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“INCOME TAXATION OF TRUSTS”

(Discussion Outline)

I. RULES ON TAXATION OF UNDISTRIBUTED TAX INCOME

A. See Exhibit #1 - **“Making Constitutional Challenges to the Income Tax on Trust Income,”** Kolasa December 2013 IBJ Article

1. Why I wrote the article...

B. **The Illinois 6.5% tax rate** (applies to “Resident” Non-Grantor Trusts)

1. 5% income tax rate

a. Scheduled reduction in rates (35 ILCS 5/201(b))

(1) 3.75% in 2015 (3.25% in 2025)

(2) reduction seems unlikely ...

2. 1.5% replacement tax

3. Top Federal and Illinois rates can reach 49.9%

C. **Illinois’ “Resident Trust” Definition** (“Founder-State” regimen)

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.

D. **Not all states follow the Illinois taxation model** (other jurisdictions determine resident trust status on differing criteria)

1. See Exhibit #2 - **“Bases of State Income Taxation of Nongrantor Trusts.”**

2. Common criteria to establish residency trust status (each jurisdiction may decide resident trust status based on any given combination of these factors):
 - a. Domicile of grantor/testator (Founder-State criteria);
 - b. Domicile of beneficiaries;
 - (1) Better chance to avoid taxation if resident beneficiaries are discretionary beneficiaries?
 - c. Domicile of trustee;
 - (1) Trust Protector may be deemed equivalent to a trustee
 - d. Location of trust property;
 - e. Location of trust administration;
 - f. Even if not a resident trust under the above criteria, some jurisdictions tax undistributed trust income under throwback rules when distributions are made to resident beneficiaries (California and New York)
3. Double or Triple Taxation of Undistributed Trust Income not a Due Process violation under Guaranty Trust Co. v. Virginia, 305 U.S. 19, 23 (1938)
 - a. However, many states have a credit for income taxes paid to other states, which mitigates double taxation.
 - (1) IL Schedule CR, Credit for Tax Paid to Other States;
 - (2) Does not apply to 1.5% Illinois Replacement Tax;
 - (3) Circular computation if both states provide for credit?
 - b. Some states do not have a credit for income taxes paid to other states. Connecticut is an example of such a state.
 - (1) such statutes may be subject to Commerce Clause attacks, i.e., that the risk of multiple taxation violates the principle that taxes affecting interstate commerce must be apportioned fairly.
4. **Seven states do not tax trust income at all** - Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.
 - a. Also, some states have liberal rules for nonresident trusts (i.e., a Delaware resident trust generally avoids Delaware income taxes if there are no Delaware beneficiaries).

II. CONSTITUTIONALITY OF FOUNDER-STATE TAXATION REGIMES

A. Supreme Court Cases (No U.S. Supreme Court decision has specifically addressed the validity of a state's trust income tax statute)

1. Safe Deposit & Trust Co. v. Virginia, 280 U.S. 83 (1929). In this case 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 because the trust did not have sufficient contacts with Virginia to be governed by its law.

2. In Greenough vs. Tax Assessor of City of Newport, 331 U.S. 486 (1947), the a Rhode Island property tax on a trust was held constitutional because it was controlled by a Rhode Island trustee, even though the assets, decedent, beneficiaries, and remaining co-trustee were all domiciled in New York.
3. Quill Corporation decision (US Supreme Court - 1982); North Dakota use tax declared unconstitutional;
 - a. Use Tax upheld under Due Process Analysis. Satisfied Due Process analysis because the taxpayer had sufficient contacts with North Dakota through its marketing effort of mailing numerous advertising catalogs to residents.
 - b. Use Tax Unconstitutional under Commerce Clause Analysis. Mainly because of precedent that required a physical presence in the state to uphold a use tax
 - (1) New grounds - most prior courts used a Due Process analysis in analyzing the constitutional limitations on a state's ability to impose taxes beyond its jurisdiction or control.

B. Cases in which Founder-State Statutes Declared Unconstitutional (cases all discussed in my article)

1. New York (1964, 1981)
2. New Jersey (1983)
3. Missouri (1987)
4. Michigan (1990)
5. Pennsylvania (2013)
McNeil v. Commonwealth of Pennsylvania, 67 A.3d 185 (Pa. 2013) (holding unconstitutional under the Commerce Clause 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)).
6. Illinois (2013) - Linn decision discussed below.

C. Cases in which Founder-State Statutes Declared Constitutional (cases all discussed in my article). Two major Court of Appeals cases:

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

Columbia Court of Appeals ruled that the 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.

