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COURT OF APPEALS, DIVISION II,  
OF THE STATE OF WASHINGTON

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SCOTT B. OSBORNE, Personal  
Representative of the Estate of Barbara Hagyard Mesdag,

Appellant,

vs.

THE DEPARTMENT OF REVENUE OF  
THE STATE OF WASHINGTON,

Respondent.

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REPLY BRIEF OF APPELLANT

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A. INTRODUCTION

In 2008, the Department of Revenue (“DOR”) erroneously demanded that the Estate of Barbra Mesdag (“Estate”) pay taxes on QTIP assets in its estate tax return. DOR’s error was made clear when the Supreme Court held in *Clemency v. State*, 175 Wn.2d 549, 290 P.3d 99 (2012) (“*Bracken*”) that DOR could not assess taxes on QTIP assets. But rather than admit its mistake and move on, DOR doubled down and refused to return \$310,937.15 in interest penalties it collected in 2010 from the Estate for taxes which were not owed until 2013 when the Legislature amended the statute.

It is undisputed that no tax was due in 2012 when *Bracken* was decided. Br. of Resp’t at 15. And the fundamental rules of statutory construction dictate that no tax was due in 2008 when DOR first tried to collect on QTIP assets. The law in Washington is clear that a taxpayer may not be charged an interest penalty until a tax is legally due to be paid.

DOR offers no rebuttal to the fundamental notion that retroactive civil penalties are unenforceable. Rather, DOR spends its entire argument ignoring the Supreme Court’s clear ruling that interest on delinquent inheritance tax assessments is a penalty. DOR cannot substitute its own judgment for that of the Supreme Court. The trial court’s decision should be reversed with interest awarded to the Estate.

B. ARGUMENT

(1) To Refute the Fact That the Estate Owed No Penalty in 2008, DOR Ignores Fundamental Rules of Statutory Interpretation and Tax Law

DOR admits that due to *Bracken*, “the Estate owed no Washington estate tax on QTIP” assets. Br. of Resp’t at 15. DOR then argues that *Bracken* “was controlling law in this state for only a few short months before it was repudiated and replaced by retroactive legislation enacted in 2013.” Br. of Resp’t at 12. Not true. The *Bracken* court’s interpretation of the estate tax statute is deemed to have applied since its enactment. “[O]nce a statute has been construed by the highest court of the State, that construction operates as if it were originally written into it.” *Johnson v. Morris*, 87 Wn.2d 922, 927, 557 P.2d 1299 (1976). Thus, in operation, QTIP trusts *were never part of a taxable estate* until 2013 when the Legislature amended the statute.<sup>1</sup> DOR was wrong in 2008 when it included them within the taxable estate. And DOR was wrong when charged interest on unpaid funds that it had no right to collect in the first place.

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<sup>1</sup> *Bracken*’s interpretation of the statute was not overruled by the Legislature, as DOR had been careful to argue in the past. Br. of Appellant at 10 n.6. Otherwise, the Legislature would have violated separation of powers principles. *In re Estate of Hambleton*, 181 Wn.2d 802, 819, 335 P.3d 398 (2014). Rather, the Legislature pronounced for the first time that QTIP assets were taxable in 2013. Those assets were *not taxable prior to that date*, thus no interest penalties could be assessed for their delinquency.

The absurdity of DOR’s argument is clear. DOR claims that due to “retroactive legislation, the Estate was not entitled to deduct QTIP on its Washington return and should have paid the tax when it was due in order to avoid interest on the underpayment.” Br. of Resp’t at 12. But the deduction was made *in 2008*. The law did not change *until 2013*. How was the Estate wrong to deduct, in 2008, that *which was not owed*? Following DOR’s logic, a taxpayer may never deduct a single item from a tax payment for fear that one day, in the distant future, the Legislature may retroactively decide to change the tax code. For although the tax may not be owed at the time a payment is due, the law could change, and interest penalties will relate back in perpetuity. That has never been the law in Washington.<sup>2</sup>

