

**CONSERVATION EASEMENT PROGRAM
ANNUAL REPORT
TO THE
ENVIRONMENTAL REVIEW COMMISSION**

November 1, 2008

Pursuant to NC G.S. 113A-235(c), the Department of Environment and Natural Resources reports to the Environmental Review Commission each year on the implementation of Article 16, the Conservation Easement Program. This Article, 113A-230 through 113A-235, includes enabling legislation for a program for conservation easement promotion/education, conservation tax credit promotion/education and quality assurance of conserved lands, and enabling legislation for a conservation grant fund. The following reports on these programs.

North Carolina Department of Environment and Natural Resources

Conservation Easement Program G.S.113A-235 (c), Article 16 (also known as the Conservation Incentives Program) includes 3 components:		
113A-230 Conservation Easement Program	113A-231 Conservation Tax Credit Program	113A-232 Conservation Grant Fund
Stewardship program monitors state-owned easements, currently EEP and CREP properties	Certifies donor gifts of interests in real property for conservation purposes	Currently holds funds for stewardship program; potentially applicable to other conservation programs

THE YEAR IN SUMMARY

Significant progress has been made in the development and integration of the programs within Article 16 during the past year.

Conservation Tax Credit Program

The number of acres and estimated value of donations of interests in real property donated for conservation purposes remains relatively stable, but the overall number of donations increased significantly in 2007. For fiscal year 2007-08, 156 applications for certification were approved for the conservation of 17,000 acres, which brings the cumulative total to 188,000 acres. A comprehensive review of the program was undertaken over the last year, resulting in changes to the process and materials used to implement the program.

Conservation Grant Fund

Only one of the programs authorized within this conservation tool received funds this year – the stewardship monitoring program for conservation easements held by the Ecosystem Enhancement Program and Conservation Reserve Enhancement Program. This was the third year of funding for the DENR Stewardship Program, which operates using only using interest earned above inflation on the endowment fund.

Conservation Easement Program

The use of conservation easements continues to grow. The Department of Environment and Natural Resources (DENR) has taken the role of administering the monitoring of Ecosystem Enhancement Program (EEP) preservation mitigation easements. The Stewardship Program Director coordinates these monitoring activities, and is advancing several strategies that will increase the program’s efficiency and effectiveness. In 2009, DENR plans to expand these stewardship activities to include monitoring permanent conservation easements for the Conservation Reserve Enhancement Program (CREP). The broader category of stewardship, including management for ecological values, remains largely unaddressed.

ANNUAL PROGRAM UPDATE

Conservation Easement Program 113A-230

Established in 1997, this program is intended to use promotion, education, and quality assurance to increase the use of conservation easements as a tool to accomplish conservation goals, such as the Million Acre Initiative. The use of conservation easements continues to grow, especially as they provide a key mechanism for water quality protection used by the Clean Water Management Trust Fund, the Conservation Reserve Enhancement Program and the Ecosystem Enhancement Program. As evidence of the popularity of conservation easements, 114 of the 156 certified donations for the conservation tax credit this year were easements, compared to 42 fee simple donations.

There is also growing acceptance of conservation easements within the farming and forestry communities, due to increased incentives provided by several programs. The General Assembly's 2007 legislative changes to G.S. 105-130.34 and G.S. 105-151.12 explicitly identifies farmland conservation as a public benefit for the Conservation Tax Credit. The North Carolina Agricultural Development and Farmland Preservation Trust Fund has further promoted easements on working lands. The expanded Federal conservation tax incentive (Income Tax Charitable Contribution Deduction) gives particular inducement to farmers and ranchers. As a result, there are an increasing number of farmland easement donations being submitted for Conservation Tax Credit certification, accounting for the overall increase in number of donations this past year for Conservation Tax Credit (see graph 1 at end of report).

