A Market for Transferable Tax Credit for Land Conservation Donations

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Introduction

My thanks to M. Max Falque, ICREI and CA2E, and the planners of this Sixth International Conference on Property Rights, Economics and Environment for inviting me to speak today. The creation of a private market for transferable tax credit for land conservation is a very suitable subject for this conference. The program I will describe is a deliberate effort to provide a powerful financial incentive for private conservation action without imposing command-and-control regulations.

In the state of Virginia in the US, we have moved from theory to practical implementation of this free-market tool. In 2004 over US$260 Million worth of property value, covering more than 47,000 acres, was donated for conservation in the state of Virginia thanks to this new incentive. Early figures for 2005 indicate this rate is continuing. The transferable tax credit and the market for credits have been startlingly successful, but they are imperfect and have attracted opposition, as you will see.

<u>Importance of Private Landowner Donations</u>
Because the amount of public funds that is appropriated by federal and local legislatures for purchase of conservation values in the United States is much smaller than the need, land conservationists in the US strive to persuade private landowners to voluntarily contribute conservation easements to protect desirable values – wildlife habitat, scenic views, and agricultural production – on their private property.

The term "conservation easement" in the United States generally means a legally-binding restriction on the future use of the land. To receive tax benefits, the restriction must be perpetual in term, it must be given to a government agency or NGO with the resources and commitment to enforce the easement, and it must protect specified qualities of the land that preserve public benefits. Common provisions of conservation easements are: limits on the subdivision of the property into smaller parcels, limits on the number of new structures that may be constructed, and requirements to protect wildlife habitat or water quality. To qualify for tax benefits, the provisions of the easement must be more restrictive than existing governmental restrictions on the use of the land. *[U.S. Tax Court, Turner v. Commissioner, 126 T.C. 16, 16 May 2006]*

When a landowner restricts the future use of his property through an easement, he frequently greatly reduces the market value of that land. For a private farm of 600 acres in the state of Virginia, a restrictive easement will often cause a reduction in value of as much as $2,000,000. If the farm is in a rapidly-urbanizing area, the reduction could be much greater.

Methods of Encouraging Private Donations

Land conservationists in the US work to develop personal relationships with land-owners on whose property they seek easements. Some landowners decide to donate easements because they personally value the natural character of their lands, or as an effort to give a benefit to the public. However, these benevolent motives are always opposed by the large amount of property value that will be lost if the future use of the land is restricted by an easement.

US Government Incentives for Conservation Donations

Land conservation is viewed as a public benefit in the US, and so the national government makes a modest effort to encourage private conservation donations. United States government policy has long encouraged private charity by allowing taxpayers to deduct the value of any money or property donated to charity from the income on which the government collects income tax (the principal tax on individuals by the US government).

In 1964, the value of donated conservation easements (servitudes) was officially recognized as a deductible charitable gift. This was clarified and specified by subsequent legislation and regulations for federal income taxes. Many of the 50 states in the United States also encourage conservation easement donations by allowing the value of the easement to be deducted from income subject to state tax. In 2003, U.S. Department of the Treasury figures show that 2,865 taxpayers claimed deductions for charitable donations of easements. The total value of the deductions claimed for easement donations in all of the United States was $2,725 Millions (due to tax rules, this number may not be the same as the total value of the donations themselves). *[U.S. Department of the Treasury, Office of Tax Analysis, OTA Paper 95, June 2005, Table 5]*

The federal government also reduces inheritance tax on lands subject to conservation easements, as do many states. States and localities also reduce property taxes on land restricted for conservation purposes.

The value of the donation of a conservation easement, under US rules, is computed as the difference between the fair market value of the property if it were sold without the restrictions of the easement, minus the fair market value of the land if it were sold subject to the restrictions of the conservation easement. The determination of these values is sometimes contested, and even with the best of motives there is delicate professional judgment involved in setting the numbers. There is a temptation to inflate the value of an easement donation to increase the tax benefits – and the recent rapid rise in values of all real property in the US has tended to mask the real reduction in market value of land whose future use is tightly constrained by an easement.

Through these tax provisions, government policy has been shaped to offer some financial incentive to landowners who place conservation restrictions on their property. However, the tax incentives do not equal the loss in property value that the restrictions impose, and a landowner often must be willing to give up a large amount of value in order to protect conservation values on his property through the donation of an easement.

