

**PROPOSED STUDY PLAN FOR AN INTERIM STUDY
OF THE CLASSIFICATION, VALUATION, AND TAXATION
OF AGRICULTURAL LAND**

Prepared for the Revenue and Transportation Interim Committee
by
Jeff Martin, Legislative Research Analyst
Montana Legislative Services Division

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Legislative Services Division
PO Box 201706
Helena, MT 59620-1706
PHONE: (406) 444-3064
FAX: (406) 444-3036
<http://leg.state.mt.us/>

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INTRODUCTION

Rep. Jim Peterson introduced House Bill No. 72 by the request of the Department of Revenue. The bill would have revised the method for appraising agricultural land for property tax purposes. The Department would have been required to determine productive capacity by using soil surveys of the U.S. Natural Resources Conservation Service. The surveys take into account the physical and chemical properties of the soil and the influence of climate, slope, aspect, and elevation on the land. Land would have been classified as either farm land or grazing land. Farm land would have been divided into two categories: land for which hay production is the more economical use of the land and farm land for which wheat production is the more economical use of the land. In addition, water costs (labor costs and energy costs) would not have been considered in the determination of value. The legislation would have also valued nonqualifying agricultural land at the statewide average productive capacity of grazing land, rather than the average grade of grazing land. Finally, the legislation would have appropriated \$1.4 million for the biennium to the Department of Revenue to conduct the reappraisal of agricultural land.

In his opening before the House Taxation Committee, Rep. Peterson said that the proposed legislation would probably not go forward. He pointed out, however, that several issues on the valuation of agricultural land should be resolved. He said that the productivity of agricultural land has not been updated in 40 years (1963) and that the current five categories (including the grades within each category) of agricultural land classifications may no longer be appropriate. In order to update productivity values, the Department needs to develop a new database. He said that a pilot project conducted by the Department of Revenue indicated that a significant portion of farm land may be misclassified as grazing land. In addition, the federal soil surveys may not be appropriate for determining the productivity of irrigated land. The bill died in the House Taxation Committee.

Rep. Peterson introduced House Joint Resolution No. 43 to examine the issues raised by House Bill No. 72. The resolution, passed by the 59th Legislature, requests that an appropriate interim committee study the classification, valuation, and taxation of agricultural land. The preamble of the resolution describes the rationale for the study:

- The Montana Constitution requires the equalization of valuation of all property subject to taxation.

- Agricultural land is classified for property tax purposes according to its use that includes irrigated use, nonirrigated use, and grazing use and is further subclassified by production categories.
- Agricultural land is taxed based on its productive capacity.
- The several classification categories and other determinants of value may result in anomalies in the equalization of value of agricultural land.
- The current classification and valuation methods applied to agricultural land may be outdated and unfair.
- The Department of Revenue requested legislation to revise the valuation of agricultural land.
- The proposed legislation did not adequately deal with the many problems associated with the valuation of agricultural land.

The body of the resolution directs the appropriate interim committee :

- to examine the current methods used for the classification and valuation of agricultural land for property tax purposes and to examine alternative methods of classification and valuation.

The resolution further directs that the study include:

- representatives of the Department of Revenue, the Department of Agriculture, and persons and organizations knowledgeable in agriculture and agricultural economics.

BACKGROUND

Agricultural land in Montana is valued based on the productive capacity of the land, regardless of the "highest or best use" of the land. Productive capacity is the ability of land to produce income from a cash crop (wheat, hay, forage, etc.). The Department of Revenue uses the income approach to value agricultural land. The procedure for determining the valuation of agricultural land for tax purposes is contained in 15-7-201, MCA:

- 15-7-201. Legislative intent -- value of agricultural property.** (1) Because the market value of many agricultural properties is based upon speculative purchases that do not reflect the productive capability of agricultural land, it is the legislative intent that bona fide agricultural properties be classified and assessed at a value that is exclusive of values attributed to urban influences or speculative purposes.
- (2) Agricultural land must be classified according to its use, which classifications include but are not limited to irrigated use, nonirrigated use, and grazing use.
- (3) Within each class, land must be subclassified by production categories. Production categories are determined from the productive capacity of the land based on yield.
- (4) In computing the agricultural land valuation schedules to take effect on the date when each revaluation cycle takes effect pursuant to 15-7-111, the department of revenue shall determine the productive capacity value of all agricultural lands using the formula $V = I/R$ where:
- (a) V is the per-acre productive capacity value of agricultural land in each land use and production category;
- (b) I is the per-acre net income of agricultural land in each land use and production category and is to be determined as provided in subsection (5); and

