



North Dakota Legislative Council

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ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - MANUFACTURING AND RECYCLING SALES TAX EXEMPTION

Pursuant to North Dakota Century Code Section 54-35-26, enacted in 2015, a variety of economic development tax incentives must be reviewed by a Legislative Management interim committee once in each 6-year review cycle. The purpose of the review is to ensure economic development tax incentives are serving their intended purposes in a cost-effective and equitable manner. This memorandum is provided to assist in the review of the manufacturing and recycling sales tax exemption and provides an explanation of the incentive, the perceived goals of the Legislative Assembly in creating or altering the incentive, the outcome of past reviews of the incentive, and the data and testimony required to conduct an effective analysis of the incentive.

EXPLANATION OF THE MANUFACTURING AND RECYCLING SALES TAX EXEMPTION

Section 57-39.2-04.3 provides a sales tax exemption for machinery or equipment used directly in manufacturing or recycling tangible personal property. For purposes of the exemption, manufacturing includes the meaning normally ascribed to the term and the processing of agricultural products but does not include mining or refining activities, oil and gas extraction, or the generation of electricity. Recycling is defined as the collection or recovery of materials that otherwise would be waste and conversion of those materials to a product for sale or a raw material for use in manufacturing.

To qualify for the exemption, the machinery or equipment must be used in a new manufacturing plant or recycling facility or used to create a physical or economic expansion of an existing plant or facility. An economic expansion is classified as an increase in production volume, employment, or the types of products that can be manufactured or recycled. To receive the exemption at the time of purchase, a manufacturer, recycler, or customer must receive a certificate from the Tax Commissioner verifying the machinery or equipment the manufacturer, recycler, or customer intends to purchase qualifies for the exemption. If a certificate of exemption is not received before the purchase, the manufacturer, recycler, or customer may apply to the Tax Commissioner for a refund of the applicable amount of tax paid. If a contractor purchases or installs the machinery or equipment, the manufacturer or recycler may apply for a refund of the amount of sales tax paid by the contractor on qualifying items.

For purposes of the exemption, equipment means a mold purchased by a customer and used directly by a manufacturer in the manufacturing process and any tangible personal property other than machinery used directly in the manufacturing or recycling process. Machinery means mechanical devices purchased or constructed by the manufacturer, recycler, or an agent and used directly in the manufacturing or recycling operation. The term includes devices used to package and process products leaving the manufacturing plant or recycling facility; electrical, mechanical, and electronic components necessary for the operation of the machinery; environmental control equipment; and computer equipment that controls or monitors the functions of the machinery. Machinery and equipment do not include hand tools, buildings, administrative equipment, transportation equipment, or any other equipment not used directly in manufacturing or recycling.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING THE MANUFACTURING AND RECYCLING SALES TAX EXEMPTION

Provisions of the manufacturing and recycling sales tax exemption were first enacted in 1991 with the passage of House Bill No. 1048. As originally enacted, the exemption applied only to manufacturing machinery and equipment used directly in manufacturing tangible personal property or processing agricultural products. The exemption replaced an existing 3 percent reduced sales tax rate on these items, which was enacted in 1989. Upon a review of the legislative history for the bill, the perceived goal of the Legislative Assembly in creating the exemption was to attract new manufacturing plants to the state and encourage the expansion of existing manufacturing plants. The exemption was viewed as a driver for job creation and increased income tax collections as a result of manufacturing plant construction and expansion. It was estimated the exemption would reduce general fund

revenue by \$2 million to \$3 million during the 1991-93 biennium, though the reduction might be offset partially by increased income tax collections.

The exemption was amended several times following its enactment. Senate Bill No. 2051 (1993) expanded the exemption to apply to machinery or equipment used directly in a new recycling facility or in the physical or economic expansion of an existing recycling facility. The expanded provisions were subject to a sunset date of July 1, 1995. Senate Bill No. 2509 (1993) expanded the definition of machinery to include environmental control equipment and devices purchased or constructed at any point from the initial stages of manufacturing through the completion and packaging of an end product. House Bill No. 1520 (1994) expanded the definition of "used directly" to include machinery and equipment used to conduct research, and development and design activities related to the manufacturing process of the plant. The bill expanded the definition of machinery to include computer equipment that controls or monitors the function of machinery used in the manufacturing process and devices used through the completion of the product, including packaging and all processes before the completed product is transported from the plant. The bill also required machinery or equipment be used in the manufacturing process at least 50 percent of the time to qualify for the exemption. Senate Bill No. 2077 (1995) removed the sunset date on the expanded recycling facility provisions. Senate Bill No. 2421 (1999) temporarily expanded the definition of manufacturing to include the refining of crude oil through July 31, 2002.

More recently, Senate Bill No. 2094 (2015) allowed a customer to qualify for an exemption at the time of purchase or apply for a refund of sales tax paid on a mold purchased by a customer and used directly by a manufacturer in the manufacturing process. House Bill No. 1044 (2017) created a uniform definition of "primary sector business" in Title 1, which expanded the definition previously referenced in Section 57-39.2-04.3 to include a definition of "new wealth."

PAST REVIEW OF THE MANUFACTURING AND RECYCLING SALES TAX EXEMPTION

The manufacturing and recycling sales tax exemption was reviewed by the 2019-20 Taxation Committee. During the course of its study, the committee received data from a representative of the Tax Department regarding the number of claimants and the amount exempted in relation to the manufacturing and recycling sales tax exemption. The data indicated an aggregate total of \$15,915,697 in sales tax was not collected from 255 taxpayers from fiscal years 2015 to 2019 as a result of the manufacturing sales tax exemption, and \$420,371 was not collected from 32 taxpayers as a result of the recycling sales tax exemption during the same period. The committee did not receive testimony from interested parties in support of retaining, eliminating, or modifying the sales tax exemption. The committee did not identify any concerns relating to the exemption or ways in which the exemption could be improved. The committee indicated the exemption was operating as intended. The committee did not recommend any legislation to eliminate or modify the exemption.

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF THE MANUFACTURING AND RECYCLING SALES TAX EXEMPTION

Data pertaining to the following items will need to be collected to effectively analyze the incentive:

1. The number of claimants;
2. The fiscal impact of the incentive;
3. Employment opportunities, business growth, or diversity in the state's economy resulting from the availability of the incentive;
4. Negative impacts created as a result of the incentive; and
5. Benefits that flow to out-of-state concerns resulting from the incentive.

Testimony will need to be solicited from the following parties to effectively analyze the incentive:

1. The Department of Commerce;
2. The Tax Department; and
3. The North Dakota Economic Development Foundation.