POLITICAL SUBDIVISION TAXATION COMMITTEE

The Political Subdivision Taxation Committee was assigned four studies for the 2015-16 interim.

- Section 1 of 2015 Senate Bill No. 2057 directed the study of economic development tax incentives as provided in North Dakota Century Code Section 54-35-26.
- Section 12 of 2015 Senate Bill No. 2206 directed the study of transferring the costs of operating social services programs from county property tax levies to general fund appropriations.
- Section 1 of 2015 House Bill No. 1401 directed a study of the application of sales and use tax to purchases made by a contractor on behalf of an exempt entity.
- The Chairman of the Legislative Management directed the committee to study the income tax reciprocity agreement between North Dakota and Montana.

The Legislative Management directed the committee to receive two reports:

- An annual report from the Department of Commerce's Division of Community Services on renaissance zone progress, pursuant to Section 40-63-03(2).
- An annual report from the Department of Commerce compiling reports from cities that have renaissance zone property included in a tax increment financing district, pursuant to Section 40-63-03(10).

Committee members were Representatives Jason Dockter (Chairman), Larry Bellew, Mark A. Dosch, Craig Headland, Kathy Hogan, Lawrence R. Klemin, Ben Koppelman, William E. Kretschmar, Mike Lefor, Alisa Mitskog, Gail Mooney, Naomi Muscha, Mike Nathe, Nathan Toman, and Robin Weisz and Senators Brad Bekkedahl, Randall A. Burckhard, Dwight Cook, Jim Dotzenrod, Tim Mathern, and Jessica Unruh.

ECONOMIC DEVELOPMENT TAX INCENTIVES STUDY

Background

Section 54-35-26 provides for the review of specified economic development tax incentives by a Legislative Management interim committee. The Political Subdivision Taxation Committee was selected to review tax incentives during the 2015-16 interim.

The 2013-14 interim Taxation Committee studied state economic development tax exemptions, including consideration of whether a regular review process should be established for state economic development tax incentives to ensure regular consideration of whether incentives are serving the intended purpose for which they were created.

The committee received testimony from multiple parties to determine the best methods for evaluating tax incentives. The committee received testimony from a representative of The Pew Charitable Trusts regarding evaluation methods the organization had observed in other states and the effectiveness of those methods in evaluating tax incentives. The committee also arranged a panel discussion comprised of representatives from the City of Bismarck, The Pew Charitable Trusts, the Economic Development Association of North Dakota, and the Department of Commerce to further assess the best methods for evaluating incentives.

The committee reviewed data provided by representatives of the Tax Department and the Department of Commerce regarding the use of various tax credits, including a review of the number of claimants and amounts claimed. The committee also considered reviewing incentives in light of the original purpose for which the incentive was enacted. The committee acknowledged some credits were created at a time when the state was seeking to create jobs, a purpose which may no longer be necessary during times in which the economy is booming.

The bill that resulted from the committee's deliberations was Senate Bill No. 2057, which created Section 54-35-26.

Tax Incentive Evaluation Law

Section 54-35-26 directs a detailed analysis of 21 specified economic development tax incentives to ensure each incentive is serving the purpose for which it was created in a cost-effective and equitable manner. Each of the 21 incentives are to be reviewed within a 6-year period.

The interim committee is required to identify the incentives selected for review during the interim by October 1 of each odd-numbered year and identify the perceived goals of the Legislative Assembly in creating or altering each of the selected incentives and the data and testimony required to conduct an effective analysis of each incentive. The committee is required to take into account any or all of the following considerations relevant to the perceived goals of the incentives:

1. The extent of achievement of the goals of the incentive and whether unintended consequences have developed in its application.
2. Whether the design and application of the incentive can be improved.
3. The extent of complementary or duplicative effect of other incentives or governmental programs.
4. Whether the incentive has a positive influence on business behavior or rewards business behavior that is likely to have occurred without the incentive.
5. The effect of the incentive on the state economy, including the extent of primary sector operation of the recipient and any competitive disadvantage imposed or benefit conferred on other state businesses, any benefit or burden created for local government, and the extent of the incentive's benefit that flows to out-of-state concerns.
6. The employment opportunities generated by the incentive and the extent those represent career opportunities.
7. Whether the incentive is the most effective use of state resources to achieve desired goals.
8. If the committee's analysis of the incentive is constrained by lack of data, whether statutory or administrative changes should be made to improve collection and availability of data.

Incentives Selected for Review During the 2015-16 Interim

In selecting the incentives to be reviewed during the 2015-16 interim, the Political Subdivision Taxation Committee received input from representatives of the Department of Commerce and the Tax Department regarding incentives for first-round study selection. The committee reviewed incentives set to expire in 2017, all income tax incentives, and the manufacturing automation equipment tax credit.

Specifically, the committee selected the following 14 of the 21 incentives listed in Section 54-35-26:

1. Seed capital investment tax credit.
2. Angel fund investment tax credit.
3. Manufacturing automation equipment tax credit.
4. Wage and salary credit.
5. Microbusiness credit.
6. Soybean or canola crushing facility construction or retrofit credit.
7. Agricultural commodity processing facility investment tax credit.
8. Biodiesel fuel production facility construction or retrofit credit, biodiesel fuel blending credit, and biodiesel fuel equipment credit.
9. Renaissance zone credits and exemptions.
10. Research expense credit.
11. Internship program credit.
12. Workforce recruitment credit.
13. New jobs credit from income tax withholding.
14. New or expanding business exemption.

The committee also included the following four incentives in its review for the 2015-16 interim:

1. Telecommunications infrastructure sales tax exemption.
2. Electrical generating facilities sales tax exemption.
3. Certified nonprofit development corporation investment tax credit.
4. Geothermal, solar, wind, and biomass energy device tax credit.

The committee received background information for each of the selected incentives, which provided an explanation of the incentive, the perceived intent of the Legislative Assembly in creating or altering each incentive, and the data and testimony required to effectively review each incentive. To track its progress in receiving information necessary to determine whether incentives were meeting the purposes for which they were enacted, the committee also reviewed an evaluation chart listing the 18 selected incentives and the 8 considerations to be taken into account when reviewing each incentive.

Seed Capital Investment Tax Credit

Explanation of the 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 must be at risk in the qualifying business for at least 3 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, with substantial interests 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 4 taxable years. Credits determined at the passthrough entity level must be 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 Department of Commerce 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 exceed 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 in Creating or Altering the Credit

Provisions relating to the seed capital investment tax credit were first enacted in 1993. 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 the enactment of the seed capital investment tax credit, the perceived goal of the Legislative Assembly in creating the 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 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 in 2001 to increase 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. An organization that 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 could also be classified as a qualified business.

The credit was amended in 2003 to eliminate the $250,000 limit per qualifying business and increase the available credit amount from 30 to 45 percent the amount of the qualifying investment. Amendments in 2005 further expanded the credit to allow it to be claimed by corporations and passthrough entities. Changes in 2005 also limited qualified investments in a qualified business for which a credit could be claimed to a maximum of $500,000. Changes to the credit in 2007 expanded the credit to allow investments by an angel fund to be eligible for the seed capital investment tax credit and reduced the maximum amount that could be claimed by a taxpayer to $112,500 per year. Provisions regarding certification of a qualified business by the Department of Commerce were also revised.

Testimony and Committee Considerations

The committee received information from representatives of the Tax Department regarding the number of taxpayers claiming the seed capital investment tax credit and the total amount of credits claimed. The number of taxpayers claiming the credit dropped substantially following the enactment of the angel fund investment tax credit. The credit was claimed on nearly 700 individual income tax returns in tax year 2006 and claimed on only 74 individual income tax returns in tax year 2014. The committee received information from representatives of the Department of Commerce indicating investors had earned credits totaling $14,530,233 since 2002 for investments in 70 companies. Of those 70 companies, 47 are still in operation. Information indicated the total direct, indirect, and induced employment related to the credit amounted to 655 jobs in 2014. The cost of offering the incentive as compared to the increase in state tax revenue resulting from the availability of the incentive equated to a 14.6 percent annual rate of return in 2014. The committee reviewed information indicating incentives similar to the seed capital investment tax credit are available in seven other states.

The committee received testimony from interested parties in favor of retaining the seed capital investment tax credit, including representatives of the Economic Development Association of North Dakota and the North Dakota State University Research and Technology Park. The committee also received testimony from business owners who received investments prompted by the availability of the credit. Testimony provided in favor of the credit indicated the credit is an important tool for supporting entrepreneurship, innovation, and startup companies in this state.

Committee members expressed a preference for the transparency provided in the seed capital program as compared to the angel fund program as it related to investments qualifying for the tax credit. Committee members also favored the assurances provided in the seed capital program that investments qualifying for a tax credit would be made in companies located in this state or in companies having current or projected substantial ties to this state. Committee members favored the seed capital's investment tax credit structure which only allowed an investor to receive a tax credit once an investment was actually received by a qualified business.

The committee also reviewed the definition of "primary sector business," as used in the seed capital investment tax credit and which is defined in nine sections of Century Code. The committee considered a bill draft to provide for a uniform definition of primary sector business. The committee received information from representatives of the Department of Commerce regarding the department's certification of primary sector businesses and a proposed definition for the creation of "new wealth." The committee reviewed a revised version of the bill draft which adds a definition for primary sector business to Title 1 of Century Code. The new definition requires a business to be certified by the Department of Commerce and employ knowledge or labor to add value to a product, process, or service to create new wealth. The bill draft defines "new wealth" as revenue generated by a business in this state through the sale of products or services to customers outside of this state or to customers in this state if the product was previously unavailable or difficult to obtain in this state.

Angel Fund Investment Tax Credit

Explanation of the Credit

Section 57-38-01.26 provides for an angel fund investment tax credit. The incentive is available to all income taxpayers and allows for a credit against state income tax liability for investments made in an angel fund. A taxpayer may claim 45 percent of the amount remitted to each angel fund during the taxable year, up to an aggregate maximum amount of $45,000 per year. The amount of the credit an individual, married couple, passthrough entity and its affiliates, or other taxpayer is allowed to claim is capped at a lifetime limit of $500,000 in cumulative credits. An investment used to calculate an angel fund credit may not be used to calculate any other income tax deduction or credit.

A qualifying investment must be at risk in an angel fund for at least 3 years. Investments placed in escrow will not qualify for the credit. The credit must be claimed in the taxable year in which the investment is received by the angel fund. The amount of the credit claimed may not exceed the taxpayer's income tax liability. The amount of credit exceeding a taxpayer's liability may be carried forward to each of the 7 succeeding taxable years. A taxpayer claiming this credit may not claim a credit resulting from an investment made by an angel fund in a qualified business for purposes of the seed capital or agricultural commodity processing facility investment tax credit.

Section 57-38-01.26 identifies the types of entities that may form an angel fund and provides a fund must be organized for the purpose of investing in at least three primary sector companies that are early and mid-stage private, nonpublicly traded enterprises with strong growth potential. An angel fund must consist of at least six accredited investors and may not have more than 25 percent of its capitalized investment assets owned by an individual investor. The angel fund must have at least $500,000 in commitments from accredited investors which is subject to call to be invested over an unspecified number of years to build a portfolio of investments in enterprises. The angel fund must be member-managed or a manager-managed limited liability company and decisions regarding enterprises worthy of investment must be made on a group basis. The angel fund must be certified by the Department of Commerce and be in compliance with the security laws of this state.

Within 30 days of receiving an investment, an angel fund must file with the Tax Commissioner information identifying the taxpayer or passthrough entity making the investment, the amount of the investment, and the date payment was received by the angel fund for the investment. The angel fund also must file a report with the Tax Commissioner within 30 days following the end of each year supplying the name and principal place of business of each enterprise in which the angel fund has an investment. The Tax Commissioner may disclose to the Legislative Management the dollar amount remitted by each taxpayer or passthrough entity to an angel fund and the date each payment was received by the angel fund for the investment. The Tax Commissioner also may disclose to the Legislative Management information provided by the angel fund pertaining to the principal place of business of each enterprise in which the angel fund has an investment.

