North Dakota Legislative Council

Prepared for the Taxation Committee
LC# 23.9216.01000
December 2021

ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - SEED CAPITAL INVESTMENT TAX CREDIT

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 study is aimed at ensuring 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 seed capital investment tax credit 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 SEED CAPITAL INVESTMENT TAX CREDIT

Section 57-38.5-03 provides for a seed capital investment tax credit. The incentive is available to all income taxpayers and allows for a credit against state income tax liability for qualified investments made in a qualifying business. A "qualifying business" is defined in Section 57-38.5-01 as a primary sector business, certified by the Director of the Department of Commerce's Division of Economic Development and Finance, which relies on innovation, research, or the development of new products and processes for growth and profitability. A qualifying business must be in compliance with the state's security laws and be a for-profit corporation, passthrough entity, or joint venture with the majority of the business's in-state employees being North Dakota residents. The business must have its principal office located in this state and perform the majority of its business activities in this state, with the exception of sales activities, or the business must have significant current or anticipated operations in North Dakota which consist of employing more than 10 employees or reaching more than $150,000 in annual sales. A qualifying business does not include a real estate investment trust.

The credit is equal to 45 percent of the amount of the qualified investment which may consist of direct cash payments or cash transfers from a retirement plan if the investor maintains a separate account and controls where the plan's assets are invested. A qualifying investment must be at risk in the qualifying business for at least 3 years. Investments placed in escrow will not qualify for the credit. A qualifying business must expend investment amounts for equipment, plant facilities, research and development, marketing, or working capital. A taxpayer, or a member of the taxpayer's immediate family, receiving more than one-half of the taxpayer's yearly gross income, or owning a controlling interest in qualified business, may not receive a credit for qualified investments in that business.

A taxpayer may claim no more than $112,500 in credits per taxable year. Credit amounts exceeding a taxpayer's liability may be carried forward for up to 4 taxable years following the year in which the investment was made. 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 and passed through to the entity's partners, shareholders, or members in proportion to their respective ownership interests in the passthrough entity. Pursuant to Section 57-38.5-07, a qualified business is required to file with the investor, the Tax Commissioner, and the Director of the Department of Commerce's Division of Economic Development and Finance information identifying each taxpayer making an investment, the amount remitted by the taxpayer, and the date on which the investment was received by the qualifying business. The total aggregate amount of all seed capital investment tax credits allowed per year is limited to $3.5 million. If the amount of credits applied for exceeds the maximum yearly cap, credits must be awarded based on the date each investment was received by a qualifying business. The maximum aggregate amount of qualified investments upon which the credit may be based may not exceed $500,000 for any one qualified business over any combination of tax years.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING THE SEED CAPITAL INVESTMENT TAX CREDIT

Provisions relating to a seed capital investment tax credit were first enacted through the passage of Senate Bill No. 2052 (1993). The bill provided a credit to individual income taxpayers for investments in primary sector companies that exported products, provided new jobs, and created new wealth from customers outside this state.

A taxpayer was required to invest between $5,000 and $50,000 in a qualified business and the investment was required to be at risk in the business for at least 3 years. The credit was equal to 30 percent of the amount invested. A taxpayer could claim no more than 50 percent of the credit in a single taxable year and the credit could not exceed 50 percent of the taxpayer's income tax liability. Credit amounts exceeding a taxpayer's liability could be carried forward for up to 15 taxable years following the year in which the investment was made. The total aggregate amount of all seed capital investment tax credits allowed per year was limited to $250,000. Upon a review of the legislative history relating to this bill, the perceived goal of the Legislative Assembly in creating this credit was to stimulate private investment in new and growing North Dakota companies to help diversify and expand the state's economy. It was estimated the seed capital investment tax credit could result in a reduction in general fund revenues of up to $500,000 during the 1993-95 biennium.

