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Valuing Farmland Conservation Easements

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This NebGuide discusses farmland conservation easements and the process of estimating their value.

According to USDA estimates, more than 2 million acres of farmland are developed for urban and other nonagricultural uses each year. Nearly 30 percent of this acreage is considered prime farmland—farmland that has the soil quality, growing season, and moisture supply needed to sustain high yields when managed according to acceptable farming methods. Much of the farmland being lost lies in two of the nation's major agricultural states, California and Florida, which account for much of the nation's fruit and vegetable production. However, the land conversion process is occurring in every state to some degree. In Nebraska, thousands of acres of farmland are converted each year, with many of those acres representing prime farmland.

The conversion of farmland to urban uses can result in more than the loss of productive farmland from which to contribute to the national and global food supply. Conversion also can result in the loss of open space, scenic views, animal habitat, resting grounds for migratory birds, clean air, and water recharge areas. Moreover, when farmland conversion becomes pronounced in a particular geographic area, it can create uncertainty about the future of production agriculture in the area—thereby contributing to an escalating farm exodus and further disconnection of the society from the land and its food source.

Federal, state and local governments and various private groups have acted in hopes of slowing or preventing the loss of farmland. At the federal level, the 1981 Farmland Protection Policy Act, the 1990 Farms for the Future Act, and the 1996 Farmland Protection Program have all made steps in providing protection and supporting state and local farmland protection efforts. At the state level, all states have enacted right-to-farm laws, and 49 have enacted differential assessment property tax relief.

Local efforts to help protect farmland include the outright purchase of agricultural land, comprehensive growth management plans, agricultural zoning, the purchase of development rights, the transfer of development rights, and the use of conservation easements.

Conservation Easements

A conservation easement is a legal document voluntarily placed by landowners on their property to restrict the use of the land to farming, open space, wildlife habitat, historic sites or scenic views. Although conservation easements can be tailored to the needs of each property owner, they usually limit subdivisions, nonfarm development and other uses that are inconsistent with commercial agriculture. Property owners still retain title to their property and are not limited in their right to enter, farm, lease, mortgage, bequeath, sell, restrict public access, or demand compensation for rights transferred. Most easements do not restrict normal farming practices and development related to the farm operation, but some may specify certain conservation standards that must be met. Some easements even permit building lots for family members.

Most agricultural conservation easements run in perpetuity and are legally binding on all future landowners. However, an easement can be modified or terminated by a court of law through eminent domain proceedings or if the land changes and the conservation objectives of the easement become impossible to achieve.

Easements are typically sold for their fair market value, donated, or sold as a bargain sale (lower than the fair market value) to a qualified conservation organization or public agency. The agency or "grantee" receives the right to monitor and enforce the restrictions set forth in the easement. Although the landowner or "grantor" relinquishes the right to develop the land, that right is not conveyed to the grantee. The grantee simply acquires the right to prevent the landowner from developing the land, while the actual right to develop the land is extinguished.

The agencies involved in conservation easement acquisition fall into four categories:

- **Federal government agencies** such as the Natural Resources Conservation Service, the Fish and Wildlife Service, and the National Park Service

- **National nonprofit groups** such as The Nature Conservancy, the Trust for Public Land, the Conservation Fund, and the American Farmland Trust
- **State and local government agencies** such as the Maryland Agricultural Land Preservation Foundation and the Lancaster County Agricultural Preserve Board
- **Land trusts** such as the Platte River Whooping Crane Maintenance Trust, the Iowa Natural Heritage Foundation, and the Montana Land Reliance

Advantages of Conservation Easements:

- The property can't be developed beyond that described in the easement even when ownership changes.
- The property remains in private ownership, which allows the landowner to live on it, sell it, or pass it on to heirs.
- Since the property remains in private ownership, it continues to contribute to the local tax base.
- The easement can increase the value of surrounding land since some people are willing to pay for open space.
- As a result of reduced property value, property taxes may be significantly lower. However, if a differential assessment program already directs the land to be assessed for agriculture rather than its highest and best use, the reduction would be minimal.
- Estate taxes may be significantly lower as a result of reduced property value, allowing heirs to hold onto family land instead of selling it to pay inheritance taxes. In addition, the Taxpayer Relief Act of 1997, Internal Revenue Code § 2031 (c), allows estate executors to exclude up to 40 percent of the land's value, subject to a qualified conservation easement. The exclusion will be phased in over five years and increase to a maximum of $500,000 in 2002.
- The donation of a perpetual conservation easement to a land trust can be treated as a charitable gift on the landowner's federal and state income tax returns. Internal Revenue Code § 170 (h) specifies that donors can deduct an amount equal up to 30 percent of their adjusted gross income in the year of the gift. Easement donations in excess of the annual limit can be applied toward federal income taxes for the next five years.

