

IT 24-0004-GIL 04/29/2024 CREDITS – FOREIGN TAX

General Information Letter: Guidance provided on the Illinois foreign tax credit under IITA Section 601(b)(3) for a dual-resident electing small business trust.
(This is a GIL.)

April 29, 2024

NAME
TITLE
FACILITY
ADDRESS
E-MAIL

Re: Illinois Income Tax – Electing Small Business Trust Residency and Foreign Tax Credit Questions

Dear NAME:

This is in response to your email received on October 2, 2023, in which you request information regarding credit for taxes paid under Illinois law for an Electing Small Business Trust (“ESBT”) when the ESBT is deemed a resident in two states. The nature of your request and the information you have provided require that we respond with a General Information Letter (“GIL”), which is designed to provide general information, is not a statement of Department policy, and is not binding on the Department. See 2 Ill. Adm. Code Section 1200.120(b) and (c), which may be found on the Department’s website at www.tax.illinois.gov.

Your letter states as follows:

I like to have some type of opinion on the issue when sending over a question, but I never dabble in trusts at all. My colleague has a question regarding the residency of a trust and credit for taxes paid to other states when trust is deemed resident in two states.

The taxpayer is an Electing Small Business Trust (“ESBT”) shareholder in various S corporations. The ESBT is irrevocable, was formed in Illinois by Illinois resident trustees, and the only beneficiary was an Illinois resident until 2022. In 2021, the trustees changed residency to STATE1. In 2022, the ESBT beneficiary changed residency to STATE2. The ESBT has filed as an Illinois resident since formation.

We believe that both STATE2 and Illinois intend to tax the ESBT as a resident in 2022.

STATE2 Rules:

In STATE2, the entire income of a trust is taxable by STATE2 if the beneficiary is a STATE2 resident. (CA Sec. 17742(a), Rev. & Tax Code). STATE2 provides resident trusts with a credit for taxes paid to other states. In addition, resident beneficiaries of trusts that are shareholders of S corporations are allowed a credit

for taxes paid to others states on double-taxed income (CA Sec. 18006(b), Rev. & Tax. Code).

Illinois Rules:

In Illinois, irrevocable trusts are treated as Illinois residents if the grantor was domiciled in Illinois at the time the trust became irrevocable. (35 ILCS 5/1501(a)(20)(D)). Illinois provides a credit for taxes paid to another state which is equal to the lesser of 1) total amount of taxes paid to other states on Illinois base income for the year; or 2) the product of Illinois income tax liability multiplied by a fraction representing income sourced to other states over Illinois taxable income. (35 ILCS 5/601(b)(3) & 86 ILAC 100.2197).

STATE2 tax rate on ESBT's is graduated, up to 12.3%. Illinois' tax rate on ESBT's is 4.95% plus 1.5%, or 6.45%.

Our Questions for Comment:

Our questions for an ESBT that is taxed as a resident in both Illinois and STATE2:

- 1) Please confirm that Illinois provides the credit for taxes paid to other states, even though the ESBT is a resident in both Illinois and STATE2.
- 2) If the ESBT claims the STATE2 other state tax credit for taxes paid to Illinois, please confirm that Illinois will still allow the credit for taxes paid to other states.
- 3) First illustration, please assume that ESBT's taxable income is \$1M, and ESBT is taxable on S corporation income in STATE1. Assume that ESBT pays \$10K taxes in STATE1– and that \$10K is the lesser credit in Illinois. ESBT will owe \$64.5K of taxes to Illinois as a resident. ESBT will be claim a \$10K credit for taxes paid to other states, and will owe \$54.5K on the Illinois form IL-1041. Assume that ESBT owes \$123K to STATE2 (assumes flat tax rate to simplify). ESBT will be able to claim \$10K credit for STATE1 and \$54.5K credit for Illinois. Please confirm that if taxpayer claims both resident credits (Illinois and STATE2) for taxes paid to other states, Illinois will honor the credit for taxes paid to STATE1.
- 4) Second illustration, please assume that ESBT's taxable income is \$1M, and ESBT is taxable on S corporation income in STATE1. Assume that ESBT pays \$10K taxes in STATE1 – and that \$10K is allowed as a credit in STATE2. ESBT will be claim a \$10K credit for taxes paid to other states. Now, assume that STATE2 tax rate is a flat 6%, and ESBT owes \$60K of taxes to STATE2 as a resident. ESBT claims the \$10K, to reduce the STATE2 tax liability to \$50K. Further, assume that ESBT will owe \$64.5K taxes to Illinois as a

