



# North Dakota Legislative Council

Prepared for the Taxation Committee  
LC# 23.9277.01000  
April 2022

## INCOME TAX REFORM AND RELIEF - BACKGROUND MEMORANDUM

The Taxation Committee has been assigned, pursuant to a directive ([Appendix A](#)) by the Legislative Management Chairman, a study of the feasibility and desirability of providing holistic tax reform and relief, focusing primarily on property tax relief and, to a lesser extent, income tax relief. The study must include consideration of current and projected state revenues and expenditures, the stability of state revenue sources identified as a funding source for tax relief, the intended recipients of tax relief, and potential restrictions on tax relief.

This memorandum provides background for the income tax portion of the study. A separate background memorandum has been prepared for the property 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 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 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, voters 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 pre-existing 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 long-form return.

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

1. Suspended the \$100 energy cost-relief credit.
2. Increased the tax rate on the short-form return from 7.5 to 10.5 percent of adjusted federal income tax liability.
3. Adjusted 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, increase the short-form tax rate from 10.5 to 14 percent of federal tax liability, and 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 the 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 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 the income brackets will keep pace with changes to federal income brackets. To reflect the fact 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 was eliminated.

Individual income tax rates established in 2001 for the five income brackets for each filing status were reduced by legislation enacted in 2009, 2011, 2013, and 2015. In Senate Bill No. 2199 (2009), the Legislative Assembly reduced the individual income tax rates by 12.3 percent. In House Bill No. 1047 (2011), the Legislative Assembly reduced individual income tax rates by 17.9 percent. In Senate Bill No. 2156 (2013), the Legislative Assembly reduced individual income tax rates by 19.3 percent. In Senate Bill No. 2349 (2015), the Legislative Assembly reduced the individual income tax rates by 9.9 percent.

The following schedule provides information on the lowest and highest individual income tax rate for the 2007-09 biennium through the 2015-17 biennium and the percentage decrease in individual income tax rates from biennium to biennium:

	Individual Income Tax Rates as a Percentage of Taxable Income				
	2007-09 Biennium	2009-11 Biennium	2011-13 Biennium	2013-15 Biennium	2015-17 Biennium
<b>Individual income tax rates</b>					
Range of tax rates	2.10% to 5.54%	1.84% to 4.86%	1.51% to 3.99%	1.22% to 3.22%	1.10% to 2.90%
Percentage increase (decrease) from prior biennium		(12.3%)	(17.9%)	(19.3%)	(9.9%)

Individual income tax rates have not been altered since the 2015 legislative session. Thus, the current tax rates, as applied to each available filing status, range from a low of 1.10 to a high of 2.90 percent.

The following schedule provides information on individual income tax collections by tax year, including actual collections, and the cumulative effect of individual income tax rate reductions approved by the Legislative Assembly during the 2009-11 biennium through the 2015-17 biennium. If the Legislative Assembly had not approved any individual income tax rate reductions during the 2009-11 biennium through the 2015-17 biennium, tax collections would have been based on the 2008 tax rates in effect prior to any rate reductions.

Cumulative Effect of Individual Income Tax Rate Reductions (Based on 2008 Tax Rates) <sup>1</sup>									
	2009-11 Biennium		2011-13 Biennium		2013-15 Biennium		2015-17 Biennium		Total 2009-16
	Tax Year 2009	Tax Year 2010	Tax Year 2011	Tax Year 2012	Tax Year 2013	Tax Year 2014	Tax Year 2015	Tax Year 2016	
Actual individual income tax collections	\$291,551,674	\$379,196,662	\$377,728,193	\$534,370,310	\$408,008,964	\$464,588,152	\$341,696,065	\$297,945,510	\$3,095,085,530
Effect of the rate reductions <sup>2</sup>	\$40,890,372	\$53,182,656	\$146,881,911	\$207,793,153	\$294,179,062	\$334,973,294	\$310,981,826	\$271,163,903	\$1,660,046,177
Total individual income tax collections without the rate reductions	\$332,442,046	\$432,379,318	\$524,610,104	\$742,163,463	\$702,188,026	\$799,561,446	\$652,677,891	\$569,109,413	\$4,755,131,707

<sup>1</sup>The information for the income tax rate reductions was provided by the Tax Department and is reported by tax year rather than fiscal year because the Tax Department only calculates the information by tax year. The income tax payments and refunds can span multiple fiscal years, but the fiscal year effect is approximately the same as the preceding tax year. For example, income tax collections in fiscal year 2010 (the 1<sup>st</sup> year of the 2009-11 biennium) are an approximate reflection of the tax collections from tax year 2009.

