TAXATION COMMITTEE

The Taxation Committee was assigned four studies. House Concurrent Resolution No. 3049 directed a study of taxation and regulatory incentives for the lignite industry in order to improve its competitive position in the energy marketplace and to identify federal and international impediments to development of the lignite industry and potential state actions to address such impediments. House Bill No. 1462 directed a study of application, enforcement, and administration under the fuels tax laws. Senate Concurrent Resolution No. 4040 directed a study of the feasibility and desirability of establishing a mechanism to allow farmers and ranchers to shelter a portion of their income in an agricultural real estate asset retirement-type fund. Senate Concurrent Resolution No. 4041 directed a study of potential tax incentives and regulatory relief that would encourage greater investment participation by North Dakota residents in agricultural business ownership.

Committee members were Senators Randel Christmann (Chairman), Meyer Kinnoin, Kenneth Kroeplin, Randy A. Schobinger, Bob Stenehjem, Vern Thompson, Steve Tomac, and Herb Urlacher and Representatives Wesley R. Belter, Mick Grosz, Pam Gulleson, C. B. Haas, Gil Herbel, Stacey L. Mickelson, Ronald Nichols, Dennis J. Renner, Earl Rennerfeldt, Arlo E. Schmidt, Ben Tollefson, John M. Warner, and Ray H. Wickenheiser.

The committee submitted this report to the Legislative Council at the biennial meeting of the Council in November 2000. The Council accepted the report for submission to the 57th Legislative Assembly.

LIGNITE INDUSTRY STUDY

Background

The lignite industry study was a continuation of the study conducted by the Taxation Committee during the 1997-98 interim. The study resolution states that taxation and regulatory compliance costs constitute up to 30 percent of the production costs for North Dakota lignite and that reduction of these costs could improve the competitive position of North Dakota's lignite industry.

Coal Severance Tax

A 1973-74 interim Legislative Council study of coal severance taxes, property tax imposition on coal gasification plants, distribution of revenues, and aid for impact of coal development led to creation in 1975 of a coal severance tax, coal impact aid program, and a privilege tax on coal conversion facilities.

Under the 1975 law, the coal severance tax rate was set at 50 cents per ton plus an amount determined by an escalator clause based upon wholesale prices. In 1977 the Legislative Assembly increased the base rate of the tax to 65 cents per ton plus an amount determined by application of a modified escalator clause. In 1979 the coal severance tax was set at a base rate of 85 cents per ton with a modified escalator clause. The formula for determining the coal severance tax rate remained unchanged until 1987, and the rate imposed reached a high of $1.04 per ton. In 1987 legislation reduced the general coal severance tax rate to 75 cents per ton, eliminated the escalator clause, and imposed an additional separate tax of two cents per ton, with the proceeds of the separate tax allocated to the lignite research fund. The rate of tax has remained unchanged since 1987.

The coal severance tax is in lieu of sales or use taxes. Any coal mined in this state which is exempt from the severance tax is subject to sales and use taxes unless a sales or use tax exemption exists. Severance tax exemptions are provided for coal used primarily for heating buildings and coal used by the state or any political subdivision. Purchases by the state or a political subdivision are exempt from the sales tax, but coal used for heating privately owned buildings is not exempt from the sales tax. North Dakota Century Code (NDCC) Section 57-61-01.4 provides a severance tax exemption for coal used in agricultural processing or sugar beet refining plants located in North Dakota or adjacent states. Coal exempted for these purposes also is exempt from sales and use taxes under Section 57-39.2-04(44). Under Section 57-61-01.3, the severance tax rate is reduced by 50 percent if the coal is to be burned in a cogeneration facility. Under Section 57-61-01.7, coal mined for out-of-state shipment was subject to a 50 percent reduction in the severance tax rate from July 1, 1995, through June 30, 2000, and was eligible for waiver of the 35 percent local share of the tax.

Coal shipped into North Dakota for use in a coal conversion facility would not have been subject to North Dakota taxes under the law as it existed until 1997. Passage of 1997 House Bill No. 1467 provided that such coal would be subject to a special sales tax of six cents per million British thermal units and that revenue from the special sales tax would be allocated in the same manner as coal severance tax revenues. The 1997 law was challenged by Montana coal producers and declared unconstitutional by the South Central Judicial District Court in a February 1, 1999, decision. Passage of 1999 House Bill No. 1454 changed the sales and use tax rate for imported coal to 75 cents per ton to match the severance tax rate on North Dakota coal. This change was recommended by the Attorney General to address the constitutional problem with the 1997 law. The Kennecot Energy Company and Spring Creek Coal Company challenged the 1999 legislation because of the legislation's potential impact on their operations in Montana. On May 3, 2000, a North Dakota district court decision found that the 1999 legislation is unconstitutional as a violation of the commerce clause of the United States Constitution. That decision is on appeal to the North Dakota Supreme Court.

An exemption from the state's 50 percent share of coal severance or sales taxes was created in 1997 by NDCC Section 57-61-01.8 for coal burned in small generating stations in this state or an adjacent state. This section also allows political subdivisions to waive collection of their share of tax revenues on such coal. This section is repealed effective July 1, 2003, by 1999 House Bill No. 1454.

Under NDCC Section 57-61-01.2, coal is considered to be severed and subject to the severance tax when it is first removed from the earth unless within 30 days of removal it is placed into a long-term storage deposit. If placed in storage, it is considered severed when removed from storage or pledged as collateral on a loan.

All severance taxes, penalties, and interest collected by the Tax Commissioner are transferred to the State Treasurer within 15 days of receipt and are credited to a special fund in the state treasury called the coal development fund. The revenue in the coal development fund is allocated under a detailed formula contained in NDCC Section 57-62-02. Fifteen percent of the revenue in the coal development fund is to be deposited in a permanent trust fund in the state treasury known as the coal development trust fund. This fund is held in trust and administered by the Board of University and School Lands for loans to coal-impacted counties, cities, and school districts. Under Section 57-61-01.5(2), 70 percent of deposits in the trust fund are to be transferred to the lignite research fund. Thirty-five percent of the revenue in the coal development fund is allocated to coal-producing counties in the proportion that the number of tons of coal severed in each county bears to the total number of tons of coal severed in the state. The remaining 50 percent of the revenue in the coal development fund is to be deposited in the state general fund, but after June 30, 1997, the general fund share of revenue from new production from clean coal demonstration projects is to be deposited in the lignite research fund.

Of the 35 percent portion of coal development fund moneys which is distributed to coal-producing counties, 30 percent is paid by the county treasurer to incorporated cities of the county based upon population, 40 percent is deposited in the county general fund, and 30 percent is apportioned to school districts within the county based on average daily membership of each school district. The distribution formula within counties also provides for recognition of impact on surrounding areas not within the county. If the tipple of a currently active coal mining operation in a county is within 15 miles of another county in which no coal is mined, revenue apportioned from that coal mining operation is apportioned according to the same formula as county revenues with inclusion of cities, school districts, and the general fund of the non-coal-producing county within certain geographical limits.

It is estimated that 59,670,900 tons of taxable lignite coal will be mined in North Dakota during the 1999-2001 biennium. Coal severance tax revenues for the 1999-2001 biennium are estimated to be $45,916,128. Of this amount, the state general fund will receive $22,346,122, allocations to political subdivisions will be $15,663,611, and the coal development trust fund will receive $6,712,977. The remaining $1,193,418 will go to the lignite research fund.

