

ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - NEW OR EXPANDING BUSINESS INCOME TAX EXEMPTION

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 new or expanding business income tax exemption 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 NEW OR EXPANDING BUSINESS INCOME TAX EXEMPTION

Section 40-57.1-04 provides for a new or expanding business income tax exemption. The income tax exemption is available to project operators approved by the State Board of Equalization. For purposes of the exemption, a project is defined as any new or expanding revenue-producing tourism or primary sector business. A primary sector business is further defined as any business that adds value to a product, process, or service through the employment of knowledge or labor and results in the creation of new wealth and tourism is defined to encompass all tourism-related businesses and activities. The amount of the exemption is equal to the net income realized by a qualifying project for a period not to exceed five years from the date the project first commenced. Following the submission of a project owner's application to the State Board of Equalization, the application must be reviewed by the Department of Commerce which then provides a recommendation to the State Board of Equalization. The project owner must also provide notice of the potential exemption to all of its competitors. The exemption will only be granted if the State Board of Equalization finds it is in the best interest of the people of North Dakota. A project will not be eligible for the exemption if it has an outstanding lien for unpaid property, income, sales, or use taxes, or if granting the exemption would endanger existing businesses or foster unfair competition.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING THE NEW OR EXPANDING BUSINESS INCOME TAX EXEMPTION

Provisions of the new or expanding business income tax exemption were first enacted in 1969 through the passage of Senate Bill No. 39 and the creation of Chapter 40-57.1. As originally enacted, Section 40-57.1-04 only applied to new businesses and required a municipality to apply to the State Board of Equalization on behalf of the project owner. A project owner could only receive an income tax exemption if the business first qualified for a partial or complete property tax exemption. The intent of the Legislative Assembly in creating this exemption was clearly stated within the text of the bill. Section 1 of the bill provided, in pertinent part, that the purpose of the newly created chapter was:

[T]o sanction, authorize, and encourage activities in the public interest and for the welfare of the state of North Dakota, its subdivisions and people by assisting in the establishment of industrial plants and promotion of economic activities within the state, and thereby increasing production of wealth, and adding to the volume of employment, particularly during those seasons when employment in farming and ranching is slack, thus alleviating unemployment among the people of the state.

The estimated fiscal effect of the new business income tax exemption could not be determined during the 1969 legislative session.

The exemption was amended in 1987 through the passage of House Bill No. 1637, which served to broaden the types of projects that could qualify for an exemption. The bill removed qualifying language regarding the types of revenue-producing entities that could qualify as a project to allow the exemption to apply to all revenue-producing entities. The scope of the exemption was expanded for a second time in 1991 through the passage of House Bill No. 1543. The bill broadened the declaration and finding of public purpose for Chapter 40-57.1 to include the expansion and retention of existing businesses, which now included primary sector businesses and tourism businesses, and removed the requirement that a property tax exemption be granted in order for a project operator to qualify for an income tax exemption. The bill shifted the responsibility of applying for the exemption from the municipality to the project operator and required the application to be made within one year after the commencement of project operations. The bill also required project operators to provide notice to competitors in a manner prescribed by the State Board of Equalization.

The only other change to the new and expanding business income tax exemption was made in 2001, through the passage of Senate Bill No. 2032, which served to create the Department of Commerce and, as a result,

merged several other entities into divisions of the Department of Commerce. The specific changes to Section 40-57.1-04 simply replaced a reference to "the department of economic development and finance" with "the department of commerce division of economic development and finance."

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 number of individual income tax returns on which the exemption was claimed and the estimated reduction in tax is as follows:

- In tax year 2006, a total of \$455,792 was claimed over 31 returns;
- In tax year 2007, a total of \$72,134 was claimed over 12 returns;
- In tax year 2008, a total of \$80,856 was claimed over 20 returns;
- In tax year 2009, a total of \$44,798 was claimed over 19 returns;
- In tax year 2010, a total of \$130,883 was claimed over 20 returns;
- In tax year 2011, a total of \$128,195 was claimed over 33 returns;
- In tax year 2012, a total of \$360,758 was claimed over 30 returns;
- In tax year 2013, a total of \$351,816 was claimed over 28 returns; and
- In tax year 2014, a total of \$26,282 was claimed over 30 returns.

The number of corporate income tax returns on which the exemption was claimed and the estimated reduction in tax is as follows:

- In tax year 2006, a total of \$162,535 was claimed over five returns;
- In tax year 2007, a total of \$223,366 was claimed over eight returns;
- In tax years 2008 and 2009, the amount claimed cannot be disclosed due to confidentiality restrictions as the exemption was claimed on fewer than five returns;
- In tax year 2010, a total of \$710,053 was claimed over five returns;
- In tax years 2011 through 2013, the amount claimed cannot be disclosed due to confidentiality restrictions as the exemption was claimed on fewer than five returns; and
- In tax year 2014, the exemption was not claimed on any corporate income tax returns.

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF THE NEW OR EXPANDING BUSINESS INCOME TAX EXEMPTION

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 of 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.