<sup>2</sup>The amounts shown for the effect of the individual income tax rate reductions reflect the cumulative individual income tax relief provided by the Legislative Assembly based on the rate reductions approved by the Legislative Assembly in 2009, 2011, 2013, and 2015, which was a reduction of 12.3 percent, 17.9 percent, 19.3 percent, and 9.9 percent, respectively.

### 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 include:

1. Interest income from United States obligations.
2. 40 percent of net long-term capital gains allocable to North Dakota.
3. 40 percent of qualified dividends allocable to North Dakota.
4. Income earned by Native Americans which qualifies as exempt income.
5. United States Railroad Retirement Board benefits.
6. Income from financial institutions received from a passthrough entity in connection with an allocation and apportionment to the state under North Dakota Century Code Section 57-38-01.35.
7. National Guard or reserve member exclusions for federal active duty compensation.
8. Servicemembers Civil Relief Act adjustments for military service members' compensation received while a nonresident of North Dakota.
9. College SAVE contributions.
10. Renaissance zone exempt income.
11. New or expanding business exempt income.
12. A human organ donor deduction.
13. An employee workforce recruitment exclusion.
14. A marriage penalty deduction.
15. A stillborn child exemption.
16. Employer paid costs directly related to higher education or career and technical education.
17. A military personnel retirement benefits exemption.
18. A Social Security benefits exclusion.

### INDIVIDUAL INCOME TAX CREDITS

Individual income tax credits are available for:

1. Paying income tax to another state (North Dakota residents only).

2. Paying qualified expenses to care for a qualified family member to avoid placement in a long-term care facility.
3. Investment in a renaissance fund organization.
4. Investment in historic property preservation or renovation in a renaissance zone.
5. Purchasing or rehabilitating a single-family residence in a renaissance zone.
6. Investment in a qualified seed capital business.
7. Investment in a qualified agricultural commodity processing facility.
8. Making a planned gift to a qualified nonprofit organization or its qualified endowment fund.
9. Blending at least a 5 percent biodiesel or green diesel fuel by a licensed fuel supplier.
10. Direct costs incurred by a licensed fuel seller to adapt or add equipment to enable retail sales of at least a 2 percent biodiesel or green diesel fuel blend.
11. Providing marriage penalty relief for eligible joint filers.
12. Compensation paid to college interns working in North Dakota.
13. Qualified research expenses incurred in North Dakota.
14. Compensation paid to an employee hired to fill a hard-to-fill position in North Dakota.
15. Compensation paid to an employee in the National Guard or armed forces reserve who is mobilized for federal active duty.
16. Premiums paid for a long-term care partnership plan insurance policy.
17. Contribution of at least \$5,000 to a qualified endowment fund held by a qualified nonprofit organization in North Dakota, or bordering North Dakota if other criteria are met.
18. A share of a passthrough entity's credit for its charitable contributions to a nonprofit private grade school, high school, or college.
19. Charitable contributions to a nonprofit private grade school, high school, or college.
20. An individual's share of an investment made by a certified angel fund in a qualified business.
21. A portion of wages paid to an individual with a developmental disability or severe mental illness, effective for taxable years 2021 and 2022.
22. Purchasing machinery and equipment to automate a manufacturing process, effective for taxable years 2019 through 2022.
23. Individuals, in the amount of \$350 per individual, or \$700 for married individuals filing jointly, effective for taxable years 2021 and 2022.

### **INDIVIDUAL INCOME TAX-EXEMPT ACTIVITIES**

Certain activities are exempt from individual income taxes. Taxpayers engaging in qualifying renaissance zone projects or investing in a renaissance fund organization set up to provide financing to projects in a North Dakota renaissance zone qualify for income tax incentives. Section 40-63-04 provides an income tax exemption to individuals who purchase or rehabilitate single family residential property for the individual's primary residence as a renaissance zone project. The amount of the exemption is up to \$10,000 of personal income tax liability for 5 taxable years beginning with the date rehabilitation is completed or the property is occupied.

