HOUSE BILL REPORT
EHB 2075

As Passed House:
June 13, 2013

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 while modifying the estate and transfer tax to provide tax relief for certain estates.

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 while modifying the estate and transfer tax to provide tax relief for certain estates.

Sponsors: Representatives Carlyle and Roberts.

Brief History:
Committee Activity:
None.
Second Special Session
Floor Activity:
Passed House: 6/13/13, 53-33.

Brief Summary of Engrossed Bill

- Requires certain marital trust property to be included in the estate for purposes of the Washington estate tax.
- Provides a deduction for family-owned businesses.
- Adjusts the $2 million deduction by inflation on an annual basis.
- Increases the top four estate tax rates.

Staff: Jeffrey Mitchell (786-7139).

Background:

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

In 1981 Initiative 402 repealed the state inheritance tax and replaced it with an estate tax equal to the amount allowed under federal law as a credit against the federal estate tax.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

For decedents dying prior to April 9, 2006, the personal representative of the estate is not personally liable for estate taxes on QTIP if the property is not located in Washington and the personal representative does not have possession of the property.

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

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

A deduction is provided for family-owned businesses. The deduction is capped at $2.5 million. A decedent's estate may not claim the deduction if the value of the decedent's interest in the business exceeds $6 million. To qualify for the deduction, material participation requirements related to the operation of the business both prior to, and after, the decedent's death are provided. More specifically, a decedent or a family member of the decedent must materially participate in the business five of eight years prior to the decedent's date of death and the heir receiving the business interest must materially participate in the business for at least three years after acquiring the interest. An additional estate tax is imposed on the heir acquiring the business interest if the material participation requirements are not met, the heir disposes of any portion of the business interest, or any of several other disqualifying events occur. The amount of the tax is equal to the tax savings from claiming the deduction. The deduction applies to decedents dying on or after January 1, 2014.

The existing $2 million deduction is indexed for inflation every year beginning in calendar year 2014.

The estate tax is modified to offset the fiscal impact of providing the family-business deduction and adjusting the $2 million deduction by inflation. More specifically, the top four marginal tax rates are increased as follows: (a) 17% is increased to 18%; (b) 18% is increased to 19%; (c) 18.5% is increased to 19.5%; and (d) 19% is increased to 20%.

Appropriation: None.

Fiscal Note: Requested on June 12, 2013.

Effective Date: The bill contains an emergency clause and takes effect immediately, except for section 3 relating to a family-owned business deduction, section 4 relating to estate tax rates, and section 6 relating to qualified terminable interest property, which take effect January 1, 2014.