HOUSE BILL REPORT
HB 1920

As Reported by House Committee On:
Finance

Title: An act relating to preserving funding deposited into the education legacy trust account used to support common schools and access to higher education by restoring the application of the Washington estate and transfer tax to certain property transfers.

Brief Description: Preserving funding deposited into the education legacy trust account used to support common schools and access to higher education by restoring the application of the Washington estate and transfer tax to certain property transfers.

Sponsors: Representatives Ormsby, Carlyle, Hunter and Pollet; by request of Department of Revenue.

Brief History:
Committee Activity:
Finance: 3/29/13, 4/8/13 [DP].

Brief Summary of Bill

- Requires certain marital trust property to be included in the estate for purposes of the Washington estate tax.

HOUSE COMMITTEE ON FINANCE

Majority Report: Do pass. Signed by 8 members: Representatives Carlyle, Chair; Tharinger, Vice Chair; Fitzgibbon, Hansen, Lytton, Pollet, Reykdal and Springer.

Minority Report: Do not pass. Signed by 5 members: Representatives Nealey, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Condotta, Vick and Wilcox.

Staff: Jeffrey Mitchell (786-7139).

Background:

In 1981 Initiative 402 repealed the state inheritance tax and replaced it with an estate tax equal to the amount allowed under federal law as a credit against the federal estate tax. This

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is commonly referred to as a "pick-up" tax. A pick-up tax is not an additional tax on the estate but merely shifts revenues from the federal government to the state. Federal law phased out state pick-up taxes (i.e. federal sharing), with a complete termination in 2005.

On February 3, 2005, the state Supreme Court invalidated Washington's estate tax by holding that Washington's "pick-up" estate tax was based on current federal law, which had ended state-sharing, and Washington law did not impose an independently operating Washington estate tax. Until the Legislature expressly created a stand-alone tax, the tax remained a pick-up tax that must be fully reimbursed by the federal credit.

In response to the state Supreme Court decision, Washington created a stand-alone estate tax in 2005. The tax took effect May 17, 2005. The current Washington estate tax is imposed on every transfer of property located in Washington at the time of death of the owner. The term "property" includes real estate and other property located in this state, as well as intangible assets owned by a Washington resident, regardless of location.

The measure of the tax is based on the taxable estate as determined under federal law, as it existed on January 1, 2005. For Washington decedents dying on or after January 1, 2006, a deduction of $2 million is allowed from the taxable estate. The value of property used for qualifying farming purposes is also deductible.

After subtracting any applicable deductions (e.g., the $2 million statutory deduction and the value of qualifying farm property), the remaining Washington taxable estate is subject to a graduated rate schedule ranging from 10 to 19 percent.

As previously mentioned, the federal taxable estate is the starting point for determining Washington's estate tax. Federal law allows an unlimited marital deduction for property passed outright to a surviving spouse. Federal law also allows certain transfers of property to marital trusts to qualify for the unlimited marital deduction even though the surviving spouse does not have total control of the property. This property is referred to as qualified terminable interest property (QTIP). The QTIP is included in the federal taxable estate of the surviving spouse upon the surviving spouse's passing. Under both federal and state law, the personal representative of the first spouse to die can make a QTIP election to qualify the property for the marital deduction. Since the current Washington estate tax did not take effect until May 17, 2005, an issue arises as to whether the Washington estate tax applies to QTIP when the first spouse passed away prior to May 17, 2005.

On October 18, 2012, the state Supreme Court, in *Estate of Bracken*, 175 Wn.2d 549 (2012), specifically held that QTIP included in the federal taxable estate where the federal QTIP election was made prior to May 17, 2005, is not subject to Washington estate tax when the surviving spouse passes away after May 17, 2005. The Court reasoned that Washington's estate tax is specifically triggered by the transfer of property of the decedent and with QTIP, the actual transfer occurs when the first spouse passes away. The surviving spouse is an income beneficiary of QTIP, but upon the surviving spouse's death, no actual transfer occurs. Under federal law, a fictional transfer of QTIP occurs when the second spouse dies based on the original QTIP election by the first spouse. However, since the current Washington estate tax did not exist until May 17, 2005, no state QTIP election could have been made prior to this time.

