Agricultural Advisory Committee
Wingate Hotel
2700 N. Oakes Street
Helena, Montana
August 28, 2014

Committee Members: Chairman Mike Jopek, Gerald Neilson, James Johnson, Representative Mary McNally, Representative Mike Miller, Helen (Jo) Shipman, Senator Bruce Tutvedt, Senator Greg Jergeson

Department of Revenue: Mike Kadas, Cynthia Monteau Moore, Bonnie Hamilton, Frank McCall

Others: Bob Story, Montana Taxpayer's Association, Mike Murphy, Montana Water Resources, Representative Roy Hollandsworth, Nick Brown, Legislative Fiscal Division, Megan Moore, Legislative Services, Jaret Coles, Legislative Services.

I. Call to Order

Chairman Jopek called the meeting to order at 8:24 a.m.

II. Approval of Minutes

Helen (Jo) Shipman made the motion is to adopt both the May 29, 2014, minutes and the June 26, 2014, teleconference minutes.

Motion: Helen (Jo) Shipman.

Second: James Johnson.

Motion Carries Unanimously.

A correction was noted by Bonnie Hamilton that on the May 29, 2014, minutes the footer needed to be changed from 2013 to 2014. Correction noted.

James Johnson made a motion to adopt both sets of minutes as edited.

Motion: James Johnson.

Second: Gerald Nielson.

Motion Carries Unanimously.

III. Discussion

a. Regional Wheat Pricing

The department worked with the Montana State University College of Agriculture to assist in calculating average prices for 2007 – 2012 on a regional basis using data from

USDA Agricultural Marketing Service (AMS). The regional prices ranged from $7.67 in the Southeast to $8.14 in Central Montana. The Northwest and Southwest had no price information available. Frank McCall explained that the advantages and the disadvantages of using a regional price. The advantage would be fair treatment of producers. Producers selling wheat for less would have their summerfallow land valued less than the producers selling their wheat for more. He also discussed disadvantages. Regional prices are higher than the Ag statistic prices; regional prices are not as readily available as prices from Ag Statistics; using a regional price would result in different treatment of summer fallow land compared to the other land uses which may also receive government subsidies; the Northwest and Southwest districts have no price information; and a regional price would result in county line differences that could be difficult for the Department to defend. Because of the numerous disadvantages, the department does not recommend a change from using an Olympic Average price from Ag Statistics.

Helen (Jo) Shipman stated that she has the prices of wheat and alfalfa for the last 40 years, and that she would be willing to provide this information if needed.

James Johnson indicated that there is no way to obtain a weighted price from AMS. Frank agreed that this is a limiting factor.

Public Comment

Representative Hollandsworth provided insight on market prices. He then asked if the study differentiated when the farmers sold their product, as this would affect the prices received. Senator Tutvedt indicated that we can defend a statewide average price derived from Ag Statistics. It may not be perfect across the state, as there are many variables, but it is defendable. Bob Story stated that any decision should consider how accurate you want to be. He believed that it would be less than a 5% difference if we went with a regional price. He added that if you are in the ball park, changing from one methodology to another is not going to make much of an impact.

b. Dry Land Hay Commodity

Frank McCall stated that the commodity used in the valuation formula for dry land hay is the 7 year Olympic Average of alfalfa hay. Ag statistics publishes prices for alfalfa and all other hay. All other hay includes, wild, clover – timothy, grain hay, other hay and hay on Conservation Reserve Program (CRP) land. All other hay had a lower price in 22 of 24 years that prices are available (2013 is not available). However, after the 20 % statutory adjustment applied to alfalfa hay, alfalfa had a lower price every year. The department has no statutory authority to adjust All Other Hay. Because of this, there is no benefit to changing from using the price of alfalfa hay.

Chairman Jopek asked when the air dry herbage was taken into account. Frank indicated that it comes in when the productivity is calculated. The current cycle uses a "step-down" method for determining productivity. The department reviews the soil survey to determine if there is an alfalfa rating for a soil, if not, we see if there is grass/alfalfa, and keep stepping down all the way to air dry herbage if needed. This committee decided to use air dry herbage only, because it is almost always in the survey, is easier to explain and defend, and results in a productivity that is closer to what is actually being achieved on dryland hay land.

