

NORTH DAKOTA LEGISLATIVE COUNCIL

Minutes of the

TAXATION COMMITTEE

Thursday, October 30, 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, John O. Syverson, Harvey Tallackson, Thomas L. Trenbeath, Herb Urlacher; Representatives Wesley R. Belter, Byron Clark, David Drovdal, Mike Grosz, C. B. Haas, Craig Headland, Ron Iverson, Frank Klein, Phillip Mueller, Kenton Onstad, Dave Weiler, Ray H. Wikenheiser

Members absent: Senators Ronald Nichols, Randy A. Schobinger, Ben Tollefson, Rich Wardner; Representatives Larry Bellew, Arlo E. Schmidt, Elwood Thorpe, Dwight Wrangham, Steven L. Zaiser

Others present: John Warner, State Representative, Ryder

See Appendix A for additional persons present

It was moved by Senator Tallackson, seconded by Representative Iverson, and carried on a voice vote that the minutes of the July 9, 2003, meeting be approved as mailed.

INCOME TAX STUDY

Chairman Cook called on Ms. Mary Loftsgard, Tax Department corporate income tax section supervisor, for presentation of testimony relating to several questions raised by the committee. A copy of Ms. Loftsgard's prepared testimony is attached as Appendix B. Attachments I through IV of Ms. Loftsgard's presentation are attached to her testimony. Copies of articles referred to in her testimony are on file in the Legislative Council office.

Ms. Loftsgard reviewed the history of the development of the water's edge election as an option for corporations that would otherwise be subject to filing on a worldwide combined reporting basis. She provided examples to illustrate computation of corporate income taxes under the worldwide method and the water's edge method. She said the number of corporate returns that elected the water's edge method since it became available for the 1989 tax year has increased from 30 to 276 corporate returns per year in the 13 years sampled.

In response to a question from committee counsel, Ms. Loftsgard said North Dakota is allowed to share information and obtain information from other states to compare reports of corporations filed in other states and the domestic disclosure spreadsheet required to

be filed in North Dakota is a method of discouraging corporations from shifting income and loss among states to avoid taxation.

Senator Cook asked whether North Dakota's existing corporate income tax structure gives businesses an incentive to move property and payroll to other states. Ms. Loftsgard said that is a difficult question to analyze. She said the answer could differ depending on the laws of each state and the circumstances of each corporation.

Committee counsel asked whether Ms. Loftsgard can point out the factors that have led to the substantial growth in water's edge filing indicated by the statistics provided. Ms. Loftsgard said reasons might include a greater understanding of the water's edge election and its consequences and perhaps increases in foreign income for some corporations.

Representative Haas asked what circumstances might prompt an audit of a corporation for income tax purposes. Ms. Loftsgard said the strongest indicator is provided by comparison of the federal return. She said audits are conducted on approximately 5 to 6 percent of corporate returns. She said the focus is generally on more complex returns of corporations doing business across state and national boundaries.

Ms. Loftsgard said she was also requested to provide information on passthrough entities and their effect on corporate income tax revenues. She said examples of passthrough entities would be partnerships, subchapter S corporations, limited liability companies and limited liability partnerships, and master limited partnerships. She said the income or loss of these entities is passed through to owners of the entity. She said there is often a tax incentive to choose to do business as a passthrough entity rather than a corporation to avoid taxation at the entity level. She reviewed statistics indicating that over the past 10 years partnership and small business corporation filings have steadily increased while corporate filings have declined.

Ms. Loftsgard said the Multistate Tax Commission has established a working group that is considering issues relating to passthrough entities. She said she will keep the Taxation Committee advised of the activities of the Multistate Tax Commission working group. She said she anticipates a report from the

working group by July 2004, which is the time of the Multistate Tax Commission meeting.