resident, before credits. ESBT will claim the Illinois resident tax credit for taxes paid to STATE1 and STATE2 = \$60K, and owe \$4.5K of net taxes to Illinois. Please confirm that if taxpayer claims both resident credits (Illinois and STATE2) for taxes paid to other states, Illinois will honor the credit for taxes paid to STATE2 and STATE1.

- 5) Given the two different outcomes for ESBT, is there any precedent of ordering between STATE2 and Illinois for the resident credit for taxes paid? Or as long as ESBT claims only net taxes paid to other states – and doesn't double-count, ESBT can claim both, as described in 3) or 4) above.

You also submitted an email to the Department on February 6, 2024, which includes the following additional information pertinent to your inquiry:

- 1) Trustee residence is STATE3 beginning 1/1/2022. Formerly Illinois.
- 2) Beneficiary residence is STATE2 beginning 1/1/2022. Formerly Illinois.
- 3) Location of trust assets is Illinois. Bank accounts and ownership shares are managed in Illinois.
- 4) Business location of trust is Illinois. Affairs are managed in Illinois.
- 5) STATE2 applies residency to trust based on beneficiary residence, resulting in potential that trust is resident in STATE2 and Illinois.

how We want to see if Illinois addresses dual-resident trusts, and therefore to apply the resident credit for taxes paid to another state.

RULING

Pursuant to Section 1501(a)(20)(D) of the Illinois Income Tax Act ("IITA") [35 ILCS 5/1501(a)(20)(D)], the term "resident" for Illinois income tax purposes includes an irrevocable trust, the grantor of which was domiciled in Illinois at the time such trust became irrevocable. A trust is considered irrevocable to the extent that the grantor is not treated as the owner thereof under Internal Revenue Code Sections 671 through 678. As a resident, the irrevocable trust is required to file an Illinois tax return if the trust is required to file a federal tax return [see IITA Section 502(a)(2)], and the trust is liable for income and replacement tax imposed under IITA Sections 201(a) and (c) on the privilege of earning or receiving income as a resident of Illinois.

In *Lewis Linn v. Department of Revenue*, 2013 IL App (4th) 121055, the plaintiff argued that requiring a trust to file returns and pay income tax as an Illinois resident based

solely upon the residence of the grantor violated due process where the trustee, beneficiaries and protector were all located out of state. The Illinois Appellate Court found that the trust lacked sufficient contacts with Illinois to satisfy the Due Process Clause of the U.S. Constitution, because none of the following factors existed to give Illinois personal jurisdiction over the trust:

- The provisions of the trust instrument
- The residence of the trustees
- The residence of the beneficiaries
- The location of trust assets
- The location where the business of the trust is conducted

You have represented that the ESBT is irrevocable, was formed in Illinois by Illinois resident trustees, and has filed as an Illinois resident since formation. In addition, you indicated the location of trust assets is Illinois and the business location of the trust is Illinois. The *Lewis Linn* case does not apply to the situation that you have described because there are sufficient contacts between the ESBT and the State of Illinois to satisfy the Due Process Clause of the U.S. Constitution given the location of trust assets in Illinois and the business location of the trust is Illinois. In *Lewis Linn*, the court distinguished that the focus on the due process analysis was on the tax year in question, so historic events had no influence on determining the residency of the trust. Therefore, pursuant to IITA Section 1501(a)(20)(D), the ESBT you describe is an Illinois resident and is required to file an Illinois income tax return under IITA Section 502(a)(2).

