

**DEPARTMENT OF REGULATORY AGENCIES
FY 2013-14 JOINT BUDGET COMMITTEE HEARING AGENDA**

**Friday, December 14, 2012
1:30 – 2:30 pm**

1:30-1:45 INTRODUCTIONS AND OPENING COMMENTS

1:45-1:50 QUESTIONS COMMON TO ALL DEPARTMENTS

1. The JBC occasionally hears complaints that base personal services reductions to capture vacancy savings result in more vacancy savings as managers reduce staff to absorb the reduction and then still experience turnover. Some departments refer to this as the *death spiral*. Has your department experienced this problem? How does your department attempt to minimize and avoid the *death spiral*?

1:50-1:55 DEPARTMENT OVERVIEW

2. Please provide an updated CAMELS report-chart as was submitted for last year's hearing. Please speak to the condition of banks in the state, particularly in relationship to recent and current economic conditions and federal policy decisions related to the financial services industry and monetary and banking policy.

**1:55-2:30 CONSERVATION EASEMENT TAX CREDIT PROGRAM PRE-APPROVAL PROCESS
AND STATUTORY CAP**

3. Would the actual *value* of conservation easement agreement be pre-approved? Would DOR then not contest the *value* of the appraisal? Would landowners or taxpayers think they are reasonably assured on *value* through this process? Would they really be assured that it is a valid easement or could DOR change it or challenge it in the future? The conservation easement is *pre-approved* in what sense in a pre-approval process?
4. Will a pre-approval process or a pre-approval process with a statutory cap on aggregate annual tax credits decrease the uncertainty of the liability of the state related to tax credit claims on a year-to-year basis?
5. Is increasing the statutory cap immediately to the staff recommended maximum of \$45 million prudent or should the cap be increased in a phased-in or ramped-up approach?
6. Is there really a capacity problem for qualified organizations holding conservation easements? Please discuss whether the Department believes there is or would be a capacity issue for

qualified organizations that requires a statutory cap on the aggregate annual amount of tax credits. If possible, please provide information, data, or feedback from qualified organizations that addresses this question.

7. Is there an *inherent cap* on the number of conservation agreements that qualified organizations can handle if there were no statutory cap on the aggregate annual amount of tax credits? In other words, qualified organizations can process and manage a certain maximum number of conservation easement agreements in a year; doesn't this necessarily create a *transaction cap* regardless of a statutory cap on the dollar amount of credits allowed in a year? If so, would this inherent transaction cap effectively replace the need for a statutory cap on the aggregate dollar amount of tax credits? Or would there be pressure on qualified organizations to spread their resources too thinly to accommodate any additional demand for conservation easements? If possible, please provide information, data, or feedback from qualified organizations that would address these questions.
8. The current process include a *first-in, first-out* (FIFO) approach to the statutory cap; tax credit certificates are granted as conservation agreements are submitted up to the aggregate dollar amount allowed. How would a pre-approval process fit into the FIFO system? Should the process or will the process allow simpler agreements to proceed prior to more complex ones within a FIFO system with a statutory cap? Please explain the conservation easement tax credit certificate process, and the options for using a FIFO system, or for using a different system, including a system that would rank the quality of conservation easement agreements relative to a statutory cap. Please explain how the timing of approvals might play out under various systems.

ADDENDUM: OTHER QUESTIONS FOR WHICH SOLELY WRITTEN RESPONSES ARE REQUESTED

1. The Joint Budget Committee has recently reviewed the State Auditor's Office *Annual Report of Audit Recommendations Not Fully Implemented* (October 2012). If this report identifies any recommendations for the Department that have not yet been fully implemented and that fall within the following categories, please provide an update on the implementation status and the reason for any delay.
 - a. Financial audit recommendations classified as material weaknesses or significant deficiencies;
 - b. Financial, information technology, and performance audit recommendations that have been outstanding for three or more years.