Ms. Loftsgard said the third issue she was requested to address relates to the factors that might contribute to apparent nationwide decline in corporate income tax revenues. She said one apparent factor is the slow pace of national economic recovery over the past three years. She said another factor affecting North Dakota corporate income tax collections is changes in federal taxable income computation, including the federal government allowing accelerated depreciation and enhanced opportunity to carry back net operating losses. She said another identifiable factor is election by corporations to choose filing methods to reduce overall tax liability, including electing the water's edge filing method. She said numerous corporations now meet the qualification of a financial institution and have filed as financial institutions since changes in the law effective 1997. She said filing as a financial institution may not reduce overall tax liability, but it moves the entity from filing under corporation income taxes to filing under financial institutions' taxes. She said five-sevenths of financial institutions' taxes are distributed to counties so there is a fiscal impact to the state. She said another factor involved in corporate income tax revenue declines is the option for businesses to organize as limited liability companies or partnerships which would allow an entity to avoid corporate income taxes. She said another factor receiving nationwide scrutiny is the effect of corporate income tax shelters. She provided copies of articles describing tax sheltering and the effect on corporate income tax revenues.

Chairman Cook called on Ms. Kathryn Strombeck, Tax Department, for presentation of information requested by the committee. Ms. Strombeck said she was requested to provide information relating to individual income tax returns with net tax liability of \$100 or less and net tax liability of zero. A copy of the statistical information presented by Ms. Strombeck is attached as Appendix C.

Ms. Strombeck said of 2002 tax year individual income tax returns, 20.8 percent had a net tax liability of zero and 15.5 percent had a net tax liability of more than zero but not more than \$100. She said the majority of filers with zero tax liability filed returns to claim a refund of withholding taxes. She said 35.3 percent of filers with zero tax liability did not have withholding or did not claim tax credits. She said of the filers with zero tax liability and no withholding and no tax credits, the majority are farmers reporting a loss or retired persons with high-itemized deductions, usually medical expense deductions.

Senator Syverson said the statistics presented reflect returns that were filed. He asked whether it is possible to identify the number of individuals who had some income but were below requirements for filing a return. Ms. Strombeck said she does not have

information on that topic, but changes to federal income tax laws in recent years have raised the filing threshold and eliminated the filing requirement for many individuals. She said she could do some research to see whether it is possible to identify the number of individuals with income below filing requirements.

In response to a question from Senator Cook, Ms. Strombeck said about 65 percent of the returns reflected in the statistics she provided are for individuals married and filing joint returns.

Representative Drovdal asked whether chances of an audit are approximately equal for returns showing lower taxable income and tax liability as they are for returns showing higher taxable income and higher tax liability. Ms. Strombeck said she cannot provide statistics on audit probability at different income levels, but, in general, audits would focus on higher income and higher tax liability. She said audits of North Dakota returns are governed by federal income tax return audits selected by the Internal Revenue Service.

Chairman Cook called on Mr. Joe Becker, Tax Department, for a presentation of information requested by the committee. A copy of the information presented by Mr. Becker is attached as Appendix D.

Mr. Becker said he was requested to provide a report on income tax preferences and information to identify the typical individual who benefits from the use of form ND-2, previously known as the long-form return.

Mr. Becker reviewed a list showing all deductions, exemptions, and exclusions allowed for individual income tax purposes with the fiscal effect and number of filers in each category. He reviewed a list of all tax credits allowed for individual income tax purposes with the fiscal effect and number of filers claiming each credit. He reviewed a table showing all corporate income tax deductions, exemptions, and exclusions with information on the number of corporations claiming each and the fiscal effect of each. He reviewed a table showing corporate income tax credits and showing the number of corporations claiming each credit and the fiscal effect of each credit.

Representative Warner asked whether information is included on interest income from municipal obligations from other states. Mr. Becker said that is not included because it would be an add-back item and not a reduction. He said he could check on whether information can be provided on that subject for the committee.

