MICROFILM DIVIDER

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

ROLL NUMBER

DESCRIPTION

2054

LaCosta Rickford 10/15/03
Operator's Signature Date

2003 SENATE FINANCE AND TAXATION

SB 2054

2003 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. SB2054

Senate Finance and Taxation Committee

☐ Conference Committee

Hearing Date January 15, 2003

Tape Number	Side A	Side B	Meter #
1	X		1,980
Committee Clerk Signature			

Minutes:

Senator Urlacher opened the hearing on SB2054. There is a fiscal note attached. All committee members were present.

Senator Rich Wardner, Interim Tax Committee Chairman (meter #1980) - Would like to change the perception that North Dakota has a high corporate income tax rate. Currently our top corporate tax rate is at 10.5%. The one thing is, the fiscal note changed since looking at it in the Interim Committee. The reason the bill was brought forward is that, when attracting companies to ND, they do not seem to take a look at the total graduated tax structure. To make ND more attractive we are looking at a flat tax that would be close to revenue neutral. May have to tweak the percentages a little bit to get it to revenue neutral. Need to take a look at this issue because the perception is out there that ND has high corporate tax rates.

Senator Randy Schobinger (meter #2340) - This is the minimum we need to do. The perception around the country is that we have the highest corporate income tax rate in the country. We can't afford to be high in tax rate. This bill proposes a flat corporate tax rate of 6.84%. This would send a message that ND is moving in the right direction. Anything that we can do to make this state more attractive to industry is good for ND and I would ask the Finance and Tax Committee to give this bill a Do Pass.

John Walstad Legislative Council (meter #2495) - Distributed copies of a portion of the study by the Interim Tax Committee. Copy attached. The concept is fairly simple. The idea here is to bring down the perceived rate of the corporate income tax in ND. The top rate now is 10.5%. One of the easiest ways to bring that rate down, that is revenue neutral to the state, is to eliminate the corporate income tax deduction for federal income taxes paid. ND is one of only four states that allows that deduction. Dropping that deduction allows 3% points to be taken out of that high end corporate tax rate. The Interim Committee had two bills under consideration that were essentially the same, one bill was revenue neutral but the rates were different, but this bill did have a fiscal impact and the fiscal note attached to this bill is right on. This bill also has fiscal impact during the current biennium. Bottom of first page, financial institution tax does not change. Getting rid of c and h references. Subsection c gets rid of the deduction for federal income tax. Adding subsection i, will allow financial institutions to continue to have that deduction. On page 6, lines 11-22, the corrections are significant. The changes make the maximum rate of 10.5% into a flat corporate income tax rate on 6.84%. The purpose of the bill was to achieve a reduction, and you can see that reduction. (meter #3070) Definition of Waters Edge corporate filer. For tax purposes we don't consider income outside of US. In order to maintain fairness and keep bill revenue neutral in the case of Waters Edge filers, the bill provides for a flat tax rate of 9.9% for Waters Edge filers only.

Senator Tollefson (meter #3275) - Question tweaking to bring bill to revenue neutral.

Mr. Walstad (meter #3320) - Tweaking is certainly an option, if done the Waters Edge filers rate would be increased.

Rick Clayburgh State Tax Commissioner (meter #3435) - For the record, the Tax Dept is in a neutral position on this bill. Would encourage the committee not to act quickly on this bill. There are number of other pieces of legislation that are being introduced that will address corporate income tax issue. This is an area of interest to me because of the perception that ND has the highest corporate tax rate. By implementing a flat rate, you can have unintended consequences. Right now there are some small corporations that are paying less than the flat tax rate. A flat rate would create winners and losers in the state, the fiscal note could then have a higher impact than what is intended. But we do need to eliminate artificial barriers for companies to do business here. Urge the committee to take your time on this issue, it is a very important one.

Senator Nichols (meter #3750) - With regard to Waters Edge, things intended and unintended with change to flat tax, how does this effect Waters Edge filers.

