ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - RENAISSANCE ZONE INCOME TAX CREDITS AND EXEMPTIONS

Pursuant to North Dakota Century Code Section 54-35-26, created by 2015 Senate Bill No. 2057, a variety of economic development tax incentives are to be reviewed by a Legislative Management interim committee over the ensuing six-year period. The study is aimed at ensuring that economic development tax incentives are serving their intended purposes in a cost-effective and equitable manner. This memorandum has been provided to assist in the review of renaissance zone income tax credits and exemptions and provides an explanation of the incentives, the perceived goals of the Legislative Assembly in creating or altering the incentives, and the data and testimony that will be required to conduct an effective analysis of the incentives.

EXPLANATION OF RENAISSANCE ZONE INCOME TAX CREDITS AND EXEMPTIONS

Chapter 40-63 provides for various renaissance zone tax exemptions and credits. Section 40-63-04 provides income tax exemptions to individuals who purchase or rehabilitate single-family residential property for the individual's primary residence as a zone project. The amount of the exemption is up to $10,000 of personal income tax liability for five taxable years beginning with the date rehabilitation is completed or the property is occupied. An exemption is also available for a taxpayer that purchases, leases, rehabilitates, or makes leasehold improvements to residential, public utility infrastructure, or commercial property for any business or investment purposes as a zone project. The amount of the exemption is equal to the income derived from the business or investment locations within the zone, up to a maximum amount of $500,000 per taxable year for five taxable years beginning with the date of purchase, lease, or completion of rehabilitation. For projects that take the form of an expansion of an existing building in the zone, the amount of the exemption is equal to the income derived from the business, or from the investment use of the building, during the taxable year times a ratio equal to the square footage added by the expansion divided by the total square footage of the building after expansion. In lieu of the previous exemption, a taxpayer may elect to exempt up to $2,000 of individual income tax liability if the cost of a new business purchase, leasehold improvement, or existing business expansion exceeds $75,000 and the business is in a city with a population of 2,500 or less.

A property owner that is not participating in a renaissance zone project may be entitled to a tax incentive in the form of a credit against income tax liability if the owner is required to make changes in utility services or in a building structure due to changes made to property that is part of a zone project. The amount of the credit is equal to the total amount of the investment necessary to complete the changes and must be claimed in the taxable year in which the changes were completed. Any earned credit amount exceeding a taxpayer's liability may be carried forward for up to five taxable years. A renaissance zone credit is also offered in Section 40-63-06 for investments in historic preservation or property renovation within a renaissance zone. The amount of the credit is equal to 25 percent of the amount invested, up to a maximum amount of $250,000. The credit must be claimed in the year the preservation or renovation work is completed and any earned credit amount exceeding a taxpayer's liability may be carried forward for up to five taxable years.

Exemptions are also available under Section 40-63-07 for renaissance fund organizations. A city with a designated renaissance zone may establish a renaissance fund organization to raise funds to finance zone projects. Financing may take the form of equity investments, loans, guarantees, and commitments for financing. A renaissance fund organization is exempt from income tax liability and the exemption may be passed through to any shareholder, partner, and owner if the organization is a passthrough entity. A taxpayer may also receive a credit against individual or corporate income tax liability for investments made in a renaissance fund organization. The amount of the credit is equal to 50 percent of the amount invested in the fund during the taxable year. Any amount of credit exceeding a taxpayer's liability may be carried forward for up to five taxable years following the taxable year in which the investment was made. The maximum amount of investment credits that may be awarded to all taxpayers is limited to $10.5 million. If an investment in a renaissance fund organization, which is the basis for a credit is redeemed by the investor within 10 years from the date it is purchased, the credit must be disallowed and any credit amount previously claimed must be repaid.

A taxpayer may not be delinquent in the payment of any state or local tax liability in order to be eligible to claim a credit or exemption under Chapter 40-63. A passthrough entity purchasing or leasing property in a renaissance zone for a business purpose, investing in a historic preservation or renovation of property within a renaissance zone, or investing in a renaissance fund organization must be considered to be the taxpayer for purposes of any investment limitations and the amount of the exemption or credit allowed with respect to the entity's investments must be determined at the passthrough entity level and passed through to the partners, shareholders, or members in proportion to their respective interests in the passthrough entity.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING RENAISSANCE ZONE INCOME TAX CREDITS AND EXEMPTIONS

Provisions of Chapter 40-63 were first enacted during the 1999 legislative session through the passage of House Bill No. 1492. The bill authorized the governing body of a city to apply to the Office of Intergovernmental Assistance to designate a portion of that city as a renaissance zone. The bill provided that income tax and property tax exemptions could be granted to taxpayers investing in real property within a renaissance zone and also authorized a historic preservation and renovation tax credit for investment within renaissance zones. Upon a review of the legislative history relating to the bill, the perceived goal of the Legislative Assembly in creating renaissance zone credits and exemptions was to provide incentives to encourage the rejuvenation of inner cities. The estimated fiscal effect of renaissance zone credits and exemptions could not be determined during the 1999 legislative session.

