# MICROFILM DIVIDER

OMB/RECORDS MANAGEMENT DIVISION
SFN 2053 (2/85) 5M

ROLL NUMBER

DESCRIPTION

2046

2005 SENATE FINANCE AND TAXATION

SB 2046

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. **SB 2046**

Senate Finance and Taxation Committee

☐ Conference Committee

Hearing Date January 10, 2005

| Tape Number | Side A | Side B | Meter # |
|---|---|---|---|
| # 1 | X | | 17.5 - 38.4 |
| | | | |
| | | | |
| Committee Clerk Signature Sharon Renfrow | | | |

Minutes: All committee members present.

**SEN. URLACHER**: called the meeting to order and opened the hearing on SB 2046.

**JOHN WALSTAD**: of Legislative Council appeared neutral to explain the bill and handed out and excerpt from the Interim Taxation Committee Report dealing with corporate tax issue and focusing on testimony that the committee received from Mr. Dan Bucks who is the Executive Director of the Multi State Tax Commission. He gave the committee a very good back ground on why we have state corporate income taxes and stated that one of the primary reasons state corporate income tax collections are declining is that corporations have focused more of their attention now on state income taxes and how to avoid paying those taxes.

One of the methods that is becoming more common to avoid state income taxes is use of tax havens to shift or shelter income of corporations so that it is out of the reach of states under their corporate income taxes. Mr. Bucks suggested that the committee maybe should consider looking at legislation as was enacted in his home State of Montana in 2003.

This bill identifies tax havens and on page 2 it lists tax havens that corporate tax payers are now using. What the bill does with tax havens, first of all, tax haven incorporation would be included in the water's group. For tax purposes we're only going to look at the income generated within that group basically within the continental limits of the United States, not outside the US, this would expand that, that we would also look at tax payments outside the continental United States as part of that Water's Edge group. On page 4, when their Water's Edge election is filed, they must include a domestic spread sheet and they must include in that any unitary relation corporations that are incorporated in a tax haven, so they have to provide information on these kinds of things. On page 5 is a provision that income shifted to a tax haven, if it is in a unitary relationship and part of that Water's Edge group, is going to be considered income subject to apportionment for ND corporate income tax purposes.

**SEN. COOK**: in the interim committee report estimated the fiscal impact at $150,000 per biennium and how did we come up with an estimate?

**ANSWER**: from the Tax Dept. during the interim committee.

**SEN. URLACHER**: the list of tax havens and assumed only those that are mentioned are going to be subject to the action here, is that right? And how do they come into the system?

**ANSWER**: that's right, it's got to be on this list to be considered a tax haven and doesn't think we could blanket it. We find out from the IRS.

**RON NESS**, of the ND Petroleum Council appeared neutral on the bill stating he had concerns with legitimate businesses doing business in one of these countries that is now being included as income in ND and thereby increasing your tax burden and didn't expect or anticipate the fiscal impact to be this high as it is, feels there are some questions that need to be answered. Feels if the Tax Dept. Can't tell us who these companies are but they could be legitimate ND business with a legitimate business activity in these states and thereby we are increasing their tax burden by up to a half a million dollars because of legitimate businesses. We are adopting border plate language from the multi-state tax commission, however, ND's world wide unitary system with water's edge makes us unique. Would request that you hold onto this and consider the impact.

**SEN. WARDNER**: requested an explanation from the Tax Dept. on how it would be different if they were or had a legitimate business that the tax havens, is there a difference.

**MARY LOFTSGAARD**: from the Tax Dept. gave explanation stating any company in the Water's Edge group would be included in the Water's Edge group for tax purposes.

**SEN. WARDNER:** Can you differentiate if this were to pass?

**MARY**: No, we'd have to have guidance from the Legislature and some sort of definition.

**SEN. BERCIER**: How many other states have this?

**MARY**: Montana is the only on active in this legislation. A number of states have done something different. There are certain entities that are included in the US ___ called 80-20 companies where they do less than 20% of their business in ND.

**SEN. WARDNER**: To really sum it up, they either get to the Water's Edge which gives them a tax break or if there in these tax havens, they don't get the Water's Edge and the tax break.

**MARY**: the number of Water's Edge has grown. They use the Water's Edge to save money and we see more and more companies moving into it because it saves them money and its legal. The reason your seeing an increase is because we have more data we received.

There being no further questions or discussion, the hearing was closed.

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. SB 2046

Senate Finance and Taxation Committee

☐ Conference Committee

Hearing Date January 18, 2005

| Tape Number | Side A | Side B | Meter # |
|---|---|---|---|
| #1 | | X | 3.4 - 7.9 |
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| Committee Clerk Signature Sharon Renfrow | | | |

Minutes: All committee members present.

