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Multistate Tax
EXTERNAL ALERT

Illinois Appellate Court Rules Illinois Income Tax Imposed on Inter Vivos Trust with No Connections to Illinois Violated the U.S. Due Process Clause

February 5, 2014

Overview

In *Lewis Linn v. Brian Hamer*,[1] the Appellate Court of Illinois ("Appellate Court") recently held that there were insufficient contacts between Illinois and the plaintiff inter vivos trust[2] to satisfy the Due Process Clause of the U.S. Constitution and, accordingly, the imposition of Illinois income tax for the year in question was unconstitutional.[3] The Illinois Department Of Revenue ("IDOR") has recently received an extension of time (to February 26, 2014) to file a petition for leave to appeal the matter to the Illinois Supreme Court. Thus, the case is not final because the parties have not yet exhausted all available appellate options. In this Tax Alert we summarize the Appellate Court's decision.

Background

In March 1961 an Illinois resident ("Grantor") created an irrevocable inter vivos trust ("Original Trust") with an Illinois resident named as trustee ("Original Trustee"). The Original Trust agreement included a choice-of-law provision stating that the trust should be governed by Illinois' laws. In 1986, the Grantor died as an Illinois resident, and his estate was probated.

In 2002, three individual residents of Illinois replaced the Original Trustee. Upon being named trustees, they exercised their powers of appointment and irrevocably disseminated assets from the Original Trust to the plaintiff, trustee of a newly created trust ("New Trust"). The New Trust agreement included a choice-of-law provision stating that the trust would be construed under Texas law.[4] The trustee of the New Trust and the beneficiary thereof were not Illinois residents and none of the assets of the New Trust were located in Illinois.

The New Trust filed a nonresident Illinois Income and Replacement Tax return for tax year 2006. It reported zero income from Illinois sources, and, therefore, paid zero tax. The IDOR disagreed and "reclassified the . . . [New Trust] as an Illinois resident under section 1501(a)(20)(D) of the Illinois Income Tax Act" and imposed tax on 100% of the trust's income for 2006.[5] The trust paid the tax under protest and then filed a trial court action, asserting that the imposition of tax violated the Commerce, Due Process and Equal Protection clauses of the U.S. Constitution and the uniformity clause of the Illinois Constitution. The parties each filed a motion for summary judgment. The trial court denied the New Trust's motion and granted the IDOR's motion, finding that the Original Trust provided that Illinois law "was to govern the trust agreement and any trusts hereby created, which would include the . . . [New Trust]."[6]

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[1] *Lewis Linn v. Brian Hamer*, 2013 IL App. (4th) 121055 (Dec. 18, 2013). A copy of the decision is available at: **http://www.state.il.us/court/Opinions/AppellateCourt/2013/4thDistrict/4121055.pdf**.

[2] The Appellate Court noted that "the case before us involves an inter vivo trust." *Linn*, 2013 IL App. (4th) 121055, at 9. Generally speaking, an "inter vivos trust" is "a trust created by a writing (declaration of trust) which commences at that time while the creator (called a trustor or settlor) is alive . . . ." *See*, *The Free Dictionary, "Legal dictionary*" Copyright © 1981-2005 by Gerald N. Hill and Kathleen T. Hill. All rights reserved.

[3] *Linn*, 2013 IL App. (4th) 121055, at 14.

[4] Provision 15 of the New Trust stated that the trust "was to be construed and regulated under Texas law, 'except that the terms 'income,' 'principal,' and 'power of appointment' and the provisions relating thereto shall be interpreted under the laws of the state of Illinois.'" *Linn,* 2013 IL App. (4th) 121055, at 3. In 2004, the plaintiff filed a complaint in a Texas probate court seeking a change to provision 15 that would remove the language referring to Illinois law, leaving only the Texas law to govern. In 2005, the plaintiff was granted the relief it sought. This 2005 ruling, however, stated that it: "shall become effective as to each of the Trusts as of the date that the Internal Revenue Service issues a favorable ruling holding that the modifications and declarations of this Judgment to the Trust do not result in the loss of such Trust's generation-skipping transfer tax exempt status or otherwise subject such Trust to the generation-skipping transfer tax." *Linn*, 2013 IL App. (4th) 121055, at 4. At the time of the *Linn* decision the IRS had not yet issued a ruling on this issue. But, the court did not consider this fact and did not give effect to the choice of law provision's reference to Illinois' laws.

[5] *Linn*, 2013 IL App. (4th) 121055, at 4. Note that the Illinois Income Tax Act defines the term "resident," specifically for a trust, as "[a]n irrevocable trust, the grantor of which was domiciled in this State at the time such trust became irrevocable." *See*, 35 ILCS 5/301(a)(29)(D). Note also that although 100% of the trust's income would be subject to tax, the beneficiary of the trust would still be allowed a credit for taxes paid to other states on this income. 35 ILCS 5/601(b)(3).

[6] *Linn*, 2013 IL App. (4th) 121055, at 6.

The court concluded that "the fact Illinois law governed the . . . [New Trust] was sufficient contact to satisfy the due process and commerce clauses."[7] The New Trust appealed the matter to the Appellate Court.