“[T]he state cannot take more than the actual tax, whether under the guise of interest or otherwise, until the taxpayer has failed or omitted to perform a duty imposed by law.” *State v. Superior Court for Stevens County*, 93 Wash. 433, 435, 161 P. 77, 78 (1916). In *Stevens County* a landowner challenged his property tax assessment and prevailed in the Supreme Court. *Id.* at 433 (discussing the facts of *First Thought Gold Mines*

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<sup>2</sup> To the contrary, DOR’s reading is foreclosed by the authorities it relies upon to justify its imposition of interest on the Estate. *See* Br. of Appellant at 7-9. Under RCW 83.100.070, any tax “*due under this chapter* which is not paid by the due date under RCW 83.100.060(1)” bears interest. There was no tax due under chapter 83.100 in 2008. Similarly, DOR’s own regulations state that interest “applies to the delinquent tax only ...” WAC 458-570-035(4). There was never a delinquent tax. DOR fails to explain how any tax was due prior to the 2013 amendments to the estate tax statute.

*v. Stevens County*, 91 Wash. 437, 439, 157 P. 1080 (1916)). On remand, the county attempted to charge interest on the funds that the landowner disputed, funds the Supreme Court already determined could not be taxed. *Id.* The Court held that the county could not charge interest, for it would be the “height of inequity” to charge interest on a tax assessment that a taxpayer prevailed in challenging. *Id.* at 438.

In reaching its decision, the *Stevens County* court discussed the exact situation at hand. The Court cited favorably the rule that:

[W]here the Legislature passes a law for the taxation of property theretofore omitted as a subject of taxation, it cannot provide for interest from some antecedent date, but must provide some future time within which the tax must be paid after which interest may be demanded.

*Id.* at 435. This makes sense, given the rule that a taxpayer cannot be charged interest on a tax which is not due, or which is invalid. *Id.*; *see also*, *HomeStreet, Inc. v. State, Dep’t of Revenue*, 166 Wn.2d 444, 452-53, 210 P.3d 297 (2009) (noting that interest requires “an existing, valid, and enforceable obligation”).<sup>3</sup>

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<sup>3</sup> In fact, it is a violation of a person’s due process rights to be forced to pay an illegal tax. *Sintra v. City of Seattle*, 119 Wn.2d 1, 24, 829 P.2d 765 (1992), *cert. denied*, 506 U.S. 1026 (1992) (imposition of legally invalidated development fees may constitute violation of developer’s due process rights); *Patel v. City of San Bernadino*, 310 F.3d 1138, 1140-41 (9th Cir. 2002) (city’s continued collection on unconstitutional tax violated due process). A taxpayer’s rights under the Fifth Amendment and Washington Constitution, article I, § 16 are also implicated by such an impermissible taking. *See, e.g., United States v. Pittman*, 449 F.2d 623, 626 (7th Cir. 1971) (IRS tax levy and consequent seizure of property that fails to give taxpayer proper credit for property seized is a Fifth Amendment taking) (cited in Br. of Appellant at 11 n.7).

The exact scenario the Court condemned in *Stevens County* is at issue here. The *Bracken* decision made it clear that QTIP assets were not subject to taxation. They were not taxable until 2013 when the Legislature passed a new law to include them. Under the rule championed by the Supreme Court, DOR cannot charge interest prior to 2013 for those funds because they were never due. It can only demand interest on delinquent payments that post-date the 2013 *Bracken* amendment.<sup>4</sup> *Stevens County* remains good law, and for over a century courts have consistently applied its underlying principle that retroactive civil penalties are unenforceable.