Senator Cook asked whether some of the individuals filing the ND-2 (long-form) return would have been better off filing the ND-1 (short form). Mr. Becker said perhaps some out-of-state filers choose the ND-2 form when they would have less tax liability on the ND-1 form. He said North Dakota

resident filers seem to be choosing the correct form and it appears there is better understanding of which form is more advantageous. He said this is reflected in the fact that the percentage of filers using the longer return has been reduced from approximately 5 percent to approximately 2.3 percent in recent years.

Representative Mueller inquired about tax incentives provided for renaissance zones. He asked whether those claiming renaissance zone tax benefits would have paid tax on that income before or whether this could be classified as new income that would not have been subjected to taxes before. Mr. Becker said filers are exempting income or getting credits against income they would have been taxed on previously in projects such as business rehabilitation and similar ventures. He said it would be difficult to measure how much renaissance zone income is new income that would not have existed without the renaissance zone tax incentives.

Mr. Becker said it is not possible to state a general rule on which taxpayers benefit from form ND-2. He said general characteristics might be inferred about who might benefit from the use of form ND-2, including income on the low end of the income scale and persons who are married filing jointly or as head of household entitled to an additional exemption of \$300. He said the difference in tax between form ND-2 and form ND-1 is generally quite small for those who do file form ND-2. The information Mr. Becker presented contains a chart identifying the income range in different filing categories where the benefit disappears for most filers using form ND-2.

Mr. Becker said another category of persons who may benefit filing form ND-2 are persons age 65 or older who have excess medical deductions not allowed on the federal return.

Senator Cook said because the savings from filing form ND-2 are small and the form is more complicated, the question is raised of whether taxpayers pay more for tax preparation fees than they save in taxes. Mr. Becker said he is not sure whether that is true, but tax preparation must be substantial because of the complexity of the return and savings are relatively small so it is likely that for some taxpayers the cost of tax preparation exceeds the tax savings. He said from the point of view of the Tax Department, administrative costs of form ND-2 are very high relative to administrative costs for form ND-1.

Representative Warner asked what the fiscal effect would be if all form ND-2 deductions were moved to form ND-1. Mr. Becker said that would be a huge fiscal effect, but he does not have an estimate at this time.

In response to a question from Senator Urlacher, Mr. Becker said only approximately 2 percent of taxpayers use form ND-2 even though many more deductions are available.

In response to a question from Senator Tallackson, Mr. Becker said long-term care insurance credit claims are limited to \$100 per taxpayer or \$200 for a joint return.

Representative Onstad asked whether form ND-2 is usually done by a professional tax preparer. Mr. Becker said he is not sure, but he could check to see whether that is the case.

Committee counsel said it appears there would be little change necessary to form ND-1 to make it more advantageous for the 2 percent of filers currently using form ND-2, but the fiscal effect would be substantial because the changes would also benefit the 98 percent of filers already using form ND-1. Mr. Becker said he believes that is correct.

Chairman Cook called on Ms. Marcy Dickerson, State Supervisor of Assessments, Tax Department, for testimony relating to whether there is evidence of a growing reliance on property taxes in recent years and the impact of increased property tax reliance on taxpayers at different income levels. A copy of Ms. Dickerson's prepared testimony is attached as Appendix E.

Ms. Dickerson said there has been only a modest increase in property tax mill rates in recent years. She said property valuations for tax purposes have increased substantially in some areas but have decreased in others. She said major cities have had substantial residential valuation increases while some smaller cities have had valuation decreases. Statistics from the eight largest cities indicate for the most recent four years an average increase in property taxes of 4.49 percent per year. She said for these cities the average residential property tax increase percentage is greater than average income increase percentages. She said the disparity is greater for persons relying on Social Security income than for working persons.

Senator Tallackson said in smaller cities there is another problem. He said assessments in smaller cities exceed actual market value because the market for property is not there. Ms. Dickerson said if market value is below assessed value, the assessment should be reduced and the sales ratio study will reveal places where these situations exist. She said there should not be tax revenue incentive to increase valuations.

