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HOUSE COMMITTEES ON WATER, LAND, OCEAN RESOURCES & HAWAIIAN AFFAIRS AND AGRICULTURE

TESTIMONY REGARDING SB 2198 SD 2 RELATING TO LAND CONSERVATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: MARCH 14, 2008
TIME: 10:30AM
ROOM: 211

This legislation provides a nonrefundable income tax credit for bargain sales or contributions of land for purposes of preservation.

The Committee on Water & Land passed this measure unamended.

The Committee on Economic Development & Taxation made amendments to the bill related to the determination of fair market value.

The Senate Committee on Ways & Means modified a definitional provision of the measure.

The Senate passed this measure on third reading.

The Department of Taxation defers to the Department of Land & Natural Resources on the policy merits of this legislation; however the Department also has **strong concerns** with this measure and **requests amendments.**

The Department also points out that this measure has not been factored into the Executive Budget and is not one of its tax relief priorities this session.

The Department very much recognizes the importance of preserving conservation and culturally relevant lands in order to maintain Hawaii's priceless lands. However, the Department has issues with administering this tax credit.

I. TECHNICAL COMMENTS

The following technical issues are apparent:

USE OF FAIR MARKET VALUE—The Department is always apprehensive when "fair market value" is used as the standard by which a tax credit or other tax incentive is calculated. Fair market value can mean something different to anyone, especially when a tax benefit is involved. The concern for the Department relates more to perceived frauds and abuses of land prices used to calculate the amount of the credit.

This bill was amended to clarify that fair market value for purposes of the credit is to be determined pursuant to federal law regulating appraisals for charitable purposes. Assuming fair market value is the only measure that can be used for this credit and use of an appraisal is the preferred method, the Department strongly suggests that the bill be amended to incorporate a penalty similar to Internal Revenue Code § 6695A that will penalize an appraiser who is complicit in a fraudulent land deal for purposes of this credit. An additional penalty similar to that provided under § 6662 of the Internal Revenue Code would prohibit taxpayers from similarly misusing any appraisals.

"**§231-A Accuracy-related penalty on underpayments due to substantial valuation misstatements.** (a) There shall be added to tax an amount of twenty per cent of the portion of an underpayment of tax required to be shown on a return if the portion of underpayment is due to a substantial valuation misstatement.

(b) There is a substantial valuation misstatement if the value of any property (or the adjusted basis of any property) claimed on any return of tax is one hundred and fifty per cent or more of the amount determined to be the correct amount of such valuation or adjusted basis, as the case may be.

(c) No penalty shall be imposed by a person under this section unless that portion of the underpayment for the taxable year attributable to the substantial valuation misstatement exceeds $1,000.

§231-B Substantial and gross valuation misstatements attributable to incorrect appraisals.
(a) There shall be assessed a penalty upon any person:
(1) Who prepares an appraisal of the value of property and such person knows, or reasonably should have known, that the appraisal would be used in connection with a return or a claim for refund; and
(2) The claimed value on a return or claim for refund which is based on such appraisal results in a substantial valuation

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          misstatement under section 231-A.
     (b)  The penalty assessable under subsection (a)
shall be equal to the lesser of:
(1)  The greater of:
     (i)  Ten per cent of the amount of the
          underpayment attributable to the misstatement
          under subsection (a); or
     (ii) $1,000; or
(2)  One hundred and twenty-five per cent of the gross
     income received by the person described in
     subsection (a) from the preparation of the
     appraisal.
     (c)  No penalty shall be imposed under this
section if the person establishes that the value
established in the appraisal was more likely than not
the proper value."
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PROPERTY CLASS STANDARDS—The Department is concerned about certain of the definitions used with the credit. For example, "conservation and preservation purpose" and "cultural property" are both very broad terms and the express definitions only increase the expanse of these definitions. The Department recognizes the rulemaking authority; however settling the issue in statute is the preferred method.

PUBLIC OR PRIVATE CONSERVATION AGENCY—There is concern over who will be running any conservation program. In order to ensure continuity and consistency, the Department suggests amending the bill to ensure some specific government agency be charged with implementing the conservation program before any tax credit is available.