Privilege Tax on Coal Conversion Facilities

The privilege tax on coal conversion facilities is imposed by NDCC Section 57-60-02. A coal conversion facility is defined as an electrical generating plant that converts coal into electrical power and has a capacity of 120,000 kilowatts or more or a facility that uses over 500,000 tons of coal per year to be converted into other products. Differing tax rates are imposed on different types of coal conversion facilities.

As enacted in 1975, the coal conversion facilities privilege tax on electrical generating plants was at a rate of one-fourth of one mill per kilowatt hour of electricity produced, and the tax on coal gasification plants was the greater of 2.5 percent of gross receipts or 10 cents per 1,000 cubic feet of synthetic natural gas. In 1983 an additional one-fourth of one mill per kilowatt hour tax was imposed on electrical generating plants. In 1985 the floor on the tax for coal gasification plants was increased from 10 cents to 15 cents per 1,000 cubic feet of synthetic natural gas. In 1987 the basis of the tax for electrical generating plants was changed from kilowatt hours of electricity produced to 60 percent of the installed capacity of each generating unit times the number of hours in the taxable period, and for damaged units, a reduced tax rate based on cost of repairs was established to be in effect until the unit is capable of generating electricity. Other 1987 legislation reduced the alternative tax for coal gasification plants from 15 cents to seven cents for each 1,000 cubic feet of synthetic natural gas produced and provided an exemption for any synthetic natural gas production in excess of 110 million cubic feet per day. In 1989 separate tax treatment was provided for coal beneficiation plants, providing an alternative tax of 20 cents per ton of beneficiated coal or one and one-quarter percent of gross receipts, whichever is greater. In 1991 legislation was enacted to provide a five-year exemption for new electrical generating plants from all but 35 percent of the one-fourth of one mill tax based upon production capacity of the generating unit, and the 35 percent remaining tax is allocated entirely to the county and may be eliminated by the board of county commissioners.

For electrical generating plants, the present coal conversion tax is at a rate of one-half of one mill on each kilowatt hour of electricity produced for the purpose of sale. This tax is divided into two separate one-fourth of one mill taxes, revenues from each of which are subject to different allocations.

For coal gasification plants, the rate of tax is either 2.5 percent of gross receipts or seven cents per 1,000 cubic feet of synthetic natural gas, whichever is greater. In 1985 gross receipts from the sale of a capital asset and any financial assistance provided by the federal government were exempted from the coal conversion tax. A 1987 amendment exempted byproducts of the gasification process, to a maximum exclusion of 20 percent of all gross receipts of a facility. Passage of 1997 Senate Bill No. 2196 increased the gross receipts byproducts exclusion maximum from 20 to 35 percent until December 31, 2000, when the limit will revert to 20 percent. Senate Bill No. 2196 also exempted sales of carbon dioxide for oil and gas recovery from the gross receipts tax. Passage of 1997 Senate Bill No. 2339 extended the property tax exemption for a pipeline to transport carbon dioxide to 10 years after initial operation rather than commencement of construction and allowed the exemption to apply to a pipeline carrying carbon dioxide outside the state.

Under the coal conversion tax, each coal conversion facility is classified as personal property and is exempt from property taxes except taxes on the land upon which the facility is located. The coal conversion tax is in lieu of property taxes on the facility. The coal conversion tax is also in lieu of taxes on rural electric cooperatives and cooperative electrical generating plants that qualify as coal conversion facilities.

Allocation of coal conversion tax revenues is made annually on or before July 15 of each year. Revenue from one-fourth of one mill of the tax on electrical generating plants is deposited in the state general fund. Revenue from all remaining coal conversion taxes is allocated 65 percent to the state general fund and 35 percent to the producing county.

Revenue allocated to counties from the coal conversion tax is allocated within the county--40 percent to the county general fund, 30 percent to cities in the county according to population, and 30 percent to school districts in the county on an average daily membership basis.

Total revenue from coal conversion taxes for the 1999-2001 biennium is estimated to be about $30,613,804. Of that amount, the state general fund is expected to receive about $24,555,184 and political subdivisions are expected to receive about $6,058,620.

Energy Development Impact Program

North Dakota Century Code Section 57-62-04 establishes an Energy Development Impact Office as a division within the office of the commissioner of the Board of University and School Lands. The director of the Energy Development Impact Office is required to develop a plan for the assistance of counties, cities, school districts, and other political subdivisions in coal development and oil and gas development impacted areas and to make grants to counties, cities, school districts, and other taxing districts within the limitations of legislative appropriations for this purpose.

Section 57-62-06 provides that it is the intent of the Legislative Assembly that the moneys appropriated to, and distributed by, the Energy Development Impact Office for grants are to be used by grantees to meet initial impacts affecting basic governmental services and directly necessitated by coal development or oil and gas development impact. The Energy Development Impact Office is funded for oil and gas development impact grants, but grants for coal development have not been funded by legislative appropriation since 1987.

Lignite Research, Development, and Marketing

North Dakota Century Code Section 54-17.5-02 requires the Industrial Commission to consult with the Lignite Research Council established by executive order in matters of policy affecting the administration of the lignite research fund. In evaluating applications for funding from the lignite research fund for North Dakota's lignite research, development, and marketing program, the Industrial Commission and the Lignite Research Council are required to give priority to those projects, processes, or activities that will preserve existing jobs and production, which will create the greatest number of new jobs and the most additional lignite production and economic growth potential in coal-producing counties or those counties with recoverable coal reserves, which will attract matching private industry investment equal to at least 50 percent or more of the total cost, and which will result in development and demonstration of a marketable lignite product or products with a high level of probability of rapid commercialization. For marketing applications, priority must be given to those projects, processes, or activities that develop baseline information, implement specific marketing strategies, and otherwise contribute to the effective marketing of lignite and its products. For reclamation applications, priority must be given to those projects, processes, or activities that will reduce unnecessary regulatory costs and assist in effectively reclaiming surface-mined land to its original or better productivity as soon as possible.

Under NDCC Section 54-17.5-05, the Industrial Commission is authorized to issue evidences of indebtedness payable solely from appropriations by the Legislative Assembly from moneys in the lignite research fund, revenues or income that may be received by the commission from lignite projects, processes, or activities funded with the proceeds of the commission's evidences of indebtedness, and revenues or income received by the commission from any other source under Chapter 54-17.5. The evidences of indebtedness may be issued for the purpose of funding research, development, and marketing projects, processes, or activities directly related to lignite and products derived from lignite. The Industrial Commission must maintain a reserve fund for evidences of indebtedness issued by the Industrial Commission relating to lignite resources. The Industrial Commission must submit to the Office of the Budget, not later than July 15 of each year preceding the biennial session of the Legislative Assembly, a request for the amount required to be appropriated from the lignite research fund to pay debt service on outstanding evidences of indebtedness during the following biennium.

North Dakota Century Code Section 54-17.5-06 provides a procedure through which an entity may file a request with the Industrial Commission to have materials designated as confidential which have been submitted to, or made or received by, the Industrial Commission and the Lignite Research Council relating to trade secrets or commercial, financial, or proprietary information. In addition, a request to have material designated as confidential is considered to be confidential.

For the 1999-2001 biennium, the estimated receipts for the lignite research fund are approximately $6,252,502. That amount includes $1,193,418 from the separate and additional two-cent coal severance tax, about $4,699,084 from the coal severance tax deposited in the permanent coal development trust fund, and about $360,000 from interest income. The balance at the beginning of the 1999-2001 biennium was approximately $5,478,001.