Stewardship of Conservation Easements

With the growing number of conservation easements generated through the Clean Water Management Trust Fund, Ecosystem Enhancement Program, Conservation Reserve Enhancement Program, and other programs, comes a growing responsibility for monitoring and effective management of their conservation values. In 2005 the Department began taking steps toward funding quality assurance-related activity for conservation easements. In 2006 the DENR Stewardship Program was implemented, which is supported by any agency prepared to make payments into the Conservation Grant Fund Endowment to cover administrative/management costs. The intent is to expand this Stewardship Program incrementally until all conservation easements held by the State are assured proper monitoring and management of their public purposes and values. Currently two agencies have contracted to participate in the Stewardship Program: the Ecosystem Enhancement Program (EEP) and the Conservation Reserve Enhancement Program (CREP). Through EEP, there are currently 102 projects on 12,740 acres. The current CREP totals are 154 projects on 5,596 acres.

In its initial year, the Stewardship program administered 71 properties in a pilot project. The cost to conduct monitoring visits to each of these properties to document site condition was \$29,000, which did not include enforcement or management. Since this amount exceeded the available interest earned from the Conservation Grant Fund Endowment, the current endowment per property is inadequate. Additional expenses

resulted from enforcement of two easement violations reported as a result of the monitoring in 2007, which exacerbated the funding shortfall.

Partly in response to having an inadequate endowment, 15A NCAC 02R .0402 was amended. As of 2008, properties and easements donated to the NC Department of Environment and Natural Resources require a fee of one thousand dollars (\$1,000) per acre at the time the land or easement is transferred to the Department's Conservation Grant Fund Endowment. For properties that are less than one acre in size, the minimum payment shall be one thousand dollars (\$1,000). This charge applies only to properties and easements donated to the Department for the sole purpose of property or easement maintenance. This does not apply to properties or easements donated to the Department in association with restoration projects conducted by the Department.

The broader issue of long-term stewardship, including management for ecological values, remains largely unaddressed due to limited financial resources.

Conservation Tax Credit Program 113A-231

The state's Conservation Tax Credit was established in 1983 to respond to donors' applications for certification of their gifts of interests in real property for conservation purposes. In 2007, changes in the Conservation Tax Credit legislation (G.S. 105-130.34 and G.S. 105-151.12), as well as problems reported in other states' programs, led to a comprehensive review of the policies and guidelines used to implement the N.C. Conservation Tax Credit program. In 2008, program staff worked with resource agency reviewers, qualified recipients and others to review the Conservation Tax Credit program. The resulting improvements include a revised application, a new website and development of reviewer guidelines. These guidelines should help our conservation partners understand the expectations for qualified tax credit properties, simplify the certification process, and reduce confusion. Potential donors or recipients are encouraged to contact the Department with questions. The process for reconsideration of rejected applications was also formalized as part of the review. A Conservation Tax Credit Certification Review Committee was established, comprised of representatives of the resource agency reviewers. An added benefit of the Conservation Tax Credit Certification Review Committee is that it encourages communication among reviewers, and should help maintain consistency in the review process.

There is sustained and growing interest in the N.C. Conservation Tax Credit program:

- Over the past year, 159 applications were reviewed for eligibility, of which 156 were certified. (Graph 1 shows only 140 applications for 2007, because fifteen of the reviews conducted during 2007 were for donations that had been made in 2006.)
- The certified projects totaled almost 17,000 donated acres of property interests, worth an estimated \$131 million. (See graphs 2 and 3 at end of report).
- Since its establishment, more than 188,000 acres have been donated, and the applicants have reported to the Conservation Tax Credit program an estimated value of \$918 million for these donations over the duration of the program.

The number of applications that did not receive favorable review was low. Six that were initially disapproved gained approval during the reconsideration process. For the three applications that were not certified to provide public conservation benefit, the reasons for rejection included:

- The gift did not meet the statutory definition of a qualified donation.
- The protected area was a small and isolated habitat and retained rights to subdivide, develop or otherwise convert habitat. There was also inadequate riparian buffer.
- The spatial arrangement of the site was fragmented with degraded habitat, and retained rights included transferability of impacted areas.