PASS-THROUGH ENTITY PROVISION—Subsection (g) is unnecessary and confusing. Well-settled principles of partnership (pass-through) entity law typically do not allow any tax consequences for the "entity." All tax attributes of a partnership flow through to the partners that realize the tax consequences on individual tax returns. When an election is made by a partnership or limited liability company to be taxed at the entity level as a corporation, the entity is then considered a corporation for tax purposes and no longer a pass-through. The Department strongly suggests that subsection (g) be eliminated entirely. The Department submits that existing conformity to partnership and corporate tax principles is sufficient.

All that is needed is the following language:

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     "(g)  In the case of a partnership, S corporation,
estate, or trust, the tax credit allowable shall be
determined at the entity level.  Distribution and share
of credit shall be determined in accordance with section
235-2.45(d)."
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POSSIBLE LOSS OF FEDERAL AND STATE CHARITABLE CONTRIBUTION DEDUCTION—In its prior testimony, the Department had concerns with a potential double benefit by receiving the credit under this bill and a state charitable deduction. After further analysis, the loss of a generous federal benefit as a result of this credit is of greater concern. Generally, the taxpayer would receive a charitable contribution deduction for the donation of the property to a government entity or a nonprofit entity. The Internal Revenue Service has indicated that an issue exists as to whether providing a state tax credit in exchange for a donation of a conservation easement qualifies as a deductible charitable contribution and recommended public guidance be published on this issue. *See CCA 200238041, attached.* The IRS has yet to publish any guidance on this issue. Therefore, it is unclear whether donors would lose their federal and state charitable contribution deduction if the donor utilizes the credit. In addition, any requirement that conditions the credit on qualifying for the Section 170 charitable contribution deduction may be unworkable.

RULEMAKING—The Department already has broad rulemaking authority. Subsection (i) is unnecessary. There is also a conflict between subsection (i) and (j). Do both agencies get to make concurrent rules? Will one agency's rules trump the other?

CERTIFICATION PROCESS—In light of the Department's concerns, the Department also suggests a certification process whereby, rather than the Board of Land & Natural Resources being authorized to make rules for this credit, the DLNR could be authorized to certify credits, maintain information, and simply send a certificate to the Department to process the credit. Other similar certification processes are currently administered with the Department of Business, Economic Development & Tourism and the Hawaii Film Office. *See e.g.*, HRS § 235-17.

TRANSACTIONS SUBJECT TO POTENTIAL ABUSE—The Department mentions that the IRS has highlighted possible abusive transactions relating to donations of conservation easements. In certain cases, the IRS has disallowed deductions and assessed penalties on transactions it has found to be shams. The Committee should be aware that conservation easements have been used in the past in allegedly abusive tax transactions.

II. <u>REVENUE IMPACT</u>

This legislation will result in a revenue loss of approximately $3.2 million for FY 2009.

The Legacy Land Conservation program under DLNR provides matching funds for non-profits to engage in land purchases for conservation. In many of these cases, a part of the land interest is gifted to the non-profit. It is assumed that most conservation land donation transactions goes through this mechanism.

Gifts through the Legacy Lands project for 2008 are projected to be $3,238,500. We assume that this covers half of all eligible transactions under the credit (including investments covered in section (c) paragraph (2)). Thus we project the value of eligible transactions to be $6.5 million, of which a 50% tax credit would cause of revenue loss of $3.2 million.

Impact for future years is indeterminate, due to the large volatility in gift amounts from year-to-year.

CCA 200238041

UIL No. 170.14-00; 170.12-07; 164.03-00; 162.05-15; 1001.00-00

Headnote:

IRS has supplemented its earlier chief counsel advice concerning transferee of Colorado conservation easement credit being entitled to federal tax deduction when using credit to reduce state taxes.

Reference(s): IRC Sec(s). 170 ; IRC Sec(s). 164 ; IRC Sec(s). 162 ; IRC Sec(s). 1001

FULL TEXT:

Release Date: 9/20/2002

Reply to: CC:ITA:B1

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 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, 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 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 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.

