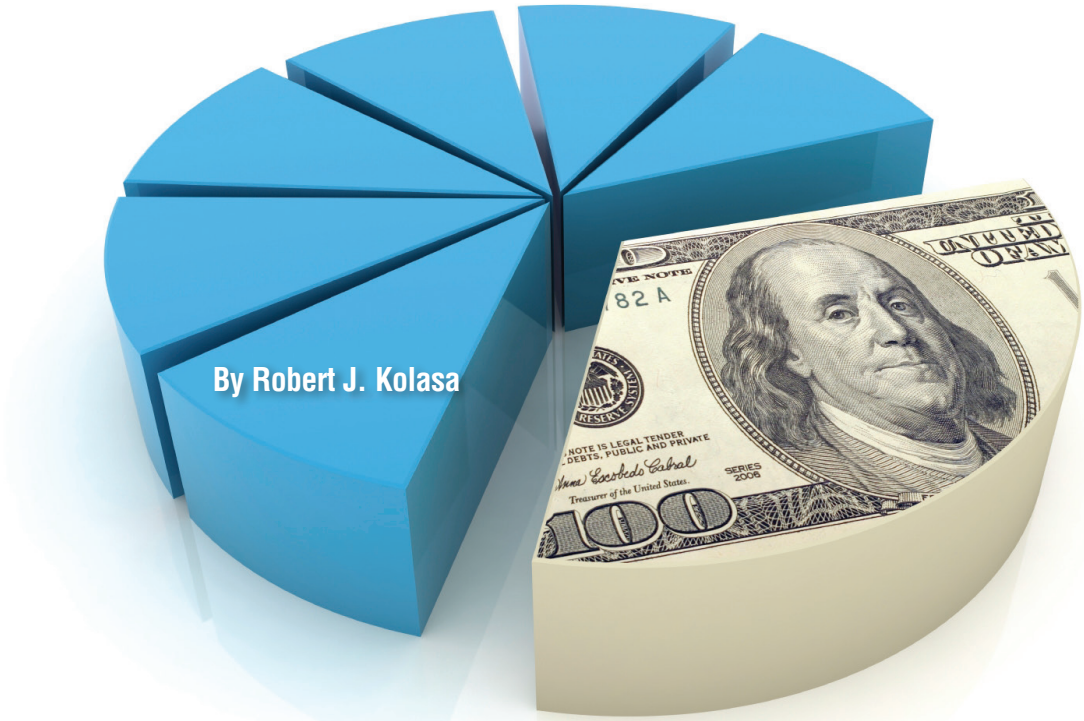
Under Illinois law, income from a trust created by an Illinois resident is taxable even if the trust is not otherwise connected to Illinois. But is the state tax constitutionally infirm for lack of minimum contacts? The author raises that possibility and offers tips to help lawyers challenge the tax.

Making Constitutional Challenges to the Illinois Tax on Trust Income



By Robert J. Kolasa

The income taxes on trust income have dramatically risen. The federal rate of 39.6 percent for trust income over $11,950, when added to the 3.8 percent Medicare surtax, equals a top federal rate of 43.4 percent.[1] Adding in the Illinois 5 percent income and 1.5 percent replacement taxes, the federal and Illinois rates on trust income can reach a whopping 49.9 percent.

Given the high stakes, trustees should consider bringing constitutional challenges to state law to avoid the 6.5 percent Illinois tax on undistributed income under the right circumstances.[2] This article looks at Illinois statutory law governing trust taxation, reviews cases from various jurisdictions that have upheld and rejected constitutional challenges, and offers advice to Illinois lawyers who might want to consider bringing suits of their own.

Illinois taxation of resident trusts – the founder-state doctrine

Illinois generally follows the federal income tax rules for grantor and non-grantor trusts. In grantor trusts, the grantor keeps some control over the trust administration and principal. Grantor trust income is taxable to its owner and

1. *See* Edwin P. Morrow III, *Avoid the 3.8 Percent Medicare Surtax*, Trusts & Estates, Dec. 7, 2012, at 32 (providing a good discussion of the new 3.8% surtax and federal trust taxation).

