Ohio Legislative Service Commission

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Fiscal Note & Local Impact Statement

Bill: S.B. 246 of the 131st G.A. **Date**: December 28, 2015

Status: As Introduced **Sponsor**: Sen. Hite

Local Impact Statement Procedure Required: Yes

Contents: Changes property tax law governing current agricultural use valuation

State Fiscal Highlights

STATE FUND	FY 2016	FY 2017	FUTURE YEARS
General Revenue Fund			
Revenues	- 0 -	- 0 -	- 0 -
Expenditures	Possible increase up to about $2 million	Possible increase up to about $2 million	Possible increase up to about $2 million/year

Note: The state fiscal year is July 1 through June 30. For example, FY 2016 is July 1, 2015 – June 30, 2016.

- Reductions in taxes on agricultural land, resulting from changes in the current agricultural use valuation (CAUV) program, would be partly offset by higher taxes on residential property, possibly resulting in net increases in state reimbursements for the rollbacks and homestead exemption on real property.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 2016	FY 2017	FUTURE YEARS
School Districts			
Revenues	Possible losses up to $15 million or more	Possible losses up to $15 million or more	Possible losses up to $15 million or more/year
Expenditures	- 0 -	- 0 -	- 0 -
Other Local Governments			
Revenues	Possible losses up to $17 million or more	Possible losses up to $17 million or more	Possible losses up to $17 million or more/year
Expenditures	- 0 -	- 0 -	- 0 -

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- Lower tax values on land enrolled in CAUV would result in revenue losses for schools and other units of local government.
- Lower values due to changes in the capitalization formula would cause net losses estimated at up to $14 million for schools and up to $16 million for other units of local government.

- Lower values due to reductions for land used for a conservation practice or in a conservation program would cause net losses estimated at $1 million or more for schools and $1 million or more for other local governments.
- For property taxes subject to tax reduction factors, the revenue losses would generally be offset by higher effective tax rates, reducing tax savings for farmers and imposing higher taxes on residential property owners.
- For property taxes intended to raise fixed sums of money, revenue losses would be offset by higher tax rates on farmers and homeowners, and also on Class II and public utility property subject to those levies.
- Revenue estimates shown in the table above are subject to considerable uncertainty.

Detailed Fiscal Analysis

The bill requires that CAUV calculations exclude appreciation and equity buildup in figuring the capitalization rate used, and specifies that land "used for a conservation practice or devoted to a land retirement or conservation program under an agreement with an agency of the federal government" be valued at the lowest per-acre amount in the list of values for various soil types published annually by the Department of Taxation.

Summary of findings

The language in the bill regarding the capitalization rate appears sufficiently flexible that its effects would depend on how it is implemented in the CAUV formula. Table 1 below presents two possible approaches to implementing the language in the bill. In the first approach, the appreciation and equity buildup terms in the current formula are zeroed out. The alternate case shown in the table builds on the first case, but changes the term in the formula representing the payment amount on debt so that it is consistent with zero equity buildup.

The two approaches are evaluated using the Department of Taxation's 2015 capitalization rate calculation as the starting point, applied to 2014 data on taxable values (latest available). The numbers are necessarily rough, based in part on statewide averages rather than detailed analysis built up from the individual levy or taxing unit level. For the first approach, the net revenue loss to school districts and other units of local government is $30 million and the increase in taxes owed by residential property owners is $71 million. With the alternate case, the net revenue loss to schools and other local governments is $15 million and the increase in taxes owed by residential property owners is $34 million.

A requirement in the bill that land used for a conservation practice or enrolled in a federal conservation program, as well as the CAUV program, be assigned a low per-acre value may have a large or small effect, depending on current per-acre

valuation of such land and on the number of such acres. This provision may cost schools and other units of local government statewide a total of $2 million per year, or possibly more, but the estimate is very rough.

Capitalization rate

The capitalization rate is used to calculate value per acre for more than 3,500 soil characteristics, for both cropland and woodland, a total of more than 7,000 values. The calculation involves dividing representative net dollar yields per acre per year by the capitalization rate. Resulting per-acre values are multiplied by acreage in parcels enrolled in the CAUV program, in figuring valuation. Taxable value is 35% of this CAUV valuation. The per-acre values are subject to minimums, consequently, changes in the capitalization rate do not, for all soil types, change those values. So the percentage valuation change due to a capitalization rate change would be less than or equal to that indicated by considering only the change in the capitalization rate.