Associate Chief Counsel

(Income Tax and Accounting)

By

PAUL M. RITENOUR

Chief, Branch 1

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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 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.

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).

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.

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).

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Notice 2004-41, 2004-28 IRB 31, 06/30/2004, IRC Sec (s). 170

Charitable contributions—conservation easements—disallowed deductions.

Headnote:

In light of possible improper charitable deductions, IRS is advising those who participate in transferring real property easement to charitable org or making payments to such org. in connection with real estate purchase from org. or who promote these type of transactions that it will disallow deductions as necessary and may impose penalties and excise taxes. IRS also reviewed requirements for donation of conservation easement under Code Sec. 170(h); , and noted that in situations involving purchase of real property from charitable org, it would apply substance-over-form doctrine to find that payment to charity for property and "donation" is in reality purchase price for property. IRS might also challenge exempt status of org., based on operation for substantial nonexempt purpose or impermissible private benefit.

Reference(s): ¶ 1704.45; Code Sec. 170;

Full Text:

The Internal Revenue Service is aware that taxpayers who (1) transfer an easement on real property to a charitable organization, or (2) make payments to a charitable organization in connection with a purchase of real property from the charitable organization, may be improperly claiming charitable contribution deductions under § 170 of the Internal Revenue Code. The purpose of this notice is to advise participants in these transactions that, in appropriate cases, the Service intends to disallow such deductions and may impose penalties and excise taxes. Furthermore, the Service may, in appropriate cases, challenge the tax-exempt status of a charitable organization that participates in these transactions. In addition, this notice advises promoters and appraisers that the Service intends to review promotions of transactions involving these improper deductions, and that the promoters and appraisers may be subject to penalties.

Contributions of Conservation Easements

Section 170(a)(1) allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in § 170(c)) that is made within the taxable year. Generally, to be deductible as a charitable contribution under § 170, a transfer to a charitable organization must be a gift of money or property without receipt or expectation of receipt of adequate consideration, made with charitable intent. *See U.S. v. American Bar Endowment* , 477 U.S. 105, 117-18 [58 AFTR 2d 86-5190](1986); *Hernandez v. Commissioner* , 490 U.S. 680, 690 [63 AFTR 2d 89-1395](1989); *see also* § 1.170A-1(h)(1) and (2) of the Income Tax Regulations.

Section 170(f)(3) provides generally that no charitable contribution deduction is allowed for a transfer to a charitable organization of less than the taxpayer's entire interest in property. Section 170(f)(3)(B)(iii) provides an exception to this rule in the case of a qualified conservation contribution.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for certain conservation purposes. Section 170(h)(1), (2), (3), and (4); § 1.170A-14(a). A qualified real property interest includes a restriction (granted in perpetuity) on the use that may be made of the real property. Section 170(h)(2)(C); *see also* § 1.170A-14(b)(2). For purposes of this notice, qualified real property interests described in § 170(h)(2)(C) are referred to as conservation easements.

One of the permitted conservation purposes listed in § 170(h)(4) is the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem. Section 170(h)(4)(A)(ii); *see also* § 1.170A-14(d)(1)(ii) and (3). Another of the permitted conservation purposes is the preservation of open space ("open space easement"), including farmland and forest land, for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy. However, if the public benefit of an open space easement is not significant, the charitable contribution deduction will be disallowed. *See* § 170(h)(4)(A)(iii); *see also* § 1.170A-14(d)(1)(iii) and (4)(iv), (v), and (vi). Section 170(h) and § 1.170A-14 contain many other requirements that must be satisfied for a contribution of a conservation easement to be allowed as a deduction.