Estimated expenditures from the lignite research fund for the 1999-2001 biennium are $10,450,000. Estimated expenditures include $500,000 for a lignite marketing feasibility study and $9,950,000 for administration and development of the lignite research, development, and marketing program. The Industrial Commission has authorized an investment of $4.2 million from the fund in the Dakota Gasification Company's lignite to anhydrous ammonia project and issuance of tax-exempt bonds to provide $8.1 million to the Dakota Gasification Company. The bonds are for 10-year financing with annual principal and interest payments of approximately $1,085,000 from lignite research fund revenues. The total bond cost to the fund was estimated to be $11 million.

Regulation of Coal Mining

North Dakota Century Code Section 38-12.1-04 provides that the Industrial Commission has jurisdiction over all persons and property necessary to regulate the exploration for coal on state and private lands within the state. The State Geologist is required to act as a supervisor responsible for enforcing the regulations and orders of the commission. The commission may require the furnishing of a reasonable bond conditioned upon the full compliance with state law and rules of the commission prescribed to govern the exploration for coal. In addition, the commission may require the delivery to the State Geologist of basic data collected during the exploration for coal and may require plugging, covering, or reburial of all holes, pits, or trenches excavated during the course of coal exploration. The commission also has authority to protect environmental quality, general health, and safety and economic values and may inspect all drilling or exploration sites. The commission is directed to require that any lands substantially disturbed in coal exploration be reclaimed, including excavations, roads, drill holes, and the removal of facilities and equipment.

North Dakota Century Code Section 38-12.1-05 requires a permit from the State Geologist before the commencement of exploration for coal. In addition, that section prohibits the removal of more than 250 tons of coal pursuant to an exploration permit without first obtaining a permit from the Public Service Commission.

North Dakota Century Code Chapter 38-14.1 addresses surface mining and reclamation operations. Under that chapter, the Public Service Commission is designated the state regulatory authority for all purposes relating to the federal Surface Mining Control and Reclamation Act of 1977. The commission is authorized to issue permits for surface coal mining operations and to adopt regulations necessary to carry out Chapter 38-14.1 and the federal Surface Mining Control and Reclamation Act of 1977.

North Dakota Century Code Section 38-14.1-04 authorizes the Public Service Commission to develop a data base and an inventory system that will permit proper evaluation of the capacity of different land areas of the state to support and permit reclamation of surface coal mining operations and to develop methods of implementing land use planning decisions concerning surface coal mining operations. The commission is also authorized to develop procedures through which determinations of the unsuitability of land for surface coal mining are integrated as closely as possible with land use planning and regulation processes at the state and local levels.

North Dakota Century Code Section 38-14.1-06 allows any person having an interest that is or may be adversely affected, including state agencies other than the Public Service Commission, to petition the Public Service Commission to hold a hearing for the purpose of having an area designated as unsuitable for surface coal mining operations under Section 38-14.1-05 or to have such designation terminated. The section requires the commission to hold public hearings in the locality of the affected area for each petition filed. The commission may designate an area as unsuitable for surface coal mining operations after a hearing if the commission determines that reclamation is not technologically and economically feasible or that the operations will be incompatible with existing state or local land use plans or programs. The commission may also designate an area as unsuitable if mining operations will affect fragile or historic lands in which the operations could result in significant damage to important historic, cultural, scientific, and aesthetic values and natural systems; affect renewable resource lands in which the operations could result in a substantial loss or reduction of productivity of long-range water supply or food or fiber products, and the lands include aquifers and aquifer recharge areas; or affect natural hazard lands in which the operations could substantially endanger life and property, and the lands include areas subject to frequent flooding and areas of unstable geology.

North Dakota Century Code Section 38-14.1-14 provides the requirements for permit applications for surface coal mining and reclamation operations. Among other things, the permit application requires the applicant to provide cultural resource information and submit a reclamation plan for the land. In addition, the permit applicant is required to file a performance bond in an amount sufficient to complete the reclamation plan.

North Dakota Century Code Chapter 38-14.1 establishes procedures for ruling on permit applications, permit renewals, and permit revisions. Section 38-14.1-24 establishes general performance standards applicable to all surface coal mining and reclamation operations.

North Dakota Century Code Section 38-14.1-27 establishes requirements for the maintenance of records for surface coal mining and reclamation operations and provides for the monitoring and inspections of the operations.

North Dakota Century Code Section 38-14.1-28 authorizes the Public Service Commission to initiate enforcement procedures when an alleged violation is discovered.

North Dakota Century Code Section 38-14.1-29 allows the Public Service Commission to assess a civil penalty after opportunity for a public hearing for a violation of Chapter 38-14.1 or any rule adopted pursuant to that chapter.

North Dakota Century Code Section 38-14.1-40 authorizes any person having an interest that is or may be adversely affected to commence a civil action on that person's own behalf to compel compliance with Chapter 38-14.1 or any rule, order, or permit issued under the chapter. The action may be commenced against any person or governmental instrumentality or agency that is alleged to be in violation of any rule, order, or permit issued pursuant to Chapter 38-14.1 or against the Public Service Commission if there is alleged to be a failure of the commission to perform any act or duty under Chapter 38-14.1 which is not discretionary with the commission. In addition, any person who is injured or sustains property damage through the violation by any operator or permittee of any rule, order, or permit issued pursuant to Chapter 38-14.1 may bring an action for damages or permanent equitable relief.

North Dakota Century Code Chapter 38-14.3 establishes a surface mining and reclamation bond fund to be maintained at the Bank of North Dakota to provide bonds for the faithful performance of all surface coal mining laws, rules, and permit conditions and terms. The bond fund is to be administered by the Industrial Commission.

Surface Owner Protection

North Dakota Century Code Chapter 38-18 was enacted in 1975 to provide the maximum amount of constitutionally permissible protection to surface owners from the undesirable effects of development of minerals underlying the surface of their property. A mineral developer is required to give the surface owner written notice of the type of land disturbance or mining operation contemplated by the mineral owner before the Public Service Commission may issue a permit to surface mine the land. The commission may not issue a permit to surface mine the land unless the permit application is accompanied by statements of consent executed by each surface owner whose land is included within the permit area. Chapter 38-18 also provides for the payment of surface damage and disruption payments to surface owners and requires a mineral developer to pay the entire cost of the surface reclamation necessitated by that developer's mining operation.

Administrative Rules

More than 300 sections of the North Dakota Administrative Code have been adopted by the Industrial Commission and Public Service Commission regarding coal exploration and surface mining and reclamation. Administrative rules of the State Department of Health and Tax Commissioner also affect coal mining operators. North Dakota Century Code Section 23-01-04.1 prohibits the State Department of Health from adopting administrative rules on air quality affecting coal conversion facilities which are more strict than federal rules or standards under the Clean Air Act (42 U.S.C. 7401 et seq.). Section 23-25-03.2 prohibits the State Department of Health from adopting administrative rules on sulfur dioxide air quality which are more strict than federal rules or standards under the Clean Air Act.

1997-98 Study of the Lignite Industry

During the 1997-98 interim study of the North Dakota lignite industry, the North Dakota Lignite Energy Council suggested, and the Taxation Committee agreed, that independent consultant analysis was necessary to assess the competitive position of lignite coal in the electric energy industry. A consultant study, funded in equal amounts by the North Dakota Lignite Energy Council and the Legislative Council, was conducted by Dr. David Ramsett, Director, Division of Economics and Public Affairs, University of North Dakota. Dr. Ramsett's report *Competition in North Dakota's Coal-Electric Utility Industry: Lignite vs. Subbituminous Coal*, reached the following major conclusions:

1. Coal is more important than ever to national energy production.
2. Open market competition exists at the wholesale level in electric energy production, and open market competition will soon become the norm at the retail level.
3. The driving force in the nation's coal industry is low-sulfur western subbituminous coal produced in Wyoming and Montana.
4. Users of subbituminous coal have enjoyed continuous price reductions due to rising productivity in mining and reduced costs of transportation.
5. Electric power producers choose the most cost-efficient energy source. Continuing price decreases in the delivered price of subbituminous coal to electric power plants in the region are threatening the economic viability of North Dakota's mine-mouth coal-electric power industry.
6. Coal taxation has become a bigger issue for the North Dakota coal-electric utility industry as the delivered price of subbituminous coal has dropped.
7. North Dakota must evaluate the economic effects of taxing lignite coal because of the economic impact and the state revenue impact of the coal-electric utility industry and the increasing potential that subbituminous coal could be burned in North Dakota power plants.

