



I've Got Trust Issues – Are Nonresident Trusts the New Nexus Fight?

Sep 30, 2019

Categories:

[Blogs](#)

[Publications](#)

[Tax Law Defined™ Blog](#)

Authors:

[Daniel G. Mudd](#)

Nexus is nearly an impossible concept to grasp in most state and local tax (SALT) contexts as states continue grasping at more and more possible connections a taxpayer may have with a respective state – and the states have won most of these fights over time, whether it was economic nexus for income tax purposes slowly over the past several years, or most recently, in the sales tax context in *Wayfair*^[1] earlier this year.

Legacy Trust – Traditional Nexus Issues for Nonresident Trusts

Even the most basic of trusts often involves a “grantor” or “settlor” to create the legal entity, multiple beneficiaries that may receive benefits from the trust either currently or in the future, and at least one trustee to manage and administer the trust, as well as the underlying trust documents themselves which are set up in or contractually obligated under the laws of a certain state – with each of these items potentially having substantial SALT consequences.

For example, say an individual settlor that is a resident of Kentucky decides to set up a Delaware trust that owns stock in his or her company which has business assets or operations in Kentucky, Indiana, Ohio, West Virginia, Tennessee, Virginia and North Carolina, with four (4) individual beneficiaries of the trust who are residents of Kentucky, Indiana, Florida and Alabama. This may seem like a complicated situation, but it's quite common in situations involving trusts with rights in a business, and as the trust begins to accumulate income or if the underlying business is ever sold, there are no less than ten (10) different states which may have a claim to tax the revenue of this income or sale – it all depends on each state's laws and where nexus has been created to determine the proper allocation and/or apportionment of same.

So, where does someone even start to make this determination? Are there any clear rules to follow to accurately report same? For

starters, one would have to look at the residence of the settlor and each of the beneficiaries, where the trust was set up, the location (situs) of the trust's assets, what state the trust is being "administered" in, etc., and then determine whether any of these states have defined statutes, regulations, case law or any other guidance regarding what creates nexus for a nonresident trust. And if the state(s) does have a statute or regulation on point, the next question may be whether it's even constitutional. Recent state court decisions over the past year or so have shed some light on the latter issue, but there is still much uncertainty.

Are States Getting a Legg Up?

Most "hot topics" in SALT tend to go in waves regarding whether the states or the taxpayers are "winning" a particular issue. A perfect example of this was just seen in the remote seller/economic sales tax nexus context after taxpayers were riding high for decades from the U.S. Supreme Court's decision in *Quill*^[2] back in 1992 which required a taxpayer to have a physical presence in a state before a state can constitutionally require a retailer to collect and remit sales tax under the Commerce Clause. However, after states began aggressively challenging this standard through the enactment and/or enforcement of "economic" nexus standards, they were finally rewarded earlier this year when the U.S. Supreme Court reversed *Quill* and permitted a lowered nexus threshold in *Wayfair*. Recent state court decisions indicate that nexus issues related to nonresident trusts may be the next area of increasing litigation after taxpayers were generally successful in the past, then lost for a while, but are now winning again.

Ohio has been a recent battleground for nonresident taxpayer/trust-related nexus issues after the Ohio Supreme Court issued two (2) important cases within a six (6) month period – decisions which seem to contradict themselves in many respects.

The most recent decision from the Ohio Supreme Court found in favor of the state in *T. Ryan Legg Irrevocable Trust v. Testa*.^[3] The *Legg* case involved an underlying individual settlor (Legg), who was the co-founder of a multistate trucking business, eventually withdrew from said business, transferred his shares of stock to Delaware trusts and then sold this 50% stock in the S-corporation

to the other cofounder, resulting in substantial capital gain. Ohio later audited the trusts and proposed that over 90% of the income resulting from the sale should be apportioned to the Buckeye state. This assessment was then upheld by the Ohio Tax Commissioner, the Ohio Board of Tax Appeals, and finally by the Ohio Supreme Court – but all three decisions were based on different reasonings and conclusions.

