NORTH DAKOTA LEGISLATIVE COUNCIL

Minutes of the

TAXATION COMMITTEE

Wednesday, July 9, 2003
Roughrider Room, State Capitol
Bismarck, North Dakota

Senator Dwight Cook, Chairman, called the meeting to order at 9:00 a.m.

Members present: Senators Dwight Cook, Ronald Nichols, Randy A. Schobinger, John O. Syverson, Harvey Tallackson, Ben Tollefson, Herb Urlacher, Rich Wardner; Representatives Larry Bellew, Wesley R. Belter, David Drovdal, Craig Headland, Ron Iverson, Frank Klein, Phillip Mueller, Kenton Onstad, Arlo E. Schmidt, Dave Weiler, Ray H. Wikenheiser, Dwight Wrangham, Steven L. Zaiser

Members absent: Senator Thomas L. Trenbeath; Representatives Byron Clark, Mike Grosz, C. B. Haas, Elwood Thorpe

Others present: See Appendix A

Chairman Cook called on Mr. John D. Olsrud, Director, Legislative Council, for review of the *Supplementary Rules of Operation and Procedure of the North Dakota Legislative Council*.

Chairman Cook welcomed committee members. He said he believes the committee has a good composition of members with experience in the taxation field. He said there were no study resolutions approved by the 2003 Legislative Assembly regarding taxation, but the Legislative Council believed it was important to have a Taxation Committee and assigned three studies to the committee, including studies of income taxes, tax preferences, and the streamlined sales tax project.

INCOME TAX STUDY

Chairman Cook called on committee counsel for a presentation of a memorandum entitled *Corporate Income Tax Study - Background Memorandum*. Committee counsel said separate memorandums were prepared to address corporate income taxes and individual income taxes to reduce confusion between provisions.

Committee counsel reviewed the history of North Dakota corporate income tax rates. He said passage of 2003 House Bill No. 1471 eliminated the deduction for federal corporate income taxes paid and reduced the highest corporate income tax rate from 10.5 percent to 7.0 percent. He said the 2003 legislation added an additional tax of 3.5 percent of taxable income for water's edge filers to take the place of the election under previous law that required water's edge filers to give up the deduction for federal corporate income taxes paid.

Committee counsel reviewed the kinds of corporations that are exempted from the North Dakota income tax. He said insurance companies paying insurance premiums taxes are exempt from the corporate income tax to the extent of insurance premiums earnings. He said financial institutions pay a financial institutions tax instead of corporate income taxes. He said any corporation exempt from federal income tax is exempt from state income taxes. He described the kinds of corporations that are exempt from federal income taxes.

Committee counsel said the starting point for determination of North Dakota corporate income taxes is a corporation's federal taxable income. He said North Dakota corporate income taxes apply only to the portion of the corporation's taxable income derived from sources within North Dakota. He said a corporation that conducts business only within North Dakota uses federal taxable income as its North Dakota taxable income. He said a corporation that conducts business inside and outside North Dakota must apportion its federal taxable income to determine the portion that is attributable within North Dakota. He said it is impossible to precisely apportion income among states and states use an estimate determined by an apportionment factor to allocate corporate income. He said the apportionment factor that is used in North Dakota compares North Dakota property, payroll, and sales to the corporation's total property, payroll, and sales. He said these three apportionment factors are used by most states, but some states have more heavily weighted the sales factor to benefit corporations located in the state.

Committee counsel said a corporation that is part of a unitary business involving one or more corporations must file under the combined reporting method. He said North Dakota is one of 23 states that have adopted the Uniform Division of Income Tax Act. He said a corporation required to file in North Dakota under the worldwide unitary reporting method may elect to use the "water's edge" method. He said this election allows exclusion of consideration of most corporate income sourced outside the United States. He said corporations making this election may not use the deduction for federal income taxes paid for taxable years beginning before 2004 and, if the election is made for taxable years beginning after 2003, the corporation will be subject to an additional tax of 3.5 percent of taxable income.

Committee counsel reviewed corporate income tax deductions, additions, credits, and exemptions.

