

Preliminary Report:

2018 Tax Preference Performance Reviews

Custom Farming and Hauling Farm Products

Legislative Auditor's Conclusion:

The tax preference for custom farming is providing tax relief to eligible farmers. However, there is no data to determine if farmers use the second tax preference for hauling farm products and equipment.

July 2018

B&O and public utility tax exemptions for those who provide services or haul goods for farmers

The Legislature enacted these preferences for farms in 2007:

1. **Custom farming and specific farm services:** A B&O tax exemption for farmers who provide custom farming services (e.g., planting or harvesting of agricultural products) to other farmers. The exemption also applies to those who provide specific farming services (e.g., farm management) to related farmers.
2. **Hauling farm products and equipment:** A public utility tax exemption for those who haul farm machinery, equipment, or agricultural products for a related farmer or person performing custom farming services.

"Related" farmer means a family member or a relationship established through a corporation or trust, as specified by the Internal Revenue Service.

Both preferences are scheduled to expire December 31, 2020.

Estimated Biennial Beneficiary Savings

\$67,500 (Custom Farming)

Unknown (Hauling Farm Products)

Tax Type

B&O Tax

Public Utility Tax

RCW 82.04.625

RCW 82.16.300

Applicable Statutes

Inferred public policy objective met by one preference. Impact of second preference unknown.

Preference	Objectives (inferred)	Results
Custom farming and specific farm services (B&O tax preference)	Provide tax relief	Met. Preference is providing tax relief to six to seven businesses annually.
Hauling farm products and equipment for related farmers (Public utility tax preference)	Provide tax relief	Unknown. Structurally, the preference would provide tax relief. No data or information is available to determine if it is being used.

Some Washington farmers reorganized their farms in response to federal regulations. This had state tax consequences.

Under Bureau of Reclamation regulations, a farm owner can receive irrigation water from a federal reclamation project on no more than 960 acres. To remain eligible for federal irrigation water, some farm owners split their farm among multiple owners but continued to operate as one farming operation.

This created an unintended structural tax issue. **If one owner provided a service or hauled products/equipment for another owner on the same farm, these services could be subject to B&O or public utility tax.** The preferences eliminate potential taxation in these situations.

Farmers who meet all eligibility criteria but were not impacted by the federal regulations also qualify for these preferences.

Recommendations

Legislative Auditor's Recommendation: Continue and clarify (structural purpose)

The Legislature should continue and clarify the two preferences to add performance statements, specify public policy objectives, and eliminate the expiration dates.

More information is available on the Recommendations Tab.

Commissioners' Recommendation

Available October 2018

REVIEW DETAILS

1. What are the preferences?

Two preferences for those who provide services or haul goods for farmers

JLARC staff infer the public policy objectives are to provide tax relief

The Legislature did not state public policy objectives for either of the preferences. Based on testimony when the preferences passed, JLARC staff infer the preferences were enacted to provide tax relief to farmers, including those who changed their farm structure in response to federal regulations regarding irrigated water.

B&O and public utility tax exemptions for providing services and hauling farm products or equipment

1. Custom farming and specific farming services (B&O tax exemptions)

- *Custom farming services* must be performed by an eligible farmer or an entity that is at least 50 percent owned by a farmer. Custom farming generally means bringing machinery or draft animals to a farm for operations such as planting or harvesting agricultural products.
- *Specific farming services* include farm management, contract labor, and services for animals considered agricultural products. Services must be performed by a person related to the farmer who receives the service.

2. Hauling farm machinery, equipment, or agricultural products for a farmer (public utility tax exemption)

- The person who does the hauling must be related to the farmer who receives the service.

In 2014, the Legislature clarified that custom farming services did not include any services involved with growing, raising, or producing marijuana. Otherwise, the preferences have not substantively changed since enacted.

"Related" is defined in federal income tax law

To qualify for the preferences, specific farming services and hauling services must be provided by someone who is related to the farmer who receives the service.

"Related" is defined as a family member or a relationship established through an organizational relationship, such as a corporation or trust, as specified by the Internal Revenue Service.