One of the perceived strengths of conservation easements is that they are flexible and can be tailored to individual landowner's preferences. However, numerous or extensive retained rights within a conservation easement can create a challenge for reviewers, as they evaluate the public benefit of a donation. With multiple rights retained, the reviewers will continue to look for the balance of public benefit and resource protection with the cumulative potential impact of the retained rights.

The Conservation Tax Credit program is an effective leveraging tool. When used in conjunction with bargain sales, the Conservation Tax Credit can yield substantial savings for conservation trust funds, local governments, and nonprofit organizations purchasing land. At least 173 of the 1000+ certified donations made in the past 25 years have included some bargain sale component. It is estimated that over the duration of the program, all grantees (state, local and non-profits) have saved more than \$152 million through bargain sales facilitated by the tax credit initiative.

The Department has the statutory responsibility to protect real property and interests in real property conserved in perpetuity by state incentive programs. Fulfillment of this responsibility will require monitoring of these properties to assure that their conservation purposes are not jeopardized. The new but limited stewardship program discussed earlier under the Conservation Easement Program needs to be expanded incrementally to provide quality assurance for all conserved properties. The current absence of permanent, full-time staff and line item budget prohibit implementation of those stewardship activities that would fully protect the public's conservation assets, but progress is being made. During the past year, advancements toward monitoring Conservation Tax Credit properties include:

- Scanning all applications, instruments of transfer, and certification letters, so that the documents could be stored digitally, and transmitted to DENR monitoring agents.
- Development of two databases: one for tracking current applications under review; and, one that contains all projects that have been certified in the past twenty-five years. This second database is understandably large, but almost populated, and greatly helps in compiling numbers for reports such as this.

Over time, the increasing benefits from the Conservation Tax Credit Program have been derived mostly from increases in the maximum tax credit allowed. Steadily increasing land values reduce the relative value of the incentive offered by the Conservation Tax Credit over time. To retain the program's effectiveness, the maximum credit allowed must increase periodically.

Another concern is that the Conservation Tax Credit is currently applied only against state income taxes. Some eligible landowners cannot use this conservation incentive because they are required to pay other types of taxes. Consideration might be directed toward broadening the types of taxes to which the credit can be applied.

Work remains to further refine the Conservation Tax Credit program. One question from the review process not yet addressed concerned the qualification of recipients. These and other questions are further addressed in the "Recommendations and Additional Topics for Consideration" at the end of this report.

Conservation Grant Fund 113A-232

The Conservation Grant Fund was established in 1997 to stimulate the use of conservation easements, to improve the capacity of private nonprofit land trusts and agencies to successfully accomplish conservation projects, to better equip real estate-related professionals to pursue opportunities for conservation, and to provide an opportunity to leverage private or other public monies for the stewardship of conservation easements.

In 2005, the General Assembly approved one-time funding in the amount of \$1,000,000 directed to the conservation of land that buffers military bases and training areas with compatible land uses. Sixteen projects were funded, benefiting all North Carolina military installations.

The Conservation Grant Fund has proven to be a sound framework for moving worth conservation projects forward, and it could be utilized to a greater extent.

2008 LEGISLATIVE ACTIONS THAT IMPACT THE NCCTC PROGRAM

In August, the General Assembly passed HB 1889: “An Act to provide property tax relief for qualifying wildlife conservation land, to clarify the present-use valuation of property subject to a conservation easement, and to provide a property tax exemption for leasehold interest in certain exempted property.” The change pertinent to the Conservation Tax Credit program is in Section 4, concerning “Exception for Easement of Qualified Conservation Lands Previously Appraised at Present Use Value.” The change to this section specifies that “the taxpayer received no more than seventy-five percent (75%) of the fair market value of the donated property interest in compensation.” However, the statute still requires that “the property is subject to an enforceable conservation easement that would qualify for the conservation tax credit provided in G.S. 105-130.34 and G.S. 105-151.12, without regard to actual production or income requirements of this section.” This becomes effective on or after July 1, 2010. This legislation could potentially result in more applications to the Conservation Tax Credit program, but the direct impact can not be known until the legislation goes into effect.