Mr. Clayburgh (meter #3830) - The Waters Edge status, is an advantageous filing status. The issue with changing the rate, the flat rate will mean a higher rate for some. Could mean some reorganizations of corporate charters, may mean less corporate filers, but more income passing through to individual filers.

Dennis Boyd, MDU Resources Group (meter #4260) - This issue has been of interest to my company for the past fifteen years. We are not opposed to the bill, but it is a very sensitive issue. It effects different tax payers differently. The argument of using this as an economic development tool is suspect, I feel that anyone that is serious about doing business in ND, is not going to use information from the web site. This bill would be slightly beneficial to my company, but worried about "tweaking". The best economic development tool you could do is to totally eliminate corporate income tax. Again, this is a sensitive issue, urging caution.

Senator Urlacher - We will be cautious. Any other testimony? Hearing closed.

General discussion by committee members followed.

Senator Tollefson (meter #5135) - If Senator Schobinger's bill comes to pass, would eliminate the need for this bill.

Hold bill for further review.

2003 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. SB2054

Senate Finance and Taxation Committee

☐ Conference Committee

Hearing Date January 21, 2003

Tape Number	Side A	Side B	Meter #
1	X		4,090
Committee Clerk Signature [signature]			

Minutes:

Senator Urlacher opened the hearing on SB2054. All committee members are present. This bill relates to changing the corporate income tax rate from a graduated rate to a flat rate.

Senator Wardner - This bill came from the Finance and Tax Interim Committee. It has a very large fiscal note, I'm not sure we can afford to do this.

Senator Wardner - Motion to Do Not Pass. 2nd by Senator Tollefson. Roll call vote 6 yea, 0 nay, 0 absent. Carrier is Senator Wardner.

General Discussion

Senator Nichols - This is a good concept, but anybody that is serious about doing business here will look closer at our tax structure.

Senator Tollefson - The timing for this bill is wrong.

FISCAL NOTE
Requested by Legislative Council
12/13/2002

Bill/Resolution No.: SB 2054

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.*

	2001-2003 Biennium		2003-2005 Biennium		2005-2007 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues	($700,000)		($3,200,000)		($4,500,000)	
Expenditures						
Appropriations						

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

2001-2003 Biennium			2003-2005 Biennium			2005-2007 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.*

If enacted, SB 2054 would repeal the corporate federal income tax deduction, remove the tax brackets, impose a flat corporate tax rate of 6.84% for the majority of taxpayers, and a flat rate of 9.9% for those taxpayers utilizing the Water's Edge filing option.

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.*

The bill is effective beginning with tax year 2003. The revenue loss in the current biennium is due to a reduction in the estimated payments on tax year 2003 liabilities. The estimated loss for the 2003-05 biennium reflects the 5% rate reduction on the portion of biennial revenues that are from 2003 and subsequent tax years. The estimate for the 05-07 biennium reflects the estimated fiscal impact assuming all returns filed in that biennium will be at the lower, flat rate.

   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 Dept.
Phone Number:	328-3402	**Date Prepared:**	01/13/2003

Date: 1.21.03
Roll Call Vote #: 1

2003 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. SB . 2054

Senate Finance and Taxation Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number

Action Taken Do not pass

Motion Made By Sen. Wardner Seconded By Sen. Tollefson

Senators	Yes	No	Senators	Yes	No
Senator Herb Urlacher-Chairman	✓		Senator Ronald Nichols	✓	
Senator Rich Wardner-Vice Chair.	✓		Senator Tom Seymour	✓	
Senator John W. Syverson	✓				
Senator Ben Tollefson	✓				

Total (Yes) 6 No 0

Absent

Floor Assignment Senator Wardner

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

REPORT OF STANDING COMMITTEE

SB 2054: Finance and Taxation Committee (Sen. Urlacher, Chairman) recommends **DO NOT PASS** (6 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). SB 2054 was placed on the Eleventh order on the calendar.