2. Any reference herein to Illinois trust income taxes will be considered as collectively referring to both the 5% income tax (scheduled to decline to 3.75% in 2015 and 3.25% in 2025) and the 1.5% replacement tax. 35 ILCS 5/201(b) to 201(d) (West 2012).

Robert J. Kolasa <robert@kolasalaw.com> is a Lake Forest attorney and CPA who holds an LL.M. in taxation from Georgetown University Law Center. Before entering private practice he was an attorney for the IRS Office of Chief Counsel in Washington, D.C.

the trust is ignored for income tax purposes, and these trusts are not under discussion here.

Any trust not classified as a grantor trust is a nongrantor trust and is treated as a separate taxpayer. Nongrantor trusts are in turn classified as either "resident" or "nonresident," a vital distinction in Illinois and most states when it comes to taxation of trust income. Illinois taxes the trust income of resident trusts, while nonresident trusts generally escape taxation, except for income generated in Illinois.

35 ILCS 5/1501(20) defines a resident trust as either: (1) a trust created by a will of a decedent who at his death was domiciled in Illinois; or (2) an irrevocable trust, the grantor of which was domiciled in Illinois at the time the trust became irrevocable. (A trust is irrevocable if the grantor is not treated as the owner under the Internal Revenue Code. [3]) The Illinois statute adopts what is commonly referred to as a "founder-state" taxation model, which permanently imputes the residency of the grantor to newly created irrevocable inter vivos or testamentary trusts.

This has constitutional implications when the trust has little or no other connection to the founder's state of residence. The question is whether the trust has a strong enough nexus to the taxing state to be subject to taxation without violating the Constitution.[4]

Constitutional challenges to taxation of trust income

Here's a look at how constitutional challenges to taxation of trust income have fared in the courts.

Cases imposing limits on a state's ability to tax income. Although no U.S. Supreme Court decision has addressed the validity of a state's trust income tax statute, a trilogy of high court cases helped develop the constitutional limitations on a state's ability to impose tax beyond its jurisdiction or control. In the seminal case of *Safe Deposit & Trust Co. v. Virginia*,[5] a Virginia resident transferred stocks and bonds to an inter vivos trust for the benefit of Virginia beneficiaries. The grantor died as a Virginia resident, with the trust being administered by a Maryland corporate trustee and assets physically located in Maryland. The Supreme Court held the Virginia tax violated the Due Process Clause[6] because the trust did not have sufficient contacts with Virginia to be governed by its law.

In *Greenough vs. Tax Assessor of City of Newport*,[7] the Supreme Court upheld the constitutionality of a Rhode Island property tax on a trust governed by a Rhode Island co-trustee, where the assets, decedent, beneficiaries, and remaining co-trustee were all domiciled in New York. The Rhode Island trustee's control over trust assets furnished an adequate basis to defeat a due process attack since the trustee did in fact receive protection under Rhode Island's courts.

Finally, in *Quill Corp. v. North Dakota*,[8] the Supreme Court did not use due process grounds to strike down a North Dakota use tax assessed on Quill Corporation's mail order business. The Court opined that the tax satisfied due process requirements because the taxpayer, which had no employees or stores in North Dakota, had sufficient contacts with the state through its marketing effort of mailing numerous advertising catalogs to residents. Nevertheless, the Court held the tax invalid under the Commerce Clause[9] based on precedent that required a substantial nexus to the taxing state, including a physical presence there, along with a fairly apportioned tax related to state services that did not discriminate against interstate commerce.

Cases suggesting the Illinois law is unconstitutional. Constitutional challenges to resident trust classifications under founder-state statutes are not cases of first impression. Taxpayers have successfully struck down similar statutes in multiple jurisdictions based on arguments that the trust did not have sufficient contacts with the taxing authority.

New York is an example of evolving state laws requiring a trust to have a strong nexus to the taxing state beyond the mere residence of the grantor. In *Mercantile-Safe Deposit & Trust Co. v. Murphy*,[10] an inter vivos trust was created by a New York grantor for the benefit of a New York beneficiary to be administered outside New York by a Maryland trustee. After the grantor's death, New York's founder-state statute classified the trust as a resident trust.

