Issue Memorandum 05-02

Economic Development in South Dakota
Incentives for Growth and Advancement

This Memorandum has been composed consistent with the intent that it provide an inventory of the inducements and stimuli available in South Dakota to encourage economic advancement. Thus, the format is a description of the available mechanisms which will promote economic development more than it is a dissection of a particular issue. Following, the reader will find brief descriptions of the methods and tools available for use in our state as well as a recitation of the model adopted by the Governor's Office Economic Development in support of its mission.

State Tax Incentives for Economic Development

Ethanol Production (10-47): The production and sale of ethanol based fuel is promoted by a preferential fuel tax rate of $.20/gallon of ethanol blended gasoline (vs. $.22/gallon for regular gasoline). Ethanol producers are also eligible for production incentive payments of twenty (20) cents/gallon for ethyl alcohol produced in South Dakota and blended with gasoline not to exceed payments of $1 MM annually and $10 MM cumulatively per facility. The source of the funds for the production incentive payments is the petroleum release compensation and tank inspection fund (34A-13-20) and the capitol construction fund (5-27-4) A cap of total funds available in the amount of $ 7,000,000 has been established for all producers for FY 2006 and thereafter with payments to be prorated if necessary. (10-47B-162)

Bank Franchise Tax (10-43): The Franchise Tax applies to financial institutions of many different types including banks, small loan companies and ready or quick loan companies. The tax is imposed upon net income at the rate of 6%. The structure of the tax offers rate relief to very large organizations. If net profits exceed $400 million, the rate decreases to 5% and further decreases in increments until the lowest rate of ¼ of 1% is reached. This lowest rate applies to net income in excess of $1.2 billion. This decreasing rate encourages the recruitment and retention of large financial institutions as well as the expansion of financial operations. The definition of a financial institution has also been modified to exclude certain intra-corporate treasury functions which is enticing to headquarters operations.

Sales and Use Tax: The application of these taxes is sometimes restricted in order to achieve an environment or condition attractive to economic development.

Following is list of those sales, and use tax exemption provisions which seem most likely to have been adopted with such development in mind.

> Merchandise imported into South Dakota into a foreign trade zone within the state. Merchandise in this context is personal property held primarily for sale and which will be shipped in international commerce to a point outside the United State and will not be returned to the United States. (SDCL 10-45-10.3)
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> Gross receipts from international sales of agricultural and industrial equipment are exempt from sales tax when physical delivery of the equipment takes place in South Dakota but the equipment is to be shipped to a point outside the United States and will not be returned to the United States (SDCL 10-45-93).
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> Toll free (800) telephone service unless the call originates and terminates in SD; sale of telecommunication service to another telecommunication service provider; and certain qualified call centers (SDCL 10-45-6.1).
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> Farm product warehousing and storage (SDCL 10-45-12.1).
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> Consumer credit reporting services, mercantile reporting agency and collection agencies (SDCL 10-45-12.1).
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> Sale of live game birds to nonprofits or commercial hunting operators (SDCL 10-45-18.1).
>
> Payments between member of a control group-3rd party services and payments between related corporations (SDCL 10-45-20.2, 20.5).
>
> Raw material, parts, and newsprint for manufacturing or products (SDCL 10-46-9).

<u>Unemployment Insurance</u>: The average unemployment insurance rate for experienced employers is 0.9 percent. The wage base remains at $7,000, the lowest allowed. For new employers the rate is 1.9 percent for the first year's operation and 1.7 percent for the second year if the company's account balance is positive. Thereafter, the rate is based on the company's experience.

<u>Worker's Compensation</u>: $2.89 per $100 payroll is the average rate a manufacturer can expect to pay in South Dakota. South Dakota manufacturers can insure workers by the type of work done, not the overall company code. South Dakota workers compensation is not charged against vacation, sick or holiday pay which can save you approximately 10 percent on workers compensation costs. In South Dakota, insurers are permitted to apply up to a 25 percent credit on a company's final workers compensation premium if the company qualifies after a safety or loss control inspection, and if the company agrees to the safety recommendations of the insurer.