An exemption also is available for an individual taxpayer who purchases, leases, rehabilitates, or makes leasehold improvements to residential, public utility infrastructure, or commercial property for any business or investment purpose as a renaissance zone project. The amount of the exemption is equal to the income derived from all of a taxpayer's business or investment interests within the zone, up to a maximum amount of \$500,000 per taxable year for 5 taxable years beginning with the date of purchase, lease, or completion of rehabilitation. For projects that expand an existing building, the amount of the exemption is equal to the income derived from the business or from the investment use of the building during the taxable year multiplied by a ratio equal to the square footage added by the expansion divided by the total square footage of the building after expansion.

Renaissance fund organizations also may qualify for an income tax exemption pursuant to Section 40-63-07.

## INDIVIDUAL INCOME TAX BURDEN

North Dakota individual income tax collections for fiscal year 2020 were just over \$352 million.<sup>1</sup> The Tax Department provides a variety of income tax statistics in its biennial report *State and Local Taxes: An Overview and Comparative Guide* (the Red Book). Attached is a graphic ([Appendix B](#)) included in the Tax Department's 2020 Red Book, which provides a Census Bureau per capita comparison of individual income tax collections for fiscal year 2019. The per capita comparison ranks North Dakota 41<sup>st</sup> out of 43 states that impose individual income tax collections. In the comparison, 25 states have a per capita individual income tax burden at least double North Dakota's per capita individual income tax burden.

In terms of the state's tax climate, North Dakota is ranked 26<sup>th</sup> out of 50 states in the individual income tax category on the Tax Foundation's *2022 State Business Tax Climate Index*, with an overall tax climate index rank of 16<sup>th</sup> out of 50 states.<sup>2</sup>

## 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 the total net income of corporations. The 1919 legislation also imposed an additional tax of 5 percent on the total net income of corporations received during a calendar or fiscal year and remaining undistributed 6 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. From 1983 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 House Bill No. 1471 (2003) 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 standard corporate income tax rates, to take the place of the election under previous law which required water's edge filers to give up the deduction for federal corporate income taxes paid.

The Legislative Assembly reduced corporate income tax rates in the 2009, 2011, 2013, and 2015 legislative sessions. In Senate Bill No. 2199 (2009), the Legislative Assembly reduced the number of corporate income tax

<sup>1</sup> North Dakota Tax Department, "2020 State and Local Taxes: An Overview and Comparative Guide" (Dec. 2020), p. 32, <https://www.tax.nd.gov/sites/www/files/documents/news-center/publications/red-book-2020-online-version.pdf>.

<sup>2</sup> Tax Foundation, "2022 State Business Tax Climate Index" (Dec. 2021), <https://taxfoundation.org/2022-state-business-tax-climate-index>.

brackets from five to three, and reduced the corporate tax rates in each bracket. In House Bill No. 1047 (2011), the Legislative Assembly reduced corporate income tax rates by 19.5 percent. In Senate Bill No. 2156 (2013), the Legislative Assembly reduced corporate income tax rates by 11.9 percent. In Senate Bill No. 2349 (2015), the Legislative Assembly reduced the corporate income tax rates by 4.9 percent. The corporate income tax rates have not changed since the enactment of Senate Bill No. 2349.

The following schedule provides information on the lowest and highest corporate income tax rate for the 2007-09 biennium through the 2015-17 biennium and the percentage decrease in corporate income tax rates from biennium to biennium:

	Corporate Income Tax Rates as a Percentage of Taxable Income				
	2007-09 Biennium	2009-11 Biennium	2011-13 Biennium	2013-15 Biennium	2015-17 Biennium
<b>Corporate income tax rates</b>					
Range of tax rates	2.60% to 6.50%	2.10% to 6.40% <sup>1</sup>	1.68% to 5.15%	1.48% to 4.53%	1.41% to 4.31%
Percentage increase (decrease) from prior biennium		N/A <sup>1</sup>	(19.5%)	(11.9%)	(4.9%)

<sup>1</sup>The 2009 Legislative Assembly reduced the number of corporate income tax brackets from five to three and reduced the tax rates in each bracket. As a result, the percentage change from the prior biennium cannot be calculated.