The state appellate court, citing *Safe Deposit & Trust Co.*, upheld the lower court's ruling that the statute violated due process because there were not enough contacts between New York and the trust. New York subsequently codified this holding by changing its laws to exclude from taxation, resident trusts where all the trustees and assets are domiciled outside New York, without any New York source income.[11]

Other courts have accepted due process arguments to nullify the effect of founder-state statutes, where contacts with the taxing state have been minimal. The Missouri Supreme Court in *In re Swift*[12] ruled that the state could not tax the income of an Illinois testamentary trust created by a Missouri testator where the trustees, beneficiaries, trust property, and trust administration were all in Illinois. To pass constitutional muster, the grantor's resident status needed to be combined with other Missouri contacts, such as the domicile of beneficiaries and trustees, the location of trust prop-

Trustees should consider making constitutional challenges to state law to avoid the 6.5 percent Illinois tax on undistributed income.

3. 35 ILCS 5/1501(20)(D) (West 2012); *see also* 26 U.S.C. §§ 671-678.

4. Not all states adopt the founder-state taxation model, and practitioners often are forced to wade through a confusing array of state laws to determine whether or not a trust has attained resident trust status for a particular jurisdiction. *See* Richard W. Nenno, *Let My Trustees Go!: Planning to Minimize or Avoid State Income Taxes on Trusts*, 46 U. Miami Inst. Est. Plan. ¶ 1500 (2012). This exhaustive article is an excellent analysis of the various state rules and underlying constitutional issues. While seven states – Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming – do not tax trust income at all, the other jurisdictions determine resident trust status on differing criteria. As a result, trust income is sometimes taxed by multiple states. *See Guaranty Trust Co. v. Virginia*, 305 U.S. 19, 23 (1938) (holding that double taxation of the same income by different states is permissible). Illinois alleviates this result by allowing a resident trust a credit for income taxes paid to other jurisdictions. *See* 35 ILCS 6/601(b)(3) (West 2012).

5. *Safe Deposit & Trust Co. v. Virginia,* 280 U.S. 83 (1929).

6. U.S. Const. art. XIV, § 1.

7. *Greenough v. Tax Assessor of City of Newport*, 331 U.S. 486 (1947).

8. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

9. U.S. Const. art. I, § 8, cl. 3.

10. *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (1964); *see also Taylor v. State Tax Commissioner*, 85 A.D.2d 821 (N.Y. App. Div. 1981) (reaching the same result for a testamentary trust).

11. Nenno, *supra* note 4, at ¶ 1503.1.

12. *In re Swift*, 727 S.W.2d 880 (1987).

erty, and trust administration.[13] Similar court decisions have been issued in Michigan[14] and New Jersey.[15]

Contrary authorities. Defenders of the founder-state taxation scheme rely upon two post *Quill Corporation* decisions for the proposition that such statutes are constitutionally sufficient, even if the only connection with the state is the grantor's domicile at the time the trust is created.

In *District of Columbia v. Chase Manhattan Bank*,[16] the District of Columbia Court of Appeals considered whether income of a testamentary trust probated in 1935 could be taxed under a founder-state statute, even though the trustee, assets, and trust beneficiaries were all located outside the District. Despite the lack of contacts with the District, the court ruled that due process was met because the trust was created under the District's laws and its courts purportedly maintained a supervisory relationship over the trust. The appellate court declined to follow the *Mercantile-Safe Deposit & Trust Co.* line of cases on the theory that *Quill Corporation* rejected the idea that a state's power to tax turns on the trust's physical presence in the taxing jurisdiction.[17]

In *Chase Manhattan Bank v. Gavin*,[18] the Connecticut Supreme Court rejected the trustees' constitutional attacks on a founder-state statute with regard to an inter vivos trust and four testamentary trusts. For the testamentary trusts, the court upheld the statute by mirroring the reasoning of the *District of Columbia* case that such trusts had sufficient contacts with Connecticut through the benefits provided by the local probate courts and administration under Connecticut law. For the vivos trust, the court also upheld the tax on undistributed income, reasoning that the trust beneficiary's right and eventual receipt of income was protected by Connecticut's laws. The court also was not persuaded that the *Safe Deposit & Trust Co.* case was still good law.