Representative Mueller asked whether Ms. Dickerson has done a similar analysis for farmland. Ms. Dickerson said she has not done that analysis because that information was not requested. She said an analysis of farmland property taxes would show some shifting of property tax burden from farmland to nonfarmland because of agricultural property valuation changes.

Representative Drovdal asked what the average property tax increase per year statewide would be. Ms. Dickerson said she would have to do some research to answer that question.

Chairman Cook invited committee discussion on other taxation issues on which the committee should seek information.

Committee counsel said it was requested that information be obtained on the amount of property owned by the federal government in the state and any payments in lieu of taxes programs that apply to that property. He said examination of information available from federal agencies on these topics indicates that the information is unreliable. He said reports of agencies vary considerably from year to year and from one agency to another. He said he has discussed this issue with Ms. Dickerson and it appears that a survey of county officials might be the best option to develop reliable information on federal property ownership. Senator Urlacher said there are other kinds of exempt property for which county officials are to have developed valuation information. He said in the course of obtaining information on federal property, a request should also be made for available information on valuation of exempt property as required by law.

Senator Cook said there is a limited variety of types of exempt property that are subject to valuation. He said it might be valid to reopen discussion of expanding the kinds of exempt property subject to valuation. He said representatives of the North Dakota Association of Assessing Officers should be invited to discuss this issue with the committee. Senator Urlacher said it would be useful to expand our knowledge about valuation of exempt property.

Representative Mueller said the information presented on individuals filing income tax returns with liability of \$100 or less was interesting. He said it would also be significant to compare how the percentage of individuals in those categories in North Dakota would compare with statistics from surrounding states.

Representative Drovdal said it might be more efficient for the state to eliminate use of form ND-2 for income tax filings. He said an analysis should be requested from the Tax Commissioner of changes that would be appropriate to form ND-1 to allow for elimination of form ND-2 and what the fiscal effect of the changes would be.

Senator Trenbeath said he has concerns with property valuation issues in rural areas. He said areas in which declining property values are the rule may experience a sale in which the buyer pays substantially more than what market value for the property should be. He said when there is low turnover of property, he is suspicious that assessment officials use the exceptional high sale price to increase valuation for the entire city. He said the committee should seek information on how the sales ratio study applies in smaller communities and whether it is being properly applied. Ms. Dickerson explained briefly how the sales ratio study is intended to work in smaller communities where fewer sales

occur. Chairman Cook said the committee can request Ms. Dickerson to take the committee through how the sales ratio study is to be applied in smaller communities at the next committee meeting.

TAX PREFERENCES STUDY

Chairman Cook called on Mr. Gary Anderson, Director, Income, Sales, and Special Tax Division, Tax Department, for testimony on application of sales taxes to services in North Dakota and other states, fiscal effect of sales and use tax exemptions, and an update on streamlined sales tax issues. A copy of Mr. Anderson's prepared testimony is attached as Appendix F.

Mr. Anderson reviewed a comparison of taxable or exempt status of specific services in North Dakota and nine other states. He said the states selected were chosen because of economic similarities to North Dakota.

Mr. Anderson reviewed an analysis of sales tax revenue that would be available if sales taxes are imposed on hunting and fishing guide fees. He said the analysis does not include income from the sale of hunting rights on agricultural lands.

Senator Cook asked whether there would be any available information to estimate possible sales tax revenue if sales taxes were imposed on the sale of hunting rights on agricultural lands. Mr. Anderson said there is no data available for North Dakota, but South Dakota imposes taxes on that activity and South Dakota might be used as a basis for an estimate of North Dakota potential sales tax revenues.

Mr. Anderson reviewed the list of sales tax exemption and fiscal effect contained in the *Red Book* prepared by the Tax Department. He said the grand total fiscal effect for all identified sales tax exemptions is \$407 million to \$540 million for the biennium. He said if sales taxes were imposed on all exempt sales and the change was to be revenue neutral, the sales tax rate could be reduced from 5 to 2.8 percent.