- (c) R is the capitalization rate and, unless the advisory committee recommends a different rate and the department adopts the recommended capitalization rate by rule, is equal to 6.4%. This capitalization rate must remain in effect until the next revaluation cycle.
- (5) (a) Net income must be determined separately in each land use based on production categories.
- (b) Net income must be based on commodity price data, which may include grazing fees, crop and livestock share arrangements, cost of production data, and water cost data for the base period using the best available data.
- (i) Commodity price data and cost of production data for the base period must be obtained from the Montana Agricultural Statistics, the Montana crop and livestock reporting service, and other sources of publicly available information if considered appropriate by the advisory committee.
- (ii) Crop share and livestock share arrangements are based on typical agricultural business practices and average landowner costs.
- (iii) Allowable water costs consist only of the per-acre labor costs, energy costs of irrigation, and, unless the advisory committee recommends otherwise and the department adopts the recommended cost by rule, a base water cost of \$5.50 for each acre of irrigated land. Total allowable water costs may not exceed \$40 for each acre of irrigated land. Labor and energy costs must be determined as follows:
- (A) Labor costs are zero for pivot sprinkler irrigation systems; \$4.50 an acre for tow lines, side roll, and lateral sprinkler irrigation systems; and \$9 an acre for hand-moved and flood irrigation systems.
- (B) Energy costs must be based on per-acre energy costs incurred in the energy cost base year, which is the calendar year immediately preceding the year specified by the department in 15-7-103(5). By July 1 of the year following the energy cost base year, an owner of irrigated land shall provide the department, on a form prescribed by the department, with energy costs incurred in that energy cost base year. In the event that no energy costs were incurred in the energy cost base year, the owner of irrigated land shall provide the department with energy costs from the most recent year available. The department shall adjust the most recent year's energy costs to reflect costs in the energy cost base year.
- (c) The base crop for valuation of irrigated land is alfalfa hay, adjusted to 80% of sales price, and the base crop for valuation of nonirrigated land is wheat. The base unit for valuation of grazing lands is animal unit months (AUM), defined as the average monthly requirement of pasture forage to support a 1,000-pound cow with a calf or its equivalent.
- (d) Unless the advisory committee recommends a different base period and the department adopts the recommended base period by rule, the base period used to determine net income must be the most recent 7 years for which data is available prior to the date the revaluation cycle ends. Unless the advisory committee recommends a different averaging method and the department adopts the recommended averaging method by rule, data referred to in subsection (5)(b) must be averaged, but the average must exclude the lowest and highest yearly data in the period.
- (6) The department shall compile data and develop valuation manuals adopted by rule to implement the valuation method established by subsections (4) and (5).
- (7) The governor shall appoint an advisory committee of persons knowledgeable in agriculture and agricultural economics. The advisory committee shall include one member of the Montana state university-Bozeman, college of agriculture, staff. The advisory committee shall:
- (a) compile and review data required by subsections (4) and (5);
- (b) recommend to the department any adjustments to data or to landowners' share percentages if required by changes in government agricultural programs, market conditions, or prevailing agricultural practices;
- (c) recommend appropriate base periods and averaging methods to the department;
- (d) evaluate the appropriateness of the capitalization rate and recommend a rate to the department;
- (e) verify for each class of land that the income determined in subsection (5) reasonably approximates that which the average Montana farmer or rancher could have attained; and
- (f) recommend agricultural land valuation schedules to the department. With respect to irrigated land, the recommended value of irrigated land may not be below the value that the land would have if it were not irrigated.

Agricultural land is classified, by administrative rule (Title 42, chapter 20, subchapter 6, Administrative Rules of Montana), into five different categories according to use:

- nonirrigated summer fallow farm land (crops produced every other year or every third year);
- nonirrigated, continuously cropped farm land (crops produced 3 out of 4 years, typically found in northwestern Montana);
- nonirrigated, continuously cropped hay land;
- tillable irrigated farmland; and
- grazing land.

Each of these classifications is further delineated based on the base crop production per acre. For example, there are 18 grades for nonirrigated summer fallow agriculture land, ranging from less than 8 bushels of wheat produced per acre to 40 or more bushels of wheat per acre. Conversions are made for barley production. There are seven grades of nonirrigated, continuously cropped hay land, ranging from less than 1/2 ton of hay per acre to 3 or more tons of hay per acre. There are 11 grades of grazing land ranging from less than 0.3 animal units per acre to 9.9 or more animal units per acre.

