

TO: Members of the Committee on Revenue

FROM: Bill Lock, Research Analyst for the Committee on Revenue

RE: LR 212, Committee on Revenue/ Interim study to examine the valuation of agricultural land for tax purposes in Nebraska and in surrounding states

DATE: December 1, 2009

One goal of this interim study is to recommend a legislative proposal or proposals for valuing agricultural land for tax purposes. A second goal is to examine enforcement of recently revised greenbelt statutes and other laws relating to the valuation of agricultural land and acreages. The report is in two sections written to address these goals, the first being the valuation of agricultural land.

#### Valuation of Agricultural Land

Past studies of the valuation and taxation of agricultural land in Nebraska have pointed out that effective tax rates and taxes per acre are higher on agricultural real estate in Nebraska than in other states in the region. Legislative bills have been introduced in past years which propose various changes in the methods of valuing agricultural land used in Nebraska. Significant recently implemented legislation includes LB 968, passed in 2006. Under this bill, the value of agricultural land for tax purposes was lowered to 75 percent of actual or market value. Prior to this change, agricultural land was assessed at 80 percent of market value.

In addition to this change, a number of changes were made in LB 808 of 2006. This bill modified the provisions of Nebraska law defining agricultural land. As noted above, Nebraska law provides for agricultural land in agricultural use to be valued at 75 percent of its agricultural market value, which can be much less than the market value in other uses. Generally, the changes made by LB 808 narrowed the availability of agricultural use value for owners of certain parcels of real estate. The bill also eliminated zoning as a requirement for agricultural use taxable value determination, and phased out the requirements of recapture of back taxes over three years. Under LB 808, a parcel was to be viewed as a whole in determining whether is to be valued as "agricultural land" rather than by examining portions being in agricultural use. "Agricultural land" in this rewriting of the law meant that an entire parcel must be predominantly used for the commercial production of agricultural products before qualifying for agricultural land value on any portion of that parcel. This meant that on some parcels, commonly small acreages, with a high-value house, and minimal agricultural land use, were disqualified for agricultural land value treatment, even on those portions of the parcel that were in what was previously viewed as agricultural use.

In the 2008 session of the Legislature, LB 777 amended section 77-1359, the definition of agricultural and horticultural land. This amended language had the impact of reversing and significantly altering the policy adopted in LB 808. Under LB 777, a parcel

of land, excluding any buildings and land directly associated with such buildings, shall be valued as agricultural land if the primary use of the non-developed portions of the parcel is in agricultural or horticultural land use. Agricultural or horticultural purposes is defined as commercial production of agricultural products, but also includes land held under conservation easements, and land removed from agricultural production under a federal or state program in which payments are received for removing such land from agricultural production.

### Agricultural Land Valuation Method and Proposals

Past examinations of Nebraska have pointed out that Nebraska uses a different method of valuing agricultural land than its border states. In Nebraska, sales of agricultural land are recorded, examined and statistically analyzed by locally elected assessors. (Recent legislation has ended a policy of state employed assessing officials in certain counties using this option.) Assessors in Nebraska are charged with determining the market value of agricultural land, and assigning a taxable value to that land which is no more than 75 percent of the market value of such land.

In most other states, including all those states bordering Nebraska, assessing officials assign value to agricultural land by using a statutorily mandated formula approach to determining value. This formula is usually referred to as an income capitalization approach. In practice, production is analyzed, income is measured by rents or commodity prices, expenses subtracted, and the resulting net amount is then divided by a capitalization rate, which then converts that net amount to a taxable value. This type of approach is illustrated below by showing a section of Iowa statute outlining the approach. This statute gives the Iowa Department of Revenue authority to determine the details of the approach by adopting rules.

Iowa Statutory Section. 441.21 (e) ACTUAL, ASSESSED AND TAXABLE VALUE.

The actual value of agricultural property shall be determined on the basis of productivity and net earning capacity of the property determined on the basis of its use for agricultural purposes capitalized at a rate of seven percent and applied uniformly among counties and among classes of property. Any formula or method employed to determine productivity and net earning capacity of property shall be adopted in full by rule.