Mr. Anderson said the committee requested analysis for the sales tax exemption for purchases by Montana residents to determine what the \$50 purchase threshold would be today if it had been adjusted for inflation since it was established. He said 1989 legislation established the \$50 threshold purchase amount and if that amount had been increased at the same rate as inflation, the threshold would now be \$72.50.

Senator Cook said the existence of the sales tax exemption for purchases by Montana residents appears to create a compliance problem under the streamlined sales tax agreement. Mr. Anderson said that appears to be correct and an option that could be considered to bring this provision into compliance would be to change from a point-of-sale exemption to a refund provision similar to the change that was made for purchases by residents of Canada.

STREAMLINED SALES TAX STUDY

Mr. Anderson continued with the portion of his testimony relating to the streamlined sales tax legislation. He said existing provisions of North Dakota law that create compliance concerns include 2003 legislation creating an additional 1 percent sales tax on lodging accommodations and provisions of city home rule sales taxes that are not in compliance, particularly provisions imposing a cap on the amount of tax on a single transaction. He said the lodging accommodation additional sales tax could be changed to a gross receipts tax on lodging effective January 1, 2006, to bring this provision into compliance. He said Tax Department staff and North Dakota League of Cities representatives have met and are considering options to bring city sales tax imposition into compliance with the streamlined sales tax agreement.

Mr. Anderson said another issue for consideration is pending federal legislation to change the Internet Tax Freedom Act. He said pending legislation would eliminate North Dakota authority to impose sales taxes on Internet access charges, which would result in an estimated revenue loss of \$4.6 million per year for North Dakota.

Representative Drovdal asked when it will be determined whether North Dakota will be in compliance with the streamlined sales tax agreement. Mr. Anderson said a meeting will be held in November of participating states to begin the process of comparing state laws for compliance. Representative Drovdal said if there are areas in which North Dakota is not in compliance, he would like to have public hearings on these issues because there will be many interested parties, especially retailers with Montana customers with regard to the issue of the sales tax exemption for purchases by Montana residents.

Representative Warner asked how sales taxes applied to a modular home as compared to a home that is built onsite. Mr. Anderson said a modular home is subject to sales tax on the entire cost of the unit, which includes the labor and materials that went into the structure. He said a home built onsite is subject to sales tax on only the materials incorporated in the structure.

Senator Cook said he hopes the Tax Department will work on preparing draft legislation for committee review before the 2005 legislative session, which

would bring North Dakota into compliance with the streamlined sales tax agreement.

Representative Drovdal said success of the streamlined sales tax project is extremely important to the states. It is estimated that lost sales tax revenue to states will exceed \$45 billion per year by 2006 if states continue to be unable to collect sales taxes from remote sellers.

Chairman Cook called on Mr. Jerry Hjelmstad, North Dakota League of Cities, for comments on the streamlined sales tax project. Mr. Hjelmstad said city finance officers have met with Tax Department representatives to discuss areas requiring changes in city sales tax application. He said a major area for consideration is that caps or thresholds on sales tax application for a purchase are not permissible. He said all cities have a cap on the amount of sales tax that may apply for a single purchase. He said city representatives are hoping to establish a refund system in place of the cap imposed at the point of sale. He said individual cities will also have to look at home rule charters for small changes in some cases.

Representative Grosz said there would be a compliance problem under the streamlined sales tax agreement for cities where voters may not approve a change to existing sales tax application, such as a city that imposes a different tax rate than other cities.

Senator Trenbeath said if there are isolated incidents of noncompliance by cities, those issues would be subject to a legislative solution.

Representative Iverson inquired what would happen if a city with a home rule provision that is not in compliance with the streamlined sales tax agreement does not obtain voter approval for a change. Senator Cook said he believes the state of North Dakota would be found to be out of compliance with the streamlined sales tax agreement if city provisions are not in compliance.

The meeting was adjourned subject to the call of the chairman at 2:10 p.m.

John Walstad
Code Revisor

ATTACH:6