Significant changes are occurring in the national electric utility industry. The industry is moving from exclusive regional operation to open market sales. The industry was segregated and is moving to a national sales market, was regulated and is moving to free market competition, and is in transition to a character that cannot be determined at this time but will clearly be significantly different.

States in this region of the country are net exporters of electric power. States in the region are in competition with each other for markets. It is necessary to closely examine competitive factors in surrounding states to assess the continued economic viability of lignite coal. North Dakota is the only state in the region using lignite coal to produce electric power. North Dakota power plants have been located at the mine site to reduce transportation costs. In contrast, all other states in the region use imported subbituminous coal to generate electric power production. The vast majority of this coal is shipped by rail from Wyoming.

The report indicated the best means of measuring competitiveness in the coal industry is comparing coal costs per megawatt hour (CCMH). The resulting statistic depends on several variables, including the price of coal delivered to the producing plant, the energy-producing quality of the coal, and the efficiency of the plant burning the coal. Comparing the CCMH for 1991 and 1996 shows that significant changes occurred in regional competition. The CCMH for North Dakota was relatively stable at $8.29 in 1991 and $8.32 in 1996. Other states in the region have experienced declines in CCMH because of importation of subbituminous coal from Wyoming at a greatly decreased cost. The CCMH in Nebraska has decreased from $8.72 in 1991 to $7.88 in 1996. Each state in this region has experienced a decrease in CCMH from 1991 to 1997 except North Dakota, which has experienced an increase of 5.7 percent. This compares with decreases of 34.9 percent for Nebraska, 33.1 percent for Missouri, 28.3 percent for South Dakota, and 19.5 percent in the national average CCMH.

Lignite productivity remained stable from 1992 to 1996. During that time period, productivity for subbituminous coal increased 49.1 percent, leading to a cost reduction of 21.3 percent. Increased productivity in subbituminous coal is attributable to thicker seams of coal, less overburden to remove and replace, larger mines, and improved equipment for subbituminous mining operations.

Another very significant edge for subbituminous coal competitiveness has been deregulation of rail rates, which has substantially reduced shipping costs for coal. Unit trains increased the number of tons that may be shipped. Greater density of track and improved rail technology have also increased the ability to ship coal.

The report emphasized it is important to remember that North Dakota tax and regulatory policy for the coal industry is not what has created the current economic problems faced by the lignite industry. Price reductions in subbituminous coal and transportation costs have been so significant that they are responsible for the competitive crisis faced by the industry. These events have focused attention on taxation policy because close competitive pricing of coal and electricity produced from coal depends on several variables and very small pricing differences spell success or failure in competition in the open market. The continued reductions in the price of delivered subbituminous coal have made it feasible to burn subbituminous coal in North Dakota power plants. This fact is important in North Dakota coal taxation and regulatory policymaking. North Dakota tax policy was established based on a coal industry that mines lignite coal at the generation plant and produces electric power for sale. Continuation of current trends will result either in a gradual loss of market share for the electric utility industry or increased use of subbituminous coal in North Dakota power plants. Either result would cause a reduction in mining of lignite coal in North Dakota. One option is to shift reliance from the coal severance tax to a tax on electric power production, which would generate tax revenues whether the source of generation is lignite or subbituminous coal.

During the 1997-98 study, Lignite Energy Council representatives reviewed the economics of using Wyoming coal in North Dakota generating plants. The price of Wyoming coal was $3.12 per ton compared to $10.56 per ton for lignite at the plant. The Wyoming coal would have been subject to transportation costs of $8.02 per ton plus the North Dakota sales tax for imported coal of $1.02 per ton (which has since been declared unconstitutional). This comparison indicated a total cost of Wyoming coal of $12.16 per ton versus a cost of $10.56 per ton for lignite. A more realistic measure of actual cost, however, requires converting the cost of coal to a price per million British thermal units produced. On this basis, the cost of North Dakota lignite was 78 cents per million British thermal units compared to 72 cents per million British thermal units for Wyoming coal delivered to the Leland Olds Station in North Dakota. Given this comparison, subbituminous coal was lower in price than lignite coal for burning in North Dakota power plants. Another significant consideration is that subbituminous coal burns with substantially lower levels of sulfur dioxide and nitrate oxide, which means that blending of subbituminous coal with lignite coal for burning in the future may become environmentally significant if air standards become more stringent.

Testimony

Law governing reclamation of mined lands is primarily the result of federal laws and regulations. The committee requested and received from the Public Service Commission an analysis of state reclamation laws and rules that are more stringent than corresponding federal requirements.

Most of the areas in which North Dakota imposes more stringent requirements than federal law and rules are the result of statutory requirements, rather than administrative rules. The most significant state provisions that are more stringent than corresponding federal requirements relate to soil handling and restoring productivity of agricultural lands after mining. These provisions were created by 1975 legislation and require a mining company, before obtaining final bond release on property, to demonstrate that reclaimed lands are as productive as similar undisturbed lands in the surrounding area. Soil suitability in the reclamation process is determined by a detailed soil survey. The Public Service Commission has used reclamation research findings to make rule changes to reduce unnecessary costs in soil handling by mining companies.

The committee requested and received from the State Department of Health an analysis of areas in which state statutes and rules are more stringent than corresponding federal laws and rules with respect to air quality, water quality, and solid waste management. Under NDCC Section 23-01-04.1, the State Department of Health is prohibited from adopting air quality, water quality, or solid waste rules more stringent than corresponding federal requirements unless it makes a specific finding after public hearings that corresponding federal requirements are not adequate to protect public health and the environment of the state. The areas in which state law and rules differ from federal requirements were described as areas in which there are no corresponding federal requirements. New federal rules require each state to develop a plan to restore air quality in defined areas within 60 years. North Dakota will be required to develop such a plan by the year 2006. North Dakota is working with regional states to develop such a plan. Canadian generating facilities degrade air quality in North Dakota, and the federal rules allow recognition of the impact of foreign air pollution. Federal rules also allow recognition of smoke from forest fires that drift into the state from Canada or neighboring states.

According to a representative of the North Dakota Lignite Energy Council, the biggest regulatory threat the North Dakota lignite industry perceives in the next 10 years is with regard to Environmental Protection Agency rules. The lignite industry has been successful in lawsuits against enforcement of Environmental Protection Agency rules, but industry representatives believe this battle will continue. Federal efforts to limit carbon dioxide and nitric oxide emissions and possibly mercury emissions were described as potential threats to the North Dakota lignite industry. Regional haze limitations being pushed by the Environmental Protection Agency were described as the greatest current threat to the lignite industry. It was recommended to the committee that legislation on state regulatory laws and rules is not needed at this point.

The committee received information on the Lignite Vision 21 Project, described as a partnership of the lignite industry and state government. The objective of the Lignite Vision 21 Project is establishment of a baseload electric power generation plant using state-of-the-art mining and generation technology and the most recent environmental technology to improve efficiency and reduce emissions. It was estimated that emissions from the proposed facility would be about 10 percent of the emissions of existing facilities in the state.