RECOMMENDATIONS AND ADDITIONAL TOPICS FOR CONSIDERATION

Through management of the Conservation Tax Credit program and observation of evolving approaches to conservation through incentives, a number of topics have surfaced that may deserve consideration. The following could improve administration of the Conservation Tax Credit program and/or the incentive offered by the state for donation of interests in real property for conservation purposes.

Recommendation

Qualified Recipient Status

During the review of the N.C. Conservation Tax Credit program, the potential for exploitation of tax incentives was highlighted by partners, and concern was expressed about the potential subsequent damage to credibility of the NCCTC program. There was some question whether some of the recipients have a commitment to protect the conservation purposes of the donation, and the resources to monitor and defend conservation easements. Lessons from other states suggest a proactive approach. Updating the definition of qualified recipient would help North Carolina remain in line with Federal requirements to ensure adequate conservation and stewardship. The Department of Environment and Natural Resources looks forward to working with the Department of Revenue to determine the best approach to review and update the “qualification” of recipients. From the NCCTC program perspective, this is the highest-priority recommendation for legislative assistance.

Additional Topics for Consideration

Corporate Incentive to Donate

Since its creation in 1983, the NCCTC has only been applied against income taxes. With the sunset provision for the way the corporate pass-through entities claim tax credit, some

of the incentive for conservation donations has been eliminated. One approach for regaining the breadth of NCCTC applicability would be to allow the credit to be used against Franchise Tax and Gross Premium Tax. This would appeal to corporate landowners that may be otherwise constrained from considering the donation of real property for conservation purposes, because they are not required to pay income taxes or they have limited income tax liability. Graphs 4 and 5 are based on data from the N.C. Department of Revenue for the amount of credit used in the past few years, and demonstrate the recent decline in corporate Conservation Tax Credit donations compared to individual and pass-through entity donations. (see graphs 4 and 5 at end of report.)

NCCTC Refundability

The NCCTC was created as an incentive for landowners to donate interests in real property for conservation purposes. While the concept has been very successful and has been emulated in other states, there is still a category of landowner that finds little incentive in the program. “Land-rich and cash-poor” landowners (typically owners of working lands such as farms and planted forests) receive disproportionately low return from their conservation donation for a tax credit. Several states with more recent conservation tax credit programs have addressed this issue by authorizing “transferability” for their tax credits, but this involves a considerable administrative workload. The issue could be addressed more simply through “refundability,” where those donors with larger income tax liabilities will have the option of electing a credit, while those donors with lower income tax liabilities will have the option of electing a partial refund. One proposal might be for a 50% refund of any remaining credit amount that would be authorized after the second year of carry-forward (third year including the year of donation). In this way, land-rich and cash-poor landowners would have more incentive to donate interests in real property for conservation purposes. If enacted, it would be three years before any refunds were paid.

Funding for Ecological Management

Attention recently given to red-cockaded woodpeckers (a federally listed species) on military bases has emphasized the lack of tools that would provide landowners the incentive for ecological management, especially those with conservation easements. In order to maximize their military lands for training, base managers have looked for help increasing red-cockaded woodpecker populations on adjacent private or public lands. In a similar manner to that used for the Military Support Act in 2005, the Conservation Grant Fund could provide the framework to competitively award grants to the most beneficial land management around military bases, if funded.

