

# MICROFILM DIVIDER

OMB/RECORDS MANAGEMENT DIVISION

SFN 2053 (2/85) 5M



ROLL NUMBER

DESCRIPTION

1065

2001 HOUSE FINANCE AND TAXATION

HB 1065

2001 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HB 1065

House Finance and Taxation Committee

☐ Conference Committee

Hearing Date January 15, 2001

Tape Number	Side A	Side B	Meter #
I	X		2.840
Committee Clerk Signature <i>Jamie Stein</i>			

Minutes:

**REP. AL CARLSON, CHAIRMAN** Opened the hearing with one committee member absent.

**JOSEPH BECKER, STATE TAX COMMISSIONER'S OFFICE** Testified in support of the bill. See attached written testimony.

**REP. CARLSON** Asked whether this bill was common, and if other states used this.

**JOSEPH BECKER** Stated there were a number of states which operated like this.

**REP. KROEBER** Asked whether this only affected the long form.

**JOSEPH BECKER** Stated the bill will affect all individuals.

**REP. SCHMIDT** Stated evidently there isn't much loss in the effect of this bill.

**JOSEPH BECKER** Stated it could be a positive negative effect.

**REP. CARLSON** Asked how they followed this.

**JOSEPH BECKER** Stated, if there is a partnership operating in this state, they have a nexus with the state.

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House Finance and Taxation Committee  
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**PAUL WOJNOUTKA, PARTNER WITH EIDE BAILLY, BISMARCK** Testified in opposition of this bill. See attached written testimony.

With no further testimony, the hearing was closed.

**COMMITTEE ACTION 2-13-01, TAPE #1, SIDE B, METER 1428**

**REP. GROSZ** Gave a report on the research of the background on this bill.

He stated most of the bill was clean up language. The actual contention part of the bill was on page 3, lines 20 - 22, which is the guaranteed payment portion. The problem with this was defining salaries for partners. He stated the bill codifies what the current practice has been, and it keeps the non resident partners honest in reporting their taxable income.

**JOSEPH BECKER, STATE TAX DEPARTMENT** Gave a report of how this would be administered. He stated it is already being administered in the fashion it is described in the bill, but for the issue of interpretation, they asked that the language be in there to clarify it.

**REP. BRANDENBURG** Made a motion for a **do pass**.

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

**14 YES 0 NO 1 ABSENT**

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

**COMMITTEE ACTION 2-19-01, TAPE #1, SIDE A, METER # 65**

The bill was rereferred back to committee for amendments.

**RICK CLAYBURGH, STATE TAX COMMISSIONER** Presented amendments to the bill, which was an agency bill drafted to clarify areas dealing with partnership taxation and how guaranty payments for partners is addressed. Gave a brief explanation of why the bill was drafted because of a lawsuit. He stated they are very concerned if this bill does not pass because of the ramifications on tax law. He explained what the amendments did in the bill.

**REP. KROEBER** Asked whether the amendments had any bearing on the fiscal note.

**RICK CLAYBURGH** Stated there would be a slight fiscal impact. Right now, the original bill was formed on our current interpretation of the statutes in the law and our administrative practices, I think the fiscal impact is probably less than ten thousand dollars, it is not a significant amount. There will still be certain items which will be subject to North Dakota tax. It will be the amount associated with the salary of the out of state partner which will now be excluded from North Dakota taxes. That is a fairly minimal amount.

**REP. GROSZ** Can you define how, reasonable salary, is determined?

**RICK CLAYBURGH** The term, reasonable, is a factual driven analysis. It occurs many times in the statutes. What we would be looking at is insuring that an unreasonable amount of partnership activity would not be put into a salary line, such as moving some of the capital payments, or interest on loans, could be disguised as a salary and escape taxation.

**REP. HERBEL** Related to one of the concerns regarding creating significant negative business environments from all states, are you saying this addresses that?

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House Finance and Taxation Committee  
Bill/Resolution Number HIB 1065  
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**RICK CLAYBURGH** I disagreed with that original statement. I don't believe our rules did that. I think this bill would actually create an incentive for partners to leave North Dakota.

**JOSEPH BECKER, STATE TAX COMMISSIONER'S OFFICE** Appeared to clear up questions the committee had.

**PAUL WOHNOUTKA, REPRESENTING EIDE-BAILLEY**, Appeared to state he was in agreement with the amendments.

**KEN TUPA, LOBBYIST FOR THE NORTH DAKOTA SOCIETY OF CPA'S**, The amendments are also agreeable to them.

**REP. WINRICH** Made a motion to adopt the amendments as presented.

**REP. BRANDENBURG** Second the motion. **MOTION CARRIED BY VOICE VOTE**

**REP. RENNER** Made a motion for a **DO PASS AS AMENDED**

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

**14 YES    0 NO    1 ABSENT**

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

## FISCAL NOTE

Requested by Legislative Council  
02/20/2001

Bill/Resolution No.:

Amendment to: HB 1065

**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.*

	1999-2001 Biennium		2001-2003 Biennium		2003-2005 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues			(\$75,000)			
Expenditures						
Appropriations						

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

1999-2001 Biennium			2001-2003 Biennium			2003-2005 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.*

HB 1065 First Engrossment addresses the apportionment and allocation of partnership income for income tax purposes.

**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.*

If enacted as amended, HB 1065 is expected to reduce state general fund revenues by an estimated \$75,000 during the 01-03 biennium. Failure to enact the bill will indicate to the Tax Department that it should change how it has been allocating certain nonresident partnership income, and revenues could fall by \$1,000,000 or more per year.

**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:	Tax Department
Phone Number:	328-3402	Date Prepared:	02/21/2001



## FISCAL NOTE

Requested by Legislative Council  
12/19/2000

Bill/Resolution No.: HB 1065

Amendment to:

**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.*

	1999-2001 Biennium		2001-2003 Biennium		2003-2005 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues						
Expenditures						
Appropriations						

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

1999-2001 Biennium			2001-2003 Biennium			2003-2005 Biennium		
Counties	Cities	School Districts	Counties	Cities	School Districts	Counties	Cities	School Districts

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

**HB 1065 codifies administrative practice and is expected to have a fiscal impact of less than \$5000 during the 01-03 biennium.**

**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.*

**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.*

ne:	Kalhryn L. Strombeck	Agency:	Tax
Phone Number:	328-3402	Date Prepared:	12/22/2000

Date: 2-13-01  
Roll Call Vote #: 1

2001 HOUSE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. HB 1065

House FINANCE & TAXATION Committee

☐ Subcommittee on \_\_\_\_\_  
or  
☐ Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken Do Pass

Motion Made By Rep. Brandenburg Seconded By Rep. Nicholas

Representatives	Yes	No	Representatives	Yes	No
CARLSON, AL, CHAIRMAN	✓		NICHOLAS, EUGENE	✓	
DROVDAL, DAVID, V-CHAIR	✓		RENNER, DENNIS	✓	
BRANDENBURG, MICHAEL	✓		RENNERFELDT, EARL	✓	
CLARK, BYRON	✓		SCHMIDT, ARLO	✓	
GROSZ, MICHAEL	✓		WIKENHEISER, RAY	✓	
HERBEL, GIL	✓		WINRICH, LONNY	✓	
KELSH, SCOT	✓				
KROEBER, JOE	✓				
LLOYD, EDWARD	✓				

Total (Yes) 14 No 0

Absent 1

Floor Assignment Rep. Grosz

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

Date: 2-19-01  
Roll Call Vote #: 2

2001 HOUSE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. HB 1065

House FINANCE & TAXATION Committee

☐ Subcommittee on \_\_\_\_\_  
or  
☐ Conference Committee

Legislative Council Amendment Number 18079.0101

Action Taken Do pass as amended

Motion Made By Rep. Renner Seconded By Rep. Grosz

Representatives	Yes	No	Representatives	Yes	No
CARLSON, AL, CHAIRMAN	✓		NICHOLAS, EUGENE	A	
DROVDAL, DAVID, V-CHAIR	✓		RENNER, DENNIS	✓	
BRANDENBURG, MICHAEL	✓		RENNERFELDT, EARL	✓	
CLARK, BYRON	✓		SCHMIDT, ARLO	✓	
GROSZ, MICHAEL	✓		WIKENHEISER, RAY	✓	
HERBEL, GIL	✓		WINRICH, LONNY	✓	
KELSH, SCOT	✓				
KROEBER, JOE	✓				
LLOYD, EDWARD	✓				

Total (Yes) 14 No 0

Absent 1

Floor Assignment Rep. Grosz

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

**REPORT OF STANDING COMMITTEE**

HB 1065: Finance and Taxation Committee (Rep. Carlson, Chairman) recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** (14 YEAS, 0 NAYS, 1 ABSENT AND NOT VOTING). HB 1065 was placed on the Sixth order on the calendar.

Page 3, line 20, replace "Guaranteed" with "Except as otherwise provided in this subdivision, guaranteed"

Page 3, line 22, after the underscored period insert "In the case of a professional service partnership, the portion of a guaranteed payment paid to a nonresident partner attributable to a reasonable salary may not be treated as a distributive share. The portion of the guaranteed payment not treated as a distributive share that is for services performed in this state must be assigned as provided under subsection 1 of section 57-38-04. For purposes of this subdivision, "professional service partnership" means a partnership that engages in the practice of law, accounting, medicine, and any other profession in which neither capital nor the services of employees are a material income producing factor."

Renumber accordingly

2001 SENATE FINANCE AND TAXATION

HB 1065

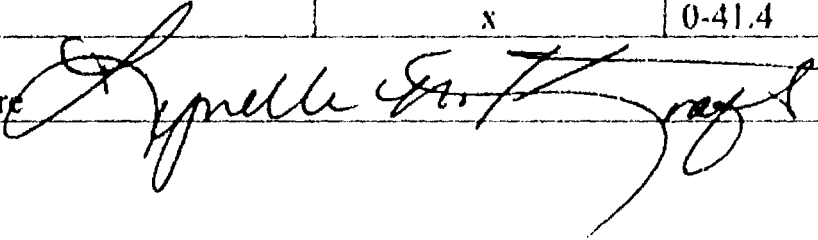
2001 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. 1065

Senate Finance and Taxation Committee

☐ Conference Committee

Hearing Date 3/12/01

Tape Number	Side A	Side B	Meter #
1		x	19.3-34.8
3/13/01 - 1		x	17.3-end
2	x		0-3
3/14/01 - 2	x		33.3-end
		x	0-24.5
3/19/01	x		45.4-end
		x	0-41.4
Committee Clerk Signature 			

Minutes:

Senator Urlacher: Opened the hearing on HB 1065, relating to the allocation and apportionment of partnership income for income tax purposes and an individual's gross income.