The Lignite Vision 21 Project has received support from the Industrial Commission in the form of approval of $10 million in matching funds for the development phase of the new generation plant. The amount approved is to come from the lignite research fund. Phase 1 of the Lignite Vision 21 Project involved analysis of environmental, generation technology, and transmission issues. The environmental study reviewed all current and pending industry regulations and identification of environmental issues and recommended solutions. The study concluded that all environmental concerns can be managed if cooperation is received. The advanced generation technology study determined that construction and operation of a 500 megawatt generation plant is feasible. The transmission study analyzed existing network constraints and lines for potential transmission upgrades and recommended a route for additional transmission with an export capability of an additional 800 megawatts if funding and approval is obtained. If the project proceeds as contemplated, the new generation plant could go on-line in 2007 or 2008.

According to the Lignite Energy Council, the lignite industry operates in a very competitive environment with competition from Canadian hydropower, subbituminous coal from Montana and Wyoming, and other fuel sources used to generate electricity in the Midwest Area Power Pool. Power sold in the Midwest Area Power Pool region operates on a margin of one-half of one mill per kilowatt hour. Because of this very small operating margin, tax and regulatory costs for lignite are critical issues, but recommendations for change would be premature until the litigation regarding sales and use taxes on imported coal is resolved.

Conclusion

The committee makes no recommendation regarding the lignite industry study.

FUELS TAX STUDY

Background Motor Vehicle Fuel Tax

North Dakota Century Code Section 57-43.1-02 imposes a tax of 21 cents per gallon on gasoline and gasohol sold or used in this state. The tax is collectible by the dealer from the consumer on all retail sales. One cent per gallon of motor vehicle fuel tax on each gallon of fuel sold in the state is allocated to the township highway aid fund for allocation to townships for road purposes. The one cent per gallon for township highway aid is withheld from refunds otherwise available to agricultural, industrial, or governmental users. Except for amounts withheld from refunds or allocated to the township highway aid fund, all motor vehicle fuel tax revenues are allocated to the highway tax distribution fund.

Agricultural users of gasoline or gasohol who paid the tax at the time of purchase may claim a refund of taxes paid. The refund is reduced by seven cents per gallon, of which two cents is deposited in the agricultural fuel tax fund, one cent is retained in the highway tax distribution fund, and four cents is deposited in the agricultural research fund. Effective January 1, 2002, the amount withheld from agricultural use refunds will be reduced to six cents per gallon, with elimination of the one cent per gallon retained in the highway tax distribution fund.

Users of gasoline or gasohol for an industrial purpose are entitled to refund of taxes paid. The refund must be reduced by one-half cent per gallon and that amount is deposited in the agricultural fuel tax fund.

The state and political subdivisions are entitled to a refund of taxes paid on gasoline or gasohol used for construction, reconstruction, and maintenance of a public road or airport.

Special Fuels Tax

A tax of 21 cents per gallon is imposed by NDCC Section 57-43.2-02 on the sale or delivery of special fuels to any consumer. The dealer is required to collect and remit the tax on all retail sales to consumers. Special fuels tax revenues are allocated to the highway tax distribution fund, except for one cent per gallon of the tax which is allocated to the township highway aid fund.

Effective for sales of special fuels after June 30, 1999, a "buy right" provision applies under which special fuels taxes are not refundable for agricultural, railroad, industrial, or governmental users. Such users are eligible for a reduced tax of two percent of purchase price, rather than 21 cents per gallon, for purchases of dyed special fuels used in unlicensed equipment for agricultural, railroad, industrial, or governmental purposes. The owner or operator of a licensed motor vehicle found to contain dyed special fuels in the fuel supply tank of the vehicle is subject to administrative fees from $250 for the first violation to $5,000 for the fourth and subsequent violations within three years. Fees for violations do not apply to a person who purchased dyed special fuels in another state or Canadian province and imported the fuel in the supply tank of a licensed motor vehicle if the state or province where the fuel was purchased does not prohibit its use in the vehicle. The fees also do not apply to a state or local government using dyed special fuels in licensed vehicles for road construction purposes.

Aviation Fuel Tax

Tax is imposed on aviation gasoline, kerosene, jet fuel, and any other motor fuel used by aircraft at a rate of eight cents per gallon. The tax is payable by a supplier or distributor on aviation fuel used, wholesale distribution of aviation fuel to a retailer, and direct sales of aviation fuel to a customer. All aviation fuel tax revenues are deposited in the state Aeronautics Commission's special fund. The moneys in the special fund are provided as a standing appropriation to the Aeronautics Commission for commission administration and for matching funds made available by political subdivisions or airport authorities that do not receive state assistance under NDCC Section 2-05-06.5. Funds allocated to governmental entities must be used for airport construction or improvement projects.

The consumer of aviation fuel is entitled to a refund of the tax paid after deduction of a special excise tax of four percent of the cost of the fuel. A person who has paid the tax on aviation fuel in North Dakota and sells the fuel in another state in which the fuel is taxable is entitled to a full refund of taxes paid in North Dakota. A person who purchased aviation fuel and paid tax in North Dakota and resells the fuel to an agency of the United States government is entitled to a refund of taxes paid.

Fuel Tax Allocation

The Constitution of North Dakota Article X, Section 11, provides:

> Revenue from gasoline and other motor fuel excise and license taxation, motor vehicle registration and license taxes, except revenue from aviation gasoline and unclaimed aviation motor fuel refunds and other aviation motor fuel excise and license taxation used by aircraft, after deduction of cost of administration and collection authorized by legislative appropriation only, and statutory refunds, shall be appropriated and used solely for construction, reconstruction, repair and maintenance of public highways, and the payment of obligations incurred in the construction, reconstruction, repair and maintenance of public highways.

The statutory provisions for deposit and allocation of fuel tax revenues are contained in NDCC Section 54-27-19. That section requires deposit of motor vehicle registration fees and fuel tax revenues in the highway tax distribution fund. Moneys deposited in the highway tax distribution fund are to be allocated monthly by the State Treasurer with 63 percent transferred to the Department of Transportation and placed in the state highway fund and 37 percent allocated to counties in proportion to the number of motor vehicle registrations credited to each county. Before each county receives its allocation, the State Treasurer must compute and deduct the incorporated cities' share of revenue allocated to the county. The cities' share of revenues is 27 percent of the amount allocated to the county. However, a weighting factor is included in the formula which provides that in each county having a city with a population of 10,000 or more the allocation is adjusted to increase the share allocated to each city.

1999 Legislation

House Bill No. 1019 extended until December 31, 2001, the additional one cent per gallon withheld from farmers' motor vehicle fuel tax refunds to be retained in the highway tax distribution fund. This additional withholding from refunds was scheduled to expire December 31, 1999.

House Bill No. 1130 eliminated the sunset provision that would have reverted the motor vehicle fuels and special fuels tax rates from 20 cents per gallon to 17 cents per gallon effective January 1, 2000. As compared with the 17 cents per gallon rate that would have been reinstated, this bill was estimated to generate an additional $14.8 million of highway fund revenue during the 1999-2001 biennium and $21.8 million of additional highway fund revenue for the 2001-03 biennium. For cities and counties, the additional revenue is estimated to be $8.7 million for the 1999-2001 biennium and $12.8 million for the 2001-03 biennium.