Smoke Easements

Initial inquiry with the State Property Office indicates that a conservation value could be determined for donation of smoke easements. Prescribed fire provides a public benefit for a number of reasons, including safety as a result of hazard reduction. For the Conservation Tax Credit program, the prime benefit would be habitat conservation. Permanent smoke easements would allow for controlled burning to reduce potentially hazardous fuel loads and to maintain North Carolina’s native habitats. Typically, a smoke easement is put into place on parcels that are directly affected by the smoke of prescribed

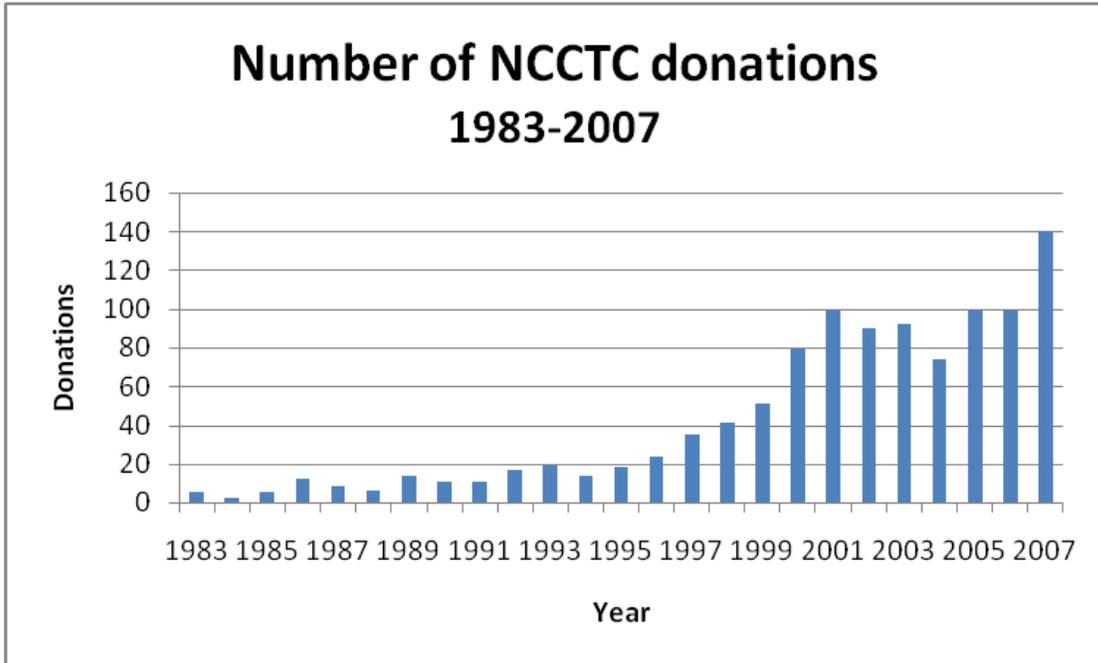
burns on adjacent property. The smoke easement would recognize that prescribed burnings take place in a specified area, and gives the authorized agency the right to continue the practice. The advantage of a Smoke Easement is that 1) property owners of affected properties are notified prior to a burn, and 2) it ensures authorized agencies can continue managing lands through burning practices. Smoke easements would demonstrate the landowner's interest in or commitment to habitat conservation. Agreements, or the terms of such an agreement, would be encouraged in all conservation easements, especially those near conservation lands.

DATA REGARDING N.C. CONSERVATION TAX CREDIT PROGRAM

Graph 1: Cumulative Number of Donations since Inception of NCCTC Program

Over the past year, 159 applications were reviewed for eligibility, of which 156 were certified. (Graph 1 shows only 140 applications for 2007, because fifteen of the reviews conducted during 2007 were for donations that had been made in 2006.)

