

NORTH DAKOTA LEGISLATIVE COUNCIL

Minutes of the

TAXATION COMMITTEE

Tuesday, June 18, 2002
Roughrider Room, State Capitol
Bismarck, North Dakota

Senator Rich Wardner, Chairman, called the meeting to order at 9:00 a.m.

Members present: Senators Rich Wardner, Dwight Cook, Kenneth Kroeplin, Ronald Nichols, Randy A. Schobinger, Ben Tollefson, Herb Urlacher; Representatives Michael Brandenburg, David Drovdal, Gil Herbel, Frank Klein, Eugene Nicholas, Dennis J. Renner, Earl Rennerfeldt, Dan Ruby, Arlo E. Schmidt, Ray H. Wikenheiser

Members absent: Representatives Al Carlson, Byron Clark, Michael Grosz, Joe Kroeber, Edward H. Lloyd, Kenton Onstad

Others present: See Appendix A

It was moved by Representative Klein, seconded by Representative Brandenburg, and carried on a voice vote that the minutes of the previous meeting be approved as distributed.

SUBSIDIZED HOUSING VALUATION

Chairman Wardner called on committee counsel to review a bill draft to provide a partial property tax exemption for certain subsidized housing properties. Committee counsel said this bill draft was reviewed by the committee at its April 2002 meeting and no changes have been made to the bill draft after that meeting. He said the bill draft provides a partial property tax exemption for housing that qualifies for the credit under Section 42 of the Internal Revenue Code. He said these properties would be valued under normal procedures and then an amount would be subtracted from the value as determined under the exemption in the bill draft. He said there are two components to the exemption. He said the first component is the value of a leasehold rent limitation under Section 42 of the Internal Revenue Code. He said this value is the value to the renter of having restrictions on rent. He said the second component of the exemption is the amount of or value received for the income tax credit under Section 42 of the Internal Revenue Code. He said the final sentence of the exemption provides that the exemption ceases when rent restrictions no longer apply to the property. He said the bill draft is limited to apply only to property under Section 42 of the Internal Revenue Code and if other subsidized housing programs are to be addressed, it would be necessary to specifically include those programs in the bill draft. He said the

bill draft is to become effective for the 2004 taxable year and it could be made effective one year earlier if the committee wishes.

Chairman Wardner called on Mr. Ben Hushka, Fargo City Assessor, for comments regarding the subsidized housing property tax exemption bill draft. A copy of Mr. Hushka's prepared testimony is attached as Appendix B.

Mr. Hushka said he was requested to provide an overview of how the assessment process would operate on property that would qualify for the exemption that would be provided by the bill draft.

In response to questions from Senator Cook, Mr. Hushka said there are three basic approaches to valuation of property, which include the income approach, cost or replacement approach, and sales comparison or market approach. He said the approach used for property will be determined in each case by the best data available to the assessor. He said each of these valuation methods would still be available to the assessor if the bill draft becomes law and the exemption would just be a deduction from the value of property determined under one of these approaches.

Representative Drovdal asked whether existing law provides an option for cities to allow an exemption as provided under the bill draft. Mr. Hushka said cities have the option to allow an exemption like this on new industries. Committee counsel said one difference between the bill draft and the new industry exemptions or payments in lieu of taxes under North Dakota Century Code (NDCC) Chapter 40-57.3 is that the exemptions that may be granted under NDCC Chapter 40-57.3 are for a limited time. Mr. Hushka said that is correct and exemptions are limited to five years' duration or payments in lieu of taxes may be extended for up to 20 years. Mr. Hushka said another substantial difference is that without enactment of the bill draft, it would be discretionary with cities as to whether this deduction would be allowed. He said the decision would be made on a case-by-case basis and if the bill draft is passed, the exemption would become uniform across the state.

In response to a question from Senator Nichols, Mr. Hushka said he believes all three approaches to valuation would still be usable if the bill draft is enacted.

