

FISCAL NOTE
Requested by Legislative Council
01/17/2019

Amendment to: HB 1111

- 1 A. **State fiscal effect:** *Identify the state fiscal effect and the fiscal effect on agency appropriations compared to funding levels and appropriations anticipated under current law.*

	2017-2019 Biennium		2019-2021 Biennium		2021-2023 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues			\$(700,000)			
Expenditures						
Appropriations						

- 1 B. **County, city, school district and township fiscal effect:** *Identify the fiscal effect on the appropriate political subdivision.*

	2017-2019 Biennium	2019-2021 Biennium	2021-2023 Biennium
Counties			
Cities			
School Districts			
Townships			

- 2 A. **Bill and fiscal impact summary:** *Provide a brief summary of the measure, including description of the provisions having fiscal impact (limited to 300 characters).*

Engrossed HB 1111 changes the income tax law governing the research expense income tax credit to provide for an alternative method of calculating the credit allowed for qualified research expenses incurred in North Dakota.

- B. **Fiscal impact sections:** *Identify and provide a brief description of the sections of the measure which have fiscal impact. Include any assumptions and comments relevant to the analysis.*

Section 1 of the bill will change North Dakota income tax law governing the existing research expense tax credit. Current state law provides an income tax credit for qualified research spending in the state, which is based on the regular method of calculating the research expense tax credit under federal income tax law. Under the regular calculation method, the credit is calculated on the amount by which qualified expenses incurred during the tax year exceed a base amount. In general, the purpose of the base amount is to allow the credit only if there is an increase in qualified research spending (over the base amount). The regular calculation method is complex, under which the determination of the base amount is based on historical data on qualified research expenses and gross receipts (often as far back as 34 years) as well as the average gross receipts for the four years preceding the tax year for which the credit is being calculated.

Under federal tax law, an alternative simplified method of calculating the federal research tax credit was created in 2006. Under the alternative simplified method, the determination of the base amount is greatly simplified by basing it on an average of the qualified research expenses incurred in the three tax years preceding the tax year for which the credit is being calculated. Because qualified research expenses on which the credit is calculated generally are higher than under the regular method, the applicable federal credit rates are set at 70% of the regular rates (or 30% of the regular rates if qualified research expenses for any of the three base years is zero). Use of this alternative simplified method is optional; a taxpayer may elect to use it on a year by year basis.

North Dakota tax law does not conform to the federal alternative simplified method, nor does North Dakota tax law provide for a similar method. Engrossed HB 1111 will provide for an alternative simplified method for state purposes that is similar to the one under federal law. A taxpayer may use the alternative simplified method for state purposes regardless of the method chosen for federal tax purposes. Under the alternative simplified method, the applicable state credit rates are set at 70% of the regular rates (or 30% of the regular rates if qualified research expenses for any base year is zero).

If a taxpayer elects to use the alternative simplified method on the original return filed for a tax year, the election is binding for that tax year. If a taxpayer calculated the research expense credit using the regular method on an original return filed for a tax year beginning before January 1, 2019, the taxpayer may not file an amended return for that year for the purpose of changing to the alternative simplified method.

3. **State fiscal effect detail:** *For information shown under state fiscal effect in 1A, please:*

- A. **Revenues:** *Explain the revenue amounts. Provide detail, when appropriate, for each revenue type and fund affected and any amounts included in the executive budget.*

If enacted, Engrossed HB 1111 is estimated to reduce state general fund revenues between \$400,000 and \$1,000,000 for the 2019-21 biennium. The midpoint of this range is -\$700,000, as shown above in 1A.

- B. **Expenditures:** *Explain the expenditure amounts. Provide detail, when appropriate, for each agency, line item, and fund affected and the number of FTE positions affected.*

- C. **Appropriations:** *Explain the appropriation amounts. Provide detail, when appropriate, for each agency and fund affected. Explain the relationship between the amounts shown for expenditures and appropriations. Indicate whether the appropriation or a part of the appropriation is included in the executive budget or relates to a continuing appropriation.*

Name: Kathryn Strombeck

Agency: Office of Tax Commissioner

Telephone: 701.328.3402

Date Prepared: 01/18/2019

FISCAL NOTE
Requested by Legislative Council
12/31/2018

Bill/Resolution No.: HB 1111

- 1 A. **State fiscal effect:** *Identify the state fiscal effect and the fiscal effect on agency appropriations compared to funding levels and appropriations anticipated under current law.*

	2017-2019 Biennium		2019-2021 Biennium		2021-2023 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues			\$(600,000)			
Expenditures						
Appropriations						

- 1 B. **County, city, school district and township fiscal effect:** *Identify the fiscal effect on the appropriate political subdivision.*

	2017-2019 Biennium	2019-2021 Biennium	2021-2023 Biennium
Counties			
Cities			
School Districts			
Townships			

- 2 A. **Bill and fiscal impact summary:** *Provide a brief summary of the measure, including description of the provisions having fiscal impact (limited to 300 characters).*

HB 1111 changes the income tax law governing the research expense income tax credit to provide for an alternative method of calculating the credit allowed for qualified research expenses incurred in North Dakota.

- B. **Fiscal impact sections:** *Identify and provide a brief description of the sections of the measure which have fiscal impact. Include any assumptions and comments relevant to the analysis.*

Section 1 of the bill will change North Dakota income tax law governing the existing research expense tax credit.

Current state law provides an income tax credit for qualified research spending in the state, which is based on the regular method of calculating the research expense tax credit under federal income tax law. Under the regular calculation method, the credit is calculated on the amount by which qualified expenses incurred during the tax year exceed a base amount. In general, the purpose of the base amount is to allow the credit only if there is an increase in qualified research spending (over the base amount). The regular calculation method is complex, under which the determination of the base amount is based on historical data on qualified research expenses and gross receipts (possibly as far back as 34 years) as well as the average gross receipts for the four years preceding the tax year for which the credit is being calculated.

Under federal tax law, an alternative simplified method of calculating the federal research tax credit was created in 2006. Under this new alternative simplified method, the determination of the base amount is greatly simplified by basing it on an average of the qualified research expenses incurred in the three tax years preceding the tax year for which the credit is being calculated. Because qualified research expenses on which the credit is calculated generally are higher than under the regular method, the applicable federal credit rates are set at 70% of the regular rates (or 30% of the regular rates if qualified research expenses for any of the three base years is zero). Use of this alternative simplified method is optional; a taxpayer may elect to use it on a year by year basis.

North Dakota tax law does not conform to the federal alternative simplified method, nor does North Dakota tax law provide for a similar method. This bill will add an alternative simplified method similar to that under federal tax law to North Dakota's research credit law. If a taxpayer elects to use the alternative simplified method for federal purposes, the taxpayer must use the alternative simplified method for state purposes. Under the alternative simplified method, the applicable state credit rates are set at 70% of the regular rates (or 30% of the regular rates if qualified research expenses for any base year is zero).

3. **State fiscal effect detail:** *For information shown under state fiscal effect in 1A, please:*

- A. **Revenues:** *Explain the revenue amounts. Provide detail, when appropriate, for each revenue type and fund affected and any amounts included in the executive budget.*

If enacted, HB 1111 is estimated to reduce state general fund revenues between \$300,000 and \$900,000 for the 2019-21 biennium. The midpoint of this range is -\$600,000, as shown above in 1A, state fiscal effect.

- B. **Expenditures:** *Explain the expenditure amounts. Provide detail, when appropriate, for each agency, line item, and fund affected and the number of FTE positions affected.*

- C. **Appropriations:** *Explain the appropriation amounts. Provide detail, when appropriate, for each agency and fund affected. Explain the relationship between the amounts shown for expenditures and appropriations. Indicate whether the appropriation or a part of the appropriation is included in the executive budget or relates to a continuing appropriation.*

Name: Kathryn Strombeck

Agency: Office of Tax Commissioner

Telephone: 701.328.3402

Date Prepared: 01/08/2019

2019 HOUSE FINANCE AND TAXATION

HB 1111

2019 HOUSE STANDING COMMITTEE MINUTES

Finance and Taxation Committee Fort Totten Room, State Capitol

HB 1111
1/9/2019
30580

- ☐ Subcommittee
☐ Conference Committee

Committee Clerk: Mary Brucker

Explanation or reason for introduction of bill/resolution:

A BILL relating to the alternative simplified method for calculating the research and experimental expenditure credit; and to provide an effective date.