A New Incentive: State Income Tax Credits

Advocates of conservation of natural lands have continued to seek additional tax inducements for landowners, in addition to the deduction for charitable gifts. Allowing a tax *credit* for easement donations was a logical next step. In 1983, the state of North Carolina adopted a modest credit against its state income tax for land-owners who donated conservation restrictions on their property.

A *credit* against tax is an amount which the taxpayer can submit to the tax collector in lieu of cash for payment of taxes. Credits have a greater net value for a taxpayer than deductions from taxable income. If the state income tax rate is 6%, a *deduction* of $1.00 from taxable income gives the taxpayer a benefit of $0.06 by reducing the tax he owes, but a *credit* of $1.00 provides a benefit of $1.00 because the credit is used directly to pay the tax.

State tax credits for land conservation are generally set at 25% to 50% of the value of the donation. So, a landowner who reduces the value of his land by $1.00 will receive a tax credit of $0.25 to $0.50. The rate in Virginia is 50%.
[Code of Virginia, §58.1-510...513]

The first state income tax credit program, in the state of North Carolina, has been continued and enlarged since 1983. Over the years, the North Carolina program has conserved, through easements or through fee donations or purchases at reduced prices, about 140,000 acres with a total value of $500 Million. The cost to the state has been much smaller than the property value conserved.

In 1999 the states of Virginia, Delaware, Colorado, and Connecticut established varying levels of state income tax credit for conservation donations. Five other states have created tax credit programs since then, most recently Georgia in April, 2006. These different state programs have varying rules and limits. Most of the state programs use the same qualifying criteria as the federal income tax regulations for a tax-deductible donation of a conservation easement.

Making Tax Credits Transferable

A *credit* against state income tax only serves as an incentive for conservation dona-tions if the landowner owes enough state income tax to use the credit. State income tax rates are not high in most of the states. Virginia's top rate is 5.75% of taxable income. Many owners of family farms pay little or no state income tax. So, these owners receive little or no benefit from the state tax credit.

To make the tax credit a valuable incentive to landowners who pay little income tax, two states in the United States have passed laws to make their conservation tax credit "transferable." By allowing direct transfers, the states allow holders of conservation tax credit to sell their credit for cash. In this way, an incentive for conservation donations is granted even to landowners who do not pay large amounts of state income tax. The state of Colorado was first to allow transferability, in 2000, but the total credit allowed to a landowner was capped at $100,000 (since increased; starting in 2007 the cap will be $375,000 per easement donation in Colorado).

In 2002 a colleague and I proposed that the laws of the state of Virginia be changed to allow its tax credit for land conservation donations to be transferred, and the legislation we proposed was enacted. This change has led to a dramatic acceleration in the rate of conservation easement donations on land in Virginia, because landowners who could not use the tax credit themselves may now sell excess credit for cash.

A Private Market for Transferable Credits

Though transferability of credits was legalized in Virginia in 2002, the creation of a working market for the sale and purchase of conservation tax credits took until late in 2003. First, the Virginia Department of Taxation took a very long time to issue rules for reporting credit transactions. Next, the community of Buyers had to develop enough confidence that purchasing and using transferable credit would not involve them in problems with the Taxation authorities. The law was clear, but human confidence requires more than a statute.

Creating a working market also demanded that Buyers and Sellers come to a common expectation about pricing. The Sellers view a dollar's worth of tax credit as being worth $1.00, and they would like to be paid full value. After all, the Seller donated $2.00 of land value for conservation, in order to receive $1.00 of tax credit in Virginia. To a Buyer, however, the tax credit is simply a means to pay his income taxes at a discount. If there is no discount, it is simpler for the Buyer to pay his taxes with cash. How great the discount should be is in the end determined by the market. Because there was no market precedent, the Buyers and Sellers in Virginia were at a standstill for many months after transferability was permitted, with Buyers unwilling to pay the price levels that Sellers of tax credit were demanding. Finally an opening sale at $0.45 per dollar of credit value started the market in mid-2003.

My company, Virginia Conservation Credit Pool, LLC, worked to create an operating market as soon as the transferability legislation was passed in 2002. Our first sales were agreed in November, 2003. In mid-December 2003, we saw a true bid-ask market develop in which prices fluctuated with Buyer demand and Seller urgency. Gross prices paid by Buyers in sales we handled in 2003 ranged from $0.60 per dollar of credit upward to a peak of $0.80 at the end of the year.