Senator Cook said Article X, Section 5, of the Constitution of North Dakota requires uniform taxation of property. He asked whether this bill draft would create a special class of property, which might violate the uniformity requirement. Mr. Hushka said it is true that any exemption creates a special class of property. Committee counsel said the uniformity of taxation requirement of the constitution does not prohibit classification of property by the Legislative Assembly. He said the uniformity provision is intended more to prevent identical properties being taxed and assessed differently in different parts of the state.

Representative Schmidt asked whether the bill draft approach would require more assessment staff and more training to do these assessments. Mr. Hushka said education would be needed for assessment staff to provide for uniform application. He said he does not believe additional assessment staff would be required.

Chairman Wardner called on Ms. Marcy Dickerson, State Supervisor of Assessments, Tax Department, for comments on the bill draft providing a property tax exemption for subsidized housing. A copy of Ms. Dickerson's prepared testimony is attached as Appendix C.

Ms. Dickerson expressed concern that the bill draft would open the door to owners of other types of property to request similar legislation to reduce property valuations. She said she has already been asked how income tax credits will be treated for valuation of centrally assessed wind turbine electric generators. Senator Wardner asked what other types of properties would be suggested for similar treatment if this legislation is passed. Ms. Dickerson said any property for which income tax credits are received would be subject to the same arguments. She said the only example that has been brought to her attention at this time is wind generators.

Chairman Wardner called on Mr. Steve Stoner for comments on the subsidized housing valuation bill draft. Mr. Stoner said he is a private developer from Fargo who has developed properties under the Internal Revenue Code Section 42 exemption. He said it was suggested earlier in the meeting that payments in lieu of taxes are an option to allow cities to provide reduced assessments for these types of properties. He said his experience with applications for payments in lieu of taxes is that treatment has not been uniform among cities. He said different treatment may even be provided for properties within one city.

Mr. Stoner said it is important to develop a uniform approach for valuation of Internal Revenue Code Section 42 property. He said he believes about 60 percent of apartment housing built in the United States last year was constructed using the Internal Revenue Code Section 42 exemption.

Mr. Stoner said Ms. Dickerson suggested that owners of similar types of property might seek legislation providing partial exemptions. He said he does not view distinguishing other properties as a problem. He said wind energy generating property differs from Internal Revenue Code Section 42 property because federal law does not limit wind energy generating property in what can be charged. He said federal law limits rents that may be charged for rental property, which is the reason it is appropriate to reduce valuation of the property. He said the idea behind the proposed legislation is that Internal Revenue Code Section 42 projects of better quality are not economically feasible without a reduction in the property tax bill. He said these projects require this valuation reduction to allow development of quality affordable housing.

Mr. Stoner said he believes legislation under consideration is necessary to avoid the current situation of trying to get assessment reduction on each property as it is developed. He said seeking reductions on each property does not provide equal treatment for all similar properties. He said this incentive is especially important for high-quality projects that communities want. He said for lower-priced projects, this approach probably will not affect valuation. He said lower-priced projects would probably not see a change in valuation if the bill draft is enacted.

Senator Cook reviewed statistics on Internal Revenue Code Section 42 properties in the state. He said it appears there are only five or six developers of these types of property in the state. Mr. Stoner said that is correct and he would like to see some encouragement for developing these types of properties because these properties provide a public benefit.

Senator Cook said Internal Revenue Code Section 42 has been used for property development usually only in larger cities and other programs have been used in smaller cities. Mr. Stoner said that has been the pattern, but he does not believe it is required by law.

Senator Schobinger said the subsidy program produces better housing and asked whether it also discourages developing projects that are not subsidized. Mr. Stoner said other projects are not discouraged because there is still a demand for housing for those who cannot qualify for occupancy of income-restricted apartments.

