ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - NEW OR EXPANDING BUSINESS EXEMPTIONS

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 every 6 years. 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 new or expanding business income and property tax exemptions and provides an explanation of the incentives, the perceived goals of the Legislative Assembly in creating or altering the incentives, and the data and testimony that will be required to conduct an effective analysis of the incentives.

EXPLANATION OF NEW OR EXPANDING BUSINESS EXEMPTIONS

The primary economic development tool in Chapter 40-57.1 is the authority of cities or counties to grant the operator of a new or expanding business a partial or complete property tax exemption or the option to make payments in lieu of taxes. A partial or complete property tax exemption also may be granted for buildings, structures, and improvements constructed and owned by a local development organization for the purposes of attracting new industry to the state. An exemption granted for local development organization property only extends to the next annual assessment date following the date the property is first occupied.

For purposes of granting a property tax exemption or the ability to make payments in lieu of taxes, a "project" must be a revenue-producing new or expanding primary sector business. A "primary sector business" is defined as a business that adds value to a product, process, or service through the employment of knowledge or labor, which results in the creation of new wealth. A project also may include projects in the retail sector in cities or counties with a population of less than 40,000 if the voters have provided the governing body authority to grant retail exemptions and the governing body has established criteria for granting those exemptions.

A project operator shall apply for the exemption before construction on the project commences or, for an existing structure, before the existing structure is occupied. If the governing body determines a project has local competitors, the project operator shall publish two notices, at least 1 week apart, in the official newspaper of the city or county to notify competitors of the project owner's pending application for an exemption. The governing body of the city or county shall consult with the Department of Commerce to determine if the total cost of the project is estimated to exceed $1 billion. The Department of Commerce shall conduct a public hearing on any projects estimated to exceed $1 billion and provide notice of the hearing to each affected taxing district and any existing business for which the project would be a competitor. Impacted school districts and townships shall be included in any exemption or payment in lieu of tax negotiations and deliberations. A city shall send notice to affected counties and school districts, pursuant to Section 40-05-24, if the city anticipates a parcel of property will receive an incentive for more than 5 years. The notified county or school district may elect to disallow the incentive from applying to its portion of the property tax for incentives granted after July 31, 2017.

After negotiation with a project operator and a public hearing, a city or county may grant a partial or complete property tax exemption for buildings, structures, fixtures, and improvements used or necessary to operate the project for up to 5 years from the date project operations commenced. A 5-year property tax exemption may be extended to a maximum length of 10 years if the project produces or manufactures a product from agricultural commodities produced in this state or the project is situated on property leased from a government entity. A project owner leasing property from a government entity shall reapply for the exemption on an annual basis. The option to make payments in lieu of taxes may be extended to a project operator through the 20th year following the date the project commenced.

The governing body of a city or county may revoke or reduce a property tax exemption or revoke or increase a project operator's payments in lieu of taxes if the governing body finds the project operator provided information that was inaccurate or untrue during incentive negotiations and deliberations, used the property for purposes other than what was anticipated at the time the incentive was approved, has improved the property to a substantially greater extent than what was anticipated at the time the incentive was approved, or if ownership of the property has changed since the incentive was approved.

In addition to receiving a property tax incentive, a project owner also may receive an income tax exemption for up to 5 years from the date the project commenced pursuant to Section 40-57.1-04. The income tax exemption is equal to the amount of net income realized by the project, or in the case of an expansion, the net income generated by the expanded portion of the business. A project owner shall submit an application for the income tax exemption to the State Board of Equalization within 1 year of commencing project operations and provide notice of the potential exemption to competitors as directed by the State Board of Equalization. For purposes of the income tax 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, which results in the creation of new wealth. "Tourism" is defined to encompass all tourism-related businesses that serve as a destination attraction. The Department of Commerce reviews applications to verify a project's eligibility as a primary sector or tourism business. The exemption will be granted if the State Board of Equalization finds it is in the best interest of the people of North Dakota.

