AGRICULTURAL LEASE DEDUCTION

EVALUATION SUMMARY

SEPTEMBER 2018
2018-TE1

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

YEAR ENACTED	2016
REPEAL/EXPIRATION DATE	December 31, 2019
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, although it has only been available for 1 year.

WHAT DOES THIS TAX EXPENDITURE DO?

The Agricultural Lease Deduction allows taxpayers who lease their land or other agricultural assets to beginning farmers or ranchers to receive an income tax deduction equal to 20 percent of the resulting lease payments, up to a maximum of $25,000 per year, for a maximum of 3 years.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The deduction is intended to provide an incentive for aging agricultural producers to lease their land and equipment to beginning farmers or ranchers to help them become established in the agricultural industry.

WHAT DID THE EVALUATION FIND?

The deduction is not yet meeting its purpose since no one applied to receive the deduction for 2017, the first year it was available.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider reviewing the administrative requirements for qualifying for the deduction and the amount of benefit it provides to taxpayers if it wants to encourage the deduction's use.

AGRICULTURAL LEASE DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Agricultural Lease Deduction was created in 2016. It allows taxpayers who lease their in-state land or other agricultural assets (e.g., crops, livestock, farm equipment, etc.) to beginning agricultural producers for a period of 3 years or longer to deduct 20 percent of the resulting lease payments from their taxable income for state income taxes, up to a maximum deduction of $25,000 per year for 3 years.

According to Sections 39-22-104(4)(v) and 39-22-304(3)(o), C.R.S., to be eligible for the deduction, the leaseholder (i.e., the individual who the taxpayer leases the asset to) must:

- Be a full-time farmer or rancher.
- Have 10 years or less of agricultural experience.
- Have a net worth of less than $2 million.
- Provide the majority of the "daily physical labor and management" on the asset, or use the asset the majority of the time.

The deduction is administered by the Colorado Agricultural Development Authority (Authority), a statutory organization created to encourage investment in the agricultural industry, primarily through issuing tax-exempt bonds to lenders to make low interest loans available to first-time agricultural producers. Both the owner of the agricultural asset claiming the deduction and the leaseholder must apply to the Authority by March 31st of the year after the lease begins (e.g., March 31, 2018, for leases that began during Calendar Year 2017). In the application, the asset owner must attach a copy of the lease that states the payment terms and a legal description of all rented assets, as well as a $50 application fee; the leaseholder must submit his/her federal Schedule F form, which denotes profit or loss from farming operations [Section 35-75-107(1)(u), C.R.S.]. In addition to these requirements, the leaseholder must have participated in a financial management education program approved by the Authority. The Authority is then responsible for issuing certificates to successful applicants who own the leased assets, which the applicants must then submit to the Department of Revenue when filing their income taxes. The Authority is also required to notify the Department of Revenue of all deductions awarded. A maximum of 100 asset owners can claim the Agricultural Lease Deduction each year [Section 35-75-107(1)(u), C.R.S.] and unused portions of the deduction cannot be carried forward to future tax years. The deduction expires at the end of Calendar Year 2019.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute mentions two key beneficiaries of the Agricultural Lease Deduction: (1) aging farmers and ranchers who own agricultural assets [Section 39-22-104(4)(v)(I)(D), C.R.S.], and (2) beginning farmers and ranchers [Section 39-22-304(3)(o)(I)(D), C.R.S.]. The Colorado agricultural industry has struggled to sustain the involvement of beginning farmers and ranchers in recent years. Specifically, according to the U.S. Agricultural Census, the number of farmers and ranchers with less than 10 years of experience has decreased from 29 percent of principal operators in 2007 to 24 percent in 2012. At the same time, according to the U.S. Agricultural Census, the average age of Colorado farmers and ranchers has risen from 50 years old in 1982 to 59 years old in 2012. This suggests that farmers and ranchers are working longer than in the past and that there may not be as many new farmers and ranchers ready to continue their operations as they retire.

