Steve Leimberg's Income Tax Planning
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Subject: Ed Morrow, David Berek, and Raj Malviya on the Minnesota Supreme Court’s Affirmation of **Fielding** and Its Impact on Minnesota’s and Other States’ Abilities to Tax Trust Income

"Continuing the trend of taxpayer friendly decisions as recent as Kaestner and older decisions that helped shape the jurisprudence in the state fiduciary income tax area (e.g. Linn v. Department of Revenue; Blue v. Michigan Department of Treasury; District of Columbia v. Chase Manhattan Bank; In re Swift;) Fielding represents yet another state court decision striking down a state’s residency nexus statute as unconstitutional.

As mentioned in **Income Tax Planning Newsletter #153**, the Fielding decision is a natural successor decision to the recent one in The Kimberly Rice Kaestner Trust v. North Carolina Department of Revenue, where the North Carolina Supreme Court upheld the North Carolina Court of Appeals’ and lower court’s holding where the North Carolina statute that taxes a non-grantor trust’s accumulated income based on residency was unconstitutional as applied to the trust at issue. The holding was based on the grounds that taxing a trust on the sole basis of the North Carolina residency of the trust beneficiaries violates the Due Process Clauses of the U.S. Constitution and the North Carolina Constitution.

In Fielding, the Supreme Court of Minnesota, over two dissents, issued an affirmation of the lower court’s decision in William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, discussed last year in **Income Tax Planning Newsletter #117**. The Minnesota Supreme Court found that “the State lacks sufficient contacts with the Trusts to support taxation of the Trusts’ entire income as residents consistent with due process.” While the development of the case law in this area has attacked the constitutionality of trust residency statutes when effectively all ties to the taxing state have been severed, this Court notably refused to find a nexus link based on other Minnesota ties that existed when the Trust was measured as a taxpayer, including the Trust’s ownership and sale of a Minnesota S corporation, the use of Minnesota law for the Trust, the Trust’s creation in Minnesota, and existence of a
Minnesota resident beneficiary of one of the four Trusts. Aside from Fielding's taxpayer friendly impact on existing irrevocable non-grantor trusts with a Minnesota settlor, the Court's analysis of these continued Minnesota-based factors provides a roadmap for taxpayers to properly break income tax situs for ongoing administrations when Minnesota-based contacts still exist.

Beyond this, Fielding will impact high-income Minnesota residents who now have greater tax planning options for their estate plans, and who may even establish intervivos non-grantor trusts (or release the applicable rights and powers in irrevocable grantor trusts so as to effectuate non-grantor trust treatment) that avoid Minnesota income tax on non-source income. Such planning is further explored in a forthcoming companion LISI newsletter by the same authors on State Income Tax Planning with Intervivos Trusts After Kaestner and Fielding."

Ed Morrow, David Berek, and Raj Malviya provide members with analysis of the Minnesota Supreme Court’s affirmation of *Fielding* and its impact on Minnesota's and other States' abilities to tax trust income.

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Now, here is their commentary:

**EXECUTIVE SUMMARY:**

In Fielding, the Supreme Court of Minnesota, over two dissents, issued an affirmation of the lower court’s decision in William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, discussed last year in *Income Tax Planning Newsletter #117*. The Minnesota Supreme Court found that “the State lacks sufficient contacts with the Trusts to support taxation of the Trusts’ entire income as residents consistent with due process.”

While the development of the case law in this area has attacked the constitutionality of trust residency statutes when effectively all ties to the taxing state have been severed, this Court notably refused to find a nexus link based on other Minnesota ties that existed when the Trust was measured as a taxpayer, including the Trust's ownership and sale of a Minnesota S corporation, the use of Minnesota law for the Trust, the Trust’s creation in Minnesota, and existence of a Minnesota resident beneficiary of one of the four Trusts.

