

CONSERVATION PARTNERS, LLC:
VIRGINIA LAND PRESERVATION TAX CREDIT

TAX CREDIT PROGRAM CHALLENGES AND REFORM
DECEMBER, 2010

Introduction

Through the Virginia Land Conservation Incentives Act of 1999 (the Act), the Commonwealth of Virginia offers meaningful financial incentives in the form of transferable state income tax credits to encourage landowners of all income levels to permanently protect the conservation values of their land. The credits are available to landowners who donate their land outright as well as those who donate conservation easements protecting their land in perpetuity; in either case, the credits are intended to reward landowners for making charitable donations that provide significant benefits to the public.

Under the Act, a qualifying easement donor can claim a land preservation income tax credit in an amount equal to forty percent (40%) of the appraised value of the donation. The credit, unlike a deduction, can be used to offset the donor's Virginia income tax liability dollar-for-dollar, subject to certain statutory limits.

To be eligible for a land preservation tax credit, the donation must satisfy various technical requirements, and the value of the donation must be estimated by a fully-supported appraisal prepared by an independent appraiser with significant expertise in valuing land and conservation easements.

Because land preservation tax credits are *transferable*, donors can choose to sell some or all of the tax credits generated by their donations to other individual and corporate Virginia taxpayers, who can then use the credits to offset their own Virginia income tax liability.

Applications for tax credits are subject to an annual overall cap of approximately \$100 million (adjusted each year for inflation), and credit applications processed by the Tax Department after the cap has been reached will be put off until the following year.

The tax credit program has been very effective in encouraging landowners to permanently protect the conservation values of their land, especially through the donation of conservation easements. For example, the number of acres protected by conservation easements donated to Virginia Outdoors Foundation more than doubled in total acreage in the first year the Act was effective, and significantly increased again in 2002 after the Act was amended to allow the transfer of credits. Since then, landowners have continued to donate easements to Virginia Outdoors Foundation at approximately double the rate that prevailed before the Act was first passed.

Necessary Elements for a Successful Tax Credit Program

In order for the land preservation tax credit program to work over the long term, and to ensure that the public receives the greatest conservation benefit possible from the tax revenues expended, there must be some assurance that the following two elements are present:

Quality Easements. Donated easements must provide significant benefits to the public: the properties encumbered by donated easements must have significant conservation values, the easements must be drafted to adequately protect those values in perpetuity, and the easements must be conveyed to responsible holders who will be willing and able to enforce their terms in perpetuity.

Proper Valuation. Easements must not be overvalued by donors. The tax credit program is designed to reward a landowner with a credit equal to 40% of the amount by which the easement reduces the fair market value of the landowner's land (referred to as the "value" of the easement). However, the credit exceeds that amount—and provides an unwarranted windfall to the landowner at the public's expense—when an abusive appraisal is used to exaggerate the value of the donated easement.

Exploitation

Unfortunately, the land preservation tax credit program is susceptible to exploitation. For example, some conservation easement donors negotiate easements allowing them to develop their land in ways that could seriously impair the conservation values the easement is supposed to protect. Some donors also obtain abusive appraisals that exaggerate the value of their donations. More recently, a few developers and real estate speculators caught in the real estate downturn have decided the credit provides them a way to salvage deals gone bad: they donate land or easements, obtain aggressive valuations, and claim mega-credits that consume a disproportionate share of the annual credit cap, leaving conservation-minded donors out in the cold.

It's difficult to estimate the extent or cost of the abusive practices, but there are reasons to suspect that the quality of easements and valuations associated with some land preservation tax credit claims is lower than it should be, which means the Commonwealth may not receive good value on some of the tax expenditures it makes through the program.