2003 TESTIMONY

SB 2054

In 1981 the highest corporate income tax rate was reduced to 7 percent and applied to income exceeding $50,000 per year.

In 1983 corporate income tax rates were increased by 50 percent. After the 1983 changes, which are still in effect, North Dakota corporate income tax rates are:

Taxable Income	Taxable Rate
$3,000 or less	3.0%
Over $3,000 but not over $8,000	4.5%
Over $8,000 but not over $20,000	6.0%
Over $20,000 but not over $30,000	7.5%
Over $30,000 but not over $50,000	9.0%
Over $50,000	10.5%

Exempt Corporations

An insurance company paying the insurance premiums tax is exempt from the corporate income tax. Insurance company earnings from business activities not subject to insurance premiums taxes are subject to corporate income taxes.

Financial institutions paying a financial institutions tax are exempt from corporate income taxes. Financial institutions pay a tax of 7 percent of taxable income.

Any organization exempt from the federal income tax is exempt from state income taxes. A substantial number of corporations, including several kinds of nonprofit corporations, are exempt from federal income taxes under the Internal Revenue Code. The most common basis for invoking tax-exempt status is an exemption for organizations operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes or to foster national or international sports competition or prevent cruelty to children or animals. Other Internal Revenue Code provisions provide exemptions for civic leagues or social welfare organizations; labor, agricultural, or horticultural organizations; business leagues, chambers of commerce, real estate boards, and boards of trade; social clubs; credit unions; farmers' cooperatives; political parties; homeowners' associations; fraternal benefit societies; cemetery companies; local life insurance associations; mutual irrigation companies; or mutual or cooperative telephone companies or similar organizations; certain insurance companies; certain United States instrumentalities; teachers' local retirement fund associations; certain fraternal organizations; farmers' cooperative associations; certain veterans' organizations; qualified state tuition programs; and certain other special purpose corporations.

Taxable Income of Corporations

The starting point for determinati[illegible] of North Dakota corporate income taxes is a corr[illegible]'s federal taxable income. Corporate taxable inc[illegible] can be an extremely complicated calculation but simply stated consists of gross income minus deductions. Federal gross income includes gross profit, determined by totaling gross sales and gross receipts from services minus the cost of goods sold; receipts from dividends, interest, rents, and

CORPORATE INCOME TAX STUDY

Background

Tax Rates History

Corporate income taxes were first imposed in North Dakota in 1919, with the imposition of a flat rate tax of 3 percent on total net income of corporations. The 1919 legislation also imposed an additional tax of 5 percent on total net income of corporations received during a calendar or fiscal year and remaining undistributed six months after the end of that year.

In 1923 the corporate income tax was imposed at a flat rate of 3 percent of net income taxable to this state, and provisions were added for allocation of income to the state. The 5 percent additional tax on undistributed income was eliminated.

In 1937 a graduated corporate income tax rate structure was created. The highest rate, 6 percent, was applied to corporate income exceeding $15,000 per year.

In 1978 an initiated measure was approved by the voters to add a rate of 8.5 percent for corporate taxable income exceeding $25,000.

royalties; net gain on sales or exchanges; and other income. Deductible expenses include salaries and wages of officers and employees, repairs, bad debts, rents, taxes, interest expenses, losses on sales or exchanges, contributions, amortization, depreciation, depletion, advertising, pension and profit-sharing, employee benefits, casualty losses, research and experimental costs, and certain other special deductions.

The North Dakota corporate income tax applies to the portion of a corporation's taxable income that is derived from sources within North Dakota. A corporation that conducts business only within North Dakota uses its federal taxable income as its North Dakota taxable income. A corporation that conducts business inside and outside North Dakota must apportion its federal taxable income to determine the portion that is attributable to sources within North Dakota. The apportionment factor is a percentage that is the average of North Dakota property, payroll, and sales compared to the corporation's total property, payroll, and sales.