This decision is fresh on the heels of the North Carolina Supreme Court similarly restricting its own state from taxing trusts, also based on Constitutional due process principles. See Ed Morrow, David Berek, and Raj Malviya, on the North Carolina Supreme Court's Affirmation on Kaestner and Its Impact on both North Caroline and Other States' Abilities to Tax Trust Income, *Income Tax Planning Newsletter #153* (August 20, 2018)

Together with *Kaestner, Fielding* is another important case for Constitutional analysis. At least eleven other states have beneficiary residency as a critical factor under their taxing statute (or administrative
interpretation of it) – Alabama, California, Connecticut, Georgia, Michigan, Missouri, North Carolina, North Dakota, Ohio, Rhode Island, and Tennessee. Even more states have settlor residency as an important factor, which Fielding also rejected as insufficient to create nexus – Delaware, Illinois, Maine, Maryland, Michigan, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, Washington D.C., West Virginia and Wisconsin.

The Constitutional precedent, reasoning and analysis of Fielding and Kaestner exposes potentially Constitutionally-defective features in the statutes of many other states that incorporate the residency of the settlor or beneficiary as a crucial factor and which may even purport to ignore the residency and actions of the trustee as irrelevant. We will certainly see both cases cited in future litigation in other states.

**COMMENT:**

This newsletter will summarize the facts of the Fielding case\(^2\), examine how the Minnesota trust residency and taxing statute allegedly applied, and examine how the Minnesota Supreme Court applied federal Constitutional law to suppress its own state's ability to tax trusts. A forthcoming companion LSI newsletter entitled *State Income Tax Planning with Intervivos Trusts After Kaestner and Fielding* will explore potential estate planning opportunities for Minnesota, North Carolina and potentially many other states’ residents whose trusts may be governed by statutes that may be equally Constitutionally-deficient.

**Overview of The Reid and Ann MacDonald Irrevocable Trusts and Its Sale of Stock of a Minnesota Corporation**

Reid MacDonald was a Minnesota resident who created four irrevocable generation skipping trusts on June 25, 2009 for the benefit of each of his children and such child's descendants (the "Trusts"). The Trusts were initially established as grantor trusts using a power of substitution under IRC 675(4)\(^3\) and were funded with nonvoting shares of Faribault Foods, Inc., a Minnesota corporation ("FFI").\(^4\) The initial trustee of the Trusts was a California domiciliary, Edmund MacDonald. Only one of the beneficiaries of the Trusts was a Minnesota domiciliary.

Likely anticipating a sale of the FFI shares and the desire to apply more favorable state income tax laws, on December 31, 2011, the settlor, Mr.
MacDonald, still a resident of Minnesota, released his grantor trust power to substitute assets under the Trusts. Thenceforward, the Trusts were taxed separately as non-grantor trusts. Not coincidentally, the California resident trustee resigned as of that same date and thereafter all trust administration was conducted in Colorado. On July 24, 2014, William Fielding, a Texas resident, became sole trustee of the Trusts. Shortly thereafter, the Trusts joined in with all FFI shareholders and sold their shares of FFI stock.

**Tax Returns Filed by Trusts and Constitutional Challenge**

After the Trusts ceased to be grantor trusts in 2012, they filed Minnesota income tax returns as resident trusts, without protest, for tax years 2012 and 2013.

In 2014, the Trusts filed Minnesota income tax returns under protest, asserting that the statute classifying them as resident trusts was unconstitutional, as applied to them. The Trusts then filed amended tax returns claiming refunds for the difference between the taxes owed as resident trusts under Minnesota statute and the taxes owed as nonresident trusts. This amount was an estimated $250,000 of tax liability for each Trust.

The Trusts did not contest the ability of Minnesota to tax the ongoing S corporation source income (reported on K-1) of FFI attributable to the S corporation shareholders (including the Trusts) but contested the imposition of Minnesota state income tax on the capital gains from the sale of the FFI shares and other non-source income generated inside the Trust's investment portfolio.

The Minnesota statute in question provided that: “Resident trust means a trust, except a grantor type trust, which . . . is an irrevocable trust, the grantor of which was domiciled in this state at the time the trust became irrevocable.” Because the grantor was a Minnesota resident when the Trusts were created, this statute was triggered. The issue was whether the statute is Constitutional, as applied to the Trusts.