The market has become more stable in 2004 and 2005. Taxpayers who want to purchase tax credit at a discount have become more confident in the system, and each year more Buyers are coming into the market. Also, more companies have moved into the business of serving as "brokers" to bring Buyers and Sellers together. The supply of credit available for sale has increased, but the demand on the part of Buyers has increased more rapidly. Prices paid have moved up slowly but steadily, with Buyers frequently paying around $0.75 per $1.00 in late 2005.

This discussion addresses the tax credit market in Virginia. In Colorado, there are different constraints built into the state law governing conservation tax credits and their sale. Due to these differences, prices in the Colorado market have been steady at a *net* payment to the landowner of $0.80 per dollar of credit. The margin added by brokers or transfer agents in Colorado has varied from $0.10 to $0.05 per dollar of credit value traded.

Conservation Results of the Transferable Tax Credit in Virginia

The effect of the state income tax credit as a conservation incentive has been spectacular. Measuring the acres of conservation easements donated to the state-chartered land trust, the Virginia Outdoors Foundation, gives one gauge of the increase. Through the mid-1990's, easement donations covered about 5,000 acres per year (2024 hectares; one hectare equals approximately 2.47 acres).

1996:	5,712	acres donated
1997:	7,673	acres
1998:	13,529	acres
1999:	11,419	acres (tax credit passed but not effective until 1/1/2000)
2000:	28,726	acres (bump due to tax credit)
2001:	22,707	acres (great increase from 1990s average)
2002:	36,976	acres (first year with credit transferability)
2003:	22,667	acres
2004:	41,587	acres
2005:	41,004	acres

Fiscal Efficiency of the Transferable Credit

The transferable tax credit has stimulated a rapid increase in the rate of conservation easement donations. As a further benefit, it has cost the state much less than acquiring the same value of property through purchase.

First, the tax credit in Virginia is set by law as one-half of the appraised value of the conservation easement. Second, it appears that much of the tax credit granted in theory is not in fact collected. It must be noted that the law allows unused credit to be "carried forward" into up to five tax years after the easement donation, so some credit that has been granted for easement donations in 2002 may not be used until 2007 (and so will not appear on state reports until the tax returns for that year are filed in 2008).

However, according to Virginia Department of Taxation reports, over the years 2002-2004 a total of $259 Million in tax credit was claimed (representing a total of $518 Million in land value donated). But, the total of tax credit used on state income tax returns for those same years was $121 Million. So the actual cash cost in terms of lost income tax revenue was $121 Million, or $0.23 per dollar of land value conserved. The use in the future of the "carry-forward" of unused credit will doubtless reduce this apparent bargain. But, it still appears very likely that the ultimate cost to the state will be considerably lower than $0.50 per dollar of land value conserved, due to credit reaching the end of its legal lifetime without being applied on tax returns.

Problems with Market Structure

Since 2003, the market between Buyers and Sellers of tax credit has grown by all measures. There are more landowners offering credit for sale, and much more interest from Buyers who are attracted to the idea of reducing the cost of paying their taxes.

However, there are some problems with the operation of the tax credit market. First, there is no central "exchange" through which all credit transactions must pass. Some credit sales are made on an individual-to-individual basis, at whatever price the parties privately agree. The firms like my company that negotiate prices between Buyers and Sellers operate independently, and there is no central reporting of the prices that are agreed to via different brokers. There is much rumor, and if one broker is selling at a lower price than the rest, the Buyers quickly find this out.

Because each claim for tax credit is based on a charitable donation, and on an appraisal, each claim for credit is open to possible challenge by the tax agencies. This means that a Buyer is taking some risk that the credit he purchases may be disallowed in the future. This risk is not the same for all credit that is sold – that is to say, some credit offered for sale is more risky than other credit. But, distinguishing the degree of risk is not practical.

The management of credit sales is itself a demanding process. Most Buyers make their decision to purchase credit in the last few weeks of the year, after they admit to themselves that, like years in the past, they will owe income tax once again. By state regulation, the sales must be concluded before the end of the calendar year. So a broker must receive orders from Buyers, negotiate agreement on price between Buyers and Sellers, and prepare and complete the necessary contracts and payments to complete the sale under a strict deadline. This is a value-added service, and the quality of management of sales gives some brokers preference in the market.