A project is not eligible for a property or income tax exemption under Chapter 40-57.1 if it has an outstanding lien for unpaid state or local taxes, if granting the exemption would endanger existing businesses or foster unfair competition, or if the business is receiving a property tax exemption under tax increment financing. A project operator shall provide state and property tax clearance records for exemptions granted after July 31, 2017.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING NEW OR EXPANDING BUSINESS EXEMPTIONS

Provisions of new or expanding business property and income tax exemptions were first enacted in 1969 through the passage of Senate Bill No. 39 and the creation of Chapter 40-57.1. As originally enacted, Chapter 40-57.1 only applied to new businesses and required a project operator to receive a property tax exemption as a condition to qualifying for an income tax exemption. A city or county also was required to apply to the State Board of Equalization for the income tax exemption on behalf of the project operator. The intent of the Legislative Assembly in creating the new business income and property tax exemption was clearly stated in 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 exemptions could not be determined during the 1969 legislative session.

Chapter 40-57.1 was subsequently amended by the passage of several bills in 1971. Senate Bill No. 2050 added the requirement that project operators publish two newspaper notices to inform potential local competitors of the owner's pending application for a property tax exemption. Senate Bill No. 2051 required a project operator to reapply for an exemption once the value of the property exceeded the original value of the property by more than 10 percent or if the project operator moved the business to a new location. Senate Bill No. 2052 allowed the State Board of Equalization to accept reapplications for an exemption if additional facts or changed circumstances arose following the initial grant of an exemption.

Senate Bill No. 2380 (1973) added the requirement that the exemption be granted before a project commenced construction and narrowed the definition of a project by excluding from the definition enterprises engaged in "any other industry or business not prohibited by the Constitution or laws of the state of North Dakota." House Bill No. 1090 (1975) changed the time period required for publishing notice to competitors and clarified that if the ownership or use of an exempted property changed, the project owner would be required to reapply for the property tax exemption. Senate Bill No. 2233 (1977) further modified the definition of a project.

Various changes were made to Chapter 40-57.1 in the 1980s, including the addition of a definition for a "local development corporation," by Senate Bill No. 2303 (1981), and the extension of the property tax exemption to property owned by a local development corporation for purposes of attracting new industry to the state, by Senate Bill No. 2398 (1981). The property tax exemption for local development corporations, provided by Senate Bill No. 2398, only extended until the next annual assessment date following the first occupancy of the structure. The bill also expanded the property and income tax exemption to apply to existing structures that would be used in, or necessary to, a project's operations. Senate Bill No. 2482 (1983) precluded the income or property tax exemption from applying to large industrial projects that exceeded $150 million in total plant costs, was projected to have gross annual sales of over $150 million, or was projected to employ more than 1,000 employees at any time during the construction or operation of the plant. House Bill No. 1673 (1987) broadened the scope 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 exemptions to apply to all revenue-producing entities. Senate Bill No. 2186 (1989) removed the requirement for the State Board of Equalization to approve property tax exemptions. Projects exempt under tax increment financing also were disqualified from receiving the new business exemption.

In 1991 the scope of the Chapter 40-57.1 was broadened by House Bill No. 1543 to allow exemptions for the expansion and retention of existing businesses. The bill removed the requirement that a property tax exemption be granted in order for a project operator to qualify for an income tax exemption and modified the income tax exemption to apply to new and expanded primary sector businesses and tourism businesses. The bill shifted the responsibility for applying for the income tax exemption from the municipality to the project operator and required an application be made within 1 year after the commencement of project operations. The bill also required project operators to provide notice of the pending income tax exemption to competitors in a manner prescribed by the State Board of Equalization and provided a phased partial property tax exemption for property used to operate a project that produces or manufactures a product from agricultural commodities.

House Bill No. 1510 (1993) required a project operator to make a showing that the operator has satisfied all state and local tax liens of record as a condition to receiving an income tax exemption. House Bill No. 1520 (1994) enabled a local governing body and project operator to negotiate the option to make payments in lieu of taxes for a period of up to 20 years and changed reapplication requirements previously based on increases in valuation to requirements based on increases in investment. House Bill No. 1275 (1995) allowed impacted taxing districts within a city or county that granted an operator the option to make payments in lieu of taxes the ability to negotiate an alternative apportionment and distribution of those payments. Senate Bill No. 2322 (1995) required a city or county to include representatives of affected school districts and townships as nonvoting ex officio members of its governing body before granting a project owner a property tax exemption or the ability to make payments in lieu of taxes. The provision expired in 1997, but was renewed and made permanent by 1999 Senate Bill No. 2051.