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- 1. The JBC occasionally hears complaints that base personal services reductions to capture vacancy savings result in more vacancy savings as managers reduce staff to absorb the reduction and then still experience turnover. Some departments refer to this as the *death spiral*. Has your department experienced this problem? How does your department attempt to minimize and avoid the *death spiral*?**

Response: The Department cannot say it has experienced any “death spirals” as characterized in the question. DORA acknowledges and manages base personal service funding reductions initiated by the legislature, in concert with all other obligations that occur outside the Department’s control (for instance, retirement payouts and turnover). The Department always works to utilize its allotted personnel resources in as effective a means as possible, including holding positions vacant as a primary strategy to manage to any personal services shortfall. It is recognized however, that the base personal service funding reductions do increase the likelihood, frequency and necessity of intentionally holding vacancies, which does negatively impact the level, speed, and manner in which public services are offered, in order to ensure budget compliance.

1:50-1:55 DEPARTMENT OVERVIEW

- 2. Please provide an updated CAMELS report-chart as was submitted for last year's hearing. Please speak to the condition of banks in the state, particularly in relationship to recent and current economic conditions and federal policy decisions related to the financial services industry and monetary and banking policy.**

Response: The following chart and discussion is being provided in response to this question.

	June 30 2009	June 30 2010	June 30 2011	June 30 2012
CAMELS Rating System Distribution (5 point scale)	Percent	Percent	Percent	Percent
Percent of institutions without adverse rating (CAMELS 1-2)	72.00%	66.40%	49.30%	60.53%
Percent of institutions adversely rated (CAMELS 3-5)	25.20%	33.60%	50.70%	39.47%
<i>Note: These ratios improve to 65.33% (CAMELS 1-2) and 34.67% (CAMELS 3-5) as of Dec 4, 2012</i>				

The financial condition of state-chartered banks in Colorado has greatly improved over last year. The trends have been positive. As you are aware, federal and state bank regulators use a CAMELS rating scale to assess the overall condition of a given bank. The components of a bank's condition that are assessed include (C) capital adequacy, (A) asset quality, (M) management, (E) earnings, (L) liquidity, and (S) sensitivity to market risk. The scale is from 1 to 5 with 1 being strongest and 5 being weakest.

For example, Colorado-chartered banks rated CAMELS 1 and 2 stood at 49.3% on June 30, 2011. And the banks adversely rated at CAMELS 3, 4 and 5 were 50.7% on that same date. A year later, on June 30, 2012, those same numbers were 60.53% and 39.47%, respectively. Recent examination findings show maintained progress. In fact, as of November 30th, there has been continued improvement in those numbers to 65.33% and 34.67%, respectively.

There has been a rebound in overall bank earnings. The return on average assets as of June 30, 2012 was 0.95%. Just two years ago, that same number was a negative 0.28%. Also, total assets show a modest increase over last year. There has been an increase of \$800 million in assets over last year. In addition, equity capital increased over \$100 million from June 30, 2011 to June 30, 2012.

All of these trends are directly related to the state's economy that has also improved. In particular, the real estate, energy and agricultural sectors have demonstrated great improvement over the previous four years.

With regard to federal policy decisions related to the financial services and banking industry, in August the federal bank regulators issued proposed rules for comment that addressed the regulatory capital requirements for banks. The basis for the proposed rules was the BASEL III international accords, whose purpose was to address the capital and risk profile of systemically significant financial institutions. However, the federal bank regulators received thousands for comment letters from bankers and other parties opposed to the capital requirements being applied to all banks, not just the very largest. Based upon the response, the federal bank regulators indefinitely postponed finalization of the proposed rule pending further review. It is our belief that the proposed capital requirement rules were overly complex and should not be applied across the board to all banks. If the rules were to pass in their current form, one could expect significantly reduced lending as well as a hastening in consolidation of community banks in Colorado and throughout the country.

