplified example, assume a taxpayer in State A and a taxpayer in State B each transfer a conservation easement with a tax basis of $4,000 and a fair market value of $10,000 to a state agency. The taxpayer in State A sells the easement to a state agency for a cash payment of $10,000. The taxpayer in State B donates the easement to a state agency and receives a cash payment of $10,000 as a refundable tax credit. For federal income tax purposes, the taxpayer in State A would not have a § 170 deduction and would pay tax on the $6,000 of capital gain. If the taxpayer in State B is able to deduct $10,000 as a charitable contribution and avoid paying tax on the capital gain—a "double benefit" that is generally allowed under § 170 when taxpayers donate appreciated property—it is difficult to explain why the two taxpayers should be treated differently, since both received $10,000 in cash. Even if the $10,000 § 170 deduction for the taxpayer in State B is offset by treating the $10,000 refundable credit payment as ordinary income, the resulting offset cancels out the benefit of the charitable deduction but still allows the taxpayer in State B to exclude 100% of the $6,000 capital gain—a benefit not available to the similarly-situated taxpayer in State A, even under the proposed legislation discussed below. Similar concerns are raised when the benefit of the state conservation easement credit is realized in the form of a reduction in state tax, or through sale of an excess credit to a third party. Finally, there is the question of whether taxpayers should be treated differently because they donated an easement to a charitable organization rather than a state agency.

II. Charitable deduction under § 170

The first issue that will need to be considered under the §170 analysis is whether the receipt of a state tax credit is a substantial return benefit. The external features of a transaction should be examined to determine whether a taxpayer transferred money or property to a charity with the expectation of a *quid pro quo*. Hernandez v. Commissioner, 490 U.S. 680, 690-691 (1989). Here, a taxpayer receives the state credit for transferring an easement to a governmental entity or § 501(c)(3) organization. As demonstrated by Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971), the benefit does not need to come from the donee and the benefit does not need to be specifically quantifiable at the time of the transfer. See also § 1.170A-14(h)(3)(i).

Under the return benefit analysis, we will need to consider the fact that the tax benefit of a federal or state charitable contribution *deduction* is not viewed as a return benefit that reduces or eliminates a deduction under § 170, or vitiates

charitable intent.[3] The question is whether a program such as Colorado's is distinguishable.

If there is a return benefit, we need to determine whether a taxpayer, at least in some circumstances, can satisfy the requirements under United States v. American Bar Endowment, 477 U.S. 105 (1986), to show that the taxpayer knowingly contributed an easement in excess of the value of the state credit received in return. See § 1.170A-14(h)(3)(i). For example, do the external features of a transaction demonstrate donative intent to the extent a taxpayer arranges to sell the credit to a third party for a discounted amount before transferring the easement to a charity? See generally § 1.170A-1(h)(1); Rev. Rul. 67-246, 1967-2 C.B. 104.

III. Disposition under § 1001

The second primary issue to consider is whether, because the original recipient of the conservation easement credit has essentially transferred property, usually appreciated property, in return for a payment or other financial benefit measured by the value of the transferred property, the transaction should be treated as a disposition of property generally resulting in capital gain.

A. Refunds

This issue is most clearly presented in the case of a refundable credit that is paid to a taxpayer in return for an easement transferred to the state. As discussed in the example above, it is difficult to distinguish this situation from other situations in which state agencies purchase conservation easements for cash.

B. Credits

If the benefit received by a particular taxpayer is a reduction in state tax liability resulting from the application of the credit, we need to consider whether the general treatment of a "nonrefundable" state tax credit as a reduction in tax liability should apply. A reduction in liability generally confers a benefit in the same manner as an outright payment, and is often taxed as such. But when the liability that is reduced is one that, like the liability for state tax, would be deductible if paid, it is often unnecessary and overly complex to recharacterize the transaction as a deemed payment to the taxpayer, followed by a deemed payment by the taxpayer, since the

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[3] See McLennan v. United States, 23 Cl. Ct. 99 (1991), subsequent proceedings, 24 Cl. Ct. 102, 106 n.8 (1991), aff'd, 994 F.2d 839 (Fed. Cir. 1993); Skripak v. Commissioner, 84 T.C. 285, 319 (1985); Allen v. Commissioner, 92 T.C. 1, 7 (1989), aff'd, 925 F.2d 348 (9th Cir. 1991); see also Browning v. Commissioner, 109 T.C. 303 (1997) (addressing the question of tax benefits as an amount realized in a charitable bargain sale, rather than as a *quid pro quo* issue).

resulting income and deduction would simply offset each other. See, e.g., § 108(e)(2) ("Income not realized to extent of lost deductions"); Rev. Rul. 79-315, 1979-2 C.B. 27, Holding (3) (Iowa income tax rebate used to reduce state tax liability is neither gross income nor deductible under § 164 as state income tax paid).

