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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.

NEW FHA Appraisal Guidelines

Effective September 10, 1999, new federal guidelines require appraisals for federally insured loans to be in much greater detail. Congress wants all homes receiving federally backed guarantees be given a clean bill of health.

The new rules may cause delays in closings and confusion with regard to inspections. Closing delays may occur because of the shortage of appraisers qualified or willing to undertake the extra work and face greater liability. Potential buyers, real estate agents and lenders may be confused about the need to an inspection following a FHA appraisal. On November 8, 1999, the Texas Real Estate Commission asked HUD for clarification on this issue.

- 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.

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 stating 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. ♣

Texas cases since 1984, the only conclusions are that attorneys are not aware of Section 5.025 or the developers have found a way to avoid the statutory prohibition.

In two of the Texas appellate cases addressing wood shingles, the Section 5.025 prohibition was not raised by the attorneys. One of the two went all the way to the Texas Supreme Court. The following is a summary of the third case, *Hoye v. Shepards Glen Land Co., Inc.* 753 S.W. 2d 226, where the issue was raised.

The Hoyes built a new home in a subdivision using a composite roof. The deed restrictions read "All roofs shall be wood shingle, slate or other permanent type." Fifty-one of the 55 houses in the subdivision had wood shingle roofs. The developers sued the homeowners for breach of the deed restriction. The trial court granted the developer a summary judgment. This was upheld on appeal.

The homeowners cited Section 5.025 concerning deed restrictions that require wood shingle roofs. The court held that "Even if this court were to strike out the portion of the covenant dealing with wood shingles, the Hoyes can still use slate or other permanent type of materials." The practical disadvantages (the costs of slate and other permanent materials) do not establish that the restriction is void, although it is the most economic alternative.

Furthermore, the court held that a composite roof is not a roof of "permanent type material." Thus, developers may force homeowners to use wood shingles simply by structuring the language in the deed restrictions so that it is the most cost effective of the given alternatives.

There is another catch, though. Insurance companies may discourage wood shingle roofs through surcharges or by limiting coverage. Therefore, before purchasing a house with wood shingles, buyers should ask an insurance agent about potential insurance problems.

LEAKING LANDFILLS

Do leaking landfills decrease surrounding land values and cause death? The answers are *yes* and *no*, according to jurors in San Patricio County. Lawyers for the plaintiffs (surrounding landowners) asked for \$34 million after toxic materials contaminated private drinking-water wells near Sinton, Texas.

The jury awarded \$27,500 for reduced property values, \$25,000 for mental anguish and \$1.5 million in punitive damages. However, the jury rejected claims for wrongful death and personal injury.

REAL ESTATE APPRAISAL METHOD

Can an appraiser use hypothetical sales to determine the highest and best use of property for purposes of

CASE NOTES AND COMMENTS

BOUNDARIES MARKED BY STREAMS—THEN NOT

Practitioners who deal with rural property encounter land where the boundaries are marked by streams. The following case may sound familiar to those who have had problems with these legal descriptions.

The property in question lay along Crabapple Creek in Gillespie County. A large tract on either side of the creek was granted to Samuel Maverick from the State of Texas in 1872. The tract was divided later using "the middle of the creek" as the boundary. A fence was erected on the east side of and parallel to the creek on the high bank sometime before 1930.

No one questioned title until 1941 when a grantor conveyed the land on the east side of the creek. Instead of using the middle of the creek in the legal description, the grantor used the eastern bank of the creek as the boundary line.

In 1979, the owners of the western side of the creek ordered a survey of the property "under fence." The survey picked up an additional 2.2 acres from the middle of the creek to the fence erected on the eastern bank.

In 1986, the owners of the eastern side of the creek, the Terrills, cut the fence and installed a gate so they could reach the water. When the owners of the western bank, the Tuckness', discovered the gate, they boarded it and erected "No Trespassing" signs. The Terrills then sued to establish title to the 2.2 acres. The Tuckness' claimed title by adverse possession.

The trial court found the owners of the western side, the Tuckness', owned the creek by adverse possession. The Terrills appealed. The appellate court reversed the trial court in a 22-page decision. Some noteworthy rules proffered by the appellate court include the following:

- A call (a boundary description) to the creek in a deed takes precedence over a course and distance call along a fence line.
- A call to the bank of a creek in a deed means to the middle of the creek.
- A call that goes "along a bank" of a creek actually sets the middle of the creek as the property boundary.

- Where no testimony exists as to who built a fence or for what purpose, the fence is a "casual fence" and cannot establish adverse possession.

- The test for hostile possession for adverse possession is whether the acts and use of the land by the claimant reasonably notified the owner that an adverse claim was being asserted to the property.

Although the case adds nothing new to the issue, it contains excellent references for anyone contemplating a claim for adverse possession for property marked by a stream (*Terrill v. Tuckness*, 985 S.W.2d 97, *San Antonio Court of Appeals*, 1998).

DROUGHT CONDITIONS, FIRES AND WOOD SHINGLES

No rain has fallen in parts of Texas since June and July. This sets the stage for many counties implementing burning bans. But what happens if an act of God starts a fire on your property and spreads to your neighbor? Are you liable? If the drought continues, the question may be raised by a number of landowners.

According to Texas case law, the answer depends on the property owner's negligence. If the owner negligently leaves or allows unguarded combustible materials where they can easily start a fire and spread, the owner is liable even though the fire starts purely by accident or an act of God. Likewise, if the owner starts a fire in an area where it can easily spread onto a neighbor's land, the owner may be held liable in negligence for the resulting damages.