House Bill No. 1183 increased motor vehicle fuels and special fuels tax rates by one cent per gallon, from 20 cents to 21 cents. The 21 cent rate is "permanent" law, meaning it has no sunset provision. This bill also increased motor vehicle registration fees by $1 per year on licensed motor vehicles, except pickup trucks 20 years old or older and farm trucks. Estimated revenue increases resulting from this bill total $11.3 million per biennium, $7.1 million of which goes to the state highway fund and $4.2 million of which is distributed to cities and counties. The fiscal note for the bill did not identify the share of increased revenue from the fuel tax rate change but Tax Department estimates were that an additional one cent per gallon motor vehicle and special fuels tax rate generates $10.3 million per biennium, including $6.5 million for the state highway fund and $3.8 million for cities and counties.

Senate Bill No. 2177 revised administrative provisions under the fuels tax law. The bill was the product of a three-year study by the office of the Tax Commissioner and a Petroleum Marketers Association study group. The most significant changes made by the bill were:

1. Allowing a tax credit or refund for a fuel reseller when the tax has been paid and the fuel is resold to an agency of the federal government. The issue relates to credit card sales. Credit cards issued by major oil companies allowed adjustments to tax returns to cover these transactions but independent credit card company involvement shifted the burden of adjustments to retailers.
2. Imposing licensing and reporting requirements for fuel terminal operators.
3. Depositing motor vehicle fuel license fees in the highway tax distribution fund rather than the state general fund (to be consistent with the constitutional requirement that fuel tax revenues must be used for highway purposes).
4. Requiring importers and exporters of fuel for resale to supply proof of licensing in the jurisdiction from which the fuel is imported or to which the fuel is exported.
5. Requiring common or contract carriers hauling fuel to be licensed, to retain records, to be subject to audit, and to report diverted loads.
6. Creating a penalty and interest requirement for the aviation fuel tax (which lacked these enforcement provisions).
7. Creating a collection allowance of one percent, to a maximum of $300 per month, for aviation fuel (to allow the same

collection allowance that is allowed for special fuels taxes).

8. Consolidating licensing and reporting requirements for interstate motor carriers (to be compatible with the International Fuel Tax Agreement).

House Bill No. 1462 was commonly referred to during the 1999 legislative session as the "rack tax bill" although the bill as passed did not change the point of taxation to the "rack." The bill as passed reduced the shrinkage allowance for fuel suppliers, distributors, and retailers from a maximum of one percent to a maximum of .5 percent. The bill created the "buy right" provision, which requires users of special fuels for nonhighway purposes to buy and use dyed special fuel, which is subject to the reduced rate of two percent, rather than the 21 cents per gallon rate for fuel used in licensed motor vehicles.

The most controversial provision of House Bill No. 1462, which was ultimately eliminated from the bill, would have moved the point of taxation for fuels taxes to the "rack," meaning a fuel storage and distribution terminal supplied by a refinery or pipeline. Reasons advanced for changing the point of taxation included decreasing the number of times fuel may change hands without taxes being collected and remitted, acceleration of tax collections, and a reduced number of fuel tax returns to improve compliance and auditing. Sixteen states have moved the point of fuel tax collections for diesel fuel to the "rack" since federal fuel tax imposition for diesel fuel was moved to the "rack" effective January 1, 1994. Only red-dyed diesel fuel is exempt from the federal "rack" tax. The primary purpose for the change in federal law was to reduce fuels tax evasion. Opponents of the "rack" tax provision argued that it will not stop fuel tax evasion and would place substantial financial stress on small- and medium-sized petroleum marketers, possibly causing some of these dealers to go out of business.

Testimony

Representatives of the North Dakota Petroleum Marketers Association restated their opposition to imposing fuels taxes at the "rack" because they believe that approach is unfair to mid-level distributors. They said if these distributors are put out of business, oil suppliers in the state will be consolidated into control by a much smaller number of larger companies. The committee received testimony from representatives of large, medium, and small petroleum marketing businesses. These individuals expressed concern with recordkeeping and reporting for fuel, which must be done for all fuel handled by the business, whether or not the fuel is taxable. Costs of computer hardware and software for recordkeeping is another area of concern and it was suggested that the two percent of collections allowance for dealers should be increased to three percent to equal the allowance in Minnesota. Petroleum Marketers Association representatives said it took a little adjustment for fuel dealers under the "buy right" provisions enacted in 1999 and some dealers needed additional storage tanks, but there is now little or no complaint among dealers about the 1999 changes.

Tax Department representatives reported very few problems or complaints from dealers or consumers with regard to 1999 fuels tax law changes. The department sent a newsletter to all consumers who claimed special fuels tax refunds for 1998 advising them of the new provisions. The department said fewer calls than expected were received after the newsletter was distributed.

Tax Department representatives initially met with representatives of the Internal Revenue Service in contemplation of entering a joint agreement with the Internal Revenue Service for testing of fuels believed to contain dye in excess of the allowable content for highway use. The Tax Department discovered that such an agreement with the Internal Revenue Service would have required the state to take samples for the Internal Revenue Service, and the Internal Revenue Service would piggyback federal penalties onto any penalties imposed by the state. Members of the committee expressed concern that samples might be used by the Internal Revenue Service for other purposes, such as testing for sulfur content. Rather than enter such an agreement with the Internal Revenue Service, the Tax Department entered an agreement with the Chemistry Division of the State Department of Health for testing for the presence of dye in diesel fuel samples collected by the Highway Patrol when violations are suspected. Committee members viewed various samples of dyed fuel containing concentrations of red dye from one part per million to 20 parts per million. The dye content of fuel added by refiners is approximately 20 parts per million of red dye. If one gallon out of 20 is dyed, that would be a concentration of approximately one part per million, which would be a violation. Estimated testing costs for tests by the Chemistry Division were about $15 to $20 per sample.

Search and seizure concerns with testing for dyed fuel raise the same constitutional issues that apply in other motor vehicle search situations. After consideration of search and seizure issues, the Highway Patrol follows the policy that the fuel tank of a vehicle will be sampled for the presence of red dye when the officer has a reasonable suspicion that a violation is occurring and that reasonable suspicion must derive from the officer's observations or reliable information furnished to the officer. The Highway Patrol does not do random sample testing.

Conclusion

The committee makes no recommendation regarding the fuels tax laws study.

FARM AND RANCH RETIREMENT STUDY

For most occupations and professions there are opportunities for retirement saving through tax deductible contributions and tax-deferred earnings. Farmers and ranchers are generally unable to take advantage of these opportunities because the reality of the agricultural economy is that earnings are put into property and operations. Upon retirement, a farmer or rancher sells or leases the property which results in capital gains or income taxes that are not eligible for special tax treatment.

Savings plans are available to employees, employers, and self-employed persons which allow pre-tax dollars to be contributed and to grow tax-deferred until retirement. There is a substantial tax benefit to the investor in these types of plans and this allows accumulation of a much larger amount for retirement than would be available without these options. A wide range of options are available for retirement plans including 401(k) plans, 403(b) plans, 457 plans, individual retirement accounts (IRAs), Roth IRAs, simple plans, simplified employee pension (SEP) plans, Keogh plans, and others. These plans and their benefits to investors are governed by federal law.

For farmers and ranchers, deposits in a retirement fund represent a substantial risk because in the event of a disaster or in times of depressed commodity prices, poor production, or high interest rates those funds might have to be withdrawn and withdrawal may result in payment of penalties imposed by federal law.

Committee Consideration

It was suggested that individual retirement accounts allowed by federal law might be feasible investments for farmers and ranchers if federal law were changed to eliminate penalties for withdrawing funds if the funds are put into an agricultural operation. The rationale for the suggestion is that farmers and ranchers would not be discouraged from placing money in IRAs if they could have access to those moneys without penalty when necessary to support the farming or ranching operation.

