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

Senate Concurrent Resolution No. 4031 (attached as Appendix A) directs a study of the state corporate income tax laws. The resolution states that "consideration should be given to the feasibility and desirability of eliminating the corporate income tax, eliminating the deduction for federal corporate income taxes paid, or making other changes that will provide a corporate income tax rate that would enhance the attractiveness of the business climate of this state."

## CORPORATE INCOME TAX RATES HISTORY

Corporate income taxes were first imposed in North Dakota in 1919, with the imposition of a flat-rate tax of 3 percent on total net income of corporations. The 1919 legislation also imposed an additional tax of 5 percent on total net income of corporations received during a calendar or fiscal year and remaining undistributed six months after the end of that year.

In 1923 the corporate income tax was imposed at a flat rate of 3 percent of net income taxable to this state, and provisions were added for allocation of income to the state. The 5 percent additional tax on undistributed income was eliminated.

In 1937 a graduated corporate income tax rate structure was created. The highest rate, 6 percent, was applied to corporate income exceeding $15,000 per year.

In 1978 an initiated measure was approved by the voters to add a rate of 8.5 percent for corporate taxable income exceeding $25,000.

In 1981 the highest corporate income tax rate was reduced to 7 percent and applied to income exceeding $50,000 per year.

In 1983 corporate income tax rates were increased by 50 percent. After the 1983 changes, which are still in effect, North Dakota corporate income tax rates are as follows:

| Taxable Income | Taxable Rate |
|---|---|
| $3,000 or less | 3.0% |
| Over $3,000 but not over $8,000 | 4.5% |
| Over $8,000 but not over $20,000 | 6.0% |
| Over $20,000 but not over $30,000 | 7.5% |
| Over $30,000 but not over $50,000 | 9.0% |
| Over $50,000 | 10.5% |

## EXEMPT CORPORATIONS

Under North Dakota Century Code (NDCC) Section 57-38-09(3), an insurance company paying the insurance premiums tax is exempt from the corporate income tax. Under NDCC Section 26.1-03-17, an insurance company is subject to a tax on gross premiums at a rate of 2 percent for life insurance, 1.75 percent with respect to accident and health insurance, and 1.75 percent with respect to all other lines of insurance. Because special taxes are paid on premiums, insurance companies are not also subjected to corporate income taxes on earnings from those premiums. However, to the extent an insurance company has earnings from business activities not subject to insurance premiums taxes, those earnings are subject to corporate income taxes.

Under NDCC Section 57-35.3-04, financial institutions paying a financial institutions tax are exempt from corporate income taxes. Financial institutions pay a tax of 7 percent of taxable income.

Under NDCC Section 57-38-09(1), any organization exempt from the federal income tax is exempt from state income taxes. A substantial number of corporations, including several kinds of nonprofit corporations, are exempt from federal income taxes under the Internal Revenue Code (IRC). The most common basis for invoking tax-exempt status is provided by IRC Section 501(c)(3), which provides an exemption for organizations operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes or to foster national or international sports competition or prevent cruelty to children or animals. Other IRC provisions provide exemptions for civil leagues or social welfare organizations; labor, agricultural, or horticultural organizations; business leagues, chambers of commerce, real estate boards, and boards of trade; social clubs; credit unions; farmers' cooperatives; political parties; homeowners' associations; fraternal beneficiary societies; cemetery companies; local life insurance associations; mutual irrigation companies; or mutual or cooperative telephone companies or similar organizations; certain insurance companies; certain United States instrumentalities; teachers' local retirement fund associations; certain fraternal organizations; farmers' cooperative associations; certain veterans' organizations; qualified state tuition programs; and certain other special purpose corporations.

Tax-exempt status may not relieve a corporation of the obligation to file a North Dakota corporate income tax return. For example, returns must be filed by cooperative corporations that distribute their net income through patronage dividends, insurance companies having income from sources other than insurance premiums, and tax-exempt nonprofit corporations having unrelated business taxable income.

## CORPORATE TAXABLE YEAR AND RETURN DUE DATE

A corporate taxable year may be, but is not required to be, a calendar year. Many corporations operate on a fiscal year basis and may choose the beginning and ending dates for their taxable years. The federal corporate income tax return is due March 15 after the close of the calendar year, if the return is on a calendar-year basis, or by the 15th day of the third calendar month after the close of the fiscal year, for a corporation filing on a fiscal-year basis. The North Dakota corporate income tax return is due April 15, following the close of the calendar year, for a corporation filing on a calendar-year basis, or by the 15th day of the fourth month after the close of the fiscal year, for a corporation filing on a fiscal-year basis.

