Steve Leimberg's Income Tax Planning
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Subject: Ed Morrow on *Fielding* - Yet Another Case Where State Income Taxation of Nonresident Trusts Ruled Unconstitutional

"Fielding v. Commissioner of Revenue continues a trend of taxpayers successfully challenging broad state income tax statutes as unconstitutionally violating due process (and probably the commerce clause) by taxing a non-resident or non-resident trust with insufficient minimum contacts and nexus with the taxing state. The Minnesota Supreme Court has granted cert to hear an appeal of the decision.

Minnesota is in one of a large group of states with the most stringent, far-reaching and what many would claim unfair and unconstitutional tax statutes vis-à-vis trust income. It attempts to tax an irrevocable trust created by a Minnesota resident as a 'resident trust' forever and thereafter no other connection with the state is required or even relevant.

This decision and the trend of prevailing cases may put pressure on similarly-taxing states to revisit their statutes. The court in Fielding refused to consider other factors such as the Minnesota residency of one of the beneficiaries, which may have provided sufficient Constitutional nexus with the state had the state statute listed it as a factor.

Practitioners in every state should consider the effect of trustee choice on state taxation when choosing trustees for trusts anticipated to accumulate substantial taxable income, and increasingly, the grantor/non-grantor status of such trusts."

We close the week with **Ed Morrow**'s commentary on *Fielding v. Commissioner of Revenue*, a significant decision impacting irrevocable, non-grantor trust planning.

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Here is Ed's commentary:

EXECUTIVE SUMMARY:

"[W]e conclude that the domicile of the grantor . . . at the time a trust became irrevocable-standing alone-is not a sufficient basis to justify the resident tax treatment of an inter vivos trust." [The Minnesota statute] "violates the due process provisions of the Minnesota and United States constitutions."[1]

Fielding v. Commissioner of Revenue continues a trend of taxpayers successfully challenging broad state income tax statutes as unconstitutionally violating due process (and probably the commerce clause) by taxing a non-resident or non-grantor trust with insufficient minimum contacts and nexus with the state. It found that the state lacked subject matter jurisdiction over gain and income from items of intangible personal property (S corporation stock) not located within Minnesota (even though the S corporation was largely based in Minnesota).

Minnesota is in one of a large group of states that arguably have the most stringent, far-reaching and many would say unfair and unconstitutional taxing statutes vis-à-vis trust income - it taxes an irrevocable trust created by a Minnesota resident as a "resident trust" forever and thereafter no other connection with the state is required or even relevant.

The use of either completed gift or incomplete gift non-grantor trusts (a.k.a. INGs) offers significant asset protection, family management, and even federal income tax benefits for Minnesota taxpayers whose income is anticipated to rise above the highest income tax bracket. Unless the case is reversed, these advantages now include the legitimate state income tax avoidance of non-Minnesota "source income."

Non-grantor trusts that have paid Minnesota income tax based on the same statute as Fielding should consider filing for a refund. Practitioners in every state should consider the effect of trustee choice on state taxation when drafting and choosing trustees for trusts anticipated to accumulate substantial taxable income."

COMMENT:

In a case decided May 31, 2017 that the Minnesota Supreme Court has agreed to hear on appeal, *Fielding v. Commissioner of Revenue*, the Minnesota Tax Court continued and may have even expanded a trend by siding with trust taxpayers in finding the state's statute to be unconstitutionally broad and violative of both state and federal due process.

Reid McDonald was a Minnesota resident who in 2009 established and funded four irrevocable trusts for his children, with some cash but principally with S corporation stock. They were initially established as grantor trusts, but he released certain retained powers causing grantor trust status (a swap power subject to Internal Revenue Code § 675(4)) as of December 31, 2011 so as to cause them to be taxed separately as non-grantor trusts. Not coincidentally, the California resident trustee resigned as of that same date and thereafter all trustees and trust administration was either in Colorado or Texas. Fielding, the named plaintiff, was trustee.