Senators Nichols and Christmann absent.

Joe Becker: State Tax Dept., testified in support. Written testimony attached.

Senator Wardner: This simply means if an individual is a partner, they live outside of the state, they get some compensation?

Joe Becker: Yes. Only if they're a member of a professional service partnership (defined in written testimony). This is only on the long-form.

Rick Clayburgh: State Tax Commissioner, testified in support. This bill came to you because of our attempt to codify existing rule. There was a taxpayer challenge to our interpretation of the

statute. I felt it was best instead of litigating the issue, that with the session approaching that we try to work something out, it is a policy decision by the legislation. I support the compromise that was worked out in the House. I ask for your favorable consideration.

Senator Urlacher: Closed the hearing. Action delayed.

Discussion held 3/13/01. Meter number 17.3-end, Tape 1, Side B & 0-3, Tape 2, Side A.

Motion was made by Senator Wardner for a DO PASS, Seconded by Senator Christmann.

Senator Wardner: Explained the bill to Senator Christmann.

Senator Nichols: If we don't pass this, the state could lose up to \$1 million each year.

Senator Christmann: By not passing this, we would have a lawsuit and probably lose and that would cost us a million dollars. If we pass this, why does it cost us \$75,000?

Senator Kroeplin: I think it's in the exemptions that the House put on.

Committee agrees.

Joe Becker: Reappeared to explain fiscal note. It does relate to the exception we put in for the professional service partnership. What's going to happen is if they have nonresident partners in the mix, and guaranteed payment is made to those partners, that money is gone, we will not tax it. There's where the negative effect comes in.

Senator Nichols: Why did they put those exemptions in?

Joe Becker: The opposition of the bill was able to stir up enough opposition to get a 49-49 vote. So we came back in with the proposed changes modeling other state's provisions that would at least give the opposition what they wanted and yet try to maintain as much of the base we could.

Senator Christmann: In a hospital, how can it be that the services of the employees and the capital that the partners purchased are not material income producing factors?



Joe Becker: We are aware that in any given firm, you may hire enough employees to do the rank and file work, you're just a partner in the firm. It's arguable as to what's generating the income-the partner is going out and making the contacts with the clients and bringing them in, or the staff doing the work. That is really a good point of discussion-where should the exemption go and who should get it.

Senator Christmann: Who was the opposition?

Joe Becker: I think it's public that it was a local accountant. He was representing a number of taxpayers that disagree with our interpretation.

Senator Christmann: What's the baseline that we're basing our fiscal note on?

Senator Wardner: Wouldn't you be using last biennium as your baseline?

Joe Becker: This number was difficult to hit. We would have to do a manual search for all the numbers. This is what we could come up with. It was a guess.

Senator Christmann: The guess is that it would be \$75,000 less than what we got less biennium?

Joe Becker: Yes.

Senator Christmann: Even though by not passing this we're not going to get that much again?

Joe Becker: That's right.

Senator Stenehjem: What the Tax Dept. did was put a bill in that said 'this is that way that we've been interpreting it, this is what we want the legislature to say if how we want to interpret it'. If it goes the way we interpret it, we're going to keep the income we have right now. But the House said we don't want to continue to business as you have been, we want these exemptions in here. So now there's a negative \$75,000 on this amendment.

Joe Becker: That's exactly right.

Senator Wardner: I think where the bill is at is fine.

Senator Stenehjem: I think the legislative intent should be to let the Commissioner keep doing what he's doing. Can't we say that on the floor?

Senator Wardner: If I were a lawyer, I will still take them to court knowing that one body didn't go along with it.

Senator Christmann: I think we should try it in the original form.

Motion for DO PASS withdrawn by Senators Wardner and Christmann.

AMENDMENT ACTION:

Motion made by Senator Stenehjem, Seconded by Senator Nichols, to remove House amendments and put in original form. Voice Vote taken. All in favor, amendment adopted.

COMMITTEE ACTION:

Motion made by Senator Christmann for a DO PASS AS AMENDED, Seconded by Senator Wardner. Vote was 6 yeas, 0 nays, 0 absent and not voting. Bill carrier was Senator Wardner.

Discussion was held 3/14/01 after bill the committee learned of more information. Meter number 33.3-end, Tape 2, Side A & 0-24.5, Side B.

Ken Lupa: Lobbyist for EideBailly CPA Firm, Presented letter to committee that contained more information. As introduced in the House, 1065 was opposed to by EideBailly as well as the Society of CPA's. Language was amended that was agreed upon by EideBailly, the Society, and the Tax Commissioner's Office that addressed our concerns. When we learned of the Senate amendment that brought it back to the original version, that's when Paul Wahnoutka put together the letter stating our concerns.

Paul Wahnoutka: EideBailly, apologized for not testifying during the hearing. I didn't anticipate there would be any action such as restoring it back to the original bill. What the Tax

Dept. is trying to do with this bill is prevent abuses, and that we're all for. Explained the problem with the partnerships. What 1065 is saying is that if you're a partnership, we're not going to allow any deductions to the owner. Even if they work there, we're not going to allow a salary deduction, if they have loans to the entity, we're not going to allow them an interest deduction, if they rent property to the partnership, we're not going to allow them a rent deduction. This is different from what the corporations are. They are saying we will add all of those back and then we are going to fine a multi-state apportionment factor. Where this scenario really gets skewed, is when you have a professional partnership. We have a number of partners in other states, we do not have this issue in any of the other states that we operate in. Only in ND, with the bill as originally introduced without the professional partnership exemption, would our out of state partners be penalized severely for operating as a partnership. So the provisions for the professional partnerships are designed to take away the penalty for operating in a partnership format. We did have a disagreement with the Tax Dept. and our out of state partners did not respond very well to the situation. If you take the MT partners, instead of the money going to their home state a bigger portion is going to ND and a lesser part is going to ND. When you take the SD partners, they would also pay a significant amount of tax to ND. They feel that's very unfair, as do we. If it was a corporation, they would not have this issue. We've been told over the years, that if we don't like the way partnerships are treated, to incorporate. We do think that that is a bad message to be sending to businesses.

Senator Wardner: What are some professional service partnerships that would be affected by this tax?

Paul Wahnoutka: Those would be partnerships that generate a lot of oil revenue, they could be land rent, it could be retail, real estate.

Senator Wardner: So how would those be different than your situation, the law, accounting and medicine?

Paul Wahnoutka: The difference is in the question of whether the salary for the partners was appropriate in relation to the amount of effort that they exerted. In the case of accounting, law, medical the vast majority of earnings are paid out for services. To have our salaries added back before we do an apportionment is where the big difference is.

Mr. Wahnoutka then went through the numbers of salaries and the taxes for out of state partners.

Senator Christmann: Different states have higher taxes in different areas. If we do make this exemption, wouldn't there be an incentive for everybody to change their business into a partnership?

Paul Wahnoutka: If that's what somebody really wanted to do, they could easily form a Sub S (corporation) and accomplish that.

Senator Nichols: So it wouldn't make any difference whether you were a Sub S or a partnership if you live in ND?

Paul Wahnoutka: That's correct.

Senator Wardner: What you're saying is, what you generate here in services, basically stays here. What's generated in MT or SD stays there.

Paul Wahnoutka: That's correct.

Senator Christmann: If we pass this bill to clarify that these types of businesses can work the way Paul's suggesting, is there a potential for other businesses to take advantage of that? I'm worried about other people would be able to shelter income just by having somebody living in SD? The fourth category of the exemption, with language that explains how the partnership is run, wasn't really understood. Is there a way we could clarify that better?

Joe Becker: At this point, I don't have an idea to offer. The language is borrowed from California so it is there. That fourth category is a judgment call, it does leave some flexibility. The bill in it's original form and the amendments are really for your discussion and decision. I don't know what is best.

Donnita Wald: Tax Dept., also appeared to clarify some things.

Committee decided they would like the bill to be referred back to the committee.

Discussion held 3/19/01. Meter number 45.4-end, Side A & 0-41.4, Side B.

Senator Wardner: Explained where the committee was at with the bill.

Senator Christmann: Asks Joe Becker to explain distributive shares.

Joe Becker: Refers to page two of his written testimony and explains.

Senator Nichols: If we were to leave the House amendments off, are the people being exempt substantially different from everybody else in this category that we would be able to do that without challenge?

Donnita Wald: I think that if you took the accountants, medical profession, and attorneys off, the remaining language after that would cover those people anyway. I think we just followed other states to set those out and to alleviate Mr. Wohnoutka's concern. I think they would be inclusive anyway. The professional service partnerships don't really sell tangibles, that's the big difference.

Senator Stenchjem: What about engineers?

Donnita Wald: Again, I think the language at the top of page four would cover them.

Senator Stenchjem: The \$75,000 doesn't seem like very much to cover all that would be exempt.

Donnita Wald: That was a pretty good guess, we were unable to pull out all of those.

Rick Clayburgh: The amendment from the House is not excluding a professional partnership from all ND income taxes, only that portion for the out of state partner. Without this bill, we believe we would loose partnership income from all sources.

Senator Christmann: Series of questions for Donnita and Rick.

Senator Stenehjem: States that committee should keep the House amendments off. Feels it's going to be different for someone using brain power versus producing widgets.

Senator Wardner: How you divide up the earnings between two states to tax?

Rick Clayburgh: We use the three factor apportionment formula, explains.

Senator Christmann: Is this at the point of good tax policy?

Rick Clayburgh: I think the way it came out of the House, we are not creating any situation in which somebody may try to structure themselves to avoid ND taxes. I think this is sound policy.

Senator Stenehjem: Do you then feel comfortable with the fiscal note?

Rick Clayburgh: Again it is a guess, so yes.

Paul Wahnoutka: We are comfortable with the way the House amended the bill. We are not comfortable with the way it was originally introduced.