Shown below is a section of Kansas state law outlining the same policy:

Kansas Statutes, Section 79-1476

The share of net income from land in the various land classes within each county or homogeneous region which is normally received by the landlord shall be used as the basis for determining agricultural income for all land devoted to agricultural use except pasture or rangeland. The net income normally received by the landlord from such land shall be determined by deducting expenses normally incurred by the landlord from the share of the gross income normally received by the landlord. The net rental income normally

received by the landlord from pasture or rangeland within each county or homogeneous region shall be used as the basis for determining agricultural income from such land. The net rental income from pasture and rangeland which is normally received by the landlord shall be determined by deducting expenses normally incurred from the gross income normally received by the landlord. Commodity prices, crop yields and pasture and rangeland rental rates and expenses shall be based on an average of the eight calendar years immediately preceding the calendar year which immediately precedes the year of valuation. Net income for every land class within each county or homogeneous region shall be capitalized at a rate determined to be the sum of the contract rate of interest on new federal land bank loans in Kansas on July 1 of each year averaged over a five-year period which includes the five years immediately preceding the calendar year which immediately precedes the year of valuation, plus a percentage not less than .75% nor more than 2.75%, as determined by the director of property valuation, except that the capitalization rate calculated for property tax year 2003, and all such years thereafter, shall not be less than 11% nor more than 12%.

Agricultural value in these two states and all other Nebraska border states is determined by use of a formula. Income and expenses are calculated, and a net income is capitalized to determine a value. In most of our border states, this is not the final determination of taxable value. The formula value in these states is reduced to a percentage of the formula value. Kansas and Wyoming state laws and constitutions provide for this approach. In Kansas, the formula approach is used to determine a value, and taxable value is then created by applying a percentage adjustment making taxable value 30 percent of the formula value. Wyoming law provides for determination of taxable value at 9.5 percent of formula value.

A policy of defining agricultural land valuation using a formula, with states then applying a percentage calculation to the formula result, appears to be consistent across Nebraska's border states, with one exception. It appears that Iowa has introduced elements to that state's agricultural land valuation policy which offset formula value growth, and limit taxable value. Valuation growth for agricultural land is limited to 4 percent growth per year in Iowa, as are most other types of property, including residential property. This results in taxable values which can be much lower than formula values, if formula values grow at a rate faster than 4 percent. In recent years, Iowa's calculated formula growth has been much higher than 4 percent, due to rapidly increasing crop prices. Iowa observers reported to us that increases of 25 to 50 percent would have occurred under the formula currently in use in Iowa, but taxable values were only allowed to increase to a level 4 percent greater than past years.

The taxable values which result from the use of both a formula approach and a percentage of assessment approach make for dramatically different taxable values than seen under Nebraska's percentage of market approach. Higher nominal rates of taxation are used, but effective rates of taxation remain lower than those found in Nebraska.

This method is used in other states for several reasons, one of which is to shift tax burden from agricultural real estate to other classes of property. The use of a formula is also advocated by those policy makers who believe that using the agricultural real estate

market can distort the assignment of value for several reasons, including purchases made by non agricultural property owners, purchases made because of the one time historic opportunity to purchase, and purchases made by owners who intend to convert or use the agricultural land for non agricultural uses. For these reasons, many states have decided to use agricultural prices, production and expenses as driving factors in determining value. In the case of Kansas, the cost of borrowing was also used as a driving factor in determining value, as an interest rate for land purchases was used in determining the capitalization rate. This approach was largely abandoned after a decline in interest rates drove values upward in a declining crop price market. Kansas now fixes the capitalization rate at 11 percent for calculating value. Wyoming continues to use a five year average of the Federal Land Bank Interest rate to determine the capitalization rate used in their formula.