Chairman Wardner called on Mr. Jim Knutson for comments on the subsidized housing bill draft. Mr. Knutson said he is a developer of subsidized housing who resides in Valley City. Mr. Knutson said this legislation originated after a meeting with Tax Department representatives and developers were advised that this type of legislation was necessary because existing law would not allow reduced valuation for Internal Revenue Code Section 42 property. He said after that meeting, interested parties proceeded accordingly. He said he is concerned to

now hear that existing law allows reduced valuations. He said he believes the legislation is necessary to provide for uniform reductions in valuation across the state.

Mr. Knutson said to subject subsidized housing property to the same taxes as nonsubsidized housing is to impose the same tax burden on low-income tenants as imposed on other tenants.

Senator Schobinger asked whether there has ever been an attempt to increase income limits to qualify for occupancy of subsidized housing. Mr. Knutson said income limitations are set by federal law and to his knowledge no effort has been made to seek increases.

Senator Urlacher said Rural Housing Service Section 515 property is a separate federal housing subsidy program. He asked whether under that program no subsidy is provided for a vacant apartment. Mr. Knutson said he believes that is correct. Senator Urlacher said he believes there are now many vacancies in the state in Section 515 property and property owners are responsible for taxes on those units whether or not they are vacant.

Chairman Wardner called on Ms. Clarice Liechty, Jamestown, for comments on the bill draft regarding valuation of subsidized housing property. Ms. Liechty asked why these properties should receive special treatment. Ms. Liechty said developers of Internal Revenue Code Section 42 properties get substantial equity from the tax credit. She said as a developer of nonsubsidized property, she must put her own equity into apartments and must make those apartments provide a return on that investment. She said as a rental property developer, she also faces a problem with vacancies. She said if a rental unit is vacant she must still pay the tax bill for the property. She said developers of subsidized rental properties have pointed out that rents are restricted by law. She said in Jamestown rental properties she develops are subject to rents that are restricted by the market. She said perhaps it is appropriate to review valuation of all rental property.

Representative Herbel asked whether information is available on occupancy rates for subsidized housing and nonsubsidized housing statewide. Senator Cook said information previously received by the committee estimated a 12 percent vacancy rate statewide for subsidized housing.

Representative Klein asked whether a fiscal note should be obtained for the bill draft. Chairman Wardner asked committee counsel for an opinion on this question. Committee counsel said there will be some impact to the state if the bill draft is enacted because of the one-mill state medical center mill levy. He said there would probably be very little impact to political subdivisions because reduced valuations do not reduce property tax levy authority. He said an estimate of the fiscal impact should be requested as

part of the committee's consideration of the bill draft, and Senator Wardner agreed.

Senator Cook said he has experience with subsidized housing issues as chairman of the Morton County Housing Authority. He said subsidized housing programs are the result of efforts of the federal government to provide affordable housing for all. He said different programs have been implemented. He said a voucher program is administered by local housing authorities and vouchers are provided to eligible renters which may be used for rent payment in any rental property. He said project-based programs are another kind of program and these would include Internal Revenue Code Section 42 programs. He said project-based programs take several forms in addition to the program authorized by Internal Revenue Code Section 42.

Senator Urlacher said not all housing projects in the state have received tax credit benefits.

RAILROAD PROPERTY TAXES

Chairman Wardner called on Ms. Dickerson for testimony on railroad property valuations and property taxes paid in North Dakota and other states. A copy of Ms. Dickerson's prepared testimony is attached as Appendix D.

In response to a question from Representative Brandenburg, Ms. Dickerson said the tax rate that applies to railroad property is determined by local taxing jurisdictions and applies to all railroad property in the taxing district.

In response to a question from Senator Urlacher, Ms. Dickerson said local governments are limited in setting rates of tax on railroad property by the same limitations that apply to taxing all property. She said the same mill rate applied to all property in the taxing district also applies to railroad property.