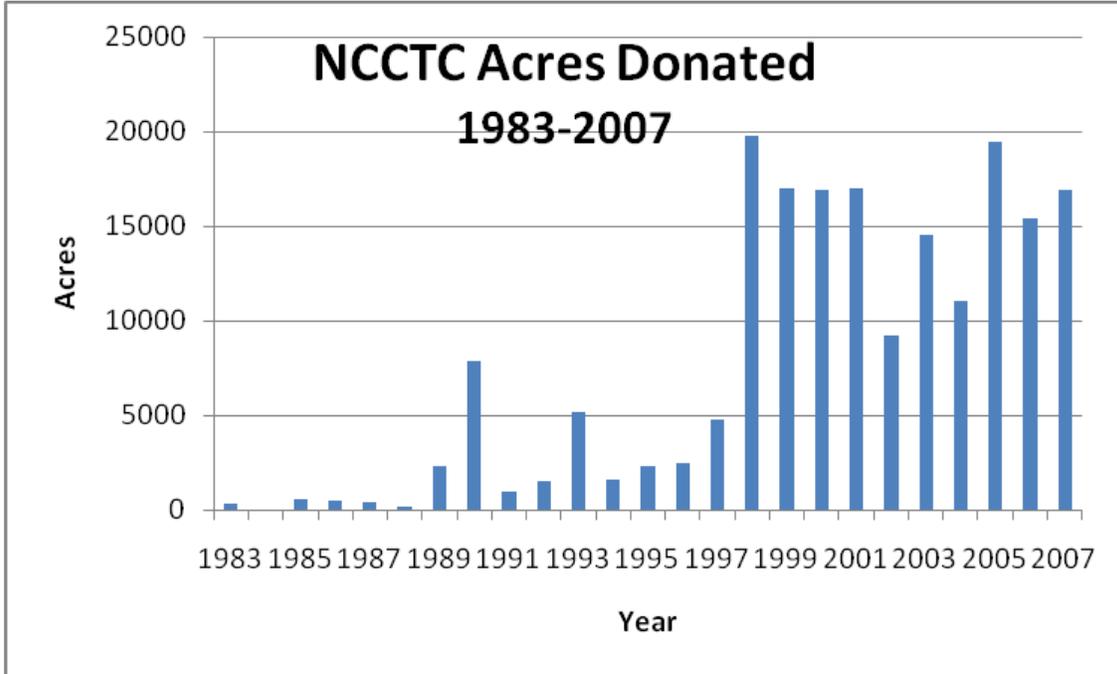
Graph 1



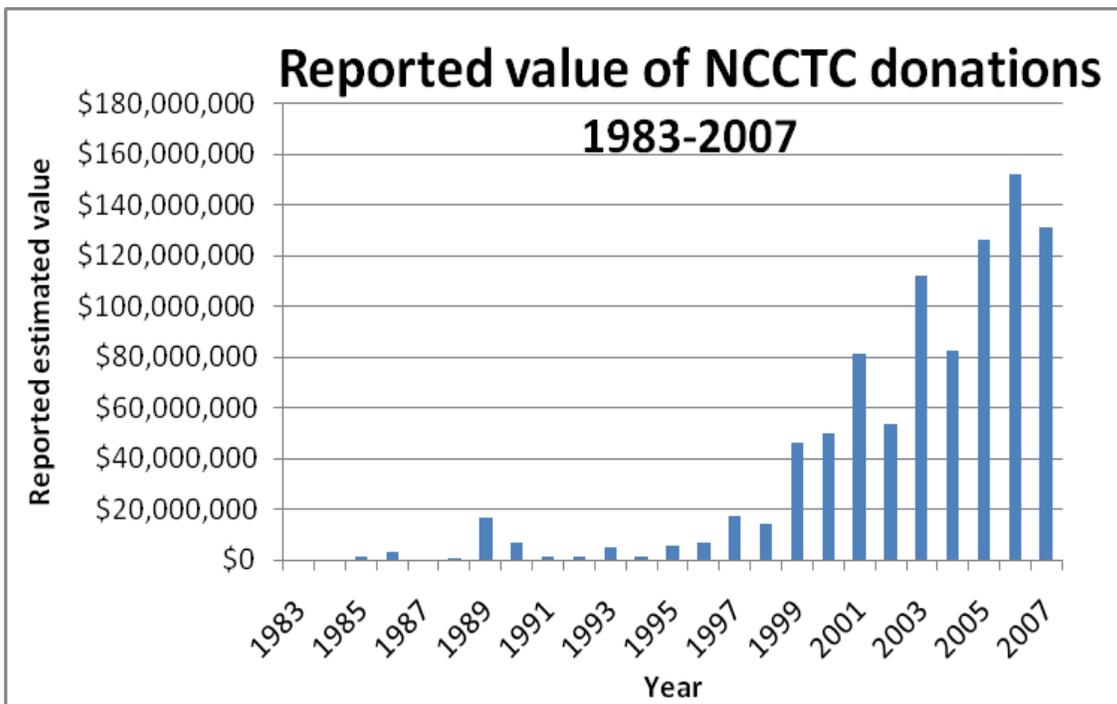
Graphs 2 and 3: Cumulative Acreage Donated and Estimated Value