The department recommends no change to using the price of alfalfa for determining the value of dryland hay.

Senator Tutvedt indicated that it appears that someone had decided that alfalfa was too highly taxed compared to wheat and arbitrarily chose to reduce the price by 20%. Because of the increase in the price of wheat this cycle we may see a significant discrepancy among the classes of land. He questioned if the committee could make a recommendation for a statutory change to the 20% adjustment to alfalfa hay to bring the classes of land back to equilibrium. Frank explained that the 20% adjustment is in law because previous Legislators felt that dairy producers were paying more for high quality alfalfa hay and that this was influencing the price that the average producer was actually receiving. He is not sure if that is still occurring as there are far less dairy producers, and stated it may not be legitimate any more. James Johnson stated that this was debated in the previous cycle. That committee had received a report that stated the price across all classes of hay showed no dairy influence and recommended a change to statute. In a subsequent meeting that decision was reversed. Senator Tutvedt asked how, with fluctuating prices, we are going to stay revenue neutral. He encouraged the committee to look at the classes in a global perspective. Director Kadas indicated that the Governor is recommending that we maintain taxable value neutrality between class 4 and class 3. He reviewed the committee's responsibilities and stated that it is the committee's job is to come up with the fairest methodology for determining the value of agricultural land. He explained that the committee could recommend a change to the 20% adjustment to alfalfa hay, but that it would still require action by the legislature. Senator Tutvedt agreed.

Chairman Jopek suggested that the committee hold the discussion to make recommendations to the Department until the end of the day, after all the information has been presented.

Senator Jergeson stated that many farmers in his area grow alfalfa to combat saline seep, but that most would otherwise make a different choice on the type of hay to grow on dryland. He also cautioned the committee that they should not become too sanguine when discussing statewide tax neutrality as that does not prevent there being a lack of neutrality in your local taxing jurisdiction and there could still be a tax shift depending on the magnitude of how much the values go up or down. Director Kadas confirmed that he is correct and that even after recommended changes are figured in, he still anticipates a significant shift from grazing land to wheat. He stated that there will be additional information presented to the committee that will help mitigate this situation somewhat, and that the committee should wait until they have seen all of the department's proposals before jumping to conclusions. Director Kadas reiterated that the department's responsibility is in trying to find the most accurate valuation and that we need to maintain a global view. Senator Tutvedt stated that some of the decisions made in the past should be reviewed and possibly changed if warranted. Bob Story provided insight on where the 20% adjustment came from.

Chairman Jopek asked if there were any objections to the department's recommendation of no change to using the Olympic Average of alfalfa hay to calculate the price of dryland hay. There were no objections and no other alternatives offered.

c. Grazing Land Valuation

Frank McCall provided an overview of Grazing Land Valuation. Section 15-7-201(5)(c), MCA, states that Montana State University (MSU), must determine the minimum number of AUMs (Animal Unit Months) required to meet the required $1500 in Ag income to be eligible as agricultural land. He then provided an overview of Dr. Mosley's report. Dr. Jeffrey Mosley is a Range Management Specialist with MSU, and was enlisted by the department to review the AUM requirement. Frank discussed Dr. Mosley's recommendations in the report. Dr. Mosley recommends the DOR continue its practice of using 25% of air dried herbage and 915 pounds as the required forage for an animal unit. The report recommends using the unfavorable grazing production published in the NRCS soil survey instead of the current midpoint of favorable and unfavorable. Dr. Mosley recommends that the DOR should adjust carrying capacity for the 1200 pound animal unit by calculating carrying capacity using 915 pounds of air dried herbage and then multiplying that by .83. Frank provided the DOR's methodology for calculating carrying capacity, and explained that it achieves the same result as that recommended by Dr. Mosley. Finally, Dr. Mosley recommends using 31 AUMs as the minimum number of AUMs necessary to generate $1500 to qualify. The current cycle requires a minimum of 30 AUMs.