Under Kansas law, and under some other states laws examined here, this method is used to value only land which is exclusively devoted to use in raising crops or livestock. Land used as building sites for farm home purposes are valued using a real estate market mass appraisal method similar to Nebraska. Once that market value is determined, a ratio of 11.5 percent is applied to property in residential use, and 25 percent for agricultural improvements. The Kansas legal definition for what is valued using this approach is shown below.

For the purpose of the foregoing provisions of this section the phrase "land devoted to agricultural use" shall mean and include land, regardless of whether it is located in the unincorporated area of the county or within the corporate limits of a city, which is devoted to the production of plants, animals or horticultural products, including but not limited to: Forages; grains and feed crops; dairy animals and dairy products; poultry and poultry products; beef cattle, sheep, swine and horses; bees and apiary products; trees and forest products; fruits, nuts and berries; vegetables; nursery, floral, ornamental and greenhouse products. Land devoted to agricultural use shall not include those lands which are used for recreational purposes, other than that land established as a controlled shooting area pursuant to K.S.A. 32-943, and amendments thereto, which shall be deemed to be land devoted to agricultural use, suburban residential acreages, rural home sites or farm home sites and yard plots whose primary function is for residential or recreational purposes even though such properties may produce or maintain some of those plants or animals listed in the foregoing definition.

In this report we will outline different approaches to valuation of agricultural land which could be used to determine taxable valuations.

The approach now used in Nebraska is to value agricultural land at 75 percent of its market value. This is lower than other properties percentage of taxable value to actual value, which for residential and business property is 100 percent of actual or market value. This approach to valuing agricultural land is unlike that used in any of our border states and in many states in the United States. Border states to Nebraska of Iowa, Kansas, Missouri, Colorado, Wyoming and most recently South Dakota, value agricultural land using a method often described as an income approach, or at times, income and productivity approach. A published description of each state's method and

policies was obtained from the South Dakota Legislature's staff. This description is available upon request.

In Nebraska, the policy of valuing agricultural land differently than other types of property is authorized by a constitutional amendment to the uniformity clause found in Article VIII, Section 1 of the Nebraska Constitution. This section allows Nebraska lawmakers to value agricultural land differently and non uniformly from other classes of land. However, this language appears to require that the values within this class must remain uniform and proportionate. See Article VIII-1 shown here, portions of which are highlighted.

#### Nebraska State Constitution VIII-1

Revenue; raised by taxation; legislative powers. The necessary revenue of the state and its governmental subdivisions shall be raised by taxation in such manner as the Legislature may direct. Notwithstanding Article I, section 16, Article III, section 18, or Article VIII, section 4, of this Constitution or any other provision of this Constitution to the contrary: (1) Taxes shall be levied by valuation uniformly and proportionately upon all real property and franchises as defined by the Legislature except as otherwise provided in or permitted by this Constitution; (2) tangible personal property, as defined by the Legislature, not exempted by this Constitution or by legislation, shall all be taxed at depreciated cost using the same depreciation method with reasonable class lives, as determined by the Legislature, or shall all be taxed by valuation uniformly and proportionately; (3) the Legislature may provide for a different method of taxing motor vehicles and may also establish a separate class of motor vehicles consisting of those owned and held for resale by motor vehicle dealers which shall be taxed in the manner and to the extent provided by the Legislature and may also establish a separate class for trucks, trailers, semitrailers, truck-tractors, or combinations thereof, consisting of those owned by residents and nonresidents of this state, and operating in interstate commerce, and may provide reciprocal and proportionate taxation of such vehicles. The tax proceeds from motor vehicles taxed in each county shall be allocated to the county and the cities, villages, and school districts of such county; (4) **the Legislature may provide that agricultural land and horticultural land, as defined by the Legislature, shall constitute a separate and distinct class of property for purposes of taxation and may provide for a different method of taxing agricultural land and horticultural land which results in values that are not uniform and proportionate with all other real property and franchises but which results in values that are uniform and proportionate upon all property within the class of agricultural land and horticultural land;** (5) the Legislature may enact laws to provide that the value of land actively devoted to agricultural or horticultural use shall for property tax purposes be that value which such land has for agricultural or horticultural use without regard to any value which such land might have for other purposes or uses; (6) the Legislature may prescribe standards and methods for the determination of the value of real property at uniform and proportionate values; (7) in furtherance of the purposes for which such a law of the United States has been adopted, whenever there exists a law of the United States which is intended to protect a specifically designated type, use, user, or owner of property or franchise from discriminatory state or local taxation, such property or franchise shall