Some have also pointed out that the credit was originally intended by the General Assembly to provide an incentive for average farmers and other landowners of more modest means who want to protect their land in perpetuity. Exploitation of the program subverts that original legislative purpose in at least two ways: it results in the allocation of a disproportionate share of the annual credit cap to a few large-scale claimants and it drives down credit prices. Credits generated by abusive easements or inflated valuations are often sold at deep discounts, and large numbers of cheap credits flooding the market can drive down the price that charitably-motivated, fully compliant easement donors

receive for their credits. Low prices in turn reduce the incentive the program can provide to “land-rich, cash-poor” farmers and other average landowners who wish to preserve their land.

If not addressed by the General Assembly and the Virginia Department of Taxation (the Tax Department), exploitation could undermine public support for this crucial program and potentially impair its viability and effectiveness. Failing to address these problems could also make it difficult for the Commonwealth to attain Governor McDonnell’s ambitious land conservation goals.

Existing laws and standards should deter exploitation, but enforcement of such laws and standards is limited to after-the-fact audits by tax authorities. That kind of enforcement is inherently very difficult and time-consuming, and despite tax authorities’ best efforts, some practitioners and donors still feel confident that they can safely ignore applicable standards.

Potentially Abusive Practices

Conservation Partners, LLC (Conservation Partners) carefully reviews the deed of easement, appraisal report, and certain other underlying documentation for compliance with our proprietary *Quality Standards* before agreeing to market any land preservation tax credit. We work hard to protect our tax credit purchasers from credits based on transactions that inappropriately manipulate and exploit the land preservation tax credit program.

Every year, Conservation Partners declines to work with a significant number of credits that fail to comply with our *Standards*. While we cannot reveal confidential information related to particular transactions and documents we have reviewed, we thought it would be helpful to describe, in general terms, several potentially abusive practices we have encountered. In our opinion, transactions employing these strategies can fail to provide significant conservation benefits to the public at a reasonable cost to the Commonwealth. Credit claims based on these transactions can result in unjustified windfalls to the “donors” at the expense of the Commonwealth and to the detriment of the majority of donors who follow the rules and the spirit of the land preservation tax credit program.

There is, of course, a fine line between “aggressive” and “abusive.” Nearly all of the conservation and appraisal standards applicable to a land preservation tax credit claim are inherently subjective. Conservation Partners has reviewed hundreds of transactions, however, and by evaluating a transaction under our *Standards* we can pretty quickly get a sense for whether the primary aim of the “donor” and his professionals is exploitation: to claim a monetary reward on the taxpayer’s nickel while failing to provide significant public benefits and/or to inflate the appraised value of the donation beyond a reasonable estimate of the donor’s true economic sacrifice.

Pre-Donation Tactics: We have seen conservation easement donors and their professional advisors employ a number of gambits before the donation, all designed to facilitate a more aggressive easement appraisal.

- *Preparing a “development plan” for the property before the easement.* This is not always abusive; with some properties, a realistic development plan can be essential to the appraiser’s complete understanding of the property’s before-easement (and, in some cases, after-easement) highest and best use. Unfortunately, however, the preparation of a development plan is too often aimed at supporting an abusive and aggressive before-easement valuation. These “development plans” are not intended to explore the realistic possibilities for the property but to create the impression that intensive development with no grounding in physical or market realities is a foregone conclusion before the easement. Such development plans are most effective when followed up by an appraisal employing the subdivision development analysis, described later in this memorandum.
 - Conservation Partners’ *Standards* require the appraiser to provide a fully-supported and convincing analysis of the property’s before-easement “highest and best use.” A fanciful development plan, no matter how sophisticated, will not help the appraiser pass this test.