Unitary Business Reporting

A corporation that is part of a unitary business involving one or more corporations, including consideration of operations outside the United States, must file using the combined reporting method. A "unitary business" is a group of corporations carrying on activities that transfer value among themselves through the unities of ownership, operation, and use. Unity of ownership means the group is under the common control of a single corporation, which is also a member of the group. Control exists when the controlling corporation directly or indirectly owns more than 50 percent of the voting stock of a controlled corporation. Unity of operation means the group receives benefits from functional integration or economies of scale. Unity of use means the group of corporations contributes to or receives benefits from centralized management and policy formation. When unity of ownership exists, there is a presumption that the corporations are engaged in a unitary business if all activities of the group are in the same general line or type of business, activities of the group constitute different steps in a vertically structured enterprise, or the group is characterized by centralized management.

North Dakota is one of 23 states that have adopted the Uniform Division of Income Tax Act. This provides for apportionment of corporate income and contains detailed provisions relating to property, payroll, and sales factor computations.

Water's Edge Election

A corporation required to file its North Dakota return using the worldwide unity combined reporting method may elect to use the "water's edge" method. This election allows exclusion of consideration of most corporate income sourced outside the United States. The water's edge election must be made on the return as originally filed and is binding on the corporation for five consecutive years. If the election is made, the corporation may not use the deduction for federal income taxes paid. A corporation electing to use the water's edge method must file with the Tax Commissioner a domestic disclosure spreadsheet and must refile the spreadsheet every third year while the election remains in effect. A domestic disclosure spreadsheet must fully disclose income reported to each state, state tax liability, the method used to apportion or allocate income to the various states, and other information required to determine the proper tax due to each state and to identify the water's edge group.

Deductions, Additions, Credits, and Exemptions

A corporation is entitled to subtract from taxable income each of the following items:

1. Interest received from obligations of the United States included in taxable income on the federal return.
2. Income included in taxable income on the federal return which is exempt from taxation by the state under the Constitution of the United States or the Constitution of North Dakota.
3. The amount of federal income tax liability to the extent those taxes are computed on income that becomes part of North Dakota taxable income.
4. Net income not allocated and apportioned to this state which was included in federal taxable income.
5. Dividends received by the corporation from a corporation that has paid North Dakota corporate income taxes or from a financial institution that has paid financial institutions taxes under NDCC Chapter 57-35.3.

The following must be added to taxable income:

1. Income taxes, including taxes of foreign countries, that were deducted to determine federal taxable income.
2. Interest and dividends from foreign securities and securities of states and political subdivisions exempt from federal income taxes, but not including obligations of the state of North Dakota or any of its political subdivisions.
3. Accelerated cost-recovery system depreciation on assets placed in service in 1981 or 1982.
4. Safe-harbor lease amounts deducted on the federal return if the minimum investment by the lessor is less than 100 percent.

Corporate income tax credits are allowed for:

1. Wages and salaries paid by a new business, in the amount of 1 percent of all wages and salaries for the first three years and one-half of 1 percent of all wages and salaries for the fourth and fifth years. A corporation that receives a new or expanding business income tax exemption under NDCC Chapter 40-57.1 does not receive this credit.
2. Investment in a North Dakota venture capital corporation in the amount of 25 percent of the investment or $250,000, whichever is less.
3. Investment in a small business investment company, limited to 25 percent of the amount invested.

4. Investment in a certified nonprofit development corporation, limited to 25 percent of the amount invested.
5. Research and experimental expenditures incurred within North Dakota.
6. Contributions to nonprofit private high schools and nonprofit private colleges in the state.
7. Installation of geothermal, solar, or wind energy devices.
8. Installation of alternative fuel equipment on a North Dakota licensed motor vehicle.
9. A portion of North Dakota wages paid to a developmentally disabled or chronically mentally ill employee.
10. Qualified investments in a North Dakota renaissance fund corporation.
11. Investment in historic property preservation or renovation in a renaissance zone.