Various sections of Chapter 40-63 were amended during the 2001 legislative session through the passage of Senate Bill No. 2033 and House Bill No. 1460. Senate Bill No. 2033 authorized a city to apply to the Division of Community Services at any time during the duration of a zone to expand a previously approved renaissance zone to up to 20 square blocks. The bill provided that the use of grant funds as the sole source of investment in the purchase of a building or space in a building would not qualify a taxpayer for a tax exemption or credit available for renaissance zone investments, and grant funds could not be counted in determining if the cost of rehabilitation met or exceeded the current true and full value of a building. The bill also authorized a city to request the Division of Community Services remove a portion of an approved renaissance zone that is not progressing after five years and make a one-time adjustment of the boundaries to add another area to the original zone. The bill allowed an income tax exemption and property tax exemption for a taxpayer who rehabilitated residential or commercial property as a zone project. The bill provided that if the cost of a new business purchase or expansion of an existing business, approved as a zone project, exceeded $75,000, and the business was located in a city with a population of not more than 2,500, an individual taxpayer could elect to take an income tax exemption of up to $2,000 of personal income tax liability in lieu of the exemption on income derived from the business. The bill removed the December 31, 2004, expiration date for the historic preservation and renovation tax credit and reduced the credit for historic preservation and renovation from 50 percent of the amount invested to 25 percent of the amount invested, up to a maximum of $250,000. The bill provided that a taxpayer could not be delinquent in payment of state and local tax liability to be eligible for a tax benefit with respect to investments in a renaissance zone.

House Bill No. 1460 provided that once the aggregate limit of $2.5 million in renaissance zone tax credits had been exhausted, an additional $1 million of credits could be available for investments in renaissance fund organizations for taxable years beginning after December 31, 2000, for renaissance zone investments if more than 65 percent of the organization's net investments received had been invested as permitted under the renaissance zone law or the organization was established after the exhaustion of the initial limit. In addition, upon exhaustion of the initial limit, an additional $1.5 million in credits could be available for investments in renaissance zone fund organizations for taxable years beginning after December 31, 2002, for renaissance zone investments if more than 65 percent of the qualifying organization's net investments received had been invested as allowed under the renaissance zone law or the organization was established after the exhaustion of the initial limit.

Additional changes were made by 2003 House Bill No. 1457 and Senate Bill No. 2259. House Bill No. 1457 authorized a city of over 5,000 population to expand a renaissance zone beyond the 20 square block maximum up to a new maximum of 35 blocks at the rate of one additional block for each additional 5,000 in population. Senate Bill No. 2259 authorized a renaissance fund organization to provide financing to businesses outside a renaissance zone and increased to $2.5 million the amount of tax credits available for investments in renaissance fund organizations and provided that a renaissance fund organization that had received investments qualifying for additional credits could not use more than 50 percent for organization investments outside a renaissance zone. The bill provided for additional annual audit requirements and repealed the provision that if an annual audit report of a renaissance fund organization showed that less than 50 percent of the net investments had been invested as authorized by law during the previous four years, and the organization had been incorporated for four years or more, that organization could not accept any new investments until the governing body of the city determined that good cause exists for the failure to reach that level of investment or until the investment level was reached.

Provisions of Chapter 40-63 were again modified by 2009 House Bill Nos. 1324 and 1428 and Senate Bill No. 2060. Senate Bill No. 2060 expanded the renaissance zone law to include tax incentives for the repair or remodeling of public utility infrastructure and for leasehold improvements to property. The bill allowed a property owner that is not participating in a renaissance zone project to claim state income tax credits equal to the amount invested by the property owner to complete changes in utility services or a building structure necessary because of changes made to property that is part of a renaissance zone project. House Bill No. 1428 provided that if a city finds that renaissance zone projects have satisfactorily completed one or more blocks within the renaissance zone, a city may request the Department of Commerce withdraw those blocks from the renaissance zone and replace them with other blocks. The bill allowed the Department of Commerce to approve a city's request to extend the duration of renaissance zone status in increments up to five years. The bill also increased the total amount of income tax credits allowed for renaissance zone investments to $7.5 million. The final change made in 2009 removed a statutory reference to the optional long-form income tax return, which was eliminated.

Amendments made during the 2011 legislative session through the passage of House Bill No. 1102 changed the procedure for electing to take a renaissance zone individual income tax credit and Senate Bill No. 2218 allowed renaissance fund organization officers and employees to be actively involved in the enterprises in which the renaissance fund organization invests, but prohibited the renaissance fund organization from investing in any enterprise if any one renaissance fund organization officer or employee owned more than 49 percent of the ownership interest in the enterprise. The bill also prohibited a renaissance fund organization from investing in an enterprise if renaissance fund organization officers and employees collectively owned more than 49 percent of the ownership interests, either through direct ownership or through ownership of interest in a passthrough entity. The bill also allowed a renaissance fund organization to finance projects other than zone projects if the projects were located within designated renaissance zones. The bill increased the total amount of income tax credits allowed for investments in renaissance zone organizations from $7.5 million to $8.5 million. The bill also required a renaissance fund organization that had received investments qualifying for income tax credits to use the investments to finance projects within a renaissance zone.

