North Dakota Office of State Tax Commissioner

Property Tax Newsletter

News and developments

A publication of the Property Tax Division

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Tax Commissioner

January 2006

Exemption Considerations For Rented Farm Buildings

When a farmer or retired farmer rents a farm building to another farmer, the assessor must determine whether that building is exempt as a farm structure or subject to assessment as a commercial building. The Property Tax Division has taken the position that a farm building located on agricultural land, owned by Farmer No. 1, rented to Farmer No. 2, and used by Farmer No. 2 as part of his farm plant is eligible for exemption as a farm structure. There is no ownership requirement for exemption of a farm building, but the building must be used as part of a farmer's farm operation. Tax Department Legal Counsel believes the courts would be more likely to consider the building exempt as part of a farm plant, rather than assessable as commercial property.

Inside this issue:

If Farmer No. 1 rents a building to a person who uses it for something other than part of a farm plant, that building is subject to assessment as commercial property.

In a letter opinion dated May 16, 1980, to Ms. Cynthia A. Rothe, Cass County State's Attorney, the Attorney General said it was necessary to determine whether the use by the renter was controlling so as to exempt those structures or whether the use of them for rental income purposes by their farmer-owner was a use that made them taxable. The Attorney General went on to say the North Dakota Supreme Court had apparently never ruled on that question and decisions of other courts showed considerable conflict. The Attorney General noted there were other facts that both the claimant and the assessing officials would wish to establish (it was not clear whether the renter's occupation was farming or a commercial venture), and in those circumstances the assessing officials were obliged to treat the structures as taxable.

If the facts establish that the renter is a farmer and uses a building as part of the renter's farm plant, we believe it is consistent with that letter opinion to consider that building exempt as a farm structure.

A question came up recently about a farm worker, an employee of Farmer No. 2, who is renting a house from Farmer No. 1. To be consistent with the position outlined above, we believe that house is taxable if rented by Farmer No. 2's employee. The employee is a wage earner, not a farmer, and does not have a farm plant. But if Farmer No. 2 rents the house and uses it as part of his farm plant to house his farm worker, we believe the building is exempt.

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Assessment of Advertising Signs

North Dakota Century Code (N.D.C.C.) § 57-02-03 provides that all property in North Dakota is taxable unless specifically exempted by the North Dakota Constitution or statutes.

N.D.C.C. § 57-02-04(2) defines real property for taxation purposes to include structures and buildings and the rights and privileges belonging or pertaining to the structures and buildings. The statute specifically excludes items that pertain to the use of the structures such as "machinery or equipment used for trade or manufacture which are not constructed as an integral part of and are not essential for the support of such structure or buildings, and are removable without materially limiting or restricting the use of such structures or buildings."

On page R-2 of the Property Taxation Manual, the term 'structure' is defined as "anything constructed or erected from an assembly of materials, which requires a permanent location on or in the ground or is attached to something having permanent location on or in the ground." Structures that support advertising signs fit that definition and are therefore considered real property and should be assessed. The advertising signs themselves are considered personal property and exempt from taxation.

Owners of the land on which the structures are located are subject to the real property assessment of those structures. N.D.C.C. § 57-02-34 provides that, in the assessment list, the assessor must list the value of taxable structures in the appropriate column opposite the legal description of the property. Arrangement for payment of the applicable tax is a decision made between the property owner and the party who erected the sign.

"Property owners who are dissatisfied with the valuation placed on their property by the assessor should always contact the assessor first to discuss their concern and the assessor's explanation of value."

Property Owners May Appeal Directly to County Board of Equalization

The informal appeal process involves the local, county and state boards of equalization. Township boards of equalization meet to review assessments on the second Monday in April; city boards of equalization meet on the second Tuesday in April. Exceptions to those dates apply if the same person serves as assessor for more than one assessment district. The county board of equalization meets within the first ten days of June and the state board of equalization meets on the second Tuesday in August to review locally assessed property values.

Property owners who are dissatisfied with the valuation placed on their property by the assessor should always contact the assessor first to discuss their concern and the assessor's explanation of value. Assessment officials should make every effort to explain the assessment process and support the value estimate.