For new farmers and ranchers, acquiring adequate land and equipment is often a key barrier to entering the industry. For example, in Colorado, the

National Agricultural Statistics Service estimates that between 1998 and 2017, the average cash rent for cropland increased from $56.30 to $73.50 per acre (an increase of 31 percent), and from $5 to $5.60 per acre for pastureland (an increase of 12 percent). Likewise, leases of agricultural equipment and machinery, which are typically the second-most costly agricultural lease expense behind land, are also becoming more expensive for new farmers and ranchers. For example, in 2008, the average farm/ranch paid $14,200 annually for leases of agricultural equipment and machinery, compared to $19,000 in 2012, a 34 percent increase. Additionally, U.S. Department of Agriculture Economic Research Service data indicates that beginning and younger farmers and ranchers often rely much more heavily on second, non-farm jobs to supplement their income than older and more experienced farmers and ranchers.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute states that the Agricultural Lease Deduction "is intended to be an incentive for aging farmers or ranchers to lease their agricultural assets to beginning farmers or ranchers in order to give the beginners a chance to get started in the industry" [Sections 39-22-104(4)(v)(I)(D) and 39-22-304(3)(o)(I)(D), C.R.S.]. Moreover, legislative committee testimony and interviews with the Executive Director of the Authority indicated that the bill sponsors primarily focused on incentivizing leases of agricultural land, which is the most expensive asset new farmers and ranchers must acquire.

IS THE TAX EXPENDITURE MEETING ITS PURPOSE, AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the Agricultural Lease Deduction is not yet meeting its purpose because no taxpayers have applied for it. However, the deduction has only been available for 1 year, so it may be too early to fully assess its effectiveness and impact. Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the exemption is meeting its purpose:

PERFORMANCE MEASURE: *To what extent does the Agricultural Lease Deduction increase the amount of assets leased by agricultural producers nearing retirement to those beginning to farm or ranch?*

RESULT: As of March 31, 2018, the Agricultural Lease Deduction has not resulted in an increase in the amount of agricultural assets leased to new farmers and ranchers because no taxpayers have applied for the deduction. Specifically, although the Authority reported that it made efforts to communicate the deduction through radio and newspaper advertisements, and stakeholder outreach, no taxpayers applied for the deduction for Calendar Year 2017, the first year it was available.

Although interest in the Agricultural Lease Deduction could increase over time, it appears that the deduction may only act as a modest incentive for aging farmers and ranchers to lease assets to new farmers and ranchers. Specifically, in the case of a taxpayer who is eligible to claim the $25,000 maximum amount of the deduction, which requires an annual lease amount of $125,000 or more, their state tax liability would be reduced by about $1,160 ($25,000 multiplied by the 4.63 percent state income tax rate). While this reduction could act as a small incentive for some farmers and ranchers to lease their land, because this amount is only about 0.9 percent of the total lease value, other factors, such as the market price of their land and the potential lease income it can generate, are more likely to influence an aging farmer's or rancher's decision to lease land to a new farmer or rancher. In addition, stakeholders we interviewed indicated that although the deduction could be beneficial, many aging farmers and ranchers are already interested in seeing their operations continue after they retire and would seek out new farmers and ranchers to lease to, regardless of the deduction. Some of the stakeholders we contacted also indicated that many farmers and ranchers are not aware of the deduction, which has likely also contributed to the lack of applications for the deduction during its first year. This corresponded with a survey we conducted of agricultural producers, in which 7 of the 26 respondents (27 percent) were familiar with the deduction.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

Since no taxpayers have applied for and received the Agricultural Lease Deduction, there is no revenue impact to the State and no economic costs or benefits. However, the deduction has only been available to taxpayers for 1 year. Thus, its economic impact could grow over time as more taxpayers become aware of it. If the deduction were utilized to its fullest extent, with 100 taxpayers claiming the maximum possible benefit ($1,160 per year), the revenue impact to the State would be $116,000 annually.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Agricultural Lease Deduction would have a relatively small impact on the intended beneficiaries, even if it is used to the maximum amount allowed. Although there is no actual impact to beneficiaries because the deduction has not yet been used, if taxpayers do plan to use it in the future, the maximum impact would be $1,160 per year, per taxpayer on a $125,000 per year lease for 100 taxpayers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Four other states have or have had tax expenditures similar to the Agricultural Lease Deduction—Nebraska, Iowa, Wisconsin, and Minnesota. Wisconsin's credit was phased out in 2013. EXHIBIT 1.1 compares the provisions of the expenditures in each state with Colorado's deduction.

