North Dakota Taxation

Corporation income tax

Corporation taxation

A. Historical perspective

1919 Enacted the first corporation income tax, with a flat rate of 3% on total net income, and an additional 5% tax on net income that remained undistributed six months after the end of the year.

1923 The 5% tax on undistributed net income was eliminated, leaving only the 3% flat rate of tax on net income.

1937 A graduated income rate structure was created. A graduated rate structure has continued to the present day, although rates and tax brackets have changed throughout the years—**see CHART 1**.

1965 The Uniform Division of Income for Tax Purposes Act was adopted as North Dakota Century Code Chapter 57-38.1. Under this act, the worldwide combined reporting method was adopted. The act also indicates how income of multistate businesses is assigned to the states.

1967 As with individual income tax, adopted federal taxable income as the starting point in calculating North Dakota taxable income. This adoption had to be reviewed each legislative session.

1987 Corporations were allowed to elect the water's edge method of reporting income for tax years beginning after December 31, 1998. The election was binding for 10 years, and was later reduced to 5 years.

1989 Use of federal taxable income as the starting point for calculating North Dakota taxable income was perpetually federalized, meaning there was no longer a requirement to review this each legislative session.

2003
- The deduction for federal income taxes paid was eliminated for tax years beginning after December 31, 2003.
- Corporations electing the water's edge filing method became subject to a 3.5% surtax on North Dakota taxable income for tax years beginning after December 31, 2003.
- North Dakota net operating losses for tax years beginning after December 31, 2002, could no longer be carried back to prior years. The losses can only be carried forward.

2007 The first transferable income tax credits were authorized. Under certain circumstances, corporations are allowed to sell, assign, or otherwise transfer unused research and experimental expenditure credits and credits for the installation of biomass, geothermal, solar or wind energy devices.

2009 The provisions allowing for the transfer of unused credits for the installation of biomass, geothermal, solar or wind energy devices were repealed. *(The transfer provisions for unused research and experimental expenditure credits were not affected.)*

B. Corporation taxation

1. Nexus
   a. Defined—Nexus is the "connection" with a state that is required before income taxes may be imposed on a business entity.
   b. Establishing nexus when there are only sales into North Dakota—Federal law (Public Law 86-272) prohibits a state from imposing an income tax on an entity whose only in-state activity consists of soliciting orders for the sales of tangible personal property, when the orders are sent outside the state for approval and are filled by shipment or delivery from outside the state.
      - Protected ancillary activity—Numerous activities considered ancillary to solicitation are allowed without subjecting a business to income tax. Some examples of such ancillary activities are salespersons carrying samples, checking display racks or inventory, training other employees.
      - Unprotected activities—Some activities are not considered mere solicitation or ancillary to solicitation. If these activities are performed in addition to solicitation, a state would not be prohibited from taxing the North Dakota business income. Some examples of unprotected activity are installing or repairing equipment that was sold, investigating credit worthiness and resolving complaints.
2. Apportionable income tax base—**see CHART 2**
   a. For companies incorporated in the United States, begin with federal taxable income (FTI)
   b. For companies not incorporated in the United States, include income from informational returns filed with the IRS
   c. Make addition and subtraction adjustments as required by law.
3. Apportionment—North Dakota taxable income is the portion of a corporation's apportionable income which is attributable to business activity in North Dakota.
   a. History—In 1965, North Dakota adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) as North Dakota Century Code Chapter 57-38.1.
   b. Non-apportioning—For a corporation or unitary group of corporations that conduct business activity solely in North Dakota, 100% of their taxable income will be subject to North Dakota's tax rates.
   c. Apportioning—Corporations which conduct business in multiple states and/or countries apportion their income amongst those jurisdictions. North Dakota uses an equally weighted, three factor formula to apportion income—**see CHART 2 and CHART 3**.
      - Special apportionment rules exist for railroads, airlines, trucking companies, television and radio broadcast companies and publishing companies.

