ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - RESEARCH EXPENSE TAX CREDIT

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 every 6 years. 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 the research expense tax credit and provides an explanation of the incentive, the perceived goals of the Legislative Assembly in creating or altering the incentive, and the data and testimony that will be required to conduct an effective analysis of the incentive.

EXPLANATION OF THE RESEARCH EXPENSE TAX CREDIT

Section 57-38-30.5 provides for a research expense tax credit. The incentive is available to all income taxpayers and allows for a credit against state income tax liability for expenditures related to conducting qualified research in this state. The amount of the credit is equal to a percentage of qualified research expenses which exceed a defined base amount. The definitions of "qualified research expenses" and "base amount," for purposes of Section 57-38-30.5, have the same meaning as provided in Section 41 of the Internal Revenue Code [26 U.S.C. 41], with the exception that any expenses incurred for research conducted outside North Dakota are excluded. The credit is equal to 25 percent of the first $100,000 in qualified expenses which exceeds the base amount and a varying percentage of any amounts exceeding the first $100,000. The percentage credit allowed on amounts exceeding the first $100,000 in excess qualified expenses varies based on the year in which a taxpayer first began conducting qualified research in this state.

If qualified research in North Dakota began before 2007, the percentage credit allowed on amounts exceeding the first $100,000 in excess qualified expenses is:

- 7.5 percent for tax year 2007;
- 11 percent for tax year 2008;
- 14.5 percent for tax year 2009;
- 18 percent for tax years 2010 through 2016; and
- 8 percent for tax year 2017 and any subsequent tax years.

A taxpayer qualifying for the credit under these conditions is limited to claiming no more than $2 million in credits in any taxable year and may not apply the amount of any unused credits in any other taxable year.

If qualified research in North Dakota began on or after January 1, 2007, and before January 1, 2011, the percentage credit allowed on amounts exceeding the first $100,000 in excess qualified expenses is equal to 20 percent for taxable years 2007 through 2016. If qualified research in North Dakota began on or after January 1, 2011, the percentage credit allowed on amounts exceeding the first $100,000 in excess qualified expenses is 8 percent. The percentage of allowable credit on amounts exceeding the first $100,000 in excess qualified expenses also is 8 percent for any credits claimed in taxable years after 2016, regardless of when the taxpayer first began conducting qualified research in this state.

For a taxpayer that began conducting qualified research in this state on or after January 1, 2007, any credit amount exceeding a taxpayer's liability may be carried back to each of the 3 preceding taxable years or carried forward to each of the 15 succeeding taxable years. A passthrough entity entitled to the credit must be considered the taxpayer for purposes of the credit and the amount of credit allowed must be determined at the passthrough entity level. A taxpayer entitled to the credit, and filing a consolidated return, may claim the credit against the aggregate North Dakota tax liability of all corporations included on the consolidated return except in the case of credits received by way of sale, transfer, or assignment.

A taxpayer certified by the Department of Commerce as a primary sector business, with annual gross revenues of less than $750,000, which did not conduct qualifying research in this state until after December 31, 2006, may elect to sell, transfer, or assign up to $100,000 of unused credits to another taxpayer. The transferor and transferee are required to jointly file information with the Tax Department, including a copy of the purchase agreement; the name, address, and taxpayer identification number of both parties; the amount of the credit being transferred; the gross proceeds received by the transferor; and the taxable years for which the credits may be claimed. Each party also is required to file a Form 500 with the Tax Department to allow the Tax Department to disclose tax information to either party for purposes of verifying the correctness of the transferred credit. This information must be filed with the Tax Department within 30 days of the parties executing a purchase agreement. The transferee must claim the credit in the year in which the purchase agreement is executed and may carry forward any unused credits to each of the 15 succeeding taxable years. The transferee may not carry unused credits back to prior tax years nor may the transferee sell, assign, or transfer the credit. The transferor must assign any gross proceeds received as a result of the credit transfer to North Dakota for purposes of taxation.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING THE RESEARCH EXPENSE TAX CREDIT

Section 57-38-30.5, providing for a research expense tax credit, was created through the passage of 1987 House Bill No. 1645. As originally enacted, Section 57-38-30.5 provided for a corporate income tax credit equal to 8 percent of the first $1.5 million of North Dakota qualified research expenses in excess of base period research expenses, and 4 percent of any amount exceeding $1.5 million in excess research expenses. The credit allowed for the same 3-year carryback and 15-year carryforward periods that are provided in current law. The 1987 legislation was patterned after a Minnesota law that had proved to be very successful for that state. Upon a review of the legislative history pertaining to House Bill No. 1645, the perceived goal of the Legislative Assembly in creating this credit was to encourage new and existing North Dakota corporations to undertake research and development. The credit was seen as a tool to help stimulate economic development. It was estimated that the research and expense credit would result in a reduction in general fund revenues of $90,000 for the 1987-89 biennium, though it was noted that this amount was potentially understated as very little information was available pertaining to future corporate research activity in the state.