If the property owner is dissatisfied with the assessor's explanation, the next step is to go to the local board of equalization meeting. Property owners may bypass the local board of equalization meeting and go directly to the county board of equalization to appeal their assessments. However, property owners who bypass the local board of equalization and go directly to the county board of equalization have only one opportunity to obtain property tax relief through the informal appeal process. The reason for this is because the state board of equalization does not have any statutory authority to reduce an assessment if the property owner did not appeal to both the local and county boards of equalization.

Property owners who appeal directly to the county board of equalization must be given the opportunity to present information to support their appeal and receive consideration regarding the assessment.

Internal Equalization of Property Values Needed

Who ever said the assessor's job is easy? Assessors not only need to identify all real property subject to taxation but also need to determine the true and full value for all taxable property within the assessment jurisdiction.

For residential and commercial property, true and full value must represent current market value on February 1, the assessment date. For agricultural property, true and full value must represent agricultural value.

The State Board of Equalization has allowed a tolerance for residential and commercial property assessments for counties whose median ratios indicate the average true and full value falls between 95 and 105 percent of market value. For agricultural land, the average value per acre must represent between 95 and 105 percent of the average agricultural land value per acre certified by the Tax Commissioner to the county. The State Board of Equalization has ordered changes made to assessments found to be outside the allowable tolerance.

For the past several years, assessment officials have done an excellent job of getting the county-wide median level of assessments within the tolerance level allowed by the State Board of Equalization. While assessments, on average, are within the acceptable tolerance level, assessment officials need to examine what other sales ratio statistics indicate about assessments and make changes in assessments to improve equalization.

To begin with, assessment official must verify each sales transaction to determine the motives of the buyer and seller, whether the transaction is an arms-length transaction and that the sale price includes only the value of the real property. Assessment officials should also make a personal inspection of each sale property to verify that the property at the time of sale is the same as it was on the assessment date. The assessment/sales ratio is determined by dividing the assessment (true and full value) by the sales price of the property. After determining the assessment/sales ratio for each sales transaction, the assessment official arrays the ratios from high to low (or vice versa) and selects the middle ratio. That middle ratio is known as the median and represents the measure of central tendency for those sales transactions.

"Assessment officials should also make a personal inspection of each sale property to verify that the property at the time of sale is the same as it was on the assessment date."

The State Board of Equalization uses the median ratio to determine whether, over all, residential and commercial property assessments represent current market value. Assessment officials need to examine the sales transactions for which the assessment sales ratios are less than 50 percent and more than 200 percent. Those sales transactions should not automatically be discarded from the study but rather be examined to determine why the property sold for such a different price than what the assessment reflects. Perhaps the condition of the property has deteriorated considerably from the last inspection date or perhaps there's been remodeling done or an addition built on the improvement. Perhaps the sale really wasn't an arm's-length transaction.

For the 2006 assessment, the State Supervisor of Assessments recommends assessment officials look at other statistics besides the median ratio for residential and commercial property. They should look at the COD and PRD for those classes of property. They should also examine the statistics for lakeshore and vacant land. Assessments of lakeshore and vacant land have been brought to the attention of the State Board of Equalization and will be again if the assessments are not brought to within acceptable percentages of indicated market value.

The coefficient of dispersion (COD) is a statistic that indicates the relative dispersion of the sales ratios around the median ratio. The COD measures uniformity of assessments. According to the Standard on Ratio Studies, the acceptable COD for single-family residential property and condominiums is .15 or less. For vacant land and income-producing properties, the COD should be .20 or less. If the COD is outside the acceptable statistic, assessment officials need to examine the properties and assessments involved as well as similar type properties and make changes to correct assessments so that similar properties all reflect current market value.

The price-related differential (PRD) measures vertical equity or the progressivity or regressivity of assessments. When low-value properties are appraised at greater percentages of market value than high-value properties, assessment regressivity is indicated. When low-value properties are appraised at smaller percentages of market value than high-value properties, assessment progressivity is indicated. Real property assessments should be neither regressive nor progressive. When assessments are vertically equitable, the PRD will be close to 1.00. The Standard on Ratio Studies provides that the acceptable range for PRD is between 0.98 and 1.03. If the PRD is higher than 1.03, assessments are regressive (older and low-valued properties are over-valued compared to newer and high-valued properties). If the PRD is lower than 0.98, assessments are progressive (newer and high-valued properties are over-valued compared to older and low-valued properties).