4. Filing methods
   a. Separate entity—no affiliated corporations (parent or subsidiary)
      - 100% ND—the company's entire apportionable income will be taxed by North Dakota.
      - Multistate apportioning—the company's apportionable income will be multiplied by its North Dakota apportionment factor to determine what portion of the income will be taxed by North Dakota.

   b. Unitary combined reporting—**see CHART 4**
      - Worldwide combined report—the unitary companies (both US and foreign incorporated)total their income or loss to establish their apportionable income. The apportionment factor numerators include only the North Dakota property, payroll and sales, while the denominators include property, payroll and sales everywhere (both US and foreign).
      - Water's edge election—the United States incorporated companies, with the exception of 80/20 corporations, total their income or loss to establish the tax base. Unitary foreign incorporated companies are excluded from the water's edge group. The apportionment factor numerators include only the North Dakota property, payroll and sales, while the denominators include property, payroll and sales of all the companies included in the water's edge group.

5. Business and nonbusiness income
   a. Definitions
      - Business income—income from:
        - transactions and activity in the regular course of the taxpayer's business (transactional test), or
        - income from tangible and intangible property if the acquisition, management and disposition of the property are integral parts of the business (functional test).
      - Nonbusiness income—all income that is not business income.

   b. Business income is apportioned. Nonbusiness income is allocated to a specific state.

6. Structure and calculation
   a. Form 40
      - Combined report—one company that is a member of the unitary group reports using the combined report method.
      - Consolidated return—multiple companies that are members of the same unitary group report on the same Form 40, using the CR schedules.

   b. Calculation of tax—**see CHART 2**

Passthrough entity taxation

1. Passthrough entities include:
   a. Partnership
   b. Subchapter S corporation (or S corporation)
   c. Limited liability company (or LLC), if treated like a partnership or S corporation for income tax purposes.
2. Generally, these business entities do not pay income tax at the entity level.
   a. One exception would be an S corporation that is subject to the tax on built-in gains or the tax on excess net passive income.
   b. Another exception is that in some states these entities do pay income tax at the entity level.
3. Generally, the income or loss is "passed through" to the owners of the entity—that is, the partners, shareholders, or members.
   a. The amount passed through to each owner is generally based on each owner's ownership percentage in the entity.
   b. The entity's owners, in turn, report their respective shares of the entity's income or loss on their income tax returns.
4. If a passthrough entity conducts its business activity in North Dakota and one or more other states, the entity's income or loss is subject to the same apportionment and allocation rules that apply to a multistate corporation.
5. North Dakota tax forms
   a. Partnership—Form 58
   b. S corporation—Form 60
   c. Limited liability company—either Form 58 or Form 40, depending on its treatment

Corporation income tax

History of Corporation Income Tax Rates

1923 to the present

For taxable years beginning on or after January 1, 2011

North Dakota taxable income ▶ Over	But not over				
$ 0	$ 25,000		1.68%	of North Dakota taxable income	
25,000	50,000	$ 420.00 +	4.23%	of the amount over	$ 25,000
50,000		1,477.50 +	5.15%	of the amount over	50,000

Water's edge election surtax: *A corporation electing to use the water's edge method to apportion its income must pay a surtax of 3.5% of North Dakota taxable income in addition to the regular tax using the above rates.*

For taxable years beginning on or after January 1, 2009

North Dakota taxable income ▶ Over	But not over				
$ 0	$ 25,000		2.10%	of North Dakota taxable income	
25,000	50,000	$ 525.00 +	5.25%	of the amount over	$ 25,000
50,000		1,837.50 +	6.40%	of the amount over	50,000

Water's edge election surtax: *A corporation electing to use the water's edge method to apportion its income must pay a surtax of 3.5% of North Dakota taxable income in addition to the regular tax using the above rates.*

For taxable years beginning on or after January 1, 2007

North Dakota taxable income ▶ Over	But not over				
$ 0	$ 3,000		2.60%	of North Dakota taxable income	
3,000	8,000	$ 78.00 +	4.10%	of the amount over	$ 3,000
8,000	20,000	283.00 +	5.60%	of the amount over	8,000
20,000	30,000	955.00 +	6.40%	of the amount over	20,000
30,000		1,595.00 +	6.50%	of the amount over	30,000

Water's edge election surtax: *A corporation electing to use the water's edge method to apportion its income must pay a surtax of 3.5% of North Dakota taxable income in addition to the regular tax using the above rates.*

For taxable years beginning on or after January 1, 2004, and prior to January 1, 2007

North Dakota taxable income ▶ Over	But not over				
$ 0	$ 3,000		2.60%	of North Dakota taxable income	
3,000	8,000	$ 78.00 +	4.10%	of the amount over	$ 3,000
8,000	20,000	283.00 +	5.60%	of the amount over	8,000
20,000	30,000	955.00 +	6.40%	of the amount over	20,000
30,000		1,595.00 +	7.00%	of the amount over	30,000