Here in Illinois, the Department of Revenue has administratively embraced the legal conclusions of the above cases. In IT 08-0004-GIL,[19] a trust not holding Illinois assets was created by an Illinois grantor that subsequently moved to a different state, presumably changing its situs. Citing the *Gavin* decision as precedent, the ruling held that a trust that became irrevocable while the grantor was a resident of Illinois, is always a resident trust and must file an Illinois income tax return allocating all its income to Illinois.

Similarly, in IT 07-0026-GIL[20] the question at issue was whether changing the situs of an irrevocable trust established by an Illinois resident would affect the resident status of the trust. The ruling provided that the trust would remain a resident trust, because the situs of the trust is not controlling for purposes of state income tax.

The Illinois statute seems ripe for constitutional challenge when a trust's only nexus with Illinois is that the grantor was an Illinois resident when the trust was created.

Constitutional analysis of the Illinois trust income tax

Under the Illinois founder-state statute, the residency of the trust creator alone determines the resident status of the trust. In cases where the grantor's Illinois residency constitutes the primary contact with Illinois, the question becomes whether this is enough to constitutionally justify the Illinois income tax.

For testamentary trusts formed under the jurisdiction of an Illinois probate court, the relationship between Illinois and the testamentary trust is strong given the benefits of the court in initially forming and funding the trust. If the trust is governed by Illinois law and has Illinois assets, trustees, and beneficiaries, unquestionably Illinois has the minimum contacts necessary under a due process or commerce clause analysis to justify its classification as a resident trust in order to tax its undistributed income.

But does the analysis change over time? What if the testamentary trust is a dynasty trust and 100 years after creation, no assets, beneficiaries, or trustees are located in Illinois and the trustees have not (since creation) benefitted from the protection of Illinois courts? Can Illinois still justify the tax where the constitutional contacts are buried deep in the past and have no relevance to current trust administration?[21]

The cases cited above striking down founder-state taxation statutes generally adopt the Supreme Court's analysis in *Safe Deposit & Trust Co.* holding there are not enough due process contacts where the residency of the grantor is the primary factor. But the more recent *District of Columbia* and *Gavin* cases reach the opposite conclusion.[22] As the *Gavin* court suggests, was *Safe Deposit & Trust Company* overruled by *Quill Corporation*, heralding a new age of minimal due process and commerce clause contacts supporting the validity of founder-state statutes? The answer to this question and the underlying constitutional analysis is unclear.

The *District of Columbia* and *Gavin* decisions have been hotly criticized.[23] Critics challenge the central tenet that the courts of the grantor's state of residency are truly "open and available" to assert jurisdiction over testamentary trusts or inter vivos trusts until the end of time, especially when such trusts have no current contacts with the taxing state.[24]

13. *See Westfall v. Director of Revenue*, 812 S.W. 513 (Mo. 1991) (applying the *Swift* factors to reach the opposite result).

14. *Blue v. Department of Treasury*, 462 N.W.2d 762 (1990).

15. *Pennoyer v. Taxation Division Director*, 5 N.J. Tax 386 (1983) (addressing a testamentary trust); *Potter v. Taxation Division Director*, 5 N.J. Tax 399 (1983) (addressing an inter vivos trust).

16. *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (1997).

17. While this case dealt with a testamentary trust, footnote 11 of the opinion suggests that the nexus between an inter vivos trust and the taxing jurisdiction may sometimes be so "attenuated" as to be vulnerable to constitutional attack. *Id.* at 547.

18. *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (1999).

19. Ill. Dep't Revenue Ltr. Rul., IT 08-0004-GIL (Jan. 23, 2008), *available at* http://tax.illinois.gov/LegalInformation/Letter/rulings/it/2008/IG080004.pdf.

20. Ill. Dep't Revenue Ltr. Rul., IT 07-0026-GIL (July 26, 2007), *available at* http://tax.illinois.gov/LegalInformation/letter/rulings/it/2007/IG070026.pdf.

21. *See generally* Bradley E.S. Fogel, *What Have You Done For Me Lately? Constitutional Limitations on State Taxation of Trusts,* 32 U. Rich. L. Rev. 165 (1998).

