

No. 84114-4

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IN THE SUPREME COURT OF THE STATE OF WASHINGTON

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In re the Matter of the:

ESTATE OF SHARON M. BRACKEN,

CAROL B. CLEMENCY, LAURA B. CLOUGH and JOHN L.  
BRACKEN, Personal Representatives of the Estate of Sharon M. Bracken,

Appellants,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE

Respondent.

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REPLY BRIEF OF APPELLANTS

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## I. INTRODUCTION

The Department of Revenue (“DOR”) is attempting to impose the new Washington Estate and Transfer Tax Act (the “Act”) on a transfer of property that occurred more than twenty years ago. Because the new Act only applies to transfers of property by the decedent and neither Sharon Bracken nor her estate transferred Jim Bracken’s trust, it cannot be taxed as a part of Sharon’s Washington taxable estate. Since there was no taxable transfer at Sharon’s death, the inquiry should end there.

But going further, and addressing DOR’s flawed arguments, I.R.C. § 2044 does not require Jim’s trust be included in Sharon’s Washington taxable estate because Jim’s trust was never subject to the new state estate tax created by the Act. Jim’s estate never took a marital deduction from that tax, the *sine qua non* for the inclusion of Jim’s trust as part of Sharon’s Washington taxable estate. In fact, Jim’s estate could not take a Washington estate tax marital deduction because the tax did not even exist at the time of Jim’s death. To tax Jim’s trust now would retroactively impose the tax on a transfer that occurred more than 20 years ago.

DOR’s arguments improperly shift between the old pick-up tax and the new Act and deliberately mix up the federal marital deduction and the new Washington marital deduction. DOR’s attempt to apply the new tax in this way is contrary to the law and the clear language of the

regulations that DOR adopted in 2006. The 2006 Regulations are clear on their face and are consistent with the Act and the tax policy of the marital deduction and QTIP elections. The citizens of this state are entitled to rely on those regulations, and DOR should not now be allowed to disavow them.

Furthermore, the new Act expressly states that it is to be applied prospectively only, and not retroactively. To apply the Act in the manner advocated by DOR would be contrary to the Act, retroactive and would violate the Contract and Due Process Clauses of the United States and Washington State Constitutions.

## II. AUTHORITY AND ARGUMENT

### A. The New Estate Tax Applies Only To A “Transfer Of Property” By A Decedent

The new Act imposes a tax on “every transfer of property” by a decedent.<sup>1</sup> RCW 83.100.040(1). DOR erroneously argues there are two transfers of property held by Jim’s trust: first by Jim’s estate to Jim’s trust

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<sup>1</sup> Under both the federal and state estate tax schemes, property is taxed when it is transferred. I.R.C. § 2001(A); RCW 83.100.040. “Transfer” is defined in RCW 83.100.020(11) as meaning the same as “transfer” as used in section 2001 of the Internal Revenue Code.” There is no further definition of “transfer” under IRC § 2001 in federal law. Although “transfer” has no special meaning in federal law, an estate tax can only be imposed on wealth *transfers*, not on wealth itself. See R. Stephens, *et al.*, FEDERAL ESTATE AND GIFT TAX ¶ 2.01 at 2-2, n.3 (8<sup>th</sup> ed. 2001). An indirect tax on the transmission of wealth is constitutional as long as it is imposed uniformly throughout the U.S. *Id.* In contrast, a direct tax on wealth must be apportioned across the states in accordance with their respective populations. *Id.* (citing L. Tribe, AMERICAN CONSTITUTIONAL LAW 841 (3<sup>rd</sup> ed. 2000)). Thus, Washington’s Estate and Transfer Tax Act may not tax Sharon’s wealth, but may only tax transfers of Sharon’s property.

and second by Sharon's Estate to the ultimate beneficiaries. Resp. Brief at 26. By this means DOR seeks to improperly tax Jim's trust as part of Sharon's Estate even though Sharon's Estate had no power or authority to transfer the assets in Jim's trust.

1. A Transfer Occurs When The Trust Is Created, Not When It Passes To Successor Beneficiaries

The distribution of property out of Jim's trust on Sharon's death was controlled solely by the terms of Jim's will. The interests of the remainder beneficiaries became vested at Jim's death. *Van Stewart v. Townsend*, 176 Wash. 311, 322-23, 28 P.2d 999 (1934). Sharon only had a transitory beneficial interest in the trust; she could not pledge, alienate or otherwise direct the disposition of the trust property, and on her death all interests she had in the trust ended. CP 389-92.