The Appellate Court's Decision

The New Trust argued that it had no connections to Illinois and thus Illinois may not constitutionally subject the trust to income tax.[8] Focusing on the Due Process Clause, the Appellate Court stated that for a tax to survive constitutional scrutiny, the following two requirements must be met: (1) there must be a minimum connection between the state and the person, property or transaction it seeks to tax, and (2) the income attributed to the taxing state must be rationally related to values connected with that state.[9] Applying this two-pronged test, the Appellate Court turned to the Connecticut Supreme Court decision in *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), explaining that,

> Connecticut taxes only that portion of the inter vivos trust's undistributed income that corresponds to the number of noncontingent beneficiaries that live in Connecticut.[10]
>
> [A]s a Connecticut resident, the noncontingent beneficiary's rights to the eventual receipt and enjoyment of the accumulated income were protected by Connecticut law so long as the beneficiary remained a resident of the state.[11]

The Appellate Court focused on the "*critical* link between the state [of Connecticut] and the *inter vivos* trust . . . ," noting that in *Gavin* the "noncontingent beneficiary was a Connecticut resident during the years in question" and thus there existed the requisite connection with the state for Due Process purposes.[12]

The Appellate Court contrasted the facts before it with the facts in *Gavin*, finding that the New Trust "does not have a noncontingent beneficiary in Illinois" and thus the requisite connection with Illinois is absent.[13] The court noted further that the IDOR has "cite[d] no cases finding [that] a grantor's in-state residency is a sufficient connection for due process with an inter vivos trust . . . [and that, to the contrary,] decisions from other states have found the grantor's in-state residence insufficient to establish a minimum connection."[14] Thus, the Appellate Court concluded further that the fact that the New Trust's "grantor was an Illinois resident is not sufficient connection to satisfy due process."[15]

The Appellate Court then addressed the IDOR's arguments:

- The New Trust "exists only because of Illinois law[,]" essentially arguing that the New Trust ultimately owes its existence to the provisions of the Original Trust agreement executed under Illinois law in 1961. The court rejected this argument, stating that "with income taxation, the focus of the due process analysis is on the tax year in question, which would be 2006 in this case[; accordingly] what happened historically . . . under Illinois law has no bearing on the 2006 tax year."[16]
- Illinois provides the trustee and beneficiary of the New Trust "with a panoply of legal benefits and opportunities." In support of this argument, the IDOR cites various testamentary trust cases. The court rejected this argument, emphasizing that the New Trust is not a testamentary trust and, accordingly, no Illinois probate court (that could provide related legal benefits) has jurisdiction over the New Trust.[17]
- The New Trust, the trustee and the beneficiary can seek the legal protection of various Illinois statutory provisions. The court rejected this argument, noting that the trust "choice-of-law provision provided for only

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[7] *Id*.
[8] *Linn*, 2013 IL App. (4th) 121055, at 9.
[9] *Linn*, 2013 IL App. (4th) 121055, at 8.
[10] *Linn*, 2013 IL App. (4th) 121055, at 10, citing *Chase Manhattan Bankv. Gavin*, 733 A.2d 782, 790 (Conn. (1999).
[11] *Linn*, 2013 IL App. (4th) 121055, at 10, citing *Gavin*, 733 A.2d at 802.
[12] *Linn*, 2013 IL App. (4th) 121055, at 11. The Appellate Court noted further that the court in *Gavin* also discussed the California Supreme Court's decision in *McCulloch v. Franchise Tax Board*, 390 P.2d 412 (Cal. 1964). Again focusing on the requirements of Due Process, the Appellate Court noted that:

> the California Supreme Court did not find a due-process violation where California taxed the undistributed income of an out-of-state testamentary trust based solely on the California residence of the trust's beneficiary. *McCulloch*, 390 P.2d at 418. It reasoned California law provided benefit and protection to the resident beneficiary. *McCulloch*, 390 P.2d at 418-19. *Linn*, 2013 IL App. (4th) 121055, at 10-11, citing *Gavin*, 733 A.2d at 790.

[13] *Linn*, 2013 IL App. (4th) 121055, at 11.
[14] *Linn*, 2013 IL App. (4th) 121055, at 11-12.
[15] *Linn*, 2013 IL App. (4th) 121055, at 12.
[16] *Linn*, 2013 IL App. (4th) 121055, at 12-13.
[17] *Linn*, 2013 IL App. (4th) 121055, at 13.

> the application of Texas law [and, accordingly, the trust] receives benefits and protections of Texas law, not Illinois law.[18]

The Appellate Court noted further that the New Trust "had nothing in and sought nothing from Illinois[, as] . . . all of the trust's business was conducted in Texas; the trustee, protector, and the noncontingent beneficiary resides outside Illinois; and none of the trust's property was in Illinois."[19] Thus, the court concluded that "none of [these] factors would give Illinois personal jurisdiction over the trust . . . ."[20]

Based on the foregoing, the Appellate Court held that imposing the Illinois income tax on the New Trust would be a violation of the Due Process clause and thus the income tax imposed on the trust in 2006 was unconstitutional.[21] The IDOR has until February 26, 2014 to file a petition for leave to appeal the matter to the Illinois Supreme Court. Thus, the case is not final because the parties have not yet exhausted all available appellate options.

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[18] *Id*.
[19] *Linn*, 2013 IL App. (4th) 121055, at 14.
[20] *Id*.
[21] *Id*.