- *Convincing the local government to rezone the property to a more intensive zoning and/or approve an intensive subdivision plan immediately before donating the easement.* This tactic is not *per se* abusive but is always highly questionable in that it nearly always is designed solely to facilitate a more aggressive valuation of the donated easement. This gambit can come in two flavors: first, if the change in entitlements is easy to obtain and merely a *pro forma* or administrative matter—such as filing a subdivision plan exercising rights that were not in question—the change wouldn’t materially increase the value of the property because the ease of making the change would have been reflected in the value of the land prior to the change. In that case, the change probably does nothing but provide superficial cover for an appraisal that inflates the before-easement value of the land using the subdivision development method or inappropriate comparable sales and/or adjustments. On the other hand, if the zoning change was a truly significant entitlement not generally available to other similarly-situated landowners, the change probably did increase the value of the land. Here, the problem is more subtle, but rewarding a landowner for giving up value that he or she obtained solely for purposes of giving it up and claiming a larger tax benefit should at least raise eyebrows. In some instances, tax authorities might raise the possibility that the entitlement was only provided to the landowner because the landowner agreed to refrain from engaging in the more intensive development.
 - Conservation Partners’ *Standards* contain extensive provisions limiting the use of the subdivision development analysis and require that, in the before-easement section of the appraisal, the appraiser estimate *the price at which the donor realistically could sell the land in its current state in the open market*. In addition, any agreement between the landowner and

the local government limiting the use of the property despite an apparent entitlement change would affect the highest and best use of the property before the easement, which must be fully and convincingly analyzed by the appraiser.

- *Removing other impediments to development before the easement.* Once again, there's a fine line between justifiable and abusive practices. Purchasing adjacent land to afford a land-locked parcel usable road frontage may make perfect sense before donating an easement on the whole property. But if the same land-locked landowner convinces his neighbor to provide a 50-foot-wide, unrestricted right of way to access his property just before donating an easement on the property, suspicions are raised. If the donor made an enforceable promise to his neighbor that he would not use the right of way to intensively develop his property, the right of way does not increase the value of his property as much as he might have hoped. Unfortunately, the appraiser probably will value the property before the easement as if it were fully developable, resulting in an overvalued easement and an excessive tax credit claim.
 - Again, Conservation Partners' *Standards* contain the fundamental requirement that the appraiser estimate the price at which the donor realistically could sell the land in its current state in the open market, and any agreement limiting the use of the property before the easement must be fully and convincingly analyzed by the appraiser.

Retained Development Rights: Some conservation easement donors retain so many development rights in the easement that the highest and best use of the property is not affected. Retaining development rights is not an abusive practice in itself, so long as the conservation values of the land are appropriately protected and the easement provides significant public benefit. However, these donors usually go on to obtain an appraisal that values their property after the easement as if the easement significantly changed the property's highest and best use, sometimes by applying percentage discounts derived from data from markets where development pressure was more intense.

- Conservation Partners' *Standards* contain extensive provisions addressing retained development rights and the protection of a property's conservation values. In addition, the *Standards* require that the appraiser properly analyze the property's before-easement and after-easement highest and best use, use proper comparable sales, analyze those sales fully and appropriately, and only use the percentage diminution method as a supplement to the more reliable direct sales comparison approach (and even then only if it is based on proper analysis carefully tailored to the subject property and the subject easement).

Easements that Protect Land Already Subject to Restrictions: Donating an easement protecting land that already has limited development potential—for example, because wetlands, floodplain, and/or endangered species are present—can be a good idea in that it makes the protection of these attributes more permanent. Too often, however, the donor

obtains an appraisal that ignores the impediments to development that existed before the easement was conveyed, resulting in significant over-valuation of the gift.

- Conservation Partners' *Standards* require that the appraiser properly analyze the property's before-easement highest and best use.

Subdivision Development Analysis: Especially after the *Kiva Dunes* Tax Court decision in 2009, promoters and appraisers are again touting the subdivision development analysis as the best way to maximize a conservation easement donor's tax benefits. This highly complex appraisal method is valid in some circumstances if used by an expert appraiser, as discussed in detail in Conservation Partners' *Quality Standards*. Unfortunately, the subdivision development analysis is often used improperly in appraisals to inflate land values far beyond what a more level-headed evaluation of the relevant real estate market would indicate.

- Conservation Partners' *Standards* contain extensive provisions limiting the use of the subdivision development analysis.