Local Tax Incentives for Economic Development

County Property Tax Incentives—Discretionary Formula (SDCL 10-6-35.2 thru 35.4)

Counties may attempt to attract economic development by offering inducements in the form of reduced property tax obligations for a period not exceed 5 years. The reduction may be incremental, the most common being a 20% reduction in the first year, 40% in the second year, 60% in the third year, 80% in the fourth year and 100% thereafter, or the county may offer a 100% reduction for all years not to exceed five. However, for state aid purposes (after November 1, 1995) any property receiving discretionary formula treatment shall be included as local effort as follows: 20% of the assessed valuation in the first year, 40% in the second year, 60% in the third year, 80% in the fourth year and 100% thereafter. This provision has forced most counties to adopt the 20-40-60-80 formula in order to protect their school districts.

If the county has not adopted a discretionary formula, a municipality may adopt such a formula for new industrial structures or commercial residential structures and improvements to either or any new commercial structures (structure or improvement must be $30,000+ in value) or for any structures within the three-mile limit of the municipal boundary.

Tax Increment Financing Districts (SDCL 11-9, 13-13-10.2):

To initiate and support economic development in specific areas, municipalities (municipalities includes counties for the purposes of Chapter 11-9) may, by resolution, establish a contiguous geographic area with defined boundaries as a tax incremental financing district (hereinafter, TIF). The assessed value of property within the TIF is determined as of its creation which establishes the amount of assessed value available to the cities, counties and schools for tax purposes during the time the district is in effect. Increases in assessed valuations and the resulting tax revenues due to improvements within the district are available to the municipality to pay for development while the assessed values of the property at the time of the designation as a TIF will continue to generate tax revenues for conventional purposes. The municipality may issue bonds or notes to pay for project costs or to reimburse the municipality for improvements made within the district. The bonds or notes are paid off using the positive tax increments. Improvements which the municipality may make include public works, structures and permanent fixtures, equipment, demolition, repair, remodeling, relocation, financing, professional services and other necessary costs to implement the project. No tax increments may be used for the construction of residential structures.

The municipality creates and implements a project which includes the purchase or condemnation of real or personal property within the TIF. A TIF district must involve the ‘reclamation’ of blighted property which must constitute at least 25% of the total TIF area and the improvement envisioned by the TIF must be likely to enhance significantly the value of substantially all the real property in the TIF. Blighted property is broadly defined and includes slums, poorly configured property, overcrowded property, problem titles or dangerous conditions that impairs or menaces the community as a whole. Open areas that “impair the sound growth of a municipality” also constitute blighted areas.

Effect of TIF on local governments:
All levels of local government, except for schools, have the amount of money they can collect from their taxpayers “capped.” This means that when property values rise in an area, the tax rates are automatically lowered, to ensure that the caps are not exceeded. The local governments cannot exceed the caps unless they choose to opt-out, which is subject to a public vote.

The caps are calculated based on the amount of property tax money the entity collected the previous year, plus an adjustment for inflation and for growth. When someone builds a new factory outside of a TIF district, this is immediately counted as growth. If a $1 million factory is built in a city with $100 million of assessed value, then the local government had 1% of “growth” from the factory. This means that the city can increase the amount of money it collects from property taxes by 1%. A TIF district delays the addition of that 1% growth to the city’s budget until the TIF bonds are paid off. TIFs affect schools as follows: SB104 which became law after the 2004 legislative session limits the effects of creating a TIF on local school districts. Before SB 104, the “increment” value for most TIFs was included in the calculation of the local effort for the school district. This meant that a school district would not be able to raise all of the local money necessary to fund the school because of the TIF. Initially, positive tax increments go to pay off the TIF bonds. To ensure that school districts receive all of the money needed, an additional levy would be assessed on the rest of the taxpayers in the school district to make up for that amount until it becomes available after repayment of the bonds or notes.

SB 104 (now SDCL 13-13-10.2) changed the law so that the “increment” value in most TIFs is not counted as local effort. This means that most TIFs no longer have an effect on the school district. This change does add a very small cost to property tax owners statewide. Not counting the TIF "increment" value until the bonds are paid off means that this value is not used when the Legislature calculates the school property tax rates. However, it takes about $73 million of TIF “increment” value to change the statewide school property tax rates one penny for every $1,000 of assessed value.