**COMMITTEE WORK.**

**SEN. URLACHER**: noted that this bill relates to the Water's Edge Corp. With a fiscal note of $585,000.

**SEN. COOK**: stated that Ron Ness had concerns of possibilities that a North Dakota business might have legitimate business in one of these countries, concerned about the resilient partnership, but that issue has been put to rest and doesn't have that concern anymore.

**SEN. WARDNER**: This bill is simply to help the Tax Dept. To cover taxes from companies that are trying to shelter taxable income that should be tax in ND in these places and I think its a good bill so he made a motion for DO PASS, seconded by Sen. Every.

**SEN. BERCIER**: With Water's Edge Legislation bill, was there any discussion with regard to a large business locating on the Indian Reservation we have adjustments and taxes and then doing business out of there?

**SEN. WARDNER**: We really didn't discuss that, but what Water's Edge means is that you can go to the Water's Edge in the continent and then if you go off shore and have these loop holes, we're not going to let you do that anymore, these tax havens. This does not affect the Tribes at all.

**SEN. EVERY**: stated if Mr. Ladasur has his business on the Reservation and he wasn't paying the taxes anyway, he certainly wouldn't have to hide him in another country. I don't think it's even an issue.

**ROLL CALL VOTE**: 6-0-0 Sen. Wardner will carry the bill.

It was noted that the motion should be DO PASS and REFER TO APPROPRIATIONS. All members noted to reflect that.

# FISCAL NOTE

**Requested by Legislative Council**
12/17/2004

Bill/Resolution No.: SB 2046

1A. **State fiscal effect:** *Identify the state fiscal effect and the fiscal effect on agency appropriations compared to funding levels and appropriations anticipated under current law.*

| | 2003-2005 Biennium | | 2005-2007 Biennium | | 2007-2009 Biennium | |
|---|---|---|---|---|---|---|
| | General Fund | Other Funds | General Fund | Other Funds | General Fund | Other Funds |
| **Revenues** | | | $585,000 | | | |
| **Expenditures** | | | | | | |
| **Appropriations** | | | | | | |

1B. **County, city, and school district fiscal effect:** *Identify the fiscal effect on the appropriate political subdivision.*

| 2003-2005 Biennium | | | 2005-2007 Biennium | | | 2007-2009 Biennium | | |
|---|---|---|---|---|---|---|---|---|
| Counties | Cities | School Districts | Counties | Cities | School Districts | Counties | Cities | School Districts |
| | | | | | | | | |

2. **Narrative:** *Identify the aspects of the measure which cause fiscal impact and include any comments relevant to your analysis.*

SB 2046 identifies certain tax havens and requires taxpayers electing the water's edge corporation income tax filing method to disclose unitary relationships with corporations incorporated in tax havens and include them in the water's edge group. SB 2046 allows taxpayers currently within their 5-year water's edge election to rescind their election if they are affected by the tax haven requirements of this bill.

3. **State fiscal effect detail:** *For information shown under state fiscal effect in 1A, please:*
   A. **Revenues:** *Explain the revenue amounts. Provide detail, when appropriate, for each revenue type and fund affected and any amounts included in the executive budget.*

It is estimated that SB 2046, if enacted, will increase state general fund revenues by $585,000 in the 2005-07 biennium.

   B. **Expenditures:** *Explain the expenditure amounts. Provide detail, when appropriate, for each agency, line item, and fund affected and the number of FTE positions affected.*

   C. **Appropriations:** *Explain the appropriation amounts. Provide detail, when appropriate, of the effect on the biennial appropriation for each agency and fund affected and any amounts included in the executive budget. Indicate the relationship between the amounts shown for expenditures and appropriations.*

| | | | |
|---|---|---|---|
| **Name:** | Kathryn L. Strombeck | **Agency:** | Office of Tax Commissioner |
| **Phone Number:** | 328-3402 | **Date Prepared:** | 01/07/2005 |

Date: 1-18-05
Roll Call Vote #: 1

**2005 SENATE STANDING COMMITTEE ROLL CALL VOTES**
**BILL/RESOLUTION NO.** ***SB 2046***

Senate **Finance and Taxation** Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number

Action Taken Do Pass + Refer to Approps.