Disadvantages of Conservation Easements:

- The land may not always be farmed, even though that is the purpose of the easement. As development occurs, nuisance ordinances may be passed restricting farming practices making farming too difficult.
- As surrounding land is developed, the value of the easement-burdened land may decrease due to the difficulty in farming and to the inability to expand.
- Eminent domain proceedings can still take land with a conservation easement.
- Since easement holders are not taxed, the community's tax base is lowered.
- The funds available to purchase conservation easements are limited.
- A conservation easement must run in perpetuity in order to receive any of the tax benefits.
- There are several conditions that must be met in order to receive the full tax benefits of donating a conservation easement. For example, in order to qualify for the estate tax benefit, IRC 2031 (c), the conservation easement must be within 25 miles of a metropolitan area, within 25 miles of a national park or wilderness area, or be within 10 miles of an urban national forest. Contact a knowledgeable tax advisor or attorney for specific tax implications.

Appraising Easements

In addition to preventing farmland from future development, one of the fundamental purposes for a farmland easement is to create real estate tax and/or income tax benefits. Internal Revenue Code § 170 (h) specifies that when an easement has a claimed value in excess of $5,000, the donor must submit a qualified appraisal by a qualified appraiser (both as defined by the U.S. Treasury Department) in order to claim a deduction. The IRS frequently audits these appraisals and the penalties for over valuation can be severe.

There are two commonly used methods for valuing conservation easements: the comparable sales method, and the before-and-after method.

Comparable Sales Method

Treasury regulation § 1.170A-14(h)(3) states: "If there is a substantial record of sales of easements comparable to the donated easement, the fair market value of the donated easement is based on the sales prices of such comparable easements."

The comparable sales method uses actual sales of similar easements to compare to the easement being appraised. Several differences must be analyzed when comparing easements. Since easements can be so flexible, the rights and interests transferred have to be carefully analyzed. For example, some easements prohibit mining, regulate the cultivation of land within a specified distance of waterways, require maintenance of grass strips to control erosion, regulate harmful pesticides, or regulate permanent plantings such as orchards or vineyards. Others may regulate the location of future or replacement farm buildings, limit billboard or other advertising, prohibit the destruction of vegetation and trees, or prohibit the disturbance or alteration of wetlands, streams or ponds.

There are several drawbacks to using this method. First, the treasury regulation states that there needs to be "a substantial record of sales of easements." The regulation does not state how many are required. But the number of similar easement

sales in most areas is relatively limited, although there has been a recent increase in the use of conservation easements in some areas.

A second problem is that government funded programs frequently acquire easements through bargain sales; therefore sales data would only show a portion of the value of the easement. In other cases, easements may be coupled with debt restructuring, tax management, or be initiated through some other motive.

A third problem is that comparable sales are based on actual transactions that have already reached their optimal conversion date. For example, on the urban fringe, each farm has some optimal conversion date, usually one to 10 years into the future, when the landowner expects to maximize his/her wealth. Comparing sales that have already reached their optimal conversion date with farmland that hasn't reached that optimal date can easily overstate a farm's urban value.

Before-and-After Easement Sales Method

The second method used to estimate the value of conservation easements is the before-and-after method. This method takes the full value of the land before the easement is placed on it and subtracts the value of the land with the easement placed on it. The difference is the value of the easement.

For example, farmer John's land has an economic worth of $2,000 per acre based on its agricultural productivity. However, similar farms in the area are selling for $5,000 per acre to be developed in the future. The estimated market value of the easement per acre would then be:

Value before the easement	$5,000
Value after the easement	- $2,000
Easement Value	$3,000

The first step in the before and after method is the determination of the property's highest and best use in its current unrestricted (before) condition. The highest and best use is the most probable and reasonable use under current market conditions. The property doesn't have to be currently used for its highest and best use. The appraiser should take into account the current use under existing zoning and estimate the likelihood of a change in use without the easement to a more profitable use. IRS audits are usually based on a disagreement of the highest and best use of a property. For example, an appraisal may state that a property's highest and best use is to support 10 houses, but the IRS may estimate that the property could only support eight houses based on zoning standards.

