Varying state systems in Midwest continue to evolve

by Carolyn Orr (orr@sarl.us)

The hows and whys of taxing farmland

I t is the single largest source of revenue raised by local governments (two-thirds of the total), and the single largest tax paid by farmers (44 percent of the total).

The property tax is the lifeblood of rural schools and other critical public services, but can also be a burden on agricultural producers: Across the United States, the equivalent of one-fifth of the gross sales produced by farmland is paid in property taxes each year.

Such costs can impact the stability of many farms, particularly in a period of income shortfall such as the one encountered by some farmers in the Midwest during the drought of 2012.

State legislators are ultimately responsible for finding the balance that works, an agricultural taxation formula that sustains both rural communities and their farmers.

“Policymakers should ensure that a logical approach is used, consistently applied and presented to taxpayers in a transparent fashion,” John Anderson, an agriculture economist at the University of Nebraska, says about the principles that guide decisions about how to tax agricultural land.

Keeping farmers farming, and ag land producing

“No farms, no food” is the message used by the American Farmland Trust, an organization that advocates for policies that protect agricultural land. One way to keep land in production is a sensible property tax system for the agricultural sector.

All land is taxed based on fair use or market value.

However, every state provides some type of preferential treatment for farmland. Farm fields are assessed at below market value as long as they are being actively used for agriculture production. This preferential treatment began in the 1960s in response to the massive conversion of tens of millions of acres of rural land to non-agricultural uses.

Farmland left on the fringes of growing urban areas tends to jump in value, as a result, an agricultural producer’s income doesn’t keep pace with escalating property tax bills.

Preferential assessment, then, has been justified as a policy to protect family farms and to keep land in farm use.

In many cases, the preferential treatment now written into state law merely codified informal and inconsistent assessment practices that had previously provided property tax relief.

State codification of these policies has not been without controversy, though. Shouldn’t a farmer, wealthy on account of owning a valuable piece of land, be paying more in taxes? Some critics ask.

Yet these preferential-treatment policies have stood the test of time, and several studies have confirmed that they help slow metropolitan sprawl and keep land in agricultural production.

In addition, over the past 15 years, a series of “cost of community services” studies have shown that working agricultural lands generate more in public revenues (through property taxes) than they receive back in public services — even after the preferential tax treatment is taken into account.

The reason is that open farmland requires little public infrastructure and few public services. Its “cost of community service” is less than one-third that of residential land.

Classification System

State systems for taxing agricultural land

Classified use — Assessed at market value, but lower rates apply (farmland assessed at 75% of value in Nebraska)

Use value — Assessed based on use of land and amount of income owner can expect to earn

Market value — Assessed at full market value, but farmers can enroll in programs to reduce tax burden (Minnesota’s Green Acres Program, Michigan’s Farmland and Open Space Preservation Program)

Most states use one of two ways to provide preferential taxation for farmland: a classified-use system or use-value assessments.

Under a classified-use system, different tax rates and exemptions are applied to different kinds of property. Nebraska is one
of 25 U.S. states that employ this type of system. In the Cornhusker State, agricultural land is assessed at market value, but only 75 percent of that value is taxed. In comparison, residential and commercial property is taxed at 100 percent.

Most states in the Midwest, though, employ some version of use-value assessment — assess the property based on the income a farmer can be expected to earn, rather than the land’s market value. Generally, the income of a farm field is calculated by the land-grant university in a state, with factors such as commodity prices, soil productivity, rental rates and production expenses all taken into account.

There is another part of this formula, too, that can make a potentially huge difference in land values and, as a result, agricultural property taxes: the interest rate for farm mortgage loans. The lower the rate, the higher the value of the land because the cost of owning it is reduced.

In North Dakota, a recent change in how the capitalization rate is calculated led to a 26 percent increase in land values across the state’s 43 counties. Prior to 2012, a capitalization-rate minimum, or floor, had been used to keep the rate artificially high (the floor was 7.4 percent in 2011). This year, the floor was removed; as a result, the actual 10-year average of mortgage interest rates was used. The result was a dramatic rise in land-use values, and potentially higher property taxes without adjustments made at the local level of government.