Senator Nichols said it appears some states tax personal property of railroads, but North Dakota has been prohibited from doing so. Ms. Dickerson said in states in which other commercial property is subject to personal property taxation, it is acceptable under the federal 4-R Act (Railroad Revitalization and Regulatory Reform Act of 1976) to impose personal property taxes on personal property of railroads. She said in North Dakota there is no general personal property tax for commercial property, so the federal law prohibits personal property tax on railroad personal property in North Dakota.

In response to a question from Senator Nichols, Ms. Dickerson said looking at the miles of track in states in the information provided is a good comparison of how much real property railroads own in each of the states.

Senator Cook asked whether every mile of railroad track is given the same valuation. Ms. Dickerson said in some cases relative traffic on a portion of railroad line affects valuation of the line.

Representative Brandenburg questioned whether allocation of gross earnings to North Dakota result in undertaxing railroads that charge higher freight rates in North Dakota as compared with other states. Ms. Dickerson said three allocation factors are considered in allocating income so the influence of only one aspect of earnings should be minimized.

Representative Schmidt said there is abandoned railroad property in his district, and he inquired how it is taxed. Ms. Dickerson said abandoned railroad property is locally assessed. She said central assessment only applies to operating property of railroads. Representative Schmidt said the problem encountered is that the railroad will not pay for spraying weeds on the property. Ms. Dickerson said if the spray costs are made a special assessment against the property, the owner can lose the property for nonpayment. She said this approach has been used in other parts of the state and appears to be a feasible solution.

AGRICULTURAL PROPERTY ASSESSMENT

Chairman Wardner called on committee counsel to review a bill draft to limit the value of agricultural property for property tax purposes for 2003-04. Committee counsel said the bill draft does not follow the approach of 2001 House Bill No. 1362, which froze valuation of each parcel of agricultural property at no more than its previous year's value. He said the Tax Department suggested that it would be administratively desirable to instead take the approach in the bill draft to provide that countywide valuations and 2003-04 would be replaced by 2002 valuations if the cropland, noncropland, and inundated agricultural land valuations for a county are each higher than the 2002 amounts.

Chairman Wardner called on committee counsel to review a bill draft providing a floor on the capitalization rate used in the agricultural property valuation formula. Committee counsel said the bill draft originated with a suggestion at the previous meeting of using longer-term rates as the basis for the capitalization rate in the formula. He said Mr. Dwight Aakre of North Dakota State University talked with Agribank officials and their recommendation was that such a change would make very little difference in the capitalization rate. Committee counsel said discussion with Mr. Aakre and Chairman Wardner concluded that it would be useful to create a floor for the capitalization rate, similar to the approach in 2001 House Bill No. 1246. He said the 2001 bill would have limited the capitalization rate to a range of 9.25 to 10.5 percent. He said in discussions with the chairman, the ceiling on the capitalization rate was not a concern and it was suggested that 9 percent would be an appropriate floor for the capitalization rate because the 2001 capitalization rate was 9.18 percent and the 2002 capitalization rate was 8.91 percent.

Chairman Wardner called on Mr. Dwight Aakre, Department of Agribusiness and Applied Economics, North Dakota State University, for comments regarding the agricultural property valuation formula. A copy of Mr. Aakre's prepared testimony is attached as Appendix E. Mr. Aakre said that at the committee's request he made inquiries with Agribank regarding loans used in computing the mortgage rate of interest which is used in the agricultural property valuation formula. He said loans included in the computation range from 3 years to 30 years in length and the most popular loans at the present time are 10-year loans with a 5-year adjustable interest rate. He inquired whether eliminating consideration of short-term loans would provide a higher rate, but an Agribank official estimated a negligible increase of perhaps one-fourth of 1 percentage point.

Mr. Aakre said freezing agricultural property valuations for two years to allow the cost of production index to be integrated into the formula is not recommended. He said the cost of production index is fully integrated in the formula at the present time. He said establishing a fixed capitalization rate may be a reasonable alternative. He said if current Agribank mortgage rates continue through 2003, the capitalization rate will drop below 8 percent two years from now.