Senator Christmann: How about taking out the three-accounting, medicine, and law-and just leaving it to say any profession in which neither capital nor the services of employees are a material income producing factor.

Paul Wahnoutka: Our preference would be to leave it in because by listing those it show the intent of what the legislation is looking at for an example.

Rick Clayburgh: There could be a problem with taking out the examples. There might be something that might not meet the definition. By taking those three professions out, some taxpayers may not trust our interpretation in the Tax Dept.

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Senate Finance and Taxation Committee  
Bill/Resolution Number 1065  
Hearing Date 3/12/01

Senator Christmann: I think we should put a sunset clause on it or something so that we remember to revisit it. I think it's something that really needs to be monitored to see how close the fiscal note is or how it really impacts revenues.

Rick Clayburgh: If we see that there is an issue, we will be back at the next session to point out the problems. I don't think we need to sunset it.

COMMITTEE ACTION: 3/19/01

Motion made by Senator Wardner to RECONSIDER DO PASS AS AMENDED.

Seconded by Senator Kroeplin. Roll Call Vote taken, all in favor.

Motion made by Senator Wardner to REMOVE SENATE AMENDMENTS, Seconded by Senator Kroeplin. Roll Call Vote taken, all in favor.

Motion made by Senator Wardner for DO PASS & REREFFERED TO APPROPRIATIONS, Seconded by Senator Christmann. Vote was 6 yeas, 0 nays, 0 absent and not voting. Bill carrier was Senator Wardner.

Date: 8/13/01  
Roll Call Vote #: 1

2001 SENATE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. 1065

Senate Finance and Taxation Committee

☐ Subcommittee on \_\_\_\_\_

or

☐ Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken NO PASS (withdrawn)

Motion Made By Wardner Seconded By Christmann

Senators	Yes	No	Senators	Yes	No
Senator Urlacher-Chairman					
Senator Wardner-Vice Chairman					
Senator Christmann					
Senator Stenehjem					
Senator Kroeplin					
Senator Nichols					

Total (Yes) \_\_\_\_\_ No \_\_\_\_\_

Absent \_\_\_\_\_

Floor Assignment \_\_\_\_\_

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



March 13, 2001

703  
3-13-01

PROPOSED AMENDMENTS TO ENGROSSED HOUSE BILL NO. 1065

Page 3, line 22, replace "Except as otherwise provided in this subdivision," with "Guaranteed"

Page 3, line 23, remove "guaranteed"

Page 3, line 25, remove "In the case of a professional service"

Page 3, remove lines 26 through 31

Page 4, remove lines 1 through 3

Renumber accordingly

Handwritten notes and stamps on the right side of the page, including "APR 13 2001" and "FOR".

Date: 3/13/01  
Roll Call Vote #: 2

2001 SENATE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. 1065

Senate Finance and Taxation Committee

☐ Subcommittee on \_\_\_\_\_  
or  
☐ Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken Remove House Amendments

Motion Made By Stenehjem Seconded By Nichols

Senators	Yes	No	Senators	Yes	No
Senator Urlacher-Chairman	✓				
Senator Wardner-Vice Chairman	✓				
Senator Christmann	✓				
Senator Stenehjem	✓				
Senator Kroeplin	✓				
Senator Nichols	✓				

Total (Yes) 6 No 0

Absent 0

Floor Assignment \_\_\_\_\_

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

Date: 2/13/01  
Roll Call Vote #: 3

2001 SENATE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. 1005

Senate Finance and Taxation Committee

☐ Subcommittee on \_\_\_\_\_  
or  
☐ Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken DO PASS AS AMENDMENTS

Motion Made By Christmann Seconded By Wardner

Senators	Yes	No	Senators	Yes	No
Senator Urlacher-Chairman	✓				
Senator Wardner-Vice Chairman	✓				
Senator Christmann	✓				
Senator Stenehjem	✓				
Senator Kroeplin	✓				
Senator Nichols	✓				

Total (Yes) 6 No 0

Absent 0

Floor Assignment Wardner

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

**REPORT OF STANDING COMMITTEE**

**HB 1065, as engrossed: Finance and Taxation Committee (Sen. Urlacher, Chairman)**  
recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends  
**DO PASS** (6 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). Engrossed HB 1065  
was placed on the Sixth order on the calendar.

Page 3, line 22, replace "Except as otherwise provided in this subdivision," with "Guaranteed"

Page 3, line 23, remove "guaranteed"

Page 3, line 25, remove "In the case of a professional service"

Page 3, remove lines 26 through 31

Page 4, remove lines 1 through 3

Renumber accordingly

Date: 3/19/01  
Roll Call Vote #: 4

2001 SENATE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. 1065

Senate Finance and Taxation Committee

☐ Subcommittee on \_\_\_\_\_  
or  
☐ Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken Reconsider Actions of DO PASS AS AMENDS

Motion Made By Wardner Seconded By Kroeplin

Senators	Yes	No	Senators	Yes	No
Senator Urlacher-Chairman	✓				
Senator Wardner-Vice Chairman	✓				
Senator Christmann	✓				
Senator Stenehjem	✓				
Senator Kroeplin	✓				
Senator Nichols	✓				

Total (Yes) 6 No 0

Absent 0

Floor Assignment \_\_\_\_\_

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

Date: 8/19/01  
Roll Call Vote #: 5

2001 SENATE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. 1065

Senate Finance and Taxation Committee

☐ Subcommittee on \_\_\_\_\_

or

☐ Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken Remove Senate Amendments

Motion Made By Wardner Seconded By Kroeplin

Senators	Yes	No	Senators	Yes	No
Senator Urlacher-Chairman	✓				
Senator Wardner-Vice Chairman	✓				
Senator Christmann	✓				
Senator Stenehjem	✓				
Senator Kroeplin	✓				
Senator Nichols	✓				

Total (Yes) 6 No 0

Absent 0

Floor Assignment \_\_\_\_\_

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

Date: 3/19/01  
Roll Call Vote #: 6

2001 SENATE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. 1065

Senate Finance and Taxation Committee

☐ Subcommittee on \_\_\_\_\_  
or  
☐ Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken DO PASS on engrossed House Bill? Referred

Motion Made By Wardner Seconded By Christmann

Senators	Yes	No	Senators	Yes	No
Senator Urlacher-Chairman	✓				
Senator Wardner-Vice Chairman	✓				
Senator Christmann	✓				
Senator Stenehjem	✓				
Senator Kroeplin	✓				
Senator Nichols	✓				

Total (Yes) 6 No 0

Absent 0

Floor Assignment Wardner

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

**REPORT OF STANDING COMMITTEE (410)**  
**March 19, 2001 11:58 a.m.**

**Module No: SR-47-6004**  
**Carrier: Wardner**  
**Insert LC: . Title: .**

**REPORT OF STANDING COMMITTEE**

**HB 1065, as engrossed: 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). Engrossed HB 1065 was rereferred to the Appropriations Committee.**



2001 SENATE APPROPRIATIONS

HB 1065

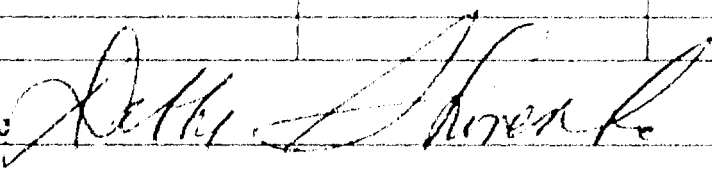
2001 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HB 1065

Senate Appropriations Committee

☐ Conference Committee

Hearing Date March 27, 2001

Tape Number	Side A	Side B	Meter #
I	X		3.2-22.4
Committee Clerk Signature 			

Minutes:

Senator Nething opened the hearing on HB 1065.

Joe Becker, ND State Tax Department, testified on the bill. This bill was introduced with no fiscal impact. Due to some opposition to the bill, and defeat of the bill in the House the first go around, the Commissioner offered some amendments to the bill to take care of some concerns that the opposition had. The amendments are causing a fiscal impact of \$75,000. Our concern is that if we lose the bill entirely that the fiscal note would be much greater perhaps \$1 million plus and our concern is that we not lose the bill. Reason for the revenue situation is that the Commissioner interpretation of current tax law that has been challenged. Rather than litigate the issue, we brought this bill to ask the legislature to address the issue one way or the other. The amendments are compromised to close the loop hole where the Commission might have to retreat from his current position if we lose the bill. Revenue impact is due to the amendments from the House and mitigate the fiscal impact.

Senator Tomac: Tell us what the bill is?

Joe Becker: The bill address partnership income taxation. To rewrite provisions to address guaranteed payment. Partnerships are allowed to make payments to their partners called guaranteed payment for salary and return of capital. Opposition did not agree with guaranteed payments to nonresident partners. The bill is going to carve an exception for treatment of guaranteed payment for professional service partnerships where salaries are a large part of what they do. It will identify four areas for an exemption, one law, one accounting, one medicine and one open ended to deal those partnerships we didn't anticipate.

Senator Tomac: Currently what happens and how are their incomes treated? What is being challenged?

Joe Becker: When you have a multi state partnership, both resident and non resident involved, current practice is to take the entire income of that entity and allocate it which included guaranteed payments. The challenge is how we are treating that. They feel the guaranteed payment to a non resident be taxed by the state, this is the opposition.

Senator Tomac: Under the rules for multi state treated, why won't that be accepted anyway? or carved out. Is this for services or just because they are in the partnership? Investment partner or working partner? Is it all made in state?

Joe Becker: Doesn't matter what they are doing. The issue is whether our current interpretation is that we are not concerned on what they are doing but looking at how the entire income of that entity that is operating in the state be apportioned to the state. Not necessarily all made in state but multi K entities, meaning operations in and out of the state how do we deal with that and how much income taxed here.

Senator Robinson: The need for the additional dollars in the fiscal note, isn't this already part of your budget? Why need for the fiscal note?

Job Becker: The bill was introduced would have simply codified what the Commissioner is in deed already doing with no fiscal impact. However, the amendments are going to carve out an exemption for the professional service partnership which means we will lose some revenue that we normally have been picking up and causing the fiscal impact.

Senator Heitkamp: What was the House's motivation for doing that? Dollars we were bringing in now and by amendment legislating some kind of tax break at a time we are short dollars.