Some of the factors that the Court focused on in determining that Ohio could tax the majority of the capital gains despite the involvement of nonresident trusts and the trusts being administered by out-of-state (Delaware) trustees and governed under Delaware law was: (i) the location of the physical (business) assets of the trusts on the last day of the involved tax year (substantially Ohio), (ii) residence of the grantor (Ohio) and beneficiaries (Ohio but not during the involved audit years), and (iii) whether the underlying business was active in Ohio (yes) despite the trust not being engaged in the business itself. Based on these contacts with the state, and especially the individual grantor's contacts with the state rather than the trust itself, the Court upheld the validity and constitutionality of Ohio's statute imposing income tax on a nonresident trust's gain in the sale of an ownership interest in a pass-through entity under the Due Process Clause. The Court also rejected the trust's equal protection arguments that there would be different treatment if the underlying trust's shares were in a C corporation, rather than a S corporation, based on the Court's belief that there are sufficient differences between such corporate structures to justify the differing treatment.

Although Ohio's underlying "qualified trust" statutes are quite unique and certainly added to why the involved assessments against the trusts were upheld, at a very high-level, the *Legg* decision is important as it is one of the first cases to find that a connection between the grantor and state (not the involved taxpayer [trust] or involved the transaction [sale]) was sufficient for income tax nexus. Moreover, the decision also seems to contradict the Court's prior, pro-taxpayer decision earlier that year in *Corrigan v. Testa*, 73 N.E.3d 381 (Oh. May 4, 2016) which held less than six months before that capital gain from the sale of stock in a passthrough entity that did business in Ohio but was owned by a

nonresident individual could not be taxed by Ohio because there was no unitary business between the nonresident individual and the pass-through entity (i.e., Ohio did not have enough minimum contacts with the actual taxpayer and the transaction).

Although the Ohio Supreme Court did its best to distinguish *Legg* by noting that *Corrigan* involved a nonresident taxpayer who was not active in the underlying company's business operations, but as evidenced by the dissenting opinion in *Legg*, it almost seems as though the Court is saying residency and involvement in the business is relevant in one scenario but not the other – so how can someone feel as though they have any certainty in the state of Ohio on a trust-related income tax issue? And to make matters even worse, Ohio is one of only a handful of states that has ruled on this topic. Therefore, a taxpayer (and counsel and tax advisors for same) either have little or no guidance in multiple states, or have unclear (and not taxpayer-friendly) case law in others like Ohio. But then there is North Carolina and Minnesota...

Trust Restored? North Carolina and Minnesota Weigh-In on the Subject

On June 18, 2018, the North Carolina Supreme Court issued a significant taxpayer victory in *Kaestner Family Trust v. North Carolina Dep't of Revenue*, 814 S.E.2d 43, when it held that a nonresident trust's in-state beneficiaries did *not* give North Carolina sufficient minimum contacts under the Federal or state constitution to tax the trust's accumulated income. The involved trust was created by a New York resident, administered by a trustee in Boston and had all of its assets in New York, but some of the trust's beneficiaries later became North Carolina residents. In finding for the taxpayer (the trust), the Court relied on the Due Process protections outlined in *Quill*[4] and other state court decisions involving similar issues[5], and rejected the two (2) cases relied on by the state which previously held that similar contacts by beneficiaries were sufficient to tax the underlying trust.[6] The Court instead recognized the separate legal status of the trust when it concluded that it was the beneficiaries, not the trust itself, that reaped the benefits and protections of North Carolina, and since they are "separate legal entities, due process was not satisfied" by

attempting to tax the trust's income through the beneficiaries' contacts only.

Just a month after *Kaestner* came another pro-taxpayer decision, this time from the Minnesota Supreme Court, in *Fielding, Trustee of the MacDonald Irrevocable GST Trust*, A17-1177, — N.W.2d — (Minn. Jul. 18, 2018). In *Fielding*, the underlying trust's contacts with the state included a resident grantor, the trust being created in Minnesota, the trust holding stock in a Minnesota S corporation, and one of the beneficiaries being a resident. Despite these multiple connections with Minnesota, the Court likewise applied due process protections to strike down Minnesota's statutory requirement that the domicile of the grantor at the time a trust became irrevocable is all that is needed to be considered a resident trust and thus all income from the trust, including intangible property, no matter where located, was subject to the state's income tax.

The Court ultimately held in *Fielding* that the grantor's domicile at the time the trust became irrevocable was not enough to step in the shoes of the "taxpayer itself" (the trust) and subject the trust's worldwide income to taxation, and confirmed that "subject matter jurisdiction – the need to establish that income was derived from in-state activity – thus remains a significant limitation upon a state's power to tax nonresident taxpayers." Even more to the point, the Court held that the involved contacts with the state, even including a resident beneficiary, were "either irrelevant or too attenuated to establish that Minnesota's tax on the Trust's income from all sources complies with due process requirements." And similar to *Kaestner*, but opposite to *Legg*, the Minnesota Supreme Court also emphasized the importance of the separate legal existence of the trust from the grantor in finding that nexus with the trust was lacking, as well as noting that the trust itself owned no physical assets in Minnesota but instead only owned stock in the in-state S corporation.