"The price-related differential (PRD) measures vertical equity or the progressivity or regressivity of assessments."

Assessors need to carefully analyze sales information and use the statistics to make changes to assessments so that residential, commercial, vacant lots and lakeshore property represent current market value, and to ensure that similar properties are valued similarly.

The Sales Ratio Study will be discussed in more detail at the NDAAO Winter Workshop scheduled for February 23-24, 2006, at the Comfort Inn in Bismarck.

Calculation of Change to Agricultural Land Values for 2006

Each December, county directors of tax equalization receive a new certification of the average agricultural values for their counties for the upcoming assessment year. Tax directors need to determine the percentage of change necessary to bring the county average value into compliance.

Tax directors need two amounts: the county average value of all agricultural land certified by the North Dakota Tax commissioner for the 2006 assessment and the 2005 county average value of all agricultural land as finalized by the State Board of Equalization in August 2005. Do not use the 2005 certified average agricultural land value. Be sure to use the 2005 average agricultural land value for the entire county.

The calculation is as follows: subtract the 2005 county average value of all agricultural land in the county as finalized by the State Board of Equalization from the 2006 average value of all agricultural land in the county as certified by the Tax Commissioner. Divide the difference by the finalized 2005 average value. Convert that decimal amount to a percentage.

That amount reflects the percentage change needed to bring the 2005 finalized county average agricultural land value to the target value for 2006. Tax directors and the board of county commissioners need to determine if they want the 2006 average agricultural land value for the county to represent the target value or something less. While the State Board of Equalization has allowed a plus or minus five percent tolerance, the State Supervisor of Assessments recommends the counties determine the average value at 97 to 99 percent of the target value. Counties that calculate the average value at only 95 percent of the target value may find their 2006 assessments fall below 95 percent, due to rounding, and will need a significant adjustment in 2007 if another increase is required.

Farm Residence Exemption – Retired Farmer

N.D.C.C. § 57-02-08(15) provides for exemption of a residence occupied by a retired farmer. "'Farmer' includes a 'retired' farmer who is retired because of illness or age and <u>who at the time of retirement owned and occupied as a farmer the residence in which the person lives and for which the exemption is claimed."</u> [Emphasis supplied.]

The statute is clear that only a residence that was occupied by the farmer, as a farmer, at the time of retirement qualifies for exemption as a residence of a retired farmer. If a retired farmer constructs or moves into a new residence subsequent to retirement, that new residence does not qualify for exemption as a residence of a retired farmer. The exemption applies only to a residence in which the farmer lived while qualifying as an active farmer.

Determining Income Qualification for the Farm Residence Exemption

To qualify for a farm residence exemption, the residence must be situated on a parcel of agricultural land containing at least ten contiguous acres and must be occupied or used by a person who is a farmer. For purposes of the exemption, "farmer" means an individual who:

- Normally devotes the major portion of time to the activities of producing products of the soil, poultry, livestock, or dairy farming in such products' unmanufactured state;
- Has received annual net income from farming activities which is 50 percent or more of annual net income, including net income of a spouse if married, during any of the three preceding calendar years; and
- Did not have nonfarm income of more than $40,000, including that of a spouse if married, during each of the three preceding years. This provision does not apply to a retired farmer or a beginning farmer, defined below.

"Farmer" includes a "retired farmer" who is retired because of illness or age and who at the time of retirement owned and occupied as a farmer the residence in which the person lives and for which the exemption is claimed.

"Farmer" also includes a "beginning farmer" who:

- Has begun occupancy and operation of a farm within the three preceding calendar years;
- Normally devotes the major portion of time to producing products of the soil, poultry, livestock, or dairy farming in such products; unmanufactured state; and
- Does not have a history of farm income from farm operation for each of the three preceding calendar years.

Neither an active farmer, a retired farmer, nor a beginning farmer is required to own the farm residence to be eligible for exemption. The only ownership requirement is that a retired farmer must have owned the residence and occupied it as a farmer at the time of retirement.