Joe Becker: They felt the amount of money the partnership pays out to a partner as a salary should be treated similarly.

Senator Kringstad: Reading the fiscal note, tax department should changed how it has been allocating certain parts of a partnership, \$1 million per year?

Joe Becker: That is our best estimate.

Senator Holmberg: The Tax Department feels how they have been interpreting the law is not attainable in court so you are asking the legislature to choice a law to conform to what you believe is the best public policy?

Joe Becker: No we are not saying that we can't sustain the case or rather than go to court and costs we decided to ask a question of you, as the law is unclear on the matter. You would just pass the bill as introduced.

Senator Holmberg: This was unacceptable to the House?

Joe Becker: That is correct.

Senator Robinson: How is this issue treated in other states?

Joe Becker: The treatment varies from state to state; no one common approach. The approach with current law is done by other states. The approach that is in the bill was done in the State of California, no one method adopted.

Senator Heitkamp: The House amendment with \$75,000 fiscal note, the Tax Department determines that this is the way we need policy wise, challenge to that by opponents. Amendments costing us \$75,000 doesn't that then lend aid to the opponents of it, in a potential lawsuit?

Joe Becker: The bill was defeated in the House by a majority 49-49. Our concern was not to lose the bill all together.

Danitta Wald, ND Tax Department, to provide that \$1 million from being lost, we addressed the issue with the opponents and came up with this compromise. This is what we had to do to pass the House, and came out of the House with the amendment 98-0. With or without the amendment, this is okay with past tax years.

Paul Wohnoutka, opposed to the bill as introduced, but not as supports the bill amended (testimony attached).

Senator Tomac: What changed before us now that was not an issue two years ago?

Paul Wohnoutka: Reason for the issue is out of state partners felt it was unfair and also the issue moving towards the court to be challenged.

Senator Tomac: You have been living with this for years, how long ago did it become an issue and why now?

Paul Wohnoutka: Probably the biggest difference is the size of our firm today and the number of partners that are out of state. This issue is important with our partners.

Page 5  
Senate Appropriations Committee  
Bill/Resolution Number HB 1065  
Hearing Date March 27, 2001

Senator Heitkamp: Is the Tax Department doing something different now for the \$75,000 fiscal impact?

Paul Wohnoutka: They are challenging this issue to the interpretation and there is no additional cost to the department.

With no further testimony, the hearing was closed on HB 1065.

Tape #1, Side A, meter 22.4.

3-29-01 Full Committee Action (Tape #1, Side A, Meter # 7.7-15.7)

Senator Nething reopened the hearing on HB1065 - Allocation and apportionment of partnership income for income tax purpose.

Senator Kringstad, Chair of the Subcommittee discussed the hearing, and finding of the Committee. Discussion.

Senator Kringstad moved a DO PASS; seconded by Senator Tallackson. Discussion; call for the vote; Roll Call Vote: 13 yes; 1 no; 0 absent and not voting.

Floor assignment went back to referring committee, Senator Wardner carrier.

Date: 3-20-01

Roll Call Vote #: \_\_\_\_\_

**2001 SENATE STANDING COMMITTEE ROLL CALL VOTES**  
**BILL/RESOLUTION NO. AB 1065**

Senate Appropriations Committee

☐ Subcommittee on \_\_\_\_\_

or

☐ Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken On Pass

Motion Made By Senator Levinson Seconded By Senator Tallackson

Senators	Yes	No	Senators	Yes	No
Dave Nething, Chairman	✓				
Ken Solberg, Vice-Chairman	✓				
Randy A. Schobinger	✓				
Elroy N. Lindaas	✓				
Harvey Tallackson	✓				
Larry J. Robinson		✓			
Steven W. Tomac	✓				
Joel C. Heitkamp	✓				
Tony Grindberg	✓				
Russell T. Thane	✓				
Ed Kringstad	✓				
Ray Holmberg	✓				
Bill Bowman	✓				
John M. Andrist	✓				

Total Yes 13 No 1

Absent 0

Floor Assignment Senator Levinson

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

**REPORT OF STANDING COMMITTEE (410)**  
**March 29, 2001 9:32 a.m.**

**Module No: SR-55-7082**  
**Carrier: Wardner**  
**Insert LC: . Title: .**

**REPORT OF STANDING COMMITTEE**

**HB 1065, as engrossed: Appropriations Committee (Sen. Nething, Chairman)**  
**recommends DO PASS (13 YEAS, 1 NAY, 0 ABSENT AND NOT VOTING).**  
**Engrossed HB 1065 was placed on the Fourteenth order on the calendar.**



2001 TESTIMONY

HB 1065

## **Testimony before the House Finance and Taxation Committee House Bill 1065**

January 15, 2001

Prepared by Joseph Becker, Auditor III/Research Specialist  
North Dakota Office of State Tax Commissioner  
Phone: 328-3451  
E-mail: jjbecker@state.nd.us

Mr. Chairman, members of the committee:

My name is Joseph Becker, and I'm here representing the North Dakota Office of State Tax Commissioner (Tax Department). House Bill 1065 is an income tax bill that contains a number of technical and substantive changes.

The Tax Commissioner introduced this bill for a couple of reasons: The primary reason is to obtain the legislature's guidance on an issue that has arisen with respect to the Tax Department's interpretation of the law as it applies to the taxation of partnerships and their partners. A secondary reason is to make a number of changes that enhance and clarify North Dakota income tax law covering partnership taxation. This secondary reason is prompted by an ever-increasing use of the limited liability company as a business entity form which, in most cases, is taxed like a partnership.

My testimony is broken down into two parts: The first part provides a brief description of the bill's provisions. The second part explains the interpretation issue that the Tax Commissioner is asking the legislature's help with.

### **Overview of bill's provisions**

**SECTION 1** of the bill pertains to that part of the income tax law covering what types of income must be reported to North Dakota by a resident or nonresident individual. It amends a number of provisions to clarify and clean up the language. None of these proposed changes affect the content or application of the law.

**SECTIONS 2, 3, and 4** of the bill pertain to that part of the income tax law covering partnerships and the tax treatment of resident and nonresident individual partners.<sup>1</sup>

**SECTION 2** amends current law covering the taxation of a partnership to replace a portion of the language with language more commonly found in federal law and other states' laws. This change also

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<sup>1</sup> This also applies to estates and trusts that are partners in a partnership. Estates and trusts are generally taxed in a manner similar to individuals under North Dakota income tax law.

removes the language that is the source of the legal interpretation issue—namely, the terminology “net profits” (on page 2, lines 27 and 28)—and replaces it with language that is more general and broader in scope. I will elaborate on this change in the second part of my testimony.

SECTION 3 of the bill creates a new section in the income tax law to incorporate existing law and add new law affecting the taxation of partnerships and their partners. It contains the following three subsections:

1. Subsection 1 (starting on page 3, line 5) recodifies part of the law that is being repealed in Section 4 of the bill. This change does not affect current law or its application.<sup>2</sup>
2. Subsection 2 (starting on page 3, line 10) also recodifies part of the law that is being repealed in Section 4 of the bill. Again, this change does not affect current law or its application.<sup>3</sup>
3. Subsection 3 (starting on page 3, line 15) provides for the tax treatment of *nonresident* individual partners. This language is new and goes hand-in-hand with the changes that are being made in Section 2 of the bill. The new language generally incorporates the current application of the law, except that substantive changes are being proposed to clarify the tax treatment of nonresident individual partners and to address the legal interpretation issue.<sup>4</sup>

Subsection 3 is further broken down into the following four subdivisions:

- a. Subdivision a (starting on page 3, line 15) relates to how a nonresident individual partner must determine the amount of income or loss to report to North Dakota. In particular, it specifically provides that a *guaranteed payment*<sup>5</sup> made by the partnership to a nonresident individual partner is to be treated as an item of income distributed to the partner for North Dakota income tax purposes. With respect to the legal interpretation issue, this treatment corresponds to the Tax Commissioner’s interpretation of current law.

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<sup>2</sup> As a practical matter, the method by which a partnership must determine the amount of its total income or loss that is reportable to North Dakota only applies for purposes of determining the amount of income or loss that its nonresident individual partners must report to North Dakota. Resident individual partners, by reason of their legal residence in North Dakota, must report their entire share of the income or loss derived from the partnership regardless of whether the partnership conducts all or only part of its business activity in North Dakota.

<sup>3</sup> See footnote 1 relating to resident partners consisting of estates and trusts.

<sup>4</sup> The new language used in Section 3 of the bill has been borrowed from language that is contained in the statutes of several other states.

<sup>5</sup> In general, a guaranteed payment is a payment made to a partner regardless of the partnership’s income or loss. It is generally made on account of the partner’s personal services or as a guaranteed return on the partner’s contributions (capital) to the partnership. Because a guaranteed payment is specifically designated for a particular partner, and the amount of the payment may differ from one partner to another, the total of all guaranteed payments are allowed to be deducted on the federal partnership return in determining the amount of income or loss that is distributable to all of the partners based on their respective ownership interests.

- b. Subdivision b (*starting on page 3, line 23*) relates to the determination of whether a payment is sourced in North Dakota (and therefore subject to North Dakota tax) or is sourced outside North Dakota (and not subject to tax). In general, the purpose of this language is to clarify that the characterization of payments to partners in the partnership agreement has no effect in determining whether income or loss has its source in North Dakota.
- c. Subdivision c (*starting on page 4, line 6*) relates only to those nonresident individual partners who use the long form method of filing for North Dakota individual income tax purposes (*which is implemented on Form 37*). In general, it provides that the amount of any modification to federal taxable income (for purposes of determining North Dakota taxable income) must be based on the partner's share of the distribution that is reportable to North Dakota.<sup>6</sup> As a practical matter, this is already done under current law; nevertheless, the change clarifies current law.
- d. Subdivision d (*starting on page 4, line 12*) provides that, subject to the Tax Commissioner's discretion, a partnership may apply to the Tax Commissioner to request the use of other methods of determining the portion of any partnership item of income, gain, loss, or deduction that is reportable to North Dakota.

**SECTION 4** of the bill repeals an existing section of income tax law covering partnerships and partners. The repealed language is being recodified in the new section of law created under Section 3 of the bill.

