

Minnesota Tax Court Holds Trust Residency Statute Unconstitutional

by Katina M. Peterson

The Minnesota Tax Court recently ruled in *Fielding v. Commissioner of Revenue* that a state statute treating certain irrevocable trusts as Minnesota “residents” for income tax purposes is unconstitutional. This decision could have significant tax ramifications for certain trusts, including the potential for income tax refunds.

The classification of a trust as a resident or nonresident trust under Minnesota law determines how much of its income (if any) will be subject to Minnesota income tax. For example, a resident trust is subject to Minnesota income tax on income associated with nonbusiness intangible assets, such as interest payments, dividends, and capital gains from investment accounts. A nonresident trust, on the other hand, would not be subject to Minnesota income tax on its nonbusiness intangible assets.

The test for determining whether a trust is classified as a Minnesota resident trust varies depending on the type of trust and when the trust was created. For trusts (1) created by the grantor during his or her lifetime; (2) that are separate taxpaying entities; and (3) that were irrevocable on or after January 1, 1996, the test is simple. Such a trust is a resident trust if the grantor was a Minnesota resident when the trust became irrevocable. No other connection to Minnesota is required. This is the statutory provision challenged in *Fielding*.

Fielding involved four irrevocable trusts established by a Minnesota resident in 2009. At no time was any trustee of the trusts a Minnesota resident. Although the trusts initially owned stock in a closely-held business located in Minnesota, this stock was later sold and the trusts then held only investment accounts administered in California. The trust beneficiaries (with one exception) were not Minnesota residents. The trust records were located outside of Minnesota. And yet, because the grantor was a Minnesota resident in 2009, the trusts were subject to (and paid) Minnesota income tax on the proceeds of the stock sale and their investment account income. Each trust subsequently filed an amended return treating itself as a nonresident trust and requesting a refund. The trusts contended that the above-described statutory provision as applied to them is

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unconstitutional.

The Minnesota Tax Court concluded that Minnesota could not properly justify a tax based solely on the residency of the grantor at a discrete historical moment. Due process under the U.S. Constitution requires that there be a rational, contemporaneous relationship between a tax imposed by a state and the protections and benefits offered by the state in return. In this case, the trusts had no connection with Minnesota, and were receiving no protections or benefits from Minnesota. Therefore, the Court determined that the Commissioner erred in denying the trusts' refund claims.

Fielding addressed only the residency statute with respect to certain irrevocable trusts created by a settlor during his or her lifetime. We do not yet know how the decision will impact the state income tax treatment of testamentary trusts (trusts that are created upon an individual's death by the terms of his or her will), if at all. Currently, testamentary trusts are considered to be resident trusts if the individual died on or after January 1, 1996, and was a Minnesota resident at death.

The Minnesota Department of Revenue may appeal the *Fielding* decision to the Minnesota Supreme Court. In the meantime, if you would like additional information or have questions about how the *Fielding* decision could apply to trusts for which you are a trustee or beneficiary, please contact us.