Business Improvement Districts (SDCL 9-55):

Any municipality may establish one or more business improvement districts in an area zoned for business, public, or commercial purposes. The property in the district does not need to be contiguous. The mayor, with the approval of the governing body, shall appoint the members to the business improvement board which makes recommendations as to the nature of the district. The municipality may impose a special assessment upon the property in the district or an occupational tax on the businesses and users of space within the district. The money generated may be used for many purposes including the construction, maintenance and repair of public improvements and utilities as well the development and promotion of events in the district area. The total amounts of any special assessment or occupation tax may not affect any assessments previously levied and must be used solely for the purposes specified in the resolution establishing the district. If the occupational tax is based on rooms rented by a lodging establishment, the tax shall be imposed on the transient guest and such tax may not exceed two dollars per occupied room per night. The municipality may issue bonds which are repayable from the proceeds of the special assessment or the occupation tax or both.

Power Production Facilities (SDCL 10-45B, 10-46C, 49-34A, 10-4-36 thru 38):

Agricultural Processing facilities: The builder may obtain a contractor's excise tax refund for a new structure (not expansions) dedicated to processing agricultural commodities or products (not involving livestock) and a sales and use tax refund for agricultural processing equipment. The project cost must exceed $4,500,000 and the application for refund made within thirty-six months of the approval of the permit required to be issued before a qualifying project begins.

Power Production Facilities: Contractor's excise tax is imposed but at the preferential rate of 1% on the construction or expansion of a commercial power production facility using renewable resources such as sun, wind, geothermal or biomass, to produce more than 10 megawatts of electricity.

Small Power Production Facilities: Construction or expansion of a small power production facility entitles the builder to a refund of contractor's excise tax if the facility uses renewable resources such as sun, wind, geothermal or biomass, produces NOT more than 10 megawatts of electricity and is located within one county.

Wind Energy Property: Property and equipment used in the production of electricity from wind resources is taxed under local property tax provisions in the same manner as other real property is assessed and taxed locally. The property subject to local taxation includes the base, foundation, tower and substation but not the wind turbine nor the blades. Wind energy property does not qualify for discretionary formula treatment as may be otherwise authorized in Title 10.

Governor's Office of Economic Development

The Governor's Office of Economic Development (GOED) works to bring diversity and strength to the South Dakota economy. GOED uses technical assistance, low interest loans and grants to retain and expand existing businesses, assist start ups, and recruit out-of-state businesses.

In-State Business Retention/Expansion: The GOED plays a vital role in encouraging South Dakota businesses to expand their operations within the state. In the Sales & Community Development division there are a manager/lead representative and four regional representatives assigned to particular regions in the state. Their duties include visiting local manufacturers, business services, call centers, etc. to promote and offer the GOED's assistance in any expansion plans they may have and to assist or help find assistance for any detriments to growth the company may be experiencing.

Business Recruitment**:** Out-of-state recruitment efforts focus on bringing businesses into the state primarily in the form of expansions, but sometimes as relocations. This division is the first point of contact with manufacturers, back office operations, business services, etc. as well as site selection consultants who have expressed an interest in South Dakota. The manager and regional representatives provide site selection expertise, financial incentives information, and host prospective companies/consultants to South Dakota. The regional reps work closely with community economic development corporations to provide the most complete and accurate information to prospective clients.

Community Development**:** The Community Development Block Grant staff and regional representatives also work closely with the communities to help prepare the communities for development. Economic development is many things to many people, and the four regions in the state have unique development issues, the GOED looks to the communities to provide direction on the technical assistance needed. Whether the goal is recruiting a manufacturer, or possibly retaining the local grocery store, the GOED works with the community to try to achieve its goals.

The GOED partners with other entities in the state to bring necessary technical assistance to local community development, and it also encourages a regional, cooperative approach to economic development. GOED also administers the State's annual Community Development Block Grant allocation from the US Department of Housing and Urban Development.

REDI Fund Program: The REDI (Revolving Economic Development and Initiative) Fund is designed to help promote job growth in South Dakota. This low interest loan fund is available to start-up firms and businesses that are expanding or relocating.

This fund provides permanent financing for the purchase of land and associated site improvements, construction, acquisition, renovations of buildings and equipment. It also can be used to help cover fees, services and other costs associated with construction. The REDI fund was created by the Governor and the Legislature in 1987 through a one percent increase in the general sales and use tax. The resulting amount of $40 MM was deposited in a revolving fund which is depleted by loans and restored by loan repayments and earnings.

The REDI Fund works by lending to companies based upon projected jobs created, with the total loan amount being no greater than 45 percent of the total project costs. Companies should secure matching funds and be able to provide a 10 percent minimum equity contribution before applying to the Board of Economic Development for a REDI Fund loan.