This Court has held that the state cannot impose or collect an estate tax "unless some right in it is transferred by the death of the decedent." *In re McGrath's Estate*, 191 Wash. 496, 503, 71 P.2d 395 (1937). The United States Supreme Court has held that a trust is transferred when it is created, not when an income interest in the trust expires. *Coolidge v. Long*, 282 U.S. 582, 51 S. Ct. 306, 75 L. Ed. 562 (1931); *see also Blodgett v. Silberman*, 277 U.S. 1, 48 S. Ct. 410, 72 L. Ed. 749 (1928) (inheritance

or death tax is tax not upon property but upon right or privilege of succession to property of deceased person).

DOR simply dismisses the holding in *Coolidge*. Resp. Brief at 29-30. But the *Coolidge* Court clearly held that even though assets subsequently pass from the trust at a later date (e.g. upon the death of the surviving spouse), the taxable transfer occurred when the trust was created and became irrevocable. *Coolidge*, 282 U.S. at 597-98. It is at that time that all control over the property was divested. *Id.* at 597. The subsequent death of the surviving spouse is not “a generating source of any right in the remaindermen,” and as a result that property cannot be reached by the tax statute on the surviving spouse’s death. *Id.* at 597.

DOR also criticizes the estate’s reliance on *Estate of Mellinger v. Comm’r*, 12 T.C. 26 (1999) and *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996). Resp. Brief at 36-37. But both of those cases demonstrate that QTIP trusts, like the one at issue here, are created at the first spouse’s death. On the survivor’s death, the QTIP trust is viewed as being separate and distinct, precisely because the benefits became fixed at the first death when the transfer occurred.<sup>2</sup>

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<sup>2</sup> In *Bonner*, the court stated “[t]he estate of each decedent should be required to pay taxes on those assets whose disposition that decedent directs and controls, in spite of the labyrinth of federal tax fictions. \* \* \* Mrs. Bonner controlled the disposition of her assets, first into a trust with a life interest for Bonner and later to the objects of her

The only other state court decision known to have addressed a similar issue is *Indiana Dep't of State Revenue v. Estate of Morris*, 486 N.E.2d 1100 (Ind. Ct. App. 1986). In *Morris*, the first spouse to die created a trust in which her surviving spouse was given a life estate. *Id.* Upon the surviving spouse's death, the Indiana DOR attempted to impose a tax against the value of the marital trust. *Id.* Under Indiana law, to impose an estate tax there must be (1) a transfer from a decedent (2) of an interest in property which the decedent owned at death. *Id.* at 1101. The court found that no transfer occurred because the trust corpus was under the control of the first spouse and merely flowed through the surviving spouse's estate. *Id.* at 1102. As a result, the court held that no tax could be imposed. *Id.*

Because Washington's estate tax is only imposed on a "transfer of property" by a decedent, no estate tax could be imposed on Sharon's Estate for Jim's trust. Applying the consistent rule in *McGrath*, *Coolidge*, *Mellinger*, *Bonner* and *Morris*, Sharon's Estate did not own, control or transfer any property in that trust. Absent a Washington statute that makes the surviving spouse the transferor of a federal QTIP trust under Washington law, Jim's trust cannot be taxed as part of Sharon's

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largesse. The assets, although taxed as if they passed through Bonner's estate, in fact were controlled at every step by Mrs. Bonner . . ." *Bonner*, 84 F.3d at 199.

Washington taxable estate. *See Helvering v. Safe Deposit & Trust Co. of Baltimore*, 316 U.S. 56, 62 S. Ct. 925, 86 L. Ed. 1266 (1942).

2. The Internal Revenue Code Does Not Create A “Transfer” Of QTIP At The Surviving Spouse’s Death

The federal statute that causes a federal QTIP trust to be included in the *federal* taxable estate of a surviving spouse is I.R.C. § 2044. DOR erroneously attempts to use language in section 2044 to argue that a transfer of Jim’s trust occurred at Sharon’s death. Resp. Brief at 25-27. DOR misconstrues both the language and the purpose of this provision.