Senate Bill No. 2032 (2001) created the Department of Commerce and, as a result, merged several other entities into divisions of the Department of Commerce. The resulting change 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." House Bill No. 1046 (2013) provided the governing body of a municipality the authority to revoke or reduce an exemption or revoke or increase payments in lieu of tax for various purposes. Senate Bill No. 2314 (2013) required the Department of Commerce to certify a business as a primary sector business before a city or county could grant a property tax exemption. The bill also allowed cities or counties with a population of less than 40,000 to grant a property tax exemption to retail sector businesses if the governing body received voter approval to grant retail exemptions and established criteria for granting those exemptions. Senate Bill No. 2035 (2015) required a governing body of a city or county to consult with the Department of Commerce to determine whether the total cost of a project seeking an exemption or payments in lieu of taxes is estimated to exceed $1 billion. The bill required the Department of Commerce to provide notice to impacted political subdivisions and competitors and hold a hearing on projects estimated to exceed the $1 billion threshold.

The most recent changes to Chapter 40-57.1 were made in 2017. Senate Bill No. 2166 required a city that anticipated granting a property tax incentive for more than 5 years to notice impacted counties and school districts to allow those taxing districts to elect to prohibit the incentive from applying to the county or school district portion of the property tax. House Bill No. 1044, created a uniform definition of "primary sector business" in Title 1, which expanded the definition previously referenced in Section 40-57.1-02 to include a definition of "new wealth."

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF NEW OR EXPANDING BUSINESS EXEMPTIONS

The interim Taxation Committee identified various items of data and testimony which would need to be collected to effectively analyze new or expanding business exemptions. The following list identifies the information the committee sought to collect and the receipt of that information throughout the course of the 2017-18 interim.

1. The number of claimants and the fiscal impact of the incentive.
   a. Information (Appendix A) provided by the Tax Department on December 14, 2017, indicated the number of individual income tax returns on which the income tax exemption was claimed and the estimated reduction in tax is as follows:
      (1) In tax year 2006, a total of $455,792 was claimed over 31 returns;
      (2) In tax year 2007, a total of $72,134 was claimed over 12 returns;
      (3) In tax year 2008, a total of $80,856 was claimed over 20 returns;
      (4) In tax year 2009, a total of $44,798 was claimed over 19 returns;

(5) In tax year 2010, a total of $130,883 was claimed over 20 returns;

(6) In tax year 2011, a total of $128,042 was claimed over 33 returns;

(7) In tax year 2012, a total of $360,758 was claimed over 30 returns;

(8) In tax year 2013, a total of $354,504 was claimed over 28 returns;

(9) In tax year 2014, a total of $618,330 was claimed over 46 returns;

(10) In tax year 2015, a total of $160,137 was claimed over 48 returns; and

(11) In tax year 2016, a total of $308,858 was claimed over 61 returns.

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

(1) In tax year 2006, a total of $162,535 was claimed over 5 returns;

(2) In tax year 2007, a total of $223,366 was claimed over 8 returns;

(3) In tax years 2008 and 2009, the amount claimed cannot be disclosed due to confidentiality restrictions because the exemption was claimed on fewer than 5 returns;

(4) In tax year 2010, a total of $710,053 was claimed over 5 returns;

(5) In tax years 2011 through 2015, the amount claimed cannot be disclosed due to confidentiality restrictions because the exemption was claimed on fewer than 5 returns; and

(6) In tax year 2016, the exemption was not claimed on any corporate income tax returns.

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

Information (Appendix B) regarding job creation was provided by the Department of Commerce on December 14, 2017.

3. Negative impacts created as a result of the incentive:

The committee continues to assess whether negative impacts have resulted from the use of the incentive.

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

The committee continues to assess whether out-of-state benefits have resulted from the use of the incentive.

5. Testimony from interested parties:

The committee has yet to receive testimony from interested parties in favor of retaining or eliminating the incentive.

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