Senator Wardner asked Mr. Aakre if he believes it would be more appropriate to freeze the capitalization rate or set a range within which the capitalization rate must fall. Mr. Aakre said freezing the rate would create more stability in valuations because a range would still leave the possibility of substantial fluctuations each year in the capitalization rate used to value property.

Representative Renner said reviewing the annual mortgage rates in Mr. Aakre's testimony indicates an average annual mortgage rate of about 9.9 percent. He said perhaps 9.5 percent would be an accurate capitalization rate to freeze.

Representative Schmidt said the cost of production index added to the formula has helped to hold down agricultural property valuations. He said the cost of production index has not been enough to offset the effect of the capitalization rate. He said he believes the capitalization rate has too much influence on valuations.

Senator Kroeplin said he believes the Federal Land Bank mortgage rate used in 1981 in the formula was based on one fixed-rate kind of loan available from the Federal Land Bank on a longer term. He said as time has passed, Agribank has developed different loan terms and rates, including variable rates, and these changes have contributed to the decrease in the capitalization rate in our formula. Mr. Aakre said he agrees that terms and rate options available from Agribank have changed in recent years.

Senator Wardner asked Senator Kroeplin if he would support a frozen capitalization rate. Senator Kroeplin said he would support a frozen rate, which would be an improvement over the effect the rate has on valuations now. He said he still believes consideration should be given to eliminating consideration of shorter-term loans from Agribank.

Senator Schobinger said a typical commercial venture seeks an increase in property value. He said he finds it interesting that the agricultural property valuation formula seems intended to keep valuations on agricultural property down for assessment purposes. Mr. Aakre said it is correct that the intention was to hold agricultural valuations below market level through establishment of the valuation formula.

Representative Schmidt said if a frozen capitalization rate is to be instituted, analysis will be required of the effects on property values at various capitalization rates.

Senator Wardner said if a fixed rate is chosen, it may be necessary to phase in the change to a fixed rate. He said if such a change is made in one year and results in a substantial rate change, there would be a substantial shift in tax burden to nonagricultural property. He said this impact could be severe in some areas.

Representative Herbel said he has concerns about the control of local government over agricultural property valuation. He said the 5 percent plus or minus variance in valuation allowed counties by the State Board of Equalization is a concern. He said this variance is not established by statute but by an opinion of the Attorney General. He said he would like to see counties have greater responsibility to set their valuations. He said perhaps the Legislative Assembly should provide statutory authority for counties to have more control over valuations.

Committee counsel said if legislation is recommended to change the capitalization rate in the formula, it is important to understand which year's capitalization rate would be the first one affected. He said on the capitalization rate chart provided by Mr. Aakre, capitalization rates are shown as 8.91 percent for 2002 and 8.53 percent for 2003. He asked which of these rates could be altered by 2003 legislation. Mr. Aakre said the 8.53 capitalization rate is the one that will be used in computations made this fall for 2004 application. Committee counsel asked whether it would be too late to alter that rate with 2003 legislation. Ms. Dickerson said 2003 legislation could alter the 8.53 percent capitalization rate and the changes would have to be recertified to local taxing officials but that could be accomplished.

Senator Cook said a review of Morton County average agricultural property valuations shows that 1981 and 2001 valuations are virtually identical. He said during those years valuations have declined and risen to approximately the same valuation as in 1981. He said during this time his home valuation has

consistently increased and is now approximately double what it was 20 years ago while agricultural property is about the same value it was 20 years ago. He said it should be recognized that the agricultural property valuation formula has been responsible for a substantial shift of tax burden from agricultural property to other property types.

Chairman Wardner called on Ms. Sandy Clark, North Dakota Farm Bureau, for comments on the agricultural property valuation formula. A copy of Ms. Clark's prepared testimony is attached as Appendix F. Ms. Clark said the North Dakota Farm Bureau would be opposed to a ceiling on the capitalization rate under the agricultural property valuation formula.