The Minnesota Tax Court focused its examination on the Due Process constraints of the residency statute. The Minnesota and U.S. Constitutions both provide that no person shall be deprived "of life, liberty, or property,
without due process of law.” 9 This newsletter will not analyze the Due Process Clause, as it applies to trust residency statutes, but an in depth analysis on the subject can be found in the authors' most recent newsletter on this topic, in Ed Morrow, David Berek, and Raj Malviya, on the North Carolina Supreme Court's Affirmation on Kaestner and Its Impact on both North Carolina and Other States' Abilities to Tax Trust Income, LISI Income Tax Planning Newsletter #153 (August 20, 2018).10 On May 31, 2017 the Minnesota Tax Court, in entertaining cross-motions for summary judgement, issued an order granting the Trusts' motion and holding that the residency statute violated the Due Process Clauses of the Minnesota and U.S. Constitutions, as applied to the Trusts. 11

Specifically, in striking down the residency statute as unconstitutional, the Minnesota Tax Court held that Minnesota lacked subject matter jurisdiction over intangible personal property located outside of Minnesota. The Court opined that consideration of the grantor’s historical domicile was insufficient to establish subject matter jurisdiction for two reasons: (1) “it reaches back through time to a discrete historical moment, and purports to rely on state protections extended (to the grantor) at that moment” and resorts to protections provided in previous tax years, not the period when the income was earned; and (2) the “grantor domicile method” to establish taxing jurisdiction “reaches across persons”, relying on connections with the grantor rather than the trust.”12

The Commissioner of Revenue appealed the Tax Court's holding to the Minnesota Supreme Court. As analyzed below, the Minnesota Supreme Court affirmed the Tax Court.13

The Court’s Conclusion that the Statute is Unconstitutional, “as Applied”

Despite working from the strong presumption that its trust residency statute was valid, the Minnesota Supreme Court affirmed the Tax Court in holding that the statute was unconstitutional as applied to the four irrevocable trusts notwithstanding the Minnesota nexus contacts summarized as follows:

1. The settlor was a Minnesota resident at the time of funding and the tax year in question;
2. The Trust applied Minnesota as governing law;
3. The Trust was drafted by a Minnesota attorney;
4. The Trust records were maintained in Minnesota;
5. One of the Trust beneficiaries was a resident of Minnesota;
6. The primary trust asset and source of income was stock in FFI, a closely held S-Corporation which was incorporated in the State of Minnesota and has always been headquartered in Minnesota.

The Minnesota Supreme Court refused to consider the above list as arguable nexus contacts that would trigger the application of the residency statute. The Court found the contacts to be either “irrelevant or too attenuated to establish that Minnesota’s tax on the Trusts’ income from all sources complies with due process requirements.”

Specifically, the Court provided three reasons for reaching its conclusion, which can be summarized as follows:

1) The residency of the settlor is irrelevant, as well as the use of a Minnesota law firm to draft or store a copy of the trust – once the Trusts became taxpayers (non-grantor trusts), it is the state’s connections with the trustee and administration that are important.

2) The Trusts did not own any physical property in Minnesota that might serve as a basis for taxation as residents. Intangible personal property such as the Minnesota S corporation stock was held outside of Minnesota – its situs moves with the trustee; and

3) Prior year contacts were irrelevant. Each year should stand on its own. During the tax year in question, the Trustee traveled to Minnesota for a weekend to attend a wedding, but he never traveled to Minnesota for any purposes related to the Trusts. This level of contact is clearly not enough to establish residency for taxation purposes.

The Court also conceded that the choice of Minnesota law was potentially relevant, but “Standing alone, however, this choice-of-law provision is not enough to permissibly tax the Trusts as residents.”

As a result of the Court's ruling, Minnesota could not tax the interest, dividends and, most importantly, the Trusts' significant capital gains derived from the sale of FFI shares. This was a big win for the taxpayer, although the Trust's pro rata share of flow-through income from FFI, as an operating
business, could still be subject Minnesota income tax on an apportioned basis under another Minnesota statute.22

Conclusion – Fielding’s Impact on Minnesota Residents (and Beyond?)

Minnesota residents may now legitimately avoid Minnesota state income taxation on accumulated non-source income of irrevocable non-grantor trusts of which they create or have a resident beneficiary, provided proper attention is paid to trustees and administration. This is even true for non-grantor trusts that sell interests in pass-through entities that are organized or are operated in Minnesota or own Minnesota situs property.

Beyond Minnesota, Fielding may have a persuasive—although not controlling—impact on many other states’ constitutional nexus jurisprudence. Given the cases trending in the state fiduciary income tax area, Fielding continues to put additional pressure on states with potentially Constitutionally-deficient taxing statutes—and will provide incentive for taxpaying trusts to challenge them.