constitute a separate class of property or franchise under the laws of the State of Nebraska, and such property or franchise may not be taken into consideration in determining whether taxes are levied by valuation uniformly or proportionately upon any property or franchise, and the Legislature may enact laws which statutorily recognize such class and which tax or exempt from taxation such class of property or franchise in such manner as it determines; and (8) the Legislature may provide that livestock shall constitute a separate and distinct class of property for purposes of taxation and may further provide for reciprocal and proportionate taxation of livestock located in this state for only part of a year. Each actual property tax rate levied for a governmental subdivision shall be the same for all classes of taxed property and franchises. Taxes uniform as to class of property or the ownership or use thereof may be levied by valuation or otherwise upon classes of intangible property as the Legislature may determine, and such intangible property held in trust or otherwise for the purpose of funding pension, profit-sharing, or other employee benefit plans as defined by the Legislature may be declared exempt from taxation. Taxes other than property taxes may be authorized by law. Existing revenue laws shall continue in effect until changed by the Legislature.

In devising a method of taxing agricultural land valuation which results in values and, therefore, property taxes, the Legislature must be mindful of this constitutional language. The most recent policy decision of the Legislature to change agricultural land values took place in the 2006 session when the required percentage of value to be assessed was lowered from 80 percent to 75 percent. This approach resulted in lower valuations than would have been assessed in a rapidly increasing market and, therefore, lowered taxes for owners of agricultural land relative to the level which would have been obtained without this change.

This approach is a way of lowering tax obligations for owners of agricultural real estate. It results in a value on agricultural land which is likely to meet the test of uniformity and proportionality within the class of agricultural land. Real estate market data on the sales of agricultural land are used to develop value, and this approach can be locally administered by locally elected officials. Uniformity in level of value within the class can be maintained by accurately measuring sales of different types of land.

A different approach which could be used in Nebraska would be to determine value by examining commodity markets and land rents. A capitalization rate could be calculated which reflects market returns to ownership of agricultural land, based on returns found in markets uninfluenced by changing uses or non farm purchases. In lieu of this, the cost of borrowing could be used to determine a capitalization rate. At this point, a taxable value percentage could be determined which lowers the formula value to that level of value desired by the Legislature to reflect the appropriate tax burden on agricultural land.

Market research done in Nebraska suggests that rate of return varies by type of use and geographic area of the state. The University of Nebraska Department of Agricultural Economics Annual Ag Real Estate Survey is the source for this information. However, none of the other states using a income and capitalization rate formula have used a variable capitalization rate in their laws or policies. All of the states we examined used a single capitalization rate.

If legislators desire to use the methods used in the other three states we have examined, the choice of the capitalization rate becomes critical in determining the result. If the goal of legislators is to reduce and shift value away from agricultural real estate to other classes of value, the capitalization rate can be adjusted to do so. If value preservation, or maintaining current taxable value, is the goal, the capitalization rate can be set in a manner to sustain current valuation. The Legislature could retain this power for itself, or delegate it to another public official, as was originally done in Kansas. Finally, the Wyoming approach of using interest rates on agricultural real estate borrowing could be used.

In the alternative, Legislators could pass a statute which scheduled an annual decline in the percentage of market value used for assessment of value. This downward adjustment could be of a fixed magnitude. This could be done by adjusting downward from 75 percent to 72.5 percent, 72.5 percent to 70 percent, and in increments each year until a level of value agreed to in the law was reached.