Certain activities are exempt from corporate income taxes. A new or expansion project in primary sector business or tourism qualifies for an income tax exemption for up to five years. The exemption is limited to income earned from the qualifying project and the operator is required to file a return even though an exemption is granted. A project may not receive the exemption if the project receives a tax exemption under tax increment financing, the exemption fosters unfair competition or endangers existing business, or there is a recorded lien for delinquent property, income, or sales or taxes against the project operator or principal ...ers.

Renaissance zone exemptions are available to exempt business income for five years for purchasing or leasing renaissance zone real property for use in the business or for improving renaissance zone real property used in the business. A renaissance zone exemption is also available for investment income for five years from renaissance zone residential or commercial real property purchased solely for investment purposes.

Tax Collections

The corporate income tax is a significant source of revenue for the state general fund. The following table shows corporate income tax collections in recent years:

Fiscal Year	Net Collections
1990	$40,486,001
1991	$49,321,208
1992	$36,778,251
1993	$42,525,921
1994	$50,727,400
1995	$44,027,738
1996	$49,047,417
1997	$50,300,520
1998	$65,543,026
1999	$57,877,194
2000	$47,528,001
2001	$51,606,853

Committee Consideration

The committee received information from several sources on the significance of corporate income taxes as a business location factor. Testimony supported the conclusion that state tax policy is not a primary consideration of businesses in choosing a location for new or expanding business. Even when tax policy becomes a consideration, it is not only corporate income taxes that must be considered but also workers' compensation and unemployment insurance rates, property taxes, and other state and local government costs of business. Studies of the issue indicate that tax policy is only a small part of business costs, but it receives attention because businesses view taxes as negotiable by use of tax incentives in business location decisions. The Economic Development and Finance Division applied an economic analysis model to gauge the effect on the North Dakota economy of eliminating the corporate income tax. The analysis projects increases in employment and statewide economic output, but these gains did not offset the loss of corporate income tax revenue to the state. A Tax Department analysis of the same issue concluded that it would be necessary to create 75,000 new jobs paying an average annual salary of $50,000 to offset the revenue lost to the state from elimination of the corporate income tax.

The committee considered a bill draft that would have repealed the corporate income tax. The Tax Department estimated the fiscal effect of repeal of the corporate income tax as a loss of $8.6 million in the first six months of 2003 and a loss of $79.5 million in the 2003-05 biennium. The committee makes no recommendation with respect to the bill draft.

North Dakota is one of five states that allow a corporate income tax deduction based on the amount of federal corporate income taxes paid. A revenue-neutral elimination of the federal income tax deduction for North Dakota corporations would result in a substantial reduction in the corporate income tax rates in North Dakota. However, the change would not be revenue-neutral for all corporations. Because of variable circumstances of corporations, eliminating the federal income tax deduction and making a corresponding reduction in the state corporate income tax rates would result in some paying more and some paying less than they pay under current law. The committee considered but makes no recommendation with respect to a bill draft that would have eliminated the federal income tax deduction and made corresponding revenue-neutral reductions in state corporate income tax rates.

Recommendation

The committee recommends Senate Bill No. 2054 to eliminate the federal income tax deduction for state income tax purposes and to replace existing graduated corporate income tax rates with a corporate income tax flat rate of 6.84 percent. The bill provides a corporate income tax flat rate of 9.9 percent for taxable income of corporations filing under the water's edge election. The reason for the higher rate for water's edge filers is that under current law, those filers must forego the federal income tax deduction for the privilege of filing on a water's edge basis and because the federal income tax deduction is eliminated by the bill, not imposing taxes at a higher rate would provide a much greater incentive for filing on a water's edge basis than exists under current law. The bill is intended to enhance the attractiveness of North Dakota's tax climate by reducing corporate income tax rates from the existing high of 10.5 to 6.84 percent. The fiscal effect of the bill is estimated to be a loss of $700,000 in the first six months of 2003 and a loss of $3.2 million for the 2003-05 biennium.