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

Senate Concurrent Resolution No. 4021 (copy attached) directs a study of income tax laws. The resolution requires emphasis on establishing a single, uniform income tax return for all individuals. Because the resolution calls for study of "income tax laws," the study directive covers both individual and corporate income taxes.

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 this state 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 an 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 since that time taxpayers have had the option of filing under either of the two different methods. For the great majority of individuals, the "short form" provides a considerably lower tax liability than the tax determined using the "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 and 9 percent on taxable income in excess of $50,000.

In 1985 the temporary changes made in 1983 were made permanent law. In a 1986 special session, legislation was passed 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 a corresponding amount 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 disapproved 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 change was made because a substantial federal income tax reduction was anticipated, which would have had a substantial negative revenue impact to the state, the amount of which was unknown during the 2001 legislative session. The revised short-term method is roughly equivalent to the previous method because it applies a set of graduated tax rates that are 14 percent of the federal tax rates at the time and the rates are applied to five income brackets that 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 the "short-form" 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 with references to "Form ND-1" (previous "short form") and "Form ND-2" (previous "long form"). The income brackets established by the 2001 legislation for Form ND-1 are unchanged in the statutory provision (North Dakota Century Code (NDCC) Section 57-38-30.3). However, the income amounts in the brackets are subject to indexing in the same manner federal income brackets are indexed and because of application of annual indexing, actual income brackets for taxable year 2007 are substantially higher than the income brackets that appear in the statutory provision.

Recent Changes

In 2003 the seed capital investment tax credit rate was increased from 30 percent to 45 percent and qualifying investment limits were increased from $50,000 to $250,000 for investments qualifying for the credit. The Tax Commissioner was required to conduct a tax amnesty program. An income tax deduction was created for compensation received by a National Guard or reserve member for federal active duty service. The domestic dividend deduction allowed on Form ND-2 was repealed in response to a court decision finding the deduction unconstitutional.

In 2005 the seed capital and agricultural commodity investment tax credits were allowed for corporations and all passthrough entities and limitations on the credits were revised. A credit for planned gifts to qualified North Dakota nonprofit organizations was created. The geothermal, solar, or wind energy device credit was amended to allow a five-year carryforward of unused credits.

In 2007 an income tax marriage penalty credit of up to $300 per couple was created to offset any marriage penalty incurred for couples with income up to $154,200. A homestead income tax credit was created for individuals for taxable years 2007 and 2008 in the amount of 10 percent of property taxes or mobile home taxes that become due during the tax year and have been paid on the individual's homestead. For purposes of the credit, "homestead" means the dwelling occupied as a primary residence in this state and any residential or agricultural property owned by an individual in this state. The amount of the homestead income tax credit may not exceed $1,000 for married persons filing a joint return or $500 for a single individual or married individuals filing separate returns. The amount of the homestead income tax credit exceeding a taxpayer's income tax liability may be carried forward for up to five years or the taxpayer may request that the Tax Commissioner issue the taxpayer a certificate in the amount of the excess. A certificate issued to a taxpayer may be used by the taxpayer against property or mobile home tax liability during the ensuing taxable year by delivering the certificate to the county treasurer of the county in which the taxable property or mobile home is subject to taxes. The county treasurer is to forward certificates redeemed in payment of tax obligations to the Tax Commissioner, who is to issue payment to the county in the amount of the certificates. A commercial property income tax credit is provided for an individual or corporation for taxable years 2007 and 2008 in the amount of 10 percent of commercial property taxes or commercial mobile home taxes that became due during the income tax year and have been paid. The amount of the credit for commercial property for a year may not exceed $1,000 for any taxpayer and is limited for individuals to $1,000 for married persons filing a joint return or $500 for a single individual or married individuals filing separate returns. An individual and corporate income tax credit was created for angel fund investments, internship employment, and workforce recruitment for hard-to-fill employment positions, and the income tax credit for research and experimental expenditures was expanded to apply to individual taxpayers. The aggregate amount of seed capital investment tax credits allowed was increased from $2.5 million to $3.5 million for each calendar year and biofuels production facilities were added to businesses for which agricultural business investment tax credits are available. Angel fund investments were allowed under the seed capital investment income tax credit. The purchaser of a geothermal, solar, or wind energy device installed after December 31, 2006, was allowed to claim the income tax credit for such devices if ownership of the device is transferred to the purchaser at the time installation is complete. Biomass energy devices were added to devices eligible for the income tax credit for geothermal, solar, or wind energy devices. Assignment of a wind energy device installation income tax credit was allowed but assignment may be made only to the purchaser of the power from the device under a power purchase agreement or a taxpayer that constructs or expands an electricity transmission line in North Dakota after August 1, 2007. An individual income tax deduction for up to $5,000, or $10,000 on a joint return, was created for contributions under a higher education savings plan administered by the Bank of North Dakota. The individual income tax credit for planned gifts to nonprofit organizations was expanded to provide a corporate income tax credit and to include gifts to qualified endowments. The credit for individuals was increased from 20 percent to 40 percent of the charitable gift and the maximum credit for individuals was increased from $5,000 per year to $10,000 per year or $20,000 for married individuals filing a joint return. The credit allowed for a corporation is 40 percent of a charitable gift to a qualified endowment and the maximum credit for a corporation is $10,000 per year. An individual and corporate income tax credit was created for operation of a microbusiness, defined as a business employing five or fewer employees inside an economically viable small community. A taxpayer certified as a microbusiness is entitled to a credit equal to 20 percent of new investment and new employment in the microbusiness during the taxable year, limited to