Motion Made By Wardner Seconded By Every

| Senators | Yes | No | Senators | Yes | No |
|---|---|---|---|---|---|
| Sen. Urlacher | ✓ | | Sen. Bercier | ✓ | |
| Sen. Wardner | ✓ | | Sen. Every | ✓ | |
| Sen. Cook | ✓ | | | | |
| Sen. Tollefson | ✓ | | | | |
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Total (Yes) 6 No 0

Absent 0

Floor Assignment Wardner

If the vote is on an amendment, briefly indicate intent:

## REPORT OF STANDING COMMITTEE

**SB 2046: Finance and Taxation Committee (Sen. Urlacher, Chairman)** recommends **DO PASS** and **BE REREFERRED** to the **Appropriations Committee** (6 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). SB 2046 was rereferred to the **Appropriations Committee.**

2005 SENATE APPROPRIATIONS

SB 2046

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. **SB 2046**

Senate Appropriations Committee

☐ Conference Committee

Hearing Date 01/24/05

| Tape Number | Side A | Side B | Meter # |
|---|---|---|---|
| 1 | x | x | 533 |
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| Committee Clerk Signature | | | |

Minutes: **Chairman Holmberg** opened meeting on SB 2046.

**John Malstad, LC (5150)** appeared to provide an overview of bill. Mr. Malstad is neither for nor against SB 2046. No written testimony was provided. Questions were raised regarding delegating legislative authority to the tax commissioner.

**Chairman Holmberg** closed hearing on SB 2046.

2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. 2046

Senate Appropriations Committee

☐ Conference Committee

Hearing Date January 24, 2005

| Tape Number | Side A | Side B | Meter # |
| --- | --- | --- | --- |
| 1 | a | | 191 - 320 |
| | | | |
| | | | |
| Committee Clerk Signature | | | |

Minutes:

**Chairman Holmberg** called the hearing to order on SB 2046 and asked for vote.

**Senator Robinson** motioned for a vote on **SB 2046**. **Senator Krauter** seconded. A roll call vote was taken 13 voted yes, 2 were absent. The motion carried.

**Senator Wardner of Finance and Taxation Committee** will carry this bill.

**Chairman Holmberg** closed the hearing on SB 2046.

Date: 1/25/05
Roll Call Vote #: 1

**2005 SENATE STANDING COMMITTEE ROLL CALL VOTES**
**BILL/RESOLUTION NO. SB 2145**

Senate Senate Appropriations Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number ~~2128~~ 2046

Action Taken Do Pass

Motion Made By Sen. Robinson Seconded By Sen Krauter

| Senators | Yes | No | Senators | Yes | No |
|---|---|---|---|---|---|
| Chairman Holmberg | ✓ | | Sen. Tallackson | | |
| Vice Chairman Bowman | ✓ | | | | |
| Vice Chairman Grindberg | ✓ | | | | |
| Sen. Andrist | ✓ | | | | |
| Senator Christmann | ✓ | | | | |
| Senator Fischer | ✓ | | | | |
| Sen. Kilzer | ✓ | | | | |
| Sen. Kringstad | ✓ | | | | |
| Sen. Schobinger | | | | | |
| Sen. Thane | ✓ | | | | |
| Sen. Krauter | ✓ | | | | |
| Sen. Lindaas | ✓ | | | | |
| Sen. Mathern | ✓ | | | | |
| Sen. Robinson | ✓ | | | | |

Total (Yes) 13 No

Absent 2

Floor Assignment Sen Wardner

If the vote is on an amendment, briefly indicate intent:

## REPORT OF STANDING COMMITTEE

**SB 2046: Appropriations Committee (Sen. Holmberg, Chairman)** recommends **DO PASS** (13 YEAS, 0 NAYS, 2 ABSENT AND NOT VOTING). SB 2046 was placed on the Eleventh order on the calendar.

2005 HOUSE FINANCE AND TAXATION

SB 2046

2005 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. **SB 2046**

House Finance and Taxation Committee

☐ Conference Committee

Hearing Date **February 14, 2005**

| Tape Number | Side A | Side B | Meter # |
|---|---|---|---|
| 1 | X | | 17.2 |
| | | | |
| | | | |
| Committee Clerk Signature | Janice Stein | | |

Minutes:

**REP. WES BELTER, CHAIRMAN** Called the committee hearing to order.

**JOHN WALSTAD, LEGISLATIVE COUNCIL** Introduced the bill. See attached interium committee report. He submitted the interium committee report for SB 2045 and SB 2046. Mr. Walstad explained the bill. He stated he wasn't sure if this is the tool the tax department needs to bring the tax haven into North Dakota for corporate income tax purposes, they can address that better then he could. There is a positive fiscal note here, so I do think the tax department recognizes that there is some income being shipped to tax havens, which would be brought into North Dakota as taxable corporate income, the number is a positive $585,000.