Interest rates have remained at 3 percent since the program's inception, and loans are amortized up to 20 years on a building and 10 years on equipment, with a balloon payment due after five years.

Economic Development Finance Authority (EDFA): Another financing option available in South Dakota is the Pooled Bond Program, available through the state's Economic Development Finance Authority (EDFA). This loan program, designed for more capital intensive projects, provides small businesses access to the public bond market through the issuance of tax exempt bonds. The program can fund projects individually or pool them to help lower the cost of the bond issuance. One of the biggest advantages of this program is that borrowers are guaranteed a long-term loan and a fixed interest rate.

Another benefit is the EDFA's "A" rating by Standard and Poor's. By maintaining an "A" rating, EDFA is able to offer a lower interest rate to the borrower.

This program is open to for-profit manufacturing businesses. The bonds can be used for three main purposes: construction; storage, distribution or manufacturing of products; or the purchase of new machinery and equipment used in an industrial process. Our tax-exempt bonds can fund project costs up to $10 million. We also offer taxable bonds that do not limit the project cost amount. The funding source for this program is the money raised by the sale of the bonds described in this paragraph.

APEX Loan Program: The APEX Loan Program is designed to assist companies in communities with a population of 10,000 or less. The program is open to for-profit businesses and some non-profit businesses. The money can be used to purchase land, purchase equipment, or buy or renovate a building.

The program may provide up to 75 percent of the total project costs and requires 10 percent minimum equity contribution. The loans are amortized over the useful life of the assets and have a 5 percent interest rate with a balloon payment at six years. The funding source is federal funds provided by USDA Rural Development. The fund regenerates as loans are repaid.

Workforce Development Program: The state's main funding source for training is the Workforce Development Program. Through matching grants, this program funds industry-education partnerships. The program supports three types of training: new employee training, current employee retraining and current employee upgrade training. Training of hard skills, those skills that deal with the technical aspects of the job, is the main goal of this program. The state does, however, recognize that soft skills and basic academic skills are also an important part of a successful training project. The program is designed as a 50/50 match-funding source. Every Workforce Development dollar must be matched with private sector contributions – either financial or in-kind. The funding source for this program is the Future Fund which is described under its own heading in this document.

<u>Value-Added Agriculture and Tourism Subfunds</u>: The Agricultural Subfund was created in 1999 to assist in funding feasibility and marketing studies for prospective value-added agricultural businesses. The funding source for this subfund is a $3 MM loan from the REDI Fund and a three (3) cent/gallon reallocation from the program for off-road motor fuel refunds. The Tourism Subfund is earmarked for feasibility studies and marketing of value-added tourism projects. The funding source is a $3 MM loan from the REDI Fund.

<u>MicroLOAN Program:</u> This program was designed to help small businesses grow and help rural communities remain viable. It is the first GOED financing program that offers businesses access to working capital and it is subordinated debt.

Local banks must fund at least 50 percent of the project costs. The state may fund up to 50 percent of the project costs, but not more than $50,000. Total project costs may not exceed $200,000. The interest rate is 3 percent. The funding source for this program is a $3 MM loan from the REDI Fund.

<u>Capital Investment Equity Program:</u> The purpose of this program is two-fold: allowing borrowers to increase their investment in South Dakota companies and enabling them to invest in more companies. Qualifying applicants will be able to secure a loan whose proceeds can be used to invest in other worthy South Dakota businesses. The funding source for this program is a loan, not to exceed $12 MM from the REDI Fund.

<u>Entrepreneur Support Program:</u> This program was established to provide financial assistance to people who have an idea for a new business, but lack all the capital necessary to breathe life into their idea. If approved for a loan, the borrower may be entitled to a 3-year debt service holiday, three years with no interest or principal payments. After the debt-service holiday period, the loan may be amortized over 12 years with monthly payments and a balloon payment after the fourth year. The funding source for this program is a loan, not to exceed $3 MM from the REDI Fund.

<u>Future Fund:</u> The Future Fund is a grant program created to stimulate economic development generally as well as increasing research capacity at the state's universities for purposes of commercializing innovations and building the South Dakota workforce for new and expanding employers. The funding source for the

Future Fund is certain employer contributions to the Unemployment Insurance Trust Fund.

This issue memorandum was prepared by James Fry, Director of the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council. The information contained in the memorandum is accurate as of the date of publication.