The best way to determine an active farmer's income eligibility for the farm residence exemption is to examine the applicant's income tax return. Examination of complex returns is time consuming. The statute does not require an applicant to provide an income tax return for examination, and neither federal nor state personnel are permitted to divulge any information about anyone's return unless the taxpayer signs an authorization. Assessors can examine only returns provided voluntarily by the applicant.

"Neither an active farmer, a retired farmer, nor a beginning farmer is required to own the farm residence to be eligible for exemption."

"The residence of an employee who performs duties unrelated to farming is not eligible for exemption as a farm building."

It may be necessary to examine three years' income tax returns to determine whether an individual qualifies for the farm residence exemption. If the individual meets both income qualifications based on the most recent preceding year's return (farm income is 50 percent or more of annual net income and applicant has no more than $40,000 nonfarm income), it is not necessary to look at prior years. The applicant is eligible for exemption for three years. For example, an applicant who qualifies for exemption for 2006 based on the 2005 income tax return also qualifies for 2007 and 2008. For the 2009 assessment, tax year 2005 will no longer be one of the three preceding calendar years and qualification will be based on the 2008, 2007, or 2006 return.

Two income conditions must be met:

1. The applicant's farm income was at least 50 percent of total annual income in any one of the three preceding calendar years;
2. And the applicant's annual nonfarm income was not more than $40,000 in at least one of the three preceding calendar years.

The applicant may meet conditions 1 and 2 in different years, as long as both are met within the three preceding calendar years.

In 2004 Dickey County, in conjunction with the Property Tax Division, developed a worksheet for use in determining eligibility for the farm residence exemption. The worksheet is easy to use and, in the case of a single proprietorship, is usually adequate for establishing whether an individual meets the income requirements for the farm residence exemption. After examining several returns, the Property Tax Division felt it was necessary to draft a more detailed worksheet. It is important to make any applicable adjustments described under <u>Examination of Applicant's Income Tax Return</u> (below) when using the worksheet. The Property Tax Division will email you the new worksheet in Excel if you request it.

The worksheet does not indicate whether an individual spends the major portion of time "producing products of the soil, poultry, livestock, or dairy farming in such products' unmanufactured state." Whether an applicant meets the time requirement must be determined by the assessor or board of equalization.

<u>Corporations, Subchapter S Corporations, Partnerships, and Limited Liability Companies</u>

Today, with many farms being structured as corporations (C-corps), subchapter S corporations (S-corps), partnerships, or limited liability companies (LLC's), qualification for the farm residence exemption has become more difficult to determine. If the applicant for exemption receives wages for doing farm work for the C-corp, S-corp, partnership, or LLC, the applicant is a wage earner, not a farmer, and is not eligible for the farm residence exemption. However, the house in which the wage earner resides may be exempt as a farm building used to house a farmer's worker (the C-corp, S-corp, partnership, or LLC is the farmer). In that case, there is no income test. The building used to house a farm worker qualifies for exemption just like any other farm building.

It is important to verify that the wage earner actually performs farm work, because some companies that are engaged in farming also have other business interests. The residence of an employee who performs duties unrelated to farming is not eligible for exemption as a farm building.

A shareholder or partner in a farming operation who receives some type of distribution from the C-corp, S-corp, partnership, or LLC may qualify as a farmer. In the case of a C-corp, only the dividends or distributions paid to the shareholders, not total income of the C-corp, are counted as income of the shareholders. Dividends from a C-corp are reported on Form 1040 Schedule B and Line 9a of Form 1040. A shareholder may also receive wages (nonfarm income).

In the case of an S-corp or partnership, the total income of the company is counted as income of the shareholders or partners. For the farm residence exemption, it is necessary to determine how much of the S-corp or partnership income flowed through to the applicant (what the applicant's share was). The applicant may have received wages (nonfarm income) from the S-corp or partnership and also a portion of total S-Corp or partnership earnings. Income from S-corps and partnerships is reported on Part II of Form 1040 Schedule E. Net long-term capital gain or loss from S-corps, partnerships, estates, and trusts is reported on line 12 of Schedule D.

An LLC may choose to be taxed as a corporation or partnership. It is necessary to know which way the LLC is taxed in order to know how to calculate income allocable to the applicant.

