

Rulings of the Tax Commissioner

Document Number: 11-155
Tax Type: Land Preservation Tax Credit
Brief Description: Land Preservation Tax Credit
Topics: Assessment; Land Preservation Tax Credit; Pass-Through Entities
Date Issued: 08/30/2011

August 30, 2011

Re: § 581-1821 Application: Land Preservation Tax Credit

Dear *****:

This will reply to your letter in which you contest the adjustments to the Land Preservation Tax Credit (the "Credit") obtained by ***** (TLLC). I apologize for the delay in responding to your appeal.

FACTS

TLLC is a pass through entity that obtained a portion of a Credit claimed by ***** (VALLC). VALLC had purchased a large tract of undeveloped land in a rural Virginia locality in June 2002. At the time of purchase, the land was zoned for agricultural and low density single family residential uses.

In December 2004, VALLC conveyed a conservation easement on approximately 64% of the tract to a nonprofit organization. Pursuant to the conveyance of the easement, VALLC registered its donation with the Department for purposes of the Credit. Subsequently, VALLC transferred a portion of the Credit to TLLC based on an appraisal that valued the easement at approximately four times the purchase price of the entire property.

Under examination, the Department prepared an appraisal that reduced the value of the easement. The Department revalued the Credit based on this appraisal and issued assessments against the entities that received the transferred Credits passed through from TLLC.

TLLC appeals the revaluation of the Credit, contending the Owner's appraiser followed the accepted professional standards and the easement was properly valued in the Owner's appraisal. Subsequent to TLLC's appeal, the Department commissioned appraisals from two different third party appraisers. After examining the appraisals, TLLC contends that the VALLC's appraisal most fairly valued the easement.

DETERMINATION

Virginia Code § 58.1-512, as in effect at the time of the donation, states in pertinent part:

For taxable years beginning on or after January 1, 2000, there shall be allowed as a credit against the tax liability . . . , an amount equal to fifty percent of the **fair market value** of any land or interest in land located in Virginia which is conveyed for the purpose of agricultural and forestry use, open space, natural resource, and/or biodiversity conservation, or land, agricultural, watershed and/or historic preservation, as an unconditional donation in perpetuity by the landowner/taxpayer to a public or private conservation agency eligible to hold such land and interests therein for conservation or preservation purposes. The fair market value of qualified donations . . . shall be substantiated by a 'qualified appraisal' prepared by a 'qualified appraiser,' as those terms are defined under applicable federal law and regulations governing charitable contributions. [Emphasis added.]

Treasury Reg. § 1.170 *et seq.* governs charitable contributions. Under Treas. Reg. § 1.170A-13(c)(3)(ii), a qualified appraisal must include the appraised fair market value of the property on the date of the contribution. Treas. Reg. § 1.170A-1(c)(2) further states the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the facts. In this case, the issue is the correct valuation of the easement.

Virginia Code § 58.1-512.1 C provides in pertinent part:

The fair market value of any property with respect to a qualified donation shall not exceed the value for the highest and best use (i) that is consistent with existing zoning requirements; (ii) for which the property was adaptable and needed or likely to be needed in the reasonably near future in the immediate area in which the property is located; (iii) that considers factors such as, byway of illustration and not limitation, slopes, flood plains, and soil conditions of the property; and (iv) for which existing roads serving the property are sufficient to support commercial or residential development in the event that is the highest and best use proposed for the property.

Easement Description

The subject property is a large tract of land located in a small rural county. The subject

property fronts a narrow two-lane paved road and lies adjacent to a navigable river. The area where the subject property is located has a few single family homes and is primarily forested.

Prior to the grant of the conservation easement, the subject property's zoning was subject to a proffer that would have allowed a maximum of 81 residential lots with each lot having a minimum of size of 15 acres. More intensive development would have required rezoning.

The easement would allow the development of 12 lots. Each lot could have a main house and three ancillary structures. New roads could be built. Eight private docks could be built. Potentially, a lodge and a marina could be built. Timber harvests would be allowed.

