

Minnesota Supreme Court Holds Trust Residency Statute Unconstitutional As Applied to Taxpayer Trusts—Time to Evaluate Income Tax Refund Claims

by Katina M. Peterson

In a 4-2 decision, the Minnesota Supreme Court ruled in *Fielding v. Commissioner* that four trusts lacked sufficient relevant contacts with Minnesota during the applicable tax year to be permissibly taxed, consistent with due process, on all sources of income as Minnesota residents. As a result, certain irrevocable trusts may be entitled to income tax refunds.

Like other Minnesota taxpayers, trusts are classified as “resident” or “nonresident” taxpayers. The statutory test for determining whether a trust is a resident trust is found in Minnesota Statutes Section 290.01, subdivision 7b, and it varies depending on when, and how, the trust was created. For a trust created by a grantor during his or her lifetime (other than a trust whose income is taxable to its grantor) that becomes irrevocable on or after January 1, 1996, the statutory test is simple. The trust is a resident if its grantor was a Minnesota resident when the trust became irrevocable.

In *Fielding*, four trusts were classified as resident trusts under this statutory test. The trusts filed Minnesota income tax returns for 2014 under protest, claiming that the test, as applied to them, was unconstitutional. The trusts then filed amended returns claiming refunds for the substantial difference between the taxes owed as resident trusts and the taxes owed as nonresident trusts. Unlike a nonresident trust, a resident trust is subject to Minnesota income tax on all of its income associated with nonbusiness intangible assets – items like interest payments, dividends, and capital gains. The Commissioner denied the trusts’ refund claims and the trusts appealed to the Minnesota Tax Court. The Tax Court held in favor of the trusts and ultimately concluded on due process grounds that Minnesota did not have a sufficient basis to tax the trusts as residents because the grantor’s domicile at the time the trust became irrevocable was not “a connection of sufficient substance” to support the exercise of taxing jurisdiction.

The Minnesota Supreme Court upheld the Tax Court’s decision. Citing *Luther v. Commissioner* and other decisions involving due process challenges to taxing statutes, the Court first determined that it “must look beyond the statutory definition that identifies

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who is subject to a tax in order to evaluate the relationship between the income taxed and the benefits provided by the State.” The Court concluded that it therefore must “examine all relevant contacts between the taxpayer and the State” for purposes of the trusts’ due process challenges, and not solely consider the grantor’s residency at the time the trusts became irrevocable.

The Commissioner argued that the trusts’ connections with Minnesota were sufficient to permit them to be taxed as Minnesota residents, citing the following factors:

- The grantor was a Minnesota resident when the trusts were created, when the trusts became irrevocable, and in 2014 (the tax year at issue);
- The trusts were created in Minnesota, with assistance of a Minnesota law firm that drafted, and until 2014 retained, the trust documents;
- The trusts held stock in a Minnesota S corporation;
- The trust documents provide that Minnesota law governs; and
- One trust beneficiary had been a Minnesota resident at least through 2014.

The Court concluded that “the contacts on which the Commissioner relies are either irrelevant or too attenuated to establish that Minnesota’s tax on the trusts’ income from all sources complies with due process requirements.” Significantly, the Court concluded that only the contacts between the trusts and Minnesota in 2014 were relevant. The Court further held that the grantor’s connections with Minnesota at any point in time are entirely irrelevant, including the grantor’s decision to use a Minnesota law firm solely to draft the trust documents and store the original trust agreement, and that the Minnesota residency of a beneficiary “does not establish the necessary minimum connection to justify taxing the trusts’ income.”

The Court did consider the trustees’ level of contact and connections with Minnesota, the location of the trusts’ administration activities, and the choice of law provisions to be relevant considerations in its due process analysis. The Court found that, standing alone, the fact that the trusts were governed by Minnesota law was not enough to tax the trusts as residents, but acknowledged that its analysis might be different with respect to testamentary trusts probated in Minnesota. Ultimately, the Court concluded that “[E]ven when the additional contacts the Commissioner cites are considered in combination, the State lacks sufficient contacts with the Trusts to support taxation of the Trusts entire income as residents consistent with due process. The State cannot fairly ask the Trusts to pay taxes as residents in return for the existence of Minnesota law and the physical storage of trust documents in Minnesota.”

The Court’s ruling in *Fielding* is highly dependent upon the specific facts in the case, but it might affect other trusts classified as resident trusts under the same statutory test. If you would like to discuss how the decision may affect a trust of which you are a trustee or beneficiary, please contact us.