Public Comment

Senator Jergeson commented that using the unfavorable column instead of the midpoint will have the effect of lowering the value of grazing land. Frank agreed and added that just changing from a 1000 pound animal unit to a 1200 pound animal unit will lower the value of grazing land. Senator Tutvedt raised some questions about the price of cows and how the carrying capacity required to be classified as agricultural land was determined. Frank directed the committee to Dr. Mosley's report where they could find the data that Dr. Mosely used to make his determinations. Bonnie Hamilton interjected that part of the problem is that eligibility and valuation are often confused, and that this is a common problem for our appraisers.

DOR recommends using the unfavorable air dry production and 31 AUMs to generate the required $1500 in annual income.

Chairman Jopek encouraged committee discussion on the Department's recommendations. Chairman Jopek asked how many farmers would be impacted by increasing the carrying capacity requirement to 31 AUMs. Frank explained that the department estimates that just changing to the 1200 pound animal unit may affect approximately 200 people and that using the unfavorable air dried herbage production may affect approximately 200 more.

Senator Tutvedt asked for more clarification on the carrying capacity requirement for grazing land and how that relates to the $15.72 private grazing fee.

Frank indicated that in the 2015 cycle, the private grazing fee will be $18.08. Senator Tutvedt expressed that he believes that if grazing values are lowered further it will cause a major shift in taxes. Director Kadas reminded them all that this is only one piece of the puzzle, and that they need to take a global perspective.

Senator Tutvedt expressed concern that wheat land taxes will increase significantly. Director Kadas reviewed several mitigating factors in our recommendations that included eliminating federal subsidies from the price of spring wheat and using a longer Olympic Average. Representative McNally asked for more clarification on why the DOR uses spring wheat for valuing summerfallow farmland. Mike Kadas explained that this is in statute.

Bob Story encouraged the committee to carefully study the issues and not make a rash decision. He stated that if you are using a larger animal, this should decrease the AUMs that would be needed to qualify.

No other public comment.

d. Federal Direct Payments

Frank McCall provided information on Federal Direct Payments to spring wheat. These payments have been included in the spring wheat price the department calculates for the last 2 reappraisal cycles. The 2014 Farm Bill ended direct payments and expanded crop insurance. The department determined the impact from direct payments for the 2015 cycle is $.58 per bushel. It is $.59 in the current cycle. The department recommends not including direct government payments for the 2015 reappraisal cycle.

Director Kadas expanded discussion on this issue by noting that we have lost our justification for including these payments as it is no longer part of the Farm Bill, government payments are not applied to other commodity prices and the data required for calculating the payments was becoming more and more difficult to access. James Johnson stated that there will still be payments to those who have a history of payments. Chairman Jopek noted that there are real benefits to the farm bill. He added that eliminating direct payments from the commodity price that the department uses is a good idea.

Public Comment

Representative Hollandsworth stated that when you are leasing on a crop share there is nothing to protect the land owner. If you are a banker you are protected. James Johnson noted that landlords on crop share leases can insure their own share.

No other public comment

e. Crop Share Survey

Frank McCall reviewed §15-7-201 (5) (b) (ii), MCA, relating to crop share and livestock share arrangements used in the valuation of agricultural land. At a previous meeting, the legitimacy of the current crop share percentages was brought into question. After that meeting the department decided to look at hiring someone to conduct a survey to determine if the current crop shares were still appropriate. Dr. George Haynes and Dr. Vince Smith (Montana State University), Department of Agricultural Economics and Economics, and Extension Economics were contacted. The department contracted also with the Bureau of Business and Economic Research, University of Montana to conduct the actual survey, and Drs. George Haynes and Vince Smith analyzed the data and provided a summary of the results of the leasing arrangements of both irrigated, non-irrigated and grazing leasing arrangements to the department. Results of the survey do not provide a sound recommendation for change. The results did not confirm the current crop share arrangements are incorrect, nor contradict them. The department recommends no change to the current crop share and livestock share arrangements.