An angel fund is restricted from investing in an enterprise if any one angel fund investor, partner, shareholder, or member of a passthrough entity directly or indirectly owns more than 49 percent of the ownership interests in the enterprise. Investors are prohibited from receiving more than $5 million in aggregate credits from investments in a single angel fund during the life of the fund. A passthrough entity entitled to a 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. Provisions regarding the sale, assignment, or transfer of the credit, were available only for investments made in the 2011 and 2012 tax years.

Perceived Goals in Creating or Altering the Credit

Provisions related to the angel fund investment tax credit were enacted in 2007. The perceived goal of the Legislative Assembly in creating the credit was to encourage investment in startup businesses by offering a tax credit to angel fund investors. The credit was described as an extension of the seed capital tax credit and was intended to stimulate private investment and grow startup or early stage companies. Companies targeted by angel fund investments were thought to be smaller companies that carried high-risk but also high-growth potential. The angel fund investment tax credit was viewed as a tool to create and maintain quality jobs and diversify a community's economic base. The estimated fiscal effect of the angel fund investment credit could not be determined during the 2007 legislative session.

Additional requirements were imposed on angel funds in 2009, including the requirement an angel fund be headquartered in this state; consist of at least six accredited investors, with no one investor owning more than 25 percent of the capitalized investment assets; have at least $500,000 in commitments from accredited investors; invest in a portfolio of at least three early or mid-stage private, nonpublicly traded enterprises; be member-managed; be certified by the Department of Commerce; and be in compliance with state securities laws. Angel funds were prohibited from investing in an enterprise if one angel fund investor owned more than 49 percent of the enterprise and the aggregate amount of credits that could be received by investors in a single angel fund was capped at a lifetime limit of $5 million.

The total lifetime amount of credits a taxpayer could obtain was placed at $150,000 per taxpayer in 2011 and the carryforward period for unused credits was extended from 4 to 7 years. Passthrough entities were added to the list of taxpayers able to claim the credit and up to $100,000 of an investor's credits were allowed to be sold or transferred to another taxpayer in the hopes of attracting more out-of-state capital to North Dakota. Reporting provisions also were added in 2011 requiring the Tax Commissioner to report to the Legislative Management during the 2011-12 and 2013-14 interims the number of in-state and out-of-state investors; the amount of each investment; and the amount of tax credits accrued, claimed, and transferred by each individual angel fund.

The lifetime credit limit was increased from $150,000 per taxpayer to $500,000 per taxpayer in 2013 and restrictions were added prohibiting angel funds from investing in real estate or real estate holding companies. Any angel fund making these types of investments, and certified before January 1, 2013, would be barred from being recertified.

Testimony and Committee Considerations

The committee received information from representatives of the Tax Department detailing the amount claimed in each tax year for the angel fund investment tax credit and the number of claimants. The committee also received information regarding angel funds from representatives of the Department of Commerce. Twenty-one angel funds have been certified by the Department of Commerce and since 2011, these angel funds have received investments that have earned investors $16,680,982 in income tax credits. The 21 angel funds certified by the department have invested in a total of 116 companies, 61 of which are North Dakota based and 55 of which were identified as out-of-state companies. Reporting requirements applicable to angel funds do not require angel funds to list the amount invested in each company. Limited information regarding the companies receiving angel fund investments also made it difficult for the committee to determine the amount of the credit's benefit that flows to out-of-state concerns. Incentives similar to the angel fund investment tax credit are found in 11 other states. Testimony regarding the angel fund credit available in Minnesota indicated nearly all available credits are being claimed under Minnesota's program despite the program restricting investments to in-state businesses.

The committee considered a bill draft that would have restricted angel funds from investing in an enterprise having its principal place of business located outside this state for purposes of an investment qualifying for the credit. The committee received testimony from angel fund industry representatives in opposition to eliminating an angel fund's ability to invest in out-of-state businesses for purposes of qualifying for the credit. Testimony indicated angel funds often syndicate deals with networks outside this state and investments in out-of-state companies can come back to add value to this state. Committee members cited examples of businesses that had benefited from out-of-state investments coming back to this state.

The committee considered multiple versions of a bill draft that would have required angel funds to invest in qualified businesses for purposes of angel fund investments qualifying for the credit and would have required the Director of the Department of Commerce to certify qualified businesses and make a list of qualified businesses publicly available. The bill draft would have added reporting requirements pertaining to the amount invested in qualified businesses and the date on which investments qualifying for the credit were received by a qualified business. The bill draft also would have incorporated additional compliance tools for the Tax Department and the Department of Commerce.

The committee considered a bill draft to sunset the availability of the angel fund investment tax credit for investments made after December 31, 2017, and increase allowable credit amounts and carryforward periods related to the seed capital investment tax credit. The bill draft allows angel funds to receive a credit for investments made through the seed capital investment tax program and amends provisions relating to the seed capital program by increasing the maximum amount of the credit allowed for all claimants from $3,500,000 to $15,000,000 per calendar year. The maximum amount that may be claimed per taxpayer also is increased from $112,500 to $225,000 per year and the carryforward period for any unused credits is expanded from 4 to 7 years. The maximum amount of qualified investments that may be received by a qualified business for all tax years is increased from $500,000 to $4,000,000 and additional reporting requirements are imposed on a qualified business to ensure the business continues to meet certain requirements in the 5-year period following the receipt of an investment qualifying for the tax credit.

The committee received testimony in favor of retaining the angel fund investment tax credit, including testimony from the Mayor of Jamestown, representatives of the Economic Development Association of North Dakota, the North Dakota State University Research and Technology Park, the University of North Dakota Center for Innovation Foundation, Great River Energy, the Midwest AgEnergy Group, and various business owners and angel fund representatives. The testimony indicated the credit is an important tool for supporting entrepreneurship, innovation, and startup companies in this state. Some individuals viewed the credit as a tool to create an equity capital industry in this state.

Some committee members expressed concern the intent of the credit was being misinterpreted. Committee members also expressed discomfort with a lack of transparency regarding where investment funds qualifying for the credit were being invested. Committee members highlighted a lack of restrictions attached to the credit's provisions which allowed investments by angel funds to be made for nearly any purpose with the exception of investments in real estate. Committee members reviewed information highlighting instances in which angel fund investments may have been made improperly in real estate ventures. Some committee members contended it did not appear angel funds were investing in the types of high-risk companies the Legislative Assembly intended angel funds to invest when the credit was enacted. Although committee members expressed appreciation for the risk angel fund investors are taking in investing in high-risk businesses, it was noted other taxpayers are taking a risk in subsidizing a 45 percent tax credit.

Electrical Generating Facilities Sales Tax Exemption

Explanation of the Exemption

Sections 57-39.2-04.2 and 57-40.2-04.2 provide a sales and use tax exemption for purchases of production equipment, building materials, and other tangible personal property used to add environmental upgrades or to construct or expand certain electrical generating facilities. The exemption is available for purchases used to upgrade, construct, or expand a wind-powered electrical generating facility if the facility will be completed before January 1, 2017, and has at least one single electrical energy generation unit with a nameplate capacity of 100 kilowatts or more. The exemption also is available for purchases used to upgrade, construct, or expand a coal-powered electrical generating facility if the facility converts coal from its natural or beneficiated form into electrical power and has at least one single electrical generation unit with a capacity of 50,000 kilowatts or more. For facilities powered by sources other than coal or wind, the exemption is available for purchases used to upgrade, construct, or expand an electrical generation facility if the facility produces electricity for resale or for consumption in a business activity and has at least one single electrical generation unit with a capacity of 100 kilowatts or more.

A facility operator may receive the sales tax exemption at the time of purchase if the operator applies for and receives a certificate from the Tax Commissioner verifying the materials the operator intends to purchase qualify for the exemption. If a certificate of exemption is not received prior to the operator making a purchase, the operator may apply to the Tax Commissioner for a refund of the applicable amount of tax paid. If a contractor purchases or installs the tangible personal property or equipment, the facility operator may apply for a refund of the amount of sales or use tax paid by the contractor on qualifying items.

Perceived Goals in Creating or Altering the Exemption

Provisions relating to a sales and use tax exemption for purchases of production equipment and property used to construct a coal-powered electrical generation facility were enacted in 1991. The exemption was expanded in 2001 to extend to purchases made by operators of wind-powered electrical generating facilities completed before January 1, 2011, with a nameplate capacity of 100 kilowatts or more and at least one single electrical energy generation unit. The perceived goal of the Legislative Assembly in providing this exemption was to encourage economic development through the construction of new electrical generating facilities. In estimating the fiscal impact of the exemption, it was determined each wind tower could qualify for a sales tax exemption of approximately $30,000 based on the assumption materials subject to the exemption would cost roughly $600,000 per wind tower.

In 2005 the exemption was expanded to apply to machinery and equipment used to reduce emissions, increase efficiency, or enhance reliability at a new or existing oil refinery or gas processing plant. The exemption also was expanded to production equipment and materials purchased by a power plant operator for purposes of environmental upgrades or repowering. The definition of a "power plant" was broadened in 2007 to include any other types of electrical generating facility in addition to coal-powered and wind-powered electrical generating facilities. The exemption also was expanded to power plants using any type of coal, rather than only lignite coal. The capacity required for a power plant to receive the sales tax exemption was reduced and the exemption was allowed to be claimed upfront by a contractor. It was estimated the changes made in 2007 would result in a $2.4 million reduction in general fund revenues during the 2007-09 biennium based on the four qualifying plants under construction at that time.

In 2009 the exemption was amended to apply to purchases of equipment used by an electrical generating plant that converts beneficiated coal into electrical power. The deadline for purchasing materials used in the construction or expansion of a wind-powered facility was extended through December 31, 2014. The deadline for purchases relating to wind-powered facilities was extended in 2013 through December 31, 2016. The July 1, 2017, sunset date pertaining to the exemption for purchases made by operators of electrical generating plants converting beneficiated coal into electric power was removed in 2015.

Testimony and Committee Considerations

The committee selected the electrical generating facility sales tax exemption for review due to the July 1, 2017, sunset date associated with the sales tax exemption for materials used to construct or expand a wind-powered electrical generating facility. The amount of the sales tax exemption realized by all claimants from fiscal year 2011 to fiscal year 2015 could not be disclosed by representatives of the Tax Department due to confidentiality restrictions because fewer than five claimants utilized the exemption in each fiscal year. The committee received information from the Department of Commerce relating to a cost-benefit analysis pertaining to the wind-powered electrical generating facility exemption. The Department of Commerce used economic modeling and publically available data to estimate the costs and benefits associated with the exemption to be approximately $10.5 million, and estimated a 50 percent return on this cost within the first 2 years. The rate of return for each year thereafter was estimated at 7 percent per year. Incentives similar to the electrical generating facilities sales tax exemption are found in six other states.

The committee received testimony from representatives of the EmPower North Dakota Commission, Economic Development Association of North Dakota, Lignite Energy Council, and several representatives of the electrical generation industry expressing support for extending or eliminating the sunset date related to the wind-powered facility sales and use tax exemption. Testimony in favor of the exemption indicated the exemption has resulted in millions of dollars of savings for North Dakota ratepayers and has allowed the state to remain competitive with surrounding states. Testimony in favor the exemption would contend the exemption continue to be important in future years, especially in light of some of the changes that may occur as a result of the federal Environmental Protection Agency's Clean Power Plan. Committee members generally stressed the importance of refraining from making any recommendations that may hinder an individual's ability to obtain affordable electricity.