Before examining the applicant's individual income tax return, it is necessary to examine the C-corp, S-corp, partnership, or LLC return to determine what percentage of that company's income was from farming activities. This is necessary because the company may have income from other activities. Adjustments similar to those described under Examination of Applicant's Income Tax Return (below) should be made to separate farm income from nonfarm income. Only the amount calculated by dividing the company's farm income by its total income and multiplying that percentage by the applicant's non-wage income from that company may be considered farm income of the applicant. The percentage should be applied to all amounts, other than wages, received by the applicant from the C-corp, S-corp, partnership, or LLC. That percentage represents farm income; the balance is nonfarm income.

Example 1: 75 percent of ABC Corporation's (a C-corp) income is from farming.
Applicant Jones received $50,000 dividends from ABC Corporation.
Applicant Jones' farm income from ABC is $37,500 (75% x $50,000).
$12,500 (25% x $50,000) is nonfarm income.

Example 2: RST Partnership had $36,000 farm income and $54,000 nonfarm income, all distributed equally among its three partners.
40 percent of the partnership income was farm income ($36,000 ÷ $90,000).
Partner Smith received $30,000 income from the partnership ($90,000 ÷ 3).
Partner Smith received $12,000 farm income ($30,000 x 40%) and $18,000 nonfarm income ($30,000 - $12,000).

All salaries and wages are considered nonfarm income, regardless of the kind of work the wage earner does.

"All salaries and wages are considered nonfarm income, regardless of the kind of work the wage earner does."

Examination of Applicant's Income Tax Return

Farm income is shown on Part I of Form 1040 Schedule F. Custom hire, entered on Line 9, is not considered farm income for purposes of the farm residence exemption. Sometimes a taxpayer enters other nonfarm income items on Schedule F. For example, one individual included income from horseracing. All nonfarm income items must be deducted from gross farm income shown on Line 11. Likewise, expenses shown on Part II must be reduced by any amounts that apply to nonfarm income deducted from Part I. **That requires examination of supplemental information not provided on the income tax return.**

N.D.C.C. § 57-02-08(15)(b)(3) defines "net income from farming activities" as taxable income from those activities as computed for income tax purposes pursuant to chapter 57-38 (chapter 57-38 income requirements are the same as IRS requirements) adjusted to include the following:

(a) The difference between gross sales price less expenses of sale and the amount reported for sales of agricultural products for which the farmer reported a capital gain.
(b) Interest expenses from farming activities which have been deducted in computing taxable income.
(c) Depreciation expenses from farming activities which have been deducted in computing taxable income.

Gains from Sales of Business Property are reported on Form 4797 and transferred to Schedule D. Only gains from the sale of agricultural products, not sale of farm equipment or farmland, are considered farm income. **The adjustment for (a) above cannot be made without additional information that is not shown on Form 4797.** Making the adjustment correctly requires identifying expenses of sale included in Column f, deducting them from the figure in Column f, and then adding the result to Column e for each sale of agricultural products.

Ordinary Gains and Losses are reported on Part II of Form 4797. The amount on line 18b for gains from sale of agricultural products is farm income.

Depreciation expenses and interest expenses from farming activities are shown on Lines 16 and 23 of Part II of Form 1040 Schedule F. Before those expenses are added back, any depreciation and interest expenses that relate to nonfarm activities and income (those that are deducted from the amount on Line 11) must be excluded. **That requires examination of supplemental information not provided on Schedule F for (b) and (c) above.**

"Only gains from the sale of agricultural products, not sale of farm equipment or farmland, are considered farm income."

A number of other forms that carry over to Schedule D are not addressed here. **All forms and schedules attached to an applicant's Form 1040 or to a C-corp, S-corp, partnership, or LLC return should be examined to determine if they include farm income.**

Amounts carried forward or carried back from one year to another should be disregarded in determining eligibility for the farm residence exemption.

Sometimes it may be acceptable to estimate expenses attributable to nonfarm income included on Schedule F, and expenses of sale relating to capital gains, if the amounts are small.

If the percentage of farm income is close to 50 percent or the nonfarm income is close to $40,000, the assessor should request supplemental information from the applicant.

Examining income tax returns is time consuming. It is important to set criteria for determining which applicants' income tax returns should be examined. Farm residence applications may be audited under N.D.C.C. § 57-12-01.1, spot checks of real property. However subjects are selected, discrimination or the appearance of discrimination should be avoided.

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