Senator Nichols said perhaps the original use of the capitalization rate in the formula was flawed. He said he understands North Dakota Farm Bureau concerns with the viability of the formula, but he thinks cost of production and income information is more reliable than loan rates, especially when different types of loans are now used in determination of the rate. Ms. Clark said she agrees that there may be differences in the rates that go into the computation now as compared to the original concept, but she believes the cost of borrowing is an important factor in agricultural property valuation.

Senator Cook said the interim Judiciary B Committee had a memorandum prepared and presented on property acquired in certain counties for hunting use. He said this memorandum should be provided to Taxation Committee members for their information. Chairman Wardner requested that copies of the memorandum be sent to committee members.

Senator Kroeplin requested preparation of a bill draft to provide that the capitalization rate in the agricultural property valuation formula is to be based on consideration of Agribank loans of a term of 15 years or more. He said the change should not affect rates that have already been computed but should apply for computation based on loans made in 2002 and later.

SPECIAL ASSESSMENTS STUDY

Chairman Wardner called on committee counsel to review information received from city officials regarding special assessment costs. Committee counsel said information was requested from city officials to gain an understanding of amounts added to construction costs on special assessment projects. He said added costs are for attorney and engineering fees, bonding costs, publication, and other administrative costs associated with special assessment projects. He reviewed responses received from the cities of Mandan, Dickinson, West Fargo, Williston, Minot, Jamestown, Fargo, and Bismarck. He said it appears these other costs generally are in the range of 15 to 25 percent additions to construction costs on special assessment projects. Copies of the

responses from the cities are on file in the Legislative Council office.

Senator Cook said he would like to receive testimony from representatives of some of these cities on how they determine percentages to add to construction costs for special assessment projects. He said he believes there are statutory limitations on other costs. He said he questions whether the procedure used is to add on a flat amount at the beginning of a project or wait until actual costs are determined. He said he questions whether, if flat amounts are added, those amounts are later justified if the actual amount is later determined to be different. Chairman Wardner said committee counsel should request city officials from Bismarck, Mandan, and Fargo to attend the next committee meeting to address these issues. Senator Cook said the North Dakota League of Cities and North Dakota Association of Counties should also be invited to comment on these issues if they wish.

Chairman Wardner called on committee counsel for presentation of a memorandum entitled *Special Assessment Lien Attachment to Privately Owned Building on State-Owned Land*. Committee counsel said it appears there is no provision of law that would prohibit imposition of a special assessment lien against a privately owned building on state-owned land. He said it appears there are public policy and other reasons why such a lien would not apply to the state-owned land upon which a structure subject to a lien is located. Senator Cook said the Legislative Audit and Fiscal Review Committee has discussed a similar issue and information provided to that committee should be reviewed to determine whether it is consistent with this advice.

Chairman Wardner called on committee counsel to review a bill draft to allow city flood control special assessments to apply to a privately owned structure on state-owned land. Committee counsel said the bill draft has been redrafted to address concerns raised at the previous committee meeting. He said the city of Grand Forks requested authority to impose city flood control special assessments against private commercial structures on state land and University of North Dakota officials indicated they would not object to this approach if it is carefully structured to not impact existing facilities. Committee counsel said the bill draft establishes two factors for examination to determine whether assessments would apply to a structure. He said ownership and use are the two factors and if a structure is owned by a private for-profit entity and used by it for commercial purposes, the structure would be subject to assessments unless the net profit from the operation is dedicated to the state institution or agency that owns the land. He said language has been added to this section to make clear that the assessment allowed against these structures must be made specifically against the structure and not against the land. He said the provision exempting a structure from assessments if the net profit is dedicated to the state institution is

intended to exempt the Engelstad Arena at the University of North Dakota because the net profits from that facility are dedicated to the University of North Dakota.