The language DOR refers to treats property as “passing” to or from a spouse. Certain federal estate tax deductions require that property “pass” to or from designated parties. “Pass” is a statutory term of art in the federal tax code that is distinct from the term “transfer.” I.R.C. § 2044 creates a legal fiction that property is “*considered to have been acquired from or to have passed from*” and is “*treated as passing from*” a deceased surviving spouse so that the surviving spouse’s estate may benefit from these estate tax deductions. 26 C.F.R. § 20.2044-1(b) (emphasis added); *see also* Senate Report on the Technical Corrections Act of 1982, S. Rep. No. 97-592 at 20; I.R.C. §§ 2056(a) and 2032A. The QTIP is *treated as* having passed from the surviving spouse “but QTIP property *does not actually pass to or from the surviving spouse.*” *Mellinger*, 112 T.C. at 35

(emphasis added). I.R.C. § 2044 does not make the surviving spouse the “transferor” of the QTIP trust.

If DOR’s argument was correct, that a QTIP trust is “transferred” by the surviving spouse at the time of his or her death, section 2044 would be completely unnecessary. In that case the QTIP simply would be includable in the surviving spouse’s estate under I.R.C. § 2031. The very enactment of section 2044 confirms that, standing alone, a QTIP trust is not includable in a surviving spouse’s estate.<sup>3</sup> In fact, DOR agrees that the only reason a QTIP trust is includable in the surviving spouse’s federal taxable estate is because of section 2044. CP 884.

**B. QTIP is Only Taxed on a Survivor’s Death if a Deduction Was Allowed Against the Same Tax at the First Spouse’s Death**

DOR claims that I.R.C. § 2044 requires inclusion of Jim’s trust in Sharon’s Washington taxable estate because the “Washington taxable estate” is based on the “federal taxable estate” under RCW 83.100.020(13) and (14). Resp. Brief at 26-27. DOR’s argument, however, hopelessly confuses the federal and state marital deductions. Section 2044 requires a QTIP trust to be included in the surviving spouse’s federal taxable estate only if a federal marital deduction was taken for that property at the time

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<sup>3</sup> Throughout its brief, DOR erroneously argues that Sharon’s Estate is seeking to “deduct” Jim’s trust from her Washington taxable estate. Resp. Brief at *passim*. This is not a deduction and calling it so does not make it so. The issue is not if Sharon’s Estate is entitled to a deduction. The issue is if Jim’s trust can be included as part of Sharon’s Washington taxable estate at all.

of the first spouse's death. See I.R.C. § 2056(b)(7)(A). DOR seeks to include Jim's trust as part of Sharon's Washington taxable estate even though Jim's estate never took a Washington estate tax marital deduction for the trust property.

1. Section 2044 Applies Only If The First Spouse's Estate Took A Deduction Under Section 2056

I.R.C. § 2044 cannot be read in isolation.<sup>4</sup> The purpose of that section and the tax policy underlying its application can only be understood by considering its role in the overall tax scheme of the federal marital deduction. Under federal law, when a QTIP election is made, I.R.C. § 2056(a) gives the estate of the first spouse to die a marital deduction equal to the amount of the property placed in the QTIP trust. I.R.C. § 2056(a)(7)(A). If no QTIP election is made under section 2056, the first spouse's estate must pay federal estate tax on the assets transferred to the trust. I.R.C. § 2056(b)(1)(A). Under section 2044, QTIP property is included in the federal taxable estate of the surviving

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<sup>4</sup> "Sometimes a section makes little or no sense without an understanding of other provisions relating to it. § 2044 is such a section. It must be examined with Sections 2056(b)(7), 2523(f), 2519, and 2207A to comprehend its message." R. Stephens, *et al.*, FEDERAL ESTATE AND GIFT TAXATION ¶ 4.16 at 4-322 (7th ed. 1997). In interpreting the provisions of the Act the fundamental objective is to ascertain and carry out the Legislature's intent. *Dep't of Ecology v. Campbell & Gwinn, L.L.C.*, 146 Wn.2d 1, 9, 43 P.3d 4 (2002). A provision "should not be read in isolation, but rather within the context of the regulatory and statutory scheme as a whole; statutory provisions must be read in their entirety and construed together, not by piecemeal." *Campbell & Gwinn*, 146 Wn.2d at 11, 43 P.3d 4 (citing *ITT Rayonier, Inc. v. Dalman*, 122 Wn.2d 801, 807, 863 P.2d 64 (1993)).

spouse only if it was subject to the federal estate tax at the first spouse's death and a federal marital deduction against that tax was taken at that time. I.R.C. § 2044(b)(1)(a).

