# MICROFILM DIVIDER

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

GREAT SEAL STATE OF NORTH DAKOTA

ROLL NUMBER

DESCRIPTION

2189

2001 SENATE INDUSTRY, BUSINESS AND LABOR

SB 2189

2001 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. SB 2189

Senate Industry, Business and Labor Committee

☐ Conference Committee

Hearing Date January 29, 2001

| Tape Number | Side A | Side B | Meter # |
|---|---|---|---|
| 1 | | x | 19.0 to 31.0 |
| 2 | x | | 19.4 to 20.1 |
| | | | |
| Committee Clerk Signature | | | |

Minutes:

The meeting was called to order. All committee members present. Hearing was opened on SB 2189 relating to a corporate income tax deduction for dividends paid to shareholders by a regulated investment company or a fund of a regulated investment company.

LYNN AAS, ND Holdings, favors the bill. Written testimony attached.

ROBERT WALSTAD, ND Holdings, favors the bill. Written testimony attached.

SIVER VINJE, ND Securities Commissioner, urge do pass. This will encourage business.

RICHARD OLSON, ND Holdings, urge do pass. Written testimony attached.

Chairman recognized presence of University of Mary students.

SENATOR ESPEGARD: Motion: Do Pass. SENATOR KLEIN: Second

Roll call vote: 7 yes; 0 no; 0 absent or not voting.

Committee reconvened. All members present.

SENATOR KREBSBACH: Motion: Reconsider this bill, amendment needed.

SENATOR KLEIN: Second.

SYVER VINJE: An effective date is needed, it is not retroactive.

SENATOR KREBSBACH: Motion: accept amendment. SENATOR ESPEGARD: Second.

Roll call vote: 7 yes; 0 no; 0 absent or not voting. Motion carried.

SENATOR KREBSBACH: Motion: Do pass as amended. SENATOR TOLLEFSON: Second.

Roll call vote: 7 yes; 0 no; 0 absent or not voting. Motion carried. Carrier: SENATOR

ESPEGARD

# FISCAL NOTE

**Requested by Legislative Council**
01/15/2001

Bill/Resolution No.: SB 2189

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 |
| | | | | | | | | |

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

SB 2189 creates an income tax deduction that appears to affect a minimal number of taxpayers in the state. The total potential negative fiscal impact is indeterminable and any information that may be available relative to this issue may be a violation of disclosure policies to address in this fiscal note.

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.*

| | | | |
|---|---|---|---|
| **Name:** | Kathryn L. Strombeck | **Agency:** | Tax Department |
| **Phone Number:** | 328-3402 | **Date Prepared:** | 01/26/2001 |

Date: 1/29/01
Roll Call Vote #: 1

**2001 SENATE STANDING COMMITTEE ROLL CALL VOTES**
**BILL/RESOLUTION NO. 2189**

Senate Industry, Business and Labor Committee

☐ Subcommittee on

or

☐ Conference Committee

Legislative Council Amendment Number

Action Taken DP

Motion Made By S Espegard Seconded By S Klein

| Senators | Yes | No | Senators | Yes | No |
|---|---|---|---|---|---|
| Senator Mutch - Chairman | ✓ | | Senator Every | ✓ | |
| Senator Klein - Vice Chairman | ✓ | | Senator Mathern | ✓ | |
| Senator Espegard | ✓ | | | | |
| Senator Krebsbach | ✓ | | | | |
| Senator Tollefson | ✓ | | | | |
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Total (Yes) 7 No 0

Absent 0

Floor Assignment S-Espegard

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

PROPOSED AMENDMENTS TO SB # 2189

Page 1, after line 18 insert:

"**SECTION 2. EFFECTIVE DATE.** This Act is effective for assessments made after December 31, 2000."

Renumber accordingly

Date:
Roll Call Vote #: 2

**2001 SENATE STANDING COMMITTEE ROLL CALL VOTES**
**BILL/RESOLUTION NO. 2189**

Senate Industry, Business and Labor Committee

☐ Subcommittee on

or

☐ Conference Committee

Legislative Council Amendment Number

Action Taken amendment adopted

Motion Made By KK Seconded By E

| Senators | Yes | No | Senators | Yes | No |
|---|---|---|---|---|---|
| Senator Mutch - Chairman | ✓ | | Senator Every | ✓ | |
| Senator Klein - Vice Chairman | ✓ | | Senator Mathern | ✓ | |
| Senator Espegard | ✓ | | | | |
| Senator Krebsbach | ✓ | | | | |
| Senator Tollefson | ✓ | | | | |
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Total (Yes) No