Preferences scheduled to expire December 31, 2020

The preferences took effect August 1, 2007 and are set to expire December 31, 2020.

REVIEW DETAILS

2. Preferences have detailed requirements

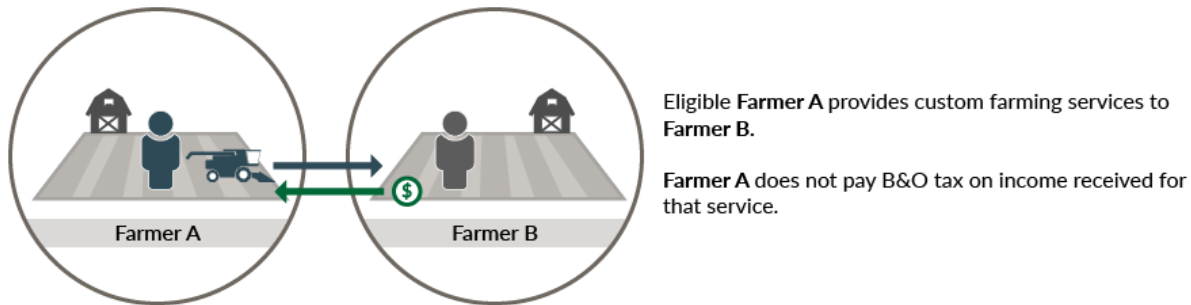
Statute specifies the services that qualify, as well as eligibility requirements

Custom farming services (B&O tax exemption) must be performed by eligible farmers or farming entities. Qualifying services are defined in statute.

Eligible farmers do not pay B&O tax when performing custom farming services. Entities that are majority-owned by an eligible farmer also qualify for the preference.

- **Eligible farmer:** Person that grows, raises, or produces an agricultural product to sell, using land they own or have a legal right to use. The person must have produced agricultural products during the previous year that grossed \$10,000 or more, or would have grossed that amount if the products had been sold.
- **Custom farming:** Specific farming operations such as planting, cultivating, or harvesting that require farm machinery or a draft animal and an operator. The law excludes services such as veterinary or farrier services, boarding, appraisals or agricultural consulting, packing or processing, and waste disposal.
- **Additional requirements:** The custom farming must be directly tied to producing an agricultural product to be sold or used by a farmer. The work must be done under contract with a farmer or under the farmer's supervision.

Exhibit 2.1: Eligible farmers exempt from B&O tax on custom farming services performed for other farmers



Source: JLARC staff analysis of RCW 82.04.625(1)(a).

Specific farming services (B&O tax exemption) must be performed by someone related to the farmer. Qualifying services must meet specific criteria.

A person who performs specific farming services does not pay B&O tax if they are related to the person who receives the service. The recipient may be either a farmer or a person who performs custom farming services.

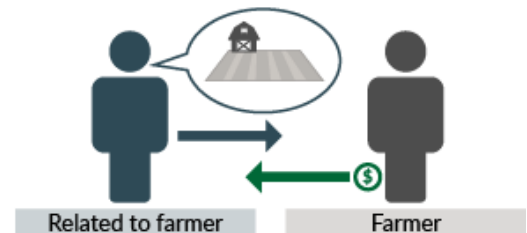
Three specific farming services qualify:

- Farm management services (e.g., professional advice about which crops to plant, fertilizer application, marketing).
- Contract labor services.
- Services provided to animals that are considered agricultural products.

Hauling services (public utility tax exemption) must be performed by a person related to the farmer

Persons who haul agricultural products, farm machinery, or farm equipment do not pay public utility tax on income earned from such hauls if they are related to the person receiving the service. The recipient may be either a farmer or a person who performs custom farming services.

Exhibit 2.2: Persons exempt from B&O tax on specific farm services provided to a related farmer



A person who provides specific farming services to a related farmer (e.g., consultation) does not pay B&O tax on income received for that service.

Source: JLARC staff analysis of RCW 82.04.625(1)(b).