not more than $10,000 in credits over any combination of years. An individual income tax exemption was provided for income of a taxpayer from activities or sources within the boundaries of any Indian reservation in this state if the taxpayer resides within the boundaries of any reservation in this state and is an enrolled member of a federally recognized Indian tribe.

Individual Income Tax Burden and Revenues

North Dakota individual income tax collections for fiscal year 2006 were almost $275 million. A Census Bureau per capita comparison of individual income taxes for 2005 ranks North Dakota No. 41 out of 43 states that impose individual income tax collections. In the comparison, 23 states have a per capita individual income tax burden that is at least double the North Dakota amount. To ensure North Dakota's continued low ranking in individual income tax burdens, the net effect of 2007 legislation is estimated to reduce 2007-09 biennium individual income tax collections by over $55 million, which is 10.1 percent less than collections in the 2005-07 biennium.

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 remained in effect until 2004, North Dakota corporate income tax rates were:

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%

Passage of 2003 House Bill No. 1471 eliminated the deduction for federal corporate income taxes paid and, except for water's edge filers, reduced corporate income tax rates beginning in 2004 as follows:

Taxable Income	Taxable Rate
$3,000 or less	2.6%
Over $3,000 but not over $8,000	4.1%
Over $8,000 but not over $20,000	5.6%
Over $20,000 but not over $30,000	6.4%
Over $30,000	7.0%

The 2003 changes added an additional tax of 3.5 percent of taxable income for water's edge filers, to be added to the above rates, to take the place of the election under previous law that required water's edge filers to give up the deduction for federal corporate income taxes paid.

In 2005 the tax rate for corporate income exceeding $30,000 was reduced from 7 percent to 6.5 percent effective for tax years after 2006.

Exempt Corporations

Under North Dakota Century Code Section 57-38-09(3), an insurance company paying the insurance premiums tax is exempt from the corporate income tax. Under 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 subject 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 Sections 57-35.3-03 and 57-35.3-04, financial institutions paying a financial institutions tax are exempt from corporate income taxes and pay a tax of 7 percent of taxable income. The financial institutions tax has many of the same deductions and credits available under the corporate income tax.

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 to 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 benefit 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. Corporate income apportionment formulas are used by all states imposing corporate income taxes and have been adjusted by some states in efforts to encourage manufacturers to locate in those states.

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 a corporation is 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 23 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 for taxable years beginning before 2004, the corporation may not use the deduction for federal income taxes paid. If the election is made for taxable years beginning after 2003, the corporation is subject to an additional tax of 3.5 percent of taxable income. 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.

SUGGESTED STUDY APPROACH

Because the study resolution is phrased in terms broad enough to cover any aspect of income tax law, the committee has wide discretion in determining which aspects of the income tax the committee might choose to examine. The study resolution specifically requires examination of adjustments necessary to minimize or negate the impact to any taxpayer of establishing a single, uniform income tax return for all individuals. At a minimum, this will require the committee to:

1. Examine the deductions and credits available to taxpayers on Form ND-1 and Form ND-2 and the extent to which each deduction or credit is used by taxpayers.
2. Examine "dummy" returns to gain an understanding of circumstances that influence the choice of filing methods.
3. Determine whether there is an identifiable group of taxpayers who have an advantage filing on Form ND-2.
4. Determine what adjustments would be required to Form ND-1 to eliminate the advantage to any taxpayer of filing on Form ND-2 and determine the fiscal effect of those adjustments.
5. Determine whether administrative costs to the Tax Department and tax preparer fees would be reduced by establishing a single filing method.

ATTACH:1