ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - MICROBUSINESS INCOME TAX CREDIT

Pursuant to North Dakota Century Code Section 54-35-26, created by 2015 Senate Bill No. 2057, a variety of economic development tax incentives are to be reviewed by a Legislative Management interim committee over the ensuing six-year period. The study is aimed at ensuring that economic development tax incentives are serving their intended purposes in a cost-effective and equitable manner. This memorandum has been provided to assist in the review of the microbusiness income tax credit and provides an explanation of the incentive, the perceived goals of the Legislative Assembly in creating or altering the incentive, and the data and testimony that will be required to conduct an effective analysis of the incentive.

EXPLANATION OF THE MICROBUSINESS INCOME TAX CREDIT

Section 57-38-01.27 provides for a microbusiness income tax credit. The credit is available to all income taxpayers certified by the Director of the Department of Commerce's Division of Economic Development and Finance as a microbusiness. A taxpayer may claim as a credit 20 percent of the cost of the taxpayer's new investment and new employment in the microbusiness during the taxable year. Credit amounts exceeding a taxpayer's liability may be carried forward to each of the five succeeding taxable years but a taxpayer is limited to claiming no more than $10,000 in credits over any combination of taxable years. A passthrough entity entitled to the credit must be considered the taxpayer for purposes of the credit and the amount of credit allowed must be determined at the passthrough entity level.

For purposes of Section 57-38-01.27, "new investment" means the amount by which a taxpayer's purchases of microbusiness buildings and depreciable personal property have increased over the amount purchased in the prior year and "new employment" means the amount by which employee compensation payments to North Dakota residents have increased over the amount paid to North Dakota residents in the prior year. The definition of new investment does not include the cost of any registered vehicles and the definition of new employment does not include any merit-based or equity-based salary increases, cost-of-living adjustments, or any other increases in compensation not directly related to the hiring of new employees. In determining the amount of the investment in property when the taxpayer is leasing, rather than purchasing property, the cost of the investment for purposes of calculating the credit is determined by multiplying the increase in average net annual rents by the number of years for which the lease is executed, but not exceeding 10 years.

A business must have fewer than six employees and be located within an economically viable small community to be certified as a microbusiness. An economically viable small community is defined as a community with a population of fewer than 2,000, but no less than 100, and which has an active community economic development organization, an ongoing relationship with a regional or urban economic development organization, or an existing city sales tax for which at least part of the revenues are dedicated to economic development. To apply for certification as a microbusiness, an application must be submitted providing a description of the microbusiness, the projected income and expenditures of the microbusiness, the market to be served by the microbusiness, the way the expansion of the microbusiness addresses market needs, the amount of projected new investment or employment increases created by the microbusiness, projected improvements in income or the anticipated creation of new jobs in the area in which the microbusiness is located, the extent of the applicant's engagement in the microbusiness, and any other information required by the Department of Commerce.

The Department of Commerce may certify a business as a microbusiness if the applicant is, or will be, actively engaged in the operations of the microbusiness; the applicant will create new employment or make a new investment in the microbusiness; the applicant's investments will create new income or jobs in the area in which the microbusiness is located; the microbusiness will not directly compete with any established businesses located within 15 miles of the proposed microbusiness; the microbusiness will be located in an economically viable small community and at least 15 miles from a city with a population of 2,000 or more; and the applicant is not closing or reducing its business operations in one area of the state and relocating substantially the same business operation to another area of the state. The Department of Commerce is required to issue a certification letter to qualifying microbusinesses stating the effective date of the certification but is limited to certifying no more than 200 microbusinesses. The taxpayer must attach the certification letter when applying for the credit.

The Tax Commissioner is required to provide a report to the Department of Commerce identifying the aggregate amount of the tax credit claimed during the previous calendar year and the actual amount of new investment and new employment reported by taxpayers certified as a microbusiness for the previous calendar year. The report must be provided by January 15th of each year and may not contain information protected by state or federal confidentiality laws.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING THE MICROBUSINESS INCOME TAX CREDIT

Section 57-38-01.27, providing for a microbusiness income tax credit, was created through the passage of 2007 House Bill No. 1403. The bill provided for an individual and corporate income tax credit equal to 20 percent of new investment and new employment in a microbusiness, which was defined as a business employing five or fewer employees inside an economically viable small community. Upon a review of the legislative history pertaining to House Bill No. 1403, the perceived goal of the Legislative Assembly in creating this credit was to provide an incentive to encourage small businesses to locate and expand in smaller communities. The credit was viewed as a tool to help stimulate rural economies. The estimated fiscal effect of the microbusiness income tax credit could not be determined during the 2007 legislative session, but the maximum lifetime impact of the credit was determined to be $2 million as each taxpayer was limited to claiming no more than $10,000 in credits. The Department of Commerce was limited to certifying no more than 200 businesses as qualifying microbusinesses.

The only other changes impacting Section 57-38-01.27 occurred through the passage of 2009 House Bill No. 1324 which served to eliminate the optional long-form filing method (Form ND-2) and replace it with a simplified filing method for any taxpayer who did not have any tax deductions or credits, and through the passage of 2013 House Bill No. 1106. House Bill No. 1106 served to streamline the lengthy description of a passthrough entity by providing a definition of the term at the outset of the income tax chapter.

Information provided to the Political Subdivision Taxation Committee by the Tax Department on July 29, 2015, and later amended on August 12, 2015, indicates the total amount of the credit claimed in tax years 2007 through 2014 cannot be disclosed due to confidentiality restrictions as the credit was claimed on less than five individual income tax returns in each tax year. The credit was not claimed on any corporate income tax returns in tax years 2007 through 2014.

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF THE MICROBUSINESS INCOME TAX CREDIT

Data pertaining to the following items will need to be collected to effectively analyze the incentive:

1. The number of claimants;
2. The fiscal impact of the incentive;
3. Employment opportunities, business growth, or diversity in the state's economy resulting from the availability of the incentive;
4. Negative impacts created as a result of the incentive;
5. Benefits that flow to out-of-state concerns resulting from the incentive; and
6. The use of this type incentive in other states.

Testimony will need to be solicited from the following parties to effectively analyze the incentive:

1. The Department of Commerce;
2. The Tax Department; and
3. The North Dakota Economic Development Foundation.