Because a bill draft was prepared for consideration by the interim Energy Development and Transmission Committee to remove the expiration date associated with the sales and use tax exemption for materials used to construct wind-powered electrical generating facilities, the committee did not consider a bill draft relating to the exemption.

Telecommunications Infrastructure Sales Tax Exemption

Explanation of the Exemption

Sections 57-39.2-04.9 and 57-40.2-03.3 provide a sales and use tax exemption for purchases of tangible personal property used to construct or expand telecommunications service infrastructure capable of providing telecommunications service in this state. The tangible personal property must be incorporated into telecommunications infrastructure owned by a telecommunications company to qualify for the exemption. A purchaser may receive the sales tax exemption at the time of purchase if the purchaser applies for and receives a certificate from the Tax Commissioner verifying the tangible personal property the purchaser intends to purchase qualifies for the exemption. If a certificate of exemption is not received before the purchase, the telecommunications company may apply to the Tax Commissioner for a refund of the applicable amount of tax paid. If a contractor purchases or installs the tangible personal property, the telecommunications company may apply for a refund of the amount of sales or use tax paid by the contractor on qualifying items. The exemption is effective for purchases made through June 30, 2017.

Perceived Goals in Creating or Altering the Exemption

Provisions relating to the telecommunications infrastructure sales tax exemption were first discussed by the 2005-06 interim Economic Development Committee, which indicated business development may be hindered in areas of the state which lacked wireless service. Provisions relating to the telecommunications infrastructure sales tax exemption were first enacted in 2009 following a 2008-09 interim Industry, Business, and Labor Committee study of issues relating to wireless service providers and the impact of wireless service on the business climate in this state. The perceived goal of the Legislative Assembly in creating the exemption was to encourage telecommunications companies to expand telecommunications service infrastructure in the state. The exemption was viewed as a tool to help enhance business opportunities in rural areas. It was estimated the telecommunications infrastructure sales tax exemption would result in a reduction of $5.15 million in general fund and state aid distribution fund revenues during the 2009-11 biennium. The exemption was extended in 2011 to apply to taxable events occurring through December 31, 2012. The exemption was extended in 2013 to retroactively apply to purchases made after December 31, 2012, and through July 1, 2017. It was estimated the telecommunications infrastructure sales tax exemption would result in a reduction of $6.44 million in general fund and state aid distribution fund revenues during the 2011-13 and 2013-15 bienniums.

Testimony and Committee Considerations

Because the exemption is set to expire on July 1, 2017, the committee selected the telecommunications infrastructure sales tax exemption for review. The committee received information from representatives of the Tax Department detailing the amount of the exemption claimed in each tax year and the number of claimants. Incentives similar to the state's telecommunications infrastructure sales tax exemption are found in four other states. The Council of State Governments published an article highlighting how North Dakota has become a leader in the deployment of fiber optic Internet, and the National Conference of State Legislatures also highlighted the exemption provisions as an example after which other state's should model incentives.

The committee reviewed a bill draft to eliminate the sunset date attached to the telecommunications infrastructure sales tax exemption. The committee received comments from representatives of the Economic Development Association of North Dakota, North Dakota Association of Telecommunications Cooperatives, Information Technology Council of North Dakota, and several industry representatives in support of the bill draft. Testimony indicated the incentive assists in the deployment of resources to facilitate business operations across the state as well as citizen's use of the Internet.

Manufacturing Automation Equipment Income Tax Credit

Explanation of the Credit

Section 57-38-01.33 provides an income tax credit for purchases of manufacturing machinery and equipment for the purpose of automating a manufacturing process in this state. The incentive is available to any income taxpayer certified by the Department of Commerce as a primary sector business. A primary sector business is defined as a business that employs knowledge or labor to add value to a product, process, or service that results in the creation of new wealth. The credit is equal to 20 percent of the cost of the manufacturing machinery and equipment purchased in the taxable year for purposes of automating a manufacturing process. Qualified expenditures for purchases of manufacturing machinery and equipment used to calculate the automation tax credit may not be used to calculate any other income tax deduction or credit allowed under Chapter 57-38.

Qualifying manufacturing machinery and equipment means new or used automation and robotic equipment. A qualifying purchase of manufacturing machinery and equipment includes items acquired under a capital lease, but only for the taxable year in which the lease was executed. Items acquired under a capital lease will be valued at fair market value at the time the lease was executed for purposes of calculating the credit. The credit must be claimed in the taxable year in which the manufacturing machinery and equipment was purchased and the amount of the credit claimed may not exceed the taxpayer's income tax liability. Any credit amount exceeding a taxpayer's liability may be carried forward to each of the 5 succeeding taxable years.

The aggregate amount of allowed credits may not exceed $2,000,000 in calendar year 2015 and $500,000 in each year for calendar years 2016 and 2017. Any credits unclaimed at the end of a calendar year may be carried forward for dispersal in the succeeding calendar year. If credits in excess of the available amount are claimed, the Tax Commissioner is required to prorate the available credits among all claimants. Taxpayers filing a consolidated return may claim the credit against the aggregate North Dakota tax liability of all corporations included on the return. 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.

The Department of Commerce is required to provide the Tax Commissioner the name, address, and federal identification number or social security number of each taxpayer approved as qualifying for the credit. The Department of Commerce also must provide the Tax Commissioner with a list of any items approved as qualified expenditures. The taxpayer must provide the Tax Commissioner the name, address, and federal identification number or social security number of the taxpayer making the purchase as well as a list of each item of machinery or equipment purchased for purposes of automation, the amount paid for each item, and the date on which payment for the item was made. This information must be provided with the taxpayer's return.

Perceived Goals in Creating or Altering the Credit

Provisions relating to an automation income tax credit for purchases of manufacturing machinery and equipment used to automate a manufacturing process were first discussed by the 2009-10 interim Workforce Committee as a result of the committee's study of technology-based entrepreneurship and economic development best practices. Provisions relating to the credit were enacted in 2011, but were made effective for the future tax years of 2013 through 2015. The credit was equal to 20 percent of costs incurred and the aggregate amount of credits allowed for all taxpayers was capped at $2 million in any calendar year. The perceived goals of the Legislative Assembly in creating this credit were to allow North Dakota manufacturing businesses to remain competitive, to advance the manufacturing sector, and to foster continued production in a labor constrained environment. The credit was amended in 2015 to extend through taxable year 2017; however, the previous $2,000,000 annual credit cap was reduced to $500,000 per year for calendar years 2016 and 2017. Distribution of the credit also was changed from a first-come first-serve basis to a system in which credits are prorated among all claimants. Any credit amounts left unclaimed at the end of the calendar year may be carried forward for distribution in the succeeding calendar year.

Testimony and Committee Considerations

Because the credit is set to expire at the end of 2017, the committee selected the manufacturing automation equipment income tax credit for review. The committee received information from representatives of the Department of Commerce indicating all $2,000,000 in available credits were awarded in calendar years 2013 and 2014, and $978,957 in credits were awarded in calendar year 2015 for a total amount of $4,978,957 awarded to 23 companies over the 3-year period. Incentives similar to the manufacturing automation equipment credit are found in seven other states.

The committee considered a bill draft to eliminate the sunset date attached to the manufacturing automation equipment income tax credit. The committee received comments from representatives of the Economic Development Association of North Dakota and the Greater Fargo/Moorhead Economic Development Corporation in support of the bill draft. Testimony in favor of continuing the credit highlighted success stories related to businesses using the automation tax credit and noted the credit is particularly important during times in which businesses face challenges recruiting and retaining a skilled workforce. The committee also received testimony expressing a desire to see the yearly amount of the credit restored to the $2 million threshold. Some committee members questioned whether economics drive a company's decision to automation more so than the availability of a tax incentive.

Certified Nonprofit Development Corporation Investment Tax Credit

Explanation of the Credit

Sections 10-33-124 and 57-38-01.17 provide a certified nonprofit development corporation investment credit. The income tax credit is available to corporate income taxpayers, with the exception of subchapter S corporations, in an amount equal to 25 percent of the amount paid for dues, membership fees, or contributions to a certified nonprofit development corporation. A taxpayer may claim no more than $2,000 in credits over any combination of taxable years and may carry forward any unused credits for up to 7 taxable years. A nonprofit development corporation must apply to the Secretary of State for certification; invest the majority of its funds in a primary sector business; and may not distribute any part of its income to its members, directors, or officers. For purposes of the credit, a primary sector business is a business that adds value to a product produced for resale through a process employing knowledge and labor. A certified nonprofit development corporation must file a form with the Tax Commissioner identifying each contributing taxpayer and the amount remitted within 30 days of receiving taxpayer funds. The contributing taxpayer must attach a copy of this form when claiming the credit.

Perceived Goals in Creating or Altering the Credit

Provisions relating to the certified nonprofit development corporation investment tax credit were enacted in 1989 and have remained substantially unchanged since enactment. The only notable changes to the credit included removing the ability of individuals, estates, trusts, and S corporations to claim the credit; making modifications in 1997 as part of the rewrite pertaining to the Nonprofit Corporations Act; and adding various reporting requirements in 2009.

Testimony and Committee Considerations

The committee received information from representatives of the Tax Department regarding the number of claimants and amount claimed in relation to the credit and indicated the credit was not claimed on any tax returns in tax years 2006 through 2014. The Secretary of State has certified eight nonprofit development corporations in this state. Credits similar to the certified nonprofit development corporate income tax credit are found in eight other states. The committee did not receive comments from parties supporting continuation of the credit. The committee considered a bill draft to repeal the certified nonprofit development corporate income tax credit due to the infrequency in which the credit is claimed and the lack of public interest in continuing the credit. The committee received testimony from a representative of the Economic Development Association of North Dakota in support of repealing the credit.

Wage and Salary Income Tax Credit

Explanation of the Credit

Section 57-38-30.1 provides for a corporate income tax credit for new industry, which is defined as "a corporate enterprise engaged in assembling, fabricating, manufacturing, mixing, or processing of any agricultural, mineral, or manufactured products or any combination thereof." The taxpayer must be a domestic corporation, which is not the result of a business reorganization or acquisition, incorporated in this state for the first time after January 1, 1969, or a foreign corporation that has received a certificate of authority to transact business in this state after January 1, 1969. The amount of the credit is equal to 1 percent of wages and salaries paid by the corporate income taxpayer in each of the first 3 tax years of operation and in an amount equal to one-half of 1 percent of wages and salaries paid by the taxpayer during tax years 4 and 5 of operation. A corporation receiving a property or income tax exemption pursuant to Chapter 40-57.1 as a new and expanding business is not eligible to receive the credit.

Perceived Goals in Creating or Altering the Credit

Provisions relating to a corporate income tax credit for new industry were enacted in 1969 and have remained substantially unchanged since enactment. The perceived goal of the Legislative Assembly in creating this credit was to provide an incentive to encourage new industry to locate to this state. The estimated fiscal effect of the corporate income tax credit for new industry could not be determined during the 1969 legislative session. The credit has been used very infrequently since its enactment.

Testimony and Committee Considerations

The committee received information from representatives of the Tax Department regarding the number of claimants and amount claimed in relation to the credit and learned the credit was claimed on less than five corporate income tax returns per year in tax years 2006 through 2010, and was not claimed on any tax returns in tax years 2011 through 2014. The inability of a corporation claiming a property or income tax exemption as a new or expanding business to also claim this credit was identified as a potential contributing factor to the lack of use of the credit. Credits similar to the wage and salary credit are found in 13 other states. The committee did not receive comments from parties supporting continuation of the wage and salary credit. The committee considered a bill draft to repeal the wage and salary credit due to the infrequency in which the credit is claimed and the lack of public interest in continuing the credit. The committee received testimony from a representative of the Economic Development Association of North Dakota in support of repealing the wage and salary credit.