Minutes:

Attachment 1

Vice Chairman Grueneich: Opened the hearing on HB 1111.

Chairman Headland: Introduced bill. This is going to provide another method of calculation when calculating the research and development credit. Currently, in state law we don't offer an alternative method which has generated concern among manufacturers who have been trying to take advantage of the research and development credit that have been able to use an alternative method on their federal returns. It's fairly complicated how the credit is determined. I will ask the tax department to explain the process.

Matt Peyerl, Tax Department: This is a fairly complicated credit to understand. The fiscal note does a good job in the overall explanation. This is a credit on income tax on the amount of research and development you have. It was created in '87 and was piloted after the federal credit that is similar. The credit is based on increasing your R&D which this bill will address. Under this regular method under North Dakota it's increasing it over a base amount which is the amount of R&D you had at first relative to sales. If you had \$100,000 in R&D and \$1 million in sales, it's saying it's 10 percent. So that is saying that you need to have more than 10% of your sales in order to get the credit. If your sales double you're R&D has to double then you only get a credit for R&D above the doubling. Your base amount moves with sales which is one of the concerns of the computation of the regular method. The alternative method uncouples it from using sales in the methodology and instead just uses your recent R&D activity. You don't have to increase it, as long as you occur R&D at a substantial level compared to your prior three years then you'll be eligible for the credit. Because more dollars are eligible for the credit the rates on the federal alternative method are lower than the regular method; they're 70% of the regular rates. This bill backs on that methodology and uses the 70% rate structure. There's not a lot of change to the bill. On page 2 line 9 it decouples from the regular method. Subsection 4a lays out the alternative method and that's what is available on the federal return; alternative method or regular method. The taxpayer would use which method is beneficial overall. If they do the alternative method on the federal return,

then the North Dakota credit would be computed similarly; the rates would be 70% of the regular rates or based on three years of R&D times half. Subsection 4b is also another component of the federal computation which is you have no R&D in your prior three years then the rates are 30% of the regular rates. The current North Dakota rates are 25% for the first \$100,000 and 8% for the next excess over \$100,000. For subsection 4a seventy percent of those rates are 17.5 and 5.6 and in 4b 30% structure would be 7.5 and 2.4. Subsection 5 defines the alternative method and 4b defines the alternative method and piggybacks it to the definition in federal code. The date would be effective for tax years 2019.

Representative Steiner: Do you know how many companies take advantage of this? Do you know how much positive research has been done because of this tax credit, do you track that?

Matt Peyerl: The latest data I have is from the interim tax committee this summer so it's not the most recent we could get. It's available to C corporations and pass through entities. When it's earned by a pass through entity then it's ultimately claimed by the individual owners. The count of actual companies earning it isn't something that's captured because one pass-through entity might have 10 owners so you'd have 10 claimants. There's about 20 C corps and about 30 pass through entities. The rough dollars claimed have been around \$8-10 million per year.

Representative B. Koppelman: Are there circumstances when we're offering a tax credit to companies or individuals where the dollars they're investing in R&D are already grant dollars or some other publicly funded revenue; is there a double dipping possibility in this?

Matt Peyerl: Under the alternative method you still earn a credit even if you don't increase because that prior three-year rolling is divided by half. If you stay constant you will still get a credit. As far as grant dollars or external being used from R&D that gets taken out what qualifies for a credit. If somebody else is funding it or getting reimbursed for it then it doesn't qualify for the R&D credit. Most of the internal expenses someone has for R&D are their internal wages generally for engineers or folks that engage in experimentation. The other form of R&D expense would be if you have a contract for somebody else through the R&D for you and you pay them then that's a component of the expense. The purchase of equipment doesn't earn R&D credit; capital expenditures don't qualify for R&D; supplies do but not capital investment.

Chairman Headland: Are salaries considered part of research when doing an R&D credit?

Matt Peyerl: Salaries are and they are often the largest component of it.

Chairman Headland: Is there testimony in support?

Jim Donovan, Partner, National Tax Office at Eide Bailly LLP: Distributed written testimony. See attachment #1. Ended testimony at 18:52.

Representative Trottier: Is it hard to put definite numbers when auditing R&D?

Jim Donovan: It is. In reality there really is no perfect record keeping system. You have to understand the activities these individuals perform, what qualifies, what doesn't qualify, and then it's a reasonable percentage.

Chairman Headland: Is there further testimony in support? Is there any testimony in opposition? Seeing none we will close the hearing on HB 1111.

2019 HOUSE STANDING COMMITTEE MINUTES

Finance and Taxation Committee Fort Totten Room, State Capitol

HB 1111
1/16/2019
30916

- ☐ Subcommittee
☐ Conference Committee

Committee Clerk: Mary Brucker

Explanation or reason for introduction of bill/resolution:

A bill relating to the alternative simplified method for calculating the research and experimental expenditure credit; and to provide an effective date.

Minutes:

Attachment 1

Chairman Headland: Dee, would you like to come up and explain your amendment?

Dee Wald, General Counsel for the Office of State Tax Commissioner: Distributed proposed amendment, see attachment #1. The purpose of the amendments was to get rid of the requirement that a taxpayer make an election on their federal return to compute the R&D tax credit before they could use that alternative simplified method in North Dakota. On page 3 lines 13-14 does that and says a taxpayer may elect to use an alternative simplified method of computing their R&D tax credit. They don't have to use it at the federal level, they can just use it here and that would be fine. At the very beginning of page 2 line 19 and page 3 line 5, those are technical amendments we put in. After we were looking at the bill we had to make an exception in the regular method of calculating to say except as alternative simplified methods. By making it at the taxpayer's discretion to use the alternative simplified method we wanted to make sure that a taxpayer who claimed the credit under the old method or the alternative simplified method on their return didn't come back three to six years later and expect a refund. The new language is on page seven after line 21 we created the new subsection fifteen. You can't flip back and forth to claim a refund and the interest that goes with that refund.

Representative Hatlestad: On the first part where it says 15, if I make a decision in this taxable year, the alternative, next year I can go back to the regular one? Is that legal?

Dee Wald: That is legal. On the first line it says, "If a taxpayer claims a credit on its original return." That election on the original return is binding for that tax year. It has nothing to do with the next year. You can bounce back and forth.

Chairman Headland: Is there any further discussion?

Representative Hatlestad: MADE A MOTION TO ADOPT THE AMENDMENT.

Representative B. Koppelman: SECONDED.

VOICE VOTE: MOTION CARRIED TO ADOPT THE AMENDMENT.

Chairman Headland: We have the amended bill before us.

Representative Blum: MADE A MOTION FOR A DO PASS AS AMENDED.

Representative Dockter: SECONDED

Chairman Headland: Any discussion?

Representative Steiner: Is it showing that this is costing \$600,000 on our fiscal note or is that \$600,000 to the good in parenthesis?

Chairman Headland: It's a reduction.

Representative Steiner: A reduction of?

Chairman Headland: \$600,000.

Representative Steiner: So it costs \$600,000 for this bill?

Chairman Headland: It does.

Representative Steiner: Why didn't it go to appropriations because it's over \$10,000?

Chairman Headland: It has to be re-referred to appropriations.

Representative Blum: MOTION INCLUDES TO RE-REFER TO APPROPRIATIONS.

Representative Dockter: SECONDED MOTION TO RE-REFER TO APPROPRIATIONS.