**SECTION 5** of the bill provides that the bill will become effective starting with the 2001 tax year.

### **Legal Interpretation Issue**

I'd like to now turn to the primary reason that the Tax Commissioner introduced this bill. An issue has arisen with respect to the Tax Commissioner's interpretation of current law.<sup>7</sup> The issue is whether or not guaranteed payments are included or excluded in determining the amount of a partnership's income or loss that a nonresident individual partner must report to North Dakota.

The Tax Commissioner's interpretation and application of the law for many years is that the guaranteed payments must be included. Under this interpretation, a nonresident individual partner must pay North Dakota income tax on that portion of a guaranteed payment that is attributable to the

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<sup>6</sup> In general, these modifications are those contained in North Dakota Century Code § 57-38-01.2.

<sup>7</sup> The issue involves the interpretation of the terminology "net profits" in N.D.C.C. § 57-38-08.

partnership's business activity in North Dakota.<sup>8</sup> This interpretation has been challenged by a number of taxpayers who argue that the law in question does not include guaranteed payments.

The Tax Commissioner introduced this bill to bring the issue to the attention of the legislature and request its guidance on the issue by way of the action it takes on this bill. Passage of this bill will reflect your wish to include the guaranteed payments, and defeat of this bill will reflect your wish to exclude them. *(Please note that the defeat of this bill will not prevent the taxation of the portion of a guaranteed payment that is attributable to the performance of services in North Dakota by a nonresident individual partner.<sup>9</sup>)*

I hasten to add that, even if it is your wish to exclude the guaranteed payments, we ask that you do not defeat the bill in its entirety. In this case, we respectfully ask that the bill be amended to reflect your wishes, so that the law is clear on the treatment of guaranteed payments. In addition, we would like to retain certain of the other proposed changes that we believe will help enhance and clarify the law.

The Tax Commissioner asks for the committee's favorable consideration of this bill, and the Tax Department gladly offers its assistance to the committee should the committee decide to amend the bill. If the committee has any questions, Mr. Chairman, I would be happy to respond to them at this time.

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<sup>8</sup> To determine the amount of a guaranteed payment that a nonresident individual partner must report to North Dakota, the amount of the guaranteed payment reported for federal income tax purposes is multiplied by the partnership's apportionment factor. The apportionment factor represents the level of the partnership's business activity in North Dakota. It is determined using a three factor formula based on the partnership's property, payroll, and sales for the tax year. If a partnership does all of its business in North Dakota, the factor is 1.000000 (i.e., 100%). If a partnership carries on its business activity both within and without North Dakota, i.e., it is a multistate partnership, the factor will generally be less than 1.000000.

Also note that this treatment of a guaranteed payment applies regardless of whether the partner performed any services in North Dakota.

<sup>9</sup> N.D.C.C. § 57-38-04(1) generally provides that compensation received for personal or professional services performed in North Dakota are reportable to North Dakota regardless of the legal residence of the individual. Therefore, the portion of a guaranteed payment that is attributable to services performed in North Dakota is reportable to North Dakota even if the partner is a nonresident of North Dakota.



Consultants • Certified Public Accountants

January 15, 2001

*Handwritten: sent with letter*

House Taxation Committee  
ND State Legislature  
600 E. Boulevard Ave.  
Bismarck, ND 58505

RE: HB 1065 Relating to Taxation of Partners

Dear Chairperson and Committee Members:

**PLEASE VOTE NO ON HB 1065**

What does HB 1065 do?

- It significantly changes the current North Dakota tax laws.
- It creates a significant negative business environment for multi-state entities that are taxed as partnerships. Entities taxed as partnerships include:
  - General Partnerships
  - Limited Partnerships
  - Limited Liability Partnerships
  - Limited Limited Liability Partnerships
  - Limited Liability Companies

What do the current North Dakota laws provide regarding a multi-state entity that is taxed as a partnership?

- The starting point for North Dakota tax purposes is federal taxable income. The **ONLY** adjustments that can be made to federal taxable income are those provided for in North Dakota's laws. As such, net earnings of a partnership are determined after deducting salaries and other guaranteed payments to owners allowed under Internal Revenue Code Section 707(c). The net earnings are allocated to the states based on the three factor multi-state allocation formula. **(FOR FURTHER TECHNICAL DISCUSSION AS TO WHAT THE CURRENT LAW PROVIDES, SEE ATTACHED NARRATION.)**

What do the current North Dakota laws provide regarding a multi-state corporation?

- Net earnings of a corporation, after deducting salaries, interest, rents and other payments to owners are allocated to the states based on the three factor multi-state allocation formula.

As can be seen, North Dakota's laws currently provide similar taxation for the earnings of a multi-state partnership as for earnings of a multi-state corporation. The primary difference is that the tax on the net earnings of a C corporation is paid by the corporation, whereas the tax on the net earnings of an S corporation and of a partnership is paid by the owners.

An example of the result of passing HB 1065, assuming a service partnership with 50% of its net earnings and 50% of its partners practicing in North Dakota, is as follows:

- **Under current law**, North Dakota will generally receive tax on something more than 50% of the earnings before salaries and other guaranteed payments to partners. This is from:
  - 100% of the salary and other guaranteed payments to North Dakota partners that are taxed in North Dakota. In addition, 100% of the net earnings, after guaranteed payments to partners, that are allocated to North Dakota partners are in taxed in North Dakota. This would be about 50% of the earnings before salaries and other guaranteed payments to partners.
  - 50% of the net earnings after salaries and other guaranteed payments to **NON-North Dakota** partners are taxed in North Dakota.
  - The sum of these two parts will generally be something more than 50% of the earnings before salaries and other guaranteed payments to partners.
- **By passing HB 1065**, North Dakota will generally receive tax on something more than 75% of the earnings before any payments to partners. This would be from:

- 100% of the 50% of the earnings before salaries and other guaranteed payments allocated to North Dakota partners that would be taxed in North Dakota. This part would be the same result as the current law, only different numbers to get the same result.
- 50% of the remaining 50% of net earnings before salaries and other guaranteed payments to partners would be taxed in North Dakota via the NON-North Dakota partners.
- Therefore, while 50% of the earnings would be earned in North Dakota, about 75% of the earnings would be taxed in North Dakota.

#### **SEE ATTACHED FOR NUMERICAL EXAMPLES**

Isn't it true that if an out of state partner pays tax to North Dakota, they can claim a credit for that tax on their home state return?

- For partners who live in a state that has a state income tax, they can claim a credit for the state tax they pay to North Dakota. But, if HB 1065 is passed, it will probably leave them with a negative impression of North Dakota as the tax dollars that should be supporting their home state would be going to North Dakota.
- For partners who live in a state that does not have a state income tax, such as South Dakota and Wyoming, they would not have any home state tax against which to claim a credit. As a result, the additional tax that would be paid to North Dakota would be an extra cash outlay to a state that they do very little, if any work in.

If HB 1065 is passed, can current entities that are taxed as partnerships plan around it?

- Sure planning can be done around HB 1065 if it was passed. For example purposes, assume an entity that is taxed as a partnership operates in North Dakota plus a non-income tax state plus another state that has a state income tax.



- They could incorporate the entire business. In that case, the net earnings of the corporation, after deductible payments to owners, would be allocated to the states on the three factor formula.

In the C corporate setting for professional organizations, the net earnings almost always turns out to be zero because the tax rate on every dollar of net earnings is taxed at a 35% federal tax rate and then taxed again to the owners if/when they are distributed to the owners. The result would be less tax collection for North Dakota as they would collect no tax on out of state owners.

In addition, it will give all the partners a very negative impression of North Dakota's business climate. This would be because the only reason the business would have converted to a corporation would be because of HB 1065.

A similar result would occur using an S corporation except it wouldn't be as critical to bring the net earning to zero every year.

- They could incorporate the portion of the business that is located in the state that does not have an income tax. This might be done because HB 1065 would affect the partners the most who live in a state that does not have an income tax.

As already noted, partners in states that have an income tax would only be irritated that they would have to send too much taxes to North Dakota resulting in lost taxes to their home state.

Using a C corporation just for the partners in the state that does not have an income tax would result in a reduction of taxes to North Dakota. This would be because those partners would be currently paying some taxes to North Dakota. They would probably pay zero to North Dakota by using a C corporation. That is because the corporation would show a zero taxable earnings every year because of planning relating to the federal 35% tax rate.

House Taxation Committee

January 15, 2001

Page 5

This planning would also give the partners of the business a negative impression of North Dakota's business climate.

A similar result would occur using an S corporation except it wouldn't be as critical to bring the net earning to zero every year. This is because the owners pay the tax on the earnings.

- Each partner in the state that does not have a state income tax could incorporate their partnership interest. This would have the same results as the prior scenario except administrative costs might increase.

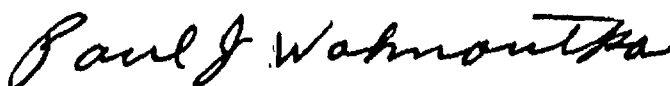
In summation, North Dakota has always been a leader in adopting statutes to welcome new types of entities to operate in North Dakota. Those statutes have fostered a favorable business climate. More and more businesses desire to operate in one of the five types of entities that are taxed as partnerships. HB 1065 significantly changes the law and would create a very negative business climate for multi-state entities that are taxed as partnerships.

We request your NO vote on HB 1065.

I am available to answer any questions at this time. I am also available to answer any subsequent questions by calling me direct at 255-8443 or emailing me at [pwohnoutka@eidebailly.com](mailto:pwohnoutka@eidebailly.com).