The Department of Revenue is required by 15-7-111, MCA, to revalue agricultural land (property class three), residential and commercial land and improvements (property class four), and forest land (property class 10). These properties must be revalued by January 1, 2009,¹ effective January 1, 2009, and each succeeding 6 years. The resulting valuation increases must be phased in for each year until the next reappraisal.

For the reappraisal of agricultural land, the Department of Revenue relies on the assistance of an agricultural advisory committee in the reappraisal of agricultural land. In 1985, the Montana Legislature directed the Department of Revenue to use the capitalization of net income for valuing agricultural land. The legislation also directed the Department to appoint an agricultural advisory committee. Under current law, the Governor is responsible for appointing the committee.

STUDY QUESTIONS

There are several issues related to the valuation of agricultural land that should be examined. The following questions may be considered in the study of the valuation of agricultural land for property tax purposes.

1. How are agricultural lands currently valued?
2. What are the factors that have led to changes in the productive capacity of agricultural land and in what classes of agricultural land have those changes occurred?

¹Under prior law, the property had to be revalued by January 1, 2008. Senate Bill No. 524 (Ch. 554, L. 2005), introduced by Sen. Mike Cooney, delayed by 1 year the revaluation of all property within property classes three, four, and ten.

3. Are the current agricultural land classifications and grades appropriate?
4. To what extent are agricultural lands misclassified by use (e.g., farm land classified as grazing land) or by productive capacity?
5. What are the issues related to the valuation of irrigated land?
6. What improvements (e.g., data sources, technology, field work, etc.) can be made to the valuation of agricultural land to ensure that the land is valued and taxed fairly?
7. How are Conservation Reserve Program lands valued for property tax purposes?
8. What are the effects of reappraising agricultural land on the taxation of nonqualifying agricultural land?
9. What are the costs associated with improving the methods for valuing agricultural land?
10. What are the costs associated with the administration of the property tax on agricultural land?
11. What are the policy implications associated with revising the valuation of agricultural land?

MAJOR STUDY AREAS

The primary focus of the study may include the following:

1. Review the history of the property taxation of agricultural land in Montana.
2. Review the current system of valuing agricultural land by agricultural land use.
3. Compare the valuation of agricultural land in Montana with other states.
4. Analyze the factors that affect the productivity of agricultural land.
5. Evaluate the data sources and methods that may be used to improve the valuation of agricultural land.
6. Consider whether the current classification and grades of agricultural land are appropriate.
7. Evaluate the taxation implications on the owners of agricultural land and the fiscal implications on local governments to proposed changes in the valuation of agricultural land.

8. Consider policy implications to proposed changes in the valuation of agricultural land.
9. Develop options, if options are considered necessary, to revise the valuation of agricultural land in Montana. The options should be evaluated using established criteria of good tax policy, including equity and fairness, economic efficiency, and simplicity.

PROPOSED SCHEDULE

The following schedule is proposed for conducting the study:

1. September 2005 meeting -- Review, refine, and adopt study plan.
2. December 2005 meeting -- Present an overview of property taxation of agricultural land in Montana and other states.
3. February 2006 meeting -- Analyze factors that affect productivity of agricultural land and evaluate data sources and methods to improve the valuation of agricultural land.
4. April 2006 meeting -- Consider whether current agricultural land use classifications and grades are appropriate and whether they should be revised.
5. June 2006 meeting -- Evaluate the implications of policy changes on taxpayers and state and local taxing jurisdictions; develop options and initial recommendations for consideration; request draft legislation if considered appropriate.
6. September 2006 meeting -- Act on draft legislation, if any; finalize recommendations; approve outline for the final report.
7. November 2006-- Review final report of committee actions

The Revenue and Transportation Interim Committee should coordinate the study with the Department of Revenue and the Agricultural Advisory Committee. The Department, with the advice of the Agricultural Advisory Committee, will develop the technical information that the Committee will need to complete the study. The Committee should request that the Department of Revenue and the Agricultural Advisory Committee provide updates on their activities at each Committee meeting.

The proposed schedule extends beyond the normal completion of interim committee work by September 15, 2006. The extension would allow for additional time to work with the Department and the Agricultural Advisory Committee, should that be necessary.

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