86 Ill. Adm. Code Section 100.3020(i) specifically recognizes that a person may be a “resident” of two different states for state income tax purposes. The IITA provides a credit for Illinois residents for the amount of tax paid to another state on income which is also subject to tax in Illinois during the same taxable year. The credit reduces the impact of the double taxation that occurs in this situation. Section 601(b)(3) of the IITA [35 ILCS 5/601(b)(3)] provides, in pertinent part:

(3) Foreign tax. The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year

As a resident of Illinois for a given state income tax year during which the ESBT was also classified as a resident of STATE2 and claims a credit for taxes paid to Illinois, as you represent, the ESBT may be eligible for the foreign tax credit (i.e., Illinois Credit for Tax Paid to Other States) against Illinois income and replacement tax, provided the ESBT meets the applicable definitions in 86 Ill. Adm. Code Section 100.2197.

Section 601(b)(3) of the IITA also provides:

For taxable years ending on or after December 31, 2009, the credit provided under this paragraph for tax paid to other states shall not exceed that amount which bears the same ratio to the tax imposed by subsections 201(a) and (b) otherwise due under this Act as the amount of the taxpayer's base income that would be allocated or apportioned to other states if all other states had adopted the provisions in Article 3 of this Act bears to the taxpayer's total base income subject to tax by this State for the taxable year.

The above limits the amount of tax paid to other states that may otherwise qualify for the credit. That limitation is determined by multiplying the amount of Illinois income tax otherwise imposed for the taxable year by a fraction, the numerator of which is the amount of the taxpayer's base income that would be allocated or apportioned outside of Illinois assuming that all other states adopted Illinois' allocation and apportionment rules as set forth in Article 3 of the IITA, and the denominator of which is the taxpayer's total base income for the taxable year. Under this provision, only income that would have been taxable by other states applying Illinois law is included in the numerator of the fraction. As a result, the amount of Illinois foreign tax credit cannot exceed an amount equal to the income tax levied on the taxpayer's Illinois base income (as defined in Section 203 of the IITA) multiplied by the ratio of the income subject to double taxation over the taxpayer's Illinois base income.

In response to both illustrations, Illinois will allow credit for taxes paid to other states on Illinois base income. A taxpayer will figure the amount of credit in Step 5 of the Schedule CR (Credit for Tax Paid to Other States) for Form IL-1041 Fiduciary Income and Replacement Tax Return. As provided in the Line 52 instructions, the taxpayer should enter the total amount of income tax paid to all other states minus all credits allowed, including a credit for taxes paid to Illinois or another state, except credits for payments the taxpayer actually made to other states or payments made on behalf of the taxpayer (see also 86 Ill. Adm. Code Section 100.2197(c)(2)). Taxes paid to other states should only be included if the income tax paid in the other state was for the same income included in Illinois base income for the same taxable year, as reported on Line 26 of the Form IL-1041. If the ESBT paid income taxes to Indiana and California, then the taxpayer can claim the total amount paid less any credits allowed in each state on Line 52 of the Schedule CR to figure the foreign tax credit allowed in Illinois.

However, your second illustration does not accurately provide for the limitation calculation as required in IITA Section 601(b)(3). The total amount of Illinois income and replacement tax owed would be multiplied by the limitation ratio as calculated on Line 51 of the Schedule CR. This result would be compared with the income tax paid to other states as calculated on Line 52, and the lesser amount would then be used to determine the amount of income and replacement tax credit for income tax paid to another state.

As stated above, this is a GIL. A GIL does not constitute a statement of Department policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you require additional information, please visit the Department's website

at www.tax.illinois.gov or contact the Department's Taxpayer Assistance Division at (800) 732-8866.

Sincerely,

Jennifer Uhles
Associate Counsel (Income Tax)