**RON NESS, NORTH DAKOTA PETROLEUM COUNCIL** Testified in opposition of the bill. We have been part of this water's edge discussion for many years. We have many companies who operate in a multi national capacity, whether it be refineries in various countries or on and off shore gas production. Our opposition would be, that if you have production in off shore and it is counted as income in that country, which is a ligitimate business operating in that country, it will now become North Dakota income. We have a growing number of companies using the water's edge filing system in North Dakota. They need to file at the water's edge in order to pay reasonable income to the state of North Dakota in lieu of their income in other parts of the world. We have a company that owns a part of a refinery in the Virgin Islands. They own fifty percent of the refinery their along with the country. That is certainly a ligitmate business in that country, and that income would then become subject to North Dakota corporate income tax. It sets a negative tone to corporations who want to domicile or do business in North Dakota. Introduced John Morrison, an attorney who represented various corporate clients in North Dakota.

**REP. NICHOLAS** Did I hear you say, when you set up this entity in this foreign country where you are participating with this foreign government, if there are losses, are you taking those losses against your profits on your other entities?

**RON NESS** Under this bill, I would think you can carry those losses back to North Dakota.

**REP. NICHOLAS** If you are carrying those losses back here, you could carry the profits back here too.

**RON NESS** I think you could carry either back.

**JOHN MORRISON, ATTORNEY, MEMBER OF THE NORTH DAKOTA PETROLEUM COUNCIL** Answered Rep. Nicholas' question. Referred to Amerado Hess Corporation, who is in litigation where they have made a water's edge election. Amerado Hess has elected to be taxed on this water's edge income. As such, its losses in the Virgin Islands refinery do not affect their North Dakota income. Under current law, if making a profit, it would not, because they made a water's edge election. If they were on a world wide combination, yes, those losses would factor into the income. It is a two way street if there is a water's edge election, all your losses and all your income end at the water's edge. My clients would be impacted negatively, by this bill. See attached written testimony.

**REP. BELTER** This bill, in a sense, negates the water's edge provision?

**JOHN MORRISON** To the extent, you have corporations organized in any of the tax haven countries,

**REP. CONRAD** Didn't understand, wanted him to repeat that.

**JOHN MORRISON** The water's edge election is designed to say that, corporations, or a group of corporations, elect to be taxed on their water's edge income, the income within the 48 states and the District of Columbia. This would be a step backward, because it would say, in addition to the water's edge income, we would take away your water's edge election, as to any affiliate corporation that is incorporated in one of these tax haven countries. It doesn't matter what the business is, if it is a refinery or oil and gas production.

**REP. CONRAD** If they are simply doing business in that country but incorporated in this country, then the change wouldn't affect them?

**JOHN MORRISON** By and large, no.

**REP. CONRAD** Why to they incorporate in other countries?

**JOHN MORRISON** It may be to take advantage of other countries' tax structures, or maybe because their business is operating in other countries, or maybe because the other countries have restructions on the licenses that require domestic companies have certain activities.

**DENNIS BOYD, REPRESENTING MDU RESOURCES GROUP** Testified in opposition of the bill. I noticed in Mr. Morrison's comments, that Montana appears to be the only state that is in active tax haven legislation, in my opinion that would be a good reason to go in the opposite direction. This is an unfriendly signal you are sending to the business community. I stood in front of this committee about four weeks ago asking you to defeat HB 1108, which was brought forth by the tax commissioner, and which disallowed a deduction that had been granted to corporations at the federal level. That bill has passed the house, I think that is an unfriendly signal you are sending to the business community.

**REP. BELTER** Your company doesn't have investments in these so called tax haven countries?

**DENNIS BOYD** Not in any of the countries that are currently listed here.

**REP. SCHMIDT** This came through the interium tax committee, and I think the reason the committee took a look at this, is that corporation income tax has taken a big decline in North Dakota, can you tell us why that corporate income tax is taking a big decline?

**DENNIS BOYD** I don't have a definitive answer to your question, but I might add, that might be a good thing, that might indicate this state is moving in a direction to attract corporations to come to this state. Personally, I think you should get rid of the whole corporate income tax.

**REP. CONRAD TO JOHN WALSTAD** You said that eight to twelve billion dollars was lost in North Dakota in 2001?

**JOHN WALSTAD** That is what Mr. Buck reported to the committee. To me, that is a shocking number.

**REP. CONRAD** Do you know how much of that is North Dakota, were there any more breakdowns?

**JOHN WALSTAD** No, Mr. Buck did not have information on that, and we didn't ask him for that kind of information. The tax department did present some information to the committee, looking at reasons why corporate income tax revenue declined. There are a variety of factors involved in the reduction.

**REP. IVERSON** It is that the companies are moving to the states that don't have corporate income tax.

**RICK CLAYBURGH, STATE TAX COMMISSIONER** Gave a comment to Rep. Conrad's question. Specific to the financial side of this, we can't tell you that corporate income tax has dropped X million dollars because of certain reasons. We know we saw a reduction in corporate income tax collections, a large majority had a lot to do with the downturn in the national economy and also the change in more incorporation of pass through entities. There was some federal treatment too, which has had an impact. We can't sit here and say A causes seven million dollars deduction or B causes whatever.