1:55-2:30 CONSERVATION EASEMENT TAX CREDIT PROGRAM PRE-APPROVAL PROCESS AND STATUTORY CAP

- 3. Would the actual *value* of conservation easement agreement be pre-approved? Would DOR then not contest the *value* of the appraisal? Would landowners or taxpayers think they are reasonably assured on *value* through this process? Would they really be assured that it is a valid easement or could DOR change it or challenge it in the future? The conservation easement is *pre-approved* in what sense in a pre-approval process?**

Response: The Office of the State Auditor, in its September 2012 performance audit, recommended a conservation easement tax credit pre-approval process as a primary alternative to the audit-based approach, which is currently utilized by the Department of Revenue. The recommended pre-approval process would: 1) provide reasonable assurances that tax credit claims are valid and comply with all statutory and regulatory requirements; 2) approve or deny tax credits separately from and prior to any use of the credit; 3) ensure avenues for appealing decisions made during the pre-approval process are clearly established and communicated to the taxpayer; 4) ensure all essential elements related to conservation easement tax credit claims are reviewed and approved by those with the most appropriate and relevant expertise; and 5) the review and approval of tax credit claims is timely.

The value of the conservation easement tax credit certificate would be approved by the Division of Real Estate (“Division”) prior to the taxpayer filing its tax return, but after the donation of the conservation easement. Authority for approving the appraised value which the credit is based on would lie with the Division. The Department of Revenue (“DOR”) would not have the authority to contest that decision. Similarly the Conservation Easement Oversight Commission (“Commission”), to whom the Division provides staff support, would be responsible for reviewing the deed of conservation easement and the conservation purposes that it protects. Again, the DOR would not have the ability to contest the decisions made by the Commission. This process would provide affirmative approval by the state in contrast to the current process which only notifies taxpayers after the fact if their tax credit claim is denied. It would also move the decision making process up by several years in most cases. The term “pre-approval” is used to indicate that approval is provided by the Division and Commission prior to the use of the credit for tax purposes.

- 4. Will a pre-approval process or a pre-approval process with a statutory cap on aggregate annual tax credits decrease the uncertainty of the liability of the state related to tax credit claims on a year-to-year basis?**

Response: A pre-approval process by itself does not provide additional certainty as to the liability in any given year related to conservation easement tax credit claims. Certainty in the state’s liability related to conservation easement tax credit claims on a year-to-year basis is only achieved through an aggregate cap similar to what is in place for 2011, 2012 and 2013.

5. Is increasing the statutory cap immediately to the staff recommended maximum of \$45 million prudent or should the cap be increased in a phased-in or ramped-up approach?

Response: The current structure of the conservation easement tax credit cap allocates \$22 million for 2011, \$22 million for 2012 and \$34 million in 2013. The appropriate or prudent level of a tax credit cap is a judgment for the legislature, which presumably takes into account a variety of fiscal concerns, including the current and forecasted health of the state's economy. It is a decision which is independent of the program's regulatory structure. However, there is no indication that a phased-in or ramped-up approach transitioning from a \$34 million cap in 2013 to \$45 million cap would be necessary to maintain the quality of conservation easement transactions from a regulatory perspective.

6. Is there really a capacity problem for qualified organizations holding conservation easements? Please discuss whether the Department believes there is or would be a capacity issue for qualified organizations that requires a statutory cap on the aggregate annual amount of tax credits. If possible, please provide information, data, or feedback from qualified organizations that addresses this question.

Response: In our opinion, there is not a capacity issue that would necessitate a cap for any other purpose than limiting the state's liability in any given year. Based on a review of certified conservation easement holders, the limited number of qualified appraisers and historical data, the Division believes that the current industry capacity is approximately 150 to 160 transactions per year which would equate to approximately \$45 million in tax credits. Additionally, the Office of the State Auditor found that in 2009, prior to the tax credit cap and after the conservation easement holder certification requirement, \$45.2 million in tax credits were claimed. These are the same amounts as the cap recommended by JBC staff. Several factors, including the number of staff at certified organizations, number of willing donors and changes in other funding sources, could either increase or decrease capacity over time.