**ROLL CALL VOTE: 9 YES 3 NO 2 ABSENT
MOTION CARRIED FOR DO PASS AS AMENDED AND RE-REFER TO
APPROPRIATIONS.**

Representative Dockter will carry this bill.

January 16, 2019

CM
1/14/19
1 of 1

PROPOSED AMENDMENTS TO HOUSE BILL NO. 1111

Page 2, line 19, overstrike "For" and insert immediately thereafter "Except as provided in subsection 4, for"

Page 3, line 5, overstrike "For" and insert immediately thereafter "Except as provided in subsection 4, for"

Page 3, line 13, replace "For a taxable year in which a" with "A"

Page 3, line 13, remove "makes an election on the taxpayer's federal"

Page 3, line 14, replace "return" with "may elect"

Page 7, after line 21, insert:

"15. If a taxpayer claims a credit under this section on the taxpayer's original return, the taxpayer's election to calculate the credit under subsections 1, 2, 3, or 4 is binding for the taxable year in which the election is made. A taxpayer claiming a credit for tax years beginning before January 1, 2019, may not file an amended return for the purpose of calculating the credit under subsection 4."

Renumber accordingly

Date: 1-16-19
Roll Call Vote #: 1

2019 HOUSE STANDING COMMITTEE
ROLL CALL VOTES
BILL/RESOLUTION NO. 1111

House Finance and Taxation Committee

☐ Subcommittee

Amendment LC# or Description: 19.0493.01001 Office of State Tax Commissioner

Recommendation: ☒ Adopt Amendment

☐ Do Pass

☐ Do Not Pass

☐ Without Committee Recommendation

☐ As Amended

☐ Rerefer to Appropriations

☐ Place on Consent Calendar

Other Actions:

☐ Reconsider

☐

Motion Made By Rep. Hatlestad Seconded By Rep. Koppelman

Representatives	Yes	No	Representatives	Yes	No
Chairman Headland			Representative Eidson		
Vice Chairman Grueneich			Representative Mitskog		
Representative Blum					
Representative Dockter					
Representative Ertelt					
Representative Fisher					
Representative Hatlestad					
Representative Kading					
Representative Koppelman					
Representative Steiner					
Representative Toman					
Representative Trottier					

Total (Yes) _____ No _____

Absent _____

Floor Assignment _____

If the vote is on an amendment, briefly indicate intent:

Voice Vote
★ : Motion carries
Getting rid of the requirement that a taxpayer make an election on their federal return to compute R + D tax credit before using the alternative simplified method in N.D.

Date: 1-16-19
Roll Call Vote #: 2

2019 HOUSE STANDING COMMITTEE
ROLL CALL VOTES
BILL/RESOLUTION NO. 1111

House Finance and Taxation Committee

☐ Subcommittee

Amendment LC# or Description: _____

Recommendation: ☐ Adopt Amendment
☒ Do Pass ☐ Do Not Pass ☐ Without Committee Recommendation
☒ As Amended ☒ Refer to Appropriations
☐ Place on Consent Calendar
Other Actions: ☐ Reconsider ☐ _____

Motion Made By Rep. Blum Seconded By Rep. Dockter

Representatives	Yes	No	Representatives	Yes	No
Chairman Headland	✓		Representative Eidson	✓	
Vice Chairman Grueneich	✓		Representative Mitskog	✓	
Representative Blum	✓				
Representative Dockter	✓				
Representative Ertelt	✓	✓			
Representative Fisher	✓				
Representative Hatlestad	✓				
Representative Kading	✓	✓			
Representative Koppelman	✓				
Representative Steiner	✓				
Representative Toman	✓	✓			
Representative Trottier	A				

Total (Yes) 9 No 3

Absent 2

Floor Assignment Rep. Dockter

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1111: Finance and Taxation Committee (Rep. Headland, Chairman) recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** and **BE REREFERRED** to the **Appropriations Committee** (9 YEAS, 3 NAYS, 2 ABSENT AND NOT VOTING). HB 1111 was placed on the Sixth order on the calendar.

Page 2, line 19, overstrike "For" and insert immediately thereafter "Except as provided in subsection 4, for"

Page 3, line 5, overstrike "For" and insert immediately thereafter "Except as provided in subsection 4, for"

Page 3, line 13, replace "For a taxable year in which a" with "A"

Page 3, line 13, remove "makes an election on the taxpayer's federal"

Page 3, line 14, replace "return" with "may elect"

Page 7, after line 21, insert:

"15. If a taxpayer claims a credit under this section on the taxpayer's original return, the taxpayer's election to calculate the credit under subsections 1, 2, 3, or 4 is binding for the taxable year in which the election is made. A taxpayer claiming a credit for tax years beginning before January 1, 2019, may not file an amended return for the purpose of calculating the credit under subsection 4."

Renumber accordingly

2019 HOUSE APPROPRIATIONS

HB 1111

2019 HOUSE STANDING COMMITTEE MINUTES

Appropriations Committee
Roughrider Room, State Capitol

HB1111
1/31/2019
31894

☐ Subcommittee
☐ Conference Committee

Committee Clerk Risa Bergquist

Explanation or reason for introduction of bill/resolution:

Relating to the alternative simplified method for calculating the research and experimental expenditure credit

Minutes:

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Chairman Delzer: Call the meeting to order for HB 1111.

1:10 Representative Headland: It was brought to my attention during the interim that the current RND credit language was not working for a lot of companies. We discovered that the federal government allowed for an alternative method so as a policy matter the committee decided to support the bill that would allow the state to also offer an alternative method. The committee thought that it was appropriate that if we are going to have it available for research at the manufacturing level that it's a good policy to offer it. It came out of committee at 9-3.

Chairman Delzer: The big issue is the reduction of the general fund, is this mostly to do with small research? Or is this for everybody?

Representative Headland: My understanding is a manufacturer that has been in business for some time, if they have not kept adequate records, under the old method they are having to keep records for 20-30 years.

4:30- Matt Pearl, Tax Department: The RND credit is not just on incurring RND expenses it's for increasing the amount that you have for RND. It's commuted by showing how you increased RND. So it looks at your ratio of RND to sales back to the mid 80's when the credit was first adopted. If you existed back then, you are locked into that ratio. Now that we are 30 years past that, companies are finding that there is no way to know what the right ratio was because there wasn't good record or we were just made aware of it. One of the main criteria is that you have to get over your base amount before you start getting the credit. The feds in 2007 were encountering tax payers having similar concerns so they offered the alternative method.

The alternative methods do two things; it unhitches that computation from the level of sales because it's based on ratio of RND to Sales. If your sales are increasing your RND had to increase at the same rate in order to get over that base. The alternative method gets rid of that sales component part of the calculation and it also uncouples it from the mid 80's or a long time ago, whenever your circumstances would require it and instead it just looks at you prior 3 years of RND. You can now claim the credit if you just have RND.

7:00 Chairman Delzer: How do you define RND?

Mr. Pearl: Qualifying research in developing expenses is defined in federal code, and it is the subject of great controversy.

Representative Nathe: What industries take advantage of this?

Mr. Pearl: I would say across the board; manufactures are the first ones that we would typically think of. A lot of software companies, about 15 years ago the feds changed their requirement for what's required to qualify. They lowered the standers and you can earn it more easily.

Representative Schmidt: We pay a lot to Research ND to give incentives to promote this and now with the 700 thousand dollars as a tax credit?

Mr. Pearl: This tax code already has this credit is out there. I am not sure how Research ND would work compared to this.

Chairman Delzer: This bill is trying to mirror the feds.

Mr. Pearl: That is correct.

Representative J. Nelson: If we don't change this for our tax code does that change things on the federal sides?

Mr. Pearl: No, it can be made on the state return independent to the federal return, it doesn't tie you to one or the other.

Representative Headland: Just to make the committee aware that neighboring states already have this to it's been clear that if we are not going to allow it in ND they can take their RND to a neighboring state.

Chairman Delzer: Any further question? We will work this later, we will put together all the tax bills and we will rework this then. We'll close this hearing for the time being.

