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

The Legislative Council has assigned to the Taxation Committee a study of individual and corporate income taxes. Separate memorandums were prepared for individual and corporate income taxes to avoid confusion between corporate and personal income tax provisions.

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 again 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 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 two different methods. For the great majority of individuals, the "short form" provides a considerably lower tax liability than the tax determined using the state 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 1986 special legislative 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 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 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, which were established to mirror federal brackets at that time. In addition, the 2001 legislation established use of the same inflation indexing factor as 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 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" have been replaced by the Tax Commissioner with references to "Form ND-1" (previous "short form") and "Form ND-2" (previous "long form"). After application of the inflation factor based on federal law to taxable income brackets, the Form ND-1 tax rate schedules for taxable year 2002 are as follows:

Single			
If North Dakota taxable income is:		**Your tax is equal to:**	
Over	**But not over**		
$0	$27,950		2.1% of North Dakota taxable income
$27,950	$67,700	$586.95	+ 3.92% of amount over $27,950
$67,700	$141,250	$2,145.15	+ 4.34% of amount over $67,700
$141,250	$307,050	$5,337.22	+ 5.04% of amount over $141,250
$307,050		$13,693.54	+ 5.54% of amount over $307,050

Married Filing Jointly and Qualifying Widow(er)			
If North Dakota taxable income is:		**Your tax is equal to:**	
Over	**But not over**		
$0	$46,700		2.1% of North Dakota taxable income
$46,700	$112,850	$980.70	+ 3.92% of amount over $46,700
$112,850	$171,950	$3,573.78	+ 4.34% of amount over $112,850
$171,950	$307,050	$6,138.72	+ 5.04% of amount over $171,950
$307,050		$12,947.76	+ 5.54% of amount over $307,050

Married Filing Separately			
If North Dakota taxable income is:		**Your tax is equal to:**	
Over	**But not over**		
$0	$23,350		2.1% of North Dakota taxable income
$23,350	$56,425	$490.35	+ 3.92% of amount over $23,350
$56,425	$85,975	$1,786.89	+ 4.34% of amount over $56,425
$85,975	$153,525	$3,069.36	+ 5.04% of amount over $85,975
$153,525		$6,473.88	+ 5.54% of amount over $153,525

Head of Household			
If North Dakota taxable income is:		**Your tax is equal to:**	
Over	**But not over**		
$0	$37,450		2.1% of North Dakota taxable income
$37,450	$96,700	$786.45	+ 3.92% of amount over $37,450
$96,700	$156,600	$3,109.05	+ 4.34% of amount over $96,700
$156,600	$307,050	$5,708.71	+ 5.04% of amount over $156,600
$307,050		$13,291.39	+ 5.54% of amount over $307,050

2003 LEGISLATIVE CHANGES

Senate Bill No. 2099 allows the Tax Commissioner to permit rounding to the nearest dollar for income tax purposes. The bill creates an individual short-form return deduction for income from a new and expanding business. The bill eliminates a provision that has been declared unconstitutional providing a tax deduction for dividends paid by North Dakota corporations.

House Bill No. 1115 allows the Tax Commissioner to share information with the Bureau of the Census on taxpayer identification numbers and county of residence.

House Bill No. 1108 allows for collection and payment of withholding taxes by payroll service providers.

Senate Bill No. 2367 provides an income tax deduction for amounts received as payment for services when ordered to federal service as a member of the National Guard or reserve of the armed forces of the United States.

Senate Bill No. 2100 allows the Tax Commissioner two years from the date of amending a state income tax return to assess additional income tax attributable to changes or corrections on the amended return.

Senate Bill No. 2101 provides that, to be eligible to use the state three-year income averaging method for farm income, the taxpayer must use the three-year income averaging method for federal income tax purposes. The bill requires a taxpayer filing a long-form return for any of the three base years in the averaging calculation to recalculate the tax for that year using the short-form method. The bill eliminates the possibility of a double deduction when farm income is averaged and included a net long-term capital gain from the sale or exchange of property other than land used in the farming operation.

Senate Bill No. 2098 provides that a North Dakota resident who pays income tax to another state will no longer be required to provide written proof of the tax paid to the other state and allows discretionary authority to the Tax Commissioner to request written proof of the tax paid to the other state if necessary.

House Bill No. 1426 provides an individual income tax deduction for interest and income from bonds issued by a commerce authority.

House Bill No. 1243 allows the Tax Commissioner to disclose to the North Dakota Lottery director whether a lottery retailer applicant has or has not complied with state income tax laws.

Senate Bill No. 2159 eliminates a requirement that adjustments to taxable income are allowed only to the extent the adjustment is attributable to income allocated and apportioned to North Dakota.

House Bill No. 1019 eliminates the limitation on seed capital investment income tax credits to $250,000 of investments in one qualified business. The bill also increases from 30 to 45 percent the amount of investment for which a taxpayer may receive a seed capital investment tax credit.

SUGGESTED STUDY APPROACH

On May 23, 2003, Congress passed a major tax cut package (Jobs and Growth Tax Relief Reconciliation Act of 2003) to reduce the tax rate for capital gains and dividends, accelerate marginal tax rate reductions, enhance small business expensing, extend bonus depreciation, increase the child tax credit, provide temporary relief from the alternative minimum tax, provide marriage penalty relief, expand the 10-percent tax bracket, and make other changes. Because the North Dakota individual income tax is no longer tied to federal income tax liability, much of the income tax revenue reduction that would have occurred without the 2001 changes will not impact the state. However, there will be a loss of North Dakota income tax revenues. As a starting point for the study of the individual income tax, the Tax Department staff has been requested to provide an analysis of the impact of the Jobs and Growth Tax Relief Reconciliation Act of 2003 on North Dakota income tax revenues. The committee may also wish to review the income tax laws of other jurisdictions.