Committee counsel reviewed 2003 legislation affecting corporate income taxes. He said House Bill No. 1471, in addition to the rate changes and elimination of the federal income tax deduction, also eliminated the option of carrying back a net operating loss. He said House Bill No. 1309 creates a corporate income tax credit of 10 percent per year for five years of costs of equipment to retrofit or adapt a facility to produce or blend diesel fuel containing at least 2 percent biodiesel fuel by volume. He said Senate Bill No. 2314 as introduced would have eliminated personal and corporate income taxes and broadened the state sales tax to offset the revenue effects. He said the bill was amended before being passed by the Senate to leave individual income taxes unchanged and to phase out corporate income taxes over a five-year period and offset revenue losses by a sales tax rate increase of one-fourth of one percentage point. He said the bill failed to pass in the House.

Committee counsel reviewed corporate income tax net collections for fiscal years 1992 through 2003. He said some of the fluctuation in collections from year to year is attributable to changes in the economy and timing of collections and audit settlements.

Tax Commissioner Rick Clayburgh said another factor that has influenced corporate income tax collections in recent years is the existence of passthrough corporations. He said under these arrangements, corporate profits distributed to shareholders are not taxed at the corporate level and are subject only to taxation to individuals receiving distributions.

Senator Wardner asked what percentage of corporations file under the water's edge method. Ms. Mary Loftsgard, Supervisor, Corporate Income Tax Section, Tax Department, said she did not have that information. Ms. Loftsgard said the election to file on a water's edge basis is available to any qualifying taxpayer, but is voluntary. Senator Wardner said it appears that a corporation making a water's edge election chooses to do so because it will pay less North Dakota corporate income tax. Ms. Loftsgard said that is correct and if the election is made, it is binding for five years. In response to a further question from Senator Wardner, Ms. Loftsgard said she believes there has been an increase in the number of corporations filing under the water's edge method.

Representative Iverson said it was stated that corporate income tax collections have declined because of passthrough corporations. He said this should result in increased distributions to shareholders and he asked how much increased distributions to individuals would increase individual income tax collections in the state. Commissioner Clayburgh said it would probably be impossible to identify this impact. He said individuals are not required to identify income from passthrough corporations and some of the recipients of distributions are not North Dakota residents and would not be subject to North Dakota individual income taxes on those distributions. Commissioner Clayburgh said passthrough corporations create some difficult issues in tax administration. He said further information on this topic can be presented by the Tax Department if the committee wishes to further investigate the issue.

Senator Cook said it appears from the corporate income tax collection data for the state and data that he has seen for other states that corporate income tax collections are going down across the nation. He said he would like to identify the reasons for the general decline in corporate income tax revenues. He asked Commissioner Clayburgh what the Tax Department could do to help the committee understand these changes. Commissioner Clayburgh said the department could provide information on why corporate income taxes are declining nationally. He said Mr. Dan Bucks of the Multistate Tax Commission has made a presentation that really addresses these issues very well and it might be helpful to the committee to invite Mr. Bucks to address these issues.

Chairman Cook said it would be useful to the committee to consider an analysis of the impact and benefits to the economy of income tax credits. Commissioner Clayburgh said the Tax Department could provide information on that topic.

Senator Tallackson asked whether passthrough corporations can be required to provide a list of shareholders. Commissioner Clayburgh said his office requires lists of shareholders, but some filing methods make compliance extremely difficult. He said a master limited partnership is a recent innovation that presents compliance problems. He said passthrough entities create issues that should be addressed by the committee and his office can provide information.

In answer to a question by committee counsel concerning whether a water's edge election is a free choice in every state and not binding on that corporation in other states and whether a corporation filing on a water's edge basis in North Dakota could elect to file on a different basis in every other state, Ms. Loftsgard said that is correct.

Chairman Cook called on committee counsel for a presentation of a memorandum entitled *Individual Income Tax Study - Background Memorandum*. Committee counsel reviewed the history of North Dakota individual income tax rates. He said in 1981 a short-form method of filing was created that has been the method used by the vast majority of taxpayers. He said in 2001 the Legislative Assembly revised the short-form method to replace use of federal income tax liability as a starting point with use of federal taxable income. He reviewed the rates that currently apply on the short-form return. He said without the 2001 change in the starting point, the Jobs Growth and Tax Relief Reconciliation Act of 2003 would have had a substantial revenue loss impact on North Dakota individual income tax revenues. He said the 2003 federal changes will have an impact, but the impact will be of a much smaller magnitude.