The credit was amended through the passage of House Bill No. 1413 (2001), which eliminated the limitation that the seed capital credit could not exceed 50 percent of a taxpayer's tax liability. The bill also increased the aggregate amount of allowable seed capital investment tax credits from $250,000 to $1 million through calendar year 2002 and to $2.5 million after calendar year 2002. The number of North Dakota employees a qualified business was required to employ was decreased to 10 and annual sales requirements were decreased to $150,000. The bill also allowed for an organization to be classified as a qualified business if it attracted investments to build and own a value-added agricultural processing facility that it leased with an option to purchase to a primary sector business.

The credit was amended further through the passage of House Bill No. 1019 (2003), which eliminated the $250,000 limit per qualifying business of investments that could qualify for the credit. The bill also increased the available credit amount from 30 to 45 percent of the amount of the qualifying investment. Legislation enacted during the 2005 legislative session, through the passage of Senate Bill No. 2032, further expanded the credit to allow it to be claimed by corporations and passthrough entities. The bill also limited qualified investments in a qualified business to a maximum of $500,000 for which the credit could be claimed. The bill allowed investments made before 2005, which did not qualify for the tax credit because of the limitation in effect at that time, to claim a credit of 45 percent of the amount invested in a qualified business with a minimum qualifying investment of $5,000 and maximum investment of $250,000 required in order to obtain the credit. For these taxpayers, no more than one-fourth of the credit could be claimed in any taxable year. It was estimated the credit would decrease general fund revenues by $250,000 in the 2005 fiscal year and by $3 million during the 2005-07 biennium if the caps provided within the credit provisions were reached.

Senate Bill No. 2224 (2007) expanded the credit to allow investments by an angel fund to be eligible for the seed capital investment tax credit and Senate Bill No. 2084 (2007) reduced the maximum amount that could be claimed by a taxpayer to $112,500 per year and revised provisions regarding certification of a qualified business by the Department of Commerce. The remaining changes to the credit were mostly technical in nature and occurred during the 2009 and 2013 legislative sessions. The passage of House Bill No. 1324 (2009) eliminated the optional long-form filing method (Form ND-2) and replaced it with a simplified filing method for any taxpayer who did not have tax deductions or credits and House Bill No. 1106 (2013) streamlined the lengthy description of a passthrough entity by providing a definition of the term at the outset of the income tax chapter.

PAST REVIEW OF THE SEED CAPITAL INVESTMENT TAX CREDIT

The seed capital investment tax credit was reviewed by the 2015-16 interim Political Subdivision Taxation Committee. During the course of its study, the committee received information from representatives of the Tax Department regarding the number of taxpayers claiming the seed capital investment tax credit and the total amount of credits claimed. The committee was informed the number of taxpayers claiming the credit dropped substantially following the enactment of the angel fund investment tax credit. The credit was claimed on nearly 700 individual income tax returns in tax year 2006 and claimed on only 74 individual income tax returns in tax year 2014. The committee received information from representatives of the Department of Commerce indicating investors had earned credits totaling $14,530,233 since 2002 for investments in 70 companies. Of those 70 companies, 47 remained in operation. Information indicated the total direct, indirect, and induced employment related to the credit amounted to 655 jobs in 2014. The cost of offering the incentive as compared to the increase in state tax revenue resulting from the availability of the incentive equated to a 14.6 percent annual rate of return in 2014. The committee reviewed information indicating incentives similar to the seed capital investment tax credit are available in seven other states.

The committee received testimony from interested parties in favor of retaining the seed capital investment tax credit, including representatives of the Economic Development Association of North Dakota and the North Dakota State University Research and Technology Park. The committee also received testimony from business owners who received investments prompted by the availability of the credit. Testimony provided in favor of the credit indicated the credit is an important tool for supporting entrepreneurship, innovation, and startup companies in this state.

The committee also reviewed the definition of "primary sector business," as used in the seed capital investment tax credit and which is defined in nine sections of the Century Code. The committee recommended legislation to provide for a uniform definition of primary sector business, which was approved during the 2017 legislative session.

The committee also recommended legislation to increase allowable credit amounts and carryforward periods related to the seed capital investment tax credit, but the increases were not approved during the 2017 legislative session.

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF THE SEED CAPITAL INVESTMENT TAX CREDIT

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. Out-of-state impacts 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.