**REP. CONRAD** Can you tell us the number of companies that are going to the water's edge or that previously did business off shore?

**RICK CLAYBURGH** That 230 number may have come from our office.

**REP. BELTER** Your tax department didn't officially testify in support of this bill, what is your thinking, is there some ligitimate tax income we should be getting?

**RICK CLAYBURGH** The water's edge issue, is a very touchy issue for a state to look at. The finance and tax committee eliminated the water's edge election and sent the bill to the senate, that was actually, what came out of the interium committee as well. There was no opposition, no discussion to it. In North Dakota, we don't have a lot of filers, it is increasing a little bit, but the fact, that any state was looking at tinkering with the water's edge issue, opposition came from all over the country, and also from companies in North Dakota. Looking at the issue here, there are ligitimate uses for water's edge and also for these tax havens. In many cases, they are totally legal operations and within the federal requirements. There is starting to be some concern, and the IRS is leading up a fairly large study right now on the use of ligitimate tax havens, and in some cases, not ligitimate. How do we address those issues when people are utilizing tax codes specifically to shelter income, compared to using it ligitimately for business purposes. The companies that spoke here today, are companies who are using it for ligitimate purposes. We have seen some cases where some of the bad actors are causing the public sentiment, which is coming out nationally. There are a lot of other states looking at this issue.

**REP. BELTER** My concern is that if there is somewhat of a problem out there, that we aren't creating problems for ligitimate businesses by having this type of legislation.

**RICK CLAYBURGH** That is the reason we don't have the answer.

**REP. NICHOLAS** There are 276 companies, out of those, how many are bad guys?

**RICK CLAYBURGH** In our analysis, the only analysis of the water's edge filers, there are a handfull who have made bad elections, they are actually paying more in taxes.

**REP. CONRAD** Do you know how this bill differs from what passed in Montana?

**RICK CLAYBURGH** I don't know the difference, or if there is any difference.

**MARY LOFTSGARD, STATE TAX DEPARTMENT** Clarified remarks which were made. She mentioned that Amerado Hess is part of the water's edge group. There are now about 308 companies filing under the water's edge. She stated these companies did have the option that if this bill became law, they could rescind their water's edge election.

2005 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. **SB 2046**

House Finance and Taxation Committee

☐ Conference Committee

Hearing Date **March 1, 2005**

| Tape Number | Side A | Side B | Meter # |
|---|---|---|---|
| 2 | | X | 22.2 |
| | | | |
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| Committee Clerk Signature | | | |

Minutes:

**COMMITTEE ACTION**

**REP. GRANDE** Made a motion for a **do not pass.**

**REP. IVERSON** Second the motion. **MOTION CARRIED.**

**9 yes 4 no 1 absent.**

**REP. IVERSON** Was given the floor assignment.

Date: 3-1-05
Roll Call Vote #: 1

**2005 HOUSE STANDING COMMITTEE ROLL CALL VOTES**
**BILL/RESOLUTION NO. SB 2046**

House FINANCE & TAXATION Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number

Action Taken Do Not Pass

Motion Made By Rep. Grande Seconded By Rep. Iverson

| Representatives | Yes | No | Representatives | Yes | No |
|---|---|---|---|---|---|
| BELTER, WES, CHAIRMAN | ✓ | | | | |
| DROVDAL, DAVID, V-CHAIR | ✓ | | | | |
| BRANDENBURG, MICHAEL | ✓ | | | | |
| CONRAD, KARI | | ✓ | | | |
| FROELICH, ROD | | ✓ | | | |
| GRANDE, BETTE | ✓ | | | | |
| HEADLAND, CRAIG | ✓ | | | | |
| IVERSON, RONALD | ✓ | | | | |
| KELSH, SCOT | | ✓ | | | |
| NICHOLAS, EUGENE | A | | | | |
| OWENS, MARK | ✓ | | | | |
| SCHMIDT, ARLO | | ✓ | | | |
| WEILER, DAVE | ✓ | | | | |
| WRANGHAM, DWIGHT | ✓ | | | | |
| | | | | | |

Total (Yes) 9 No 4

Absent 1

Floor Assignment Rep. Iverson

If the vote is on an amendment, briefly indicate intent:

## REPORT OF STANDING COMMITTEE

**SB 2046: Finance and Taxation Committee (Rep. Belter, Chairman)** recommends **DO NOT PASS** (9 YEAS, 4 NAYS, 1 ABSENT AND NOT VOTING). SB 2046 was placed on the Fourteenth order on the calendar.