James Johnson noted that the average cash lease on grazing land was $21 per AUM and the expense was $3 per acre, which would be about one quarter of the income. Bob Story pointed out not to confuse the expense with the land owner's opportunity to own the property. The 25% includes the landowner's investment in the property plus the cost of ownership. Expenses and taxes or other expenses are included in the rental price. Many of these formulas were put together 25 years ago and have not been looked at since. James Johnson indicated that the 25% does not contain the opportunity costs for the land. Helen (Jo) Shipman indicated that there are many variables and that 25% is reasonable.

The department is recommending no change to the 25/75% crop share that is currently used and no change to the 25% expense to grazing land.

Public comment

Representative Hollandsworth stated that he thinks continuing with the current percentages is fair.

f. Commodity Base Period

Frank showed slides representing the calculations of commodity prices using a 10 year Olympic Average; this drops the high and low year, and averages the remaining 8 years. He then showed how this compares with the current 7 year Olympic average. Changing to a 10-year Olympic Average will reduce the commodity price for spring wheat for the upcoming reappraisal by $1.00.

James Johnson commented that these are unadjusted prices. Government payments are not included, and not adjusted for inflation. Slides were provided showing the estimated 2015 prices, for both 7 and 10 year averages. Using a 7 year average Frank estimates spring wheat at $7.36, alfalfa at $85.76, and the private grazing fee at $18.88. Corresponding prices using a 10 year average are $6.36, $77.00 and $18.08.

Senator Tutvedt indicated that it was a consensus to take out the direct payments of spring wheat for 2015, and whether they were included in this analysis. Frank indicated that the information he provided shows a comparison of the current spring wheat price which includes direct payments, to what the price would be in 2015 without the direct payments.

Director Kadas referred to the charts provided which show that a 10 year average is more likely to average two price cycles, and emphasized the price stability obtained by using a 10 year average. He stated that the Department of Revenue is proposing switching to a 10 year Olympic Average.

Senator Jergeson stated he liked the graph that showed the 10 year Olympic average. He added that the price volatility of wheat is a good reason to consider moving to a 10 year average. A longer average time includes more peaks and valleys.

James Johnson confirmed that if the Department uses a 10 year, or less cycle, there would be less impact from inflation. Director Kadas indicated that it would not take a legislative change to go with a different averaging number.

Senator Tutvedt– made a motion to move to a 10 year cycle. After discussion is was decided that he is a non-voting member and cannot make a motion. The committee will wait until the end to vote on all recommendations.

Public comment

Bob Story asked Director Kadas to explain the rule making process and asked how much time was required to adopt rules. Director Kadas and Cynthia explained the rule making process and timelines involved.

Representative Roy Hollandsworth stated that if the 7 year Olympic Average is used, two cycles are not included, only one. If a 10 year Olympic Average is used, two full cycles are captured.

g. Capitalization Rate

Frank McCall provided information on the capitalization rate is and how the 6.4% rate was developed. The capitation rate is used to convert the income stream into value. There is an inverse relationship of value and the cap rate. The lower the capitalization rate the higher the value, the higher the capitalization rate, the lower the value.

James Johnson asked for clarification on what the income that is calculated truly represents. It represents the share to the landlord used to pay all of the resources that the landlord provides for the fulfillment of the lease, including property tax. Frank responded that we are calculating the income based on a crop share approach, but that the income calculated may not be the true net income. James Johnson provided a history on how the 6.4% rate came about. In 1993, the legislature coupled the agricultural tax rate to the residential tax rate. A 6.4% cap rate was used on agricultural land in order to maintain tax neutrality. Senator Jergeson provided additional historic information on the tax rate and cap rate.

James Johnson commented that using rent to value ratios to set cap rates results in an inaccurate rate because when the Montana Agricultural Census questionnaire asked land owners what they valued their land at, the answers did not necessarily represent what the land could actually sell for, but someone's best estimate of what they think the value of the land is worth. Frank indicated that Montana Ag Statistics staff validated this. Bob Story interjected that the price that is reported is what people thought their market value was, and not the productive value. Frank agreed that history shows that using the rent to value ratio was not a good idea.

Senator Tutvedt stated that as long as we maintain revenue neutrality among the classes, it will not really matter what the cap rate is.

Frank reviewed neighboring states' cap rates. The Department is proposing calculating the cap rate by adding an effective interest rate to an effective tax rate.