Appraisals

In the valuation process, the appraisers develop a supportable estimate of market value of the property appraised. This process involves collecting market evidence to support an analysis of value trends, the reactions of buyers and sellers in the marketplace, and a proper interpretation of these facts. The appraisal process typically involves three approaches in determining value: the Cost Approach, Sales Comparison Approach, and Income Capitalization Approach. A brief description of each technique follows:

The **COST APPROACH**: An appraisal procedure using depreciated replacement or reproduction costs of improvements, plus land value, as a basis for estimating market value. The underlying assumption is most reliable when the improvements are relatively new and are the highest and best use of the land.

The **SALES COMPARISON APPROACH**: An appraisal procedure using sales prices of whole properties similar to the subject property as a basis for estimating market value. The nature and condition of each sale are analyzed, making adjustments for dissimilar characteristics. The Sales Comparison Approach offers a good indication of value when reliable data exists for a sufficient quantity and quality of sales in the marketplace.

The **INCOME CAPITALIZATION APPROACH**: An appraisal procedure using capitalization of expected future income as a basis for estimating market value. In this approach, there is a direct relationship between the amount of income a property earns and its value. An appropriate capitalization rate is used to estimate value based on the anticipated net operating income of the property. Factors such as risk, time, interest on the capital investment, and recapture of the depreciating asset are considered in deriving an overall rate.

The underlying assumption in this approach is that an informed purchaser will pay no more for the subject property than would have to be paid for another property with an income stream of comparable amount, duration, and quality. When analyzing land, the Income Capitalization approach may be presented as a discounted cash flow and is known as the Subdivision Development Approach.

The final step in the appraisal process is the reconciliation of value indications and the final estimate of value. The appraiser considers each approach according to the quantity and quality of information available, as well as the peculiarities of the subject property, and weighs each value estimate. The result is a final conclusion of market value for the subject.

The subject property consists of vacant land in a rural Virginia locality. Because there are no improvements to consider, the Cost Approach is not applicable to this appraisal assignment. Although part of the subject property's land is rented for hunting, such income streams are typically small. Also, due to the subject property's rural location, the limited number of water view and/or development lots that could be created, the Income Capitalization or Subdivision Development Approach would not be applicable to the subject property.

The Sales Comparison Approach is customarily the primary approach used to estimate the value of vacant land. Under the Sales Comparison Approach, the land value is estimated based on comparable land sales in the area and adjustments are made for the differences between the comparable properties and the subject property.

VALLC's Appraisal

VALLC's appraiser appraised the value of the property prior to the easement at approximately \$36 million and valued it after the easement at \$5 million, resulting in the value of the easement at approximately \$31 million.

The appraiser used a "discounted cash flow analysis" to determine the value of the easement. The appraiser describes the "discounted cash flow analysis" as a combination of using the cost approach, the income approach and the sales comparison approach. The appraiser used individual waterfront lot sales in various counties throughout Virginia as sales comparisons. The appraiser estimated that the 81 lots would sell out in 2½ years while appreciating at two percent per month. The appraiser states that infrastructure would be funded through a community development authority. The appraiser then added in the timber value.

The Department's examination reveals numerous problems with the Owner's appraisal. There are no sales comparisons with other large acreage sales as comparisons.

Rather, the appraiser uses comparisons of individual waterfront lots located in other counties, incomplete sales data, and does not support his adjustments. The supporting documentation for proposed development costs is not complete and no support has been provided to show that a community development authority would be formed or would fund such infrastructure.

The land was part of a larger purchase that was acquired in 2002 for approximately \$2,850 per acre. In December 2004, the appraiser's value of the property prior to conveyance of the easement is \$22,300 per acre. Such an increase presumes that either the Owner purchased the property at significantly below its fair market value or the subject property appreciated by almost eight times the purchase price in approximately 2½ years. No evidence in the appraisal supports either conclusion.

