VIEWPOINT
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Impasse Over Light Rail Derails Minnesota Tax Residency Provisions

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In this article, Peterson and Wessbecker write about the pocket veto by Minnesota Gov. Mark Dayton (DFL) of the state's 2016 omnibus tax bill, which included provisions addressing unresolved residency issues.

Minnesota's 2016 omnibus tax bill (HF 848), which included much-needed provisions addressing unresolved residency issues, was derailed by an impasse over funding for a light-rail system. The Legislature failed to pass similar income tax residency legislation in 2015.

In June Gov. Mark Dayton (DFL) pocket vetoed the 2016 omnibus tax bill because it had a drafting error regarding charitable gambling taxes, which was estimated to cause $100 million in lost revenue. Although the tax bill could have been revived and passed in a special session, Dayton and lawmakers remained at an impasse all summer because the governor refused to call a special session without an advance agreement to provide state funding for a light-rail transit project. In July, hopes rose that the parties could broker a deal, but by mid-August negotiations had broken down. Although the light-rail project is now back on track, not so with the residency provisions and the rest of the 2016 omnibus tax bill. Talk of a special session resurfaced in early September, but chances of one actually materializing are bleak.

Had the tax bill passed in its 2016 or 2015 form, it would have provided clarity about the effect of the location of a taxpayer's attorneys, accountants, and bank accounts in the application of Minnesota's domicile test. It would have also provided an exception (albeit imperfect) for days spent in Minnesota while receiving medical care. Both bills were silent on other significant residency issues that have been of great interest to the Legislature, the Department of Revenue, and individual taxpayers and their tax advisers in recent years — including apportionment of compensation paid to nonresident corporate board members.

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Clarity on those residency issues is crucial in a state home to a thriving business community and to Mayo Clinic and other fine healthcare institutions, and that also experiences brutal winter weather that drives many to spend part of the year in warmer climates. The Legislature is expected to revisit the 2016 omnibus tax bill in its regular session beginning in January 2017. In the meantime, taxpayers and their advisers are left with continuing uncertainty. The November elections could change the composition of the Legislature, which in turn could affect the likelihood of passage of a similar bill next year.

Minnesota's Income Tax Residency Laws

Under current law, an individual is treated as a resident for Minnesota income tax purposes if he is domiciled in Minnesota (the domicile test), or domiciled outside Minnesota but maintains a place of abode in the state and spends in the aggregate at least 183 days of the year in Minnesota (the 183-day test).[1] For purposes of the 183-day test, presence in Minnesota for any part of a calendar day constitutes a day spent in Minnesota.

For purposes of the domicile test, "domicile" means presence in a place with the intention of making it a permanent home. Domicile is also the place to which, whenever an individual is absent, she intends to return. Minnesota's

[1] Minn. Stat. section 290.01, subd. 7.

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income tax regulations list 26 factors to consider in determining whether an individual is domiciled in Minnesota.[2] Those regulations have been in effect and unchanged since at least 1981. The regulations explicitly state — and Minnesota courts agree — that no one factor, by itself, will determine an individual's domicile.

Minnesota law provides different rules for allocating income to the state depending on an individual's residency. Residents are subject to state income tax on all of their income.[3] Nonresidents are subject to Minnesota income tax only on income from Minnesota sources, and the law contains rules for allocating income to Minnesota. Part-time residents are taxed as residents for the portion of the year they are residents and as nonresidents for the rest of the year.

This article discusses some of the current issues and uncertainties surrounding Minnesota's residency laws, particularly in light of the recent, failed attempts to pass legislation.

Location of a Taxpayer's Attorneys, Accountants, And Bank Accounts

The 2016 omnibus tax bill would have modified the domicile test by prohibiting the DOR and courts from considering the location of an individual's attorney, CPA, or financial adviser in determining where an individual is domiciled for Minnesota income tax purposes. The legislation would have also prohibited consideration of the place of business of a financial institution where an individual applies for any new type of credit or at which she opens or maintains any type of account.

> **Those regulations have been in effect and unchanged since at least 1981. The regulations explicitly state — and Minnesota courts agree — that no one factor, by itself, will determine an individual's domicile.**

Under the 26-factor analysis, the location of a taxpayer's bank accounts, especially the location of the most active checking account, is considered in determining residency.[4] The location of a taxpayer's attorneys and accountants is not expressly mentioned in any of the 26 factors, but the DOR has interpreted one factor, the "location of business relationships and the place where business is transacted,"[5] to encompass all types of contacts and relationships, including a taxpayer's relationships with attorneys and accountants.