The provisions of Section 57-38-30.5 were amended during the 1993 legislative session through the passage of Senate Bill Nos. 2222 and 2223. These bills provided for the creation of the North Dakota Limited Liability Company Act and referenced this new type of business entity within the language providing for the research expense tax credit.

The first substantial restructuring of Section 57-38-30.5 did not occur until the 2007 legislative session with the passage of House Bill Nos. 1412 and 1018. House Bill No. 1412 expanded the availability of the research expense tax credit to passthrough entities and House Bill No. 1018 allowed for individual income taxpayers to qualify for the credit. House Bill No. 1018 also broadened the scope of the research expense tax credit by allowing a taxpayer to sell, transfer, or assign up to $100,000 in unused credits and further amended the section to include substantially the same provisions as are seen in current law. The fiscal impact of expanding the availability of the credit to passthrough entities could not be determined, but the impact of expanding the credit to individuals, and increasing the available amount of the credit, resulted in an estimated reduction in general fund revenues of $2.47 million for the 2007-09 biennium. A notation provided in the fiscal note indicated that this figure could increase depending on the degree by which the increased credit rate, and the new transferability feature, expanded the use of the credit. The identified goals of applying the changes provided in 2007 House Bill No. 1018 were to attract new businesses to this state to conduct research activity and retain those businesses already present.

Amendments to Section 57-38-30.5 during the 2009 legislative session generally consisted of technical corrections, including a slight modification to a defined term pursuant to the passage of 2009 House Bill No. 1086, and the elimination of a reference to the optional long-form filing method (Form ND-2) pursuant to the passage of 2009 House Bill No. 1324. The credit also was modified during the 2013 legislative session through the passage of House Bill No. 1106 and Senate Bill No. 2207. Changes made pursuant to House Bill No. 1106 streamlined the lengthy description of a passthrough entity by providing a definition of the term at the outset of the income tax chapter. More substantive changes resulted from the passage of 2013 Senate Bill No. 2207, which added an additional subsection to Section 57-38-30.5 to safeguard references made to federal definitions throughout the section from becoming ineffective should the federal research tax credit be discontinued. The most recent change resulted from 2017 House Bill No. 1044, which created a uniform definition of "primary sector business" in Title 1.

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF THE RESEARCH EXPENSE TAX CREDIT

The interim Taxation Committee identified various items of data and testimony which would need to be collected to effectively analyze the research expense tax credit. The following list identifies the information the committee sought to collect and the receipt of that information throughout the course of the 2017-18 interim.

1. The number of claimants and the fiscal impact of the incentive:

a. Information (appendix) provided by the Tax Department on December 14, 2017, indicated the number of individual income tax returns on which the credit was claimed and the total amount claimed is as follows:

(1) In tax year 2007, a total of $530,888 was claimed over 75 returns;

(2) In tax year 2008, a total of $867,722 was claimed over 152 returns;

(3) In tax year 2009, a total of $856,534 was claimed over 132 returns;

(4) In tax year 2010, a total of $1,247,417 was claimed over 150 returns;

(5) In tax year 2011, a total of $1,383,298 was claimed over 173 returns;

(6) In tax year 2012, a total of $2,256,413 was claimed over 187 returns;

(7) In tax year 2013, a total of $2,231,708 was claimed over 152 returns;

(8) In tax year 2014, a total of $2,273,653 was claimed over 186 returns;

(9) In tax year 2015, a total of $3,660,279 was claimed over 189 returns; and

(10) In tax year 2016, a total of $4,549,132 was claimed over 234 returns.

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

(1) In tax year 2006, a total of $516,834 was claimed over 14 returns;

(2) In tax year 2007, a total of $1,944,382 was claimed over 15 returns;

(3) In tax year 2008, a total of $1,694,636 was claimed over 13 returns;

(4) In tax year 2009, a total of $3,502,244 was claimed over 16 returns;

(5) In tax year 2010, a total of $3,642,723 was claimed over 12 returns;

(6) In tax year 2011, a total of $5,381,168 was claimed over 19 returns;

(7) In tax year 2012, a total of $6,570,148 was claimed over 16 returns;

(8) In tax year 2013, a total of $3,971,384 was claimed over 22 returns;

(9) In tax year 2014, a total of $5,241,660 was claimed over 25 returns;

(10) In tax year 2015, a total of $3,068,067 was claimed over 21 returns; and

(11) In tax year 2016, a total of $538,736 was claimed over 12 returns.

2. Employment opportunities, business growth, or diversity in the state's economy resulting from the availability of the incentive:

The committee continues to assess whether employment opportunities or business growth has resulted from the use of the research expense tax credit.

3. Negative impacts created as a result of the incentive:

The committee continues to assess whether negative impacts have resulted from the use of the research expense tax credit.

4. Benefits that flow to out-of-state concerns resulting from the incentive:

The committee continues to assess whether out-of-state benefits have resulted from the use of the research expense tax credit.

5. Testimony from interested parties:

a. The committee has yet to receive testimony from parties in support of the research expense tax credit.

b. The committee has yet to receive testimony from parties opposed to the research expense tax credit.

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