Unsupported/Unwarranted Assumptions in the Appraisal: Sometimes, instead of going to the trouble of actually having the property rezoned, donors and their appraisers will simply assume that the property could be rezoned if they wanted. The appraiser then values the property as if it were subject to the more intensive zoning. State and federal tax authorities have stated that such unsupported assumptions are improper and will be carefully scrutinized in audits. Other commonly-made improper assumptions include ignoring limited access to a property, ignoring the lack of development pressure in the property's neighborhood, and assuming without support that a property would be released from an Agricultural/Forest District.

- Conservation Partners' *Standards* require that the appraiser properly analyze the property's before-easement highest and best use.

Inappropriate Comparable Sales and Adjustments: One reason the sales comparison appraisal approach is much preferred over the subdivision development analysis in most situations is the appraiser must look directly at actual sales of properties and compare those properties to the subject property. This more direct method is certainly susceptible to improper manipulation by an over-aggressive appraiser, but abusive practices are easier to spot and can't be hidden in the depths of complex calculations, spreadsheets, and multiple levels of discount assumptions as is the case with the subdivision development analysis. Abusive practices in sales comparison approach appraisals include the use of comparable sales that are not sufficiently similar to the subject property (because of location, timing, or other factors like zoning) and were obviously chosen because they supported the donor's agenda of asserting unrealistically high before-easement values and/or unrealistically low after-easement values. Tax authorities have told us they have even encountered conservation easement appraisals with entirely falsified comparable sales. Appraisers might also apply unrealistic and unsupported

adjustments to comparable sale prices to inflate before-easement values or deflate after-easement values.

- Conservation Partners' *Standards* require that the appraiser use proper comparable sales and analyze those sales fully and appropriately, applying adjustments that are reasonable and supported by market data.

Audits by the Virginia Department of Taxation

The Tax Department has a new source of funding in the transfer fees it collects when land preservation tax credits are transferred. In addition, for better or worse, the IRS is stepping up its enforcement efforts in the land conservation area.

The after-the-fact procedure the Tax Department must follow in order to review a claim of tax credits places it at a strategic disadvantage. Because a credit only can be registered after the deed of gift has been recorded, the Tax Department's oversight—by definition—cannot occur until the donation is irreversible, and often the credit will have been transferred to other unrelated taxpayers and the funds realized will have been spent. Recovery of tax revenues associated with an abusive credit claim is expensive and often results in extensive litigation, which increases the program costs borne by the taxpayers. In short, enforcement by the Tax Department is indispensable, but correcting the problems after-the-fact is less effective and more expensive than preventing them in the first place.

The most efficient way to encourage widespread compliance with applicable standards is to provide a means for qualified professionals to pre-screen the various elements of credit claims, eliminating most potential abuse before the credits are even registered with the Tax Department.

Review of Large Credit Claims by the Department of Conservation and Recreation

The requirement that credit claims of \$1 million or more be reviewed for conservation value by the Department of Conservation and Recreation has probably helped to quell abuse and increase the quality of conservation supported by the tax credit program. However, DCR review is not sufficient on its own to ensure proper operation of the tax credit program. First, the requirement does not affect credit claims of less than \$1 million, and donors of more valuable land or easements can avoid DCR review by simply claiming a credit slightly below the \$1 million threshold. More importantly, DCR review does not include any scrutiny of the appraisal of the donation, and the largest single problem with exploitation of Virginia's land preservation tax credit is the overvaluation of donations.

Pre-Registration Screening by Easement Holders

The mission of government agencies and non-profit organizations that accept easement donations is to implement good land conservation, and as a rule easement holders should

be carefully screening the easement transactions they engage in to ensure they benefit the public. However, safeguarding the efficiency and efficacy of the tax credit program is not always foremost in easement holders' minds, and holders typically do not have the expertise to thoroughly screen appraisals or other highly technical aspects of easement transactions.

