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Ag-use Exemption: Fact or Fiction?

By Judon Fambrough

Prospective buyers of rural or fringe property generally inquire about the tax status of the land. They want to know if the property qualifies and receives the agricultural use (ag use) exemption. A substantial tax saving may be achieved if it does.

While the question is valid, any answer is suspect. The Texas Tax Code (the code) affords no land a tax reduction known as an ag use exemption. The confusion stems from the misuse of terms.

Some land in Texas receives tax reductions known as *exemptions*. All exemptions are found in Chapter 11 of the code. The rural homestead exemption (Section 11.13) is a good example. However, rural land as a whole receives substantial tax saving by qualifying for one of two types of special *appraisal* methods.

The first type is called "Assessments of Lands Designated for Agricultural Use" authorized by Texas Constitution Article VIII, Section 1-d and described in Sections 23.41 through 23.47 of the code. The other is called "Open-Space Land" authorized by Texas Constitution Article VIII, Section 1-d-1 and further described in Sections 23.51 through 23.59 of the code.

Generally, when people speak of receiving an ag-use exemption, they are actually referring to the open-space appraisal method found in Section 1-d-1, not the agricultural-use appraisal method found in Section 1-d.

With more and more rural land being converted to subdivisions or into smaller tracts, the question of which, if either, rural appraisal method the property qualifies for becomes important. Likewise, because of the stiff penalties for tax rollbacks when the land no longer qualifies for either appraisal, buyers and sellers must consider this factor when negotiating the price of land.

This article discusses both types of appraisals, the qualifications for each and the tax rollback consequences.

Agricultural-Use Appraisal (Section 1-d)

The Section 1-d appraisal method is reserved for landowners whose primary occupation and source of income are

agriculture. Under this section, both the landowner and the land must qualify.

According to the statutes, the landowner and the land must meet four requirements as of January 1 of each year.

- The land must have been devoted exclusively to or developed continuously for agriculture during the past three years.
- The owner's primary occupation and source of income are agriculture.
- The owner intends to use the land for agriculture and as an occupation or business for profit during the coming year.
- The owner files an application by sworn statement with the chief appraiser before May 1 of each year with all the documentation required to determine the validity of the claim. For good cause, the chief appraiser may extend the filing deadline 60 days.

After reviewing the application and all the relevant information, the chief appraiser must:

- approve the application and allow the appraisal as agricultural use,
- disapprove the application and request additional information or
- deny the application.

Except for six limited circumstances, all the information filed in support of the application (primarily, the sources and amounts of the applicant's income) must be kept confidential.

The statute defines two important terms for this appraisal method. *Agriculture* means the use of land to produce plant or animal products, including fish or poultry products, under natural conditions but does not include the processing of harvesting or the production of timber or forest products.

The term *occupation* includes employment and a business venture that requires continual supervision or management.

If the chief appraiser approves the application, the property is valued on its capacity to produce agricultural products, not its market value. This is determined by capitalizing the average

net income that the land would have been earned during the past five years using prudent agricultural management practices.

Also, the chief appraiser appraises the land at its market value and places this figure in the appraisal records. If the land is sold or diverted to a non-agricultural use, the difference between the two appraisals for the preceding three years, plus interest, must be recaptured. The additional taxes and interest are due by the next February 1 occurring 20 days after the bill for the additional taxes is delivered to the present owner of the land.

To secure payment, a tax lien attaches to the land whenever the sale or change of use occurs. This is commonly referred to as the three-year ag-use tax rollback even though the term "rollback" is never used in the statutes and even though the reversion covers four years, the present plus the past three.

Open-Space Appraisal (Section 1-d-1)

The other appraisal method, better known as Open-Space or Section 1-d-1 land, requires the land, not the landowner, to qualify. The owner's occupation, business and sources of income are irrelevant.

According to the statutes, there are three primary requirements for receiving the exemption.

- The land must be currently devoted principally to **agricultural use** to the degree of intensity generally accepted in the area.
- The land has been devoted principally to **agricultural use** or production of timber or forest products for five of the preceding seven years.
- The owner files a prescribed form provided by the appraisal office with the chief appraiser before May 1 with all the necessary information to determine the validity of the claim. For good cause, the chief appraiser may extend the filing deadline 60 days.

Land Ineligible for Open-space Appraisal

Section 23.56 lists three categories of land that do not qualify for open-

space appraisal. These include the following.

First, land located within the corporate limits of a town or city where:

- the city is providing governmental and proprietary services comparable to other parts of the city with similar topography, land utilization and population density,
- the land has not been devoted principally to agricultural use continuously for the preceding five years or
- the land has not been devoted principally to agricultural use or to production of timber or forest products continuously for the preceding five years and is used for wildlife management.

Second, land owned by an individual who is a nonresident alien or by a foreign government that is required to register the ownership or acquisition under federal law.

Third, land owned by a corporation, partnership, trust or other legal entity that is required by federal law to register its ownership or acquisition of the property because nonresident aliens or foreign governments (or any combination thereof) own a majority interest in the entity.