Corporate income tax rates have not been altered since the 2015 legislative session. Thus, the current corporate income tax rates applicable to corporations range from 1.41 to 4.31 percent.

The following schedule provides information on corporate income tax collections by tax year, including actual collections, and the cumulative effect of corporate income tax rate reductions approved by the Legislative Assembly during the 2009-11 biennium through the 2015-17 biennium. If the Legislative Assembly had not approved any corporate income tax rate reductions during the 2009-11 biennium through the 2015-17 biennium, tax collections would have been based on 2008 tax rates in effect prior to any rate reductions.

	Cumulative Effect of Corporate Income Tax Rate Reductions (Based on 2008 Tax Rates) <sup>1</sup>								
	2009-11 Biennium		2011-13 Biennium		2013-15 Biennium		2015-17 Biennium		Total 2009-16
	Tax Year 2009	Tax Year 2010	Tax Year 2011	Tax Year 2012	Tax Year 2013	Tax Year 2014	Tax Year 2015	Tax Year 2016	
Actual corporate income tax collections	\$74,471,905	\$139,076,051	\$138,910,271	\$206,732,706	\$190,563,515	\$193,073,757	\$94,967,392	\$73,341,168	\$1,111,136,765
Effect of the rate reductions <sup>2</sup>	\$3,919,574	\$7,319,792	\$42,731,143	\$63,594,468	\$92,278,785	\$93,494,349	\$53,249,807	\$41,123,621	\$397,711,539
Total corporate income tax collections without the rate reductions	\$78,391,479	\$146,395,843	\$181,641,414	\$270,327,174	\$282,842,300	\$286,568,106	\$148,217,199	\$114,464,789	\$1,508,848,304

<sup>1</sup>The information for the income tax rate reductions was provided by the Tax Department and is reported by tax year rather than fiscal year because the Tax Department only calculates the information by tax year. The income tax payments and refunds can span multiple fiscal years, but the fiscal year effect is approximately the same as the preceding tax year. For example, income tax collections in fiscal year 2010 (the 1<sup>st</sup> year of the 2009-11 biennium) are an approximate reflection of the tax collections from tax year 2009.

<sup>2</sup>The amounts shown for the effect of the corporate income rate reductions reflect the cumulative corporate income tax relief provided by the Legislative Assembly based on the rate reductions approved by the Legislative Assembly in 2009, 2011, 2013, and 2015. In Senate Bill No. 2199 (2009), the Legislative Assembly reduced the number of corporate income tax brackets from five to three and reduced the corporate tax rates in each bracket. In House Bill No. 1047 (2011), the Legislative Assembly reduced corporate income tax rates by 19.5 percent. In Senate Bill No. 2156 (2013), the Legislative Assembly reduced corporate income tax rates by 11.9 percent. In Senate Bill No. 2349 (2015), the Legislative Assembly reduced the corporate income tax rates by 4.9 percent.

## EXEMPT CORPORATIONS

Under 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 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 amateur 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 organizations; 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. A corporation with a fiscal tax year ending June 30 must file its federal corporate income tax return by the 15<sup>th</sup> day of the 3<sup>rd</sup> month after the end of its tax year. 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 15<sup>th</sup> day of the 4<sup>th</sup> month after the close of the fiscal year, for a corporation filing on a fiscal year basis. Differing filing deadlines are applicable to cooperatives, domestic international sales corporations, and foreign sales corporations and for exempt organizations reporting unrelated business income.

### **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, or attributable to, 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 attributable to sources within North Dakota. A corporation historically has to apportion its business income using an apportionment formula with equally weighted property, payroll, and sales factors. 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.

However, starting in 2016, businesses that apportion income may elect an alternative method to the equally weighted three-factor apportionment formula. Corporations may elect to more heavily weight the sales component of its apportionment factor, instead of the standard weighting of one-third. If elected, income is apportioned using a double-weighted sales factor in tax years 2016 and 2017, a sales factor which is six times the weight of other factors in tax year 2018, and using only the sales factor in tax years 2019 and forward. Alternative apportionment elections are binding for 5 consecutive taxable years.