How much less is indicated, at least roughly, by the following figures on the 2014 CAUV program. The statewide average per-acre value of land in the program was $1,862 (or taxable value of $652 at the 35% assessment rate), and about 70% of soil types were valued above minimums of $230 per acre for woodland and $350 per acre for cropland. Percent of soil types is not the same as percent of land enrolled in the program, but plausibly a substantial portion of the potential reduction would be realized.

The Department of Taxation figures the capitalization rate using an approach called the Akerson formula. If the term in the Akerson formula for appreciation in the value of the farmland is assumed to be zero, rather than 5% over five years as in the Department's calculations, and the buildup of equity term in the formula is set at zero, capitalization rates for 2009 through 2015 are increased by 2.4 to 3.5 percentage points. Corresponding reductions in land valuations range from 27% to 36% for recent years, as shown in column three of Table 1. As noted above, actual reductions would likely be less because valuations for some soil types would remain unchanged at the minimum values.

An alternative interpretation of the wording in the bill is that, in not including assumed buildup of equity, in keeping with "standard and modern appraisal techniques" as required by the bill, the loan assumed in the valuation model might be presumed to be an interest only loan. The buildup of equity term in the current CAUV formula represents the effect on the capitalization rate of reduction in the amount of the loan that remains due after five years, as a result of payments larger than interest due with the excess applied to principal. No equity buildup would be consistent with payments equal to the amount of interest due. The current capitalization rate formula is based on an assumption that the farmland investor buys the land by investing borrowed funds as well as equity money, realizes net revenues (or incurs net costs) for five years, then sells the land and pays off the remaining loan. Owing less at the end of the five years leaves more equity money for the farmland investor, hence makes the

land more valuable. Subtracting the equity buildup term reduces the capitalization rate, which implies a higher valuation.

An interest only loan would likely carry a higher interest rate than a loan fully amortized (paid down) over the course of its life, but the figures shown in column four of Table 1 are based instead on an assumption that the interest rate on the debt remains the same as that used in the calculation for each of the past seven years. The property value appreciation and equity buildup terms are again set to zero. The effect on the capitalization rates for 2009 through 2015 would be an increase of 0.8 to 0.9 percentage point. The corresponding effect on land values in the CAUV program would be reductions of up to 9% to 13%, depending on the year. Actual reductions would likely be less, as noted above.

Table 1. Effect of Formula Changes on Current Agricultural Use Valuations Up to Percentages Shown – Values Are Affected by Other Factors

Year	Actual	No Appreciation and No Equity Buildup Term	No Appreciation, No Equity Buildup Term, Interest Only Payments
	Capitalization Rates		
2009	7.9%	11.1%	8.7%
2010	7.8%	11.0%	8.6%
2011	7.6%	10.8%	8.4%
2012	7.5%	10.8%	8.3%
2013	6.7%	10.2%	7.6%
2014	6.2%	9.7%	7.1%
2015	6.6%	9.0%	7.6%
	Change in Value vs. Actual, Up to Percentages Shown		
2009	NA	-29%	-9%
2010	NA	-29%	-9%
2011	NA	-30%	-10%
2012	NA	-31%	-10%
2013	NA	-34%	-12%
2014	NA	-36%	-13%
2015	NA	-27%	-13%

Effects of capitalization rate changes on school districts and residential property owners

Land valued using the CAUV method in 2014, the latest year published, had taxable value of $10.5 billion. Reductions in land values of 27% and 13%, the percentages shown in Table 1 for 2015, would reduce taxable values by $2.8 billion and $1.4 billion respectively.[1] These amounts are sizable relative to changes in recent years in taxable values of Class I property (which includes agricultural and residential real

[1] All numbers that follow are rounded to no greater precision than the nearest million dollars, reflecting the considerable uncertainties in deriving these numbers.

property). In the past eight years, for example, annual changes in Class I taxable value have averaged $3.2 billion without regard for whether the changes were increases or decreases.