The tax year in question was 2014, when the trusts sold a very large block of S corporation stock. The trustee had paid the Minnesota income tax (as well as tax in Arizona, California, Colorado and Illinois!) and subsequently filed for a refund. The trustee did not contest the ability of Minnesota to tax the ongoing S corporation income (reported on the corporation's K-1 to the trust) attributable to the S corporation prior to the sale of stock, but contested the imposition of Minnesota state income tax on the capital gains from the sale of the stock and other income.

Minnesota's taxing statute is quite broad for trusts that became irrevocable after 1995, as in this case:

> **Subd. 7b. Resident trust.**
>
> (a) Resident trust means a trust, except a grantor type trust, which either (1) was created by a will of a decedent who at death was domiciled in this state or **(2) is an irrevocable trust, the grantor of which was domiciled in this state at the time the trust became irrevocable**. For the purpose of this subdivision, a trust is considered

> irrevocable to the extent the grantor is not treated as the owner thereof under sections 671 to 678 of the Internal Revenue Code. The term "grantor type trust" means a trust where the income or gains of the trust are taxable to the grantor or others treated as substantial owners under sections 671 to 678 of the Internal Revenue Code. This paragraph applies to trusts, except grantor type trusts, that became irrevocable after December 31, 1995, or are first administered in Minnesota after December 31, 1995.

Despite working from the strong presumption that its statute was constitutional, the Minnesota Tax Court found that it was *beyond a reasonable doubt* that the statute was unconstitutional as applied to the four irrevocable trusts. This is despite what might be considered a few "bad facts" - not only was the settlor a Minnesota resident, but one of the four trusts had a Minnesota-domiciled beneficiary who received distributions during the tax year, a Minnesota attorney created the trust, the trust referenced and used Minnesota law, the original documents were kept in Minnesota but most surprisingly to some, "[T]he Trusts' primary trust asset and source of income during 2014 was stock in FFI, a closely held S-Corporation which was incorporated in the State of Minnesota and has always been headquartered in Minnesota." Importantly, however, Minnesota's state statute did not invoke any factor but the residency of the settlor. It was this simplicity which may have doomed the ability of the state to tax.

This holding applied to the trust with the Minnesota beneficiary as well as to the three trusts with primarily out-of-state beneficiaries (presumably their brother would be a contingent beneficiary). Had the Minnesota legislature incorporated additional prongs into its statute (similar to about a dozen other states), such as the additional need for a resident trustee, beneficiary or assets sitused in state, the case could have turned out differently. The court declined to add or consider other additional prongs that might provide sufficient nexus, since the statute was clearly silent on those points:

> "We will not, as the Commissioner requests, consider other (nexus) factors such as the storage in Minnesota of trust instruments *or the Minnesota domicile of a beneficiary*."
>
> "[W]e conclude that the domicile of the grantor . . . at the time a trust became irrevocable-standing alone-is not a sufficient basis to justify the resident tax treatment of an inter vivos trust." [The Minnesota

statute] "violates the due process provisions of the Minnesota and United States constitutions"

Fielding v. Commissioner of Revenue continues a trend of taxpayers successfully arguing that many state income tax statutes unconstitutionally violate due process (and the commerce clause) by taxing a non-grantor trust with insufficient minimum contacts and nexus with the state. Minnesota is in one of a group of states that arguably have the most stringent, far-reaching and some say unfair and unconstitutional taxing statutes vis a vis trust income - it taxes an irrevocable trust created by a Minnesota resident as a "resident trust" forever and thereafter no other connection with the state is required or even relevant.

States with similar statutes are Delaware, Illinois (which also has similar case law, see below), Maine, Maryland, Michigan (which also has case law, see below), Nebraska, Oklahoma, Pennsylvania (which also has case law, see below), Vermont, Virginia, Washington D.C., West Virginia and Wisconsin.[2]

This attempt by states to be as broad as possible with their definitions of "resident trusts" may come back to bite them. Ironically their statutes' breadth may have the potential (as in this case) to curb their ability to tax income more than if the states had a more nuanced statute.

