Prepared by the North Dakota Legislative Council
staff for the Taxation Committee
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INCOME TAX CREDIT STUDY - BACKGROUND MEMORANDUM

The Legislative Management has assigned to the Taxation Committee a study of the state's income tax credits as described in Section 6 of 2011 Senate Bill No. 2006. The study must involve the Tax Commissioner and include an inventory of all of the state's income tax credits, a review of the nature of each credit, an indication of the targeted class of recipients of each credit, an analysis of possible barriers to using the credits, an analysis of possible gaps and overlaps in the state's income tax credits, the relationship of state income tax credits to federal tax policy, and a review of the effectiveness of each credit.

The committee also has been assigned a separate study of corporate income taxes, and a separate background memorandum has been prepared for that study. This memorandum provides background for the individual income tax portion of the study.

INDIVIDUAL INCOME TAX RATES HISTORY

In 1919 the state's first income tax law was enacted. Earned income and unearned income of individuals were taxed at different rates. In 1923 the individual income tax was revised to follow federal income tax law, the distinction between earned and unearned income was eliminated, and rates were adjusted to range from 1 percent on the first $2,000 to a high rate of 6 percent on income over $10,000.

In 1933 individual income tax rates were adjusted so that the highest rate was 15 percent on taxable income over $15,000. In 1953 state income tax rates were decreased with the lowest rate set at 1 percent of the first $3,000, and the highest rate was reduced to 11 percent of taxable income over $15,000. In 1973 income tax rates were changed to include a lowest rate of 1 percent and a highest rate of 10 percent on income over $8,000.

In 1978 voters of the state approved an initiated measure that reduced individual income tax rates and increased corporate income tax rates. The initiated measure adjusted the income brackets and imposed a top individual income tax rate of 7.5 percent on income in excess of $30,000.

In 1980 the voters of the state again approved an initiated measure to create a state oil extraction tax. The measure included creation of the energy cost relief credit to allow individual income taxpayers a credit of up to $100 against state income tax liability.

In 1981 the Legislative Assembly created a simplified optional method of computing individual income taxes (the "short-form" method) which allowed most individual income taxpayers a substantial income tax liability reduction. The simplified optional method of computing individual income tax liability provided that individual liability was equal to 7.5 percent of the individual's adjusted federal income tax liability. The preexisting method of determining income tax liability based upon a percentage of federal taxable income ("long form") was retained, and from 1981 through 2008 taxpayers had the option of filing under two different methods. For the great majority of individuals, the "short-form" return provided a considerably lower tax liability than the tax determined using the state long-form return.

In 1983 several actions combined to increase individual tax liability. The 1983 changes were all enacted as temporary measures and provided the following changes:

1. Suspension of the $100 energy cost-relief credit.
2. Increase of the tax rate on the short-form return from 7.5 percent to 10.5 percent of adjusted federal income tax liability.
3. Adjustment of the rates on the individual long-form return to provide rates ranging from 2 percent of taxable income up to $3,000 to 9 percent on taxable income in excess of $50,000.

In 1985 the temporary changes made in 1983 were made permanent law. In the 1986 special legislative session, legislation was enacted to provide mandatory state income tax withholding for all employees subject to federal income tax withholding, to increase the short-form tax rate from 10.5 percent to 14 percent of federal tax liability, and to increase long-form rates by an equivalent percentage to provide a highest rate of 12 percent on income exceeding $50,000. The 1986 special legislative session changes were referred and approved by state voters on March 18, 1987.

In 1987 a 10 percent surtax on state individual income tax liability was created to apply only for taxable year 1987.

In 1989 the Legislative Assembly increased the short-form income tax rate from 14 percent to 17 percent of adjusted federal income tax liability and increased long-form rates by corresponding percentages. The legislation providing these rate increases was referred and defeated by the voters in the December 1989 special election.

In 2001 the Legislative Assembly revised the application of the "short-form" method. This change eliminated reliance on federal income tax liability as a starting point for the short-form return and substituted use of federal taxable income as the starting point to calculate North Dakota taxable income. This method is roughly equivalent to the previous method because it applied a set of graduated tax rates that were 14 percent of the federal tax rates at the time and the rates were applied to five income brackets, which were established to mirror federal brackets at that time. In addition, the 2001 legislation established use of the same inflation indexing factor that applies under federal law so that the income brackets will keep pace with changes to federal income brackets. To reflect the fact that the vast majority of taxpayers file under this method, the statutory reference to an "optional" method of computing tax was moved from the "short-form" to the "long-form" return method. In addition, references to "short form" and "long form" were replaced by the Tax Commissioner with references to "Form ND-1" (previous "short form") and "Form ND-2" (previous "long form"). In 2009 the optional filing method on the Form ND-2 (previous "long form") was eliminated.

Individual income tax rates for the five income brackets for each filing status were established in 2001 and reduced by legislation enacted in 2009 and 2011. The tax rates against North Dakota taxable income after these legislative changes were:

2001	2009	2011
2.1%	1.84%	1.51%
3.92%	3.44%	2.82%
4.34%	3.81%	3.13%
5.04%	4.42%	3.63%
5.54%	4.86%	3.99%

The cumulative effect of these reductions is a decrease in tax rates of approximately 28 percent in 10 years. In addition, 2007 legislation provided an income tax credit in the amount of 10 percent of property taxes paid in 2007 and 2008.

INDIVIDUAL INCOME TAX DEDUCTIONS

Several deductions are available to individual taxpayers which allow subtraction of deductible amounts to determine North Dakota taxable income before application of income tax rates to determine liability. The available deductions are:

1. Interest income from United States obligations.
2. Net long-term capital gain.
3. Native American exempt income.
4. United States Railroad Retirement Board benefits.
5. Income from financial institutions received from a passthrough entity subject to financial institution taxes.
6. National Guard or reserve member exclusion for federal active duty compensation.
7. Servicemembers Civil Relief Act adjustment for military service members' compensation received while a nonresident of North Dakota.
8. College SAVE contributions.
9. Qualified dividend exclusion.
10. Renaissance zone income exemption.
11. New or expanding business income exemption.
12. Human organ donor deduction.
13. Employee workforce recruitment exclusion.
14. Marriage penalty deduction.
15. Nonresident mobile workforce exclusion, effective in 2013.

INDIVIDUAL INCOME TAX CREDITS

The Tax Department has compiled and will present to the committee an inventory of individual and corporate income tax credits, the apparent purpose or objective of each credit, the targeted class of taxpayers for each credit, and the dollar amount claimed for each credit.