Committee counsel said 2003 North Dakota legislation allows an individual short-form return deduction for income from a new and expanding business, allows collection and payment of withholding taxes by payroll service providers, provides an income tax deduction for amounts received as payment for services when ordered to federal service as a member of the National Guard or reserve, provides a deduction for interest in income from bonds issued by a commerce authority, and expands the amount available in seed capital investment tax credits.

Representative Drovdal said many workers from Montana and North Dakota cross the border to perform work and he asked how the credit for taxes paid to another state is administered for these people. Mr. Joseph Becker, Tax Department, said North Dakota has reciprocity agreements with Montana and Minnesota. He said under the agreement with Montana a North Dakota resident working in Montana is exempt from Montana taxes and simply pays North Dakota income taxes on all income. He said the reverse situation applies for Montana and Minnesota residents working in North Dakota.

Chairman Cook said Mr. Michael J. Walsh, Bismarck, distributed copies of printed information on taxation issues to committee members. He said Mr. Walsh wanted committee members to be aware of this information but did not wish to comment to the committee. A copy of the materials distributed is on file in the Legislative Council office.

Chairman Cook called on Ms. Kathryn Strombeck, Tax Department, for a review of the impact of the Jobs and Growth Tax Relief Reconciliation Act of 2003 on North Dakota income tax revenue. A copy of her prepared testimony is attached as Appendix B. Ms. Strombeck reviewed the impact of the increase in the child credit, marriage penalty relief, reduction in individual income tax rates, reduction in capital gains tax rates, dividend tax relief, business depreciation deduction increase, and business expensing increase. She said the overall effect of the federal legislation is estimated to be a decrease of $13.8 million in state general fund revenues for the 2003-05 biennium.

Representative Drovdal asked whether the estimated revenue effects include any consideration of improvement to the economy of the state from individual federal income tax reductions. Ms. Strombeck said those effects are not estimated. She said it is possible that stimulus to the economy will occur but that will depend on whether North Dakotans decide to use federal income tax savings to spend, save, or pay debts.

Chairman Cook said the Tax Department will address several issues already discussed for the next committee meeting. He asked whether committee members have requests for other information for the income tax study.

Senator Schobinger said there are multiple organizations that would be able to assist the committee in its studies. He said he has been in contact with organizations on these issues and at some point may wish to invite them to address the committee.

Representative Mueller said he believes the committee should discuss recouping part of the lost income tax revenue to the state from the federal tax cut package. Chairman Cook said he is not sure how the committee could address that question. Representative Mueller said there has been discussion of the federal legislation providing $69 million new revenue to the state. He said he believes some of that revenue was intended to offset the loss of state income tax revenue. Ms. Strombeck said one of the considerations of Congress on the funds provided to states was the impact of the federal tax relief package on state income tax collections.

Representative Drovdal said the efforts of Congress to stimulate the economy through tax relief results in a loss of North Dakota income tax revenue. He said he would like to hear an analysis by an economist of what revenue gains might result from economic stimulus in North Dakota.

Senator Tallackson said with respect to the question raised by Representative Mueller regarding federal funds to be received by the state under the 2003 federal tax legislation, the most recent Budget Section meeting included an extensive discussion of treatment of those funds. He said approximately $19 million will be made available for the Medicaid program and the remaining amount of approximately $50 million in federal funds is proposed to be deposited into the state general fund. He said one of the reasons Congress provided the funds to the state is to offset state income tax revenue losses as a result of the federal legislation and deposit of the money in the state general fund will cover the estimated revenue reduction from state income tax revenues.

Chairman Cook said Ms. Strombeck has prepared information at his request in the past relating to the number of income taxpayers paying less than $100 and those paying nothing. He said an update of that information would be useful for committee review at the next meeting. Ms. Strombeck said that information could be prepared.