EXHIBIT 1.1. DIFFERENCES BETWEEN STATES' BEGINNING FARMERS/RANCHERS AGRICULTURAL LEASE TAX EXPENDITURES

State	Type	Percent of Lease Amount	Lease Length	Max Net Worth of Beginning Farmer	Annual Max per Taxpayer	Annual State Cap on Expenditure	Business Course Required to be Eligible	Carry Forward Allowed
Colorado	Deduction	20%	3 years or longer	<$2 million	$1,160	$116,000	Yes	No
Nebraska	Credit	10% for cash rentals, 15% for crop share rentals	Exactly 3 years	<$200,000	None	None	Yes	No, but refundable
Iowa[1]	Credit	5% for cash rentals, 15% for crop share rentals	2-5 years	<$645,284	$50,000	$6 million	No	10 years
Wisconsin	Credit	15% of machinery, facility, and livestock leases	3 years or longer	<$200,000	None	None	No	No, but refundable
Minnesota	Credit	10% for cash rentals, 15% for crop share rentals	Not specified	None	$7,000 for cash rentals, $10,000 for crop share rentals	$5 million ($6 million in 2019-2023)	Yes	15 years

SOURCE: Office of the State Auditor analysis of similar tax expenditures in other states.
[1]Between 2013 and 2017, taxpayers could claim a credit equal to 7 percent of the lease amount for cash rent leases and 17 percent for crop share leases (for veterans, 8 percent and 18 percent, respectively), with an annual statewide cap of $8 million.

In addition to its agricultural lease program, Nebraska also offers beginning farmers and ranchers an exemption from the State's business personal property tax.

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE?

There are numerous other tax expenditures and programs available in Colorado that help new farmers and ranchers to afford the assets required to enter the agricultural industry. Specifically, we identified the following:

- **FINANCIAL PRODUCTS AND SERVICES.** There are a number of state and federal agricultural loan programs geared towards beginning farmers and ranchers. For example, the Authority primarily works on issuing tax-exempt bonds to lenders that significantly reduce the interest rates on loans to beginning agricultural producers. In addition, the U.S. Farm Credit System is a network of borrower-owned financial institutions that provide credit to agricultural producers whose mission it is to support agriculture and rural communities. According to the Farm Credit Administration, the federal agency that regulates the farm credit sector, the U.S. Farm Credit System made 74,000 new loans totaling $12.4 billion to farmers and ranchers with 10 years or less of experience nationwide in 2017, representing 23 percent of all new loans it made that year, and 16 percent by value. Moreover, the U.S. Department of Agriculture's Farm Service Agency provides low-interest financing to agricultural producers who cannot qualify for conventional loans, with applications from beginning farmers and ranchers receiving a significant preference. It also has other relevant programs, such as the Beginning Farmer and Rancher Individual Development Accounts Pilot Program, which offers matching funds set aside through savings accounts for new farmers and ranchers of limited means. Another is the Down Payment Loan Program, under which the Farm Service Agency acts as a joint-financer and loan-guarantor for beginning agricultural producers purchasing a farm or ranch. On certain occasions, the Farm Service Agency can additionally guarantee private land sales between retiring and beginning farmers and ranchers.

- **"LAND LINK" SERVICES.** These organizations work to connect established agricultural producers who are looking to lease some of their land and/or eventually sell it to beginning farmers and ranchers. Many also offer training and mentorship for the new farmer/rancher. Some examples of such services in Colorado include Guidestone Land-Link, Healthy Community Food Systems' Land Link, and LandShare Colorado.

- **INTERNSHIPS.** Many established farms and ranches have internship opportunities that give aspiring farmers and ranchers technical experience, while providing needed labor for the agricultural landowner. Senate Bill 18-042 created a 6-year trial agricultural workforce development program that allows qualified agricultural businesses to be reimbursed up to 50 percent of the cost of hiring qualified interns.