For levies subject to tax reduction factors, on carryover property, the decline in agricultural land values from CAUV formula changes would be offset by higher effective tax rates, but these would be set to raise the same amount of tax revenue from these levies including both residential and agricultural carryover real property in each taxing district, hence farmers generally would gain and residential property owners would lose.[2] The relative impact would vary enormously depending on the mix of agricultural and residential real property in each taxing district. Class I real property in taxing districts around the state ranges from 100% residential to 100% agricultural. Statewide, about 90% of Class I real property taxable value is residential and 10% is agricultural, implying that on average most of the gains to farmers from the lower taxable property values would not be offset by higher effective tax rates, and most of the higher taxes from the effective tax rate increases would be paid by persons not participating in the CAUV program, mostly residential property owners.

Rates on levies designed to raise fixed amounts of money (fixed-sum levies) would need to be adjusted, with CAUV program participants generally gaining from their lower taxable values and other taxpayers losing from the higher rates needed to keep total revenues unchanged.

For levies not subject to tax reduction factors and not fixed-sum levies, CAUV program participants would gain from their lower taxable values. Residential property owners and owners of agricultural real property not in the CAUV program would be unaffected by the CAUV changes, for these levies.

The valuation reductions of 27% and 13% assumed above, and resulting taxable values reductions of $2.8 billion and $1.4 billion, would at the statewide average effective tax rate on agricultural land in 2014 of 49.58 mills[3] imply potential revenue reductions of $141 million and $68 million, respectively. These revenue reductions are before account is taken of increases in effective tax rates for levies on carryover property and subject to tax reduction factors, or of rate increases for fixed-sum levies.

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[2] Carryover property is real property taxed in the same class of property in both the current and preceding years. Some levies are not subject to this adjustment, including unvoted taxes within 1% (10 mills) of taxable value (inside millage), and levies to raise fixed sums of money (bond and emergency levies). Also, tax reduction factors cannot cause a school district's effective current expense millage rate (including inside and outside millage) to fall below 20 mills, or a joint vocational school district's effective current expense millage rate to fall below 2 mills. The 20-mill floor, or the 2-mill floor for JVSDs, does not limit upward adjustments of effective rates if real property valuations fall. The statement that the same amount of revenue would be raised is subject to a limitation however. The effective rate on a levy cannot adjust upward to more than the voted millage rate. Consequently, less tax revenue will be raised from any levies constrained by this ceiling.

[3] The average effective tax rate on agricultural land in 2014 shown here is that reported by the Department of Taxation in its explanation of CAUV calculations on May 28, 2015.

These changes are analyzed in what follows using average 2014 tax rates, partly estimated, applied to tax year 2014 property taxable values. Results are summarized in Table 2. The effects are estimated at the individual school district level but the analysis does not drill down to the political subdivision or taxing district level for other units of local government, or to the individual levy level, so is at best only an approximation to outcomes that might be expected from the assumed valuation changes. The school district estimates are based on an assumption that reductions in the value of agricultural land resulting from the CAUV changes are uniform across the state, which is unlikely to be the actual outcome if the bill draft becomes law.

A $141 million reduction in taxes on agricultural land, from a $2.8 billion decline in taxable value, would give rise to increases in taxes from levies subject to tax reduction factors estimated at $93 million and to increased revenues from fixed-sum levies on Class I real property of $15 million. An additional estimated $4 million for fixed-sum levies would be owed by owners of Class II real property and public utility tangible personal property, mostly to schools. The net tax revenue loss to school districts statewide would be an estimated $14 million, consisting of $17 million on Class I real property partly offset by added fixed-sum taxes on Class II real property and public utility tangible personal property. Also, most districts would receive additional foundation aid as a result of the taxable value decrease. The increase in taxes due on residential real property would be an estimated $85 million, of which property owners would pay about $71 million with higher state reimbursements for the 10% and 2.5% rollbacks and homestead exemption accounting for the rest. The net impact on the state would be an estimated net increase of $2 million in reimbursements for the rollbacks and homestead exemption, consisting of a $12 million reduction on agricultural real property and a $14 million increase on residential real property, and higher foundation aid payments. These fiscal effects are summarized in Table 2 below.