Three years ago, when South Dakota moved from a market-based system to use-value assessments, the Legislature stipulated that the capitalization rate be set at 6.6 percent.

“Legislative requirements that the conversion be revenue neutral and involve no tax shift between different categories of land put significant constraints on the actual formula used to calculate land-use value,” says Republican Sen. Larry Rhoden, chair of the state Legislative Agricultural Land Assessment and Oversight Task Force.

“We set our capitalization rate at 6.6 percent to meet the revenue-neutral goals.” In general, the formula economists use to calculate use-value assessment is this:

\[ UV = \text{net income} \times \text{interest rate} \times \text{property taxes} \]

This formula comes closest to determining what a farmer can afford to pay for land at current commodity and production costs. When commodity prices, yields or cash rents increase, or interest rates decrease, the assessed value rises.

The actual property tax is then determined by multiplying the use-value assessment by the tax rate set by the local taxing authority.

**Same formula, different applications**

Illinois, Indiana, Iowa, Kansas, North Dakota, Ohio, South Dakota and Wisconsin are among the states that employ some type of use-value assessment. These assessment systems, however, can vary widely from state to state.

In determining net income, some states use actual commodity prices and production costs, while others use cash rental rates.

Another key difference is whether caps are in place to control year-to-year increases or decreases in agricultural property’s assessed value. Illinois (10 percent), Iowa (4 percent) and South Dakota (10 percent) are among the states that have such statutory limits.

Some states allow local assessors to adjust for conditions like flooding, while others use boards of community residents who are appointed by elected officials. And some states only tax a portion of the final use-value assessment — for example, 30 percent in Kansas, 33.33 percent in Illinois and 85 percent in South Dakota.

Nationally, 11 states provide automatic enrollment of farmland into their use-value assessment program; 38 states require landowners to apply. A few states, too, levy a penalty when land is

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**Overview of formulas used in Midwestern states to assess and tax arable farmland**

**Under Illinois’ use-value assessment system,** the income potential of each farm field is calculated using a soil productivity index, commodity prices and production costs. It is then divided by a five-year average of mortgage interest rates (based on Federal Land Bank data). This calculation determines each parcel’s “agricultural economic value.” In each county, a farmland assessment committee approves the “agricultural economic value.” One-third of that value is then taxed.

**Under Indiana’s use-value assessment system,** a base rate estimating net income is calculated using yield, commodity prices, government payments and production costs. This base rate is multiplied by a soil-productivity factor and then divided by the mortgage interest rate. This calculation is done annually and is based on a six-year rolling average. A constitutional amendment in the state limits property taxes on farmland to 2 percent of its assessed value.

**Iowa uses five-year averages of cash rental rates in a county.** The capitalization rate is set at 7 percent (rather than being based on current mortgage interest rates). To determine the income-producing ability of each parcel of land, county-by-county averages are used rather than individual field-level calculations. A soil-rating system can also be used to adjust assessed land values within a county. The taxable value of land cannot increase annually by more than 4 percent.

**Under Kansas’ use-value assessment system,** the net income for agricultural land is based on median production levels in the county (an eight-year average is used). That net income is then divided by the capitalization rate, which, in Kansas, is based in part on the county’s tax rate and the five-year average of the Federal Land Bank’s mortgage interest rates. Thirty percent of that use value is then taxed.

**Michigan does not employ a use-value assessment system.** However, landowners can enroll in the Michigan Farmland and Open Space Program. They commit to keeping property in agricultural use for a certain amount of time (10 years or more); in return, they become eligible for income tax credits equal to the amount of property taxes that exceeded 3.5 percent of the household income. In addition, increases in taxable values are capped at the lower of two rates: 5 percent or the rate of inflation.

**In Minnesota,** agricultural property taxes are handled almost exclusively by each county. Sixty percent of the counties participate in the state’s Green Acres program, which allows eligible property to be taxed at its value as agricultural land — rather than at its full market value.