Once the highest and best use is determined, the appraiser then applies the three recognized approaches to valuing property—the income, cost, and sales comparison approaches to come up with a "before" value.

The first step in the "after" valuation is to determine the property's highest and best use after the imposition of the easement. The appraiser analyzes the terms of the easement and compares them to existing zoning regulations and other controls to determine the extent to which the easement will affect current and future uses of the property. As in the "before" valuation, the appraiser then uses the three recognized approaches to valuing to estimate an "after" value.

The "after" condition is highly dependent upon the rights retained by the seller. The more rights the seller retains, the lower the value of the conservation easement. For example, farmer Joe places a conservation easement on a parcel of scenic farmland that prohibits subdivision of the land. However, he keeps the right to build large billboards and the right to destroy scenic vegetation. The value of farmer Joe's easement would be less, and the remaining value of his farmland would be higher, than an easement that prohibited billboards and required strict conservation standards.

A change in highest and best use of the property is commonly cited as the main factor in the before and after method. When changes in highest and best use call for immediate demolition of buildings or improvements, an easement prohibiting such changes will have a substantial effect on value. Conversely, where the current use is the highest and best use, an easement prohibiting development may have little value. Agricultural areas experiencing a rapid change in highest and best use frequently have higher easement values.

The first two steps are all that is needed to estimate the value of the easement. However, the IRS requires additional calculations if the appraised easement will be donated as a charitable gift, or sold as a bargain sale, and deducted from taxes. The next step is to determine the easement's impact on adjacent properties owned by the donor or related persons. If the value of adjacent or other land increases because of the easement, the increased value of the surrounding land must be deducted from the value of the easement.

The final step is to reduce the value of the easement by any benefit received by the donor. These benefits could include direct compensation, transferred development rights, a low-interest loan or zoning concessions.

To extend the earlier example, farmer John owns 320 acres two miles out of a major metropolitan area that is growing rapidly. John's land in its current unrestricted use is worth $5,000 per acre. John sells a conservation easement on 200 acres, worth $600,000 (200 acres at $3,000) as a bargain sale to the Big Town Land Trust, of which he is paid $60,000. This causes the value of the 200-acre parcel to drop to $2,000 per acre because it can only be used for farming. However, people in town like to have open space and are now willing to pay $7,000 per acre for the remaining 120 acres of unrestricted land. When all calculations are finished, the net value that can be used as a charitable gift is $300,000, not the original donation of $540,000 ($600,000 easement value - $60,000 cash).

Gross value of conservation easement (200 acres at $3,000)	$600,000
Less direct benefits to donor	$ 60,000
Value of easement donation	$540,000
Less enhancement to remainder (120 acres at $2,000)	$240,000
Net value of easement (tax purposes)	$300,000

Conclusion

The United States continues to lose thousands of acres of productive and scenic farmland every year to urban and other nonagricultural uses. In response to this trend, conservation easements have evolved as one of several land protection tools. Conservation easements allow the continued use of land for agricultural purposes, while allowing the landowner to still receive some of the benefits of his/her development rights.

Several of the benefits from conservation easements come in the form of reduced taxes. In order to receive the desired tax benefits, the IRS requires that a qualified appraisal by a qualified appraiser be submitted.

Appraisers use two methods to estimate the value of a conservation easement. The first method is the comparable sales method where sales of similar easements are analyzed and adjusted to estimate the value of the subject easement. The comparable sales method has several drawbacks including the lack of comparable sales and the differences in rights transferred.

The second method commonly used is the before-and-after method. The "before" appraisal estimates the value of the land in its highest and best use with no restrictions. The "after" appraisal estimates the value of the land at its highest and best use considering the restrictions that have been placed on it by the easement. The difference of these two is the value of the easement. If only a part of a parcel of land had an easement, the appraiser must estimate the easement's effects on the remaining land in the parcel that the landowner or a relative owns. If there is a change in the remaining land's value, it also must be factored into the appraisal estimate.

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