## TAXABLE INCOME OF CORPORATIONS

The starting point for determination of North Dakota corporate income taxes is the corporation’s federal taxable income. Corporate taxable income can be an extremely complicated calculation but simply stated consists of gross income minus deductions. Federal gross income generally includes gross profit, determined by totaling gross sales and gross receipts from services minus the cost of goods sold; receipts from dividends, interest, rents, and royalties; net gain on sales or exchanges; and other income. Deductible expenses include salaries and wages of officers and employees, repairs, bad debts, rents, taxes, interest expenses, losses on sales or exchanges, contributions, amortization, depreciation, depletion, advertising, pension and profit-sharing, employee benefits, casualty losses, research and experimental costs, and certain other special deductions.

The North Dakota corporate income tax applies only to the portion of a corporation’s taxable income that is derived from sources within North Dakota. A corporation that conducts business only within North Dakota uses its federal taxable income as its North Dakota taxable income. A corporation that conducts business inside and outside North Dakota must apportion its federal taxable income to determine the portion that is attributable to sources within North Dakota. The apportionment factor is a percentage that is the average of North Dakota property, payroll, and sales compared to the corporation’s total property, payroll, and sales. Attached as Appendix B is an article comparing use of corporate income apportionment formulas among the states and comparing efforts to encourage manufacturers to locate in a state.

## COMBINED REPORTING REQUIREMENTS

A corporation that is part of a unitary business involving one or more corporations, including consideration of operations outside the United States, must file using the combined reporting method. A "unitary business" is a group of corporations carrying on activities that transfer value among themselves through the unities of ownership, operation, and use. Unity of ownership means the group is under the common control of a single corporation, which is also a member of the group. Control exists when the controlling corporation directly or indirectly owns more than 50 percent of the voting stock of a controlled corporation. Unity of operation means the group receives benefits from functional integration or economies of scale. Unity of use means the group of corporations contributes to or receives benefits from centralized management and policy formation. When unity of ownership exists, there is a presumption that the corporations are engaged in a unitary business if all activities of the group are in the same general line or type of business, activities of the group constitute different steps in a vertically structured enterprise, or the group is characterized by centralized management.

North Dakota is one of twenty-three states that have adopted the Uniform Division of Income Tax Act. This Act is codified as NDCC Chapter 57-38.1 and provides for apportionment of corporate income and contains detailed provisions relating to property, payroll, and sales factor computations.

## WATER'S EDGE ELECTION

A corporation required to file its North Dakota return using the worldwide unity combined reporting method may elect under NDCC Chapter 57-38.4 to use the "water's edge" method. This election allows exclusion of consideration of most corporate income sourced outside the United States. The water's edge election must be made on the return as originally filed and is binding on the corporation for five consecutive years. If the election is made, the corporation may not use the deduction for federal income taxes paid. A corporation electing to use the water's edge method must file with the Tax Commissioner a domestic disclosure spreadsheet and must refile the spreadsheet every third year while the election remains in effect. A domestic disclosure spreadsheet must fully disclose income reported to each state, state tax liability, the method used to apportion or allocate income to the various states, and other information required to determine the proper tax due to each state and to identify the water's edge group.

## CORPORATE INCOME TAX DEDUCTIONS

A corporation is entitled to subtract from taxable income each of the following items:

1. Interest received from obligations of the United States included in taxable income on the federal return.
2. Income included in taxable income on the federal return which is exempt from taxation by the state under the Constitution of the United States or the Constitution of North Dakota.
3. The amount of federal income tax liability to the extent those taxes are computed on income that becomes part of North Dakota taxable income.
4. Net income not allocated and apportioned to this state which was included in federal taxable income.
5. Dividends received by the corporation from a corporation that has paid North Dakota corporation income taxes or from a financial institution that has paid financial institutions taxes under NDCC Chapter 57-35.3.

## CORPORATE INCOME TAX ADDITIONS

The following must be added to taxable income:

1. Income taxes, including taxes of foreign countries, that were deducted to determine federal taxable income.
2. Interest and dividends from foreign securities and securities of states and political subdivisions exempt from federal income taxes, but not including obligations of the state of North Dakota or any of its political subdivisions.
3. Accelerated cost-recovery system depreciation on assets placed in service in 1981 or l982.
4. Safe-harbor lease amounts deducted on the federal return if the minimum investment by the lessor is less than 100 percent.