This would have the effect of gradually phasing in the fiscal cost to the state aid for schools and community colleges, which is a well known and predictable impact of the lowering of taxable value.

Every downward adjustment to agricultural land value costs the state budget additional state aid for schools, and to a lesser extent, more state aid for community colleges. Downward adjustments also decrease the ability of counties and other local governments to generate funds at the same tax rate used prior to the lowering of valuation. While raising rates can increase to neutralize this loss, most Nebraska governments face statutory rate limits which may not be exceeded without a vote of the people. In the case of county government tax rates, these are limited by Article 8, Section 5, of the Nebraska State Constitution, shown here:

**VIII-5. County taxes; limitation.** County authorities shall never assess taxes the aggregate of which shall exceed fifty cents per one hundred dollars of taxable value as determined by the assessment rolls, except for the payment of indebtedness existing at the adoption hereof, unless authorized by a vote of the people of the county. Given this levy rate effect on local capacity, and in other cases, costs to the state budget, legislators who want to reduce agricultural land value and taxes may wish to do so gradually through small adjustments to the level of valuation.

One aspect of this gradual downward adjustment approach is that it would also gradually phase in the fiscal loss to other governments like county governments. In the case of county governments, no state aid policy mitigates the loss of local ability to generate tax dollars. This is also the case for other local governments where aid programs do not address lack of or loss of fiscal capacity.

This policy option would provide an additional way for legislators to reduce the growth in state appropriations for school aid. The postponement of a planned decrease in the percentage of agricultural value would decrease the forecasted and budgeted amount needed for state aid.

If legislators desire to lower agricultural real estate value, and taxes, in order to lower taxes on this land and make the agricultural sector more competitive with other states as to property taxes, either method described above could be used.

One other aspect of the current system of determining market value by adjusting to the statutory percentage of taxable value, and certifying that value amount by local governments can be appealed by taxpayers who disagree with the market value determination. Taxpayers can do this by offering alternative market data. Formula values leave little ground for argument, unless price or cash rental data can be shown to be inaccurate. Since averages of income and expenses are used, no individual farm will experience the formula pattern exactly.

Finally, we should note that implementation of the income capitalization approach has normally cost states amounts ranging from \$100,000 to \$150,000 as a start-up cost. This cost is incurred when University resources are employed to gather income, productivity and expense information. South Dakota is the most recent state to implement this approach. Their cost of implementation was reported to us as over \$100,000 a year, with on-going cost of \$80,000 a year.

In the states using the formula approach to values, even averaged price changes can still produce a dramatic swing in value. As we noted earlier, officials from the state of Iowa reported dramatic change in the level of formula value took place in 2009. Increases in formula assessed value of over 50 percent occurred, using an income capitalization approach with a fixed 7 percent capitalization rate and 5 year average of crop prices and expenses. A similar result would be obtained if no power to adjust for rapidly changing prices were given to administrators of an income capitalization method and approach here in Nebraska. Iowa avoided this impact in 2009 because other Iowa tax laws prohibit an increase of more than 4 percent in taxable value in any one year.

### Summary

Legislators who wish to examine the goal of reducing agricultural land value, and the taxes paid on that land, can pick an approach which is the least financially costly way of implementing this tax shift. Adjusting the value by using a formula approach and changes to a formula is the option commonly used in other states. In many of these states, the formula value is also adjusted by a percentage designed to deliver a tax burden shift.

Nebraska's current system of percentage valuation changes could also be used, as it was in 2006. Copies of Kansas, Iowa, and Colorado statutes are included in Attachment E for use in examining the structure of laws creating a formula approach.

Two options or courses of action are suggested.