The DOR and the Legislature have repeatedly attempted to address the uncertainty around the effect of those relationships on a taxpayer's residency. A bill with language similar to the 2016 omnibus tax bill was pending in the Legislature during the 2014 legislative session, but those provisions were not in a final bill. The discussions during the 2014 session regarding residency caused the DOR to initiate a review of Minnesota residency laws and to issue its 2015 residency report to the Legislature. In that report, the DOR indicated that it would issue a revenue notice stating that the physical locations of attorneys, accountants, and bank accounts were not factors in determining an individual's residency.[6]

> **The DOR and the Legislature have repeatedly attempted to address the uncertainty around the effect of those relationships on a taxpayer's residency.**

During its 2015 session, the Legislature considered a measure providing that the location of a taxpayer's professional advisers and financial accounts had no bearing on the residency analysis. Although the 2015 bill failed to pass, virtually identical residency language was in the ill-fated 2016 omnibus tax bill.

After the Legislature failed to pass the 2015 omnibus tax bill, the DOR issued Revenue Notice 16-01, as promised in its 2015 residency report. The notice states:

> employing, hiring, or engaging an attorney or CPA, or who has a business relationship with an attorney or CPA, whose address is in Minnesota, does not, by itself, demonstrate an intent to establish or retain domicile in Minnesota, [and]
>
> having one or more bank accounts located in Minnesota, does not, by itself, demonstrate an intent to establish or retain domicile in Minnesota.

That language sharply contrasts with the 2015 and 2016 omnibus tax bills and the DOR's statement in its 2015 residency report. Rather than stating clearly that the locations of attorneys, accountants, and bank accounts are not relevant factors under the domicile test, it appears to state that they are relevant — but not determinative — factors. Since the 26 factors were promulgated decades ago, no one factor, by itself, has ever established domicile. Accordingly, the notice provides no clarification and casts doubt on the DOR's position clearly stated in its 2015 residency report.

With the 2016 omnibus tax bill's demise, the revenue notice is the only available guidance on this issue. How the DOR will interpret and apply the revenue notice is unclear. As a result, the language from the 2016 omnibus tax bill will likely resurface in the 2017 legislative session.

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[2] *See* Minn. R. 8001.0300, subp. 3.
[3] *See* Minn. Stat. section 290.17, subd. 1(a).
[4] *See* Minn. R. 8001.0300, subp. 3Q.
[5] *See* Minn. R. 8001.0300, subp. 3T.
[6] Minnesota DOR, 2015 Residency Report, at 10.

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Medical Care Exception to the 183-Day Test

The 2016 omnibus tax bill also provided that a day in Minnesota does not count as a day spent in the state for purposes of the 183-day test if (1) the taxpayer traveled from a place outside of Minnesota primarily for and essential to obtaining medical care as defined in IRC section 213(d)(1)(A); (2) the medical care in Minnesota is for the taxpayer, spouse, or a dependent of the taxpayer; and (3) the travel expense is allowed under IRC section 213(d)(1)(B) and is claimed by the taxpayer as deductible.

> **Since the 26 factors were promulgated decades ago, no one factor, by itself, has ever established domicile. Accordingly, the notice provides no clarification and casts doubt on the DOR's position clearly stated in its 2015 residency report.**

That language is narrower than a similar exception in the 2015 omnibus tax bill. Unlike the 2015 legislation, the 2016 bill does not exclude days the taxpayer spent in Minnesota for medical treatment received by the taxpayer's parent. The travel to Minnesota must be "primarily for and essential to obtaining medical care" rather than simply for the "primary purpose of receiving medical treatment." Plus, travel expenses regarding the medical care must be deductible under IRC section 213(d)(1)(B) and claimed by the taxpayer.