### **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 formulation. 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 24 states that have adopted the Uniform Division of Income Tax Act. This Act is codified as 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 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 5 consecutive years. 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.

### **CORPORATE INCOME TAX DEDUCTIONS**

A corporation is entitled to subtract from federal 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 United States Constitution or the Constitution of North Dakota.
3. Net income not allocated and apportioned to this state which was included in federal taxable income.
4. State income tax refunds.
5. Dividends paid by a regulated investment company.
6. Actual or deemed distributions to the owners of interest-charge domestic international sales corporations without economic substance owned by individuals or passthrough entities.

### **CORPORATE INCOME TAX ADDITIONS**

A corporation must add certain items to federal taxable income, including the following:

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. Special deductions and net operating losses deducted on the federal return.
4. Dividends paid by captive real estate investment trusts.
5. Amounts related to contributions to an endowment fund to the extent the contributions reduced federal taxable income.

### **CORPORATE INCOME TAX CREDITS**

Corporate income tax credits are allowed for:

1. Investment in a qualified seed capital business.
2. Investment in a qualified agricultural commodity processing facility.
3. Qualified research and experimental expenses incurred in North Dakota.
4. Contributions to nonprofit private grade schools, high schools, and colleges.
5. A portion of wages paid to an individual with a developmental disability or severe mental illness, effective for taxable years 2021 and 2022.
6. Investment in a renaissance fund organization.

7. Investment in historic property preservation or renovation in a renaissance zone.
8. Direct costs incurred to retrofit an existing facility or adapt a new facility to produce or blend biodiesel or green diesel fuel, or to crush soybeans or canola.
9. Direct costs incurred by licensed fuel sellers to adapt or add equipment to enable retail sales of at least 2 percent biodiesel or green diesel fuel blend.
10. Blending at least a 5 percent blend of biodiesel or green diesel fuel by a licensed fuel supplier.
11. Compensation paid to college interns working in North Dakota.
12. Compensation paid to employees hired to fill hard-to-fill positions in North Dakota.
13. Contributions to a qualified endowment fund held by a North Dakota nonprofit organization, or bordering North Dakota if other criteria are met.
14. Compensation paid to an employee in the National Guard or armed forces reserve who is mobilized for federal active duty.
15. Contributions to the Rural Leadership North Dakota Scholarship Tuition Program conducted by the North Dakota State University Extension Service.
16. Purchasing machinery and equipment to automate a manufacturing process, effective for taxable years 2019 through 2022.

### **CORPORATE INCOME TAX-EXEMPT ACTIVITIES**

Certain activities are exempt from corporate income taxes. A new or expansion project in a primary sector business or tourism qualifies for an income tax exemption for up to 5 years. The exemption is limited to the net 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.

Corporate taxpayers engaging in qualifying zone projects or investing in a renaissance fund organization set up to provide financing to projects in a North Dakota renaissance zone qualify for income tax incentives. Section 40-63-04 provides an income tax exemption to a taxpayer that purchases, leases, rehabilitates, or makes leasehold improvements to residential, public utility infrastructure, or commercial property for any business or investment purpose as a renaissance zone project. The amount of the exemption is equal to the income derived from all of a taxpayer's business or investment interests within the zone, up to a maximum amount of \$500,000 per taxable year for 5 taxable years beginning with the date of purchase, lease, or completion of rehabilitation. For projects that expand an existing building, the amount of the exemption is equal to the income derived from the business or from the investment use of the building during the taxable year multiplied by a ratio equal to the square footage added by the expansion divided by the total square footage of the building after expansion.

Renaissance fund organizations also may qualify for an income tax exemption pursuant to Section 40-63-07.