Department's Appraisal

The Department appraised the, value of the property prior to the easement at approximately \$12.3 million and valued it after the easement at \$4.8 million, resulting in the value of the easement of approximately \$7.5 million. After considering the third party appraisals, the Department concludes that its appraisal does not provide the best representation of the value of the easement.

Third Party Appraisal

As mentioned above, the Department commissioned two independent third party appraisals subsequent to the Taxpayer's appeal. After reviewing these appraisals, it is my determination that the appraisal prepared by ***** (the "Third Party Appraiser") most accurately reflects the value of the subject easement.

The Third Party Appraiser valued the property prior to the easement at \$8,275,000 and valued it after the easement at \$4,375,000, resulting in the value of the easement of \$3,900,000.

The Third Party Appraiser used the sales comparison approach with four comparables that ranged in size from 298 to 653 acres with water frontage. The value ranged from \$3,272 to \$8,551 before easement. The Third Party Appraiser then looked at the sale of four comparable properties that sold with limited development potential. The Third Party Appraiser then made some significant adjustments based on the location, size and physical characteristics of these properties. The range of the sales price before adjustments was \$965 to \$1,339 per acre. After the adjustments were made, the Appraiser determined that: the value of the subject property after the easement is \$2,700 per acre.

The Third Party Appraiser's value of the property before the easement appears reasonable and had the best comparables and best analysis. The value after the

easement is well above the comparables, and the percentage of diminution appears reasonable. Accordingly, the Department finds that the appraisal by the Third Party Appraiser represents the most accurate valuation of the easement.

Allocation of Liability

Under VALLC's operating agreement, approximately 80% of the Credit was to TLLC. The remaining Credit was passed through to the other members of VALLC. VALLC argues that under the operating agreement, TLLC is entitled to receive an amount of the revised Credit up to the amount originally allocated with the remainder, if any, passed through to the members of VALLC.

Virginia Code § 58.1-513 B provides that any tax credits that arise from the donation of land by a pass-through entity must be used by the owner of the pass-through interest in proportion to the ownership share or "asset forth in the agreement of said entity". This section mandates how land preservation tax credits must be used by when credits arise from the donation of an easement by a pass-through entity.

The Department's role is limited to properly administering the laws regarding taxation. In this situation, the Department's authority is limited to revaluation of the Credit based on the appraised value of the donation and making appropriate adjustments to the income tax returns of those taxpayers who claimed the Credit based on the revaluation. The Department will not interject itself in a matter of indemnification between entities earning the Credit and entities claiming the Credit unless a tax matters representative has been designated as provided under *Va. Code* § 58.1-513 F.

CONCLUSION

Based on this determination, the total amount of the Credit earned by VALLC will be reduced from approximately \$15.6 million to \$1,950,000. In this case, assessments were issued based on a Credit valued at \$3,750,000. As such, the assessments previously issued are understated.

Under *Va. Code* § 58.1-1822, if an assessment appealed by a taxpayer "is less than the proper amount, the Tax Commissioner shall order that the applicant pay the proper taxes." Under this statute, the Tax Commissioner has the authority to increase a tax assessment as a result of a determination of an appeal filed under *Va. Code* § 58.1-1821. The Department's policy has been to make such assessments only if the statute of limitations for otherwise making an assessment has not expired. See Title 23 of the Virginia Administrative Code (VAC) 10-20-160 D 6.

Because the statutory time for issuing assessments for the taxable years in which taxpayers claimed the Credit has expired, the Department will not issue additional assessments for the correct amount of tax.

Accordingly, the assessments issued against the taxpayers claiming the Credit passed through from TLLC are upheld. Once the Department issues an updated bill with accrued interest, the Taxpayer must pay the outstanding balance within 30 days of the bill date to avoid the accrual of additional interest.

The *Code of Virginia* sections cited are available on-line at www.tax.virginia.gov in the Tax Policy Library section of the Department's website. If you have any questions about this determination, you may contact ***** in the Department's Office of Tax Policy, Appeals and Rulings, at *****.

Sincerely,

Craig M. Burns
Tax Commissioner

AR/1-2533366541.B