Under this scheme, the first spouse to die can postpone the federal estate tax on QTIP property while also retaining control over the ultimate disposition of the property. "Inclusion in the estate of the second spouse to die, however, is the quid pro quo for allowing the marital deduction for the estate of the first spouse to die." *Mellinger*, 12 T.C. at 35.<sup>5</sup> The basic bargain demanded by I.R.C. § 2056 is inclusion in the surviving spouse's taxable estate as the price for the marital deduction in the original decedent's estate. 5 B. Bittker & L. Lokken, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 129-60 (2d ed. 1993). Thus, Jim's trust was taxed as part of Sharon's *federal* taxable estate under section 2044 only because Jim's estate got the benefit of a *federal* marital deduction under section 2056(b)(7)(A).

2. Jim's Estate Never Received The Benefit Of A Washington Marital Deduction

To justify inclusion of Jim's trust in Sharon's Washington taxable estate, Jim's estate must have received a deduction from the Washington estate tax at the time of his death. Like the marital deduction allowed for

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<sup>5</sup> See also *Estate of Clayton v. Comm'r*, 976 F.2d 1486, 1491 (5th Cir. 1992) (essential feature of marital deduction is that property of first spouse to die that passes untaxed to surviving spouse should be taxed in estate of surviving spouse).

federal estate tax purposes by I.R.C. § 2056, a marital deduction is allowed for state estate tax purposes by RCW 83.100.047. The election to qualify a QTIP trust for the Washington estate tax marital deduction is separate and distinct from an election to qualify the trust for the federal estate tax marital deduction. RCW 83.100.047. The new Act specifically recognizes that there can be different state and federal elections. *Id.* What must be included as part of the surviving spouse's estate for federal estate tax purposes is not the same as what must be included as part of the surviving spouse's estate for state estate tax purposes. The plain language of DOR's 2006 Regulations incorporate this basic tenet that the state deduction must match with the state inclusion, and the federal deduction must match with the federal inclusion. *Compare* WAC 458-57-105(3)(q)(iii) & (v) (2006) *with* WAC 458-57-105(3)(q)(iv) & (vi) (2006); WAC 458-57-115(2)(d)(iii) & (v) (2006) *with* WAC 458-57-115(2)(d)(iv) & (vi) (2006).

While Jim's estate took a federal estate tax marital deduction, it did not take a Washington estate tax marital deduction. The new Act, which for the first time provided for a Washington estate tax marital deduction, was enacted in 2005. Because the Act did not even exist in 1984, it was not possible for Jim's estate to make a state QTIP election and take a Washington marital deduction. The transfer in 1984 was not taxable under

the Act. No Washington marital deduction was taken, no Washington QTIP election was made, and no Washington estate tax was deferred. Consistent with the express provisions of the Act and the 2006 Regulations, Jim's trust cannot now be taxed as a part of Sharon's Washington taxable estate.

3. DOR's 2006 Regulations Are Consistent with the Exclusion of the Federal Marital Deduction Property In Determining the Washington Taxable Estate

Again confusing the federal and state marital deductions, DOR suggests the QTIP property that is included in Sharon's federal taxable estate under I.R.C. § 2044 also must be included in her Washington taxable estate. Resp. Brief at 15. But DOR's position is contrary to the tax policy underlying a marital deduction, and is contrary to the express provisions of the 2006 Regulations. In fact, the 2006 Regulations say exactly the opposite of what DOR now argues.

Under the 2006 Regulations, the Washington taxable estate of the first spouse to die excludes any property for which a state QTIP has been elected, but includes any property for which a federal QTIP is elected. WAC 458-57-105(3)(q)(iii) & (iv) (2006); WAC 458-57-115(2)(d)(iii) & (iv) (2006). On the surviving spouse's death, the survivor's Washington taxable estate includes property for which a Washington QTIP election was made at the first death, but *excludes* any property for which a federal

QTIP election was made. WAC 458-57-105(3)(q)(v) & (vi) (2006); WAC 458-57-115(2)(d)(v) & (vi) (2006). This is consistent with Washington's policy to disregard the federal QTIP elections in determining the Washington taxable estate.