The most recent changes to the renaissance zone provisions occurred in the 2013 and 2015 legislative sessions. The passage of 2013 House Bill No. 1166 limited the maximum amount of income a taxpayer could exempt from tax under the business or investment exemption for the purchase, lease, or rehabilitation of property within a renaissance zone to $500,000 in a taxable year. The bill also provided that if a zone project consisted of a physical expansion of an existing building owned and used by the taxpayer for business or investment purposes, the amount of income exempt from tax was limited to an amount equal to the income derived from the business, or from the investment use of the building, during the taxable year multiplied by a ratio equal to the square footage added by the expansion divided by the total square footage of the building after expansion. The passage of 2015 Senate Bill No. 2329 increased the maximum allowable size of renaissance zones to not more than 34 square blocks, except in a city with a population of greater than 5,000 at a rate of one additional block per additional 5,000 population up to a maximum of 49 square blocks. The bill increased the total amount of credits allowed for investments in renaissance fund organizations to $10.5 million.

Information provided to the Political Subdivision Taxation Committee by the Tax Department on July 29, 2015, and later amended on August 12, 2015, indicates the number of individual income tax returns on which the credit was claimed and the total amount claimed is as follows:

- In tax year 2006, a total of $644,606 was claimed over 126 returns;
- In tax year 2007, a total of $861,202 was claimed over 153 returns;
- In tax year 2008, a total of $1,142,211 was claimed over 153 returns;
- In tax year 2009, a total of $1,107,863 was claimed over 153 returns;
- In tax year 2010, a total of $1,723,920 was claimed over 149 returns;
- In tax year 2011, a total of $2,342,776 was claimed over 222 returns;
- In tax year 2012, a total of $1,252,363 was claimed over 160 returns;
- In tax year 2013, a total of $725,590 was claimed over 126 returns; and
- In tax year 2014, a total of $590,889 was claimed over 86 returns.

The number of corporate income tax returns on which the credit was claimed and the total amount claimed is as follows:

- In tax year 2006, the amount claimed cannot be disclosed due to confidentiality restrictions as the credit was claimed on fewer than five returns;
- In tax years 2007 and 2008, the credit was not claimed on any corporate income tax returns; and
- In tax years 2009 through 2014, the amount claimed cannot be disclosed due to confidentiality restrictions as the credit was claimed on fewer than five returns.

The number of financial institution tax returns on which the credit was claimed and the total amount claimed is as follows:

- In tax year 2006, the credit was not claimed on any financial institution tax returns;
- In tax year 2007, the amount claimed cannot be disclosed due to confidentiality restrictions as the credit was claimed on fewer than five returns;
- In tax year 2008, a total of $941,477 was claimed over six returns; and
- In tax years 2009 through 2012, the amount claimed cannot be disclosed due to confidentiality restrictions as the credit was claimed on fewer than five returns.

The number of individual income tax returns on which the deduction was claimed and the total estimated amount of those deductions are as follows:

- In tax year 2006, a total of $234,482 was claimed over 165 returns;
- In tax year 2007, a total of $586,900 was claimed over 251 returns;
- In tax year 2008, a total of $749,544 was claimed over 267 returns;
- In tax year 2009, a total of $691,869 was claimed over 256 returns;
- In tax year 2010, a total of $658,023 was claimed over 287 returns;
- In tax year 2011, a total of $665,755 was claimed over 295 returns;
- In tax year 2012, a total of $1,098,880 was claimed over 301 returns;
- In tax year 2013, a total of $861,070 was claimed over 283 returns; and
- In tax year 2014, a total of $266,461 was claimed over 161 returns.

The number of corporate income tax returns on which the deduction was claimed and the total estimated amount of those deductions is as follows:

- In tax year 2006, a total of $329,181 was claimed over 13 returns;
- In tax year 2007, a total of $181,263 was claimed over 15 returns;
- In tax year 2008, a total of $88,912 was claimed over 17 returns;
- In tax year 2009, a total of $327,276 was claimed over 23 returns;
- In tax year 2010, a total of $184,894 was claimed over 20 returns;
- In tax year 2011, a total of $967,866 was claimed over 17 returns;
- In tax year 2012, a total of $1,241,062 was claimed over 14 returns;
- In tax year 2013, a total of $201,188 was claimed over 10 returns; and
- In tax year 2014, a total of $126,201 was claimed over nine returns.

The number of financial institution tax returns on which the deduction was claimed and the total estimated amount of those deductions is as follows:

- In tax year 2006, a total of $131,614 was claimed over five returns;
- In tax year 2007, a total of $513,453 was claimed over six returns;
- In tax year 2008, a total of $832,928 was claimed over eight returns;
- In tax year 2009, a total of $710,729 was claimed over nine returns;
- In tax year 2010, a total of $1,365,333 was claimed over eight returns;
- In tax year 2011, a total of $1,301,097 was claimed over eight returns; and
- In tax year 2012, a total of $977,167 was claimed over eight returns.

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF RENAISSANCE ZONE INCOME TAX CREDITS AND EXEMPTIONS

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;
5. Benefits that flow to out-of-state concerns resulting from the incentive; and
6. The use of this type of incentive in other states.

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.