Questions Still Remain(der)

As alleged in the taxpayer's petition for writ to the U.S. Supreme Court in *Legg*, could the Ohio decision be enough ammunition for other states to come hard after the income of nonresident trusts, or will the more recent taxpayer-friendly decisions in *Kaestner* and

Fielding, and other prior state cases relied upon therein[7], keep states at bay? We may find out in the near future as several states currently have laws similar to those that have already been disputed and/or decided in North Carolina (i.e., statutes allowing trusts to be taxed if there is an in-state beneficiary), Ohio (i.e., statutes allowing trusts can be taxed if settlor is a resident when the trust became irrevocable and there is a resident beneficiary in the current tax year), and Minnesota, Illinois and Pennsylvania (i.e., “forever tainted trust” statutes permitting taxation if the settlor was a resident at the time it became irrevocable despite it no longer being a resident and there being no resident beneficiaries, trustees or assets), which may be next on the docket.[8]

And what about the U.S. Supreme Court’s recent decision in Wayfair which will further embolden states to go after taxpayers with even less contacts in a state than has traditionally been sufficient – could that also effect income tax nexus for trusts even though the more recent cases have focused on the Due Process Clause rather than Commerce Clause? The outcome of another pending state decision – the so-called Massachusetts “cookie-nexus” case[9] – may also have some indirect effect on nexus standards as whole in the future, including trusts.

It all remains to be seen at this point, and there likely won’t be more certainty or uniformity unless the U.S. Supreme Court decides to weigh in. But until that day comes (if ever), taxpayers across the country will have to continue asking themselves, what rules can I really trust?

[1] *South Dakota v. Wayfair, Inc.*, 585 U.S. ----, 138 S.Ct. 2080, 2100, --- L.Ed.2d ---- (2018).

[2] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[3] 75 N.E.3d 376 (Oh. Dec. 28, 2016) *reconsideration denied*, 2017–Ohio–905, 148 Ohio St.3d 1429, 71 N.E.3d 299, and *cert. denied*, 138 S.Ct. 222, 199 L.Ed.2d 121 (2017).

[4] Note that the Court did not rely on the Commerce Clause principles in *Quill*, which may prove important to *Kaestner* maintaining precedential or longstanding value since the North

Carolina Supreme Court's decision came out just three (3) days before *Wayfair*.

[5] See *Linn v. Dep't of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013); *Fielding, infra*; *Residuary Tr. A v. Director, Div. of Taxation*, 27 N.J. Tax 68 (N.J. Tax Ct. 2013).

[6] The Court declined to follow the holding in *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Ct. 1999) that an intervivos trust did not violate due process because the beneficiary was a Connecticut domiciliary because it believed the Connecticut court "erroneously failed to consider that a trust has a legal existence apart from the beneficiary" and the trust itself must have some minimum connection with the taxing state, as well as distinguished a similar holding in *McCulloch v. Franchise Tax Bd.*, 390 P.2d 412 (Ca. 1964) because the taxed entity there was both a beneficiary and trustee, and because it pre-dated *Quill's* Due Process analysis.

[7] See e.g., *supra* at note 3; *Robert L. McNeil, Jr. Tr. ex rel.*, 67 A.3d 185, 193-94 (Pa. Cmwlth. 2013); *Blue v. Dep't of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990); *Mercantile-Safe Deposit & Tr. Co. v. Murphy*, 19 A.D.2d 765, 242 N.Y.S.2d 26, 28 (N.Y. App. Div. 1963), *aff'd*, 15 N.Y.2d 579, 203 N.E.2d 490 (1964) (identifying the various states with these similar laws which have yet to be litigated).

[8] See Jeffrey Schoenblum, *Strange Bedfellows: The Federal Constitution, Out-of-State Nongrantor Accumulation Trusts, and the Complete Avoidance of State Income Taxation*, 67 Vand. L. Rev. 1945, 1959-62 (2014).

[9] See *Crutchfield Corp. v. Harding*, No. CL17001145-00 (Va. Cir. Ct.).

Note: This article was originally published by the journal of *Multistate Taxation and Incentives* (Thomson Reuters/Tax & Accounting)

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.