REVIEW DETAILS

3. Inferred objective: provide tax relief

Some Washington farmers reorganized their farms in response to federal regulations. This had unintended state tax consequences. JLARC staff infer that the preferences were enacted to provide tax relief.

Inferred objective: provide tax relief for those affected by unintended state tax consequences

The Legislature did not state public policy objectives when it enacted these preferences. The preferences were passed before the Legislature required a performance statement for new preferences.

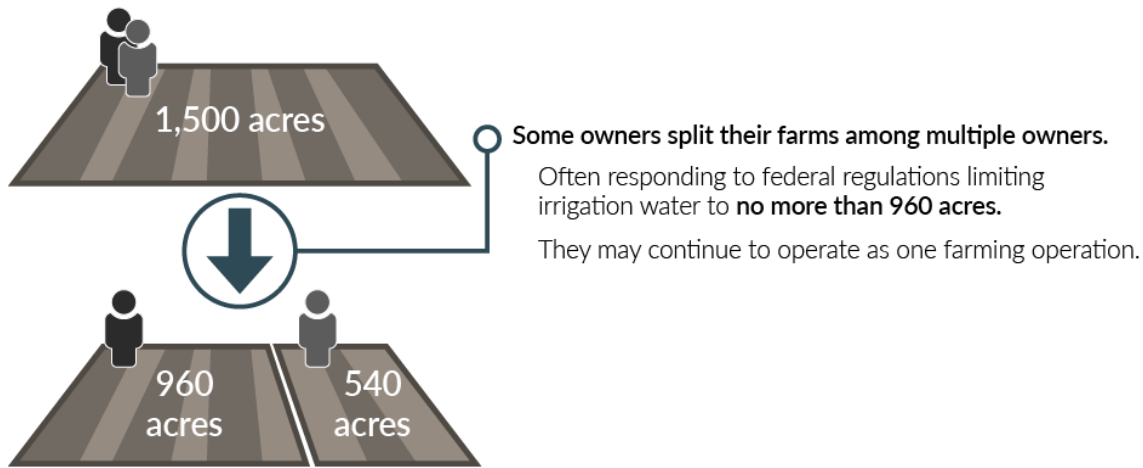
JLARC staff infer the public policy objective for the preferences was to provide tax relief to farmers and entities owned by farmers, including those that were affected by a structural tax issue related to federal regulations.

Federal Reclamation regulations limit the number of acres that can receive irrigation water from federal reclamation projects

Under Bureau of Reclamation (Reclamation) regulations, a farm owner can receive irrigation water from a federal reclamation project on no more than 960 acres. The limit is adjusted for quality of land.

Testimony provided to legislators by farm industry proponents indicated that this limitation led some farm owners to split the farm among multiple owners. Following a split, the land is legally owned by different persons or entities. But, the proponents noted that in these situations the land continues to be run as one farming operation.

Exhibit 3.1: Federal irrigation limits can lead farm owners to split farms among multiple owners



Source: JLARC staff analysis of 43 USC 426.5(b), archival documentation and testimony submitted to Legislature.

Changes in farm ownership created an unintended structural tax issue: Services provided on a farm that is run as one operation, but with multiple landowners, may be subject to B&O or public utility tax

For state tax purposes, a farmer is any person who grows, raises, or produces agricultural products on land they own or have a legal right to use. The products must be produced for sale.

Farm services or hauling of farm products/equipment that farmers do for themselves on land they own or lease is not taxable. However, if a person or business other than the farmer/landowner performs services or hauls goods for the farmer, those activities may be taxable.

On farms with split ownership, farmers may concentrate certain activities. For example, one owner may maintain equipment while another maintains materials. As a result, if one owner provides a service to another owner on the same farm, the income could be subject to B&O or public utility tax. The preferences eliminate potential taxation in these situations.

Farmers who meet all eligibility criteria but were not impacted by changes to Reclamation regulations also qualify for these preferences.

Neighboring states impose different tax structures with no similar preferences

JLARC staff found no similar preferential tax treatment for these activities in Oregon or Idaho. Neither Idaho nor Oregon imposes a tax similar to Washington's B&O tax or public utility tax.