2019 HOUSE STANDING COMMITTEE MINUTES

Appropriations Committee Roughrider Room, State Capitol

HB1111
2/6/2019
32262

- ☐ Subcommittee
☐ Conference Committee

Committee Clerk Risa Bergquist

Explanation or reason for introduction of bill/resolution:

Relating to the alternative simplified method for calculating the research and experimental expenditure credit

Minutes:

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Chairman Delzer: We will bring back up the HB 1111, this is a bill that came out of Finance and Tax. I basically align us along with the feds on research and development issues. There is a fiscal note of 700 thousand, it allows certain manufactures in our state to claim some of this on the state side. Came out with a Do Pass 9-3, it's just a question or not if we want to allow general fund revenues be reduced by 700 thousand. What are your wishes?

Representative Beadle: Motion for a Do Pass

Representative B. Anderson: Second

Chairman Delzer: Further discussion?

A Roll Call vote was taken. Yea: 15 Nay: 4 Absent: 2

Motion carries, Representative Dockter will carry this bill.

Chairman Delzer: If there isn't any more discussion we will close this hearing.

Date: 2/6/2019
Roll Call Vote #: 1

**2019 HOUSE STANDING COMMITTEE
ROLL CALL VOTES
BILL/RESOLUTION NO. HB 1111**

House Appropriations Committee

☐ Subcommittee

Amendment LC# or Description: _____

Recommendation: ☐ Adopt Amendment
☒ Do Pass ☐ Do Not Pass ☐ Without Committee Recommendation
☐ As Amended ☐ Rerefer to Appropriations
☐ Place on Consent Calendar
Other Actions: ☐ Reconsider ☐ _____

Motion Made By Representative Beadle Seconded By Representative B. Anderson

Representatives	Yes	No	Representatives	Yes	No
Chairman Delzer	X				
Representative Kempenich	A				
Representative Anderson	X		Representative Schobinger		X
Representative Beadle	X		Representative Vigesaa	X	
Representative Bellew	X				
Representative Brandenburg	A				
Representative Howe	X		Representative Boe		X
Representative Kreidt	X		Representative Holman	X	
Representative Martinson	X		Representative Mock	X	
Representative Meier	X				
Representative Monson		X			
Representative Nathe	X				
Representative J. Nelson	X				
Representative Sanford	X				
Representative Schatz	X				
Representative Schmidt		X			

Total (Yes) 15 No 4

Absent 2

Floor Assignment Representative Dockter

Motion Carries

REPORT OF STANDING COMMITTEE

HB 1111, as engrossed: Appropriations Committee (Rep. Delzer, Chairman)
recommends **DO PASS** (15 YEAS, 4 NAYS, 2 ABSENT AND NOT VOTING).
Engrossed HB 1111 was placed on the Eleventh order on the calendar.

2019 SENATE FINANCE AND TAXATION

HB 1111

2019 SENATE STANDING COMMITTEE MINUTES

Finance and Taxation Committee Lewis and Clark Room, State Capitol

HB 1111
3/4/2019
Job #33092

- ☐ Subcommittee
☐ Conference Committee

Committee Clerk: Alicia Larsgaard

Explanation or reason for introduction of bill/resolution:

A BILL for an Act to amend and reenact section 57-38-30.5 of the North Dakota Century Code, relating to the alternative simplified method for calculating the research and experimental expenditure credit; and to provide an effective date.

Minutes:

Attachments: 0

Chairman Cook: Called the hearing to order on HB 1111.

Representative Craig Headland: Introduced the bill. This bill allows the creation of an alternative method which will help a lot of manufacturers utilize the credit. The old way has become a burden. It has forced manufacturers to keep records dating back 30 years. I think you would probably be best served by letting Matt explain this bill to you. I put this piece of legislation together at the request of the largest manufacturer in my district. They essentially said they couldn't make it work for them anymore without the alternative method. They said they would be forced to move their RND to a neighboring state where an alternative method was allowed.

Matt Peyerl, Tax Department: The current RND tax credit ND was adopted in 1987. It was patterned after a similar federal credit that exists for the same research and development expenditures. It is based on the amount of RND that you spend. It is also based on a relationship of how much sales you have. It is not a credit for spending an RND, it is a credit for increasing the amount of spending on RND. The current law has to have a way of determining how to increase spending. The current structure couples it to your sales you're your sales double, your RND is expected to double and you only get a credit from the incremental amounts beyond the doubling. That is where it is labeled at an increasing RND credit. In the mid-90s the feds adopted an alternative method that did away with that original structure because it recognized that when you are locked into that relationship of your RND to your sales, over time, that becomes less practical because you have some companies that when you are locked into what they did in the mid-80s, might have a very low threshold to get over in order to get the credit. Some might have a very high one. Either way, to be locked into it, was the primary reason the feds offered the alternative method which means you can just get a credit for incurring RND. In exchange for that, the rate is a little lower to offset that. Under the alternative method, more companies will be able to qualify for the credit. That is

why there is a fiscal note on this. There are some companies that do not qualify because of the existing structure of the competition that is required. With opening that up to allow this alternative, more companies will qualify for the credit, thus the negative fiscal impact. One of the highlights is on page 3 which lays out the credit rates. The existing rate is a graduated rate of 25% of the first \$100,000 and then 8%. Under the alternative method, on page 3 line 16, it says the rates are 70% of the regular rate which mirrors the federal alternative method. This is because you are going to get more expenditures qualifying so you get a little less of a rate as an offset.

Chairman Cook: So you get 70% of 25%.

Matt Peyerl: That is correct. Those come out to be 17.5 and 5.6.

Chairman Cook: This seems to be tied quite heavily into federal tax law.

Matt Peyerl: It is based on qualifying RND as defined in federal law which isn't defined clearly. That is what qualifies what is laid out in federal code and regulations.

Senator Dotzenrod: Do we know what this credit is costing the state?

Matt Peyerl: About \$9 - \$10 M per year. This summer, this credit was one of the incentive that interim taxation selected to have the bank of ND use the model for dynamic estimating what the credits, benefits, and costs are. The legislative assembly's website has access to that report. The RND was one of the ones selected and then the new jobs training credit was the other one.

Chairman Cook: Who selected them?

Matt Peyerl: I am not sure who selects those.

Senator Dotzenrod: So the changes in here were modeled after a state near us correct?

Chairman Cook: Another state.

Matt Peyerl: The computation is mirrored after the federal computation. In addition to that, 40 states have income taxes. About 30 have an RND credit and a good number of those offer an alternative method of some sort.

Chairman Cook: Could we have our own definition of research and have our own credit that is free and clear of the federal law?

Matt Peyerl: We certainly could.

Chairman Cook: We will close the hearing on HB 1111.

2019 SENATE STANDING COMMITTEE MINUTES

Finance and Taxation Committee Lewis and Clark Room, State Capitol

HB 1111
3/18/2019
Job 33865

- ☐ Subcommittee
☐ Conference Committee

Committee Clerk: Alicia Larsgaard

Explanation or reason for introduction of bill/resolution:

A BILL for an Act to amend and reenact section 57-38-30.5 of the North Dakota Century Code, relating to the alternative simplified method for calculating the research and experimental expenditure credit; and to provide an effective date.

Minutes:

Attachments: 0

Chairman Cook: Called the committee to order on HB 1111. We have current law deals with the research and experimental expenditures tax credit. This is a simplified method that may make more eligible manufacturers apply for it.

Senator Unruh: We had that in the interim as one of the things we evaluate and this concept in this bill never came up. I have struggled with why we have this in front of us now and why we did not, then.

Chairman Cook: Since the interim, a manufacturer in Jamestown talked to Representative Headland.