Microbusiness Income Tax Credit

Explanation of the 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. The Department of Commerce is limited to certifying no more than 200 microbusinesses. 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, 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. 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 5 succeeding taxable years, but a taxpayer is limited to claiming no more than $10,000 in credits over any combination of taxable years. "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 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. "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.

Perceived Goals in Creating or Altering the Credit

Provisions relating to the microbusiness income tax credit were enacted in 2007. The credit 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. 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 $2,000,000 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.

Testimony and Committee Considerations

The committee received information from representatives of the Tax Department regarding the number of claimants and amount claimed in relation to the credit which indicated the credit was claimed on fewer than five individual income tax returns per year in tax years 2007 through 2014, and was not claimed on any corporate income tax returns in tax years 2007 through 2014. Credits similar to the microbusiness income tax credit are found in 13 other states. The committee did not receive testimony supporting continuation of the microbusiness income tax credit. The committee considered a bill draft to repeal the microbusiness income tax credit due to the infrequency in which the credit is claimed and the lack of public interest in continuing the credit. The committee received testimony from a representative of the Economic Development Association of North Dakota in support of repealing the microbusiness income tax credit.

Soybean or Canola Crushing Facility Construction or Retrofit Income Tax Credit

Explanation of the Credit

Section 57-38-30.6 provides for a soybean or canola crushing facility construction or retrofit credit. The incentive is available to corporate income taxpayers and allows for a credit against state income tax liability in the amount of 10 percent per year for 5 years of the taxpayer's direct costs incurred after December 31, 2008, to adapt or add equipment to retrofit an existing facility or to construct a new facility in this state for the purpose of producing crushed soybeans or canola. Credit amounts exceeding a taxpayer's liability may be carried forward to each of the 5 succeeding taxable years, but a taxpayer is limited to claiming no more than $250,000 in credits over any combination of taxable years. Eligible costs incurred by a taxpayer before a facility begins crushing soybeans or canola may not be claimed for purposes of the credit until taxable years on or after crushing begins.

Perceived Goals in Creating or Altering the Credit

Provisions relating to construction or retrofit income tax credits were enacted in 2003. As enacted, Section 57-38-30.6 provided a corporate income tax credit for costs incurred to adapt or add equipment to retrofit an existing facility or construct a new facility in this state for the purpose of producing or blending diesel fuel containing at least 2 percent biodiesel fuel by volume. The credit was expanded in 2009 to apply to the costs incurred to adapt or add equipment to retrofit an existing facility or construct a new facility in this state for the purpose of producing crushed soybeans or canola. The perceived goal of the Legislative Assembly in creating this credit was to encourage the modification of existing facilities or the construction of new facilities capable of crushing soybeans or canola to process those commodities in North Dakota rather than shipping them out of state for processing. It was noted large amounts of soybeans were being shipped to neighboring states such as Minnesota and South Dakota for crushing and processing. The credit was viewed as a tool to help build a stronger rural economy in North Dakota. The estimated fiscal effect of the soybean or canola crushing facility construction or retrofit credit could not be determined during the 2009 legislative session.

Testimony and Committee Considerations

The soybean or canola crushing facility construction or retrofit credit has never been claimed. Incentives similar to the credit are found in eight other states. The committee considered bill drafts that would have repealed the soybean or canola crushing facility construction or retrofit credit. The committee received testimony from representatives of the North Dakota Soybean Growers Association, EmPower North Dakota Commission, North Dakota Soybean Council, Department of Commerce, and the Economic Development Association of North Dakota in opposition to the bill drafts. Testimony provided in favor of retaining the credit indicated that although the credit has yet to be claimed, it is beneficial to maintain the availability of the incentive for instances in which an opportunity may arise to attract businesses to this state. Testimony indicated a large soybean processing plant that recently announced plans to locate in South Dakota had considered this state as a potential site of operations; however, other factors contributed to the plant's decision to locate in South Dakota. North Dakota exports 90 percent of its soybean crop for processing outside the state. Proponents of the credit contended there is value in allowing the incentive to continue to prevent the state from being passed over for consideration by future processing plants. The committee discussed the potential benefit of increasing the amount of the credit in consideration of the high cost of equipment used in soybean and canola crushing facilities.

Agricultural Commodity Processing Facility Investment Tax Credit

Explanation of the Credit

Section 57-38.6-03 provides for an agricultural commodity processing facility 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 as an entity organized or incorporated in this state after December 31, 2000, for the primary purpose of being an agricultural commodity processing facility. A qualifying business also must be certified by the Securities Commissioner, be in compliance with North Dakota security laws, and have an agricultural commodity processing facility in this state or intend to locate a facility within this state. An agricultural commodity processing facility consists of a facility that adds value to an agricultural commodity raised in North Dakota or a livestock feeding, handling, milking, or holding operation that uses a byproduct from a biofuels production facility. The credit is equal to 30 percent of the amount of the qualified investment which may consist of direct cash payments, direct cash transfers from a retirement plan, or transfers of a fee simple interest in real property in this state. A qualifying investment must be at risk in the qualifying business for at least 3 years and be in the form of a purchase ownership interest or right to receive payment of dividends from the business. A qualified business must file with the investor, Tax Commissioner, and 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. A taxpayer may claim no more than $50,000 in credits per taxable year and no more than $250,000 in credits over any combination of taxable years. Credit amounts exceeding a taxpayer's liability may be carried forward for up to 10 taxable years following the year in which the investment was made.

Perceived Goals in Creating or Altering the Credit

Provisions relating to the agricultural commodity processing facility investment tax credit were enacted in 2001 and provided a credit to individual income taxpayers for investments in a cooperative or limited liability company organized to process and market agricultural commodities, having an agricultural commodity processing facility in this state, and having a majority of its ownership interests owned by producers of unprocessed agricultural commodities. The maximum annual investment for which the credit was allowed was $20,000 and no more than 50 percent of the credit could be claimed in a single taxable year. The credit also could not exceed 50 percent of the taxpayer's income tax liability. Investments were required to remain in a qualifying business for the same period of time, and be expended for the same purposes, as specified in current law. The perceived goal of the Legislative Assembly in creating this credit was to provide an incentive to encourage investment in value-added processing facilities for North Dakota commodities. The credit was described as a tool that would benefit producers, create jobs, and reduce reliance on federal assistance to maintain farm income. Credits related to the production and sale of ethanol in Minnesota and South Dakota were discussed and it was noted the average cost of constructing an ethanol plant was roughly $40 million. The estimated fiscal effect of the agricultural commodity processing facility investment tax credit could not be determined during the 2001 legislative session.

The credit was broadened in 2005 to allow qualifying investments to be made by corporations and passthrough entities, but the credit was limited to investments made in the first 10 qualifying businesses. The maximum annual credit limit allowed per taxpayer also was increased from $20,000 to $50,000 and the lifetime amount of credit per taxpayer was limited to $250,000. The changes were intended to make the credit more functional and more user-friendly. Carryforward provisions related to the credit were revised in 2007 and extended to 10 years.

Testimony and Committee Considerations

The committee received information from representatives of the Tax Department and the Department of Commerce detailing the amount claimed for the agricultural commodity processing facility investment tax credit and the number of claimants. Seventeen investors in agricultural commodity processing facilities have earned credits totaling $12,497,869 for investments in 23 companies since 2001. Of the 23 companies that received investments, 12 remain in operation. The total direct, indirect, and induced employment related to the credit amounted to 331 jobs in 2014. The cost of offering the incentive as compared to the increase in state tax revenue resulting from the availability of the incentive equated to a 9.5 percent annual rate of return in 2014. Incentives similar to the agricultural commodity processing facility investment tax credit are found in six other states. The committee also received information pertaining to the differences between the soybean and canola crushing facility equipment credit and the agricultural commodity processing facility investment tax credit. The primary difference between the credits centers around the taxpayer receiving the benefit as a company receives the benefit under the first incentive and a taxpayer investing in a company receives the benefit under the second incentive. The soybean and canola crushing facility equipment credit serves to motivate companies to locate to this state, whereas the agricultural commodity processing facility investment tax credit encourages investment in processing facilities already located in this state. The committee received testimony from representatives of the North Dakota Ethanol Producers Association, the North Dakota Association of Rural Electric Cooperatives, and various other industry representatives in support of retaining the investment tax credit.

Biodiesel Income Tax Credits

Explanation of the Credits

A variety of income tax credits are available to taxpayers for the production or sale of biodiesel fuel. Section 57-38-30.6 provides for a biodiesel fuel production facility construction or retrofit income tax credit in the amount of 10 percent per year for 5 years of the taxpayer's direct costs incurred after December 31, 2002, to adapt or add equipment to retrofit an existing facility or to construct a new facility in this state for the purpose of producing or blending diesel fuel containing at least 2 percent biodiesel fuel or green diesel fuel by volume. Lifetime credit limits are capped at $250,000 per taxpayer and credits exceeding a taxpayer's liability may be carried forward to each of the 5 succeeding taxable years.

Section 57-38-01.22 provides for an income tax credit for blending biodiesel fuel or green diesel fuel and is available to a taxpayer licensed by the Tax Commissioner as a fuel supplier who blends biodiesel fuel or green diesel fuel in this state. The amount of the credit is equal to five cents per gallon of biodiesel fuel or green diesel fuel of at least a 5 percent blend. Any credit amount exceeding a taxpayer's liability may be carried forward to each of the 5 succeeding taxable years.

Section 57-38-01.23 provides for an income tax credit for adapting a facility to allow for sales of biodiesel or green diesel fuel and is available to a taxpayer licensed by the Tax Commissioner as a fuel retailer. The amount of the credit is equal to 10 percent per year for 5 years of the direct costs incurred by the fuel retailer to adapt or add equipment to a facility to enable the facility to sell diesel fuel containing at least 2 percent biodiesel fuel or green diesel fuel by volume. Credit amounts exceeding a taxpayer's liability may be carried forward to each of the 5 succeeding taxable years, but a taxpayer is limited to claiming no more than $50,000 in credits over any combination of taxable years.

Perceived Goals in Creating or Altering the Credits

Provisions relating to biodiesel credits were enacted in 2003 and pertained to credits for producing or blending diesel fuel. The perceived goal of the Legislative Assembly in creating the credit was to encourage the development of biodiesel production or blending facilities. It was noted the credit would assist in reducing dependence on foreign energy sources and dependence on farm subsidies because the credit likely would result in increased demand for the state's soybean crops. The credit was viewed as a tool to help stimulate the development of a new industry in North Dakota. The estimated fiscal effect of the corporate income tax credit for biodiesel production and blending equipment costs could not be determined during the 2003 legislative session. The credit was expanded in 2009 to apply to costs incurred to construct or retrofit a facility for the purposes of producing crushed soybeans or canola, and expanded in 2011 to apply to costs incurred to construct or retrofit a facility for the purpose of producing or blending diesel fuel containing at least 2 percent green diesel fuel by volume.

Additional biodiesel credits were added in 2005 to provide for an income tax credit to biodiesel blenders, in the amount of five cents per gallon of biodiesel fuel of at least a 5 percent blend, and a credit to biodiesel retailers equal to 10 percent per year for 5 years of the direct costs incurred by the fuel retailer to adapt or add equipment to enable a facility to sell diesel fuel containing at least 2 percent biodiesel fuel by volume. The perceived goal of the Legislative Assembly in creating these credits was to incentivize development of the renewable fuels industry in North Dakota. Enactment of the credits was viewed as significant step toward biodiesel production in this state. Both credits were expanded in 2011 to apply to the blending or sale of green diesel fuel in addition to biodiesel fuel. Credit provisions were modified in 2013 to clarify that a licensed fuel supplier must blend biodiesel fuel or green diesel fuel in this state to qualify for the credit.

