

## **ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - SEED CAPITAL INVESTMENT 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 seed capital investment 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 SEED CAPITAL INVESTMENT TAX CREDIT**

Section 57-38.5-03 provides for a seed capital investment tax credit. The incentive is available to all income taxpayers and allows for a credit against state income tax liability for qualified investments made in a qualifying business. A "qualifying business" is defined in Section 57-38.5-01 as a primary sector business, certified by the Director of the Department of Commerce's Division of Economic Development and Finance, which relies on innovation, research, or the development of new products and processes for growth and profitability. A qualifying business must be in compliance with the state's security laws and must be a for-profit corporation, passthrough entity, or joint venture with the majority of the businesses in-state employees being North Dakota residents. The business must have its principal office located in this state and perform the majority of its business activities in this state, with the exception of sales activities, or the business must have significant current or anticipated operations in North Dakota which consist of employing more than 10 employees or reaching more than \$150,000 in annual sales. A qualifying business does not include a real estate investment trust.

The credit is equal to 45 percent of the amount of the qualified investment which may consist of direct cash payments or cash transfers from a retirement plan if the investor maintains a separate account and controls where the plan's assets are invested. A qualifying investment must be at risk in the qualifying business for at least three years. Investments placed in escrow will not qualify for the credit. A qualifying business must expend investment amounts for equipment, plant facilities, research and development, marketing, or working capital. A taxpayer, or a member of the taxpayer's immediate family, receiving more than half of the taxpayer's yearly gross income, or owning a controlling interest in qualified business, may not receive a credit for qualified investments in that business.

A taxpayer may claim no more than \$112,500 in credits per taxable year. Credit amounts exceeding a taxpayer's liability may be carried forward for up to four taxable years following the year in which the investment was made. 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 and passed through to the entity's partners, shareholders, or members in proportion to their respective ownership interests in the passthrough entity. Pursuant to Section 57-38.5-07, a qualified business is required to file with the investor, the Tax Commissioner, and the Director of the Department of Commerce's Division of Economic Development and Finance information identifying each taxpayer making an investment, the amount remitted by the taxpayer, and the date on which the investment was received by the qualifying business. The total aggregate amount of all seed capital investment tax credits allowed per year is limited to \$3.5 million. If the amount of credits applied for exceeds the maximum yearly cap, credits must be awarded based on the date each investment was received by a qualifying business. The maximum aggregate amount of qualified investments upon which the credit may be based may not exceed \$500,000 for any one qualified business over any combination of tax years.

### **PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING THE SEED CAPITAL INVESTMENT TAX CREDIT**

Provisions relating to a seed capital investment tax credit were first enacted through the passage of 1993 Senate Bill No. 2052. The bill provided a credit to individual income taxpayers for investments in primary sector companies that exported products, provided new jobs, and created new wealth from customers outside this state. A taxpayer was required to invest between \$5,000 and \$50,000 in a qualified business and the investment was required to be at risk in the business for at least three years. The credit was equal to 30 percent of the amount invested. A taxpayer could claim no more than 50 percent of the credit in a single taxable year and the credit could not exceed 50 percent of the taxpayer's income tax liability. Credit amounts exceeding a taxpayer's liability could be carried forward for up to 15 taxable years following the year in which the investment was made. The total aggregate amount of all seed capital investment tax credits allowed per year was limited to \$250,000. Upon a review of the legislative history relating to this bill, the perceived goal of the Legislative Assembly in creating this credit was to stimulate private investment in new and growing North Dakota companies to help

diversify and expand the state's economy. It was estimated that the seed capital investment tax credit could result in a reduction in general fund revenues of up to \$500,000 during the 1993-95 biennium.

The credit was amended through the passage of 2001 House Bill No. 1413, which eliminated the limitation that the seed capital credit could not exceed 50 percent of a taxpayer's tax liability. The bill also increased the aggregate amount of allowable seed capital investment tax credits from \$250,000 to \$1,000,000 through calendar year 2002 and to \$2,500,000 after calendar year 2002. The number of North Dakota employees a qualified business was required to employ was decreased to 10 and annual sales requirements were decreased to \$150,000. The bill also allowed for an organization to be classified as a qualified business if it attracted investments to build and own a value-added agricultural processing facility that it leased with an option to purchase to a primary sector business.