22. *But see Residuary Trust A v. Director, Division of Taxation*, Docket No. 000364-2010 (N.J. Tax. 2013) (rejecting the *District of Columbia* and *Gavin* cases to follow the authorities cited *supra*, footnote 10).

23. Joseph W. Blackburn, *Constitutional Limits on State Taxation of a Nonresident Trustee:* Gavin *Misinterprets and Misapplies Both* Quill *and* McCulloch, 76 Miss. L.J. 1 (2006); *see also* Nenno, *supra* note 4, at ¶ 1502.5.

24. Nenno, *supra* note 4, at ¶ 1506.1 (listing authorities for the proposition that under conflict of laws principles, the state of trust administration has primary jurisdiction to determine trust matters, making the protections offered by the courts of the grantor's residency illusory). *But see Ohlheiser v. Shepherd*, 84 Ill. App. 2d 83, 228 N.E.2d 210 (1st Dist. 1967) (providing a contrary argument regarding testamentary trusts).

While commentators have expressed skepticism about constitutional challenges to a founder-state statute for testamentary trusts given the unfavorable results of the *District of Columbia* and *Gavin* cases, they do not rule out the possibility of success. For inter vivos trusts, the consensus opinion is that disputing a resident trust classification under a founder-state statute should have a better chance of prevailing, especially where the only constitutional contact supporting taxation is the grantor's residency.[25] Other contacts with the taxing jurisdiction (such as in-state trustees, assets, administration, and possibly the residence of trust beneficiaries) may reduce the chances of success.

Planning opportunities: raising the odds of a successful challenge

An obvious strategy to avoid Illinois taxation of trust income is for the grantor to move out of Illinois before some occurrence like the grantor's release of powers makes a revocable trust irrevocable (for inter vivos trusts) or before he or she dies (for testamentary trusts).[26] Assuming this is not possible, are there other ways to avoid the tax? Query whether a breach of fiduciary duty occurs if Illinois' founder-state classification of a resident trust is disputable and the trustee continues to pay such tax without protest?[27]

While constitutional challenges to the Illinois statute for testamentary trusts may be less likely to succeed (versus inter vivos trusts), because of unfavorable Illinois case law,[28] such a challenge could obviously still prevail if the court is persuaded by the precedent discussed above.

To increase the likelihood of success, some suggest using the will to designate the law of another state to govern the testamentary trust, giving the courts of that other state exclusive jurisdiction over the trust.[29] In the case of both testamentary and inter vivos trusts, a good candidate for a challenge would be a resident trust that hasn't had contacts with Illinois or its court system for many years.

Another option in some cases is to move the so-called situs of the trust outside Illinois. The situs of a trust is generally the place where the trustees and the bulk of trust assets are located.[30] Moving the situs is possible if the trust instrument provides for the removal and replacement of trustees without court approval. If the trust agreement is silent as to removal, then the acting Illinois trustee may resign and a nonresident trustee be appointed, as long as that is permitted under the trust or applicable law.[31]

Assume the trust situs has been moved outside Illinois, but the trust has Illinois beneficiaries. Do those beneficiaries provide the contact necessary to preclude a constitutional challenge? Courts reviewing founder-state statutes have taken beneficiaries into account in determining the nexus between the trust and taxing state, with varying results.[32]

While a constitutional challenge probably isn't out of the question for trusts with Illinois beneficiaries, challengers will strengthen their position by creating separate trusts for residents and nonresidents, and attacking only the trusts having nonresident beneficiaries. Another possibility is to make the trust discretionary. If the trust is purely discretionary and gives beneficiaries no guaranteed piece of the trust pie, the beneficiary's residency may be meaningless because his or her rights to trust distributions are not enforceable property rights.[33]

Challengers might also consider distributing assets to a new trust having a nonresident trustee. The old trust would file a final Illinois income tax return, and the trustee of the new trust would decide whether to file tax returns with Illinois. Does the creation of the new trust by a nonresident also make the new entity a nonresident trust under 35 ILCS 5/1501(20)?[34] The filing of a final return for the old trust should decrease the audit risk for trustees.