Absent

Floor Assignment

If the vote is on an amendment, briefly indicate intent:
To provide an effective date

Date: 1/29/01
Roll Call Vote #: 3

**2001 SENATE STANDING COMMITTEE ROLL CALL VOTES**
**BILL/RESOLUTION NO. 2189**

Senate Industry, Business and Labor Committee

☐ Subcommittee on ______
or
☐ Conference Committee

Legislative Council Amendment Number ______

Action Taken DPAA

Motion Made By S K Krebsbach Seconded By S Tollefson

| Senators | Yes | No | Senators | Yes | No |
|---|---|---|---|---|---|
| Senator Mutch - Chairman | ✓ | | Senator Every | ✓ | |
| Senator Klein - Vice Chairman | ✓ | | Senator Mathern | ✓ | |
| Senator Espegard | ✓ | | | | |
| Senator Krebsbach | ✓ | | | | |
| Senator Tollefson | ✓ | | | | |
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Total (Yes) 7 No 0

Absent 0

Floor Assignment S. Espegard

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

## REPORT OF STANDING COMMITTEE

**SB 2189: Industry, Business and Labor Committee (Sen. Mutch, Chairman)** recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** (7 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). SB 2189 was placed on the Sixth order on the calendar.

Page 1, line 4, after "company" insert "; and to provide an effective date"

Page 1, after line 18, insert:

"**SECTION 2. EFFECTIVE DATE.** This Act is effective for assessments made after December 31, 2000."

Renumber accordingly

2001 HOUSE INDUSTRY, BUSINESS AND LABOR

SB 2189

2001 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. SB 2189

House Industry, Business and Labor Committee

☐ Conference Committee

Hearing Date Feb. 28, 2001

| Tape Number | Side A | Side B | Meter # |
|---|---|---|---|
| 1 | X | | 0-20.1 |
| | | | |
| | | | |
| Committee Clerk Signature | | | |

Minutes: Chairman R. Berg, Vice-Chair G. Keiser, Rep. M. Ekstrom, Rep. R. Froelich, Rep. G. Froseth, Rep. R. Jensen, Rep. N. Johnson, Rep. J. Kasper, Rep. M. Klein, Rep. Koppang, Rep. D. Lemieux, Rep. B. Pietsch, Rep. D. Ruby, Rep. D. Severson, Rep. E. Thorpe.

Sen Karen Krebsbach: **Sponsor of bill.**

Lynn Aas: **Written testimony of bill in support.**

Chairman Berg: Is this similar to LLp's, and co-op's, and such?

Aas: Yes and it is identical to other states as well.

Rep Klein: If this were not passed?

Aas: We could be double taxed.

Bob Walstead: **Written testimony in support of bill.**

Rep Forelich: Has there been monetary increase for the state?

Walstead: Yes, 28-30 full time employees would lose jobs if we left. No other state taxes dividends at this level.

Rep Keiser: I move a do pass.

Rep M. Klein: I second.

**14 yea, 0 nay, 1 absent** **Carrier Rep Keiser**

Date: 2-28-01
Roll Call Vote #: 1

**2001 HOUSE STANDING COMMITTEE ROLL CALL VOTES**
**BILL/RESOLUTION NO. SB2189**

House Industry, Business and Labor Committee

Legislative Council Amendment Number ______

Action Taken Do Pass

Motion Made By Keiser Seconded By M. Klein

| Representatives | Yes | No | Representatives | Yes | No |
|---|---|---|---|---|---|
| Chairman- Rick Berg | ✓ | | Rep. Jim Kasper | ✓ | |
| Vice-Chairman George Keiser | ✓ | | Rep. Matthew M. Klein | ✓ | |
| Rep. Mary Ekstorm | ✓ | | Rep. Myron Koppang | ✓ | |
| Rep. Rod Froelich | ✓ | | Rep. Doug Lemieux | | |
| Rep. Glen Froseth | ✓ | | Rep. Bill Pietsch | ✓ | |
| Rep. Roxanne Jensen | ✓ | | Rep. Dan Ruby | ✓ | |
| Rep. Nancy Johnson | ✓ | | Rep. Dale C. Severson | ✓ | |
| | | | Rep. Elwood Thorpe | ✓ | |
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Total (Yes) 14 No 0

Absent 1

Floor Assignment Rep Keiser

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

## REPORT OF STANDING COMMITTEE

**SB 2189, as engrossed: Industry, Business and Labor Committee (Rep. Berg, Chairman)** recommends **DO PASS** (14 YEAS, 0 NAYS, 1 ABSENT AND NOT VOTING). Engrossed SB 2189 was placed on the Fourteenth order on the calendar.