2019 SENATE STANDING COMMITTEE MINUTES

Finance and Taxation Committee Lewis and Clark Room, State Capitol

HB 1111
3/20/2019
Job #34006

- ☐ Subcommittee
☐ Conference Committee

Committee Clerk: Alicia Larsgaard

Explanation or reason for introduction of bill/resolution:

A BILL for an Act to amend and reenact section 57-38-30.5 of the North Dakota Century Code, relating to the alternative simplified method for calculating the research and experimental expenditure credit; and to provide an effective date.

Minutes:

Attachments: 0

Chairman Cook: Called the committee to order on HB 1111. This is an alternative method of applying for the research and expenditure credit.

Senator Unruh: We looked at this in the last interim. This did not come up once. No one brought it to the table for consideration. It seemed odd to me that we would have this in front of it now but we did not hear anything of it when we were doing our study.

Chairman Cook: It was after the interim when a manufacturer in Jamestown talked to his legislator about a problem he ran into when applying for it. It is currently connected to federal income tax law. This is a simplified method that separates it from that. The researcher that was a manufacturer in Jamestown did not get his credit. He lost it through an audit. This would help him get it.

Senator Unruh: I am a no.

Senator Unruh: Moved a Do Not Pass on HB 1111.

Senator Meyer: Seconded.

Chairman Cook: Any Discussion?

A Roll Call Vote Was Taken: 2 yeas, 4 nays, 0 absent

Motion Failed

Senator Kannianen: Moved a Do Pass on HB 1111 and Refer to Appropriations.

Senator Dotzenrod: Seconded.

Chairman Cook: Any Discussion?

Senator Dotzenrod: We currently provide a credit under our state law, if it is an income tax credit, for research and for experimental expenditures. This bill allows an alternative to that. That starts on page 3. It is copied out of federal law. Is that a good simplified explanation of what this does? We are not adding a new credit to our law, we are just allowing that credit to be computed in an alternative way.

Chairman Cook: That is the way I read it. I am going to ask someone from the tax department to speak to the fiscal note. How do we get a fiscal note on this when so many other times, it is determined that it is undeterminable?

Dee Wald, General Council: We extrapolated using the data we already had from people already claiming the credit. That is how we came up with this estimate. It is going to cost because it allows some tax payers to claim it, that were unable to before. The main reason for the bill is that right now, the R&D credit requires that you have records going back to 1983 – 1985. This this will allow tax payers who do not have records going back that far or who just started R&D to take the credit.

Senator Dotzenrod: Dee, do you know how many dollars we are currently providing in credits without this bill?

Dee Wald: There are about 20 tax payers that take this credit. The numbers are pretty good. There are a lot of dollars claimed on that. They have been doing R&D in ND for a while.

Senator Kannianen: In my notes, I have it written down that it was around \$9 M - \$10 M annually and the fiscal note would add.

A Roll Call Vote Was Taken: 6 yeas, 0 nays, 0 absent

Motion Carried

Senator Unruh will carry the bill.

Date: 3-20-19
Roll Call Vote #: 1

2019 SENATE STANDING COMMITTEE
ROLL CALL VOTES
BILL/RESOLUTION NO. 1111

Senate Finance and Taxation Committee

☐ Subcommittee

Amendment LC# or Description: _____

Recommendation: ☐ Adopt Amendment
☐ Do Pass ☒ Do Not Pass ☐ Without Committee Recommendation
☐ As Amended ☐ Rerefer to Appropriations
☐ Place on Consent Calendar
Other Actions: ☐ Reconsider ☐ _____

Motion Made By Unruh Seconded By Meyer

Senators	Yes	No	Senators	Yes	No
Chairman Cook		✓	Senator Dotzenrod		✓
Vice Chairman Kannianen		✓			
Senator Meyer	✓				
Senator Patten		✓			
Senator Unruh	✓				

Total (Yes) 2 No 4

Absent 0

Floor Assignment _____

If the vote is on an amendment, briefly indicate intent:

Date: 3-20-19
Roll Call Vote #: 2

2019 SENATE STANDING COMMITTEE
ROLL CALL VOTES
BILL/RESOLUTION NO. ||||

Senate Finance and Taxation Committee

☐ Subcommittee

Amendment LC# or Description: _____

Recommendation: ☐ Adopt Amendment
☒ Do Pass ☐ Do Not Pass ☐ Without Committee Recommendation
☐ As Amended ☒ Rerefer to Appropriations
☐ Place on Consent Calendar
Other Actions: ☐ Reconsider ☐ _____

Motion Made By Kannianen Seconded By Dotzenrod

Senators	Yes	No	Senators	Yes	No
Chairman Cook	✓		Senator Dotzenrod	✓	
Vice Chairman Kannianen	✓				
Senator Meyer	✓				
Senator Patten	✓				
Senator Unruh	✓				

Total (Yes) 6 No 0

Absent 0

Floor Assignment Unruh

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1111, as engrossed: Finance and Taxation Committee (Sen. Cook, Chairman) recommends **DO PASS** and **BE REREFERRED** to the **Appropriations Committee** (6 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). Engrossed HB 1111 was rereferred to the **Appropriations Committee**.

2019 SENATE APPROPRIATIONS

HB 1111

2019 SENATE STANDING COMMITTEE MINUTES

Appropriations Committee Harvest Room, State Capitol

HB 1111
3/26/2019
Job # 34231

- ☐ Subcommittee
☐ Conference Committee

Committee Clerk: Rose Laning / Carie Winings
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Explanation or reason for introduction of bill/resolution:

Relating to the alternative simplified method for calculating the research and experimental expenditure credit.

Minutes:

No Attachments

Legislative Council: Levi Kinnischtzke
OMB: Becky Deichert

Vice-chairman Wanzek: Called the committee to order on HB 1111.

Representative Headland, Bill Sponsor, District 29: Testified as sponsor of HB 1111.

HB 1111 is a bill that would help create an alternative method when calculating the credit for research and development for manufacturers. I would ask that you allow Matt Peyerl to explain how it works. Senator Cook and I put the bill forward for a local manufacturer who brought it to our attention that what was available on the federal tax returns was not available in the state of North Dakota. There were some problems I believe amongst how it was applied and it was viewed differently by different manufacturers. We put the bill forward to make some clarification and also provide for this alternative method. On the fiscal note, what is there is because there would be manufacturers who would qualify now when they use the alternative method versus those that don't have that opportunity.

(2:15) Matt Peyerl, Tax Administration, North Dakota Tax Department:

For some background on HB 1111, North Dakota has an existing income tax credit for increasing R&D expenditures (Research & Development). The one issue is that it is a credit for increasing the amount of R&D. It is not just a credit for having R&D, it is for increasing it. Along with the federal similar credit, North Dakota's credit, needs a method of how you determine if you have increased your R&D. It is not just looking at the flat dollar amount of R&D because \$100,000 twenty years ago isn't viewed the same as \$100,000 now. So, what the computation in existing law provides for is a comparison of your R&D to your sales. That is what pegs your base amount. During the credit, you have to spend dollars on R&D that exceed your base amount. That base amount needs to go back and look at when you first had R&D. It starts way back in the 80s. If you have been incurring R&D since the 80's, it requires you to look at your computation from the 80's to determine what your credit is this year potentially if you have been doing it that long. 15 to 20 years ago, the federal system

changed to provide for an alternative method because it recognized that some companies, when they use that ratio from the 80's, you are locked into it forever. For better or worse. If you had a certain relationship, it might be very hard for you to get a credit in the recent years. Or, some companies benefited by it and so it would be very easy to get a credit. What they provide for in federal law was an alternative method. It did away with using sales to measure your increase in R&D or not. It also did away from anchoring that determination way back in the 80's or way back when you first had R&D. What the alternative method provides for is that it looks at your most recent 3 years, and looks at your R&D compared to that and you don't necessarily need to be increasing your R&D but you get more credit if you have been increasing it. The more significant policy item has been addressed in having an alternative method would be decoupling from that being locked in from that old year, and then also not having it just for increasing your R&D. In exchange for allowing more companies to get the credit using the alternative method, is that the Federal rules provide for a lower rate on the credit as the offset. Or, everybody would go to that method. HB 1111 provides for a rate that is 70% of the regular rate as an offset to make because under this bill you can get a credit for just having R&D as opposed to increasing R&D. If you elect to use the alternative method, the rate would be at 70%, but it is elective. Part of the fiscal impact is that more companies would be able to get the credit, but then with the election you would have some companies that would get maybe a larger credit under this method so they would elect this. They would use whichever method is most beneficial.