Testimony and Committee Considerations

The committee received information from representatives of the Tax Department indicating income tax credits related to biodiesel have been claimed on only a small number of returns in tax years 2009 through 2014. Incentives similar to the biodiesel income tax credits are found in eight other states. Considering the infrequency in which the credits are claimed, the committee considered bill drafts that would have repealed the biodiesel income tax credits. The committee received testimony from representatives of the North Dakota Soybean Growers Association and the EmPower North Dakota Commission in opposition to the bill drafts. Testimony provided in favor of retaining the credits indicated that although the credit is not frequently claimed, it is beneficial to maintain the availability of the credits for instances in which an opportunity might arise to attract businesses to this state.

Renaissance Zone Credits and Exemptions

Explanation of the Incentives

Chapter 40-63 provides for various renaissance zone tax exemptions and credits. Section 40-63-04 provides income tax exemptions to individuals who purchase or rehabilitate single-family residential property for the individual's primary residence as a zone project. The amount of the exemption is up to $10,000 of personal income tax liability for 5 taxable years beginning with the date rehabilitation is completed or the property is occupied. An exemption also is available for a taxpayer that purchases, leases, rehabilitates, or makes leasehold improvements to residential, public utility infrastructure, or commercial property for any business or investment purposes as a zone project. The amount of the exemption is equal to the income derived from the business or investment locations within the zone, up to a maximum amount of $500,000 per taxable year for 5 taxable years beginning with the date of purchase, lease, or completion of rehabilitation. For projects that take the form of an expansion of an existing building in the zone, the amount of the exemption is equal to the income derived from the business, or from the investment use of the building, during the taxable year times a ratio equal to the square footage added by the expansion divided by the total square footage of the building after expansion. In lieu of the previous exemption, a taxpayer may elect to exempt up to $2,000 of individual income tax liability if the cost of a new business purchase, leasehold improvement, or existing business expansion exceeds $75,000 and the business is in a city with a population of 2,500 or less.

A property owner that is not participating in a renaissance zone project may be entitled to a tax incentive in the form of a credit against income tax liability if the owner is required to make changes in utility services or in a building structure due to changes made to property that is part of a zone project. The amount of the credit is equal to the total amount of the investment necessary to complete the changes and must be claimed in the taxable year in which the changes were completed. Any earned credit amount exceeding a taxpayer's liability may be carried forward for up to 5 taxable years. A renaissance zone credit also is offered in Section 40-63-06 for investments in historic preservation or property renovation within a renaissance zone. The amount of the credit is equal to 25 percent of the amount invested, up to a maximum amount of $250,000. The credit must be claimed in the year the preservation or renovation work is completed and any earned credit amount exceeding a taxpayer's liability may be carried forward for up to 5 taxable years.

Exemptions are available under Section 40-63-07 for renaissance fund organizations. A city with a designated renaissance zone may establish a renaissance fund organization to raise funds to finance zone projects. A taxpayer may receive a credit against income tax liability in the amount of 50 percent of the amount invested in a renaissance fund organization. The maximum amount of investment credits awarded to all taxpayers is limited to $10.5 million and any credit amount exceeding a taxpayer's liability may be carried forward for up to 5 taxable years.

Perceived Goals in Creating or Altering the Incentives

Provisions relating to renaissance zones were enacted in 1999 to allow a governing body of a city to apply to designate a portion of the city as a renaissance zone. Income and property tax exemptions were created for taxpayers investing in real property within a renaissance zone. A historic preservation and renovation tax credit also was created for investment within a renaissance zone. The perceived goal of the Legislative Assembly in creating renaissance zone credits and exemptions was to provide incentives to encourage the rejuvenation of inner cities. The estimated fiscal effect of renaissance zone credits and exemptions could not be determined during the 1999 legislative session. Various changes were made to renaissance zone provisions in later years, including granting the ability to expand the boundaries of an existing renaissance zone or remove portions of a renaissance zone that were not progressing in 2001, authorizing a renaissance fund organization to provide financing to businesses outside a renaissance zone in 2003, authorizing the Department of Commerce to approve a city's request to extend the duration of a renaissance zone in 2009, modifying provisions related to investments in renaissance zone organizations in 2011, changing the manner in which income related to a business expansion is attributed in 2013, and increasing the maximum allowable size of renaissance zones in 2015.

Renaissance Zone Reports

The committee was assigned the responsibility to receive an annual report from the Department of Commerce, Division of Community Services on renaissance zone progress, pursuant to Section 40-63-03(2), and a report compiling reports from cities that have renaissance zone property included in a tax increment financing district, pursuant to Section 40-63-03(10). According to the report on renaissance zone progress, 1,533 projects have been approved and 1,175 projects have been completed since the inception of the renaissance zone program. There were 58 renaissance zones in the state in 2015. A survey of renaissance zone communities conducted in 2015 indicated renaissance zones created 11 new businesses, 15 business expansions, and 122 new jobs. The benefits realized by the 59 projects that reached completion in 2015 amounted to over $2,800,000 in property tax exemptions; $250,000 in historic property preservation or renovation income tax credits; and over $1,100,000 in single-family, business, and investor income tax credits and exemptions. Information contained in the second report indicated the cities of Bismarck, Hazen, and Mandan have properties located in both a renaissance zone and a tax increment financing district. Mandan is the only city with properties receiving benefits from both the renaissance zone program and tax increment financing program.

Testimony and Committee Considerations

The committee reviewed background memorandums, multistate surveys, and claimant data pertaining to renaissance zone credits and exemptions and received information from a representative of the Department of Commerce regarding the ability to extend the duration of a renaissance zone without receiving support from political subdivisions impacted by the renaissance zone. As the committee did not have adequate time to receive testimony from interested parties or gather further data pertaining to renaissance zones, committee members agreed renaissance zone incentives would need to be reviewed further by a future interim committee.

Additional Credits and Exemptions

The committee reviewed background memorandums, multistate surveys, and claimant data pertaining to the research expense credit; internship program credit; workforce recruitment credit; new jobs credit from income tax withholding; new or expanding business exemption; and the geothermal, solar, wind, and biomass energy device tax credit, but did not have adequate time to receive testimony from interested parties and additional data required to fully assess the effectiveness of the tax incentives. Committee members agreed the incentives would need to be carried forward for review by a future interim committee.

Economic Analysis Tools for Evaluating Incentives

The committee reviewed information regarding various economic analysis tools used in evaluating the effectiveness of incentives. The committee reviewed information pertaining to the Regional Input-Output Modeling System, the Impact Planning and Analysis (IMPLAN) software package, and software developed by Regional Economic Models, Inc. (REMI). The committee received testimony from representatives of the Department of Commerce regarding the department's use of REMI software and received a demonstration of the capabilities of REMI's Tax-PI software from the company's representatives. The Regional Economic Models, Inc. software is capable of evaluating the economic and fiscal effects of a program or policy over an extended duration and allows for customized state government expenditure models and customizable tables to reflect actual or projected revenues. The committee also reviewed information pertaining to the prevalence of staff economists in other states and discussed the potential value of having a state economist.

Committee members expressed interest in acquiring REMI software as a tool to assist the committee in conducting a cost-benefit analysis of the incentives selected for review. The committee considered the amount of funds needed to acquire the software in relation to the millions in foregone revenue resulting from the availability of tax incentives. The committee discussed potential barriers to effectively using the software including the limited amount of data available for certain incentives. The committee received information pertaining to the disclosure of confidential tax information and received a summary from representatives of the Department of Commerce and the Tax Department regarding the information each agency obtains in relation to the incentives selected for study and, of that information, the data each agency may publically disclose. The committee also discussed a potential future source of publically available information in relation to new developments pertaining to the financial reporting requirements set to be imposed on political subdivisions under Government Accounting Standards Board Statement 77.

The committee reviewed information from various states that use REMI and considered a bill draft modeled after a Texas law which would have directed the preparation of dynamic fiscal impact statements for any legislative measure with a positive or negative fiscal impact over an amount specified by the Legislative Assembly. The bill draft would have required an analysis be conducted 5 years after the enactment of the legislative measure to gauge the accuracy of the dynamic fiscal impact statement prepared at the time the legislative measure was introduced. The committee also considered a bill draft to allow the Legislative Council to acquire dynamic fiscal impact analysis software, upon the directive of the Legislative Management, for use during the 2017-18 interim in evaluating of economic development tax incentives. The committee received information from representatives of REMI regarding the cost of acquiring REMI's Tax-PI software. The committee received a quote of $136,000 to purchase the software for a period of 1 year, with an additional update and maintenance fee of $28,500 for each year thereafter. The committee also received a quote of $54,700 for a 6-month rental of the software, as well as various pricing options pertaining to available consulting services. The committee did not factor the cost of any additional staff resources into the $165,000 appropriation provided in the bill draft.

Recommendations

The committee recommends a bill [17.0077.02000] to provide a uniform definition of "primary sector business."

The committee recommends a bill [17.0158.01000] to sunset the availability of the angel fund investment tax credit for investments made after December 31, 2017, and increase allowable credit amounts and carryforward periods related to the seed capital investment tax credit.

The committee recommends a bill [17.0293.01000] to eliminate the sunset date attached to the telecommunications infrastructure sales tax exemption.

The committee recommends a bill [17.0292.01000] to eliminate the sunset date attached to the manufacturing automation equipment income tax credit.

The committee recommends a bill [17.0167.02000] to repeal the certified nonprofit development corporation income tax credit.

The committee recommends a bill [17.0162.01000] to repeal the wage and salary income tax credit.

The committee recommends a bill [17.0163.01000] to repeal the microbusiness income tax credit.

The committee recommends a bill [17.0299.02000] relating to the acquisition of software necessary to prepare dynamic fiscal impact statements for economic development tax incentives selected for review during the 2017-18 interim.

SOCIAL SERVICES FINANCING STUDY

Section 12 of Senate Bill No. 2206 provided for a Legislative Management study of transferring the costs of operating social services programs from county property tax levies to general fund appropriations. The development of a proposed transition plan must include a timeline for the major milestones of the transition plan, considerations for the transition, estimated costs, a plan to require a property tax reduction for the amount of the budgeted savings brought about by the transfer of county social services costs to the state, a plan resulting in the elimination of the county social services levy under Section 50-06.2-05, and potential legislation to implement recommended changes. The study also must include consideration of the feasibility of implementing the proposed transition plan.

Background

A county's ability to levy tax for comprehensive human service programs arose in 1989 with the passage of House Bill No. 1521. The bill granted the board of county commissioners the authority to levy an annual tax, not to exceed 20 mills, "for poor relief purposes." Prior to the passage of the bill, the costs of human service programs were funded primarily by state and federal sources.

As the realm of social services programs expanded and populations shifted, funding formulas developed in the early 1980s for certain economic assistance programs began to lose relevance. Consideration of the responsibilities of county social services agencies, regional human service centers, and the Department of Human Services became a topic for review, as was evidenced by the passage of 1995 House Concurrent Resolution No. 3045 directing a study of the responsibilities of these agencies. The 1995-96 interim Budget Committee on Human Services was selected to conduct the study, and as a result, recommended 1997 House Bill No. 1041 to the Legislative Management for introduction during the 1997 legislative session. House Bill No. 1041, as passed by the 1997 Legislative Assembly, required counties to assume the financial responsibility for the costs of administering the following economic assistance programs:

1. Aid to families with dependent children.
2. Job opportunities and basic skills program.
3. Child care block grant.
4. Title IV-A at-risk child care.
5. Food stamps.
6. Medical assistance.
7. Low-income home energy assistance program.
8. Refugee assistance.
9. Basic care.

In return, the state assumed complete financial responsibility for grant programs, including temporary assistance to needy families, basic care, child care assistance, and medical assistance. The state also was required to provide additional support for administrative costs of counties with Indian land. The bill's provisions were described as the "swap" agreement and resulted from joint discussions among the Department of Human Services, the North Dakota Association of Counties, and the North Dakota Association of County Social Service Board Directors regarding alternative methods for the delivery and funding of the administrative costs of economic assistance programs.