It was suggested that an obstacle to retirement for farmers and ranchers is that the wealth they accumulate during a lifetime of work is tied up in the value of the farm or ranch property. An operator is faced with capital gains taxes upon sale of the property, which substantially reduces assets available for retirement. It is also apparent that much of the valuation increase subject to capital gains taxes upon sale of farm and ranch property is attributable to inflation. Examples were reviewed of situations in which capital gains taxes upon sale of farm or ranch property were in excess of the actual valuation increase of the property after discounting for inflation.

Congress has considered legislation to allow farm and ranch risk management (FARRM) accounts as a management tool for farmers and ranchers to defer income by setting it aside in tax-deferred accounts to be drawn upon as taxable income when needed in years of lower income. Proposals before Congress generally limit the time funds could be held in FARRM accounts to a maximum of five years. It was suggested that it may be more appropriate to limit the amount that may be held in FARRM accounts rather than the time the funds may be held, so these accounts could be used for retirement planning and other long-range benefits for farmers and ranchers.

Recommendation

The committee recommends Senate Concurrent Resolution No. 4003 urging Congress to reduce or eliminate the impediment of capital gains and estate taxes on passage of stewardship of family farms to succeeding generations. The resolution states that accumulation of value in family farm property is the result of a lifetime of hard work and sacrifice and that capital gains and estate taxes often require liquidation of family farm property and put families out of the farming business. The resolution points out that Congress has recognized the erosion of the family farming tradition caused by capital gains and estate taxes and Congress attempted to provide relief in 1999 legislation that was vetoed for other reasons.

The committee recommends Senate Concurrent Resolution No. 4004 urging Congress to provide a greater opportunity for farmers to participate in retirement investments by allowing withdrawals without penalty when necessary to support family farming operations. The resolution states that early withdrawal penalties that apply to retirement investments allowed by federal law make these investments infeasible for farmers. The resolution states that income of farmers is subject to influences beyond their control, and this lack of control merits special consideration in the establishment of policies regarding retirement savings and permitting farmers to withdraw funds from retirement accounts without penalty for legitimate needs of family farming operations would help to stabilize economies of rural communities.

The committee recommends Senate Concurrent Resolution No. 4005 urging Congress to reduce or eliminate capital gains taxes on inflationary valuation increases of farm and ranch property. The resolution states that Congress has recognized the unfairness of taxing inflationary increases as income by providing for indexing of income tax rate brackets, standard deductions, personal exemptions, and the earned income credit. The resolution states that the unfairness of taxing inflationary valuation increases can be devastating to owners of property held for a long period of time, such as family farm and ranch property, for which a valuation increase may be almost entirely attributable to inflation, with little or no real gain in value relative to the rest of the American economy.

The committee recommends Senate Concurrent Resolution No. 4006 urging Congress to enact legislation to allow FARRM accounts and to consider limiting the size of the accounts rather than the time funds may be held in the accounts. Farm and ranch risk management accounts would allow farmers and ranchers to set aside income in tax-deferred accounts to be drawn upon as taxable income when needed in years of lower income. The resolution states that it may be more appropriate to limit the amount that may be held in these accounts rather than the time funds may be held so these accounts could be used for retirement planning and other longer-range benefits.

AGRICULTURAL BUSINESS INVESTMENT STUDY

Background

North Dakotans invest considerable sums of money outside the state. If viable agricultural processing businesses can be established which would attract a part of those investments to businesses within the state, there would be mutual benefit to investors and the agricultural economy. There are several programs under state law to encourage investment in and development of agricultural businesses.

Under NDCC Chapter 40-57.1, a city or county may grant a property tax exemption for up to 10 years for buildings and structures used in a project that produces or manufactures a product from agricultural commodities. In addition, payments in lieu of taxes in any amount may be allowed for any new or expanded business through the 20th year of project operations. This chapter also allows a qualifying project to obtain an exemption from state income taxes for up to five years upon approval by the State Board of Equalization.

Under NDCC Chapter 57-38.5, an investor in a qualified business may be entitled to a seed capital investment tax credit against income tax liability. This credit is only available on the individual long-form return. The taxpayer may qualify for a credit of 30 percent of the amount invested in qualified businesses for investments of at least $5,000 and not more than $50,000. The taxpayer may not take more than 50 percent of the credit in a single taxable year, and the credit is limited to not more than 50 percent of the taxpayer's tax liability. Unused credit may be carried forward for up to 15 taxable years. The aggregate amount of seed capital investment tax credits for all taxpayers in any taxable year is limited to $250,000. A qualified business for purposes of the seed capital investment tax credit must have North Dakota residents as a majority of its employees in the North Dakota principal office or satellite operation, have its principal office in this state, have a majority of its business activity performed in this state or have a significant operation in North Dakota, and have a majority of its ownership interests owned by one or more individuals for whom operation of the business is their full-time professional activity.

Under NDCC Chapter 26.1-50, an insurer or group of insurers may establish a corporation or limited liability company to operate the North Dakota low-risk incentive fund. The fund may make loans to low-risk business for primary sector business projects in this state. An insurer participating in a loan under this chapter is entitled to a credit against insurance premium tax liability equal to the difference between interest earned on the loan and the amount the insurer could have earned at 300 basis points more than a comparable treasury security rate. For purposes of loans, a primary sector business is defined as a business that adds value to a product, process, or service resulting in the creation of new wealth.

The Bank of North Dakota operates several programs that may be of assistance to farmers and agricultural businesses. The Department of Economic Development and Finance administers the North Dakota Development Fund, which is a means of providing capital for new or expanding business and administers the regional rural development revolving loan fund, which provides funding for primary sector business in rural areas of the state. The Agricultural Products Utilization Commission, a division of the Department of Economic Development and Finance, administers an agricultural prototype development program.

Committee Consideration Agricultural Products Utilization Commission Programs

The committee reviewed programs administered by the Agricultural Products Utilization Commission. The commission administers five grant programs including programs for basic and applied research, marketing and utilization, cooperative marketing, farm diversification, and agricultural prototypes. The committee reviewed the programs and projects that have been funded under these programs. According to an Agricultural Products Utilization Commission representative, it is very difficult to establish a cooperative form of business that must rely on capital investment by producers because many farm and ranch operators cannot afford to invest in agricultural processing businesses.

Bank of North Dakota Programs

The committee reviewed Bank of North Dakota programs to assist development of agricultural businesses. The Bank has a two-part strategy to assist agriculture. The Bank's farm initiative is geared toward dealing with the agricultural crisis and consists of a financial assistance loan program, farm operating and family farm programs, and encouragement of young farmers to enter farming through a beginning farmer program and a first-time farmer program. The second phase of the Bank's strategy is to move agriculture into the future, which requires increasing value-added agricultural processing and diversifying and increasing the value of agricultural production. The Bank encourages investment in agricultural businesses through the agriculture partnership in assisting community expansion program, which provides an interest subsidy for farmers diversifying their operations. This program can also be used by farmers and ranchers to buy equity shares in a value-added processing facility or first-time purchase of irrigation equipment. The Bank has developed an Envest program to make available to all North Dakota residents the ability to purchase stock in a value-added agricultural processing facility by financing the stock purchased at a below market interest rate.