REVIEW DETAILS

4. Custom farming preference provides tax relief

The preference for custom farming and specific farming services (B&O tax) is providing tax relief as intended

Tax preferences have **direct beneficiaries** (entities whose state tax liabilities are directly affected) and may have **indirect beneficiaries** (entities that may receive benefits from the preference, but are not the primary recipient of the benefit).

Exhibit 4.1: Farmers, and entities owned by farmers, are the beneficiaries

	Direct Beneficiaries	Indirect Beneficiaries
Description	Farmers, and entities that are majority-owned by a farmer, that perform custom farming for any other farmer. Farmers that provide specific farming services to a related farmer.	Farmers receiving the services, if the tax savings are passed on to them.
Number	Six to seven businesses (fiscal years 2015 through 2017)	Unknown. No tax return data is collected on this detail.

There may be more beneficiaries. But, in response to a JLARC staff inquiry, agriculture industry representatives stated that they had no additional information or data on use of the preference.

Estimated direct beneficiary savings for the 2019-2021 Biennium is \$67,500

JLARC staff estimate the direct beneficiary savings for fiscal year 2017 was \$45,000. The estimated beneficiary savings for the 2019-2021 Biennium is \$67,500.

JLARC staff used Department of Revenue tax return deduction detail for fiscal years 2016 and 2017 to prepare the estimate.

Exhibit 4.2: Estimated direct beneficiary savings for custom farming (B&O) preference

Biennium	Fiscal Year	Estimated Taxable Income	Estimated Beneficiary Savings
2015-17 7/1/15-6/30/17	2016	\$3,079,000	\$46,000
	2017	\$2,995,000	\$45,000
2017-2019 7/1/17 - 6/30/19	2018	\$3,000,000	\$45,000
	2019	\$3,000,000	\$45,000
2019-21 7/1/19-12/31/20	2020	\$3,000,000	\$45,000
	2021	\$1,500,000	\$22,500
	2019-21 Biennium	\$4,500,000	\$67,500

Source: JLARC staff analysis of Department of Revenue tax return deduction detail for 2016, 2017. No growth estimated in future years.

Absent the preferences, farmers and related entities would owe tax

Absent the tax preference, farmers who perform custom farming and persons who perform specific farming services for related farmers would be subject to B&O tax. The current rate for income earned from performing a service is 1.5 percent.

REVIEW DETAILS

5. Unknown if preference for hauling products/equipment meets objective

Tax preference for hauling farm products or equipment is structured to provide tax relief. But, there is no data to indicate that it has been used.

The tax preference applies to income earned from hauling farm machinery, equipment, or agricultural products for a related farmer (public utility tax).

Direct beneficiaries would be people who haul agricultural products or equipment for farmers, if the two parties are related. If savings were passed on to customers, farmers receiving the services would be **indirect beneficiaries**.

The extent to which the preference is used is unknown

The Department of Revenue's most recent tax exemption study notes that situations where the preference would apply are "believed to be quite rare" and that while the impact cannot be quantified, it is "likely minimal."

- No businesses have reported using the preference on tax returns in the last three fiscal years.
- There are no reporting requirements or other methods of identifying direct or indirect beneficiaries of the preference.
- JLARC staff asked agriculture industry representatives if they knew, or could estimate, how many farmers might be receiving these tax-exempt services. They responded that they had no relevant information.

Absent information about the preference's use, its economic and revenue impact is unclear. However, when the preference was enacted in 2007, the fiscal note assumed the revenue loss associated with the preference would be minimal.

Without data about use, the impact of allowing the preference to expire is unclear

The preference is set to expire December 31, 2020. Without the preference, those who haul equipment or goods for related farmers would owe public utility tax under the motor transportation rate. The rate is currently 1.926 percent.