Market-Based Pre-Registration Screening

If the Tax Department presents a credible threat that it will enforce existing public benefit and valuation standards after the fact, the market for transferable credits should operate to leverage the Tax Department's efforts *before the fact* and increase compliance with the standards generally.

In other words, if there is a real risk of enforcement, credit buyers will prefer to buy credits that are less likely to be disallowed in whole or in part by the Tax Department, and easement donors and credit transfer agents will have a strong incentive to bring to market only credits that are based on easements and appraisals that comply with applicable standards. Given the likelihood of credible enforcement, credit transfer agents ideally (eventually) would emerge as professional "gatekeepers" of the program, working on behalf of donors, credit buyers, and the public at large to ensure that the program provides significant public benefit at a reasonable public cost.

The problem with the theory above is not that it's wrong, but that the predicted transition to market-driven tax credit quality assurance is occurring at a snail's pace. Several factors have been responsible for the delay:

- Until recently, the Tax Department's resources and ability to pursue exploiters have been limited, though this should be changing soon.
- The risk of enforcement has been perceived by market participants to be very low.
- Promoters have fostered the perception in the market that all land preservation tax credits are of equal quality, that there is no exploitation of the program, and that substantially all easements and appraisals are compliant with applicable laws and regulations.
- The proper standards for easements and appraisals are poorly understood by most participants. Because so few have the expertise to divine and apply existing standards, the natural emergence of effective gatekeepers is proceeding slowly.
- Professionals who assist donors often prefer to limit the scope of their representation: appraisers only address valuation, attorneys only draft the deed of easement, and accountants only fill out the tax forms. Many—perhaps most—land preservation tax credit claims are made before anyone with significant expertise has evaluated the donation transaction as a whole.

Conservation Partners, LLC's Approach to the Tax Credit Market

Conservation Partners has been a leader in Virginia land conservation since its founding in 2002. At Conservation Partners, we employ a comprehensive approach to land conservation that begins with an introduction to the various tools and tax benefits available, followed by facilitation of the entire donation process through registration and sale of the donor's land preservation tax credit. Our work includes extensive qualitative reviews of the documents underlying the tax credit against a proprietary set of conservation easement and appraisal standards, as well as on-call consultation for professionals engaged in the donation process. This approach has been recognized for maximizing the quality of the resulting tax credit in a cost-effective manner both for the conservation easement donor and the Commonwealth.

We are very proud of our record of providing comprehensive services to landowners interested in preserving their land for future generations. To date, our programs have resulted in the following accomplishments:

- We have worked with easement and land donors—reviewing their easements and appraisals, marketing their land preservation tax credits, and facilitating and sometimes even originating their donations—who have protected over 100,000 acres throughout Virginia.
- The average cost to the Commonwealth in terms of tax credits related to easements we have worked with state-wide compares favorably with the average cost of all other donations of both large and small easements. State-wide statistics are available from the Tax Department.
- The costs of our work in conservation and professional training are covered entirely by fees charged the beneficiaries of our services. We are not subsidized by separate state expenditures or by charitable contributions. The comprehensive nature of our programs and our adherence to quality have helped hold down the cost of easement donations for the average landowner.
- Each deed and appraisal associated with the donation of an easement we originate or facilitate must meet our *Quality Standards* before we market and sell the resulting tax credit to Virginia tax credit purchasers. *As a result of our strict adherence to these exacting Standards, not one tax credit we have worked with has been disallowed or devalued by the Department of Taxation.* This record spans eight years to date.

Conservation Partners' programs include the following:

- Comprehensive assistance to landowners throughout the easement donation process, beginning with an introduction to conservation easements and culminating in the sale of the donor's tax credit.

- Advance funding of costs associated with easement donation for qualifying landowners. This program has benefited a number of land-rich/cash-poor landowners, particularly farmers, who without our advance funding would not have been able to protect their treasured family lands.
- We have established a program by which we provide high-level continuing education seminars throughout the Commonwealth for attorneys, appraisers, and accountants specializing in conservation donations.