For example, had the Minnesota statute included a requirement similar to Ohio or other states that in addition to a resident settlor there must also be a Minnesota resident beneficiary entitled to trust distributions, the statute would likely have been constitutional and the state would have at least been able to tax one of the four trusts that still had a Minnesota resident (the younger son attended college in New York, but was still considered a Minnesota domicile and filed Minnesota income tax returns at the time).

Here are a few other recent cases indicating this trend - the *Fielding* court discussed the *Linn, Potter* and *Blue* cases below extensively and cited *Kaestner* in a footnote:

1) *Linn v. Department of Revenue,* 2 N.E.3d 1203 (Ill. Ct. App. 2013) – holding that Illinois could not tax a trust created during lifetime where there was no trustee in Illinois, no real or tangible property in Illinois and no Illinois source income;

2) *McNeil v. Commonwealth of Pennsylvania,* 67 A.3d 185 (Commw. Ct. 2013) – Pennsylvania could not tax a trust created during lifetime where there was no trustee in Pennsylvania, no real or tangible property in Pennsylvania and no Pennsylvania source income;

3) **Residuary Trust A u/w Kassner v. Director, Division of Taxation* (N.J. Tax 2013) – a lower court in New Jersey ruled that the state could not tax retained income where testamentary trust had a New York trustee and beneficiary, despite the trust owning interests in four New Jersey based S corporations This case was affirmed on appeal May 28, 2015, but on non-constitutional grounds (the New Jersey tax department was equitably estopped from applying a new policy retroactively).

4) *Kaestner 1992 Trust v. N.C. Dept of Revenue,* 789 S.E.2d 645, 649-51 (N.C. Ct. App. 2016). Temporary stay allowed by N.C. Supreme Court July 25, 2016, pending likely review – North Carolina could not tax non-source income where trustee, administration were in New York, even though all the beneficiaries were North Carolina residents;

5) *Blue v. Michigan Dept of Treasury,* 462 N. W.2d 762 (Mich. Ct. App. 1990) – Despite its statute, Michigan may not constitutionally tax trust income if all trustees, beneficiaries and the trust administration is outside of the state, even though there was still Michigan real estate held by the trust (non-income producing;

6) *Mercantile-Safe Deposit & Trust Co. v. Murphy,* 242 N.Y.S.2d 26 (1963), aff'd, 203 N.E.2d 490 (N.Y. App. Div. 1964) - New York cannot tax an intervivos trust that has no ties to New York other than that the trust was created by a resident and has a resident contingent beneficiary.

7) *Pennoyer, Potter v. Tax Div. Director, 5 N.J. Tax 399* (1983) - New Jersey cannot tax testamentary trust if trustees and trust assets are outside of the state and there is no New Jersey source income.

Source Income from Pass-Through Entities such as S Corporations and *Mobilia Sequuntur Personam*

The trust taxpayers conceded that their flow-through income from owning S corporation stock doing business in Minnesota could still be taxed on an apportioned basis. However, that is not where the big tax hit occurred. The important result of the ruling was that the substantial capital gains on the sale of the S corporation stock were not taxable by Minnesota.

MN Stat. § 290.17(2)(c) provides that

> "[i]ncome or gains from intangible personal property not employed in the business of the recipient of the income or gains must be assigned to this state if the recipient of the income or gains is ... a resident trust.;'

For a nonresident trust, by contrast, gains from intangible personal property not employed in the taxpayer's trade or business "shall be assigned *to the taxpayer's domicile*."[3]

As discussed in a prior **LISI** newsletter (*Ed Morrow on Corrigan v. Testa: Avoiding State Income Tax on Source Income*, Income Tax Planning Newsletter #93, (May 25, 2016)), capital gain income from the sale of intangibles is traditionally allocated to the state of the taxpayer's domicile through the doctrine of *mobilia sequuntur personam.*[4] This is generally confirmed through many states' adoption of the Uniform Division of Income for Tax Purposes Act (UDITPA).[5] State taxing statutes that attempt to tax non-residents on the sale of an intangible only because the entity owns property or runs a business in state may be unconstitutional.[6]

Thus, the trusts' sale of the S corporation stock, no matter how much of the business real estate or operations were in Minnesota, was not Minnesota source income.