But what about building a new home using wood shingles? If lightning strikes the roof causing a fire to spread throughout the neighborhood, could the homeowner be held liable for negligence?

Although this may be a far-fetched question, Texas legislators attempted to prohibit the use of wood shingles in 1984 with the addition of Section 5.025 to the Texas Property Code. It states, "To the extent that a deed restriction applicable to a structure on residential property requires the use of a wood shingle roof, the restriction is void."

With such strong language in a statute, why do wood shingle requirements still appear in deed restrictions? After analyzing the three related appellate

condemnation? The Corpus Christi Court of Appeals approved the method in *City of Harlingen v. Estate of Sharboneau*, No. 13-97-874-CV, 8/26/99.

The City of Harlingen sought to condemn Sharboneau's property. Both parties stipulated that the highest and best use was for a single-house development.

Using the "subdivision development" method, the appraiser for the landowner placed the value at \$296,620. This approach projects sales from the developed property and deducts estimated development costs, expenses and the developer's profit.

The city appealed the value because the approach was based on hypothetical sales. The appellate court affirmed the trial court.

"So long as the value of the land, when put to its highest and best use, is reasonably ascertainable, and therefore not the subject of mere speculation, assigning a value according to the reasonable potential use is consistent with the concept of fair market value."

The case is unique because the court distinguished it from *Kaufman N.W., Inc. v. Bi-Stone Fuel Co.*, 529 S.W.2d 281, where the court ruled that hypothetical plans for non-existent subdivisions generally are not proper evidence for valuation of condemned land. Also, the court had to overcome a Texas Supreme Court ruling that held the use of comparable lots in developed areas does not meet the test of similarity.

OVERFLIGHT EASEMENTS

The Center's technical report No. 394 entitled "Understanding the Condemnation Process" details the items landowners should strive to include in any easement negotiated in lieu of condemnation. For example, state the number of pipelines that can be laid, their maximum diameter and pressure and what substances they can carry.

Being specific paid off for a landfill operated by the Travis County Landfill Company. The predecessor in title to the landfill company granted a "Perpetual Overflight Easement for *Military Aircraft*" to Bergstrom Air Force Base in Austin. When the city took over operations of the base, it continued to use the easement for civilian planes. The landfill company sued the city for a "taking" or inverse condemnation because of their intrusion into the easement.

The trial court granted the landfill company a \$2,950,000 judgment for the 135-acre tract. The City of Austin

appealed, arguing, among other things, that the overflights did not decrease the fair market value of the tract. The appellate court affirmed the trial court's judgment.

Appraisers testified that airport operations decreased the value because the landfill could not expand vertically. Also, there was an increased risk associated with operating a landfill near a municipal airport.

However, the court refused to grant an injunction stopping the flights or to award the landfill company attorneys' fees.

City of Austin/Travis Co. Landfill Co. LLC v. Travis Co. Landfill Co. L.L.C./City of Austin. Austin Court of Appeals, No. 03-98-00455-CV, 8/26/99.

ENVIRONMENTAL UPDATE

On October 20, 1999, the Devils River Minnow, a two-inch fish that once thrived in creeks around Del Rio, was listed as threatened. A threatened status under the Endangered Species Act (ESA) occurs when a species is likely to become endangered in the foreseeable future.

What is unique about this species and several endangered ones, such as the blind salamander, fountain darter and riffle beetle, is that they are found exclusively in Texas and then in only two counties. In fact, 80 percent of all species currently listed as endangered exist solely within one state. They do not range across state lines.

This fact raises constitutional issues. The primary basis for the congressional enactment and enforcement of the ESA is the Interstate Commerce Clause in the U.S. Constitution. This clause gives the federal government the right to regulate matters that have a substantial affect on interstate commerce. In contrast, the Tenth Amendment to the U.S. Constitution grants to the states the power to regulate intrastate matters. Some legal scholars feel that the ESA is unconstitutional when applied to species located solely in one state and then on privately owned land.

This argument recently found favor with the United States Supreme Court in *U.S. v. Lopez*, 514 U.S. 549 (1995). In

a 5-4 decision, the high court struck down the Federal Gun Free School Zone Act as unconstitutional because it did not substantially affect interstate commerce. This was a matter left to the states under the Tenth Amendment.

The Texas Justice Foundation, a non-profit organization in San Antonio, played a major role in formulating and preparing the arguments in *Lopez* before the Fifth Circuit in New Orleans and then before the U.S. Supreme Court. The foundation currently represents a Texas rancher and water-well pumper, Hunter Schuehle, who is threatened with civil and criminal prosecution for violating the ESA by the U.S. Fish and Wildlife Service should salamanders die 200 miles downstream.

The case is pending before Federal Judge Lucius Bunton in the Midland Western Division of Texas. The foundation feels the judge will rule favorably for the government and the Sierra Club and against Schuehle. That will provide an opportunity to appeal the question to the U.S. Fifth Circuit Court of Appeals in New Orleans, where Judge Bunton has been overturned several times based on

Some legal scholars feel the ESA is unconstitutional when applied to species located solely in one state and then on privately owned land.

federal intrusion into traditional state matters.

The foundation anticipates that the U.S. Supreme Court will ultimately take and decide the issue regarding the constitutionality of the ESA when applied solely to intrastate species as is being raised in the *Schuehle* case. The foundation thinks it has a good chance to receive the same 5-4 decision achieved in *Lopez*, assuming the same justices are still on the court.

To learn more about the Texas Justice Foundation and its mission to defend property rights in Texas through the courts call 210-614-7157 or visit their website at www.TxJF.org. ♣

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