In its argument DOR attempts to renege on the clear terms of the interpretative rules that DOR itself promulgated. To avoid application of its own 2006 Regulations, DOR argues there are "conditions precedent" before the regulations can be applied.<sup>6</sup> Resp. Brief at 15-16. DOR argues that only if Jim had made a Washington QTIP election could Sharon's Estate exclude Jim's trust from her Washington taxable estate. Resp. Brief at 17-20. In a misleading manner, DOR quotes only the last two subsections of WAC 458-57-105(3)(q) suggesting that the "and" between them supports its argument. Resp. Brief at 18-19. In reading the full text of the section, however, it is clear that the "and" is between the next to last

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<sup>6</sup> DOR's argues that because RCW 83.100.047 does not apply to Sharon's Estate, the 2006 Regulations do not apply and thus Jim's federal QTIP trust must be included as part of Sharon's Washington taxable estate. Resp. Brief at 13-14. That provision merely authorizes the establishment of a state marital deduction and directs DOR to adopt regulations to implement it. It does not create conditions precedent for the applications of DOR's regulations. DOR did adopt regulations in 2006 that implement not only the state marital deduction but generally all aspects of the state's new estate tax. Following DOR's faulty logic, RCW 83.100.047 does not apply to the estate of any surviving spouse and thus, according to DOR, none of its 2006 Regulations would apply to those estates either. The Court should avoid such an absurd interpretation of RCW 83.100.047 and DOR's own regulations.

and last elements of a series.<sup>7</sup> Plainly not every element set out in the regulation is applicable to every estate. The elements are steps in a calculation, some of which will be relevant, some of which will not. Contrary to DOR's arguments, nowhere do the 2006 Regulations state that they only apply if a Washington QTIP election has been made. Moreover, the regulations include none of the conditions precedent that DOR claims. Only in this case, DOR wants to disregard its own regulations and the statute and retroactively tax Jim's trust as part of Sharon's Estate.

4. The New Act Supports the Exclusion of Section 2044 Property in Determining the Washington Taxable Estate

The new Act itself operates to exclude any section 2044 property from the Washington taxable estate. RCW 83.100.040(1) requires a taxable "transfer" for the new estate tax to apply, and the definition of "taxable estate" in RCW 83.100.020(13) & (14) must be read in a manner that is consistent with that provision. RCW 83.100.040(3) states that the tax imposed by the Act "incorporates only those provisions of the Internal Revenue Code . . . that *do not conflict* with the provisions of this chapter." RCW 83.100.040(3) (emphasis added). Using I.R.C. § 2044 as the basis to include federal QTIP assets in the Washington taxable estate of the surviving spouse conflicts with the notion of applying the Act

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<sup>7</sup> The full text of the 2006 Regulations is set forth in the Appendix to Appellants' Brief.

prospectively only to “transfers” by decedents dying after May 17, 2005.<sup>8</sup> To avoid this conflict, the 2006 Regulations properly exclude section 2044 property in computing the Washington taxable estate. By including only property for which a prior Washington QTIP election has been made the 2006 Regulations resolve the conflict. The Act then is applied prospectively only, and the core policy behind QTIP elections is sustained.

**C. The Act Created A New State Estate Tax That Is Different From the Prior Pick-Up Tax**

DOR argues that it can tax Jim’s trust as part of Sharon’s Estate because Jim’s estate effectively got a deduction under the prior pick-up tax. Resp. Brief at 39. DOR’s argument improperly relies on the old pick-up tax to bootstrap its application of the new estate tax to Jim’s trust. But they are not the same tax, nor is the new Act simply an amendment of the prior tax. The Legislature passed the new Act in direct response to this Court’s decision in *Hemphill*. As this Court suggested in *Hemphill*, the Legislature expressly created a new stand-alone estate tax and completely changed the character of the tax from a pick-up tax to an independently operating Washington estate tax. *Hemphill*, 153 Wn.2d at 551.

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<sup>8</sup> To the extent DOR’s position creates any ambiguity in the new Act, the *Hemphill* Court made clear: “ambiguities in taxing statutes are to be construed ‘most strongly against the government and in favor of the taxpayer.’” See *Estate of Hemphill v. Dep’t of Revenue*, 153 Wn.2d 544, 552, 105 P.3d 391 (2005) (citing *Dep’t of Revenue v. Hoppe*, 82 Wn.2d 549, 553, 512 P.2d 1094 (1973)). Even though DOR argues a different interpretation, the statute should be construed “most strongly” in favor of the taxpayers. *Id.*

1. The Old Pick-Up Tax Was Eliminated

The pick-up tax equaled a credit that was available on the decedent's federal estate tax return, the amount of which the federal government set. *Hemphill*, 153 Wn.2d at 547. No consideration was given to how the federal tax was determined or what assets were subject to the tax. It was a revenue sharing arrangement between the federal government and the states, not a Washington imposed tax or an additional tax. *Id.* at 550 (citing *Estate of Turner*, 106 Wn.2d 649, 655, 724 P.2d 1013 (1986)). The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased out the federal credit for state death taxes. Because Washington's pick-up tax was tied to the amount of that credit, Washington's estate tax was eliminated as of December 31, 2004. *Id.* at 551. Because the state estate tax that applied when Jim died was eliminated, without the new Act, Sharon's Estate would have paid *no* Washington estate tax.