Committee counsel reviewed correspondence from University of North Dakota President Charles E. Kupchella stating that the university has reviewed this bill draft and the bill draft would not be unacceptable to the university. A copy of the letter is on file in the Legislative Council office.

Chairman Wardner called on committee counsel to present a bill draft to limit expenses that may be added to a special assessment improvement project. Committee counsel said the bill draft amends three sections of existing law to make clear that the expenses that may be added to a special assessment improvement project may not exceed the actual expenses for engineering and attorneys' fees, publication, and other administrative expenses. Senator Cook said the cities and North Dakota League of Cities representatives who are invited to comment on determination of other expenses on projects should also be invited to comment on how they think this bill draft would affect them.

Ms. Connie Sprynczynatyk, North Dakota League of Cities, said she questions why determination of other expenses on projects has become an issue. She asked whether the objective of the committee is to obtain information on how these other costs are determined. Chairman Wardner said that is the committee's objective and assistance of city officials would be useful.

Chairman Wardner called on committee counsel to review two bill drafts previously considered by the committee. Committee counsel reviewed a bill draft which would require inclusion of estimated assessments against each affected parcel of property in the published resolution of necessity for a special assessment project. Committee counsel reviewed a bill draft to require voter approval of special assessment improvements in a city of 5,000 or more population if the improvement district contains 75 percent or more of the area of property within the city. He said the bill draft requires voter approval before a call for bids, which would require an election after the opportunity to protest a project has passed and before the project is let for bids.

Chairman Wardner called on committee counsel to review a bill draft to adjust eligibility for the homestead property tax credit. Committee counsel said the bill draft has been revised to reflect suggestions made by Ms. Dickerson at the previous committee meeting. He said the most significant of these revisions is reinstatement of limitations on reduction of property values. He said the bill draft has been adjusted to provide a maximum taxable valuation reduction of \$3,600. He said this translates to a reduction of approximately \$80,000 of true and full valuation. He said this amount is decreased by 20 percent in each

of the other categories of income eligibility and the resulting maximum reductions in true and full valuation in the five income categories are \$80,000, \$64,000, \$48,000, \$32,000, and \$16,000. He said other technical changes are made in the bill draft, the most significant of which are probably the provisions relating to persons residing together and entitlement to one or more refunds, depending upon their status as spouses or dependents.

Chairman Wardner called on Ms. Dickerson for comments on the homestead credit bill draft. A copy of Ms. Dickerson's prepared testimony is attached as Appendix G.

CORPORATE INCOME TAX STUDY

Chairman Wardner called on Mr. Cory Finneman, Vice President, Research, Economic Development and Finance Division, Department of Commerce, for comments on any positive revenue estimates that might relate to reduction of corporate income tax rates. A copy of Mr. Finneman's prepared testimony is attached as Appendix H.

Mr. Finneman said if the corporate income tax rate is adjusted in a manner that is revenue-neutral with elimination of the federal income tax deduction, the model available for analyzing changes will not measure any positive impact. He said the model is meant to assess effective tax rates and their impact and the effective tax rate would not be changed.

Senator Schobinger asked what North Dakota could do to enhance its image with regard to corporate income taxes. Mr. Finneman said a reduced corporate income tax rate would certainly enhance efforts to encourage businesses to consider North Dakota as a business location.

Chairman Wardner called on Ms. Kathryn Strombeck, Tax Department, for a presentation of information relating to corporate income tax issues. A copy of her report on income taxes paid by rural corporations is attached as Appendix I. A copy of statistical information provided by Ms. Strombeck is attached as Appendix J. She said Table 1 shows characteristics of rural corporations. She said a question was raised about whether farm and ranch corporations are responsible for the growth in rural corporation income in recent years. She said those corporations are not responsible for most of the growth. She said most of the growth in rural corporation income is attributable to telecommunications corporations.