Water's edge election surtax: *A corporation electing to use the water's edge method to apportion its income must pay a surtax of 3.5% of North Dakota taxable income in addition to the regular tax using the above rates.*

For taxable years beginning on or after January 1, 1983, and prior to January 1, 2004

North Dakota taxable income ▶ Over	But not over				
$ 0	$ 3,000		3.00%	of North Dakota taxable income	
3,000	8,000	$ 90.00 +	4.50%	of the amount over	$ 3,000
8,000	20,000	315.00 +	6.00%	of the amount over	8,000
20,000	30,000	1,035.00 +	7.50%	of the amount over	20,000
30,000	50,000	1,785.00 +	9.00%	of the amount over	30,000
50,000		3,585.00 +	10.50%	of the amount over	50,000

For taxable years beginning on or after January 1, 1981, and prior to January 1, 1983

North Dakota taxable income ▶ Over	But not over				
$ 0	$ 3,000		2.00%	of North Dakota taxable income	
3,000	8,000	$ 60.00 +	3.00%	of the amount over	$ 3,000
8,000	20,000	210.00 +	4.00%	of the amount over	8,000
20,000	30,000	690.00 +	5.00%	of the amount over	20,000
30,000	50,000	1,190.00 +	6.00%	of the amount over	30,000
50,000		2,390.00 +	7.00%	of the amount over	50,000

Corporation income tax

History of Corporation Income Tax Rates

1923 to the present

For taxable years beginning on or after January 1, 1981, and prior to January 1, 1983

North Dakota taxable income ▶

Over	But not over			
$ 0	$ 3,000		2.00%	of North Dakota taxable income
3,000	8,000	$ 60.00 +	3.00%	of the amount over $ 3,000
8,000	20,000	210.00 +	4.00%	of the amount over 8,000
20,000	30,000	690.00 +	5.00%	of the amount over 20,000
30,000	50,000	1,190.00 +	6.00%	of the amount over 30,000
50,000		2,390.00 +	7.00%	of the amount over 50,000

For taxable years beginning on or after January 1, 1978, and prior to January 1, 1981

North Dakota taxable income ▶

Over	But not over			
$ 0	$ 3,000		3.00%	of North Dakota taxable income
3,000	8,000	$ 90.00 +	4.00%	of the amount over $ 3,000
8,000	15,000	290.00 +	5.00%	of the amount over 8,000
15,000	25,000	640.00 +	6.00%	of the amount over 15,000
25,000		1,240.00 +	8.50%	of the amount over 25,000

For taxable years beginning on or after January 1, 1937, and prior to January 1, 1978

North Dakota taxable income ▶

Over	But not over			
$ 0	$ 3,000		3.00%	of North Dakota taxable income
3,000	8,000	$ 90.00 +	4.00%	of the amount over $ 3,000
8,000	15,000	290.00 +	5.00%	of the amount over 8,000
15,000		640.00 +	6.00%	of the amount over 15,000

For taxable years beginning on or after January 1, 1923, and prior to January 1, 1937

3.00% of North Dakota taxable income

Corporation income tax

Form 40 System

2011 tax year

Federal taxable income

plus

Addition adjustments

minus

Subtraction adjustments

equals

Apportionable income

multiplied by

Apportionment factor

equals

ND apportioned income

plus

ND allocable income

equals

Total ND income

Federal taxable income

This amount may include the federal taxable income (FTI) of more than one corporation—

- Non-unitary entity: Includes only its own FTI
- Unitary entity: Includes the FTI and foreign companies' income of all unitary entities on a worldwide basis or on elective water's edge basis

Additions

1 Interest from non-North Dakota state and local obligations
2 All income taxes and franchise or privilege taxes based on income deducted on federal income tax return
3 ND endowment tax credit contribution
4 Federal domestic production activity deduction (except certain cooperatives)
5 Income and expenses related to unrecognized safe harbor leases
6 Depreciation on certain 1981 and 1982 assets using federal accelerated cost recovery system (ACRS) depreciation method
7 Dividends-received deduction ("special deductions" on federal return)
8 Dividends-paid deduction of captive REIT owned by corporation
9 Federal net operating loss deduction