Conservation easement donations are complicated real estate transactions that involve many components and professionals. In order to process these transactions, the conservation easement holders must negotiate the terms of the conservation easement, work with qualified professionals to assess and document the current condition of the property, conduct title review and related due diligence, obtain environmental assessments, investigate mineral ownership and appraise the monetary value. In many cases it is also necessary to obtain legal opinions on these issues. The complex and interconnected nature of conservation easement transactions require a significant amount of work to process to completion.

The following chart shows the aggregate amount of conservation easement tax credits per year.

	2009	2010	2011	2012
Estimated by DRE ¹	\$50,224,554	\$42,736,802	\$24,226,176	\$27,932,665
Actual ²	-	-	\$22,000,000	\$22,000,000
OSA's Analysis of DOR Data ³	\$45,200,000	-	-	-

7. Is there an *inherent cap* on the number of conservation agreements that qualified organizations can handle if there were no statutory cap on the aggregate annual amount of tax credits? In other words, qualified organizations can process and manage a certain maximum number of conservation easement agreements in a year; doesn't this necessarily create a *transaction cap* regardless of a statutory cap on the dollar amount of credits allowed in a year? If so, would this inherent transaction cap effectively replace the need for a statutory cap on the aggregate dollar amount of tax credits? Or would there be pressure on qualified organizations to spread their resources too thinly to accommodate any additional demand for conservation easements? If possible, please provide information, data, or feedback from qualified organizations that would address these questions.

Response: We do not believe there is an inherent cap on the number of conservation easement transactions that certified conservation easement holders can handle. It is noted in the response above that these transactions are complicated and time consuming. Factors related to the complexity of transactions and the certified organization's ability to process them leads the Division to believe that the current industry capacity is approximately 150 to 160 transactions per year, which would equate to approximately \$45 million in tax credits. Several factors, including the number of staff at certified organizations, number of willing donors and changes in other funding sources, could either increase or decrease capacity over time. There is no indication that certified conservation easement holders would act improperly or jeopardize the quality of transactions in order to meet additional demand. Only an aggregate yearly cap can ensure that the state does not exceed a specified amount.

8. The current process include a *first-in, first-out (FIFO)* approach to the statutory cap; tax credit certificates are granted as conservation agreements are submitted up to the aggregate dollar amount allowed. How would a pre-approval process fit into the FIFO system? Should the process or will the process allow simpler agreements to proceed prior to more complex ones within a FIFO system with a statutory cap? Please explain the conservation easement tax credit certificate process, and the options for using a FIFO system, or for using a different system, including a system that would rank the

¹ Estimations by the Division of Real Estate are based on appraisals submitted for review. Estimated amounts are likely higher than actual due to the assumption that all bargain sale (partial donation) transactions maximized the tax credit.

² Actual numbers are based on the aggregate amount of tax credit certificates issued by the Division of Real Estate.

³ See page 16 of the Conservation Easement Tax Credit Performance Audit performed by the Office of the State Auditor.

quality of conservation easement agreements relative to a statutory cap. Please explain how the timing of approvals might play out under various systems.

Response: The order in which tax credit certificates are issued is based on the date the application is submitted to the Division of Real Estate (“Division”). All certificates are processed in the order in which they are received. When a taxpayer submits a tax credit certificate application to the Division, it is reviewed to ensure the deed of conservation easement was recorded, an appraisal supporting the value was completed and that it was donated to a certified holder. After the Division has determined the application meets all requirements, the requested tax credit amount is applied toward the aggregate cap. A tax credit certificate listing the amount of the credit is then issued to the taxpayers. Because applications are processed in the order in which they are received, credit certificates against the cap are issued in this order as well. The taxpayer must obtain a tax credit certificate from the Division in order to claim the credit on tax forms filed with the Department of Revenue (“DOR”).