REVIEW DETAILS

6. Applicable statutes

RCW 82.04.625 and RCW 82.16.300

Custom Farming

82.04.625

Exemptions—Custom farming services. (Expires December 31, 2020)

(1) This chapter does not apply to any:

(a) Person performing custom farming services for a farmer, when the person performing the custom farming services is: (i) An eligible farmer; or (ii) at least fifty percent owned by an eligible farmer; or

(b) Person performing farm management services, contract labor services, services provided with respect to animals that are agricultural products, or any combination of these services, for a farmer or for a person performing custom farming services, when the person performing the farm management services, contract labor services, services with respect to animals, or any combination of these services, and the farmer or person performing custom farming services are related.

(2) The definitions in this subsection apply throughout this section.

(a)(i) "Custom farming services" means the performance of specific farming operations through the use of any farm machinery or equipment, farm implement, or draft animal, together with an operator, when: (i) [(A)] The specific farming operation consists of activities directly related to the growing, raising, or producing of any agricultural product to be sold or consumed by a farmer; and (ii) [(B)] the performance of the specific farming operation is for, and under a contract with, or the direction or supervision of, a farmer. "Custom farming services" does not include the custom application of fertilizers, chemicals, or biologicals, or any services related to the growing, raising, or producing of marijuana.

(ii) For the purposes of this subsection (2)(a), "specific farming operation" includes specific planting, cultivating, or harvesting activities, or similar specific farming operations. The term does not include veterinary services as defined in RCW 18.92.010; farrier, boarding, training, or appraisal services; artificial insemination or stud services, agricultural consulting services; packing or processing of agricultural products; or pumping or other waste disposal services.

(b) "Eligible farmer" means a person who is eligible for an exemption certificate under RCW 82.08.855 at the time that the custom farming services are rendered, regardless of whether the person has applied for an exemption certificate under RCW 82.08.855.

(c) "Farm management services" means the consultative decisions made for the operations of the farm including, but not limited to, determining which crops to plant, the choice and timing of application of fertilizers and chemicals, the horticultural practices to apply, the marketing of crops and livestock, and the care and feeding of animals. "Farm management services" does not include any services related to the growing, raising, or producing of marijuana.

(d) "Related" means having any of the relationships specifically described in section 267(b) (1), (2), and (4) through (13) of the internal revenue code, as amended or renumbered as of January 1, 2007.

[2014 c 140 § 10;2007 c 334 § 1.](#)

Hauling agricultural products or machinery

RCW 82.16.300

Exemptions—Custom farming services. (Expires December 31, 2020)

(1) This chapter shall not apply to any person hauling agricultural products or farm machinery or equipment for a farmer or for a person performing custom farming services, when the person providing the hauling and the farmer or person performing custom farming services are related.

(2) The exemption provided by this section shall not apply to the hauling of any substances or articles manufactured from agricultural products. For the purposes of this subsection, "manufactured" has the same meaning as "to manufacture" in RCW 82.04.120.

(3) The definitions in RCW 82.04.213 and 82.04.625 apply to this section.

[2007 c 334 § 2.\]](#)

RECOMMENDATIONS & AGENCY RESPONSE

Legislative Auditor's Recommendation

Legislative Auditor recommends continuing and clarifying the preferences (structural purpose)

The Legislature should continue and clarify the two preferences to:

- **Add performance statements that specify public policy objectives.** The preferences were passed before the Legislature required a performance statement for new preferences. Based on testimony provided at the time the preferences passed, JLARC staff infer that the preferences are intended to provide tax relief to those affected by a structural tax issue.
- **Eliminate expiration dates.** Consider exempting the preferences from the statutory requirement for an expiration date. The inferred objectives appear to address a structural tax issue that arose after some farmers reorganized their farms in response to federal regulations. At this time, the federal regulations are not scheduled to expire. If the Legislature confirms the inferred objective of the preferences, it is unclear why an expiration date is needed.

Legislation Required: Yes (preferences expire on December 31, 2020).

Fiscal Impact: Depends on legislative action.

RECOMMENDATIONS & AGENCY RESPONSE

Letter from Commission Chair

Available October 2018

RECOMMENDATIONS & AGENCY RESPONSE

Commissioners' Recommendation

Available October 2018

RECOMMENDATIONS & AGENCY RESPONSE

Agency Response

If applicable, available October 2018

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