So far, the Buyers and Sellers in Virginia and Colorado have been tolerant of these theoretical concerns about the market. There has been no scandal over operations of the market, and no major default by market-makers that has caused alarm. There is little discussion of stricter regulation of the tax credit market itself. If the financial volume of trading increases, though, this could change.

<u>Policy and Political Considerations</u>

The transferable tax credit program has created a pathway to bring private funds, driven by free-market profit motives, to provide financing for the conservation of important public values in the landscape. The tax credit avoids the problems and hostility associated with command-and-control methods of land use regulation. It also requires a minimum amount of government agency staff and oversight.

The Landowner's rights to determine the use of his property are given top priority under a voluntary conservation easement donation program. While the tax benefits and the potential cash payment from selling tax credit are a strong financial encouragement for conservation, they are not a compulsion. The decision whether to place permanent conservation restrictions on his land remains one for the landowner to make.

While many conservation programs in the United States have been opposed by "property-rights" advocates, and many environmental-protection regulations have been attacked as "takings" of private property value, advocates of landowner rights have generally supported conservation tax credit incentives.

In the state Legislature of Virginia, the tax credit program has drawn political support from property-rights advocates, from anti-tax groups (because the tax credit reduces state tax collections), and from land conservation advocates. This creates a broad spectrum of political support.

However, as a tax credit, the program costs the state a loss of revenues it would otherwise collect. There has been criticism of the program based on its revenue loss. One group of critics questions whether the conservation easements really are worth the value that is being claimed for them. These critics believe that the restrictions which an easement places on future use of the land do not reduce the land's future

market value as much as is claimed. The values claimed must be supported by a formal appraisal, performed by a licensed property appraiser, but the critics are unconvinced. In my opinion, most appraisal values for conservation easements are reasonable, but a few exaggerated values get all the attention.
Another issue inherent in a landowner-initiated program like the tax credit is that it does not direct the tax expenditure to priority locations. The decision as to which lands receive the benefit of the tax credit is made exclusively by the landowner himself, when he decides to donate an easement. To qualify for a tax credit the easement must provide public benefit, as specified in tax regulations, but the public benefit need not be in a high-priority location. Some advocates would prefer a system in which a land-use planning agency identified areas of high priority. The credit could be limited to those locations, or tax revenues could be spent to restrict the use of those lands instead of relying on the landowner's volition. However, this quickly becomes a command-and-control regulation, rather than a market incentive.
A third concern in Virginia is simply the fiscal cost of the tax credit program as it now operates. In 2004, claims for tax credit for conservation donations exceeded $130,000,000 (though not all of that credit claimed was actually used). The Virginia legislature would not approve spending so much money for easement purchases out of state revenues. Several members of the legislature have attempted to pass limits on the amount of tax credit that will be permitted in the future, to reduce the loss of tax revenue.
A final concern has been the philosophical contradiction between the concept of a landowner making a charitable "donation" of a conservation restriction on his land, and the landowner then engaging in a for-profit market process to receive compensation for his "gift." This is sometimes genuinely psychologically troubling for the landowner, particularly when he has to negotiate with Buyers over the price he will receive for the tax credit for his "gift." It is also a concern for the non-profit culture of the charitable organizations that receive easement donations. There are possibilities for conflicts of interest in these transactions, and in one case in Colorado easements were created for the purpose of generating tax benefits with little, if any, corresponding public benefit. However, problems have been rare.

Conclusion

It is evident that the creation of an open market for transferable tax credits has been a very powerful stimulus for voluntary land conservation actions by landowners in the state of Virginia. Making the tax credit transferable has greatly increased its incentive power, beyond the effect of a similar but non-transferable credit.

Politically, providing this conservation incentive in the form of a *reduction in taxes*, rather than through *appropriating state funds*, has been much more acceptable within the political culture of Virginia. Whether this is the best use of public resources to achieve the desired land-use result remains to be seen. However, it is clear that a great deal of conservation protection is being achieved with this market mechanism that would not have been accomplished by any other politically achievable method.

I thank once more M. Max Falque, ICREI and CA2E, and you, my patient audience. The topic of forming a market for transferable tax credit for land conservation donations is an active one, with many changes every year. I invite your questions and suggestions. Merci!

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Reference: Hocker, Philip M.: "Transferable State Tax Credits as a Land Conservation Incentive," Chapter 8 in *From Walden to Wall Street*, Island Press, Washington, DC, USA, 2005.

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