### **CORPORATE INCOME TAX BURDEN**

North Dakota corporate income tax collections for fiscal year 2020 were just over \$91.5 million.<sup>3</sup> The Tax Foundation provides a variety of income tax data for states throughout the nation. Attached is a graphic ([Appendix C](#)) available on the Tax Foundation website which provides a comparison of state corporation income tax rates as of January 1, 2022.<sup>4</sup> The comparison provides North Dakota's top corporate income tax bracket rate of 4.31 percent is the fourth lowest nationally of states that impose a corporate income tax, with only North Carolina, Oklahoma, and Missouri reporting lower corporate income tax rates.

In terms of the state's tax climate, North Dakota is ranked 9<sup>th</sup> out of 50 states in the corporate tax category on the Tax Foundation's *2022 State Business Tax Climate Index*, with an overall tax climate index rank of 16<sup>th</sup> out of 50 states.<sup>5</sup>

<sup>3</sup> North Dakota Tax Department, "2020 State and Local Taxes: An Overview and Comparative Guide" (Dec. 2020), p. 23, <https://www.tax.nd.gov/sites/www/files/documents/news-center/publications/red-book-2020-online-version.pdf>.

<sup>4</sup> Tax Foundation, "State Corporate Income Tax Rates and Brackets for 2022" (Jan. 2022), [https://taxfoundation.org/state-corporate-income-tax-rates-brackets-2022/#\\_ftnref1](https://taxfoundation.org/state-corporate-income-tax-rates-brackets-2022/#_ftnref1).

<sup>5</sup> Tax Foundation, "2022 State Business Tax Climate Index" (Dec. 2021), <https://taxfoundation.org/2022-state-business-tax-climate-index>.

## **PAST INCOME TAX INTERIM STUDIES**

This section provides information regarding income tax related interim studies conducted during the 2011-12 interim to present.

### **2011-12 Interim**

House Bill No. 1047 (2011) directed the Taxation Committee to study corporate income taxes, corporate income apportionment factors, and the potential impact of federal legislation on state corporate income taxes. This study was amended by a Legislative Management directive to exclude the study of financial institutions taxes. The committee made no recommendation for legislation related to this study.

Section 6 of Senate Bill No. 2006 (2011) directed the Taxation Committee to study the state's income tax credits, including 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 made no recommendation for legislation related to this study.

### **2015-16 Interim**

The Chairman of the Legislative Management assigned the Political Subdivision Taxation Committee a study of the income tax reciprocity agreement between North Dakota and Montana, including consideration of the number of individuals utilizing the agreement's optional provisions and the resulting fiscal impact on the income tax revenues of North Dakota and Montana. The committee made no recommendation related to this study.

### **2019-20 Interim**

Section 32 of Senate Bill No. 2015 (2019) created the Legacy Fund Earnings Committee to study the potential uses of legacy fund earnings, including the use of earnings to provide tax relief, provide for reinvestment of legacy fund earnings, fund research and technological advancements, promote economic growth and diversification, and promote workforce development and career and technical education. The committee was permitted to consider public input on the use of legacy fund earnings and review the operation of other funds, such as Norway's sovereign wealth fund. Following the study, the committee recommended the following legislation:

- House Bill No. 1037 (2021) relating to the establishment of a percent of market value method for determining the amount of legacy fund earnings available to be spent each biennium and the creation of a legacy earnings fund. The bill failed to pass.
- House Bill No. 1038 (2021) relating to the Legacy Fund Earnings Committee. The bill provided for the continuation of the Legacy Fund Earnings Committee for the 2021-22 interim with the same committee membership and study purpose.

### **2021-22 Interim**

Section 6 of House Bill No. 1380 (2021) directs the Legacy Fund Earnings Committee to study potential uses of legacy fund earnings, including the use of earnings to provide tax relief, research and technological advancements, innovation, economic growth and diversification, and workforce development. The committee has not completed its study to date.

## **POSSIBLE STUDY APPROACH**

The following is a proposed study plan for the committee's consideration in its study of income tax reform and relief:

1. Receive information from Legislative Council staff regarding current and projected state revenues and expenditures and stability of state revenue sources identified as a funding source for tax relief.
2. Receive input as necessary from the Tax Department and interested parties regarding administration of proposed legislation considered by the committee.
3. Develop recommendations and any bill drafts necessary to implement the recommendations.
4. Prepare a final report for submission to the Legislative Management.

ATTACH:3