Sincerely,

EIDE BAILLY LLP



Paul J. Wohnoutka, Partner

NUMERICAL EXAMPLE OF EFFECTS OF HB 1065

CURRENT LAW	ND PARTNERS	SD PARTNERS	KANSAS PARTNERS	TOTAL
EARNINGS BEFORE SALARIES AND OTHER GUARANTEED PAYMENTS TO PARTNERS	500,000	250,000	250,000	1,000,000
LESS SALARIES TO PARTNERS	450,000	225,000	225,000	900,000
BALANCE	50,000	25,000	25,000	100,000
ND APPORTIONMENT FACTOR	N/A	50%	50%	
APPORTIONED TO ND		12,500	12,500	
TAXED TO ND	500,000	12,500	12,500	525,000

HB 1065	ND PARTNERS	SD PARTNERS	KANSAS PARTNERS	TOTAL
EARNINGS BEFORE SALARIES AND OTHER GUARANTEED PAYMENTS TO PARTNERS	500,000	250,000	250,000	1,000,000
LESS SALARIES TO PARTNERS	450,000	225,000	225,000	900,000
BALANCE	50,000	25,000	25,000	100,000
ND APPORTIONMENT FACTOR	N/A	50%	50%	
APPORTIONED TO ND		125,000	125,000	
TAXED TO ND	500,000	125,000	125,000	750,000

HB 1065 - NARATIVE OF CURRENT LAW  
FOR MULTI-STATE ENTITIES TAXED AS PARTNERSHIPS

**OVERALL SUMMARY:** North Dakota's laws currently provide that salaries and other guaranteed payments to partners allowed under Internal Revenue Code Section 707(c) are deductible before allocation of net earnings among the states on the three factor formula. This is the same result as with C corporations and S corporations. HB 1065 would substantially change how multi-state entities that are taxed as partnerships would be taxed in North Dakota. HB 1065 would result in a significant difference in how much is taxed in North Dakota compared to existing laws and compared to operating as either a C or an S corporation (a C corporation pays its own tax on corporation's earnings. The owners of an S corporation pay the tax on the corporation's earnings.)

**TECHNICAL DISCUSSION OF CURRENT LAW PER THE NDCC:** NDCC 57-38-10 states: "... The income or loss of a partnership must be allocated and apportioned to North Dakota and outside North Dakota as the income or loss of a corporation is allocated and apportioned to the state and outside the state. . . " The income allocated and apportioned by a corporation is determined after deducting salaries to owners. This applies to both a C corporation which pays income taxes on its taxable income and to an S corporation which passes taxable income through to its owners in a manner similar to the pass through of partnership taxable income to its partners. Section 707( c ) of the Internal Revenue Code states that payments to a partner for services (e.g., guaranteed payments) shall be considered as made to non-partners, in other words, as salary payments to employees. It follows that for a partnership to allocate and apportion income in the same manner as a corporation, as required by NDCC 57-38-10, guaranteed payments must be deducted before income is allocated and apportioned. NDCC 57-38-13 further provides: "...for purposes of NDCC 57-38-12, payments of wages, salaries, and other compensation must be assigned to the state in which the services therefore are performed. . . "

NDCC 57-38-01(10) states: "Any term, as used in the code, as it pertains to the filing and reporting of income, deductions, or exemptions or the paying of North Dakota income tax, has the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required or contemplated." NDCC 57-38 does not address the term or treatment of guaranteed payments to partners. As such, the Internal Revenue Code should be referred to regarding guaranteed payments to partners. IRC 707(c) and IRS Regulation 1-707-1(c) provide that guaranteed payments to a partner from a partnership shall be considered income to the partner under IRC 61(a) and a deduction to the partnership under IRC 162(a) just as is the case for salaries paid to employees of C corporations and of S corporations. NDCC 57-38-01(10) requires the same treatment for North Dakota tax purposes; therefore, guaranteed payments to partners are deductible payments at the partnership level and are separate income items to the partners.

HB 1065 - NARATIVE OF CURRENT LAW  
FOR MULTI-STATE ENTITIES TAXED AS PARTNERSHIPS  
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**APPLICABLE COURT CASES:** In the 1980 court case of Erdle v. Dorgan the North Dakota Supreme Court, the court stated:

Statutes unambiguously state that federal taxable income is the starting point for the preparation of state income tax return, and only those adjustments expressly provided by statute may be made to increase or decrease federal taxable income on state tax return. NDCC 57-38-01, subd. 20, 57-38-01.1, 57-38-01.2.

"57-38-01.1. Declaration of legislative intent. It is the intent of the legislative assembly to simplify the state income tax laws and to demonstrate that federal legislation is not necessary to deal with certain interstate tax problems, by adopting the federal definition of taxable income as the starting point for the computation of state income tax by all taxpayers and providing the necessary adjustments thereto to substantially preserve and maintain existing exemptions and deductions."

[1] We reiterate our statement in Lanterman, supra, that the North Dakota statutes unambiguously state that federal taxable income is the starting point for the preparation of the state income return, and only those adjustments expressly provided by statute may be made to increase or decrease federal taxable income on the state tax return.

The North Dakota tax statutes clearly provide that federal taxable income is the starting point for the computation of state income tax by all taxpayers. Section 57-38-01(20), N.D.C.C.; Section 57-38-01.1, N.D.C.C.; Lanterman v. Dorgan, 255 N.W.2d 891 (N.D.1977). An adjustment to the federal taxable income figure cannot be made on the state tax return unless such adjustment is expressly provided by statute. Section 57-38-01(20), N.D.C.C.; see also, Hardy v. State Tax Commissioner, 258 N.W.2d 249 (N.D.1977). Consequently, the ultimate question to be resolved with respect to this issue is whether or not our statutes provide for an adjustment to federal taxable income to reflect differential treatment of a taxpayer's stock basis in a corporation which elects Subchapter S treatment for federal tax purposes and regular tax treatment for state tax purposes. Upon reviewing our tax statutes, we have found no such provision, nor has the Commissioner directed us to any statutory language which would allow such an adjustment. Accordingly, we reverse that part of the district court's judgment which affirms the Commissioner's determination to assess additional taxes against the taxpayers with respect to their sale.

HB 1065 - NARATIVE OF CURRENT LAW  
FOR MULTI-STATE ENTITIES TAXED AS PARTNERSHIPS  
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In the 1981 court case of Arley C. Running, 313 NW 2nd 772, the North Dakota Supreme Court Stated

The correctness of a reported "taxable income \* \* \* for federal income tax purposes" is a federal question that must be determined under the United States Internal Revenue Code. NDCC 57-38-01, subd. 20, 57-38-01.1, 57-38-01.2, subd. 2

The court has not always been unanimous, nevertheless the precedent is firmly established that until the Legislature changes the language of the law, the North Dakota taxable income is determined by starting with federal taxable income and adding or subtracting there from only pursuant to specific authorization of law, including regulations adopted pursuant to law.

Unspoken, but nevertheless basic to that principle, is that there must be a correct starting point. The correctness of a reported "taxable income...for federal income tax purposes" is a federal question that must be determined under the United States Internal Revenue Code. Because the legislative assembly declared its intention by federalizing, "to simplify" the state income tax, (FN3) we conclude that a taxpayer's reported taxable income for federal tax purposes is entitled to a presumption of correctness.

In view of these explicit legislative directions, correction of the federal taxable income should not be accomplished by vague and complex application of "audit criteria" that do nothing to simplify the procedure. The presumption that Running's reported taxable income for federal tax purposes is correct has not been overcome in this case.

## **Testimony before the Senate Finance and Taxation Committee**

### **Engrossed House Bill 1065 (First engrossment)**

March 12, 2001

Prepared by Joseph Becker  
North Dakota Office of State Tax Commissioner  
Phone: 328-3451  
E-mail: jjbecker@state.nd.us

Mr. Chairman, Members of the Committee:

My name is Joseph Becker, and I'm here on behalf of the Office of State Tax Commissioner. House Bill 1065 proposes a number of technical and substantive changes to the income tax law covering individuals and partnerships. The main purpose of the bill is to clarify the partnership provisions to make them more explicit on how the income of a partnership is taxed to its partners who are nonresident individuals.

### **Background**

Before I explain the bill's provisions, some background information is necessary to help you understand the purposes of the bill and why it was introduced.

Current income tax law covering the treatment of nonresident individual partners is very general and brief. The Commissioner introduced this bill because of an issue that has recently arisen with respect to the Commissioner's interpretation of this law. The issue involves the treatment of a special payment, called a guaranteed payment, that a partnership makes to a nonresident partner.

In general, a guaranteed payment is a payment made by a partnership to a partner regardless of whether the partnership's activity produces a profit or loss for the year. It is up to the partners whether or not to set up a guaranteed payment arrangement. A guaranteed payment arrangement may be set up for a number of reasons, including:

- (1) Paying a guaranteed minimum rate of return to a partner on the partner's capital investment in the partnership.
- (2) Paying off a loan that a partner made to the partnership.
- (3) Paying a guaranteed amount as a salary for a partner's services.

The following illustration generally shows how guaranteed payments fit into the federal partnership tax structure:

**Federal partnership return**

Total income less all allowable

deductions except guaranteed payments..... \$ 100,000

Less: Guaranteed payments to partners<sup>1</sup> ..... (60,000)

Ordinary income ..... \$ 40,000

Directly allocated to the partner(s) based on their agreement. For example, one partner may receive \$40,000 while another partner receives \$20,000.

Apportioned to the partners based on their respective profit percentages. For example, if each partner's profit percentage is 50%, each partner's share of the ordinary income is \$20,000.

The Commissioner's current interpretation and administration of the law requires that a guaranteed payment made to a nonresident partner must be apportioned to North Dakota based on the partnership's percentage of business in North Dakota.<sup>2</sup> For example, if a partnership conducts 40% of its business in North Dakota, then 40% of a guaranteed payment made to a nonresident partner is subject to North Dakota income tax. (*Note: 40% of the nonresident partner's share of the ordinary income would also be subject to North Dakota income tax.*)

The Commissioner's interpretation has recently been challenged by a number of taxpayers who contend that a guaranteed payment to a nonresident partner should not be apportioned in this manner, but should be taxed in North Dakota only to the extent it is compensation for services performed in North Dakota.<sup>3</sup>

Rather than take the guaranteed payment issue to court, the Commissioner chose to present the issue to the 2001 legislature for its consideration and decision on the state tax policy. The bill, as introduced, sought to codify the Commissioner's interpretation, with the understanding that the legislature could reject that interpretation by not passing the bill. The House voted 49-49 on the bill as introduced, resulting in its failure for lack of a majority. However, the bill was rereferred to the House Finance and Taxation Committee for reconsideration.

<sup>1</sup> Because a guaranteed payment is specifically designated for a particular partner, and the amount of the payment may differ from one partner to another, the total of all guaranteed payments are subtracted from total income (less expenses) to determine the amount of profit or loss to distribute to the partners based on their respective profit and loss percentages.