TAX PREFERENCES STUDY

Chairman Cook called on committee counsel for presentation of a memorandum entitled *Taxation Preferences Study - Background Memorandum*. Committee counsel said the study directive is very broad. He said in addition to tax exemptions, deductions, or credits, virtually every provision of every tax law makes some kind of distinction between taxpayers or events which could be viewed as a tax preference.

Committee counsel said the memorandum does not attempt to identify all tax preferences. He said it appears the memorandum allows authority for the committee to investigate any form of state or local taxation and it will be necessary for the committee to identify areas where specific information is desired. He reviewed Legislative Council interim committee studies of tax preference items since 1993. He said during the 2003 legislative session there was considerable discussion of sales tax broadening and the Tax Department has been requested to review sales tax exemptions and fiscal effect for this meeting to initiate this study effort.

Committee counsel said the committee chairman has identified two areas in which he would like to have information presented for the next committee meeting. He said one of the areas is federal lands and property tax exemptions or payments in lieu of taxes programs. He said the other area involves valuation of tax-exempt property in the state. Committee counsel said there has always been a lack of information on this topic, but recent legislation required assessment of exempt property so it should be possible to get a better understanding of the amount of exempt property in the state.

Senator Tollefson said one area that should be examined by the committee is the effectiveness and cost to the state of exemptions, deductions, and credits under the corporate income tax. He said it would be important to look at the impact of these tax breaks and to try to determine whether benefits are being received by the state.

Senator Cook said he believes the committee should examine the fiscal effect of each corporate income tax exemption, deduction, or credit.

Senator Urlacher said it is important for the committee to review the fiscal impact and the fairness of providing tax breaks.

Representative Drovdal said for property that is exempt from property taxes, an attempt should be made to identify the amount of governmental, charitable, or other exempt status property. He said for property subject to payments in lieu of taxes, an examination should be made of whether payments change with inflation or are based on fixed amounts. Senator Urlacher said payments in lieu of taxes should also be compared to private land taxes. Senator Tollefson said payments in lieu of taxes are sometimes optional depending upon whether Congress provides appropriated funds. Representative Schmidt said he believes payments in lieu of taxes on Game and Fish Department lands are based on the method of taxing neighboring property. He said the committee should review how this works.

Senator Tallackson said his concern with the tax preferences study is the potential for unfairness in our tax structure. He said increasing pressure to increase property taxes seems to be the biggest problem in the state. He said growing reliance on property taxes is an issue that needs to be addressed in terms of how it impacts different taxpayers.

Chairman Cook called on Mr. Gary L. Anderson, Director, Sales and Special Taxes Division, Tax Department, for testimony relating to identification and fiscal impact of sales tax exemptions. A copy of Mr. Anderson's prepared testimony is attached as Appendix C. He said the biennial fiscal effect for sales and use tax exemptions was taken from the 2002 Tax Department *Red Book* publication and a more detailed fiscal analysis could be provided on specific exemptions identified by the Taxation Committee. He reviewed sales and use tax exemption studies done on a regular basis in Kansas and Tennessee and a proposal in Florida for a constitutional amendment to require tax fairness consideration with regard to any exemption being considered.

Mr. Anderson said sales tax exemptions are divided into four categories in the compilation. He said the categories distinguish exemptions based on who purchases or sells the product, the kind of product, the purchaser's use of the product, or the nature of the transaction. He said the compilation also divides exemptions based on federal or constitutional provisions, farm uses, health care, manufacturing and processing, business uses, educational uses, nonprofit organizations, nonbusiness uses, and miscellaneous. He said the compilation includes a partial listing of services that are exempt from sales and use taxes. He reviewed the exemption categories and estimated fiscal effect of exemptions by category. He reviewed a compilation of fiscal effect of business incentive sales and use tax exemptions from 1990 to 2003.

In response to questions from Senator Schobinger, Mr. Anderson said the Tax Department is continuing its review of the fiscal effect of sales tax exemptions. He said as further work is done on the estimates, the committee should bear in mind that possible changes will result in some of the estimates.

Senator Schobinger said three of the four states listed on the memorandum do not impose individual or corporate income taxes. He asked whether greater scrutiny of the effect of sales tax exemptions in these states might be due to the lack of income tax revenue. Mr. Anderson said that is probably correct and heavy reliance on sales taxes requires greater scrutiny of the impact of exemptions.