The effects of the 1997 "swap" legislation were later reviewed by the 2003-04 interim Budget Committee on Human Services pursuant to the study provided in Section 14 of 2003 Senate Bill No. 2012, directing the study of administrative costs of human services programs, including costs incurred by the central office of the Department of Human Services, human service centers, and county social services. The success and effects of the 1997 "swap" legislation also were studied by the 2007-08 interim Human Services Committee. Testimony provided to that committee indicated since the "swap" agreement, the reimbursement process and budgeting process had become easier for counties. Counties had better control over staffing issues and were able to better manage tax revenue requirements. The agreement had resulted in efficiencies to counties for administering economic assistance programs.

Legislation passed in 2009 provided for another study addressing the funding responsibilities for certain social services programs. House Bill No. 1425 (2009) directed the study of the feasibility and desirability of transferring from the county to the state the responsibility for the funding of nonfederal foster care and subsidized adoption costs.

Following the 2009 study, legislation was introduced during the 2011 legislative session which contained substantive provisions to provide for state assumption of county foster care and subsidized adoption costs that were funded at the county level. The restructuring proposed in 2011 House Bill No. 1333 was unsuccessful, as was a proposed study in 2011 Senate Bill No. 2240 for the development of a plan to restructure the human service delivery system.

The concepts provided in House Bill No. 1333 were reiterated in 2013 in House Bill No. 1233, yet legislators raised concerns regarding accountability for passing along savings derived from state tax relief to property taxpayers and that bill failed to pass.

2015 Legislation

Discussion of restructuring social services funding responsibilities resumed in 2014 as the Governor's Property Tax Task Force began the task of reviewing the multitude of tax levies available to political subdivisions for potential areas of consolidation or simplification. As the task force reviewed levies, it was determined four levies potentially could be repealed through state assumption of county social services costs. After receiving testimony from individuals involved in the administration of state and county social services, the task force determined the complex task of restructuring funding responsibilities for social services programs exceeded the scope of the consolidation and simplification efforts undertaken in 2015 Senate Bill No. 2144. The provisions for restructuring funding responsibilities for social services programs were ultimately placed in Senate Bill No. 2206.

Senate Bill No. 2206 provided for the assumption of certain county social services costs by the Department of Human Services. The bill provided for a phased transition of county social services funding from the county level to the state level. The first phase of the transition takes place during the 2015-17 biennium and is anticipated to result in over $23 million in property tax savings. County property tax savings for the 2017-19 biennium are estimated at just over $31 million.

In the first phase of the transition, each county social service board is required to submit its 2016 budget using the budget submitted in 2014 as a starting point. County social service boards would then subtract the reduction in the county's social services funding responsibility for 2014, which is derived from transferring county social service costs from county social service boards to the Department of Human Services. County social service boards would then apply the percentage salary and benefits increase provided by legislative appropriation for state employees for 2015 to the resulting amount. For 2017, a county's social service budget may not exceed an amount determined using the 2015 budget as a starting point and applying to that amount the percentage salary and benefits increase provided by legislative appropriations for state employees for 2016.

The cost savings realized by the counties are derived from the state assumption of certain social services costs, including the county portion of foster care and subsidized adoption assistance payments, medical assistance payments for therapeutic foster care services, service payments for the elderly and disabled, county administrative costs for providing family preservation services, computer processing costs for the technical eligibility system, and the costs of electronic benefit transfers for the supplemental nutrition assistance program.

Senate Bill No. 2206 required the remaining county share of the human service budget to be funded entirely from the county's property tax levy for that purpose. The bill did not allow the county to use funds from any other source to supplement the human services budget with the exception of a county's use of an identifiable amount of other sources the county has used to supplement its human services budget for 2015, and any funds received from the human services grant program.

Senate Bill No. 2206 also required the Department of Human Services to develop a process to review requests from a county social service board if increased staff is needed to address substantially increased caseloads. Consideration must be given to the potential for multicounty sharing of staff when reviewing caseload information. A human services grant program was established by the bill for counties adjacent to or included as part of an Indian reservation or a state hospital, which has utilized the emergency human services mill levy provided in Chapter 50-03 to cover human service costs in the past.

The second phase of transitioning payment of county social service costs from county property tax levies to general fund appropriations lies in the development of a funding formula to adequately reimburse counties for the costs of administering social services. The provisions provided in Section 12 of Senate Bill No. 2206 direct the study of the feasibility of transferring the costs of operating social services programs from county property tax levies to general fund appropriations. The study provided for the optional formation of a County Social Services Finance Working Group consisting of:

1. The Director of the Department of Human Services or the Director's designee;
2. The Chief Financial Officer of the Department of Human Services;
3. Two members representing elected county officials identified in Section 11-10-02 as selected by the North Dakota Association of Counties;
4. The Tax Commissioner or the Tax Commissioner's designee;
5. The Director of the Office of Management and Budget or the Director's designee;
6. Two county social services directors selected by the North Dakota County Social Services Director's Association; and
7. One member representing the North Dakota Association of Counties.

The working group was to report its progress and findings to the interim committee tasked with conducting the study during the 2015-16 interim.

Testimony and Committee Considerations

Purpose of Transitioning County Funding Responsibility to State Sources

The committee received information from the Governor regarding the history behind the concept of transitioning the remaining county funding responsibility for social services to the state level. The motivation for transitioning the costs of social services for payment at the state level centers around the opportunity to provide significant and permanent property tax relief.

The testimony from a representative of the North Dakota Association of Counties highlighted county support for the concept of replacing county property tax levies with state-funded sources for the payment of county social service costs. The testimony contended property taxes are a poor funding source for the costs of administering federal- and state-directed social service programs because counties have little control over program eligibility requirements that are often dictated at the federal level. In addition, federal economic assistance programs bear no relationship to property tax values as do other services such as fire protection and road maintenance. The testimony indicated counties with the lowest property values often have proportionally higher costs related to the delivery of social services due to increased needs in poorer counties. County representatives expressed support for the replacement of county-funded revenue sources with state revenues if access to local services is not eroded.

The committee received an update on the human services grant program, created by Senate Bill No. 2206 as a result of the elimination of emergency human services levy 1222. The Department of Human Services drafted emergency rules pertaining to the operation of the grant program and eight counties had been awarded a total of $1.7 million of the available $1.9 million in grant funding for calendar year 2017. The grant program allows for $2 million in emergency funds to be awarded during calendar year 2018.

County Social Services Finance Working Group

The optional working group provided for in Senate Bill No. 2206 held its first meeting in June 2015. The committee received periodic updates from representatives of the County Social Services Finance Working Group throughout the course of the interim. The working group collected data pertaining to county budgets for calendar years 2015 and 2016, and information pertaining to counties' actual expenditures for calendar year 2015 as a means of establishing a starting point for the development of a reimbursement formula. Cost information collected by the working group encompassed all county social service expenditures in calendar year 2015, including expenditures for employee salaries and payroll benefits and expenditures for facility costs such as light, rent, and heat. Cost information related to programs entirely county-funded and countywide indirect cost information was collected for calendar years 2014 and 2015. Representatives of the working group provided information regarding the difference between program costs and administrative costs and information regarding the portion of administrative costs funded with federal funds. The committee received information pertaining to the reasons per capita costs of social services differ between counties. Per capital costs are higher in counties with a large concentration of clientele in rural areas due to higher transportation costs and in counties that must offer higher pay to attract applicants for skilled positions. The largest increases in county costs are attributable to salary increases and costlier insurance plans for employees.

The County Social Services Finance Working Group collected information related to county caseloads and divided caseload counts and the costs associated with caseloads into two groups. Economic assistance caseloads pertain to eligibility determinations for temporary assistance to needy families, child care assistance, the supplemental nutrition assistance program, medical eligible services, the low-income heating assistance program, and foster care. Social service caseloads pertain to case management services in the areas of foster care case management, foster care home licensing, subsidized adoptions, child abuse and neglect, family preservation, and child care licensing. The working group determined one case-month is equal to the provision of economic assistance or social services to one individual for the period of 1 month or the provision of energy assistance to one household for the period beginning October 1 of each year and ending May 31 of the following year. The committee received data reflecting the work effort related to each type of economic assistance and social service case statewide over the past 4 years. The committee was informed counties have little ability to influence the number of individuals who qualify for services.

Structure and Delivery of Social Services

The committee received information from a representative of the Department of Human Services regarding the organizational structure of the department. The committee learned the department consists of a medical services section, a behavioral health section, an administration and support section, and a program and policy section. The program and policy section is responsible for drafting administrative rules, administering federal funding, and setting policies for various programs. The medical services section and the economic assistance policy division within the program and policy section are highly involved with counties because many economic assistance programs are state supervised and county administered. The state provides the policies behind the administration of economic assistance programs and counties determine the eligibility of individuals applying for services within a county in accordance with state and federal policies.

The Department of Human Services operates eight regional human service centers with each center serving a designated multicounty area and providing an array of community-based services. The committee received information regarding the privatization of social services in various states and the department's partnership with private service providers. The committee received a description of how an individual or entity can become a qualified service provider and the types of services offered by qualified service providers. Committee members voiced concerns regarding difficulties often encountered in accessing private service providers in rural areas.

Each board of county commissioners is responsible for appointing and overseeing a county social service board, which supervises and directs all human service activities conducted by the county. There are 47 county social service boards in the state, some of which include combined boards. The county commission has budgetary control over county social services and determines the level of funding available from property taxes. Some counties share social service staff through the use of joint powers agreements or other contracting arrangements.

The committee received information from a representative of Traill County Social Services regarding the manner in which counties are sharing services and a county-by-county listing of county-funded services. The committee also received information from the Director of Dakota Central Social Services regarding the history behind the consolidation of McLean, Mercer, Oliver, and Sheridan Counties into the Dakota Central Social Services district.

The committee was informed consolidations with counties containing a large amount of reservation land are unlikely to occur because a large amount of the property in those counties is untaxed. Under the current property tax funding mechanism, consolidations likely would be avoided due to the resulting property tax shift to the county containing a greater amount of taxable property. It was argued funding social services using state revenue sources may create a new dynamic in counties electing to consolidate or share services. The committee discussed options for incentivizing counties to consolidate under a state-funded reimbursement formula. Committee members noted consolidations could be incentivized in the same manner school district consolidations were incentivized under the K-12 funding formula.

Representatives from various counties and the Department of Human Services noted they did not believe this study contemplated the migration of county staff to the state level or any substantial restructuring of the administration or delivery of social services. Although committee members expressed interest in discussing the potential for transferring county employees to the state level and finding efficiencies in the delivery of social services, the committee determined the main focus of the study was transferring funding responsibility for social services, not restructuring the delivery of social services.

County Budgets and Ending Fund Balances

The committee received information from a representative of the North Dakota Association of Counties regarding the number of mills levied for social services in each of the 53 counties and the amount of each county's ending fund balance. The total ending fund balance for calendar year 2015 for all counties was $26 million, or 28 percent, of the total amount of funds budgeted for all counties in calendar year 2015. The amount of carryforward reserves varied greatly from county to county.

The committee reviewed data pertaining to the savings to property taxpayers resulting from the state assumption of grant costs pursuant to Senate Bill No. 2206, which indicated $13 million in property tax savings to taxpayers, or an average levy reduction of 2.51 mills. Although some committee members expressed discomfort with the amount of funds being carried forward from previous budget years, other committee members noted high carryforward balances might be attributable to a county losing staff mid-year and being unable to find a replacement to fill the vacant position.