(6:10) Senator Wanzek: And that is acceptable?

Matt Peyerl: That is how the bill is written. That is patterned after federal law. One year you could use one method and another year you can use the other method, however, you need to use the most beneficial method. One provision that was added to this bill is that the original bill said "whatever method you use for your federal return, that is the method you have to use on your North Dakota return", and the bill was amended to say that you could use either method on the state return so that you know you are not linked to your federal election; which increased the fiscal note just a bit.

Senator Bekkedahl: What I don't understand is that if you have a base that goes back way to the 80's and you are a large corporation and you have been doing research development since then, it would seem to me that it would be beneficial to keep that base because it is probably pretty low compared to what you are spending. Or your spending over the next 30 or 40 years. This seems like it's more targeted for smaller entities that don't always do research development every year to the very large corporations. Is that what is happening here?

Matt Peyerl: I don't think it is specifically unique to smaller or larger. As far as what happened in the 80s for a company, if you are a large company or a small company, it all has to do in the 80's how much R&D you had to your sales. If you were a brand new company with very small sales with a lot of R&D, that would be the worst position to try and claim the credit under the existing law because your ratio would be very very high. If you grew and had a lot of sales now, it takes that ratio and applies it to this high level of sales and it says you have to have this much R&D to get over that base hump to get into the R&D credit computation. It is all about that relationship back in the 80's – if you existed that long. If you did not exist that long, then it goes back just to when you started existing. It has always been a little bit of an

issues that has existed for as long as the feds have had the method, but it has probably gotten a little bit higher profile since more recently there has been a lot of tax practitioners and consultants that go to companies and tell them what they are doing probably qualifies as R&D. Then that says that if you have always been doing it, you have to go back and look at what you did when you started doing it to figure out if you have been doing more of it proportionately. If you have not been keeping records about how much you did back when you started doing what you are doing, you can't establish that you have been doing more of it. That is one of the policy issues, of the alternative method, that it achieves is that it says that you don't have to go back and try to figure out how much you did back in the 80's, whether it was good, or bad, or otherwise. Now you just look at the most recent 3 years and you are probably more capable to show what your level of R&D was in that more recent time period.

(9:50) Senator Bekkedahl: This is tax credit and its applicable year by year upon application, and there's no carry forward provisions with this because it just takes the current year into account, correct?

Matt Peyerl: It is a tax credit so it's a dollar for dollar tax credit. If you earn \$100,000, it can go against your tax bill for \$100,000. It does have a carry back provision so if your tax bill is only \$80,000 and you earn \$100,000, you can take that \$20,000 and carry it back against last year's tax liability. It also has a carry forward provision. So, if you didn't have any tax liability in the prior three years, you would carry it forward up to the next 15 years. Much like most tax credits, it has a carry forward provision. This one is unique because there are very few that have a carry back provision. This one does.

Senator Bekkedahl: The \$700,000 fiscal note that you've estimated here, that's based on information you have today but that aspect could go up or down in its utilization?

Matt Peyerl: That is the estimate that we have analyzed. There are probably about 30-40 taxpayers, or businesses, that have earned the credit. So we went back and did some recalculating of some of those existing, and estimated that there would be more that can claim it. That is part of the fiscal note, and then there will be some that already earn one, but they will earn a little bit larger one if they choose the alternative method. There kind of two components to that. That is the estimate for a two-year estimate, but it is a rough estimate.

Senator Oehlke: I noticed that it was 2006 when the feds came out with an alternative, simplified method of determining this. Has this been brought before our Finance and Tax Committee since then? Or, is this the first time this has popped up?

Matt Peyerl: This is the first time it has been brought to the legislature. We've had the credit since the late 80's with the regular method. It has been a generous credit for those that qualify. It is not so generous for those that don't. We have had 15-20 companies claim the credit through time. Ten to fifteen years ago the legislature opened it up to provide it to pass-through entities as well. It used to be just for C corporations. Pass-through entities now have it and if they earn it the credit gets passed through to the individual owners on their individual returns to claim. In recent years the popularity of the credit and some of the consultants that are out there that put studies together to say that it's easier – when people think of research

and development, it is not just manufacturers that develop prototypes and so forth. There are a lot of activities that can be potentially claimed to be research and development. It has raised the profile of this quite a bit. When a consultant goes to a trade show and says to all these people that what they are doing is probably R&D, and they say they will do a study for you for 30% of the credit as our fee. They do the study and now you have this credit as far as an audit and issue for the state and the IRS. That is part of the process too. Then the What you're doing is R&D and we're doing the study for 30% of profit. Now it's part of process. If you have this regular method. If you did this before, now how much were you doing. If you were approached in recent years, you were not keeping records so you don't know. You cannot compute something at that point. This alternative method gets away from the catch 22 that you can compute something that you didn't know from 20 years ago. It has just become more of a frequent audit controversy issue.

(15:02) Joan Morris, Controller for Agri-Cover, Inc. Jamestown, North Dakota:

No written testimony but testifying in support of HB 1111.

I'm a certified public accountant and a certified management accountant. Agri-Cover has taken advantage of the North Dakota R&D (Research & Development) tax credit and also the national R&D tax credit. Just to give you a little bit of background about Agri-Cover, I always consider it kind of a poster child of what you would like a company in North Dakota to be. It was founded by two brothers with a high school education. It was started in garage and then moved to Courtney, North Dakota and set up business in an old school house. In 1991, they moved to their present location. They expanded the building that they purchased twice. They added a cold storage building and then in 2002, 2005, and 2017 they moved across the street and built a new factory and then kept adding on to it. Our primary product that you are most aware of is a soft roll-up cover that called the Access Cover on the back of pickups. We also manufacture snow plows and roll-up tarps for the back of agricultural trucks. Our owners are inventors. They employ about 150 people and they are a primary sector business. Over 90% of our product is shipped outside of North Dakota over the US and to Canada. I started at Agri-cover about 15 years ago. As part of that I was the first controller and the first CPA. I brought in some tax experts from Eide Bailly in Fargo. One of the items as we were looking at the business of Agri-Cover and the tax items that they had, was the R&D credit. For the federal R&D credit in the early 2000's you needed a base year as Matt alluded to. Agri-Cover did not have those records. As you are aware, most records require that they are retained for about 7-10 years and then they are destroyed. We looked at the federal regulations and we could not feel comfortable pinning down what our sales and R&D expenses were for those years when the records had been destroyed. In 2008 or 2009 the federal government recognized the fact that a lot of companies were like us and they didn't have those records because of record retention. They were destroyed. They offered the alternative tax credit. ND is one of the 21 states that automatically adopts federal regulations. In visiting with Eide Bailly, at the time they used a consulting group out of Texas. The R&D credit is extremely complicated, so you do use consultants to help you figure out the credit. We used this group out of Texas, and when Eide Bailly brought in-house we went with them. We have two firms that had determined that North Dakota had a credit that would be available to us along with the federal credit. We found out during an audit that North Dakota doesn't recognize the alternative calculations. Therefore, when we were told that all of our credits that we had taken for about 4 or 5 years were going to be tossed out, we were confused. The outside experts were confused. In fact, one of the attorneys from Texas called the North Dakota tax department and said they had looked everywhere to find out why you

have not adopted the alternative tax method. North Dakota automatically adopts all of the federal tax regulations and they were thinking that it should have been adopted. The response back was that there was nothing in writing that they could look at. It was basically department policy that they would not accept the alternative tax credit. They knew it was a problem, but they did not know how to fix it. Agri-Cover was pretty frustrated. The owners are not the type of people that ask for money when they are not eligible for it. We truly believe that we were eligible for the credit based on what the outside experts had told us. We're dealing with Eide Bailly who is one of the largest accounting firms in North Dakota and does a lot of the large manufacturing companies in state and nationally. We were very fortunate that we have a very good North Dakota tax department. We worked with them and we were able to come to some agreement with them. From now on, Agri-Cover is eligible to receive the North Dakota tax credit. I thank them for being willing to work with us. The reason I am here today is because it was a very frustrating and painful experience for our owners. I don't want to see this happen to another business in North Dakota. We asked for help to get it clarified. So that there would be an indication in the law of what North Dakota would accept for the R&D credit.