One is to pass a statute directing the creation of crop productivity, price and expense information through the resources of the University of Nebraska School of Agriculture. Once developed, the information could be used to determine the income for three classes of land. After this process is complete, a capitalization rate or rates could be developed which would result in the same statewide total valuation as existed in the

2010 valuation year. The Legislature could adopt this capitalization rate, or rates by law. Thereafter, any change in valuation would be a result of upward or downward movement of prices. A capitalization rate of 6 percent, currently used in South Dakota and Wyoming, would appear to generate this result, based on current income amounts. If agricultural prices were to decline or increase, valuation levels would respond. We suggest that the use of a three-year average may be more practical, as this would maintain a closer connection between current economic conditions and the valuation of land. Most states using formula approaches use a five-year average of prices and expenses, with Kansas using an eight-year average.

An alternative course of action would be to annually adjust the percentage of taxable value to market value percentage by law. A statute putting the 75 percent standard on a schedule to be reduced could be developed. The phasing in of lower percentage of market value would offset the increases generated by agricultural real estate market increases. Small downward adjustments in the percentage would minimize the impacts on state aid and loss of county fiscal capacity. Taxpayer impacts from tax shifting would also be milder. Local assessors would continue to develop real estate market analysis as they do now, and the degree of shifting of value and tax shares would depend on the timing and percent of adjustment provided.

#### Agricultural Land Definition and Greenbelt Law Review

In the 2008 session of the Legislature, LB 777 modified the statutes governing the determination of values on parcels of real estate with agricultural land use. The definition of land qualifying for agricultural value had been modified in prior sessions to require a determination of the "primary use" of such parcels. Value was then assigned accordingly, with parcels where house values dominated as a percent of total value being designated ineligible for agricultural land treatment. This eliminated agricultural land valuation treatment for some acreage rural properties. This policy of valuing agricultural land based on its use as agricultural land in market areas where other higher value uses dominate the real estate market was established in 1977.

Qualification of parcels for this tax treatment had been modified in LB 808 of 2006. Parcels which were of predominately residential value were disqualified for agricultural land value treatment on the entire parcel, even if other portions of the parcel were in an agricultural use under prior laws. This resulted in a large number of parcels in certain urban counties being disqualified and valued based on residential use value only.

LB 777 was passed in 2008 to return to a practice of determining the value of parcels based on separately determined parcel uses, including either examining other agricultural use or site uses separately, and examining use of agricultural land which do not include structures. Tax year 2009 is the first year of this change in method and valuation.

The Revenue Committee was asked by LR 212 to monitor the implementation of this change. This policy of defining agricultural land to include only those lands used for crop or animal production remains a source of conflict. Assessors implementing LB 777 have begun to separate and assign value to the sites associated with houses separately from the agricultural land, along with farm associated building sites. This practice has resulted in changes in parcel values, and house site values. We interviewed assessors

in Lancaster and Seward counties to determine if problems highlighted in public hearings on LB 777 had been resolved. Based on these interviews, we believe that some problems which came to light in these hearings have been addressed in these counties. Problems did surface in Sarpy County property value assigned to house sites in rural Sarpy County. This problem appears to be related to the methods and data used in determination of residential sites' values, rather than the definition of agricultural land.

We did note in our review of other states' methods and procedures for valuing agricultural land for tax purposes that some states appear to be allowing agricultural facilities and outbuilding sites to be assessed in the same manner as other agricultural land. This includes allowing some degree of preference in determining level of value. This policy generally does not apply to residential properties located on farms, which appear to be assessed in the same manner as all other residential properties in all states. This usually involves a market analysis, and classified or percentage of market assessment.

It does appear that what qualifies for agricultural land valuation treatment in assessing taxable value does vary from state to state, with some states allowing land associated with farm improvements to be valued differently than other types or classes of properties. Nebraska requires farm improvement sites to be valued using real estate market methods now used to value all agricultural land. These sites do not qualify for the 75 percent assessment treatment accorded agricultural land or real property. An alternative definition of agricultural land and land used in commercial agriculture may need to be developed.

Iowa law on this subject appears to include farm structure site land in the definition of agricultural land. This definition seems to include production facilities for crops and livestock, including distilleries and retail selling sites for vineyards. Nebraska's agricultural land percentage of market value policy could be extended to farm buildings sites under this or similar language.