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

The Legislative Management has assigned to the Taxation Committee a study of corporate income taxes. Section 16 of House Bill No. 1047 directs a study of the feasibility and desirability of revision of the financial institutions taxes, including the feasibility of taxing financial institutions under the state corporate income tax laws and including consideration of corporate income taxes, including corporate income apportionment factors and potential impact of federal legislation on state corporate income taxes. The Legislative Management approved the study but amended it to eliminate consideration of financial institutions taxes and retain only the study of the corporate income tax issues.

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. 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 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 standard corporate income tax 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 2007 corporate income tax rates were reduced to the following:

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	6.5%

In 2009 corporate income tax rates were reduced to the following:

Taxable Income	Taxable Rate
$25,000 or less	2.10%
Over $25,000 but not over $50,000	5.25%
Over $50,000	6.40%

In 2011 corporate income tax rates were reduced to the following:

Taxable Income	Taxable Rate
$25,000 or less	1.68%
Over $25,000 but not over $50,000	4.23%
Over $50,000	5.15%

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 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 Section 57-35.3-04, financial institutions paying a financial institutions tax are exempt from corporate income taxes. Financial institutions pay a tax that was reduced by 2011 House Bill No. 1047 from 7 percent to 6.5 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 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. 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 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. Under North Dakota law, the corporate property, payroll, and sales factors are equally weighted. Corporate income apportionment formulas are used by all states imposing corporate income taxes and have been adjusted by some states to provide unequal weighting among factors in efforts to encourage businesses to locate in the state or to provide favorable tax treatment for businesses already located in the state. The Tax Department will provide information on apportionment factor adjustments used by 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 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 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.

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 Constitution of the United States 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.

CORPORATE INCOME TAX ADDITIONS

The following must be added to federal 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. The amount of United States domestic production activities income deducted on the federal return.
4. Special deductions and net operating losses deducted on the federal return.

CORPORATE INCOME TAX CREDITS

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

2011 CORPORATE INCOME TAX LEGISLATION

House Bill No. 1047 reduces corporate income tax rates by approximately 19.5 percent, resulting in an anticipated reduction in state general fund revenues of approximately $25 million for the 2011-13 biennium. The bill reduces individual income tax rates by 17.9 percent, which is expected to reduce state general fund revenues $120 million for the 2011-13 biennium.

Senate Bill No. 2034 provides an individual and corporate income tax credit of 5 cents per gallon for a fuel supplier who blends green diesel fuel of at least 5 percent blend. The bill provides an individual and corporate income tax credit for a seller of green diesel fuel equal to 10 percent per year for five years of the direct costs incurred to adapt or add equipment to allow sale of diesel fuel containing at least 2 percent green diesel fuel. The bill provides a corporate income tax credit of 10 percent per year for five years of the costs for a facility to produce or blend diesel fuel containing at least 2 percent green diesel fuel. The bill also extends the agricultural business investment tax credit to cover investment in a facility producing green diesel fuel of at least 5 percent blend.

Senate Bill No. 2160 expands the income tax credit for charitable gifts to qualified endowments. The credit is 40 percent of a gift of $5,000 or more. The bill did not change the credit provisions for corporate income taxpayers.

Senate Bill No. 2210 establishes a housing incentive fund and creates individual and corporate income tax credits for contributions to the fund. The credit allowed is equal to the amount of the contribution to the housing incentive fund. A taxpayer may not claim more than 20 percent of the credit during a taxable year and the unused portion of the credit may be carried forward for up to 10 years. The aggregate amount of tax credits for all contributors is limited to $4 million per biennium.

Senate Bill No. 2057 creates a corporate and individual income tax credit for purchasing manufacturing machinery and equipment to automate manufacturing processes. The amount of the credit is 20 percent of the costs incurred and the aggregate amount of credits allowed for all taxpayers may not exceed $2 million in any calendar year.

House Bill No. 1057 makes changes in the angel fund investment tax credit available to corporate and individual income taxpayers to allow passthrough entities to qualify and to allow investors to transfer their credits. Aggregate lifetime credits for angel fund investments are limited to $150,000. The angel fund is required to provide the Tax Commissioner a report showing the name and principal place of business of each enterprise in which the angel fund has an investment. The angel fund is also required to provide the Tax Commissioner information on each investor in the angel fund showing the name, address, Social Security number or employer identification number, amount of investment, and date of investment. For tax years 2011 and 2012, a taxpayer may elect to sell, transfer, or assign an angel fund investment tax credit subject to certain conditions and limited to $100,000 of transfers over any combination of taxable years. The bill requires the Tax Commissioner to report to the Legislative Management during the 2011-12 and 2013-14 interims on the number of in-state investors, amount of investment, and the amount of tax credits accrued, claimed, and transferred by each individual angel fund. The Legislative Management assigned the responsibility to receive this report to the Taxation Committee for this interim.

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 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 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 five years for investment income from renaissance zone residential or commercial real property purchased solely for investment purposes.

CORPORATE INCOME TAX COLLECTIONS

The corporate income tax is a significant source of revenue for the state general fund. The following table shows revenue history for recent years.

Fiscal Year	Net Collections
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	$51,606,853
2002	$41,374,297
2003	$46,027,577
2004	$40,257,083
2005	$62,669,889
2006	$111,789,578
2007	$119,955,748
2008	$140,737,698
2009	$98,958,239
2010	$87,874,592
2011 estimated	$91,201,000

Source: North Dakota Office of State Tax Commissioner, *State and Local Taxes, An Overview and Comparative Guide 2010*.