Conservation Partners does not condone or participate in tax credit claims that result from practices we believe are abusive of the tax credit program. Virginia’s taxpayers should receive high-quality land conservation for each dollar spent on conservation programs. We believe the model we have established at Conservation Partners can work for the rest of the state and result in a more cost-effective tax credit program to help the Commonwealth meet its ambitious land conservation goals.

Proposal: License Transfer Agents to Foster More Effective and Widespread Market-Based Pre-Registration Screening

We propose that legislation be implemented that would require most land preservation tax credit transfers be conducted by a licensed transfer agent. The licensure requirements would include, among other things, public registry, bonding, and significant penalties for transfer agents facilitating the transfer of credits that are subsequently disallowed in whole or in part by the Tax Department.

State licensing of credit transfer agents should foster the market’s capacity to leverage the Tax Department’s enforcement efforts into better up-front compliance with existing conservation and valuation standards. Faced with appropriate sanctions for marketing credits that don’t meet the Department’s criteria, transfer agents will have a strong incentive to pre-screen tax credits to ensure the easements provide significant public benefit and the valuations are properly supported...*before* the credit is registered with the Tax Department.

Because land and easement donors are rarely able to use more than a small percentage of their credits against their own income tax liability, most of the credits claimed each year are eventually sold to other Virginia taxpayers. And it appears that most credit sales are made through an intermediary of some sort, whether an accountant, an attorney, or a person or entity that specializes in land preservation tax credit transfers. These intermediaries—or “transfer agents”—are not subject to any regulatory oversight or requirements directly related to the land preservation tax credit. A mandatory licensing regime imposing certain basic requirements for licensure (in-state office, insurance, bonding, etc.) would ensure that these transfer agents who facilitate the transfer of tens of millions of dollars of land preservation tax credits each year are at least minimally credible businesses.

More significantly, the transfer agents—whether attorneys, accountants, or transfer

specialists—represent a natural bottleneck in the tax credit program, where a relatively small number of entities have the opportunity to evaluate a large number of tax credits. Thus, a licensing regime for credit transfer agents could be designed to encourage the transfer agents to act as effective gatekeepers for the tax credit program. For example, license requirements would subject facilitators that repeatedly transfer credits from abusive transactions to severe monetary penalties and suspension/revocation of their licenses. Licensees also might be required to meet annual continuing education standards in general program knowledge and relevant legal, appraisal, and accounting fields. They could be required to submit and keep up-to-date a written set of standards by which they evaluate the credits they work with, and provide curricula vitae of the persons who will be conducting the evaluations. This material should be made available to the public so that tax credit buyers could assess the expertise of the transfer agents they may be dealing with.

Increasing the transparency of the various transfer agents and imposing some of the risk of enforcement on credit transfer agents through such a licensing program makes sense. Transfer agents are both “repeat players” who would be less inclined to gamble on risky transactions and “compliance consolidators” who can influence a large number of transactions over time.

A licensing strategy should accelerate the professionalization of tax credit transfer agents, and over time it should lead to the establishment of a number of highly qualified transfer agents who would ensure most land preservation tax credits are pre-screened before they are claimed, significantly easing the Tax Department’s enforcement workload, curbing abuse in a cost-effective manner, and resulting in a far more efficient and efficacious land preservation tax credit program.

Conservation Partners, LLC

Conservation Partners was formed to help Virginians realize the benefits of land conservation. To accomplish our mission, we have established a program focused on providing comprehensive support services to donors of high-quality conservation easements and the conservation professionals those donors depend upon. Assisting landowners in their efforts to protect their lands for the future is the primary focus of Conservation Partners.

NOTICE: This document is intended for educational and informational purposes only. Nothing herein is to be considered legal advice, and readers are responsible for obtaining such advice from their own legal counsel.

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