(20:26) Senator Wanzek: One of the brothers graduated with me in high school. He has impressed me with what they've done and the business that they have grown.

Senator Sorvaag: Thank you for bringing this forward. Eide Bailly contacted me earlier this year about this same issue. I got the word that the chairman of the tax committee was taking it on and I was glad it was being addressed. You're not their only customer that has had problems.

Joan Morris: One of the questions that I put to Eide Bailly was, "what are you going to tell your clients of North Dakota?". You don't know right now if you do or don't qualify. I also asked them if they were going to make them to go through an audit to find out. With this legislation, it will make it clearer for everyone as well as make it easier.

Senator Wanzek: (Asked for further testimony and thanks all those that came to testify.)

Senator Grabinger: Is the tax department on board with this?

Matt Peyerl: I'm providing neutral testimony. It is a policy decision on whether to offer it or not. You heard the benefits of having such a policy as opposed to trying to recreate or estimate records from so long ago.

Senator Grabinger: Would you agree that we have a situation that needed to be corrected?

Matt Peyerl: There is quite a bit of literature at the federal level about why they created the alternative method, and that is kind of help those that are unjustly penalized by being locked into this old computation from the 1980s. What benefit is that serving of locking someone in when you are trying to incent R&D 20 plus years ago. It would seem that at some point in time you would want to unhook yourself from what happened in the 80s. It seems like a pretty reasonable outcome. If our credits are provided for in statute and so it would not be providing alternative methods. Like I mentioned with the alternative method, the rate is a little bit lower

but that is set in statute. It is not a matter of policy as far as trying to offer an alternative method. That is what brings this bill to you today to put it into statute.

Representative Headland: I believe the House and Senate Tax committee have both agreed that if we're going to have a R&D credit, we want one that works for those who are doing it. We moved forward with what we believe is proper.

Senator Bekkedahl: I appreciate the chairman stepping up to do that, but our policy committee did recommend a do pass 6-0 as well.

Vice-chairman Wanzek: Closed the hearing on HB 1111.

2019 SENATE STANDING COMMITTEE MINUTES

Appropriations Committee Harvest Room, State Capitol

HB 1111
3/28/2019
JOB # 34308

- ☐ Subcommittee
☐ Conference Committee

Committee Clerk: Alice Delzer

Explanation or reason for introduction of bill/resolution:

A BILL for an Act re: calculating the research and experimental expenditure credit (DO PASS)

Minutes:

No testimony submitted.

Chairman Holmberg: opened the discussion on HB 1111. All committee members were present except Senator Hogue. Alex Cronquist, Legislative Council and Larry Martin, OMB were also present.

V. Chairman Wanzek: This bill came to us as a result of a manufacturing company in our area. There was some confusion in how the credit for research and development dollars get treated when it comes to the IRS and how it carries over in this state. This bill is clarifying that. They can use an alternative method in determining whether their research dollars investment increased. They had to go back to a base of 20-30 years ago and how they were spending research dollars and compare it today and it doesn't work that well. This is allowing the alternative method which the IRS allows to be utilized in the state. This company had Eide Bailly hired, and Eide Bailly felt that was the case. the tax department said "no, you only have the one option so there was some confusion there and this bill is attempting to clarify that.

Chairman Holmberg: And its \$700,000 fiscal impact.

Senator Mathern: moved a do pass. 2nd by V. Chairman Wanzek.

Senator Dever: I am not sure it should be before this committee.

Chairman Holmberg: But they sent it to us.

Senator Dever: It does represent a reduction of \$700,000. I am just kind of curious if anyone happens to know how many different that companies that might affect. Does that amount affect the one that spoke to us. Is there any sense how many research dollars would be impacted by a reduction of \$700,000?

V. Chairman Wanzek: The CFO of that company spoke to the committee here and she made the statement it would not affect their company, what was done was done, but she felt moving forward it should be clarified for other companies. They went through a lot of problems, they had already taken the credit, then the state came back after they had taken the credit. They took the credit based on the advice of Eide Bailly, their folks that did their tax return, and they had to pay some of that back and this was not retroactive, this is moving forward providing that clarification that they can use one of the two options in determining whether their investment in research and development is increased.

Senator Dever: I think is whether it incentivizes further research and development?

Senator Grabinger: That is the intent. It would allow them that tax deduction going forward.

Senator Bekkedahl: This bill is fairly complicated on the policy side. The policy committee did look at that. I sat on that committee. It did come back as a do pass. So we know the policy in their mind, at least in that committee, is sound policy and they would like to see the clarification. I think it is just for us to decide is the \$700,000 appropriation, is that what we want to allow at this time. the second thing, that \$700,000 is generally taken from tax department research about claims that they've seen in this tax law category already. I don't think in the hearing they gave us any indication of what it would do in the future.

Senator Sorvaag: I was approached by Eide Bailly about this. I talked to the tax department. My understanding it wasn't just the one customer. She stated that Eide Bailly was there. Their problem was, and obviously they made a mistake, its confusion, because its it kind of punishing those that have the right history, or short history. Those with the long history are the ones getting punished, s it was more of an equitable thing of who was qualified and who was not. They never disclosed how many customers. It's really confusing out there, and it's not fair. I agree with Senator Bekkedahl the policy committee looked at this and unanimously thought it was the right thing to do.

Chairman Holmberg: Call the roll on a Do Pass on HB 1111.

A Roll Call vote was taken. Yea: 13; Nay: 0; Absent: 1. This goes back to Finance and Tax. Senator Unruh will carry the bill.

The hearing was closed on HB 1111.

Date: 3-28-19Roll Call Vote #: 1

**2019 SENATE STANDING COMMITTEE
ROLL CALL VOTES
BILL/RESOLUTION NO. 1111**

Senate Appropriations

Committee

☐ Subcommittee

Amendment LC# or Description: _____

Recommendation: ☐ Adopt Amendment
☒ Do Pass ☐ Do Not Pass ☐ Without Committee Recommendation
☐ As Amended ☐ Rerefer to Appropriations
☐ Place on Consent Calendar

Other Actions: ☐ Reconsider ☐ _____

Motion Made By Mathern Seconded By Wanzek

Senators	Yes	No	Senators	Yes	No
Senator Holmberg	<input checked="" type="checkbox"/>		Senator Mathern	<input checked="" type="checkbox"/>	
Senator Krebsbach	<input checked="" type="checkbox"/>		Senator Grabinger	<input checked="" type="checkbox"/>	
Senator Wanzek	<input checked="" type="checkbox"/>		Senator Robinson	<input checked="" type="checkbox"/>	
Senator Erbele	<input checked="" type="checkbox"/>				
Senator Poolman	<input checked="" type="checkbox"/>				
Senator Bekkedahl	<input checked="" type="checkbox"/>				
Senator G. Lee	<input checked="" type="checkbox"/>				
Senator Dever	<input checked="" type="checkbox"/>				
Senator Sorvaag	<input checked="" type="checkbox"/>				
Senator Oehlke	<input checked="" type="checkbox"/>				
Senator Hogue	<u>A</u>				

Total (Yes) 13 No 0Absent 1Floor Assignment F & T unruh

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1111, as engrossed: Appropriations Committee (Sen. Holmberg, Chairman)
recommends **DO PASS** (13 YEAS, 0 NAYS, 1 ABSENT AND NOT VOTING).
Engrossed HB 1111 was placed on the Fourteenth order on the calendar.