<sup>2</sup> A partnership's percentage of business in North Dakota is determined by using a 3-factor apportionment formula based on the amount of the partnership's property, payroll, and sales inside and outside North Dakota.

<sup>3</sup> For example, if a nonresident partner does not perform any services in North Dakota, the entire amount of a guaranteed payment to that partner would not be taxable in North Dakota. On the other hand, assuming a nonresident partner spent 50% of his or her total working hours in North Dakota, 50% of that portion of the guaranteed payment constituting compensation for services would be taxable in North Dakota.



Because of the concern that defeat of the bill would open a serious loophole in the income tax law, the Commissioner determined it was necessary to propose amendments to the bill.<sup>4</sup> Our office proposed amendments that we felt would address the opposition's concerns and yet prevent the open-ended use of a guaranteed payment arrangement by all partnerships to avoid North Dakota income tax. The amendments were agreed to by those opposing the bill, and the amended bill now before you passed unanimously in the House.

### Explanation of provisions of House Bill 1065 (First engrossment)

**SECTION 1** of the bill makes a number of technical changes to the income tax provisions covering the types of income that must be reported to North Dakota by resident and nonresident individuals. The changes clarify that income derived from a business conducted in North Dakota includes income derived from any business, regardless of whether the business is in the form of a sole proprietorship, partnership, S corporation, etc. These changes do not affect the content or application of the law.

**SECTION 2** amends current income law covering the taxation of a partnership to replace a portion of the language with language more commonly found in federal and other states' income tax laws.

**SECTION 3** of the bill creates a new section in the income tax law that more explicitly defines the taxation of partnerships and their individual partners, particularly nonresident individual partners.

- **Page 3, lines 7-16**—The language on these lines recodifies part of the law that is being repealed in Section 4 of the bill. This language does not change current law or its application.
- **Page 3, lines 17-31, and page 4, lines 1-3.** This is new language that explicitly sets out how nonresident individual partners are taxed on income derived from a partnership.
  - **General rule (page 3, lines 17-25)**—The general rule provides that a nonresident partner's share of both ordinary income and guaranteed payments must be apportioned to North Dakota based on the partnership's percentage of business in North Dakota. This follows the Commissioner's current interpretation and administration.

$$\text{Nonresident partner's share of} \\ \text{ordinary income + guaranteed payments} \quad \times \quad \text{Partnership's percentage of} \\ \text{business in North Dakota}$$

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<sup>4</sup> Defeat of the bill as introduced would be understood by the Commissioner as indicating the legislature's intent that guaranteed payments made to nonresident partners are not to be apportioned to North Dakota based on the partnership's percentage of business in North Dakota, but are to be specifically allocated to the state(s) based on where the nonresident partners perform their services. This would create a loophole in which a multistate partnership (with nonresident partners) could exempt income derived from its business activity in North Dakota through the use of a guaranteed payment arrangement.

- **Exception to general rule for professional service partnership (page 3, lines 25-28)**—An exception to the general rule is created for a professional service partnership. In the case of a professional service partnership, the portion of a guaranteed payment made to a nonresident partner that is compensation for services is not included in the partner's share of partnership income that must be multiplied by the partnership's percentage of business in North Dakota.<sup>5</sup> This exception was added by the amendments to the bill to address the objections to the bill.

$$\begin{array}{l} \text{Nonresident partner's share of} \\ \text{ordinary income + guaranteed payments} \\ \text{that are NOT compensation for services} \end{array} \times \begin{array}{l} \text{Partnership's percentage of} \\ \text{business in North Dakota} \end{array}$$

The portion of a guaranteed payment that is compensation for services is allocated to North Dakota only to the extent it is for services performed in North Dakota.



- **Professional service partnership defined (page 3, starting on line 30)**—A "professional service partnership" means a partnership that engages in the practice of:
- (1) Law.
  - (2) Accounting.
  - (3) Medicine.
  - (4) Any other profession in which neither the capital nor the services of employees are a material income-producing factor. This means that the services of the partners themselves must be the primary income-producing factor.

A professional service partnership does not include one that primarily engages in wholesale or retail sales activity, oil and gas production activity, manufacturing activity, or other similar types of activities.

<sup>5</sup> The portion of a guaranteed payment constituting a payment for items other than compensation for services—such as interest on a loan, return on capital investment, etc.—is included in the partner's share of partnership income that is subject to the North Dakota apportionment factor.

- ▶ **Sourcing of partnership income** (*page 4, lines 4-17*)—This language provides that the terms of a partnership agreement will be disregarded to the extent they are used to avoid paying North Dakota income tax solely by the way they characterize or label income.<sup>6</sup>
- ▶ **Statutory adjustments** (*page 4, lines 18-23*)—This language clarifies the proper treatment of certain income and deduction items that a partner receives from a partnership. As a practical matter, this language applies only if a partner uses Form 37, the long-form method of filing for individuals.
- ▶ **Alternative apportionment/allocation method** (*page 4, lines 24-27*)—This language gives the Commissioner authority to consider and allow a partnership to use an alternative method to determine the amount of a nonresident partner's income that is taxable in North Dakota.<sup>7</sup>

**SECTION 4** of the bill repeals an existing section of income tax law covering partnerships and partners. The repealed language is being recodified in the new section of law created under Section 3 of the bill.

**SECTION 5** of the bill provides that the bill will become effective starting with the 2001 tax year.

Mr. Chairman, the Tax Commissioner asks for your favorable consideration of this bill.

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<sup>6</sup> For example, a partnership may not use its partnership agreement to characterize or label a guaranteed payment as being for services when, in substance, it is a payment for use of a partner's capital investment.

<sup>7</sup> For example, there may be partnerships engaged in business activities other than law, accounting, and medicine that are as equally entitled to use the professional service partnership exception.



Consultants • Certified Public Accountants

March 14, 2001

Senators  
North Dakota Senate  
600 E Boulevard Ave.  
Bismarck, ND 58505

**RE: Please vote NO on the Senate Amendment to HB 1065**

Dear Senators:

HB 1065, as passed by the House, provides statutory wording regarding taxation of out of state owners in a multi-state partnership operating in North Dakota. HB 1065 has provisions regarding professional partnerships, because they are different from other partnerships.

HB 1065, as passed by the House, was agreed to by the Tax Department and CPAs. It passed the House 98 to 0. The Senate amendment deletes the provisions for professional partnerships. This letter is intended to explain why these provisions, as passed by the House, are appropriate.

With professional partnerships, the owners are paid a salary for services provided. In partnership terminology, these salaries are called guaranteed payments. After salaries to owner/employees, there is usually a profit remaining which is allocated to all the owners regardless of location. Without the provision for professional partnerships, a significant disparity occurs as can be seen by the following example.

Assumed facts: A professional partnership with 50 owner/employees in Fargo, 5 owner/employees in Dickinson and 60 owner/employees in Rapid City. Assume each owner/employee is paid \$75,000 a year and there is a net profit after owner/employee salary of \$15,000 per owner/employee.

Based on these assumptions, this is the result to EACH of the Rapid City owner/employees: **If the entity is an S corporation**, each Rapid City owner/employee will pay ND tax on \$7,174. **If the entity is a partnership and the Senate amendment passes**, each Rapid City owner/employee will pay ND tax on \$43,043. The difference between being an S corporation and a partnership with the Senate amendment is \$35,869 of North Dakota taxable income per Rapid City owner/employee every year.

March 14, 2001

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If the 50 owner/employees were located in Moorhead instead of Fargo, and the Dickinson office remains in Dickinson, this is the result to the Rapid City owner/employees if the Senate amendment passes: If the entity is an S corporation each Rapid City owner will pay ND tax on \$652 and Minnesota tax on \$6,522 for a total of \$7,174 (same total as office in Fargo). If the entity is a partnership and the Senate amendment passes, each Rapid City owner/employee will pay ND tax on \$3,913 and Minnesota tax on \$6,522 for a total of \$10,435. If the Senate amendment passes, the difference to EACH Rapid City owner/employee between having an office in Fargo vs. Moorhead, is paying state income taxes on \$43,043 vs. \$10,435 every year.

If the Senate amendment passes, there will be a significant deterrent for multi-state partnerships to locate in North Dakota or to expand in North Dakota.

If the Senate amendment fails and HB 1065 is passed as received from the House, the Rapid City owners will: 1) pay state taxes on the same amounts regardless if they have an office in Fargo or if that office is in Moorhead; and 2) the Rapid City owners would only be penalized on \$3,261 of additional taxable income for operating as a partnership vs. an S corporation.

**Please vote NO on the Senate Amendment to HB 1065.**

Sincerely,

EIDE BAILLY LLP

  
Paul J. Wohnoutka, Partner



Consultants • Certified Public Accountants

March 27, 2001

Senate Appropriations Committee  
State Capitol  
Bismarck, ND 58505

RE: HB 1065 - Professional Partnerships

Dear Mr. Chairman and Committee Members:

We respectfully request that you pass HB 1065 as received from the House for the following reasons.

Our State is struggling to attract new businesses to locate and expand here. The most popular forms of organization for new business entities are those taxed as partnerships. HB 1065, as originally introduced, is very unfair to multi-state businesses that are taxed as partnerships, and especially so regarding professional service firms.

- HB 1065 does not affect the tax North Dakota residents pay.
- HB 1065, as originally introduced, would impose North Dakota tax on income earned outside of North Dakota by non-resident partners. This is basically unfair. (See Attachment A)
- HB 1065, as originally introduced, will cause a significantly larger amount of income to be taxed to North Dakota than if that same exact business operated as either:
  - A C corporation (that pays tax on its earnings) or
  - An S corporation (where the owners pay tax on the corporation's earnings).(See Attachment B)
- HB 1065, as originally introduced, will have a significantly different tax effect to non-residents (other than Minnesota) depending on if an office is located in North Dakota, or just across the border in another state. (See Attachment C)
- There are some states that do tax partnerships negatively like the original version of HB 1065.
  - North Dakota should choose to be with the favorable business climate states, not the unfavorable business climate states.

HB 1065, as passed by the House, contains rules relating to professional service partnerships.