## TAX CREDITS

Corporate income tax credits are allowed for:

1. Wages and salaries paid by a new business, in the amount of 1 percent of all wages and salaries for the first three years and one-half of 1 percent of all wages and salaries for the fourth and fifth years. A corporation that receives a new or expanding business income tax exemption under NDCC Chapter 40-57.1 does not receive this credit.
2. Investment in a North Dakota venture capital corporation in the amount of 25 percent of the investment or $250,000, whichever is less.
3. Investment in a small business investment company, limited to 25 percent of the amount invested.
4. Investment in a certified nonprofit development corporation, limited to 25 percent of the amount invested.
5. Research and experimental expenditures incurred within North Dakota.
6. Contributions to nonprofit private high schools and nonprofit private colleges in the state.
7. Installation of geothermal, solar, or wind energy devices.
8. Installation of alternative fuel equipment on a North Dakota licensed motor vehicle.
9. A portion of North Dakota wages paid to a developmentally disabled or chronically mentally ill employee.
10. Qualified investments in a North Dakota renaissance fund corporation.
11. Investment in historic property preservation or renovation in a renaissance zone.

## CORPORATE INCOME TAX EXEMPT ACTIVITIES

Certain activities are exempt from corporate income taxes. A new or expansion project in primary sector business or tourism qualifies for an income tax exemption for up to five years. The exemption is limited to income earned from the qualifying project, and the operator is required to file a return even though an exemption is granted. A project may not receive the exemption if the project receives a tax exemption under tax increment financing, the exemption fosters unfair competition or endangers existing business, or there is a recorded lien for delinquent property, income, or sales or use taxes against the project operator or principal officers.

Renaissance zone exemptions are available to exempt business income for five years for purchasing or leasing renaissance zone real property for use in the business or for improving renaissance zone real property used in the business. A renaissance zone exemption is also available for investment income for five years from renaissance zone residential or commercial real property purchased solely for investment purposes.

## 2001 LEGISLATION

Senate Bill No. 2189 was enacted to provide a corporate income tax deduction for passthrough dividends earned by a regulated investment company and allocated to shareholders.

Senate Bill No. 2336 would have allowed a corporate income tax deduction equal to 20 percent of qualified research and development costs for a product produced in this state for the first five taxable years of sales of the product by the corporation. The bill passed the Senate but failed in the House.

Senate Bill No. 2294 would have allowed a small business tax credit to individuals and corporations in the amount paid to the United States Small Business Administration (SBA) as an annual guarantee fee to obtain SBA guaranteed financing. The bill passed the Senate but failed in the House.

House Bill No. 1077 was introduced by the Tax Commissioner and was enacted to provide a filing date of May 15 or the 15th of the fifth month after the close of the fiscal year for an exempt corporation required to report unrelated business taxable income.

## OTHER RECENT CORPORATE INCOME TAX CONSIDERATIONS

The study resolution specifically mentions elimination of the corporate income tax or elimination of the federal income tax deduction as topics for consideration.

In 1999 Senate Bill No. 2385 was introduced to eliminate the North Dakota state corporate income tax. The bill failed to pass in the Senate by a vote of 10-38.

In 1991 Senate Bill No. 2510 was introduced to eliminate the North Dakota state corporate income tax. The bill failed to pass in the Senate on a vote of 8-42.

North Dakota is one of only five states that allows a corporate income tax deduction for federal income taxes paid. Eliminating this deduction could allow a reduction of corporate income tax rates by approximately one-third without a reduction in revenue. Although this would be revenue neutral to the state, it would shift tax burdens among corporations. The federal income tax deduction is of varying significance to different corporations, depending on whether the corporation is incorporated in North Dakota or elsewhere and a variety of other factors. This was the primary complaint of those testifying against 1987 House Bill No. 1619, which would have reduced the federal income tax deduction. The bill failed to pass the House by a vote of 36-57.

## CORPORATE INCOME TAX COLLECTIONS

The corporate income tax is a significant source of revenue for the state general fund. Consideration of modification or elimination of the corporate income tax will necessarily involve consideration of revenue impact. The following table shows corporate income tax collections in recent years:

| Fiscal Year | Net Collections |
|---|---|
| 1990 | $40,486,001 |
| 1991 | $49,321,208 |
| 1992 | $36,778,251 |
| 1993 | $42,525,921 |
| 1994 | $50,727,400 |
| 1995 | $44,027,738 |
| 1996 | $49,047,417 |
| 1997 | $50,300,520 |
| 1998 | $65,543,025 |
| 1999 | $57,877,194 |
| 2000 | $47,528,001 |
| 2001 estimated | $46,513,000 |

**SOURCE:** North Dakota Office of State Tax Commissioner, *State and Local Taxes, An Overview and Comparative Guide 2000*.

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