However, one situation in which a transaction is generally recharacterized is one in which a liability is reduced or satisfied by the transfer of property. In order to reflect accurately the substance of the transaction, such a transaction is generally treated as a deemed disposition of the property, resulting in the realization of gain or loss, followed by a deemed payment of the sales proceeds in satisfaction of the liability. For example, in our previous Chief Counsel Advice on the tax treatment of a *purchaser* of a Colorado conservation easement credit, we advised that rather than treating the purchaser's use of the credit as a reduction in state tax liability, which would deprive the purchaser of a deduction for the payment of state tax, we viewed the situation as analogous to one in which the state permitted the taxpayer to pay the state tax liability with property. In such a case, the taxpayer would be treated as having first disposed of the credit, with the "face amount" of the credit as an amount realized, and then paid the proceeds to the state, resulting in a deduction for the full face amount under § 164. We need to consider whether a similar approach is appropriate for the original recipient of the conservation credit as well, who would be treated as having disposed of the easement and then made a deemed payment of state tax with the proceeds.[4]

C. Transfers

If the benefit received by the transferor of a conservation easement takes the form of cash received on the sale of the credit to another taxpayer, the question is whether that benefit should be treated as an amount realized from the disposition of the easement, from the disposition of the credit itself, or in some other manner. This would affect the character of any gain as well as the basis to be used in the calculation.

D. Bargain sale

Another question is whether a taxpayer could be treated as making a bargain sale of an easement in certain circumstances—for example, as discussed above, to the

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[4] Note that recharacterizing the transaction in this way has the advantage of providing a rationale for allowing a deduction under § 162 or § 164 that would compensate for the denial of a § 170 deduction. This is appropriate, since, unlike the refund or transfer scenarios, the taxpayer does not end up with cash when the state tax credit is used to reduce state tax liability.

extent that the amount received on the transfer of a credit is less than the value of the easement, and the requirements of American Bar Endowment are satisfied.

E. Timing

If or to the extent that it is determined that the benefit of the credit is an amount realized from the transfer of the easement, an additional issue to consider is whether the transaction should be considered as "closed," resulting in an amount realized in the year the easement is transferred. Alternatively, since the credit can be carried forward, can the taxation of gain be deferred until the benefit of the credit is "realized" through sale, refund, or use, in a manner similar to an installment sale, perhaps under the principles of Arrowsmith v. Commissioner, 344 U.S. 6 (1952)? Such treatment would also raise the issue of how the basis of the easement should be handled.

F. Transfers to charity

Another question is whether, for § 1001 purposes, the benefit of the tax credit should be viewed as an amount realized from the transfer of an easement even though the easement is transferred to a charitable organization rather than the state.[5]

IV. Effect of pending legislation

Finally, we note that a bill pending in the Senate contains a provision that, if enacted, would affect the analysis of the state conservation easement credit for easements transferred after December 31, 2003. Specifically, section 107 of H.R. 7 would add a new Code section 121A to provide for the exclusion of 25% of the long-term capital gain for certain sales of land interests to eligible entities for conservation purposes. In the case of a bargain sale, a taxpayer will not fail to qualify for a charitable contribution deduction solely because the taxpayer derives a tax benefit from the partial exclusion of long-term capital gain from the sale. The version of H.R. 7 passed by the House does not contain a provision similar to section 107.

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By ____________________________

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[5] Cf. Rev. Rul. 88-95, 1988-2 C.B. 28; Notice 87-26, 1987-1 C.B. 470; Standley v. Commissioner, 99 T.C. 259 (1992), aff'd without published opinion, 24 F.3d 249 (9th Cir. 1994).