Director Kadas indicated that if the legislature takes mitigation steps similar to what it has done for the last 18 years, then the effective Tax Rate will be about 1%. If the legislature makes changes to current mitigation steps the effective tax rate could be higher or lower. This is why the Department prefers that the committee recommend a methodology for calculating the cap rate, and not a specific number.

Senator Tutvedt expressed concern about what the farm credit interest shown in the slide actually represented. Whether they were long or short term interest rates to purchase land only, or if it included machinery and other agricultural related assets. Senator Tutvedt requested a tighter definition of what the farm credit interest rates represented. This sparked further discussion on interest rates. Senator Tutvedt asked why the effective tax rate is being included in the proposed formula. Director Kadas indicated that the formula should include an effective tax rate in order to account for the property taxes which are not included elsewhere in the formula. Senator Tutvedt asked about the 8% cap rate on timber land and how that can be rationalized. Senator Tutvedt stated that there needs to be some sort of rationalization or there will be a battle among classes. Director Kadas stated that there has not been a defined rule on how to develop a cap rate for agriculture and timber for many years. Bob Story stated that part of the cap rate includes a risk factor and that every property class has a different cap rate because of different risks involved in owning that property. Director Kadas explained that for commercial appraisal we look at it industry by industry and that each industry has a different risk.

The department recommends calculating a cap rate by adding an effective interest rate to an effective tax rate.

Public comment

Bob Story stated that land is a long term investment, thus a 30 year interest rate would be appropriate.

h. Irrigated Energy Costs

Frank McCall provided information on irrigated energy costs. He explained that all irrigated land gets a water cost deduction as stipulated in §15-7-201, MCA, whether the farmers supply the department with energy costs or not. The minimum irrigated land would receive is $20, which represents a $15 base cost and a $5 labor cost for a pivot system. All other irrigation types would be higher. The Department of Revenue is required by statute to send out letters requesting information on the energy costs. If producers return information it is entered into the system. The department has mailed questionnaires for the 2015 cycle and has been busy entering returned information into the system.

No Public Comment.

i. Minimum Irrigated Value

Frank McCall provided information on §15- 7- 201 (7)(f),MCA, regarding the minimum value of irrigated land. This was a discussion item brought up at a previous meeting. Statutory law gives direction on the recommended value of irrigated land stating that the value of irrigated land may not be below the value that the land would have if it were not irrigated. The department calculates the minimum value by using 23 bushels of spring wheat and the continuously cropped formula. The minimum value of irrigated land is currently $411.48. In the 2009-2014 cycle 88% to 89% of irrigated acres are valued at $411.48. For the 2015 – 2020 using the 7 year Olympic Average the minimum value is $661.25 and the 10 year minimum value is $571.41.

Director Kadas noted that 88%- 89% of the irrigated acres are at the minimum value right now. It is an indication that the complicated methodology that we are using may be more bother than it is worth. It may be better to just use the minimum value on all irrigated lands. The Director noted however that this would require a statutory change.

Public Comment

Representative Hollandsworth stated his area is all dry land.

IV. Recommendations

a. Dry Land Hay Commodity

The department recommends no change to using the price of alfalfa to calculate the value of dryland hay for the 2015 cycle.

No comment. No objection.

b. Grazing Land Valuation:

The department recommends using the unfavorable air dry herbage production in the productivity calculation and 31 AUMs as the required carrying capacity to equate to $1500 in gross income for the 2015 reappraisal cycle.

Helen (Jo) Shipman made a motion to approve the department's recommendation for both the dry land hay commodity and the grazing land productivity calculation and 31 AUMs as the required carrying capacity.

Motion: Helen (Jo) Shipman.

Second: Gerald Neilson.

The Motion Carries Unanimously.

c. Federal Direct Payments

DOR recommends that we do not include direct payments in the price of spring wheat for the 2015 cycle.

James Johnson made a motion to accept the department's recommendation to not include direct payments in the price of spring wheat for the 2015 reappraisal cycle.

Motion: James Johnson.

Second: Gerry Nielson.

The motion passes unanimously.