As the State’s tax authority, DOR is currently responsible for processing tax filings and determining compliance with Colorado’s tax laws and regulations. Thus, DOR is the decision maker when it comes to determining whether taxpayers meet the legal and regulatory requirements to qualify for a conservation easement tax credit. A two-step risk-based approach is used when reviewing conservation easement tax credit claims, which means that not every statutory and regulatory requirement is examined on every claim. The first step examines compliance with basic requirements and identifies risk-based triggers. If a risk-based trigger is found the transaction undergoes additional scrutiny which may include consulting with the Division and Conservation Easement Oversight Commission (Commission). Tax examiners only review tax credits 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 the review does not occur until 2012.

The proposed pre-approval process is being developed to operate with or without an aggregate cap. When a taxpayer submits a tax credit certificate application to the Division, it is reviewed to ensure it contains all required documentation before the requested tax credit amount is applied toward the aggregate cap. Prior to the Division issuing a tax credit certificate, the transaction undergoes a full review. The Division will review the conservation easement appraisal to ensure the valuation is credible and complies with applicable requirements. The Commission will assess and evaluate the quality of transactions including a review of the deed of conservation easement and the conservation purposes. After the Division and Commission have determined the application meets all of their respective requirements, the tax credit certificate, listing the amount of the credit, is issued to the taxpayer. The taxpayer must obtain a tax credit certificate from the Division in order to claim the credit on tax forms filed with DOR. The DOR will retain authority over other tax-related requirements such as ensuring the donation occurred before the end of the donor’s tax year, ensuring that the taxpayer has a tax liability to offset, the total amount of the credit used by the donor and transferees does not exceed the total amount of the credit allowed and the donor has not claimed or used more than one conservation easement tax credit for the same tax year.

The proposed process moves most of the decision making authority related to conservation easement transactions from the DOR to the Division and Commission, assigning decision-making authority to the agencies with the appropriate subject matter expertise. As indicated above, the Division will be responsible for approval or denial of the appraisal, and the Commission will be responsible for approval or denial of the valuation of the conservation easement transaction. Under the proposed pre-approval process, the review of a transaction and a decision on its validity will occur generally one to two years earlier in the process and provide affirmative approval, in contrast to the current approach that only notifies a taxpayer after the tax filing if a credit is denied.

Tax credit certificate applications are applied to the cap based on the time of submission which is not dependent on the order in which the applications are reviewed. This allows the Division and Commission to spend more time reviewing complicated transactions without delaying the review of simpler transactions. Multiple transactions will be simultaneously reviewed thus a particularly complex review will not halt the entire review process.

The proposed pre-approval process reflects the recommendation from the Office of the State Auditor, which does not include prioritization as a requirement. If a prioritization system were implemented, it would fundamentally change the proposed pre-approval and tax credit cap processes. At this time the Division is not in a position to adequately address how different methods of prioritization could be implemented.

ADDENDUM: OTHER QUESTIONS FOR WHICH SOLELY WRITTEN RESPONSES ARE REQUESTED

1. The Joint Budget Committee has recently reviewed the State Auditor's Office *Annual Report of Audit Recommendations Not Fully Implemented* (October 2012). If this report identifies any recommendations for the Department that have not yet been fully implemented and that fall within the following categories, please provide an update on the implementation status and the reason for any delay.
 - a. Financial audit recommendations classified as material weaknesses or significant deficiencies;
 - b. Financial, information technology, and performance audit recommendations that have been outstanding for three or more years.

Response: The only recommendation affecting the Department that fits into these categories is Recommendation 13 from the Cash Funds Uncommitted Reserves Report Statewide Audit (October 2011), which pertains to the management of cash funds within the 16.5% maximum reserve set forth in S.B. 98-194. The Department agrees with the recommendations and continually monitors all fund balances for compliance with Senate Bill 98-194's limitations on excess uncommitted reserves as soon as possible. While license renewal cycles, fluctuations in licensee population, and expenditure trends can in some cases prevent immediate compliance, in all cases fee adjustments are made at the earliest available opportunity to bring the funds into compliance as quickly as possible. The Department does fully carry out the audit recommendations to monitor fund balances and make fee adjustments on a continual basis each year in order to both carry out the recommendation and comply with the provisions of Senate Bill 98-194.