2001 TESTIMONY

SB 2189

Lynn Aas

Statement In Support Of: SB 2189

I support SB 2189 because it provides for the pass-through of income to shareholders of mutual funds that are based in North Dakota. This bill would put in-state fund managers on a level playing field with the estimated 7,000 mutual funds in the United States that enjoy tax-free pass-through of income to investors. This includes North Dakota residents, who in turn are responsible for paying individual income tax.

Without this legislation, mutual funds headquartered in North Dakota could be singled out for an inadvertent and unintended application of tax code. Fair and equitable taxes are currently being paid by individual mutual fund investors nationwide and this bill would accommodate and encourage other mutual fund companies to look to North Dakota as a place to employ people and manage funds. Our state has only begun to share in the sponsorship of the $5 trillion dollar mutual fund industry. SB 2189 will accommodate additional management companies, large or small who may look to North Dakota as a place to establish offices.

North Dakota does not tax mutual fund companies which are based out-of-state. It wouldn't make sense to tax our own in-state funds. I will be glad to answer your questions on this matter.

/////

Industry Source: Investment Company Institute

Bob Waldstad

STATEMENT IN SUPPORT OF SB 2189

I support SB 2189 because:

* The bill is good for the promotion of professional jobs in North Dakota. Prior to 1989 there were no mutual fund companies operating in our state even though billions of North Dakota dollars have been invested in such funds. Today over thirty professional jobs exist and countless others could be recruited with the help of this legislation.

* SB 2189 allows for equitable investment in North Dakota by asset management firms. By encouraging small firms and major firms alike, our State could participate in the quest of significant financial service centers within our borders. Hundreds of jobs could be provided by any one of many financial companies if we were to clear the way through legislation such as SB2189.

* This bill infringes upon no one while it allows for new opportunities and diversification of our State's economy.

* This bill treats investors of North Dakota-managed funds fairly with respect to funds managed in other states. The attached letter attests to the fact that no other states impose taxes on mutual funds, but rather they allow for the pass-through of income to investors, who in turn deal with taxes individually.

* SB 2189 serves as a welcome signal to the financial services industry across the United States and worldwide.

Thank you for your consideration.

INVESTMENT COMPANY INSTITUTE

KEITH D. LAWSON
SENIOR COUNSEL

January 25, 2001

The Honorable Karen K. Krebsbach
President Pro Tem, North Dakota Senate
State Capitol
600 E. Boulevard Ave.
Bismarck, ND 58505-2916

RE: Clarification of the Tax-Exempt Status of Municipal Bond Funds

Dear Senator Krebsbach:

The Investment Company Institute[1] strongly supports the enactment of Senate Bill No. 2189. This important piece of legislation has been introduced by you, Senator Espegard and Senator Robinson to clarify North Dakota's tax treatment of mutual funds that hold municipal (or "muni") bonds issued by states (or political subdivisions of states) other than North Dakota.[2]

Specifically, Senate Bill No. 2189 will ensure that no North Dakota income tax is inadvertently assessed against *mutual funds managed by North Dakota mutual fund companies* (hereinafter "North Dakota-domiciled muni bond funds") on non-North Dakota muni bond interest that is distributed to the fund's shareholders.[3] The imposition of North Dakota tax on a North Dakota-domiciled muni bond fund holding non-North Dakota obligations would reduce the return to the fund's shareholders and thereby prevent the North Dakota-domiciled fund from competing effectively with a muni bond fund managed by a company located in *any* other state. *Every* other state, to our knowledge, recognizes the conduit nature of mutual funds and taxes muni bond interest (if at all) *only* at the shareholder level.

Mutual funds provide an ideal way for moderate-income people to invest in securities generally and muni bonds in particular. Specifically, mutual funds provide investors with interests in professionally managed, diversified pools of securities. Federal and state tax laws effectively treat mutual funds for most purposes as "pass-through entities," by providing mutual fund shareholders with tax treatment comparable to that received by direct investors in

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,433 open-end investment companies ("mutual funds"), 491 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.796 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

[2] We understand that a companion bill is sponsored in the House of Representatives by Representatives Berg, Mahoney and Price.