(2) DOR Ignores the Law in Washington That Interest on Estate Taxes is a Penalty and Cannot Be Applied Retroactively

DOR advances no argument disputing the rule that retroactive civil penalties are unenforceable. *Adcox v. Children's Orthopedic Hosp. & Medical Center*, 123 Wn.2d 15, 30, 864 P.2d 921 (1993) (civil penalties imposed on hospitals not retroactive); *Johnston v. Beneficial Mgmt. Corp. of Am.*, 85 Wn.2d 637, 642, 538 P.2d 510 (1975), *modified on other grounds in Salois v. Mutual of Omaha Ins. Co.*, 90 Wn.2d 355, 581 P.2d 1349 (1978) (treble damage remedy in CPA applied only prospectively). Instead, it

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<sup>4</sup> To be clear, the retroactivity of the tax itself is not at issue here. The Estate paid \$2,919,171.86 in additional estate taxes per the 2013 *Bracken* amendment. But DOR is not content with that gain, retroactively imposed by the Legislature. It insists on keeping \$310,937.15 in interest penalties it had no right to collect when the penalty was paid under protest back in 2010.

argues that the interest it charged the Estate for withholding the disputed funds was not a penalty, *even though the Supreme Court has directly stated otherwise*. Faced with this reality, DOR imagines ambiguity where there is none and uses irrelevant federal authority to reinterpret the clear law in Washington.

Washington courts have long held that “[i]nterest upon delinquent taxes is a penalty, and not interest.” *Stevens County*, 93 Wash. at 435. “And this is so whether the penalty be in the way of interest, the addition of a certain per cent. [sic], or by doubling the tax.” *Id.* In *In re Elvigen’s Estate*, 191 Wash. 614, 71 P.2d 672 (1937), the Supreme Court expressly adopted this principle in the context of the estate tax. It explained that “[t]he purpose of imposing penalties for tax delinquencies is to compel all property owners to bear their equal share of the public burden, to pay their taxes promptly, and to *punish* taxpayers for frauds, evasions, and neglect of duty.” 191 Wash. at 621 (emphasis added). Thus, the Court wrote, “In the event one is delinquent in paying an inheritance tax, by the express terms of [the inheritance tax statute], an interest *penalty* is imposed.” *Id.* (emphasis added); *see also, Dep’t of Revenue v. Estate of Pohelmann*, 63 Wn. App. 263, 818 P.2d 616 (1991) (addressing whether DOR could collect “a *penalty* for the tardy filing of a state estate tax return”) (emphasis added).

Inexplicably, DOR argues that this clear language is “ambiguous” as to whether the interest is a penalty. Br. of Resp’t at 25-26. The Court could not have been clearer when it said that the purpose of charging interest on delinquent estate tax payments is to “punish taxpayers.” *Elvigen’s Estate*, 191 Wash. at 621. DOR advances no argument, other than substituting its preferred reading of the statute for that of the Supreme Court. No Washington case has ever undermined the clear finding of *Elvigen’s Estate* that interest collected on delinquent estate taxes is a penalty.

Given this lack of authority, DOR is forced to cite federal cases that do not involve the Washington estate tax. Br. of Resp’t at 27 (citing, *e.g.*, *United States v. Childs*, 266 U.S. 304, 309, 45 S. Ct. 110, 69 L. Ed. 299 (1924); *In re Beardsley & Wolcott Mfg. Co.*, 82 F.2d 239, 240 (2d Cir. 1936)). These cases merely discuss interest versus penalties in general terms and have no bearing on Washington tax law as outlined by the *Elvigen’s Estate*.<sup>5</sup> DOR cites these cases to argue that the court must

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<sup>5</sup> DOR also cites *Rufer v. Abbot Labs*, 154 Wn.2d 530, 114 P.3d 1182 (2005) for the proposition that the “plain language” of the statute controls regardless of other considerations such as the ban on retroactive penalties and interest on taxes. Br. of Resp’t at 10. *Rufer* has nothing to do with this case. It is not a tax case, but rather involved postjudgment interest on a tort award which the court explicitly stated “is not imposed as a punishment.” *Id.* at 552.