Adopting a no-tax position based on the alleged invalidity of the Illinois founder-state statute can be a risky strategy if it fails. Interest charges combined with various penalties would be substantial,[35] especially if the statute of limitations never closes because no tax return was filed.

The prudent approach would be to file the trust income tax return detailing the no-tax position, which would start the statute of limitations and mitigate the applicable penalties. Note, however, that Illinois might have difficulty collecting an out-of-state tax levy or convincing a foreign court to respect an Illinois judgment for a trust having no current contacts with Illinois.[36]

Conclusion

Illinois taxes trust income based on whether the trust constitutes a resident trust under its founder-state statute. Under this regimen, if the testator is a resident at the time of death or the grantor a resident when the trust becomes irrevocable, the trust will always be treated as a resident trust for state income tax purposes whether or not the trust maintains any nexus with Illinois.

Prior cases have successfully attacked similar classifications, but after the Supreme Court's decision in *Quill Corporation*, there is confusion as to how the law should be applied. The Illinois statute seems ripe for constitutional challenges involving trusts not having a situs in Illinois, where the primary contact is the grantor's Illinois residency at the time of creation. ■

---

25. Nenno, *supra* note 4, at ¶¶ 1502.6, 1504, 1505; Fogel, *supra* note 21, at 210-219; Blackburn, *supra* note 23, at 48-56; Bernard E. Jacob, *An Extended Presence, Interstate Style: First Notes on a Theme from Saenz*, 30 Hofstra L. Rev. 1133 (2002); Jeffrey A. Schoenblum, *Multistate and Multinational Estate Planning*, § 22.02 (3d ed. 2008).

26. Another strategy would be to distribute all income to beneficiaries, but this may not be consistent with the purpose of the trust.

27. Nenno, *supra* note 4, at ¶ 1507.1 (citing the trustee's duty under § 176 of the Second Restatement of Trusts to "use reasonable care and skill to preserve the trust property").

28. Constitutional arguments against the Illinois founder-state statute went unheeded in an administrative hearing involving a testamentary trust having no beneficiaries, trustees, or assets in Illinois. *See Aloysius B. Carmichael Trust v. Ill. Department of Revenue*, IT 00-7, *available at* http://tax.illinois.gov/legalinformation/hearings/it/it00-7.pdf.

29. Nenno, *supra* note 4, at ¶ 1504.2.

30. Care should be taken in examining the laws of the targeted jurisdiction to determine what contacts are necessary for such jurisdiction to become the new situs. Tax rules should also be studied. For example, a Delaware resident trust generally avoids income taxes in that state if there are no Delaware beneficiaries.

31. 760 ILCS 5/13 (West 2012).

32. Resident beneficiaries were present in *Safe Deposit & Trust Co.* and *Mercantile-Safe Deposit &Trust Co.*, while the other cases successfully challenging founder-state statutes generally had nonresident beneficiaries. This factor is arguably not relevant in determining the nexus between the taxing state and the trust. *See* Blackburn, *supra* note 23, at 25-27.

33. Restatement (Second) of Trusts §§ 128, 155 (1959); *see McNeil v. Commonwealth of Pennsylvania*, 67 A.3d 185 (Pa. 2013) (holding a founder-state statute taxing an inter vivos trust created by a Pennsylvania grantor for discretionary resident beneficiaries (with no trustees, assets, or income located in Pennsylvania) to be unconstitutional under the Commerce Clause).

34. It appears doubtful whether this position is correct under Regulation Section 1.671-2(e)(5). Nenno, *supra* note 4, at ¶ 1507.7; *see also* 760 ILCS 5/16.4(t) (West 2012) (precluding this result under the Illinois decanting statute).

35. 35 ILCS 5/1001 *et seq.* (West 2012); 35 ILCS 735/3-1 *et seq.* (West 2012).

36. The new situs might not give full faith and credit to an Illinois tax levy or judgment for unpaid Illinois income taxes. *Hanson v. Denckla*, 357 U.S. 235 (1958); *see also* Nenno, *supra* note 4, at ¶ 1506.2.

Reprinted with permission of the *Illinois Bar Journal*,
Vol. 101 #11, November 2013.

www.isba.org