2. The New Stand-Alone Estate Tax Differs Markedly From the Pick-Up Tax

While the pick-up tax was merely a function of the credit available in computing the federal estate tax, the new Act expressly provides that "[t]he tax imposed under this chapter is independent of any federal estate tax obligation and is not affected by the termination of the federal estate tax." RCW 83.100.040(3). The new estate tax differs from the pick-up

tax in a number of important ways. Unlike the pick-up tax, the new Washington estate tax is imposed “on every transfer of property located in Washington,” regardless of the federal estate tax. *Id.* The new Washington estate tax imposes additional taxes on estates above and beyond what the federal estate tax imposes.<sup>9</sup> The amount of the new stand-alone estate tax is determined by the state Legislature, not by the federal Congress. These are very fundamental changes. The new Act is not just a new way of calculating the tax.

Furthermore, relevant to this case, in applying the former pick-up tax, Washington did not tax property for which the estate of the first spouse took a federal marital deduction. Where the federal marital deduction reduced the federal taxable estate, the pick-up tax was likewise reduced. Under the new Act, however, the state disregards the federal QTIP election. *See* WAC 458-57-105(3)(q)(iv) & (vi) (2006); WAC 458-57-115(2)(d)(iv) & (vi) (2006). Property for which a federal QTIP election is made is subject to the new Washington estate tax at the first

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<sup>9</sup> Consider the following example: Surviving spouse dies in 2009, with a \$3,000,000 taxable estate. Because the federal estate tax exemption was \$3,500,000, no federal estate tax is owed. For Washington purposes, because the Washington estate tax exemption is only \$2,000,000 the surviving spouse’s estate will owe a Washington estate tax of \$100,000. Under the pick-up tax, Washington would be entitled to nothing on the surviving spouse’s death because she is not paying any federal estate tax. But under the new Washington estate tax, her estate has a \$100,000 liability to Washington. The new Washington estate tax is not a continuation of the pick-up tax, nor is it merely a new way to calculate what Washington would have received under the old tax. It is an entirely new tax, imposing a new tax burden.

spouse's death. There is no deferral of Washington estate tax on this property. See WAC 458-57-105(3)(q)(iv) (2006); WAC 458-57-115(2)(d)(iv) (2006). But this new Act did not exist at the time of Jim's death. DOR cannot rely on a fictitious deduction allegedly taken under an eliminated law to tax Jim's trust as part of Sharon's Washington taxable estate under the new Act.

**D. The New State Estate Tax Is To Apply Prospectively Only**

DOR utterly ignores the Legislature's express direction that the Act is to be applied prospectively only. According to the Legislature's stated intent, the new tax "applies prospectively only and not retroactively" to estates of decedents dying on or after May 17, 2005.

Laws of 2005, Ch. 516, § 20. By the Legislature's own mandate, the new Act cannot be applied to the November 23, 1984 transfer from Jim's estate to his trust under the terms of his will.

Highlighting its retroactive application of the law, DOR argues that if Sharon's Estate wants to exclude federal QTIP property, Jim's estate had to make a Washington QTIP election for that property. Resp. Brief at 17. Of course that was impossible since the Washington QTIP election did not exist until May 17, 2005. If the proper function of a law requires an action to be taken 20 years before the law is even enacted, the law inherently applies retroactively. This retroactive application is the

foundation of DOR's position in this case. Only by excluding Jim's trust from Sharon's Washington taxable estate (as the 2006 Regulations required) is the tax applied prospectively.

DOR relies on the cases of *Welch v. Henry*, 305 U.S. 134, 59 S. Ct. 121, 83 L. Ed. 87 (1938) and *Fernandez v. Wiener*, 326 U.S. 340, 66 S. Ct. 178, 90 L. Ed. 116 (1945), but those cases do not address the central question. In *Welch* the question was whether an amendment to an existing tax could be applied retroactively to corporate dividends. No interests in trust were involved, and there was no question about whether a valid "transfer" had been made to give rise to the tax. The statute in *Welch* also provided specifically that it was to be applied retroactively. *Welch*, 305 U.S. at 150-51.