- a. Reliance on Quill Corporation rejecting precedent that a state's power to tax turns on the trust's physical presence in the taxing jurisdiction.
 - b. Theory that testamentary trust had sufficient contacts with Connecticut through the benefits provided by the local probate courts and administration under Connecticut law.
 - (1) Is this a valid argument? Under conflict of laws principles, doesn't the state of trust administration have primary jurisdiction to determine trust matters, making the protections offered by the courts of the grantor's residency illusory?
 - c. 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.
2. In Chase Manhattan Bank v. Gavin, 733 A.2d 782 (1999), 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.
- a. For the testamentary trusts, taxation was upheld by mirroring the reasoning of the above 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.
 - b. For the inter vivos trust, taxation was upheld because the beneficiary was a Connecticut resident whose eventual right to trust assets was protected under Connecticut law.
3. But see Residuary Trust A v. Director, Division of Taxation, Docket No. 000364-2010 (N.J. Tax. 2013), rejecting both the District of Columbia and Gavin cases.
- a. Linn case (below) also discredits these cases.
4. Illinois precedent upholding Founder-state statute:
- a. Aloysius B. Carmichael Trust v. Ill. Department of Revenue, IT 00-7 (2000 administrative law case);
 - b. IT 08-0004-GIL & IT 07-0026-GIL (IL General Information Letters)

III. **BREAK-THROUGH - THE LINN CASE** - Linn v. Dept. of Revenue, 2013 IL App (4th) 121055 (See Exhibit #3 for summary), where the Illinois Appellate Court for the Fourth District held that without any current connections to Illinois (non-Illinois trustee, beneficiaries and assets), the tax on trust income violated Due Process.

A. **Facts**

1. In 1961, A.N. Pritzker establishes an inter vivos trust governed by Illinois law, with an Illinois trustee, for trust property located in Illinois.
2. Trust provided for a power of appointment to distribute trust assets to a different trust or trustee.
3. In 2002, new trustees (also residing in Illinois) distributed the assets to create a new trust with a new trustee residing outside of Illinois.
4. New Trust was to be construed under Texas law, except that the terms “income,” “principal” and “power of appointment” were directed to be interpreted under Illinois law.
 - a. Unclear validity of 2005 Texas court order striking all reference to Illinois law in the trust.
5. In year of challenge (2006) the trust had:
 - a. Non-Illinois trustee;
 - b. Non-Illinois trust protector;
 - c. No Illinois beneficiaries;
 - d. No assets located in Illinois.

B. **Court Holding** - Illinois taxation of undistributed trust income unconstitutional as the Trust had “no connections with Illinois.”

1. Distinguishes case from District of Columbia decision (inter vivos trust involved here; not a testamentary trust).
2. Distinguishes current case from Gavin decision (no current Illinois beneficiaries present).
3. Cites Michigan, New York and Missouri cases holding Founder-state statutes unconstitutional.
4. Court states that the focus should only be on the connections to Illinois for the tax year in question, and “what happened historically with the trust in Illinois has no bearing on the 2006 tax year.”
 - a. Doesn’t this annihilate the Illinois Founder-State statute, which is grounded

in what occurred in the past (i.e., the residency of the trust creator)?

IV. PLANNING STRATEGIES

- A. **Grantor moves out of Illinois** before death or creation of inter vivos trust;
- B. **Constitutional challenges preferred for inter vivos trusts.**
 - a. Constitutional challenges for testamentary trusts less likely to succeed
 - (1) Drafting tip: Will provision should designate the law of another state to govern the testamentary trust, giving the courts of that other state exclusive jurisdiction over the trust
 - b. Preferably, trust hasn't had contacts with Illinois (non-Illinois trustee, beneficiaries and assets) for many years.
- C. **Move “situs” of existing Trusts outside Illinois**
 - 1. Removal of Illinois Trustees and Trust Protectors:
 - a. Trust provisions may authorize removal and replacement without court approval.
 - b. If all named Trustees resign and Trust is silent as to successor trustee, trust beneficiaries may appoint successor trustees under 760 ILCS 5/13.
 - c. Exercise of power of appointment to create new trusts without Illinois contacts (similar to the Linn case).
 - (1) Better if non-Illinois resident creates new trust.
 - d. Use Decanting statute (760 ILCS 5/16) to create new trusts without Illinois contacts (best argument if exercised by a non-Illinois trustee):
 - (1) 760 ILCS 5/16.4(t) facially prohibits the Illinois Decanting statute from changing the identity of the Grantor to a non-resident in order to avoid application of the Illinois Founder-state statute.
 - (a) Query: Isn't this provision meaningless if the new trust is unconstitutional under the Due Process or Commerce clauses?
 - e. Move asset management outside of Illinois;
 - f. Trusts with Illinois beneficiaries

- (1) Unclear whether this precludes a constitutional challenge
- (2) Best practice may be to:
 - (a) Divide/create separate trusts for residents and nonresidents, and attacking only the trusts having nonresident beneficiaries; or
 - (b) Make the trust purely discretionary for Illinois beneficiaries (see the McNeil case above).

V. INCOME TAX FILING ISSUES

A. **Substantial interest and filing penalties** (penalties for failure to file; failure to pay; underpayment of tax, frivolous returns)

1. Exposure become unlimited if the statute of limitations never closes because no tax return was filed.
2. Does Linn case mitigate penalties?

B. **Best Practices**

- a. File the trust income tax return detailing the no-tax position
- b. File the trust income tax return paying the tax, then file an amended return asking for refund.

C. **Stop Filing Returns - Not for the Faint of Heart**

- a. Change the trust situs and file a “final return” which may, or may not detail that no return will be filed for future years
 - (1) Will Illinois challenge future years by trying to obtain a tax levy or judgment for unpaid Illinois income taxes?
 - (2) Illinois Collection Risks - Even if Illinois is successful in obtaining a tax levy or judgement, 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)/
- b. Open statute of limitations for all ongoing years because no return has been filed
 - (1) Will the trustee of the “old trust” agree to such a position and incur potentially unlimited liability?