Senator Urlacher said committee members received a book on 50 state comparisons of taxes and revenues and other topics published by the Taxpayers Network. He said it is interesting to observe the effects of tax burdens based on differing income levels.

Chairman Cook said the information presented by Mr. Anderson does not identify the sales tax exemption for the service provided for fee-for-hunting property owners. He requested that the Tax Department prepare information on this service for the committee.

Chairman Cook asked whether the Tax Department would be able to provide a review of the taxation of services in North Dakota and other states. Mr. Anderson said the department could do a comparison with up to approximately 10 other states, including surrounding states, with regard to the taxable status of different services.

Representative Mueller asked whether home rule cities imposing sales taxes are required by current law to match the taxable status of goods and services under state law. Mr. Anderson said city sales taxes generally mirror state sales taxes, which is an advantage when state law changes are automatically incorporated in sales taxes imposed by these cities. He said not all cities follow this method and this may also result in a need for changes to comply with the 2003 legislation under the streamlined sales tax project which is scheduled to take effect January 1, 2006.

Representative Drovdal said a sales tax exemption is made for residents of Montana making a purchase of $50 or more. He said the $50 limitation has not been adjusted since the exemption was created and he would like to know what that amount would be if it had been increased to keep pace with inflation since the time it was created.

STREAMLINED SALES TAX STUDY

Chairman Cook called on Mr. Anderson for a presentation of background information on the streamlined sales tax study. A copy of an outline of Mr. Anderson's testimony is attached as Appendix D.

Mr. Anderson said the streamlined sales tax project was initiated in March 2000 with streamlined sales tax project meetings involving 26 states, including North Dakota. He said the United States Supreme Court decision in *Quill v. North Dakota* was the impetus for the National Governors Association and National Conference of State Legislatures to promote uniformity among states in sales taxes in hopes that interstate sales by remote sellers could be subjected to state sales taxes. He said it has been recognized that a growing portion of retail sales in the United States are escaping state sales taxes because of mail order and Internet sales as a growing part of the retail economy.

Mr. Anderson described the working groups and activities of the streamlined sales tax project. He said the November 2002 streamlined sales and use tax agreement was the basis for 2003 Senate Bill No. 2095 and Senate Bill No. 2096, which were enacted to implement the streamlined sales and use tax agreement. He said January 1, 2006, is the effective date of the North Dakota legislation.

Mr. Anderson reviewed the states that have already enacted legislation to adopt the streamlined sales and use tax agreement. He said approval of the agreement is pending in several more states. He said upon adoption by states representing a sufficient percentage of United States population, a governing board of states will be established and it is hoped that North Dakota will be one of the states represented on the governing board.

Mr. Anderson described the implementation issues North Dakota must address before the 2006 effective date of the Streamlined Sales Tax Act. He said the legislative issues that appear necessary to address include dealing with compliance with multiple tax rate limitations. He said the recent creation of the Lewis and Clark Bicentennial additional 1 percent hotel tax creates a problem. He said it appears the problem might be addressed by creating a special gross receipts tax for this additional tax to move the collection outside the sales tax law. He said it will also be necessary to consider whether state legislation is necessary to deal with home rule sales tax imposition issues involving matching the state tax base, eliminating caps on taxes on a purchase, and imposition of more than one sales tax rate in a jurisdiction. Attached to Mr. Anderson's testimony is a chart comparing home rule sales and use tax imposition similarities and differences.

Senator Schobinger said North Dakota sales and use tax laws allow retailers to retain a portion of sales tax collections for administrative costs. He asked whether a remote seller subject to North Dakota sales and use tax collection would qualify for this allowance. Mr. Anderson said the allowance is not limited to North Dakota businesses and if a business in another state qualifies under the terms of the statute, the allowance would be allowed to the retailer.