2005 TESTIMONY

SB 2046

EXCERPT FROM INTERIM TAXATION COMMITTEE REPORT NOV. 2004
RELATING TO SB 2046

**Multistate Tax Commission**

The executive director of the Multistate Tax Commission addressed the committee regarding corporate income tax issues. It was stated that the creation and continued existence of state corporate income taxes is due to weaknesses of other tax types in addressing the corporate business form. A tax on income was viewed as fairer than other tax types because it taxes knowledge, patents, and other intangibles. It would be impractical to tax corporate earnings at the shareholder level because shareholders may reside in other states or countries or may be other corporations. The rationale for taxing corporate business activity is that states provide services to benefit businesses. The corporate income tax serves as a necessary companion to individual income taxes so income transfers to corporations cannot be used to avoid individual income taxes. Corporate income taxes are better suited than other tax types to fairly tax the new economy.

There are areas in which corporate income taxes are subject to criticism. The corporate income tax is a tax on production instead of consumption. The corporate income tax favors debt financing over equity and distorts business investment choices. Too many individuals and corporations are able to avoid corporate income taxes. The corporate income tax may be viewed as a double layer of taxation because income taxed at the corporate level is again subject to taxation at the individual level after distribution to shareholders.

It is important for states to observe principles to promote equity and make corporate income taxes work in practice. Income must be fully and fairly reported in reasonable relation to where that income is earned. The means of determining where multistate entity income is earned should be consistent among states.

States must recognize corporate income tax realities. Corporate income taxes have declined as a percentage of revenues for all states from approximately 9.7 percent in 1980 to 4.9 percent in 2002. Effective corporate income tax rates have declined from approximately 8.96 percent in the 1980s to 5.92 percent in 2001. A variety of factors have contributed to the decline in state corporate income tax revenues as a share of state tax collections. Changes in federal corporate income tax laws affect states due to the piggyback nature of state corporate income taxes on the federal corporate income tax structure. Federal preemption of state authority to tax some activities has caused some companies to restructure to take advantage of federal law protection. There has clearly been an increase in aggressive tax planning by corporations aimed at reducing state corporate income taxes. State policy choices on business incentives and economic development have reduced corporate income taxes for qualifying corporations. There has been a substantial shift to forms other than corporations for doing business, such as limited liability companies and similar business structures, including the creation of layers of corporate and noncorporate entities to reduce or avoid the impact of corporate income taxes.

The Multistate Tax Commission conducted a tax shelter study as an attempt to measure the degree to which income reporting for corporations does not reflect the place income was earned. One of the conclusions of the study was an estimate that states lost $8 billion to $12 billion in 2001 due to two or three categories of tax shelters. This represents a loss of approximately one-third of total state corporate income tax collections. It appears the primary method of sheltering corporate income is shifting income to a nontaxable location or tax haven or using other methods to avoid federal corporate income taxes.

It was recommended that combined reporting, including requiring information on tax haven activities, would improve corporate income tax administration. Montana enacted a 2003 law requiring that a water's edge report must include information on tax havens. It was recommended that states develop nexus rules on doing business which are consistent with how corporate income is apportioned. Uniformity among states would reduce incentives to shift income. A concerted effort should be made to curb tax sheltering and income shifting at the state and federal levels.

The Multistate Tax Commission working group also investigated the use of passthrough entities to avoid corporate income taxes. Traditional corporate forms of doing business which are subject to corporate income taxes are rapidly declining as a percentage of business organizations and as a percentage of business income. It has become clear that states need to take action to address growing use of passthrough entities. States need effective and simplified systems of ensuring proper reporting of passthrough entity income, which requires composite return and withholding requirements. It is necessary for state tax systems to address tax sheltering that employs layers of passthrough entities or single-member limited liability companies within corporations.

COMMITTEE RECOMMENDATION SB 2046

The committee recommends Senate Bill No. 2046 to require inclusion of corporations in a unitary relationship and incorporated in a tax haven as part of a water's edge corporate income tax filing election. The bill is patterned after 2003 Montana legislation and would allow the Tax Commissioner to require a taxpayer to include in a domestic disclosure spreadsheet any corporation in a unitary relationship with the taxpayer and incorporated in a tax haven. The bill also provides that income shifted to a tax haven, to the extent that it is taxable, is considered income subject to apportionment for income tax purposes. The estimated fiscal impact of the bill is an increase in general fund revenue of approximately $150,000 per biennium.