[3] Of course, to the extent that the fund's shareholders were North Dakota taxpayers, this income would be taxable, upon receipt, at the shareholder level.

securities. The elimination of fund-level tax (a critical element in pass-through treatment) is accomplished by a deduction funds may claim for dividends paid to shareholders (the "dividends paid deduction").[4]

The federal tax exemption for muni bond interest is provided by section 103 of the Internal Revenue Code ("IRC"), which exempts from federal income tax the interest income paid on state and local bonds of any of the 50 states (or political subdivisions thereof). IRC section 103 applies to muni bond interest received by a mutual fund. Since IRC section 103 exempts this income from tax at the fund level, mutual funds do not receive a dividends paid deduction when the muni bond interest is distributed to the fund's shareholders. IRC section 852(b)(2)(D). If a dividends paid deduction were provided for tax-exempt interest, funds effectively would receive a double benefit from the muni bond interest and could use the double benefit to retain tax-free at the fund level otherwise-taxable income.

Exempting a mutual fund's muni bond interest from federal tax at the shareholder level requires a special rule, however, because mutual funds are corporations for federal tax purposes and their distributions generally are treated as "dividends." The tax-exempt character of muni bond interest is preserved in the hands of the fund shareholder by IRC section 852(b)(5), which permits a fund to designate as an "exempt-interest dividend" the portion of the fund's distribution attributable to muni bond interest, so long as the fund invests at least 50 percent of its assets in muni bonds. An exempt-interest dividend is treated for all federal tax purposes as exempt from tax under IRC section 103.

Thus, although federal tax law does not provide a dividends paid deduction for dividends attributable to muni bond interest, it nonetheless treats the fund as a passing through the muni bond interest to its shareholders. This approach is consistent with the pass-through nature of mutual funds.

Taxation of muni bond income at the state level is a matter of state law. North Dakota provides, in North Dakota Century Code ("NDCC") sections 57-38-01.2(1)(g) and 57-38-01.3(1)(e), that interest income on North Dakota obligations is exempt from tax in the hands of the bondholders. NDCC section 57-38-01.3(1)(e) thus exempts North Dakota-domiciled funds from tax on interest income received from North Dakota muni bonds. Pursuant to NDCC section 57-38-01.2(1)(s), this tax exemption for North Dakota obligations applies as well when the interest income is received by a shareholder in North Dakota from a fund that is a qualified investment fund as described in NDCC section 57-38-01(9).

Interest income on non-home state muni bonds is taxable in North Dakota, as it generally is under the laws of most states, in the hands of its resident taxpayers. NDCC sections 57-38-01.2(1)(g) and 57-38-01.3(1)(e). Because federal tax law does not provide mutual funds with a deduction for dividends paid with respect to muni bond income (as such a deduction would, as noted above, provide funds with a double tax benefit), and because North Dakota

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[4] Those mutual funds that meet the requirements for treatment as regulated investment companies ("RICs") under Subchapter M (sections 851 *et seq.*) of the Internal Revenue Code ("IRC") may, pursuant to IRC section 852(b)(2)(D), claim the dividends paid deduction provided by IRC section 561.

generally conforms to federal law with respect to the calculation of a fund's taxable income,[5] it may be argued that North Dakota law inadvertently taxes North Dakota-domiciled funds on non-North Dakota muni bond interest. Nevertheless, as North Dakota generally conforms to federal tax law, and as one of the federal tax principles of mutual fund taxation is that funds are not taxed on income distributed to shareholders, it may be argued that North Dakota law effectively provides this exemption already.

Senate Bill No. 2189 would clarify that no fund-level tax is imposed on non-North Dakota muni bond interest distributed to shareholders by expressly providing North Dakota-domiciled funds with a dividends paid deduction for muni bond interest that otherwise would be taxed in North Dakota. This clarification should be enacted, first and most importantly, because the imposition of tax in such a situation would place North Dakota-domiciled funds at a significant competitive disadvantage compared to funds located in every other state. Second, given North Dakota's general treatment of a mutual fund as a pass-through entity that is not, itself, subject to tax, there is no tax policy reason to impose tax at the fund level on this income when tax will be collected again when the income is distributed to any fund shareholder taxable in North Dakota.

The pass-through principles implicitly embedded in North Dakota law are intended to ensure that North Dakota tax is collected only once when a North Dakota-domiciled fund distributes all of its income to its shareholders; tax is assessed after the income is received by shareholders resident in North Dakota. Senate Bill No. 2189 simply makes these pass-through principles explicit in order to avoid any possibility of inadvertent assessment of tax against North Dakota-domiciled funds investing in non-North Dakota muni bonds.