**Under Nebraska’s classified-use system,** agricultural property is taxed at 75 percent of its market value. In comparison, commercial and residential property is taxed at 100 percent of its market value.

**Under North Dakota’s use-value assessment system,** production and input costs are divided by mortgage interest rates to determine the average agriculture value for cropland and non-cropland. A 10-year average is used to determine the mortgage interest rates.

**In Ohio,** a property’s “current agriculture use value” is calculated by determining gross income, input costs and the capitalization rate. A five-year moving average is used. Agricultural land converted to other uses is subject to a penalty, which amounts to three years’ worth of tax savings from being assessed on use value rather than market value.

Until 2009, agricultural land in South Dakota was taxed based on its market value. The state now employs a use-value assessment system. The capitalization rate is set in statute at 6.6 percent. Eighty-five percent of the use value is taxed. Annual changes in the assessed value of land is capped at 15 percent, 20 percent or 25 percent, depending on the county.

**Wisconsin** has employed a use-value assessment system since 1997. A property’s use value is determined by dividing net income by the Federal Land Bank’s five-year average for mortgage interest rates. A 10-member Farmland Advisory Council oversees Wisconsin’s use-value assessment system.
removed from a use-value assessment program and developed for another use. The reason for this penalty is to guard against property owners taking advantage of the preferential tax treatment until they can sell the land at a good price.

A high penalty per acre that declines with years of enrollments is thought to defer development for years. Professor Anderson encourages states to impose this type of penalty.

Anderson, too, says policymakers should make a point of carefully reviewing their methods of determining capitalization rates and net income. Only then, he adds, can they be sure that a fair and rational approach is being used to tax agricultural land.

Regardless of the formula, agricultural taxation is posing challenges to the region’s policymakers.

In states with no statutory cap to limit increases in assessed land value, taxes have the potential to spike up due to rises in commodity prices and productivity as well as decreasing mortgage interest rates. The base rate in Indiana, for instance, (a state that has no cap) has increased 70 percent over the past five years.

In states with a cap, there is a growing disparity between the farm’s actual value and the level at which it is being assessed.

South Dakota is a case in point. As Sen. Rhoden notes, the state’s old market-based system had already created wide disparities in the appraisal of agricultural land from county to county. The 10 percent cap under the new use-value assessment, he says, made it impossible to close those disparities and to close the gap between a land’s taxable value and its actual value.

This year, the Legislature loosened the cap: Taxable values will be allowed to increase 15, 20 or 25 percent annually depending on the county.

Farm real estate value in 2012, $ per acre, and % change from 2011*

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* The average value of U.S. farm real estate in 2012 is $2,650 per acre, up 10.9 percent from 2011.


North of the border: How neighboring Canadian provinces tax farmland

- **Alberta** — Each municipality in the province oversees taxation, basing it on agriculture use value and adjusting the assessment for location.
- **Manitoba** — Farmland is assessed every two years and taxed at 26 percent of market value. If the farmland is developed for other use, a tax payback equivalent to up to five years is required to make up for the preferential tax treatment given to the farmland.
- **Ontario** — Farmland must be at least 50 percent Canadian-owned to be eligible for the preferential rate, which is 25 percent of current market value. Only farmer-to-farmer sales data are used to calculate the value.
- **Saskatchewan** — Farmland is taxed at 55 percent of market value, which is set by an independent agency.

(Actual property taxes for farmers won’t rise by that amount, because state law prevents local governments from collecting any more than year-to-year increases in inflation.)

In Nebraska, the only state in the Midwest that employs a classified-use system, irrigated farmland values have increased by 41 percent in the last year alone. Without corresponding cuts in tax rates by local governments, the result would be higher taxes for agricultural producers.

Rapidly increasing farmland prices and drought-induced rises in commodity prices both have the potential to raise taxes on agricultural land. As a result, how states and local governments tax farmland will be a subject of intense interest among rural state policymakers in 2013 and beyond.