*Fernandez* is also clearly distinguishable. Like *Welch*, it did not involve interests in trust, and it involved a statute that expressly imposed a tax on the property in issue (community property held by the decedent and the decedent's surviving spouse). *Fernandez*, 326 U.S. at 342. The *Fernandez* Court criticized *Coolidge* not for its holding that the taxable transfer occurred when the trust was created and became irrevocable, but rather for the application of its holding to joint or community interests. *Id.* at 357. In fact, *Fernandez* itself has been criticized. As noted by Judge Wiener in *Clayton v. Comm'r*, 976 F.2d at 1491, n.6, it has been suggested

that the *Fernandez* decision can only be understood “in the context of the extreme fixation of Congress on raising revenue to finance the war effort for World War II, and the equally pervasive patriotism of those times, which even seeped uphill to the Supreme Court.”

**E. DOR’s Retroactive Application of the New Estate Tax Is Unconstitutional**

1. DOR’s Contract Clause Analysis is Inapplicable

In its brief, DOR reproves Sharon’s Estate for failing to apply the three-part contract impairment analysis found in *Pierce County v. State*, 159 Wn.2d 16, 148 P.3d 1002 (2006). DOR argues that by failing to apply that analysis, the estate “effectively abdicated” its duty to establish the unconstitutionality of the attempted retroactive imposition of the Act on Jim’s estate. Resp. Brief at 41-42. However, the three-part analysis DOR advocates applies only when “analyzing impairment of public contracts.” *Caritas Servs., Inc. v. DSHS*, 123 Wn.2d 391, 403, 869 P.2d 28 (1994) (citing *Carlstrom v. State*, 103 Wn.2d 391, 694 P.2d 1 (1985); *United States Trust Co. v. New Jersey*, 431 U.S. 1, 97 S. Ct. 1505, 52 L. Ed. 2d 92 (1977)). The contract at issue here is between private parties.<sup>10</sup>

The first question then is “whether the state law has, in fact, operated as a substantial impairment of a contractual relationship.” *Allied*

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<sup>10</sup> A trust is a contract in the eyes of the law. *Coolidge v. Long*, 282 U.S. 582, 595, 51 S. Ct. 306, 75 L. Ed. 562 (1931) (cited with approval in *In re McGrath’s Estate*, 191 Wn. 496 at 508).

*Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244, 98 S. Ct. 2716, 57 L. Ed. 2d 727 (1978). Applying the Act to Jim's trust has a very substantial impact. When Jim planned for the creation of the trust in his Will he had every expectation that the ultimate beneficiaries of that trust – his children – would be able to enjoy those benefits without the imposition of an additional and substantial state estate tax. That tax did not exist at the time of his death, and he had no reason to anticipate that a state estate tax enacted more than twenty years after his death would be retroactively imposed to reduce the amount passing to his children by more than \$2,500,000. CP 39-41.

Next, *Allied* requires courts to weigh the nature of the state interest in promoting police power functions against the impairment. *Allied*, 438 U.S. at 247-250. “[A]n impairment that is severe, permanent and irrevocable and retroactive” will be sustained only if it serves a “broad generalized economic or social purpose.” *Morseburg v. Balyon*, 621 F.2d 972, 979 (9th Cir.). The severity of the impairment “increase[s] the level of scrutiny to which the legislation will be subjected.” *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411, 103 S. Ct. 697, 74 L. Ed. 2d 569 (1983) (quoting *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 434, 54 S. Ct. 231, 78 L. Ed. 413 (1934)).

Washington's stand-alone estate tax was enacted more than four years after EGTRRA's effective phase out of the pick-up tax. In 2001 Washington lawmakers knew that as of December 31, 2004, the estate tax revenue sharing arrangement under the pick-up tax would end. DOR and the Legislature had four years to consider the issue, but took no meaningful action until ordered to do so by this Court in *Hemphill*. The state had the ability to enact an effective stand-alone estate tax at any time after it learned of changes to the federal law in 2001, but it chose not to do so.

The proposed retroactive application of the Act also applies only to a very narrow group of individuals – persons who established a federal QTIP trust before May 17, 2005 and whose surviving spouse dies a resident of Washington. Like the unlawful retroactive application of law analyzed in *Allied*, this attempted retroactive application of the Act is very narrowly focused, and negates specific benefits intended by the terms of Jim's trust by imposing a completely unexpected tax in very substantial amounts.

To constitutionally support such an application, there must be a showing that it was necessary to meet an important general social problem. *Allied*, 438 U.S. at 247. Although there may be a general social benefit to raising tax revenue from a narrow class of decedents, a "trickle-

down” effect eventually inuring to the general welfare is not enough.

