INCOME TAX RECIPROCITY AGREEMENT BETWEEN NORTH DAKOTA AND MONTANA

The Political Subdivision Taxation Committee has been assigned, pursuant to a directive by the Legislative Management Chairman, a study of the reciprocity agreement between North Dakota and Montana pertaining to the collection and payment of income tax.

BACKGROUND INFORMATION

Generally, compensation received by an individual for services performed in North Dakota is taxable by North Dakota even though the individual receiving the compensation is not a legal resident of this state. This practice of taxation centers around the principle of source-based jurisdiction, whereas the state serving as the source of an individual's income has the right to tax income earned within its borders. There are some exceptions to the general rule of taxing North Dakota source income, including the exemptions applied to compensation earned by United States armed forces service members and their spouses, certain interstate commerce employees, certain nonresident individuals present in the state for a limited duration, and Minnesota and Montana residents covered under reciprocity agreements.

The Tax Commissioner has the authority to enter reciprocal agreements with other taxing officials and entities pursuant to North Dakota Century Code Section 57-38-59.1. The Montana Department of Revenue is provided similar authority under Montana Administrative Code Section 15-30-2621. The reciprocal agreement between North Dakota and Montana regarding the taxation of personal and professional service income was first entered in January 1, 1975. The most recent version, signed in 2014, is scheduled for renewal on January 1, 2016.

The agreement provides that compensation for personal or professional services earned in North Dakota by a Montana resident is not subject to income tax in North Dakota if the individual earning the compensation elects to be exempt from North Dakota withholding. The same option exists for North Dakota residents earning compensation for personal or professional services in Montana. Thus, if a Montana resident who is working and earning compensation for professional services in North Dakota files an election with the individual's employer to refrain from having North Dakota income tax withheld, the Montana resident would not be required to file a North Dakota return or remit North Dakota income tax on that compensation. However, the Montana resident would be required to file and pay tax on that compensation in Montana as, pursuant to the principle of residence-based jurisdiction, Montana has the right to tax income earned by its residents regardless of whether that income is earned outside Montana's borders.

In analyzing the fiscal impact of this reciprocity agreement, some basic numbers can be applied to the previous example to illustrate its effects. For instance, assume the amount of compensation earned by the Montana employee would result in $2,100 of income tax liability when applying Montana's income tax rates and $2,000 of income tax liability when applying North Dakota's rates. Under the current agreement, the Montana resident would owe $2,100 in income tax to Montana but would not owe any income tax to North Dakota and would not be required to file a return in this state.

In the absence of the agreement, the Montana resident's compensation would be subject to North Dakota income tax withholding and the Montana resident would be required to file and pay North Dakota $2,000 in income tax. The Montana resident also would be required to file and pay income tax in Montana, but would receive a credit for any amount of tax remitted to North Dakota. Thus, the resulting amount of income tax paid to the North Dakota would be $2,000 and the amount paid to Montana would be $100 (*after subtracting the credit for tax paid to North Dakota*).

While the revenue analysis in this hypothetical is quite simple, the task of conducting a full-scale analysis encompassing all compensation impacted by the reciprocity agreement would be much more complex. This is especially true considering many Montana residents working in this state are not required to file a North Dakota tax return. Following an inquiry with the Tax Department, it does not appear a study of this magnitude has been conducted.