The committee received testimony from county representatives regarding the amount of carryforward funds counties would prefer to retain if the state assumed the remaining county social service costs associated with staffing and administration. Preferences were expressed for the ability to retain an amount defined in terms of dollars and in terms of a percentage of a county's prior year budget. County representatives noted a carryforward limit of $100,000, or 35 percent of the county's prior year budget, whichever is greater, would be an adequate amount of funds to allow counties to address any unforeseen circumstances that might arise.

The committee discussed treatment of funds that exceed carryforward limits and expressed a preference for returning any excess funds originally derived from property tax revenue to property taxpayers. The committee reached a consensus that the most effective way to return funds would be through future mill levy reductions in an amount equivalent to the amount of funds exceeding the carryforward limits. Committee members agreed amounts exceeding carryforward limits originally derived from state funds should be deducted from a county's future formula distributions.

Funding Formula Costs and Property Tax Relief

The committee discussed funding sources for the replacement of county-funded social service costs. The committee considered the $300 million earmarked for property tax relief and received an illustration of how the 12 percent state-paid property tax relief credit would compare to property tax relief resulting from the elimination of social service mill levies. The amount of tax relief individual property owners would realize as a result of the state funding social service costs would vary based on the amount of each county's prior social service levy. As a means of eliminating inequities in the amount of property tax relief realized from one county to another, the committee discussed the provision of a hold-harmless payment to ensure counties receive no less funding than the amount of property tax relief received by all taxing districts in each county in calendar year 2017 as a result of the 12 percent state-paid property tax relief credit.

The committee discussed the method in which property tax relief would be distributed to taxpayers in the form of a hold-harmless payment, including requiring counties to reduce future year county general fund levies in an amount equivalent to the amount a county's 2017, 12 percent state-paid property tax relief credit exceeds the amount a county receives under the funding formula. Committee members were supportive of incorporating mechanisms in the funding formula to ensure property tax relief is passed through to taxpayers.

Information provided to the committee indicated the estimated cost of providing state funding for county social service costs would be $258.7 million for the 2017-19 biennium. An estimated $5 million to $10 million in additional costs also could be added to that amount depending on the rate of case-growth in counties. A representative of the North Dakota Association of Counties noted county auditors likely would be in favor of replacing the 12 percent state-paid property tax relief credit with a county general fund mill levy reduction because the 12 percent state-paid property tax relief credit is challenging to administer.

Working Group Recommendations

The committee received the County Social Services Finance Working Group recommendations regarding the development of a funding formula and a transition plan for transferring the costs of operating social service programs from county property tax levies to the state funding sources. The transition plan would eliminate county social service levy authority beginning in tax year 2017. The first year of state-funded formula payments would begin in January 2018. Calendar year 2015 data pertaining to county expenditures and case-months would be used for the base year. A county's 2015 base-year expenditures would be inflated by 5 percent for calendar year 2016 and an additional 5 percent for calendar year 2017 to arrive at equivalent 2017 adjusted base year expenditures. The inflated 2017 adjusted base year expenditures in counties with the highest base year case-months for social service cases and economic assistance cases would be divided by 2015 case-months for each county to determine the per-case base rate for economic assistance cases and social service cases. Per-case base rates would be inflated by 5 percent for calendar year 2018 formula payments and an additional 5 percent for calendar year 2019 formula payments. The per-case base rates would be multiplied by a weighting factor for counties with smaller case-month totals in recognition of the efficiencies that are generally seen in counties with higher case-month totals.

Formula payments for calendar year 2018 would be calculated in June of the prior year and would be based on a county's recorded economic assistance and social service case-month data for calendar year 2016. The first half of a county's calendar year formula payment would be distributed on or before January 10 of each year. A county's current year formula payment would be recalculated in June of each year using case-month data that is 1 year more current than the data used to calculate the original formula payment. A county's formula payment for the calendar year would be adjusted only if the recalculated payment amount exceeded the original payment amount by more than 5 percent. For calendar year 2018, a county would be protected against receiving less than 102 percent of the amount the county received using a county's adjusted 2017 base year expenditures and be restricted from receiving more than 110 percent of a county's adjusted 2017 base year expenditures unless the county experienced growth in either economic assistance case-months or social service case-months that exceeded the county's case-month totals for either case type in the previous year by more than 5 percent. The second half of a county's calendar year formula payment would be distributed on or before June 15 of each year. A county's hold-harmless payment resulting from the elimination of the 12 percent state-paid property tax credit would be distributed to a county on or before January 31 of each year.

The formula also would provide incentives for counties that consolidated into combined service areas. A county would be limited to carrying forward no more than $100,000, or 35 percent, of its prior year budget amount, whichever is greater. Any funds exceeding carryforward limits would be credited to property taxpayers through future year county general fund levy reductions for funds exceeding carryforward limits at the end of 2017. Funds exceeding carryforward limits at the end of 2018 would be accounted for through reductions to a county's future formula payments.

The committee considered a bill draft that would have implemented the County Social Services Finance Working Group recommendations. Committee members generally agreed the working group made tremendous progress in the development of a transition plan that addressed county concerns regarding adequate social service funding and legislative concerns regarding limits on county spending and assurances that property tax relief would be passed through to taxpayers. Committee members acknowledged the funding formula likely would be subject to additional adjustments if introduced during the 2017 legislative session.

Committee members expressed interest in incorporating in the bill draft a requirement that property tax statements reflect the amount of property tax savings realized by the elimination of county social service mill levies and mill levy reductions resulting from the 12 percent state-paid property tax relief credit hold-harmless payment. Committee members also expressed support for adding provisions to account for the impact on rural electric cooperatives as a result of eliminating the 12 percent state-paid property tax credit. Although committee members debated whether the bill draft would have a better chance of success if recommended as an interim committee bill or introduced as privately sponsored legislation, the committee agreed that regardless of the method of introduction the concepts in the bill draft would require support from committee members throughout the 2017 legislative session.

The committee reviewed proposed additions to the bill draft to include studies pertaining to restructuring the ownership of the Life Skills and Transition Center in Grafton, transferring of ownership of the State Hospital to the Department of Corrections and Rehabilitation, and restructuring the eight human service centers. Committee members expressed support for the concepts contained in the proposed studies and agreed additional consideration should be given to how the quality of social services may be improved and how programs may run more efficiently.

Conclusion

The committee makes no recommendation with respect to its study of transferring the costs of operating social services programs from county property tax levies to general fund appropriations.

CONTRACTOR SALES AND USE TAX STUDY

Section 1 of House Bill No. 1401 directs the Legislative Management to study the application of sales and use taxes to purchases made by a contractor on behalf of an exempt entity. As introduced, the bill would have created a sales and use tax exemption for materials, supplies, or equipment acquired by a contractor, subcontractor, or builder on behalf of an exempt entity. The bill would have required the purchaser to obtain a purchasing agent authorization letter and an exemption certificate or number from the exempt entity and would have required that any items exempt from sales or use tax be installed or completely consumed in the performance of the contract. The fiscal note for the bill, as introduced, indicated a combined reduction in general fund and state aid distribution fund revenues of an estimated $56 million for the 2015-17 biennium. The bill was amended in the House to remove the substantive provisions and to provide for this study.

Background

The application of sales and use tax is governed by Chapters 57-39.2 and 57-40.2. Sales tax is imposed at a rate of 5 percent on the gross receipts from taxable retail sales of tangible personal property and services. The tax is paid by the purchaser and collected and remitted by the retailer. Use tax, which is also imposed at a rate of 5 percent, is applied to tangible personal property purchased at retail for storage, use, or consumption in this state, or tangible personal property purchased outside this state but later brought into this state. Use tax is applied to the purchase price of an item at the time of purchase, or to the fair market value of the item at the time it is brought into this state.

Pursuant to Sections 57-39.2-04 and 57-40.2-04, a wide range of products, services, and activities are exempt from the imposition of sales and use tax. Exempt products range from small items, such as the ink used to print newspapers, to larger items, such as durable medical equipment. In addition to the exemptions available for individual items, various groups and entities are also exempt from paying sales and use tax on some, or all, of their purchases. Groups and entities exempt from payment of sales and use tax on purchases include:

- Private nonprofit schools, on purchases of textbooks, yearbooks, and school supplies, pursuant to Section 57-39.2-04(5);
- Public schools, on all purchases made using a school district check or warrant, pursuant to Section 57-39.2-04(6);
- The federal government, including federal corporations, on all purchases made by the United States government or its agencies, departments, or instrumentalities, pursuant to Section 57-39.2-04(1);
- State and local governments, on all purchases made by any state or any state's subdivisions, departments, agencies, or institutions so long as a political subdivision of the other state would treat a sale to a North Dakota political subdivision as an exempt sale in that state, pursuant to Section 57-39.2-04(6);
- Indian tribes, on all purchases made by a tribal government agency, instrumentality, or political subdivision that performs essential government functions, pursuant to Section 57-39.2-04(6);

- Hospitals, skilled nursing facilities, intermediate care facilities, basic care facilities and emergency medical services providers licensed by the State Department of Health, and assisted living facilities licensed by the Department of Human Services, on all purchases made for the use or benefit of the provider's patients or occupants, pursuant to Section 57-39.2-04(24);
- Nonprofit voluntary health associations and nonprofit medical research institutes, exempt from federal income tax under Section 501(c)(3) of the United States Internal Revenue Code [26 U.S.C. 501(c)(3)], on all purchases, pursuant to Sections 57-39.2-04(32) and 57-39.2-04(43);
- Commerce authorities, on purchases integrated into the infrastructure of a commerce authority to directly serve the commerce authority's infrastructure needs, pursuant to Section 57-39.2-04(48);
- Special fuel businesses, on purchases of equipment to enable a facility to sell diesel fuel containing at least 2 percent biodiesel or green diesel fuel, pursuant to Section 57-39.2-04(51); and
- Montana residents and businesses, on all purchases exceeding $50 for use outside of this state, pursuant to Section 57-39.2-04(12).

Payment of Sales and Use Tax by Contractors

A contractor or subcontractor is deemed to be the final user or consumer of any tangible personal property used in the performance of a contract with another party. As the final user, a contractor is required to remit sales or use tax on any tangible personal property used in the performance of a contract, subject to limited exemptions. The amount of tax due will be determined by applying the applicable tax rate to either the purchase price of the property, or to the fair market value of the property, whichever is greater. A contractor may take various approaches in remitting the required amount of sales or use tax.

A contractor may remit sales tax on all purchases of tangible personal property at the time of purchase or a contractor may present a certificate of resale or a contractor's certificate to avoid payment of sales tax at the time of purchase. If a contractor presents a contractor's certificate and elects not to pay sales tax at the time of purchase, the contractor will be required to remit use tax on those items in the reporting period in which the purchases were made. If a contractor presents a certificate of resale and elects not to pay sales tax at the time of purchase, the contractor will be required to remit use tax on those items once they are used in the performance of a contract. In both instances, the contractor may build in the cost of the tax paid into the contract, but may not explicitly designate the charge as relating to sales tax on the customer's invoice as the contractor is always deemed to be the final user of tangible personal property and the party ultimately responsible for remitting sales or use tax on those items.

A contractor's responsibility to remit sales or use tax on items used in the performance of a contract is not extinguished by the fact that some of the items may have been purchased by an entity that is exempt from paying sales and use tax. A contractor must remit use tax on any items used in the performance of a contract on which sales or use tax was not remitted by a previous purchaser, subject to limited exceptions. Items that may be purchased by an individual or entity without the payment of sales or use tax and later installed by a contractor without payment of use tax include medical equipment purchased by a long-term care facility and later installed into the hospital or facility making the exempt purchase; production equipment and other tangible personal property used for repowering, environmental upgrades, or power plant construction; machinery, equipment, or other tangible personal property used to construct an agricultural commodity processing facility; tangible personal property used to construct or expand a system used to compress, process, gather, or refine gas recovered from an oil or gas well in this state or used to expand or build a gas processing facility; tangible personal property used to construct or expand a qualifying oil refinery; tangible personal property used to construct or expand a processing facility to produce liquefied natural gas; tangible personal property used to construct or expand a facility for coal gasification byproducts; tangible personal property used to construct or expand telecommunications service infrastructure that is capable of providing telecommunication service; materials used in compressing, gathering, collecting, storing, transporting, or injecting carbon dioxide for use in enhanced recovery of oil or natural gas; and tangible personal property used to construct a qualifying fertilizer or chemical processing facility.