“Financial necessity, though superficially compelling, has never been sufficient of itself to permit states to abrogate contracts.” *Carlstrom*, 103 Wn.2d 391, 396, 694 P.2d 1 (1985); *see also United States Trust*, 431 U.S. 1, 25-26, 97 S. Ct. 1505, 52 L. Ed. 2d 92 (1977).

Although the State has a legitimate objective in raising tax revenue, it cannot reach that objective by impermissibly focusing on a narrow class of individuals and retroactively imposing a substantial new tax that negatively impacts the vested rights of trust beneficiaries. Against the rights guaranteed by the Contracts Clause, the conclusion must be that a retroactive application of the Act to Jim’s trust is an unconstitutional impairment of rights.

2. Retroactive Taxation Violates the Due Process Clause

Statutes that burden private rights are not given retroactive effect unless the Legislature has clearly provided for a retroactive application. *Landgraf v. USI Film Prods.*, 511 U.S. 244, 270, 114 S. Ct. 1483, 128 L. Ed. 2d 229 (1994). In fact, there is a presumption against statutory retroactivity because of the unfairness of imposing new burdens on persons after the fact. *Id.* Unlike the law considered in *United States v. Carlton*, 512 U.S. 26, 114 S. Ct. 2018, 129 L. Ed. 2d 22 (1994), the Act does not state that it is to be applied retroactively. To the contrary, the Act

provides clearly that the new tax “applies prospectively only and not retroactively.” Laws of 2005, Ch. 516, § 20.

“Due process is violated if the retroactive application of a statute deprives an individual of a vested right.” *In re Marriage of MacDonald*, 104 Wn.2d 745, 750, 709 P.2d 1196 (1985).<sup>11</sup> A vested right entitled to protection under the due process clause:

must be something more than a *mere expectation* based upon an anticipated continuance of the existing law; *it must have become a title*, legal or equitable, *to the present or future enjoyment of property, a demand, or a legal exemption from a demand by another.*

*Id.* (quoting *Godfrey v. State*, 84 Wn.2d 959, 963, 530 P.2d 630 (1975))

(emphasis in original). There is no question the beneficiaries’ rights in Jim’s trust vested in 1985. *See Strand v. Stewart*, 51 Wash. 685, 687-88, 99 P. 1027 (1909). Those rights are entitled to protection under the due process clause of both the federal and state Constitutions.

DOR attempts to distinguish *Dot Foods, Inc. v. Dep’t of Revenue*, 166 Wn.2d 912, 215 P.3d 185 (2009), but it is clearly on point. DOR is attempting to impose the new Washington estate tax on Sharon’s Estate by reason of an action taken by her husband, Jim Bracken, more than 20

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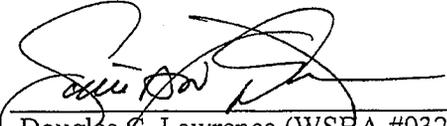
<sup>11</sup> *See also* L. Tribe, AMERICAN CONSTITUTIONAL LAW 587 (2d ed. 1988) (“We deal here with the idea that government must respect ‘vested rights’ in property and contract—that certain settled expectations of a focused and crystallized sort should be secure against governmental disruption, at least without appropriate compensation.”)

years before. Those are actions that were beyond Sharon's control, and she should not now be taxed as a result of them. To do so would be a violation of the Due Process Clauses of both the United States and Washington State Constitutions. *Id* at 923.

### III. CONCLUSION

For these reasons, Sharon's Estate requests this Court reverse the trial court's order granting summary judgment in favor of DOR and denying summary judgment in favor of Sharon's Estate. Sharon's Estate further requests this Court enter summary judgment in its favor and order DOR to refund the amount of estate tax Sharon's Estate has paid attributable to Jim's trust, with interest. Sharon's Estate further requests an award of costs on appeal.

Respectfully submitted this 9th day of August, 2010.

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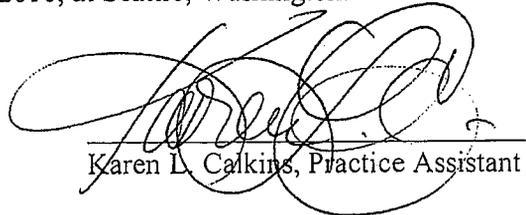
CERTIFICATE OF SERVICE

I hereby certify under penalty of perjury under the laws of the State of Washington that on the 9th day of August, 2010, I caused a true and correct copy of the foregoing document, "Reply Brief of Appellants," to be delivered via email to the following counsel of record:

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