To assist the chief appraiser, the statute contains an extensive definition of *agricultural uses* that qualify for open-space appraisal. Without going into detail, the definition contains the following:

- planting and producing crops,
- raising or keeping livestock or exotic animals,
- devoting the land to floriculture, viticulture and horticulture,
- producing or harvesting logs and posts for agricultural improvements and
- wildlife management.

After the application is received and all relevant information reviewed, the chief appraiser must:

- approve the application and permit the appraisal as open space,
- disapprove the application and request additional information or
- deny the application.

None of the information accompanying the application must be kept confidential.

If the application is approved, the chief appraiser places the land in the category to which it is principally devoted. The categories include, but are not limited to, irrigated and dry croplands, native and improved pastures, orchards and wastelands. The categories may be further divided according to soil type and capability, general

topography, geographic features and other factors influencing productivity.

The chief appraiser then appraises the categorized land using an income capitalization approach. This involves a two-part process. First, the net average annual income for the preceding five years must be determined based on what the land category would have earned had ordinary, prudent management practices been employed. The calculation includes income from hunting and recreational activities.

Second, the five-year net average annual income is then divided by a capitalization rate for the appraised tax value. The capitalization rate is the greater of 10 percent or the Farm and Credit Bank of Texas interest rate on December 31 of the preceding year plus 2.5 percentage points.

Also, the chief appraiser appraises the land at its market value and places this figure in the appraisal records. If the land use changes, an additional tax equal to the difference in the two appraisals will be assessed on the current owner for the five years preceding the land-use change.

In addition, interest at an annual rate of 7 percent will be imposed on the additional taxes due on a year-by-year basis. Consequently, the additional tax due five years ago will be subject to the 7 percent interest five times but without compounding. The taxes and interest are payable by the next February 1 occurring 20 days after the bill for the additional taxes is delivered to the present owner.

To secure the payment, a tax lien attaches to the land on the date the land-use changes. This is commonly referred to as the five-year open-space tax rollback even though the statute never uses the term "rollback" and even though reversion covers six years, the present plus the past five.

What's the Difference?

Other than the use of confusing terminology, significant differences exist between the ag-use appraisal (1-d) and the open-space appraisal (1-d-1) that have not been addressed. Here is a list of several.

- The purpose for ag use is to assist legitimate, full-time farmers and ranchers, while open space is to promote the preservation of open-space land.
- Landowners must make annual applications to receive ag use, while an approved application for open space lasts until a change of use or shift within a category occurs.
- Landowners are not penalized for failing to tell the chief appraiser of a change of ownership or a change of use under ag use while

the landowners must notify the chief appraiser immediately of either a change of use or a shift to another category under open space or be assessed a 10 percent penalty in addition to the rollback and interest.

- The rollback consequences when part of the land no longer qualifies for ag use is not addressed in the statutes, while, in the same circumstances, the rollback applies only to the portion of the property where the change occurs under open space.
- No mention is made for a change of use that avoids a rollback under ag use while several changes of use avoid the rollback for open space. These include changes resulting from a sale of land for rights-of-way, condemnation, transfers of land to the state and eight others listed in Section 23.55 of the code.
- To qualify for ag use, the land must be devoted exclusively to or developed continuously for **agriculture**, while open space requires the land to be devoted principally to **agricultural use**.
- The ag-use rollback is limited to three years in addition to the present one, while the open-space rollback may go back five years with a possible five additional years plus the present one. Section 23.54(j) of the code allows the chief appraiser to assess a rollback for land erroneously allowed open-space valuation in any of the past five years. In addition, Section 23.55(a) allows the chief appraiser to impose an **additional tax** for each of the five years preceding the year in which the change of use occurs. The additional tax is the difference between the two appraisals plus 7 percent annual interest. Thus, a literal reading of the statutes results in a possible ten-year rollback, not five, depending on when the change of use occurs. The 7 percent annual interest, though, would apply only to the last five of the ten years.

Liability for Tax Rollback, Interest and Penalties

According to the statutes, the party responsible for triggering the rollback is not necessarily the one liable for the additional taxes, interest and penalties. A lien attaches to the land when the rollback is triggered to secure the payments. Thus, the burden may fall on a buyer following a sale even if the buyer is innocent of causing the rollback.

To remedy the problem, Texas Property Code Section 5.010 was added effective September 1, 1997. The new law makes the seller personally liable for any additional taxes and interest (but not penalties) triggered because of the sale of land or a prior change of use occurring five years before the sale unless:

- a prescribed statutory provision entitled "Notice Regarding Possible Liability for Additional Taxes" is included in the sales contract in bold-faced type or

- a separate paragraph in the sales contract expressly provides for the payment of any additional ad valorem taxes and interest triggered by a sale of the land or a subsequent change in the use of the land.

Unfortunately, the new law does not extinguish the lien against the property to secure repayment. Instead, the statute permits the present owner to personally pursue the prior owner (seller) for the amount without stat-

ing whether attorney's fees and court costs are recoverable.

The Texas Property Code contains other exceptions when the seller is not liable for the rollback regardless of whether the notice or special provision are included in the sales contract. These transactions parallel the instances in which a property disclosure statement is not required. ♣



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Texas A&M University
2115 TAMU
College Station, TX 77843-2115

<http://recenter.tamu.edu>
979-845-2031

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