For 2007, the certified projects totaled almost 17,000 donated acres of property interests. These are worth an estimated \$131 million.

Graph 2



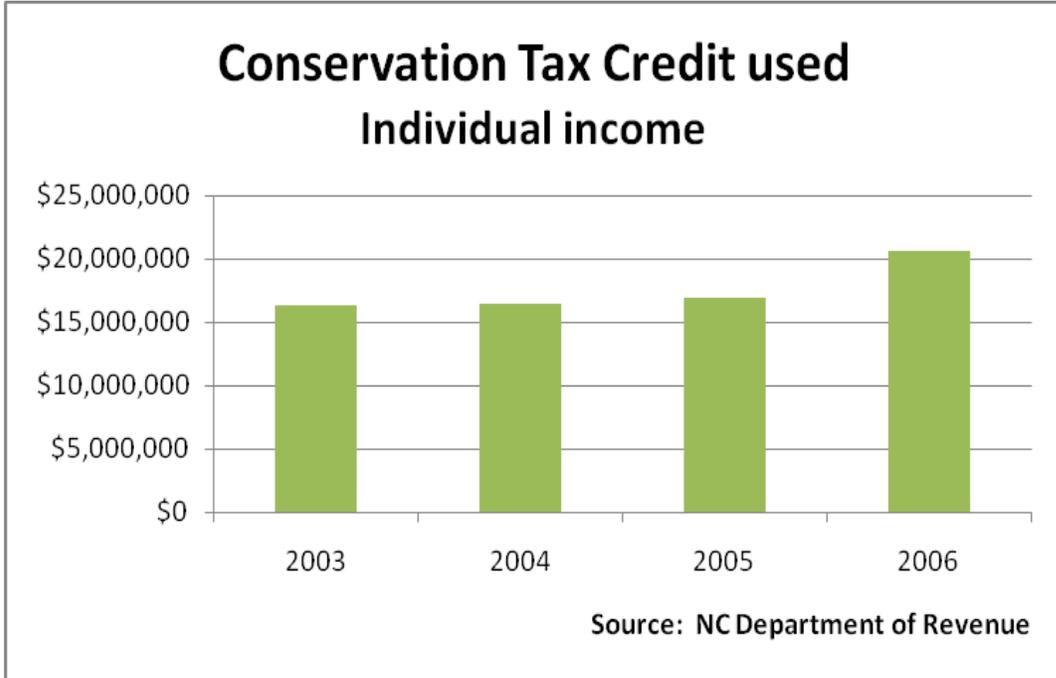
Graph 3



Graphs 4 and 5: Individual and Corporate Tax Credit Used 2003 – 2006

These graphs demonstrate the recent decline in corporate Conservation Tax Credit donations compared to individual and pass-through entity donations.

Graph 4



Graph 5