Because the proper tax treatment expressly provided by Senate Bill No. 2189 is critical to the competitiveness of North Dakota's mutual fund industry, and is consistent with the well-established treatment of mutual funds as pass-through entities, we urge its prompt enactment. If I can provide you with any additional information regarding the Institute's position on your bill or the tax treatment of muni bond funds by other states, please feel free to call me at (202) 326-5832.

Sincerely,

Keith Lawson
Senior Counsel

[5] NDCC sections 57-38-01.2(1) and 57-38-01.3(1).

Richard Olson
ND Holdings

(1)

**Impact Statement**
**RE: SB 2189**

Taxation of North Dakota Managed Mutual Funds

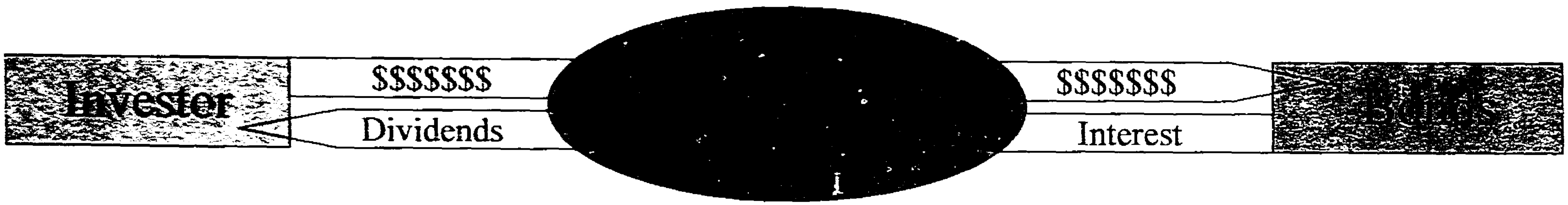
The taxation issue concerning mutual funds managed in North Dakota is critical to the two companies operating here in North Dakota. Mutual funds are designed to be "pass through" investment vehicles, where earnings and tax consequences are passed through to the investor. Placing any type of tax burden on these locally managed funds would lower their returns and put them in a position where they could not compete with other funds managed elsewhere. If the fund operations were to survive, they would be forced to move out of state.

That move would take over 30 jobs out of North Dakota and more than $1,000,000 per year in salaries. Additionally, these two companies cash flow more than $4,500,000 in operating revenues, a great deal of which is spent here in North Dakota. These companies also pay commissions to registered brokers who sell their funds. Since 1989, when the first fund was offered to the public, more than $9,321,000 has been paid to these brokers.

A chart is attached which points out the job potential of mutual fund management. In addition to professional positions within the advisory company, several in-state service providers are paid for auditing, custody, selling and promotion, printing and handling, legal, etc. Mutual fund management in North Dakota encourages investment and employment in our state and we should promote more development in this industry.