The credit was further amended through the passage of 2003 House Bill No. 1019, which eliminated the \$250,000 limit per qualifying business of investments that could qualify for the credit. The bill also increased the available credit amount from 30 to 45 percent the amount of the qualifying investment. Legislation enacted during the 2005 legislative session, through the passage of Senate Bill No. 2032, further expanded the credit to allow it to be claimed by corporations and passthrough entities. The bill also limited qualified investments in a qualified business to a maximum of \$500,000 for which the credit could be claimed. The bill allowed investments made before 2005, which did not qualify for the tax credit because of the limitation in effect at that time, to claim a credit of 45 percent of the amount invested in a qualified business with a minimum qualifying investment of \$5,000 and maximum investment of \$250,000 required in order to obtain the credit. For these taxpayers, no more than one-fourth of the credit could be claimed in any taxable year. It was estimated that the credit would decrease general fund revenues by \$250,000 in the 2005 fiscal year and by \$3,000,000 during the 2005-07 biennium if the caps provided within the credit provisions were reached.

Senate Bill No. 2224 (2007) expanded the credit to allow investments by an angel fund to be eligible for the seed capital investment tax credit and Senate Bill No. 2084 reduced the maximum amount that could be claimed by a taxpayer to \$112,500 per year and revised provisions regarding certification of a qualified business by the Department of Commerce. The remaining changes to the credit were mostly technical in nature and occurred during the 2009 and 2013 legislative sessions. The passage of 2009 House Bill No. 1324 eliminated the optional long-form filing method (Form ND-2) and replaced it with a simplified filing method for any taxpayer who did not have tax deductions or credits and 2013 House Bill No. 1106 streamlined the lengthy description of a passthrough entity by providing a definition of the term at the outset of the income tax chapter.

## **DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF THE SEED CAPITAL INVESTMENT TAX CREDIT**

The interim Political Subdivision Taxation Committee identified various items of data and testimony that would need to be collected to effectively analyze the seed capital investment tax credit. The following list identifies the information the committee sought to collect and the receipt of that information throughout the course of the 2015-16 interim.

1. The number of claimants and the fiscal impact of the incentive.
  - Information ([Appendix A](#)) provided to the Political Subdivision Taxation Committee by the Tax Department on December 2, 2015, indicated the number of individual income tax returns on which the credit was claimed and the total amount claimed.

In tax year 2006, a total of \$1,657,308 was claimed over 699 returns.

In tax year 2007, a total of \$3,456,317 was claimed over 662 returns.

In tax year 2008, a total of \$3,041,632 was claimed over 396 returns.

In tax year 2009, a total of \$2,892,224 was claimed over 295 returns.

In tax year 2010, a total of \$1,950,451 was claimed over 143 returns.

In tax year 2011, a total of \$1,273,452 was claimed over 87 returns.

In tax year 2012, a total of \$1,404,615 was claimed over 87 returns.

In tax year 2013, a total of \$1,577,110 was claimed over 86 returns.

In tax year 2014, a total of \$1,289,347 was claimed over 74 returns.

- The information provided by the Tax Department also indicated the number of corporate income tax returns on which the credit was claimed and the total amount claimed.

In tax years 2006, 2007, and 2009, the total amount claimed could not be disclosed due to confidentiality restrictions as the credit was claimed on fewer than five returns in each tax year.

In tax year 2008 and tax years 2010 through 2014, the credit was not claimed on any corporate income tax returns.

2. The use of similar incentives in other states.

- Incentives similar to this state's seed capital investment tax credit ([Appendix B](#)) were found in seven other states.

3. Employment opportunities, business growth, or diversity in the state's economy resulting from the availability of the incentive.

- Information (Appendices [C](#), [D](#), and [E](#)) pertaining to this item was provided by the Department of Commerce on January 13, 2016, and March 1, 2016.

4. Negative impacts created as a result of the incentive.

- The committee continues to assess whether any negative impacts have been created as a result of the incentive.

5. Benefits that flow to out-of-state concerns resulting from the incentive.

- The committee continues to assess whether any benefits flow to out-of-state concerns as a result of the incentive.

6. Testimony from interested parties.

- The following parties provided testimony in support of retaining the seed capital investment tax credit.

The Economic Development Association of North Dakota ([Appendix F](#)).

The North Dakota State University Research and Technology Park.

Mr. Corey Kratcha, Co-Founder and Chief Executive Officer of c2renew and c2sensor.

- Testimony has yet to be received from parties in opposition to retaining the seed capital investment tax credit.
- Testimony has yet to be received from the North Dakota Economic Development Foundation.

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