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WEALTH PLANNING

ILLINOIS APPELLATE COURT DECISION

Income Taxation of Irrevocable Inter Vivos Trust Violated Due Process

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In December of 2013, the Fourth District Appellate Court of Illinois issued a notable trust income tax decision, ruling that the Illinois income taxation of an irrevocable inter vivos trust having no Illinois beneficiary, trustee or assets in the tax year in question and not governed by Illinois law is unconstitutional. This is an appellate court decision, but the appeal period has ended.

In *Linn v. The Department of Revenue* (Appellate Court of Illinois, Fourth District, No. 4-12-1055 (December 18, 2013)), the court found that the income taxation of the trust in question in 2006 violated the due process clause because there was not a sufficient minimum connection between the trust and the State of Illinois.

The decision was based on the following:

- Section 201(a) of the Illinois Income Tax Act (35 ILCS 5/201(a) (West 2006)) provides in part that “[a] tax measured by net income is hereby imposed on every individual, corporation, trust and estate … on the privilege of earning or receiving income in or as a resident of this State.”

- Section 1501(a)(20)(D) of the Illinois Income Tax Act (35 ILCS 5/1501(a)(20)(D) (West 2006)) defines a “resident” as “[a]n irrevocable trust, the grantor of which was domiciled in this State at the time such trust became irrevocable.”

- For a trust to comply with the due process clause, (1) a minimum connection must exist between the state and the person, property, or transaction it seeks to tax, and (2) the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State.

- The trust in question, Autonomy Trust 3, is an inter vivos trust established by the exercise of a lifetime limited power of appointment by the trustees of a separate irrevocable inter vivos trust established under a trust agreement by a resident of Illinois in 1961.

- The court considered the grantor of the trust under the 1961 trust agreement from which Autonomy Trust 3 originated to be the grantor of Autonomy Trust 3 and thus, under the Illinois Income Tax Act, Autonomy Trust 3 an Illinois resident subject to Illinois income tax.

- The basis of the decision is constitutional. It is not a decision based on statutory interpretation. The burden was on the taxpayer to clearly establish constitutional invalidity. The court characterized the burden as “a formidable one.”

- The Department of Revenue asserted that the required minimum connections existed because Autonomy Trust 3 owes its existence to Illinois and Illinois provides the

Autonomy Trust 3's trustee and beneficiary with the "panoply of legal benefits and opportunities."

For purposes of this summary we note a number of factors of significance in support of the taxpayer's position, including the following:

- The 1961 trust agreement was an inter vivos trust agreement, not a will, and not subject to probate administration.
- The power under the 1961 trust agreement exercised to establish Autonomy Trust 3 was a limited power (not a general power) held by trustees (not beneficiaries), and was exercised without the involvement of an Illinois court.
- The Illinois Income Tax Act does not provide for the allocation of income of a resident trust on the basis of the residence of beneficiaries, as is the case, for instance, under Connecticut law.
- In the tax year in question, Autonomy Trust 3 did not have an Illinois trustee, beneficiary or assets.
- Autonomy Trust 3 provided for the application of Texas law following a 2005 Texas reformation of the choice of law provision.
- Considering the above, the court determined that the fact the Autonomy Trust No. 3's grantor was an Illinois resident is not sufficient to satisfy due process.

The *Linn* decision is a significant development in Illinois fiduciary tax law and is highly fact specific. Although the Illinois Department of Revenue decided not to pursue an appeal, the impact of the decision will be followed closely.

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