Summary of Bill:

The definition of "transfer" is amended to specifically include property where the decedent economically benefitted in the property, i.e., property in a QTIP marital trust. A commensurate change is made to the definition of the "Washington taxable estate" to specifically include an interest in QTIP, regardless of whether the decedent acquired the interest in the property prior to May 17, 2005.

The changes in the bill apply prospectively as well as retroactively to decedents dying on or after May 17, 2005.

The changes in the bill do not impact the parties involved in the *Estate of Bracken* decision.

Appropriation: None.

Fiscal Note: Available.

Effective Date: This bill takes effect 90 days after adjournment of the session in which the bill is passed, except for section 4 relating to a Washington QTIP election, which takes effect January 1, 2014.

Staff Summary of Public Testimony:

(In support) When Washington's stand-alone estate tax took effect in 2005, the intent was to treat all estates in similar fashion and not have differential treatment for married and single couples. This is a complicated issue. The intent was to provide money for education. If a marital estate is properly structured, it will be exempt from Washington estate tax. The policy question is whether the Legislature intended for the tax to apply only to single and divorced individuals. From an equitable point of view, the tax should apply to all estates. A gift tax is a tax on a lifetime event. This bill does not create a gift tax. Courts apply a rational purpose test to evaluate whether a retroactive tax violates due process. A significant and unanticipated revenue loss, such as that resulting from the *Bracken* decision, is a legitimate, rational purpose.

(With concerns) The Washington State Bar Association (Bar) supports clarifying legislation, but this bill is broader than necessary. It is incorrect to say the tax will not apply to married couples. To argue that no estate tax will apply where both spouses die after May 17, 2005, is to take an unreasonably broad interpretation under *Bracken.* The Bar thinks the court decision only applies to pre-2005 QTIP trusts. Also, the surviving spouse's own assets will be subject to tax regardless of the property in a QTIP trust. There is a rule with the Department of Revenue (DOR) where the lead case goes forward. The fiscal impact is overstated. Imposing the tax retroactively, pre-2005, is bad public policy, unfair, and undermines the concept of separation of powers and fair play. It leaves too much to the

discretion of the DOR. Taxpayers will not be able to rely on precedent. This is not a windfall for the estates involved. The taxes have been under protest. These are not taxpayers that have come out of the woodwork after the court decision. The Bar thinks the retroactivity provision is unconstitutional as violating taxpayer's due process rights. There are limits to permissible retroactivity. In this bill, the period of retroactivity is eight years, or even longer if you consider the prior creation of the QTIP trust. This lengthy period of retroactivity violates a 1940 decision of the Washington Supreme Court. The meat of the Washington estate tax is in the Washington Administrative Code. Much of this should be codified to eliminate confusion. The bill implicitly creates a gift tax. Under this bill, if a spouse transfers property into a QTIP trust during his or her life, it will be subject to tax upon the death of the second spouse.

(Opposed) Regardless of whether the bill passes, family-owned businesses remain at risk of paying an unfair Washington estate tax. The Washington estate tax should be aligned as much as possible with the federal tax to confer the broadest amount of protection. A deduction should be provided for family-owned businesses, similar to what exists for farmers. The underlying solution in the bill is overly broad and will result in additional litigation.

Persons Testifying: (In support) Representative Ormsby, prime sponsor; Drew Shirk and Mark Mullin, Department of Revenue; and Cam Comfort, Attorney General's Office.

(With concerns) Kathryn Leathers, Mark Roberts, George Mastrodonato, Timothy Burkart, and Claudia A. Gowan, Washington State Bar Association.

(Opposed) Amber Carter, Association of Washington Business.

Persons Signed In To Testify But Not Testifying: None.