Finally, trust nexus of a non-grantor trust is not a "one-size fits all" analysis. Engaging in the features of a more robust or flexible trust design may actually present potential roadblocks when trying to prevent a trust nexus issue. Practitioners need to consider the many variables in the life cycle of a trust administration that could alter the taxpayer-friendly results in Kaestner and Fielding. For example, the Trusts in Fielding were analyzed for nexus soon after the Minnesota settlor released grantor trust status (power to substitute). Query whether the type of grantor trust power being released may cause a Court to analyze a residency statute differently. If an independent person must exercise a grantor trust power (e.g. a law firm or trust protector who is non-adverse) without the consent of anyone in a fiduciary capacity, would the state of residency of the independent person (not the settlor) create nexus? What if under the applicable state law, the independent person is deemed a fiduciary?

Stay tuned as the authors will explore these potential scenarios and suggestions on how to approach them in a forthcoming LISI newsletter “State Income Tax Planning with Intervivos Trusts After Kaestner and Fielding.”
HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

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1 This newsletter represents the opinion of the authors and not of their respective organizations.


3 It is unknown if other grantor powers existed under subpart E of subchapter J of chapter 1 of the IRC that would make the Trusts grantor trusts for federal income tax purposes. The case history only indicates that the Trusts contained a power of substitution under to IRC §675(4).
4 Faribault Foods, Inc. was a pass through entity for tax purposes—an S corporation. As an S corporation, the Trusts needed to be either grantor trusts, QSSTs, or ESBTs, in order to be eligible S shareholders. See IRC § 1361(c)(2).

5 Colorado has more favorable state income tax rules for resident trusts, including a lower income tax rate (4.63% compared to Minnesota at 9.85%) and certain exemptions that apply to certain passive securities and pass through interests. See Colo. Rev. Stat. § 39-22-103(10).

6 Texas does not impose a state income tax on non-grantor trusts.

7 Leading up to 2014, the Trusts had paid Minnesota income tax (as well as tax in Arizona, California, Colorado and Illinois!) and subsequently filed for a refund.

8 Minn. Stat. § 290.01, subd. 7b(a)(2).


10 This newsletter also outlines the potential impact of the recent U.S. Supreme Court decision, South Dakota v. Wayfair, Inc., 585 U.S. _____ (2018)


12 Id. at pg. 36-37 of Memorandum opinion.

13 See FN no. 2, supra.

14 The Trusts' ownership of shares of a Minnesota Corporation was the focus of the Dissenting opinion supporting a due process challenge under the theory that the State of Minnesota offered benefits and protections to the Trust, as a shareholder of a Michigan corporation. See Fielding, A17-1177, Minn. July 18, 2018, at Dissenting Opinion, D-2 and 3.

15 See Fielding, A17-1177, Minn. July 18, 2018, at 12.

Citing to decisions such as Greenough v. Tax Assessors of Newport, 331 U.S. 486-495-496 (1947); Anderson v. Wilson, 289 U.S. 20, 27 (1933); and Safe Deposit & Tr. Co. of Baltimore v. Virginia, 280 U.S. 83, 91-93 (1929) in support of the position that a trust is its own legal entity with a legal existence separate from the grantor or beneficiary.

Citing to decisions such as Westfall v. Dir. of Revenue, 812 S.W. 2d 513, 514 (Mo. 1991); Safe Deposit & Tr. Co., 280 U.S. 83, 92 (1929); In re Swift, 727 S.W. 2d 880, 881-82 (Mo. 1987) in support of the position that intangible assets move with the Trust and do not serve as a method to make a nexus connection with the state of the grantor or state of incorporation/organization.

Citing to decisions such as Linn v. Dep't of Revenue, 2 N.E. 3d 1203, 1210 (Ill. App. Ct. 2013); Potter v. Taxation Div. 5, N.J. Tax 399, 404-05 (N.J. Tax Ct. 1983); and Blue V. Dep't of Treasury, 462 N.W. 2d 762, 764-65 (Mich. Ct. App. 1990), in support of the position that states can't pick and choose among historical facts unrelated to the tax year at issue in support of taxation. Each year should be reviewed on its own.


Id.

Minn. Stat. § 290.014, subd. 2