Cooperative Business Structure

Many value-added agricultural projects in the state have chosen the cooperative as the preferred business structure for their organizations. The cooperative form of business limits opportunities for investment in a project by anyone other than a participating agricultural producer. One reason for choosing the cooperative form relates to federal tax considerations. Corporations are subject to two levels of taxation on earnings, including the corporate income tax and income taxes paid by individuals on distributions from the corporation. Earnings of a cooperative may be distributed as patronage dividends to members and avoid imposition of corporate income taxes. Cooperatives are also used as a way to keep any earnings among those who are producers of the commodities used by the cooperative. Opening the venture to outside investment means earnings must be shared with outside investors. Another incentive for the cooperative form of business exists under federal securities laws. An exemption under federal law allows organizers to avoid registration with the Securities and Exchange Commission for a tax-exempt cooperative. One requirement imposed upon cooperatives under the securities laws is 85 percent minimum ownership by producers, even though it is really not possible to structure for less than 100 percent ownership by producers. Another consideration under federal law is that a cooperative may be established to allow each member one vote in decisions of the cooperative. This differs from laws on corporations in which ownership of shares determines the number of votes an individual has in corporate decisions. Another consideration relates to business control because if the business is established as a corporation, a larger corporation could buy controlling interests in the venture once it has become profitable. There are ways under current law to structure a business to allow outside investment in value-added agricultural projects, but producers in North Dakota have shown a preference for the cooperative form of organization for reasons that outweigh attracting outside investment under their present circumstances.

Farmers Equity Trust Fund Proposal

Representatives of Renewable Resources Research Institute and the Cooperative Development Center suggested establishing a farmers equity trust fund. The fund could be capitalized by the sale of bonds to private investors and the moneys accumulated in the fund could be used by the Agricultural Products Utilization Commission to acquire ownership in value-added agricultural projects or for loans to value-added agricultural projects. Tax incentives could be provided for purchasers of bonds. One of the primary problems in establishing value-added agricultural projects is accumulating equity capital to begin the project. The objective of the fund would be to attract equity capital, and it was suggested this fund would be an attractive investment alternative to investments in mutual funds and other investments that generally go to out-of-state investments. The committee requested preparation of a bill draft to establish a farmers equity trust fund and solicitation of comments from the Tax Department, Agricultural Products Utilization Commission, Bank of North Dakota, Municipal Bond Bank, and agricultural groups.

The Tax Department suggested some technical changes in the bill draft but did not estimate the fiscal effect of the bill due to lack of information on which to base an estimate.

A representative of the Agricultural Products Utilization Commission expressed support for the concept and the proposal to create a mechanism to finance the equity needs of value-added agricultural projects. The commission representative expressed concern over the commission's responsibilities under the bill draft regarding investment and loan decisions relating to value-added ventures because it would require additional staff to carry out the commission's responsibilities.

According to a representative of the Bank of North Dakota, a successful farmers equity trust fund program could augment agricultural loan programs available through the Bank of North Dakota. Areas of concern, however, were the potential of the farmers equity trust fund to duplicate programs of the Bank of North Dakota and exclusion of the private sector from the delivery system of the bond proceeds.

According to a representative of the Municipal Bond Bank, bonds issued under the farmers equity trust fund as it would exist under the bill draft would not be marketable without some form of credit enhancement, such as bond insurance or state or federal backing. Earnings from equity investments and interest on loans would be available to repay bondholders, but it may be many years before there is a return on the purchase of equity.

A North Dakota Farm Bureau representative expressed support for the concept of the farmers equity trust fund but expressed concern about whether investors would buy the bonds.

A representative of the Cooperative Development Center said farmers and livestock producers have spent down the equity in their operations in recent years. Several years of poor prices have forced agriculture producers to draw upon their equity. When an opportunity arises to invest in a value-added project or project to increase production, producers have no equity to draw upon for investment and the opportunity cannot go forward. It was suggested that the farmers equity trust fund would allow agricultural processing projects to overcome this obstacle.

In discussion of the bill draft, committee members noted there were unsolved questions about the bill draft but proponents could work on these issues before the Legislative Assembly convenes in 2001.

1997 Kyoto Protocol

The committee reviewed information on the 1997 Kyoto Protocol treaty on global warming, which called for reduction in emissions of carbon dioxide to at least seven percent below 1990 levels and application of carbon permit fees to fuel users in industrial countries. Congress rejected the treaty but it has been suggested that implementation of the key points of the treaty is being attempted through federal regulations. A concern of committee members is that implementation would increase fuel costs in the United States, and these increases would fall particularly hard on farmers, who rely to a large degree on use of fuel in agricultural production.

Used Farm Machinery Sales and Use Tax

The committee considered a bill draft to provide a complete sales and use tax exemption for sales and use of used farm machinery, farm machinery repair parts, and used irrigation equipment used exclusively for agricultural purposes. The bill draft was intended to continue and expand on the sales and use tax rate reduction created by passage of 1999 Senate Bill No. 2217. The 1999 legislation reduced the sales and use tax rate from three percent to 1.5 percent for used farm machinery, farm machinery repair parts, and used irrigation equipment used exclusively for agricultural purposes. The 1999 legislation expires June 30, 2001. The bill draft would provide a complete sales and use tax exemption for these items effective July 1, 2001.

The Tax Department estimated the fiscal effect of the bill draft to be a loss for a biennium of $8.94 million to the state general fund and $788,000 to the state aid distribution fund. One additional consideration regarding the fiscal effect is that under NDCC Section 57-39.2-01(3), a trade-in allowance is given for sales tax calculation purposes if the item being traded in will later be subject to sales tax when it is sold. This allowance was available under the reduced 1.5 percent sales tax rate but would not be available when a complete exemption is provided for used farm machinery and irrigation equipment. Some of the revenue loss would be offset by a gain in revenue from the denial of trade-in allowances and this gain was estimated at approximately $926,000 for 1999 Senate Bill No. 2217. Adding the revenue gain from the denial of trade-in allowances to the overall revenue loss would show a net fiscal effect for the bill draft of a loss of approximately $8.8 million for a biennium.

Recommendations

The committee recommends House Bill No. 1051 to establish a farmers equity trust fund. The bill requires the Industrial Commission to establish the farmers equity trust fund at the Bank of North Dakota. The fund would be capitalized by the sale of bonds by the Industrial Commission, through the Bank of North Dakota. Moneys in the farmers equity trust fund could be used by the Agricultural Products Utilization Commission on behalf of the fund to acquire ownership interests in value-added agricultural projects or for loans to value-added agricultural projects. The bill requires a loan to be secured by ownership interests in the project. The bill allows the Agricultural Products Utilization Commission to establish procedures for applicants to apply for investments and loans and to establish procedures to evaluate applications for investments or loans. The bill allows various tax incentives for purchasing bonds sold to capitalize the farmers equity trust fund. An individual or corporate income taxpayer would be entitled to a credit of 20 percent of the amount invested in bonds. The bill requires the credit to be split between two taxable years and any credit may not exceed 50 percent of the taxpayer's tax liability for the year. The bill requires bonds to be held for three years to claim the income tax credit, to prevent taxpayers from purchasing and selling bonds just to acquire tax credits. The bill provides an individual long-form and short-form income tax credit for investments and a corporate income tax credit for investments. The bill provides that interest income from the bonds is deductible on the corporate return and the individual long-form and short-form returns.

The committee recommends House Concurrent Resolution No. 3004 urging Congress not to implement or allow implementation of the Kyoto Protocol because of the potentially disastrous impact on American agriculture. The resolution states that impact of the Kyoto Protocol on United States farmers would be devastating because farmers are forced to rely on fuels in agricultural production, and increased fuel costs would aggravate the farm crisis.

The committee recommends House Bill No. 1052 to provide a complete sales and use tax exemption for sales and use of used farm machinery, farm machinery repair parts, and used irrigation equipment used exclusively for agricultural purposes. The bill would become effective July 1, 2001.