- **STATE SALES TAX EXEMPTION FOR FARM EQUIPMENT PURCHASES AND LEASES [SECTION 39-26-716, C.R.S.].** This tax expenditure exempts all purchases and leases of farm equipment with a fair market value of $1,000 or more from state sales tax.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURE?

We did not encounter any data constraints that impacted our ability to evaluate the tax expenditure.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE APPLICATION OF THE STATUTORY REQUIREMENT THAT THE LEASEHOLDERS SUBMIT THEIR FEDERAL SCHEDULE F FORM IN ORDER TO QUALIFY FOR THE AGRICULTURAL LEASE DEDUCTION MAY MAKE IT DIFFICULT FOR MANY AGRICULTURAL PRODUCERS TO APPLY. Specifically, under Section 35-75-107(1)(u), C.R.S., leaseholders are required to submit a copy of their federal Schedule F form along with their application, although statute does not specify whether the form needs to be from the same tax year for which the deduction is claimed. For Calendar Year 2017, the Authority required leaseholders to provide the Schedule F form from their 2017 federal tax return (filed in 2018) with the asset owner's application, which was the same year that taxpayers would have been claiming the deduction. This means that leaseholders would have had to file their federal (but not state) income taxes before they or the asset owner could file their application with the Authority, which was due March 31st, to qualify for the deduction. This may have limited the ability of those agricultural producers who normally file for extensions on their federal taxes to qualify, since they would not have completed their Schedule F prior to the March 31st application deadline. The requirement that leaseholders submit their Schedule F form appears to be intended to allow the Authority to verify that the leaseholders are agricultural producers and are not using the leased asset for other purposes. However, the General Assembly may wish to clarify how the Authority should verify that leaseholders are farmers or ranchers to allow more flexibility for farmers and ranchers who are interested in applying for the deduction. For example, the General Assembly could require that the Authority allow leaseholders to submit Schedule F forms from the year prior to the establishment of the lease or allow for alternative forms of documentation to show that they intend to use the leased asset for agricultural purposes. This would allow asset owners and leaseholders to submit applications before the March 31st deadline.

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE TAX BENEFIT PROVIDED BY THE AGRICULTURAL LEASE DEDUCTION TO DETERMINE WHETHER IT PROVIDES A SUFFICIENT INCENTIVE TO ACCOMPLISH ITS PURPOSE. Specifically, in the four other states with similar tax expenditures, the expenditures were structured to provide a more significant benefit for taxpayers. For example, the four other states have offered similar provisions as tax credits, which provide a direct reduction in income tax liability, as opposed to deductions, which instead reduce taxable income. In addition, they have offered higher caps on the amount each taxpayer can claim, which can also make these provisions more attractive to taxpayers. All four other states have also allowed taxpayers to either carry-forward (i.e., apply the tax benefit to later tax years) or obtain monetary refunds for the expenditures, which provides taxpayers with more flexibility to maximize the benefit they receive.

In at least three of the four states where these provisions are included, it appears that more taxpayers have taken advantage of these expenditures, which has also substantially increased the state revenue impact of the tax expenditures as compared to Colorado. For example, Iowa offers a similar tax expenditure structured as a tax credit that allows each taxpayer to claim up to $50,000 per year, provides for a 10-year carry-forward period, and until this year was capped at $12 million per year in total credits provided by the state. This provision has been widely used in Iowa and may have had some success in keeping program participants in farming and ranching, although it has come at a cost to the state. Specifically, a 2015 study of Iowa's credit program conducted by its Department of Revenue, indicated that new farmers who participated in the program tended to have more of their income come from on-farm revenues (as opposed to work off the farm) and persisted in farming at higher ratios over a 5-year period (95 percent for participants versus 82 percent for non-participants), which indicates that they may have become more established in farming than farmers who did not participate in the program. The report also notes that Iowa issued about $33.5 million in credits and the program had assisted 963 new farmers from 2007 through 2014.