The medical care exception, if enacted as part of 2017 legislation, would be helpful for nonresident taxpayers who travel to Minnesota to receive medical care. However, the language of the exception poses some interpretive questions, including:

- When will travel be considered "primarily for and essential to" obtaining medical care in Minnesota? If the taxpayer schedules medical visits so that they coincide with social visits (for example, a family member's birthday party), can the taxpayer exclude the entire day spent in Minnesota for purposes of the 183-day test?
- How many days can a taxpayer exclude under this exception if, for example, she travels to Minnesota for seven days, the travel was primarily for and essential to obtaining medical care, but she received medical care on only two days out of the seven and spent the remaining five at her lake cabin? What if she had medical appointments scheduled on days one and seven and was waiting at the cabin on days two through five? Presumably, the taxpayer should be allowed to exclude all days regarding the medical travel, but that is unclear under the proposed language.
- If the travel expenses do not exceed 10 percent of adjusted gross income and therefore may not be claimed as an allowable expense deduction by the taxpayer under the IRC, is the taxpayer prohibited from excluding the day spent receiving medical care as a Minnesota day? Based on the literal language of the exception, that appears to be the case, but that would render the exception inapplicable to most taxpayers.

Apportionment of Compensation to Nonresident Corporate Board Members

The 2016 omnibus tax bill did not contain any provisions to address the ambiguities surrounding the taxation of nonresident director compensation.

Current law provides that compensation received by an individual for service on a corporation's board of directors is generally considered to be income from a trade or business carried on by the individual director. Income from a trade or business that is carried on both inside and outside Minnesota must be apportioned among the states where the business is carried on.[7] Income from the sale of services, including compensation for board service, is generally apportioned to the state where the services are "received," unless that state is not readily determinable or the corporation does not have a fixed place of doing business there.

If the state where the services are received is not readily determinable or the corporation does not have a fixed place of doing business there, the services are apportioned to the location from which the services were ordered or — if that location cannot be determined — from the location to which the services are billed. Alternatively, directors may apply for an alternative method of apportionment under Minnesota Statute section 290.20.

> **The 2016 omnibus tax bill did not contain any provisions to address the ambiguities surrounding the taxation of nonresident director compensation.**

Because of the limited statutory authority regarding apportionment of nonresident director compensation, the DOR announced in Revenue Notice 14-02 that it would permit an alternative method of apportioning compensation of nonresident directors who are paid for service on one or two corporate boards during a tax year. That alternative method, if applicable in a board member's circumstances, permits apportionment based solely on the time spent working for the board.

Although Revenue Notice 14-02 provides a relatively clear method of apportionment for nonresident directors who receive compensation for service on one or two corporate boards, the notice does not resolve many of the ambiguities surrounding taxation of nonresident director compensation. During the 2015 legislative session, House and

[7] *See* Minn. Stat. section 290.191.

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Senate bills were introduced on that issue.[8] The bills provided a rule similar to the alternative method in the revenue notice, though it would have applied more broadly to individuals who serve on more than two boards and to members of bodies similar to boards of directors. The language appeared in the 2015 omnibus tax bill but not in the final version of the 2016 omnibus tax bill.

Lack of guidance on the taxation of nonresident director compensation leaves many questions unanswered, such as:

- For directors who do not exceed the two-board limit, exactly what services should the director include when determining his or her "time spent . . . working for" that board? How should the director keep track of his or her time spent on board matters — hourly, daily, or otherwise?
- How should directors who exceed the two-board limit apportion compensation? And how should they ascertain where their services are received?
- For all nonresident directors, how will deferred compensation be treated, and, in particular, will deferred compensation be apportioned based on the year when it is earned or the year when it is received?
- For all nonresident directors, how will compensation arising from equity awards (such as stock options or restricted stock units) be apportioned?
- For nonresident directors who desire to petition for an alternative apportionment method under Minnesota Statute section 290.20, how should they do so, and what will the DOR consider when deciding whether to grant such a petition?

[8] *See, e.g.*, HF 2179, 89th Leg., Reg. Sess. (Minn. 2015); and SF 2028, 89th Leg., Reg. Sess. (Minn. 2015).

Conclusion

Dayton's pocket veto of the 2016 omnibus tax bill caused continuing uncertainty about the effect of the location of a taxpayer's attorneys, accountants, and bank accounts on Minnesota's domicile test, as well as about the residency effect of days spent in Minnesota for the purpose of receiving medical care. Other key residency issues, which would not have been resolved in the proposed legislation, also remain, including apportionment of compensation paid to nonresident corporate board members.

> **Lack of guidance on the taxation of nonresident director compensation leaves many questions unanswered.**

Taxpayers will look to the Legislature and the DOR for guidance and clarity in 2017, but political hurdles may continue to get in the way — and those hurdles may worsen, depending on the outcome of the November 2016 elections. ■

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