2019 TESTIMONY

HB 1111

House Committee on Finance and Taxation
Sixty-Sixth Legislative Assembly of North Dakota

#1
1-9-19
HB 1111
p. 1

Testimony in support of House Bill Number 1111 as introduced by Representative Headland, Representative Dockter, Representative Grueneich, Senator Cook and Senator Wanzek.

Jim Donovan

Partner, National Tax Office at Eide Bailly LLP

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I am honored to provide my observations and experience on the importance of House Bill 1111, not as a lobbyist, but as a resource with eighteen years in public accounting working primarily with the research tax credit at the federal and state level.

Current Law

We are discussing this change to statute as the current law limits the ability for North Dakota taxpayers to calculate, claim, and substantiate the research expense tax credit. The present law provides a single calculation method to taxpayers to calculate the credit. The challenge with the current calculation method is that it can mandate an unreasonable record-keeping standard. In some cases, a taxpayer would need to retain detailed records substantiating qualified research costs and gross receipts from up to 35 years ago. Second, it is very difficult for the state to audit the research credit claims as there is no formal guidance on what constitutes reasonable

substantiation for records that could be up to 35 years old. For example, if a taxpayer has records for 1986 to 1988, but not 1984 to 1985, is it acceptable to extrapolate qualified costs and gross receipts to compute a fixed base percentage? In addition, the availability of the research expense tax credit has not been widely known or understood. Few public accounting firms have the resources available to advise clients on credits and incentives. Taxpayers may have kept older records had they learned of the credit sooner. As a result, many companies pass on attempting to calculate a research tax credit as the record keeping requirements are too burdensome or the records are simply not available, which is why House Bill 1111 is so important as it provides a second option. For comparison purposes, in preparing federal research credit claims, over 90% of my clients utilize the alternative simplified credit. Of those that do use the regular credit method, most companies are recent start-ups that only need to look at recent records which are readily available. For the clear majority of my clients, the records are simply not available or are too challenging to unearth to even assess the benefit of the regular credit calculation.

The Incremental Nature of the Research Tax Credit

Three key goals of the federal research tax credit are to keep jobs in the United States, encourage companies to invest in resources, and to continue innovation. The federal and North Dakota research credit calculations encourage this behavior by making the credits incremental, that is, asking taxpayers to spend more in research costs now than in the past to receive the benefit. To claim a research tax credit, a taxpayer must have current year qualified costs greater than the spend in a base period. The base period under the alternative simplified credit calculation is 50% of the average research expense spend for the three prior years. For the regular credit method, the base amount is function of the average of the prior four years gross receipts multiplied by a fixed

#1

HB 1111

1-9-19

p. 3

base percentage. The fixed base percentage is a ratio of the qualified research expenses over gross receipts for the base period. The base period is defined as 1984 to 1988 for companies in existence with research costs and gross receipts in at least 3 of the five years. Alternatively, for start-up companies, it is an eleven-year window beginning when the taxpayer first has qualified costs. Further detail is available in the next section, but the key takeaway is that record-keeping can be onerous, and the calculations are complicated. Thus, the federal research credit has gone through many iterations since its inception.

History of the Federal Research Credit and North Dakota Impact

The federal R&D tax credit began in 1981 as an alternative simplified credit calculation. In 1989, the federal law was rewritten to set a fixed base period of 1984 to 1988 by calculating a ratio of qualified research costs (QREs) over gross receipts for the same period. This ratio is then multiplied by the average of the prior four years' gross receipts to compute the base amount. In the 1993, the law was adjusted for "start-up companies". A start-up company is defined as a company whose first tax year with both gross receipts and QREs occurred after 1983, or firms that had fewer than three tax years from 1984 to 1988 with both gross receipts and QREs. An eleven-year calculation is laid out in the Internal Revenue Code to determine a fixed base percentage for start-up companies beginning as far back as 1994. In 2006, a bill reintroduced the alternative simplified credit as an option for tax years ending after 12/31/2006 as determining and auditing base periods became too challenging at the federal level with record-keeping requirements exceeding twenty years. While North Dakota had the research expense tax credit, the law was rewritten in 2006 providing for a variety of credit rates depending on when a taxpayer's research started in North Dakota. However, the rules utilized to define the base

1

HB 1111

1-9-18

P. 4

periods available to taxpayers in North Dakota did not include the alternative simplified credit calculation which is why we are here today. The federal and state credit is important to taxpayers as it provides some return on investment on innovation. On a global scale, the federal benefit is not as lucrative as when it was enacted 38 years ago. However, the credit was made permanent in 2015 as a testament to its importance.

Experience

The companies that have been penalized under the current law are those that have a long history in North Dakota, the “brick and mortar” or manufacturing businesses. These companies may have a long history of research and development, but ownership has changed, or the taxpayer simply wasn’t aware of the research credit until after records from over 30 years ago were destroyed. Taxpayers often assess the research credit with the maximum (16%) fixed base percentage if they are unable to substantiate a base period. In most cases, with federal gross receipts being used in the credit calculation, a qualifying taxpayer cannot clear the base amount in order to qualify for a North Dakota credit even though they qualify for a federal credit and qualify for credits in other states due to the availability of the alternative simplified calculation.

Surrounding States with Research Tax Credits

North Dakota competes with the surrounding states for businesses and jobs. The research expense tax credit is one tool to lure and keep businesses in the state. While Montana and South Dakota don’t offer a research tax credit, Nebraska, Iowa, and Wisconsin offer a version of the alternative simplified credit calculation. Minnesota does not offer an alternative simplified credit calculation yet, but it was introduced in 2016 and failed to pass. In addition, Minnesota increased

#1
HB 1111
1-9-19
P. 5

their second-tier credit rate for 2017 (from 2.5% to 4%) and utilizes apportioned gross receipts versus federal gross receipts as North Dakota does, which usually makes the hurdle amount lower. House Bill 1111 makes it easier to calculate, claim, and substantiate the research expense tax credit which may increase utilization of the credit and help spur growth in desirable job sectors.

Recommendation

The language on page 3, item 4, line 13 reads “For a taxable year in which a taxpayer makes an election on the taxpayer’s federal return to use the alternative simplified credit under section 41(c)(5) of the Internal Revenue Code...” Consideration should be given to changing item 4 to allow taxpayers the option to elect between the alternative simplified method and the regular method for North Dakota credit purposes regardless of the method employed for the federal credit. This would ensure that a qualifying taxpayer is more likely to be able to utilize some amount of credit. For example, a taxpayer may have substantial research expenses in other states where the regular method of computing the research credit may provide a better benefit at the federal level versus the alternative simplified credit. However, with the taxpayer having less qualified costs in North Dakota and the application of federal gross receipts in the credit calculation, the taxpayer may only be able to benefit from the research credit using the alternative simplified method in North Dakota.

#1
HB 1111
1-16-19

Prepared by the
Office of State Tax Commissioner
House Finance & Taxation
19.0493.01000

PROPOSED AMENDMENTS TO HOUSE BILL NO. 1111

Page 2, line 19, overstrike "For" and insert immediately thereafter "Except as provided in subsection 4, for"

Page 3, line 5, overstrike "For" and insert immediately thereafter "Except as provided in subsection 4, for"

Page 3, line 13, replace "For a taxable years in which a" with "A"

Page 3, line 13, replace "makes an election on the taxpayer's federal" with "may elect"

Page 3, line 14, remove "return"

Page 7, after line 21, insert:

15. If a taxpayer claims a credit under this section on its original return, the taxpayer's election to calculate the credit under subsections 1, 2, 3, or 4 is binding for the taxable year in which the election is made. A taxpayer claiming a credit for tax years beginning before January 1, 2019, may not file an amended return for the purpose of calculating the credit under subsection 4.

Renumber accordingly