Mr. Anderson said the Tax Department has reviewed the provisions of home rule sales tax imposition and has determined that 12 cities and one county are not presently in compliance with the requirements that become effective in 2006. He said 18 cities have a contractor removal provision that does not comply with the provisions to become effective in 2006. He said the other significant issue to address is the caps that exist for a maximum amount of tax on a single purchase and these caps would have to be removed. He said the requirement of a single rate of sales tax in a city would be a problem because Grand Forks currently has two separate taxes that are lumped together. He said if these taxes were combined into a single tax rate, it appears the problem would be resolved.

Mr. Anderson said the Tax Department will probably be working with the North Dakota League of Cities to create boilerplate language for city ordinances to mirror the state sales tax base. He said there are some exemption "carve outs" that would be allowed to be treated differently by cities.

Committee counsel said the *Quill v. North Dakota* decision stated that Congress has authority to authorize states to impose sales taxes on remote sellers. He said much of the streamlined sales tax project basis came from the hope of states that promoting uniformity of states' sales taxes would overcome retailers' objections to compliance problems that would exist without streamlining and convince Congress to authorize states to collect sales taxes from remote sellers. He asked whether the Tax Department has an estimate of the potential additional revenue per year North Dakota could collect if Congress authorizes sales and use tax collections from remote sellers. Mr. Anderson said it is presently estimated that about $27 million per year in additional collections would result for North Dakota.

Senator Wardner asked whether state legislation could force home rule city and county sales tax compliance with the streamlined tax provisions. Mr. Anderson said Senate Bill No. 2096 already requires compliance effective January 1, 2006. He said it is hoped that a way can be found to allow cities to come into compliance without the necessity of citywide elections to change sales tax provisions.

Senator Cook said one of his concerns with imposition of sales taxes on remote sellers is the issue of to whom does a purchaser complain if the remote seller collects the wrong amount of tax. Mr. Anderson said complaints would have to be directed to the retailer. He said the Tax Department would refund an erroneous amount of tax payment to whomever paid the amount to the Tax Department. He said in these situations, the Tax Department would work with the taxpayer to correct errors.

Ms. Connie Sprynczynatyk, Executive Director, North Dakota League of Cities, said cities have some concerns with the efforts to streamline sales taxes. Ms. Sprynczynatyk said the League of Cities does not want to place the cities in the position of having to go to the difficulty and expense of going back to the voters to change provisions of local sales tax law. She said the League of Cities has discussed options with the Tax Department and will be working to achieve compliance by cities. She said city home rule charters will be reviewed to see if it is possible to provide by state law or city governing body action necessary changes for city sales tax application.

Representative Drovdal said one consideration with city sales tax changes is that simply eliminating caps on the amount of tax on a purchase would be viewed by many as being a tax increase. He said that would be opposed by many legislators. Ms. Sprynczynatyk said League of Cities representatives think they can arrive at a fair means of compliance regarding caps.

Representative Wrangham said the streamlined sales tax project opposition to city sales tax caps seems strange in view of the agreements allowing different city sales tax rates. Senator Cook said he participated in discussions on these issues and caps on taxes are a pain in the neck for retailers. Representative Wrangham said it appears differing sales tax rates would also be a pain in the neck for retailers. Senator Cook said that is true, but the lengthy debate arrived at the decision that caps should be eliminated to solve one of these problems for retailers.

COMMITTEE DISCUSSION

Chairman Cook invited further requests from the committee regarding information to be provided for the next committee meeting.

Representative Belter said there has been consideration in the past of the issue of eliminating one of the two optional forms that may be used for filing individual income taxes. He said the committee should investigate the feasibility of eliminating the long-form or the short-form return. Ms. Strombeck said use of the long-form return has fallen off recently. Committee counsel said information was developed in a previous interim to try to determine what taxpayers benefit from the existence of the long-form option and it might be useful to review this kind of information.

Representative Mueller said it appears the information on the fiscal effect of sales tax exemptions will continue to be relevant to committee discussions. He said he hopes information on these exemptions and further discussion of them would be an ongoing committee consideration. He said it may be justifiable to consider eliminating some exemptions.

Chairman Cook said the next meeting of the committee will be tentatively scheduled for September.

The meeting was adjourned subject to the call of the chair at 2:45 p.m.

John Walstad
Code Revisor

John D. Olsrud
Director

ATTACH:4