Senator Jergeson supports this recommendation. James Johnson favors the motion and encouraged the department to work with Vince Smith, an economist with the MSU Department of Agricultural Economics and Economics, to understand what is being substituted for direct payments in the farm bill.

d. Crop Share Arrangements

DOR recommends no change to the current crop share and livestock share arrangements used in the valuation formula for the 2015 cycle. No comment. No objection.

e. Commodity Base Period

The department recommends using a 10-year Olympic Average instead of the current 7-year Olympic Average for calculating the price of commodities used in the valuation formula for the 2015 cycle.

Gerald Neilson made a motion to accept the department's recommendation to use a 10-year Olympic Average.

Motion: Gerald Neilson.

Second: James Johnson.

There was discussion from Senator Jergeson in which he stated that he cannot vote but supports this recommendation.

The motion passes. Helena (Jo) Shipman voted no.

f. Capitalization Rate

The department recommended calculating a cap rate by adding an effective interest rate to an effective tax rate. An effective interest rate is determined using an average of rates published by Farm Credit Services, and the effective tax rate is calculated by dividing the total taxes paid on agricultural land by the total productive value of agricultural land. Director Kadas interjected that the Department's proposal could be complicated to administer, and that inflation should also be included. After discussion, Director Kadas decided to withdraw the previous recommendation and ask that the committee recommend a number instead.

Senator Tutvedt asked where the other cap rate comes from for commercial property. Cynthia Monteau Moore stated that we gather income and expense data from commercial property types (and sales) to develop a cap rate. Director Kadas further explained how commercial information is gathered and how we use best accounting practices to set the cap rate. Representative Miller does not feel we are qualified to do that. Director Kadas stated that there have been no recent appeals regarding our cap rate. Senator Tutvedt believes that there needs to be some science behind how the cap rate is determined, in order to be a real cap rate. Chairman Jopek reviewed that the rate is at 6.4% and that people are comfortable at 6.4%.

Gerry Neilson made a motion to encourage the department to work towards a more scientific rate.

Motion: Gerry Neilson.

Second: James Johnson.

Bob Story adds comment and reads the statute regarding the cap rate as allowing the committee to recommend a cap rate, but that the department has to adopt the rate by rule. Chairman Jopek stated the statute defaults to 6.4% unless the committee recommends a different cap rate. There was no further discussion.

Director Kadas also recommends using a 6.4% cap rate for the valuation of agricultural land in the 2015 cycle.

Motion Carries Unanimously.

g. Other Recommendations

Chairman Jopek brought up revenue neutrality by class. Director Kadas explained that it is actually taxable value neutral. Chairman Jopek asked that the legislature do not use the growth in agriculture to give another class a tax break.

Bob Story mentioned the $1500 income requirement for agricultural eligibility and also brought up cherry orchards. He suggested that there be an interim committee convened to study this issue. Director Kadas agreed. There are some significant equity issues at this time. Frank indicated that this issue significantly impacts our appraisers in the field, especially in the more urbanized counties. Frank explained that $1500 is relatively easy to achieve, especially with today's agricultural prices. With the higher market values of land in some counties, and the huge reduction if you can get the land classified as agricultural, more and more people are applying for ag on marginal agricultural property, creating more work for already stretched staff. Chairman Jopek indicated that this is also an issue with timber classification, since timber has the most desirable tax rate. Representative McNally asked how wide spread this issue was. Frank stated that it is difficult to quantify as we don't systematically track what was used to qualify a property, only that a property was qualified. Gerry Neilson asked how this problem could be alleviated. Frank suggested one possible solution could be increasing the $1500 income threshold.

Representative Hollandsworth commented on the cap rate and that we have been through years of low inflation rates. He asked for examples of what happens to the cap rate if the higher interest rates from the 80's were used. Director Kadas indicated that the Department needs to study this issue and prepare this information for future discussions.

V. Adjourn

James Johnson made a motion to adjourn at 1:53 pm.

Motion: James Johnson.

Second: Gerald Nielson.

The Motion Carries Unanimously.

Director Kadas thanked the committee members for their hard work on the committee.

Chairman Jopek thanked the committee, the public in attendance, and the director.