If any of these items are purchased or installed on behalf of an exempt entity or individual by a contractor who remits sales or use tax on the items, the individual or entity qualifying for the exemption may apply to the Tax Commissioner for a refund of the difference between the amount of tax paid and the exemption imposed or allowed.

Recent Sales and Use Tax Legislation Pertaining to Contractors

The provisions of House Bill No. 1401, as introduced, were not the first to be considered by the Legislative Assembly in modifying the application of sales and use tax for purchases made by contractors on behalf of an exempt entity. Since 2007, three similar bills have been introduced for consideration by the Legislative Assembly, all of which were defeated.

Senate Bill No. 2253 (2007) would have allowed an individual or organization to apply for a refund of the amount of sales or use tax paid by a contractor for tangible personal property delivered or installed by a contractor for that individual or organization if sales or use tax would not have applied had the individual or organization purchased or installed those items directly. Testimony provided during the committee hearings on the bill indicated the bill originally arose due to concerns expressed by a medical center. The example provided during testimony on the bill illustrated a scenario in which a large medical center that could afford to have maintenance staff on its payroll could purchase a piece of equipment and have it installed by the facility's maintenance staff without incurring any sales or use tax liability. This scenario was contrasted with a situation in which a smaller medical center would make the same purchase, but hire a contractor to install the item as the facility did not employ its own maintenance staff. The contractor hired by the smaller facility would be required to pay use tax when installing the item purchased by the medical center as sales tax was not remitted at the time the item was purchased. The contractor in this situation presumably would pass the cost of remitting use tax on that item to the facility in which the contractor executed the installation contract. During discussion of the bill, testimony indicated the language provided in the bill may have broader application reaching beyond just medical centers. The fiscal note for the bill indicated an anticipated reduction in general fund and state aid distribution fund revenues of $15.4 million for the 2007-09 biennium.

Following the defeat of Senate Bill No. 2253, 2009 Senate Bill No. 2186 and 2011 Senate Bill No. 2159 were introduced to allow a sales and use tax exemption for purchases made by a contractor on behalf of an exempt entity. The provisions in these bills prompted similar discussion regarding scope of application and potential revenue impacts as the provisions contained in 2007 Senate Bill No. 2253. When similar discussion arose in 2015, the House Finance and Taxation Committee voted to amend the bill into a study.

Testimony and Committee Considerations

The committee received testimony from a representative of the Tax Department indicating a contractor that holds a sales tax permit and is registered with the Secretary of State may use an exemption certificate to buy materials without the payment of sales tax. This practice results in more of a tax deferral than a true exemption because a contractor must remit use tax on the materials purchased with an exemption certificate once the materials are used in a construction project. Contractors also must remit use tax on items purchased without the payment of sales or use tax by an exempt entity but later used by the contractor in the completion of a construction or installation contract with the exempt entity.

The committee discussed the option of providing refunds to contractors for the amount of sales and use tax paid. A refund option can be somewhat burdensome for contractors as a contractor would be required to remit all purchasing invoices related to the project and finance any sales and use tax charges until the refund was issued. Construction of a $500 million hospital in Fargo was used to illustrate the difficulties of employing a refund option for larger projects.

Concerns also were raised that requiring contractors to separate costs for labor and materials might be problematic for contractors as contractors typically submit bids in the form of a lump sum. A representative of the North Dakota Township Officers Association expressed a preference for a bill draft that would allow a sales and use tax exemption to be provided up front rather than requiring a contractor to apply for a refund.

The committee considered a bill draft which would have exempted contractors from the requirement to remit use tax on materials used in the performance of a contract with an exempt entity. The committee also considered a bill draft which would have eliminated the requirement for a contractor to remit sales or use tax items purchased by or for an exempt entity and installed by a contractor. The contractor would have been required to obtain a purchasing agent authorization letter and a copy of the exempt entity's exemption certificate prior to purchasing items, or withdrawing items from the contractor's inventory, to be used in completion of a contract with an exempt entity. The bill draft also would have required the tangible personal property be incorporated as part of an improvement to real property that is owned by the exempt entity upon completion of the contract. The committee considered a revised version of the bill draft that would have required the exempt entity own the property and any improvements to the property at the time the contractor enters a contract with the exempt entity.

The committee received information regarding the fiscal impact of eliminating sales and use tax liability on items purchased by or for an exempt entity and installed by a contractor. The exemption would result in an estimated loss of $44.25 million in sales and use tax collections representing three categories of contracts. The first category consisting of contracts related to highway projects, higher education facility projects, and state agency facility projects accounts for a $27.25 million reduction in sales and use tax collections. The second category consisting of contracts related to municipality projects and primary and secondary school projects accounts for a $11.7 million reduction in sales and use tax collections. The third category consisting of contracts entered with the federal government and contracts related to hospital, nursing home, intermediate and basic care, assisted living, and emergency service provider projects accounts for a $5.3 million reduction in sales and use tax collections. Sales and use tax is levied at the local level in 137 cities and 7 counties and the loss in sales and use tax collections at the local level would amount to an estimated $2.9 million.

The committee discussed the potential for portion of the lost sales and use tax collections to be offset by lower appropriations to state agencies and lower property tax bills for taxpayers as a result of sales and use tax charges no longer being built into the overall contract price. While some committee members agreed a portion of the loss sales and use tax revenue would be offset, others were not convinced contractors would reduce bids to reflect a 5 percent reduction in the cost of materials.

Conclusion

The committee makes no recommendation with respect to its study of the payment of sales and use tax by contractors.

INCOME TAX RECIPROCITY STUDY

The Chairman of the Legislative Management assigned the committee a study of the reciprocity agreement between North Dakota and Montana pertaining to the collection and payment of income tax. The study was requested due to increased cross-border employment in the western part of the state.

Background

Compensation received by an individual for services performed in North Dakota is generally taxable by North Dakota even though the individual receiving the compensation is not a legal resident of this state. This practice of taxation centers around the principle of source-based jurisdiction, whereas the state serving as the source of an individual's income has the right to tax income earned within its borders. There are some exceptions to the general rule of taxing North Dakota source income, including the exemptions applied to compensation earned by United States armed forces service members and their spouses, certain interstate commerce employees, certain nonresident individuals present in the state for a limited duration, and Minnesota and Montana residents covered under reciprocity agreements.

The Tax Commissioner has the authority to enter reciprocal agreements with other taxing officials and entities pursuant to Section 57-38-59.1. The Montana Department of Revenue is provided similar authority under Montana Administrative Code Section 15-30-26-21. The reciprocal agreement between North Dakota and Montana regarding the taxation of personal and professional service income was first entered on January 1, 1975. The most recent version of the agreement was signed by the Tax Commissioner on January 8, 2016.

The agreement provides compensation for personal or professional services earned in North Dakota by a Montana resident is not subject to income tax in North Dakota if the individual earning the compensation elects to be exempt from North Dakota withholding. The same option exists for North Dakota residents earning compensation for personal or professional services in Montana. Thus, if a Montana resident who is working and earning compensation for professional services in North Dakota files an election with the individual's employer to refrain from having North Dakota income tax withheld, the Montana resident would not be required to file a North Dakota return or remit North Dakota income tax on that compensation. However, the Montana resident would be required to file and pay tax on that compensation in Montana as, pursuant to the principle of residence-based jurisdiction, Montana has the right to tax income earned by its residents regardless of whether that income is earned outside Montana's borders.

Simplified figures can be applied to the previous example to illustrate the fiscal impacts of the agreement. For instance, assuming the amount of compensation earned by the Montana employee would result in $2,100 of income tax liability when applying Montana's income tax rates, and $2,000 of income tax liability when applying North Dakota's rates, the agreement would result in the Montana resident owing $2,100 in income tax to Montana and no income tax to North Dakota. The Montana resident also would not be required to file an income tax return in North Dakota.

Absent the agreement, the Montana resident's compensation would be subject to North Dakota income tax withholding and the Montana resident would be required to file and pay $2,000 in income tax to North Dakota. The Montana resident also would be required to file and pay income tax in Montana, but would receive a credit for any amount of tax remitted to North Dakota. Thus, the resulting amount of income tax paid to North Dakota would be $2,000 and the amount paid to Montana would be $100 after subtracting the credit for tax paid to North Dakota.

While the revenue analysis in this hypothetical is quite simple, the task of conducting a full-scale analysis encompassing all compensation impacted by the reciprocity agreement would be much more complex. This is especially true considering many Montana residents working in this state are not required to file a North Dakota tax return.

Testimony and Committee Considerations

The committee was informed by a representative of the Tax Department that the income tax reciprocity agreement between North Dakota and Montana has operated smoothly since its inception. A fiscal impact assessment of the agreement has not been conducted, but there generally have been more Montana residents working in North Dakota than North Dakota residents working in Montana. An overall negative fiscal impact on North Dakota revenue and an overall positive impact on Montana revenue is observed when analyzing the available 2013 data. The negative impact on North Dakota revenue results from the fact that the amount of Montana residents' wages exempt from North Dakota income tax is greater than the amount of North Dakota residents' wages exempt from Montana income tax. The positive impact on Montana's revenue results from Montana receiving the full amount of tax on the income of its residents working in North Dakota rather than losing a large portion of that revenue to the credit provided for taxes paid to North Dakota. On an individual level, Montana residents will pay the same amount of income tax overall, whether they have to file and pay in North Dakota and in their home state or whether they are working under a reciprocity agreement. This results from the fact that Montana income tax rates are higher than North Dakota income tax rates. A North Dakota resident working in Montana receives two benefits under the reciprocity agreement in that the North Dakota resident is allowed to pay tax at the lower North Dakota rate and is allowed the convenience of not having to file an income tax return in Montana.

The committee received a rough estimate of the fiscal impact of the agreement from representatives of the Tax Department. An estimated $3.5 million loss to North Dakota revenue was determined by applying various averages and assumptions to figures from the 2013 tax year. A more precise estimate could not be determined because the only data required to be exchanged under the agreement relates to the exemption forms employees file with their employers. A full set of data is not available to provide a more precise estimate.

The committee was informed of a more detailed study conducted regarding the income tax reciprocity agreement between Minnesota and Wisconsin. The study, conducted in 2009, cost an estimated $600,000 and involved the collection and review of income tax returns from both states. The study determined Minnesota was losing roughly $6,000,000 per year as a result of the reciprocity agreement because far more Wisconsin residents were working in Minnesota than Minnesota residents working in Wisconsin. Minnesota withdrew from the reciprocity agreement with Wisconsin in 2009.

The committee also received information pertaining to the income tax reciprocity agreement between North Dakota and Minnesota, which is broader than the agreement with Montana. While the agreement with Montana pertains only to employee's wages, the agreement with Minnesota pertains to wages, and under certain conditions, income derived from a sole proprietorship or partnership.

Some committee members expressed frustration that the state would remain party to an agreement that was negatively impacting state revenues and argued it was unfortunate Montana would not provide the information necessary to fully evaluate the fiscal impact of the agreement. Other committee members were resistant to the idea of withdrawing from a reciprocal agreement with either Montana or Minnesota in light of the difficulties that might arise for North Dakota workers employed in either state. Committee members also expressed concern the number of individuals coming to work in North Dakota from outside of this state may level as a result of the recent downturn in the energy industry.

Conclusion

The committee makes no recommendation with respect to its study of the income tax reciprocity agreement between North Dakota and Montana.