In contrast to this case, *Rufer* did not involve a change in law that affected a prior award or the reversal of an award by an appellate court. It is no wonder DOR avoided a meaningful analysis of the case because – like tax assessments that are later reversed – trial awards that are reversed on appeal *do not* accrue postjudgment interest. *Fisher Properties, Inc. v. Arden-Mayfair, Inc.*, 115 Wn.2d 364, 373, 798 P.2d 799 (1990).

determine whether an interest charge is meant to punish delinquent taxpayers. But the Supreme Court already did that, *expressly*, when it said that the purpose of charging interest on late estate tax payments is to “*punish* taxpayers for frauds, evasions, and neglect of duty.” *Elvigen’s Estate*, 191 Wash. at 621 (emphasis added). Other than ignoring this clear language and imagining ambiguity where there is none, DOR offers no rebuttal to the rule that retroactive estate tax penalties are unenforceable.

By failing to reckon with *Elvigen’s Estate*, DOR simply ignores controlling Supreme Court precedent. When the Estate filed its return in 2008, it did not owe any tax on the funds held in the QTIP trust. DOR had no right to collect that money, nor could it impose any penalty by charging interest on the QTIP taxes withheld. Five years later – after the Estate’s position was vindicated by *Bracken* – the Legislature chose to amend the estate tax code, applying a civil penalty to withheld QTIPs for the first time. That new penalty cannot apply retroactively. *See, e.g., Adcox*, 123 Wn.2d at 30; *Johnston*, 85 Wn.2d at 642.

(3) DOR Should Pay Interest on the Penalties It Illegally Collected

DOR received a windfall when it collected \$310,937.15 in an interest penalty which, as discussed above, was never due. From 2010 to 2013, DOR enjoyed the use of that money, including any earnings it may

have accrued. DOR admits that RCW 83.100.130(1) requires it to issue refunds with interest when an overpayment occurs. Br. of Resp't at 32. Yet, DOR spends the rest of its brief merely pronouncing that this Court should strictly construe refunds and only do so in light of "clear statutory authority." Br. of Resp't at 31-33.<sup>6</sup>

Strictly construed or not, the Estate is owed a refund. DOR improperly collected \$310,937.15, overpaid by the Estate. RCW 83.100.130(1) is clear statutory authority for the proposition that when an overpayment occurs DOR "shall refund" the amount with interest. The statute is mandatory. RCW 83.100.130(3) expressly discusses refunds for "taxes, penalties, [and] interest paid," highlighting the obvious fact that the Legislature intended for refunds of unauthorized penalties with interest. DOR's arguments on this point, or lack thereof, fail.

#### C. CONCLUSION

DOR bends over backwards to avoid admitting its mistake. It ignores fundamental rules of statutory interpretation, clear Supreme Court precedent, and rules of tax law that date back over a century in this State. The law in Washington does not allow DOR to impose an interest penalty

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<sup>6</sup> DOR also appears to labor under the misconception that the Estate is seeking interest on the entire tax assessment, rather than just the interest it illicitly assessed against the Estate. Br. of Resp't at 30. It cites the Estate's opening brief at 15 for this proposition. The Estate's brief did not say that. The Estate is seeking interest on its overpayment of interest to DOR, \$310,937.15, for the period since 2008.

accruing from 2008 to 2010, when the underlying tax was not legally due until 2013. The trial court should be reversed, and DOR should be ordered to repay the penalty paid by the Estate with interest. To hold otherwise would be the “height of inequity.” *Stevens County, supra*.

DATED this 5<sup>th</sup> day of February, 2018.

Respectfully submitted,



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DECLARATION OF SERVICE

On said day below, I electronically served a true and accurate copy of the *Reply Brief of Appellant* in Court of Appeals, Division II Cause No. 50762-5-II to the following parties:

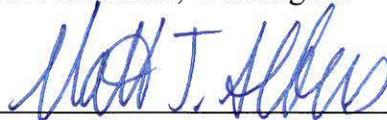
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I declare under penalty of perjury under the laws of the State of Washington and the United States that the foregoing is true and correct.

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