2

# Mutual Fund Structure




## A Mutual Fund….

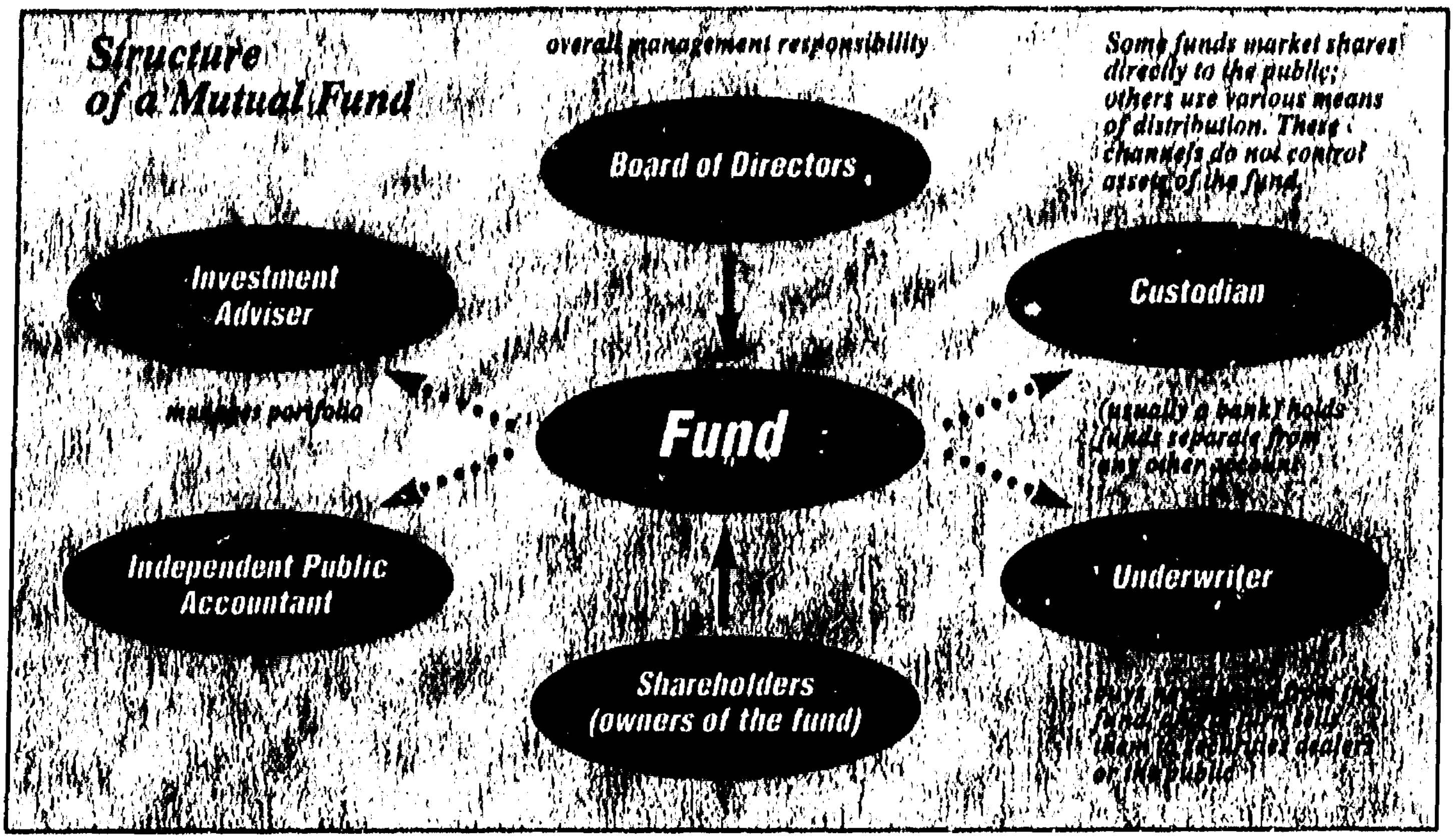
….**Pools Investor's Money**

….**Purchases Securities such as Bonds**

….**Collects the Interest on behalf of the Shareholders**

….**Passes the Interest through to the Investor in the form of a Dividend**

# Why Mutual Funds Don't Go Broke




Mutual funds are one of America's most popular investments. More than 28 percent of American households own at least one mutual fund investment. Although mutual funds are neither guaranteed nor insured, strong regulatory safeguards protect mutual fund shareholders from being affected by the financial misfortunes of mutual fund managers or affiliated companies. Here are answers to commonly asked questions about mutual fund protections:

***1.Q*** **What happens if my mutual fund goes broke?**

***1.A*** A mutual fund's assets can and will fluctuate in value, and even rise or fall substantially. But it would be virtually impossible for a fund's liabilities to exceed its assets. A mutual fund does not make loans. The market value or price of its assets (i.e., its securities holdings) is calculated daily. Thus it cannot go bankrupt or "broke."

***2.Q*** **What happens if the fund's management company (sponsor) goes bankrupt? Will I lose my money? I'm particularly worried when the bankrupt company is a private company, and I cannot obtain the types of information routinely available about publicly traded companies.**

***2.A*** Any financial difficulties that may be experienced by a fund's investment adviser, sponsor or underwriter will not affect the assets in your mutual fund. The fund is organized as a wholly separate company and has its assets held by a separate custodian. No creditor would have any recourse against the assets of your mutual fund to meet the obligations of an investment adviser, sponsor or underwriter.

Perhaps most important of all, under the Investment Company Act of 1940, mutual funds are subject to strict requirements governing custody of their securities and other investments. Most funds use bank custodians. The standard mutual fund custody agreement with a bank is far more elaborate and specific than the typical custody agreement for other bank clients. The SEC requires mutual fund custodians to protect the fund's assets by segregating them from the other assets held by the custodian. Fund custodians must refuse to deliver cash or securities except in the case of specified transactions and upon receipt of proper instructions from officers of the fund.

The 1940 Act also requires, among other things, fidelity bonding of officers and employees, annual audits by outside firms, detailed semi-annual reports that are filed with the SEC, and periodic financial reports to shareholders.