## Committee Consideration - Corporate Income Tax

### Revenue Decreases

The committee examined reasons for the nationwide decline in corporate income tax revenues. One factor is slowing of the national economy in recent years. North Dakota corporate income tax collections are reduced because of recent federal corporate income tax reductions, including allowing accelerated depreciation and enhanced opportunities to carry back net operating losses. Corporations choose filing methods that will reduce overall tax liability, including electing to file under the water's edge filing method. In North Dakota the number of corporations choosing the water's edge filing election has increased from 30 to 276 in 13 years. In North Dakota numerous corporations have become eligible for taxation as a financial institution. Financial institution taxes are substantially equivalent in terms of tax liability but five-sevenths of financial institutions' taxes are distributed to counties, so there is a fiscal impact to the state general fund. A growing drain on corporate income tax revenues is the fact that businesses may organize in other business forms such as limited liability companies or partnerships, which allows an entity to avoid corporate income taxes. Another factor receiving nationwide scrutiny is the effect of corporate income tax shelters.

The Tax Department conducts audits on approximately 5 to 6 percent of corporate income tax returns. The focus of audit activity is generally on more complex returns of corporations doing business across state and national boundaries.

The committee examined detailed information on the effect of passthrough entities on corporate income tax revenues. Examples of passthrough entities include subchapter S corporations, partnerships, limited liability companies, limited liability partnerships, and master limited partnerships. The income or loss of these entities is passed through directly to owners of the entities and is not subject to corporate income taxes. There is a tax incentive to avoid corporate income taxes by choosing to do business as a passthrough entity rather than as a corporation. Over the past 10 years, passthrough entity filings in North Dakota have steadily increased while corporate filings have declined.

The Multistate Tax Commission has a working group considering issues relating to passthrough entities. The working group recommended legislation to states to require a passthrough entity to either file a composite income tax return or withhold income tax on the share of income of the entity distributed to each nonresident member. Nonresident members are subject to North Dakota income taxes on passthrough entity income earned in North Dakota, but there is a compliance problem under current law to identify nonresident members and collect taxes due.

### Multistate Tax Commission

The executive director of the Multistate Tax Commission addressed the committee regarding corporate income tax issues. It was stated that the creation and continued existence of state corporate income taxes is due to weaknesses of other tax types in addressing the corporate business form. A tax on income was viewed as fairer than other tax types because it taxes knowledge, patents, and other intangibles. It would be impractical to tax corporate earnings at the shareholder level because shareholders may reside in other states or countries or may be other corporations. The rationale for taxing corporate business activity is that states provide services to benefit businesses. The corporate income tax serves as a necessary companion to individual income taxes so income transfers to corporations cannot be used to avoid individual income taxes. Corporate income taxes are better suited than other tax types to fairly tax the new economy.

There are areas in which corporate income taxes are subject to criticism. The corporate income tax is a tax on production instead of consumption. The corporate income tax favors debt financing over equity and distorts business investment choices. Too many individuals and corporations are able to avoid corporate income taxes. The corporate income tax may be viewed as a double layer of taxation because income taxed at the corporate level is again subject to taxation at the individual level after distribution to shareholders.

It is important for states to observe principles to promote equity and make corporate income taxes work in practice. Income must be fully and fairly reported in reasonable relation to where that income is earned. The means of determining where multistate entity income is earned should be consistent among states.

States must recognize corporate income tax realities. Corporate income taxes have declined as a percentage of revenues for all states from approximately 9.7 percent in 1980 to 4.9 percent in 2002. Effective corporate income tax rates have declined from approximately 8.96 percent in the 1980s to 5.92 percent in 2001. A variety of factors have contributed to the decline in state corporate income tax revenues as a share of state tax collections. Changes in federal corporate income tax laws affect states due to the piggyback nature of state corporate income taxes on the federal corporate income tax structure. Federal preemption of state authority to tax some activities has caused some companies to restructure to take advantage of federal law protection. There has clearly been an increase in aggressive tax planning by corporations aimed at reducing state corporate income taxes. State policy choices on business incentives and economic development have reduced corporate income taxes for qualifying corporations. There has been a substantial shift to forms other than corporations for doing business, such as limited liability companies and similar business structures, including the creation of layers of corporate and noncorporate entities to reduce or avoid the impact of corporate income taxes.

The Multistate Tax Commission conducted a tax shelter study as an attempt to measure the degree to which income reporting for corporations does not reflect the place income was earned. One of the conclusions of the study was an estimate that states lost $8 billion to $12 billion in 2001 due to two or three categories of tax shelters. This represents a loss of approximately one-third of total state corporate income tax collections. It appears the primary method of sheltering corporate income is shifting income to a nontaxable location or tax haven or using other methods to avoid federal corporate income taxes.