Subtractions

1 Interest from U.S. obligations
2 Gain from involuntary conversion due to eminent domain
3 Depreciation on certain 1981 and 1982 assets using pre-1981 federal depreciation methods
4 Income and expenses related to unrecognized safe harbor leases
5 Dividends paid by RIC based on income subject to ND income tax
6 Interest from ND regional railway authority bonds
7 Distributions by certain electing IC-DISCs
8 Net nonbusiness (or "allocable") income from all sources

Apportionment factor is calculated using an equally weighted 3-factor formula—

$$\left[\frac{\text{ND property}}{\text{Total property}} + \frac{\text{ND payroll}}{\text{Total payroll}} + \frac{\text{ND sales}}{\text{Total sales}}\right] \div 3 = \text{Apportionment factor}$$

Note: For a unitary group, the denominator of each factor includes the total property, payroll, and sales of the entities included in the unitary group.

See CHART 4 for examples of this calculation

This is the portion of any net nonbusiness (or "allocable") income subtracted from federal taxable income that is allocable to North Dakota.

Continued on side 2

Corporation income tax

Form 40 System

2011 tax year

Total ND income

minus

Deductions

Deductions
1 New or expanding business income exemption
2 Renaissance zone business income exemption
3 North Dakota net operating loss carryforward

equals

Net ND income or loss

plus

Income from sale of ND tax credits

This income cannot be offset by a net North Dakota loss—tax must be paid on it.

equals

ND taxable income

multiplied by

Tax rates

2011 tax rates

ND taxable income: Over	But not over	**Tax equals:**
$ 0	$ 25,000	1.68% of ND taxable income
25,000	50,000	$ 420.00 + 4.23% of the amount over $ 25,000
50,000		1,477.50 + 5.15% of the amount over 50,000

equals

Tax

Water's edge method tax
For a unitary corporation electing the water's edge method, the tax equals the regular tax (using above rates) plus an additional tax of 3.5% of ND taxable income.

minus

Tax credits

Tax credits
1 New corporation wage and salary credit
2 Nonprofit private college contribution credit
3 Solar energy device credit
4 Wind energy device credit
5 Nonprofit private high school contribution credit
6 Geothermal energy device credit
7 Credit for hiring developmentally disabled or chronically mentally ill person
8 Research expense credit
9 Seed capital investment credit
10 Certified nonprofit development corporation investment credit
11 Renaissance zone historic property credit
12 Renaissance zone RFO investment credit
13 Agricultural commodity processing facility investment credit
14 Biodiesel fuel production plant and equipment credit
15 Biodiesel fuel blending credit *(supplier/wholesale)*
16 Biodiesel fuel sales equipment credit *(seller/retail)*
17 Biomass energy device credit
18 Internship program credit
19 Microbusiness credit
20 Angel fund investment credit
21 ND endowment fund credit
22 Workforce recruitment credit
23 Carryover of unused commercial property tax credit
24 Soybean and canola crushing equipment credit
25 Federal active duty mobilization wage credit
26 Renaissance zone nonparticipating property owner credit
27 Housing incentive fund contribution credit

equals

Net ND tax liability

minus

Estimated tax payment(s)

equals

Tax due or Refund

Corporation income tax

Examples of North Dakota Apportionable Income Calculation

Example 1

100% North Dakota Corporation

Assume that Corporation A conducts 100 percent of its business within North Dakota. Its property, payroll, and sales in North Dakota are as follows:

Property	$ 100,000,000
Payroll	$ 5,000,000
Sales	$ 200,000,000

Corporation A's North Dakota apportionment factor and North Dakota apportionable income are calculated as follows—

		North Dakota		Everywhere		ND Factor
Property factor	=	$100,000,000	÷	$100,000,000	=	1.000000
Payroll factor	=	$5,000,000	÷	$5,000,000	=	1.000000
Sales factor	=	$200,000,000	÷	$200,000,000	=	1.000000
						3.000000
						÷ 3
						1.000000

Total apportionable income	$ 30,000,000
ND apportionment factor	x 1.000000
ND apportionable income	$ 30,000,000

Example 2

Multistate Corporation

Assume that Corporation B conducts its business in both North Dakota and Montana. Its total property, payroll, and sales and the amounts attributable to North Dakota and Montana are as follows:

	Everywhere	North Dakota	Montana
Property	$ 100,000,000	$ 90,000,000	$ 10,000,000
Payroll	$ 5,000,000	$ 4,000,000	$ 1,000,000
Sales	$ 200,000,000	$ 150,000,000	$ 50,000,000