Ms. Strombeck said Table 2 provides a computation of income tax rates for corporations that would be revenue-neutral with elimination of the federal income tax deduction. She said assumptions were made in these computations, including assuming that existing income tax rates would continue to apply for water's edge filers and that anticipated revenue losses from federal legislative changes would not be made up by rate increases.

Ms. Strombeck said Table 3 was intended to indicate which corporations in filing brackets would owe more or less tax under the changes analyzed in Table 2. She reviewed the information.

Ms. Strombeck said Table 4 is an analysis of corporations that will owe more or less tax under a flat rate approach to corporate income tax revision. She said Table 5 illustrates rates that would be necessary if it is determined necessary to adjust rates to make up for anticipated revenue losses due to recent federal legislation.

Senator Schobinger said a flat rate tax appears from the statistics to increase taxes for a majority of taxpayers, but it should be remembered that the increases are probably not very large for most of these taxpayers. He said he likes the aspect of reducing taxes for the highest income bracket corporations because it is likely that these corporations will pay high wages to employees.

Chairman Wardner called on committee counsel to review a bill draft to eliminate the corporate income tax deduction for federal corporate income taxes paid and to make revenue-neutral reductions in state corporate income tax rates. Committee counsel said the bill draft has been revised since the previous committee meeting and that the state income tax rates have been adjusted slightly higher to account for forecasted changes in corporate income tax revenues. He said probably the most significant change in the bill draft is a provision that water's edge filers would remain subject to corporate income tax rate brackets that are the same as the rates and brackets under existing law. He said if these rates are not retained for water's edge filers, there will be a substantial incentive for corporations to change their status to become water's edge filers, which would have a substantial negative fiscal impact and would require rate adjustments to substantially increase rates. He said the bill draft also does not attempt to make up loss of tax revenue from recent federal legislation, which would also require substantial rate increases.

Ms. Mary Loftsgard, Corporate Income Tax Section Supervisor, Tax Department, said it is important to remember that this is not a "decoupling" bill. She said the bill draft eliminates a state income tax deduction of federal corporate income tax liability, but corporate income taxes would still be based on federal taxable income of corporations. She said Tax Department legal counsel have not had an opportunity to review this bill draft, and she would like to have that review done to determine whether technical changes are required.

Senator Schobinger said North Dakota has lost and continues to lose substantial population. He said lack of jobs is clearly the primary reason. He said corporations that earn substantial profits are the ones that will pay good wages to employees so there would be a benefit to encourage those companies to locate

in North Dakota or expand current operations. He said he would suggest that this could be accomplished by reducing corporate income tax rates. He said he would like to have two bill drafts prepared. He said one bill draft should completely eliminate corporate income taxes. He said the other bill draft would provide a flat rate corporate income tax with elimination of the federal income tax deduction and determination of a rate that would result in a 5 percent reduction in corporate income taxes.

In answer to a question by committee counsel on how to address treatment of water's edge filers in the second bill draft, Senator Schobinger said he would discuss that issue with the staff before the next committee meeting.

Senator Nichols said it appears that a flat rate corporate income tax could hurt some rural enterprises that are smaller businesses. He said small corporations with lower incomes would pay more taxes under a flat rate approach.

Senator Schobinger said he believes the impact to smaller corporations should be minimal with a flat rate tax. He said many rural businesses operate as limited liability companies or as cooperatives and a rate change would not affect their operations.

Chairman Wardner said he anticipates that the next committee meeting will be held in September. He asked whether committee members are aware of any dates in September that should be avoided for the next committee meeting. Senator Nichols said he thinks there will be a late harvest in his part of the state.

Representative Ruby said he would like to see an analysis of which corporations would pay more and less tax under the bill draft requested by Senator Schobinger for a flat rate corporate income tax with a 5 percent reduction in revenue.

It was moved by Senator Schobinger, seconded by Representative Rennerfeldt, and carried on a voice vote that the meeting be adjourned subject to the call of the chairman. The meeting was adjourned at 3:10 p.m.

John Walstad
Committee Counsel

ATTACH:10