Choice to Move to Non-Grantor Trust Status

Generally, the common wisdom for the last few decades has been for taxpayers to cause their intervivos irrevocable trusts to be grantor trusts, as the settlor had initially done here. Settlors in states with relatively high tax rates such as Minnesota (9.85%), however, may have a different calculus and this default may change greatly if the estate and/or gift tax is repealed (see *Ed Morrow on the Introduction of the "Death Tax Repeal Acts of 2017" - How the Proposed Bills Differ, in their Attack on INGs of All Things, and Threats to CRTs*, Estate Planning Newsletter #2516 (February 10, 2017).

Had the settlor kept the trust as a grantor trust, he would have paid Minnesota income tax on the sale of the stock (and all other income of the trust). The settlor's switch to non-grantor trust status prior to sale enabled the state tax avoidance here (at least so far as to Minnesota, with the primary beneficiary of one of the four trusts being a daughter domiciled in California and that trust presumably paying a higher California income tax, it may well have been more efficient for that trust to remain a grantor trust).

This is a lesson that practitioners should consider not only trustee choice and tax status at inception, but ongoing – it may well make sense, as here, to start as an irrevocable grantor trust and switch to a non-grantor trust status prior to a large taxable event. In some cases, a bifurcation of trusts for different beneficiaries may be in order as well.

Conclusion

This case, like the *Kaestner* case in North Carolina, is being appealed to its state supreme court. However, trustees that have paid Minnesota income tax in recent years who might otherwise avoid it should examine their trust administration and consider filing a protective refund in the hopes of the case being upheld or otherwise followed.

Other states with broad trust residency statutes such as Minnesota should be forewarned - their statutes may seem stronger because they are so incredibly broad, but ultimately this feature may doom them as constitutionally deficient and hurt the state coffers more than a better-reasoned and more narrowly tailored statute. Trustees in such states should consider fighting these statutes if the amount in question merits the fight.

Practitioners should consider the effect of trustee choice both when drafting and, as in this case, later during administration when a substantial sale of assets is anticipated. Moreover, for the most common of large taxable events, the sales of pass through entities, the form of the transaction may also have a large impact on state taxation. The trustees and their counsels' choices made in this case may have saved the family substantial state income tax.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Ed Morrow

CITE AS:

CITATIONS:

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[1] *Fielding v. Commissioner of Revenue*, Minnesota Tax Court Cases 8911-R, 8912-R, 8913-R, 8914-R decided May 31, 2017.

[2] 30 Del. C. § 1601(8)-(9), 35 Ill. Comp. Stat. 5/1501(a)(20)(C)–(D), Me. Rev. Stat. Ann. tit. 36, § 5102(4)(B)–(C), MD Tax-Gen Code § 10-101(k)(1), MI Comp L § 206.18, Neb. Rev. Stat. § 77-2714.01(6)(b)–(c), Okla. Stat. tit. 68, § 2353(6), 72 P.S. §§ 7301(s), 32 V.S.A. § 5811(11)(B), Va. Code Ann. § 58.1-302, D.C. Code § 47-1809.01, W. Va. Code § 11-21-7(c), Wis. Stat. § 71.14(2), (3), (3m).

[3] MN Stat. § 290.17(2)(e).

[4] Latin for "movables follow the person."

[5] Uniform Division of Income Tax Purposes Act (UDITPA), §6(c).

[6] *Corrigan v. Testa*, 2016-Ohio-2805.