Corporation B's North Dakota apportionment factor and North Dakota apportionable income are calculated as follows—

		North Dakota		Everywhere		ND Factor
Property factor	=	$90,000,000	÷	$100,000,000	=	.900000
Payroll factor	=	$4,000,000	÷	$5,000,000	=	.800000
Sales factor	=	$150,000,000	÷	$200,000,000	=	.750000
						2.450000
						÷ 3
						.816667

Total apportionable income	$ 30,000,000
ND apportionment factor	x .816667
ND apportionable income	$ 24,500,010

Corporation income tax

Worldwide and Water's Edge Filing Methods: Background Overview

Historical overview

1965 North Dakota adopts the Uniform Division of Income Tax Purposes Act (UDITPA) as North Dakota Century Code Chapter 57-38.1

- Under this Act, North Dakota adopts the **worldwide combined reporting method** for unitary groups of corporations.

  Unitary Business

  1. **Unity of Operation**—contributions to or receipt of benefits from functional integration or economies of scale. *Examples include shared research facilities, reduced cost of goods due to increased purchasing power, common computer system, and intercompany financing or loan guarantees.*
  2. **Unity of Ownership**—common control by a single corporation. In North Dakota, direct or indirect ownership > 50% would meet this test.
  3. **Unity of Use**—contributions to or receipt of benefits from centralized management and policy formation. *Examples include common officers and directors, common personnel policies, and common ethics standards.*

  Example: Corporation A owns 100% of Corporations B and C. Corporation A mines copper in State X. Corporation A ships the copper to Corporation B in State Y, where B manufactures copper pipe. Corporation B ships pipe to Corporation C's warehouse in State Z. Corporation C ships the pipe to its retail hardware stores located throughout the United States.

- A **unitary group** of corporations' property, payroll, and sales within North Dakota are compared to the group's worldwide (i.e., United States and foreign) property, payroll, and sales to determine the portion of the group's worldwide income that is taxable to North Dakota.

1983 U.S. government actions prompt states to adopt the "water's edge" unitary apportionment method

In response to a U.S. Supreme Court case, [Container Corp of America v. Franchise Tax Board, 463 U.S. 159 (1983)(worldwide combined reporting does not impose an undue burden on foreign commerce)], President Reagan established the Worldwide Unitary Taxation Working Group, which concluded that water's edge unitary apportionment should be applied to all corporations, foreign and domestic.[1]

Under pressure from the Reagan Administration's working group and the introduction of two bills in the 99th Congress in 1985-86 (S. 1974 and H.R. 3980, respectively), the states began to enact water's edge legislation.

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[1] The worldwide combined reporting method was again upheld as not burdening foreign commerce in 1994 by the U.S. Supreme Court in Barclays Bank v. Franchise Tax Board, 114 S. Ct. 2268 (1994). This case involved a foreign parent corporation with domestic subsidiaries.

Corporation income tax

Worldwide and Water's Edge Filing Methods: Background Overview

Historical Overview *continued*

1987 **North Dakota enacts legislation allowing an election to use the water's edge method starting with the 1989 tax year**

- Allows exclusion of most corporate income sourced outside the United States.
- Significant differences from **worldwide combined reporting method**—
  1. 70% of income from an 80/20 corporation is excluded.

     *An "**80/20 corporation**" is an affiliated U.S.-incorporated corporation for which 80% or more of the corporation's property and payroll is assigned outside of the United States.*
  2. Income from a controlled foreign corporation (CFC) is excluded.

     *A "**CFC**" is an affiliated corporation that is incorporated outside the U.S.*
  3. 70% of dividends from a CFC is excluded.
  4. The election is binding for 5 consecutive tax years.
  5. A federal income tax deduction is not allowed. This was the trade-off for allowing a corporation to use the water's edge election.
  6. For tax years beginning on or after January 1, 2004, a surtax equal to 3.5% of North Dakota taxable income must be paid in addition to the regular tax.

Comparison with other states

- 5 states require worldwide combined reporting by a unitary group of corporations—

  Alaska California Idaho
  Montana North Dakota
- 24 states have some method of domestic combination, which includes the 5 states listed above.
- 22 states do not allow combination—they use separate entity filing.
- 4 states do not have a corporation income tax—

  Nevada Washington
  South Dakota Wyoming