Estimates for the analogous fiscal effects if the reduction in taxes on agricultural land is assumed to be $68 million, from a $1.4 billion decline in taxable value, are shown in Table 2 alongside those for the first set of estimates described above. Future valuation changes would, in general, differ from those shown here, and would reflect prices, costs, crop yields, and interest rates in future years, as part of the ongoing CAUV calculation process.

Table 2. Estimated Effects on Tax Revenues and Payments of S.B. 246		
	27% or $2.8 Billion Reduction in Taxable Value	13% or $1.4 Billion Reduction in Taxable Value
	Millions of Dollars	
Decrease in property taxes paid		
Gross, CAUV program participants (before tax reduction factors & fixed-sum levy adjustment)	$141	$68
Net, agricultural real property (after tax reduction factors & fixed-sum levy adjustment)	$119	$57
Net, agricultural real property, after 10% rollback	$107	$51
Increase in property taxes paid		
Residential owners (before rollbacks & homestead exemption)	$85	$40
Residential owners (after rollbacks & homestead exemption)	$71	$34
Class II and public utility	$4	$2
Decrease in property tax receipts		
Schools	$14	$7
Other local governments	$16	$8
Increase in GRF payments	**$2**	**$1**

Effects of provision affecting taxation of land in federal conservation programs

The bill provides that "land . . . used for a conservation practice or devoted to a land retirement or conservation program under an agreement with an agency of the federal government" is to be assigned the lowest of the per-acre values determined as part of the CAUV program.[4] In order to quantify the effect of this provision, LSC would need to know or estimate the values or average value assigned to such land currently, as well as the acreage enrolled in these programs. For land qualifying to be valued at the lowest per-acre value, but already at low per-acre values under the CAUV program, this provision would have little effect. Taxable value and taxes on qualifying land currently at high per-acre values would decline substantially. The statewide effect would depend on the mix of enrolled acreage currently assigned low and high values.

The wording of the requirement in the bill is a further source of uncertainty. Is all land enrolled in the CAUV program and "used for a conservation practice" to be assigned the lowest per-acre value? Or must this land also be "under an agreement with an agency of the federal government" for the requirement to apply? In other words, does the phrase "under an agreement with an agency of the federal government" apply both to "used for a conservation practice" and "devoted to a land retirement or conservation program" or only to the second of these uses? Limiting the requirement to

[4] R.C. 5713.31 as proposed to be amended by the bill.

land under an agreement with a federal agency would be less costly than applying it to all land used for a conservation practice.

A contact with the U.S. Department of Agriculture noted a couple of federal programs within that Department's Natural Resources Conservation Service (NRCS) that appear to meet the definition in the bill. The programs take land out of production or create easements that limit development.

The Conservation Reserve Program (CRP) lets land be taken out of production and planted in grass or trees. The owner of the land receives an annual payment based on the soil type. CRP contracts can be for as long as 15 years. A landowner may withdraw from a CRP contract on payment of a penalty. Choices for enrollment include whole field sign-up and enrollment of waterways and buffer strips.

Other NRCS programs are under the Agricultural Conservation Easement Program (ACEP). These include the Wetland Reserve Easement program under which the United States holds either a permanent or a 30-year easement on lands restored to wetlands. Also part of ACEP is the Agricultural Land Easement program, which provides for private trusts to hold permanent easements on working lands. The NRCS can fund as much as 50% of the easement's purchase cost.

Additional NRCS programs were repealed by the Agricultural Act of 2014, with the land previously in these programs now considered enrolled or held under ACEP. These include the Wetland Reserve Program, under which the United States held a permanent or 30-year easement on land restored to wetlands; the Farm and Ranch Land Protection Program, with private land trusts holding permanent easements on working lands; and the Grassland Reserve Program, with grasslands held under easement to be used as grazing land.

Data downloaded from the Department of Agriculture's website indicate that 278,409 acres of land in Ohio were enrolled in CRP as of the end of September 2014. This acreage is 1.7% of the approximately 16.1 million acres that were in the CAUV program in calendar year 2014. Enrolled acreage varies from year to year. Some of the Ohio acreage in CRP may not have been enrolled in the CAUV program.