It was recommended that combined reporting, including requiring information on tax haven activities, would improve corporate income tax administration. Montana enacted a 2003 law requiring that a water's edge report must include information on tax havens. It was recommended that states develop nexus rules on doing business which are consistent with how corporate income is apportioned. Uniformity among states would reduce incentives to shift income. A concerted effort should be made to curb tax sheltering and income shifting at the state and federal levels.

The Multistate Tax Commission working group also investigated the use of passthrough entities to avoid corporate income taxes. Traditional corporate forms of doing business which are subject to corporate income taxes are rapidly declining as a percentage of business organizations and as a percentage of business income. It has become clear that states need to take action to address growing use of passthrough entities. States need effective and simplified systems of ensuring proper reporting of passthrough entity income, which requires composite return and withholding requirements. It is necessary for state tax systems to address tax sheltering that employs layers of passthrough entities or single-member limited liability companies within corporations.

SENATE BILL NO. 2046

HOUSE FINANCE AND TAXATION COMMITTEE

FEBRUARY 14, 2005

Chairman Belter and members of the House Finance and Taxation Committee, my name is John Morrison. I am an attorney and I represent various corporate clients with respect to state income tax matters in North Dakota. I am also a member of the North Dakota Petroleum Council and am appearing before you as a member of the Petroleum Council.

I'd like to address briefly the history of unitary business taxation in North Dakota. World-wide combination – combining the "world-wide" income of a group of related business and taxing that world-wide income in North Dakota through an apportionment formula - was administratively applied in North Dakota by then-Tax Commissioner Byron Dorgan beginning as early as 1973. The legislature did not pass any legislation providing for world-wide combination. There were no administrative rules promulgated. Combination was simply administratively implemented as an audit technique. In doing so, North Dakota followed the lead of the California Franchise Tax Board.

In the late 1970's, foreign governments began to voice strong objection to the taxation of their businesses in the United States. After the United States Supreme Court upheld the constitutionality of world-wide combination in 1983, the Reagan Administration undertook an active role in resolving the controversy. A Working Group chaired by Treasury Secretary Donald Regan worked with both state tax officials and U.S. based multi-national corporations to come up with a compromise in 1984. Essentially, the states agreed to abandon worldwide combination if the multi-nationals would allow apportionment of foreign dividends and the inclusion of 80/20 corporations (U.S.-based corporations with 80% of their activities conducted in foreign countries). State legislatures began enacting water's-edge legislation. Water's edge was enacted in California in 1986. Finally, in 1987, while Heidi Heitkamp was Tax Commissioner, the North Dakota legislature enacted what is now Chapter 57-38.4 of the North Dakota Century Code. It allows multi-national corporations to make an election to be taxed on a "water's edge basis." In provides for the inclusion of foreign dividends and income from 80/20 corporations in the water's edge income.

As originally enacted, a corporation making a water's edge election gave up its right to deduct its Federal income tax. In a compromise during the last session, when the Federal income tax deduction for all corporations was eliminated in exchange for a lowering of the tax rates, a 3 ½% additional tax, or surcharge, was placed on water's edge filers.

Senate Bill No. 2046 is a significant step backwards from the 1987 water's edge enactment. Assertions that corporations avoid taxes by incorporating in "tax havens" are not new. The original version of the water's edge legislation in 1987 included a tax haven provision. Like Senate Bill No. 2046 it was a Legislative Council Interim Finance and Tax Committee proposal. The 1987 legislation was carefully negotiated by Tax

Commissioner Heitkamp, various business interests including GNDA, Northwest Bell and Amoco and a number of key legislators. The legislation ended up in conference committee and Representatives Schneider and Moore drafted the compromise legislation. It did not contain the tax-haven provisions.

Even in 1987, the tax haven was substantially different than that included in Senate Bill No. 2046. Affiliates incorporated in "tax havens" were only included in the water's edge income if 50% or more of sales, purchases, income or expenses were made to one or more members of the water's edge group and the tax haven corporation had "no significant economic activity." These protections are missing from Senate Bill No. 2046.

Senate Bill No. 2046 is primarily the result of a presentation to the Interim Taxation Committee by the executive director of the Multistate Tax Commission. It is essentially an MTC proposal. It represents a significant step back from the water's edge law enacted in 1987 and the tax rate restructuring enacted in 2003. It will send a signal to the business community that North Dakota is returning to the aggressive tax policies it pursued in the 1970's and 1980's.

Every state which adopted world-wide combination now provides for a water's edge election. We believe that only one state – Montana – has enacted "tax haven" legislation. Other water's edge states include Alaska, California, Colorado, Idaho, Illinois, New Hampshire, Oregon and Utah. Of our neighboring states, South Dakota has no income tax and Minnesota applies purely domestic combined reporting.

For these reasons, we recommend a do not pass on Senate Bill No. 2046.