- While the House amendment does not solve the negative business climate for all partnerships, it addresses the negative business climate for professional service

partnerships. Professional service partnerships are the ones most negatively affected by the original version of HB 1065.

Senate Finance and Taxation Committee

March 27, 2001

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- Unlike most businesses, professional service partnerships have:
  - Owners generating revenue based on their personal expertise in that profession.
  - The vast majority of the revenue generated in a particular location stays at that location via salary payments to the employees and to the owner/employees at that location.

There appears to be a concern about potential abuses regarding partnerships and payments to the owners.

- With professional service partnerships, there is little opportunity for abuse.
  - HB 1065, as passed by the House, uses the term "reasonable salary."
  - Partners in one location would not have additional compensation paid to another partner for the sole purposes of trying to avoid state taxes.
- If a person works part of the time in North Dakota, that portion of the person's salary is taxed to North Dakota.
- With other partnerships, there might be a higher potential for abuse without HB 1065.
  - How much or how little perceived abuse would actually be achieved via payments to partners in other types of partnerships is an unknown.

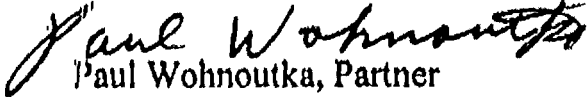
HB 1065, as passed by the House, was a compromise.

- There is no perfect solution to a complex situation.
- The amendments to HB 1065 were proposed by the Tax Department and agreed to by Eide Bailly LLP and the North Dakota Society of CPAs. HB 1065, as amended, was unanimously passed by both the House Finance & Taxation Committee the House Chamber and the Senate Finance & Taxation Committee.

We request your DO PASS on HB 1065 as received from the House.

Respectfully Submitted,

EIDE BAILLY LLP

  
Paul Wahnoutka, Partner

**ATTACHMENT A: Assumes each partner is paid a salary for services of \$50,000 and there is a \$10,000 profit per partner at each location. This attachment shows HB 1065's effect on salaries paid to out of state partners for services provided out of state.**

			<b>HB 1065 - WITH Professional Partnership Provision</b>	<b>HB 1065 - NO Professional Partnership Provision</b>
OFFICE LOCATIONS	OWNERS	MEMO \$50,000 OWNERS SALARY	\$10,000 PROFIT PER OWNER	\$60,000 PROFIT BEFORE OWNERS SALARY
FARGO	5	250,000	50,000	300,000
DICKINSON	1	50,000	10,000	60,000
RAPID CITY	6	300,000	60,000	360,000
TOTALS	12	600,000	120,000	720,000
ND ALLOCATION RATIO			0.5000	0.5000
INCOME ALLOCATED TO ND			60,000	360,000
ND TAXABLE - RAPID CITY OWNERS TOTAL			30,000	180,000
ND TAXABLE - RAPID CITY OWNERS EACH			5,000	30,000

**RESULT:**

1. HB 1065, WITH THE HOUSE AMENDMENTS, TAXES THE OUT OF STATE PARTNERS ON THEIR PORTION OF NORTH DAKOTA INCOME AFTER SALARIES TO PARTNERS. IN THIS EXAMPLE \$5,000.
2. HB 1065, WITHOUT THE HOUSE AMENDMENTS, TAXES THE OUT OF STATE PARTNERS ON \$30,000 VS \$5,000.

**NOTE: IT IS NOT A COINCIDENCE THAT THE DIFFERENCE IN THE AMOUNT TAXED TO NORTH DAKOTA IS THE NORTH DAKOTA APPORTIONMENT FACTOR TIMES THE OUT OF STATE PARTNERS SALARY. THAT IS THE RESULT OF HB 1065 WITHOUT THE HOUSE AMENDMENTS. IT TAXES OUT OF STATE PARTNERS ON THEIR OUT OF STATE SALARIES BASED ON THE NORTH DAKOTA APPORTIONMENT FACTOR.**



**ATTACHMENT B:** Assumes each partner is paid a salary for services of \$50,000 and there is a \$10,000 profit per partner at each location. This attachment shows the effects of HB 1065 on multi-state partnership compared to an S corporation.

HB 1065 EXAMPLE OFFICE IN FARGO			An S Corporation	HB 1065 - WITH Professional Partnership Provision	HB 1065 - NO Professional Partnership Provision
OFFICE LOCATIONS	OWNERS	\$50,000 OWNERS SALARY	\$10,000 PROFIT PER OWNER	\$10,000 PROFIT PER OWNER	\$60,000 PROFIT BEFORE OWNERS SALARY
FARGO	5	250,000	50,000	50,000	300,000
DICKINSON	1	50,000	10,000	10,000	60,000
RAPID CITY	6	300,000	60,000	60,000	360,000
MOORHEAD	0	0	0	0	0
TOTALS	12	600,000	120,000	120,000	720,000
ND ALLOCATION RATIO			0.5000	0.5000	0.5000
INCOME ALLOCATED TO ND			60,000	60,000	360,000
ND TAXABLE - RAPID CITY OWNERS TOTAL			30,000	30,000	180,000
ND TAXABLE - RAPID CITY OWNERS EACH			5,000	5,000	30,000

**RESULT:**

1. HB 1065, WITH THE HOUSE AMENDMENTS, TAXES THE OUT OF STATE PARTNERS THE SAME AS IF THEY OPERATED AS AN S CORPORATION (WHERE THE OWNERS PAY TAX ON THE CORPORATION'S EARNINGS. IN THIS EXAMPLE, TAXED ON \$5,000 IF OPERATING AS AN S CORPORATION AND TAXED ON \$5,000 IF OPERATION AS A PARTNERSHIP).
2. IN THIS EXAMPLE, HB 1065, WITHOUT THE HOUSE AMENDMENTS, TAXES OUT OF STATE PARTNERS ON SUBSTANTIALLY MORE (\$30,000 vs \$5,000) BECAUSE THEY OPERATE AS A PARTNERSHIP vs A CORPORATION.
3. THE COMPARISON IS SIMILAR BETWEEN A C CORPORATION (A CORPORATION THAT PAYS TAX ON THE CORPORATION'S EARNINGS) AND A PARTNERSHIP.

**ATTACHMENT C:** Assumes each partner is paid a salary for services of \$50,000 and there is a \$10,000 profit per partner at each location. This attachment shows the effects of HB 1065 on multi-state partnership with the variable being having an office in Moorhead vs. Fargo.

HB 1065 EXAMPLE OFFICES IN: FARGO DICKINSON RAPID CITY			HB 1065 - WITH Professional Partnership Provision	HB 1065 - NO Professional Partnership Provision
OFFICE LOCATIONS	OWNERS	\$50,000 OWNERS SALARY	\$10,000 PROFIT PER OWNER	\$60,000 PROFIT BEFORE OWNERS SALARY
FARGO	5	250,000	50,000	300,000
DICKINSON	1	50,000	10,000	60,000
RAPID CITY	6	300,000	60,000	360,000
TOTALS	12	600,000	120,000	720,000
ND ALLOCATION RATIO			0.5000	0.5000
INCOME ALLOCATED TO ND			60,000	360,000
ND TAXABLE - RAPID CITY OWNERS TOTAL			30,000	180,000
ND TAXABLE - RAPID CITY OWNERS EACH			5,000	30,000
HB 1065 EXAMPLE OFFICES IN: MOORHEAD DICKINSON RAPID CITY			HB 1065 - WITH Professional Partnership Provision	HB 1065 - NO Professional Partnership Provision
OFFICE LOCATIONS	OWNERS	\$50,000 OWNERS SALARY	\$10,000 PROFIT PER OWNER	\$60,000 PROFIT BEFORE OWNERS SALARY
MOORHEAD	5	250,000	50,000	300,000
DICKINSON	1	50,000	10,000	60,000
RAPID CITY	6	300,000	60,000	360,000
TOTALS	12	600,000	120,000	720,000
ND ALLOCATION RATIO			0.0833	0.0833
INCOME ALLOCATED TO ND			10,000	60,000
ND TAXABLE - RAPID CITY OWNERS TOTAL			5,000	30,000
ND TAXABLE - RAPID CITY OWNERS EACH			833	5,000
MN ALLOCATION RATIO			0.4167	0.4167
INCOME ALLOCATED TO MN			50,000	50,000
MN TAXABLE - RAPID CITY OWNERS TOTAL			25,000	25,000
MN TAXABLE - RAPID CITY OWNERS EACH			4,167	4,167
ND & MN TAXABLE - RAPID CITY OWNERS EACH			5,000	9,167

**RESULT:**

1. HB 1065, WITH THE HOUSE AMENDMENTS, PROVIDES THE SAME TAX RESULTS TO OUT OF STATE PARTNERS REGARDLESS IF THEY LOCATE AN OFFICE IN NORTH DAKOTA OR JUST ACROSS THE BORDER. IN THIS EXAMPLE, FARGO vs. MOORHEAD. HB 1065 WILL HAVE THE OUT OF STATE PARTNERS PAYING TAX ON \$5,000 OF INCOME COMBINED TO NORTH DAKOTA AND MINNESOTA REGARDLESS OF LOCATING AN OFFICE IN FARGO OR IN MOORHEAD.
2. HB 1065, WITHOUT THE HOUSE AMENDMENTS, MAKES A BIG DIFFERENCE WHERE A PROFESSIONAL PARTNERSHIP LOCATES ITS OFFICES. IN THIS EXAMPLE, HAVING OFFICES IN FARGO, DICKINSON AND RAPID CITY vs. MOORHEAD, DICKINSON AND RAPID CITY RESULTS IN \$30,000 COMPARED TO \$9,167 OF INCOME THAT THE OUT OF STATE PARTNERS WOULD PAY TAX ON TO NORTH DAKOTA AND MINNESOTA. IF THE DICKINSON OFFICE ALSO MOVED TO MONTANA, THE OUT OF STATE PARTNERS WOULD PAY NO TAX TO NORTH DAKOTA, AND THE COMBINED INCOME THEY WOULD BE TAXED ON IN MINNESOTA AND MONTANA WOULD BE \$5,000.

**HB 1065, WITHOUT THE HOUSE AMENDMENTS, IS A VERY SIGNIFICANT DETERRENT FOR A PROFESSIONAL PARTNERSHIP TO LOCATE OR EXPAND OFFICES IN NORTH DAKOTA.**