Data on easements from the National Conservation Easement Database, accessed on December 15, 2015, show 28,880 acres held in easements in Ohio with the federal government listed as the holder.[5] The National Conservation Easement Database is a partnership of federal agencies and private conservation organizations and foundations, formed for sharing and managing information about conservation easements. LSC is unable to vouch for the completeness or accuracy of the information. Of the Ohio acreage held in conservation easements by the federal government, most (95%) is listed as held by NRCS. Other federal holders include the National Park Service and the Fish and Wildlife Service. The total Ohio acreage held in conservation

[5] The Internet address from which this information was obtained is http://conservationeasement.us/reports/easements.

easements for which the federal government is the holder is 0.2% of total CAUV acres in 2014.

These figures indicate approximately 307,000 acres that appear to qualify to be valued at the lowest CAUV per-acre valuation. Other acreage may also qualify, under other federal programs or because it is used for a conservation practice. If, at the extreme, all of the 307,000 acres were valued at the highest 2015 value, $4,770 per acre for cropland, and would instead be valued at the lowest 2015 value, $230 per acre for woodland, the reduction in taxes would total about $24 million at the 2014 statewide average effective tax rate on agricultural property of 49.58 mills. Alternatively, if the acreage was valued at the statewide average value for land in the CAUV program in 2014, $1,862 per acre, and would instead be valued at $230 per acre, the reduction in taxes would be about $9 million. Additional qualifying acreage would imply additional tax revenue losses.

As with valuation reductions resulting from changes in the CAUV capitalization formula, the loss of tax revenue to school districts and other units of local government from lower valuations for land in qualifying conservation practices would be partly offset by increased taxes on residential property owners and others, and likely also by a small increase in state payments from the GRF for rollbacks and the homestead exemption. On the assumption that the reduction in valuation for these acres is, on average, from the statewide average valuation for CAUV land, the net loss of tax revenue for schools statewide might be about $1 million, and the loss for other units of local government might be similar, but these figures are very rough, given the uncertainties.

Timing

The bill specifies that these changes apply to all counties beginning in tax year 2015. Historically, valuation changes resulting from updated CAUV calculations have been implemented over a period of three years, as property in the various counties is revalued under the state's system of reappraisals and updates. The bill states that amendment of the Revised Code sections dealing with CAUV apply beginning with tax year 2015 "in all counties." If this wording is understood to mean that valuations are to be adjusted annually, this change may impose significant additional costs on county auditors.

Property tax payments for tax year 2015 will be due in the first half of calendar year 2016.[6] The full impact of the changes may occur over three years or in the first year, depending on the interpretation of the wording noted above.

Additional considerations

A further observation on the capitalization rate is suggested by the wording of the bill. It says that the capitalization rate should "represent as nearly as possible the

[6] Due dates may be extended, on a county-by-county basis.

rate of return a prudent investor would expect from an average or typical farm in this state considering only agricultural factors." The capitalization rate in the Akerson formula is in fact a divisor such that a fixed stream of net returns is converted to a corresponding valuation that is consistent with assumed rates of return to providers of equity and debt capital, taking account of property taxes. It is an after-tax rate of return to the assumed combination of equity and debt capital. The rate of return a prudent investor would expect is the equity rate in the capitalization rate formula, which is intended to reflect the investor's required rate of return on equity money.

This anticipated rate of return needs to be high enough to induce the investor to make the investment. The equity rate should generally be higher than the debt rate, which is the rate that the investor has to pay on borrowings used to finance the investment. This is so because if a project or investment turns out badly, the lender will usually be paid if enough money remains even if the investor realizes no return from the investment. The investor is at higher risk so would generally expect a higher return to compensate for this higher risk.

In the CAUV formula used by the Department, the equity rate is set based on the prime lending rate plus two percentage points. In 2013, 2014, and 2015, the resulting equity rate has fallen increasingly below the debt rate. Such a relationship appears inconsistent with the theoretical underpinnings of the Akerson formula. In order to match the rate of return a prudent investor would expect, the equity rate in the formula used by the Department may need to be higher than the prime lending rate plus two percentage points.

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