A charitable contribution is allowed as a deduction only if substantiated in accordance with regulations prescribed by the Secretary. Section 170(a)(1) and (f)(8). Under § 170(f)(8), a taxpayer must substantiate its contributions of $250 or more by obtaining from the charitable organization a statement that includes (1) a description of any return benefit provided by the charitable organization, and (2) a good faith estimate of the benefit's fair market value. *See* § 1.170A-13 for additional substantiation requirements. In appropriate cases, the Service will disallow deductions for conservation easement transfers if the taxpayer fails to comply with the substantiation requirements. The Service is considering changes to forms to facilitate compliance with and enforcement of the substantiation requirements.

If all requirements of § 170 are satisfied and a deduction is allowed, the amount of the deduction may not exceed the fair market value of the contributed property (in this case, the contributed easement) on the date of the contribution (reduced by the fair market value of any consideration received by the taxpayer). *See* § 1.170A-1(c)(1), (h)(1) and (2). Fair market value is the price at which the contributed property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and each having reasonable knowledge of relevant facts. Section 1.170A-1(c)(2). *See* § 1.170A-14(h)(3) and (4) for a discussion of valuation.

If the donor (or a related person) reasonably can expect to receive financial or economic benefits greater than those that will inure to the general public as a result of the donation of a conservation easement, no deduction is allowable. Section 1.170A-14(h)(3)(i). If the donation of a conservation easement has no material effect on the value of real property, or enhances rather than reduces the value of real property, no deduction is allowable. Section 1.170A-14(h)(3)(ii).

Purchases of Real Property from Charitable Organizations

Some taxpayers are claiming inappropriate charitable contribution deductions under § 170 for cash payments or easement transfers to charitable organizations in connection with the taxpayers' purchases of real property.

In some of these questionable cases, the charitable organization purchases the property and places a conservation easement on the property. Then, the charitable organization sells the property subject to the easement to a buyer for a price that is substantially less than the price paid by the charitable organization for the property. As part of the sale, the buyer makes a second payment, designated as a "charitable contribution," to the charitable organization. The total of the payments from the buyer to the charitable organization fully reimburses the charitable organization for the cost of the property.

In appropriate cases, the Service will treat these transactions in accordance with their substance, rather than their form. Thus, the Service may treat the total of the buyer's payments to the charitable organization as the purchase price paid by the buyer for the property.

Penalties, Excise Taxes, and Tax-Exempt Status

Taxpayers are advised that the Service intends to disallow all or part of any improper deductions and may impose penalties under § 6662.

The Service intends to assess excise taxes under § 4958 against any disqualified person who receives an excess benefit from a conservation easement transaction, and against any organization manager who knowingly participates in the transaction. In appropriate cases, the Service may challenge the tax-exempt status of the organization, based on the organization's operation for a substantial nonexempt purpose or impermissible private benefit.

In addition, the Service intends to review promotions of transactions involving improper deductions for conservation easements. Promoters, appraisers, and other persons involved in these transactions may be subject to penalties under §§ 6700, 6701, and 6694.

Drafting Information

The principal author of this notice is Patricia M. Zweibel of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Zweibel at (202) 622-5020 (not a toll-free call).

HARC

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**TESTIMONY BEFORE THE HOUSE COMMITTEES
ON
WATER,LAND, OCEAN RESOURCES & HAWAIIAN AFFAIRS
AND
AGRICULTURE**

**SB2198 SD2
RELATING TO LAND CONSERVATION**

March 14, 2008

Chairs Ito and Tsuji and Members of your Committees:

My name is Stephanie Whalen. I am President and Research Director of the Hawaii Agriculture Research Center (HARC). I am testifying today on behalf of the center, our research and support staff, and our members and clients.

HARC **supports the intent SB 2198 SD2** Relating to Land Conservation.

In order to preserve some of the lands of Hawaii incentives are important. Because of the unique land holding situation in Hawaii many land owners do not qualify for the federal tax credits provided to those helping to preserve lands for the purposes proposed in this measure. Although there has been efforts to make an exception specifically for Hawaii to allow our land owners to receive these federal tax credits, those efforts have not been successful.

It is in the public interest of this state to provide those tax credits to ensure some lands for unique or special use are preserved in perpetuity.

Thank you for this opportunity to provide SUPPORT for SB2198, preserving land in Hawaii for the public interest.