NO. 44766-5-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

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

Respondent,

v.

THE DEPARTMENT OF REVENUE OF THE STATE OF WASHINGTON,

Appellant.

APPELLANT'S SUPPLEMENTAL BRIEF

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I. INTRODUCTION

After the Supreme Court held in *In re Estate of Bracken,* 175 Wn.2d 549, 290 P.3d 99 (2012), that Washington's estate tax statutes were not intended to apply to qualified terminable interest property ("QTIP") passing under Internal Revenue Code § 2044, the Legislature responded rapidly by amending the relevant statutes to expressly provide that QTIP passing under section 2044 is subject to the Washington tax. The Supreme Court in *In re Estate of Hambleton*, ___ W.2d ___, 335 P.3d 398 (2014), upheld these amendments, and they resolve this case.

II. STATEMENT OF THE CASE

In 2010 the estate of Barbara Mesdag ("Estate") filed a complaint seeking review of a Department letter decision denying the Estate's claim for refund of estate tax. CP 4. The Estate asserted that it had overpaid the Washington tax on the value of QTIP included in the Estate's federal gross estate. The trial court proceedings were stayed pending final resolution of *In re Estate of Bracken*, which involved the same QTIP issue. CP 40. *Bracken* was decided in October 2012. In that case, the Supreme Court held that the Legislature did not intend to impose estate tax on QTIP passing at the death of the second spouse. *In re Estate of Bracken*, 175 Wn.2d 549, 574, 290 P.3d 99 (2012), *superseded by statute as recognized in In re Estate of Hambleton*, ___ W.2d ___, 335 P.3d 398 (2014).

After the Supreme Court issued *Bracken*, the Estate moved for judgment on the pleadings asserting that, under the holding in *Bracken*, it was entitled to the estate tax refund it was seeking. CP 42. The trial court granted the Estate's motion, and the Department appealed. CP 96, 99.

In June 2013, while this appeal was pending, the Legislature amended the estate tax code in response to *Bracken*. Laws of 2013, 2d Spec. Sess., ch. 2. That 2013 legislation (the "2013 Act") amended the definitions of "transfer" and "Washington taxable estate" to expressly include QTIP in the Washington taxable estate of a decedent. *Id.* at § 2. These amendments apply retroactively to "all estates of decedents dying on or after May 17, 2005." *Id.* at § 9. The amended law applies to the estate of Barbara Mesdag, who died in 2007.

Several estates, including the Mesdag Estate, challenged the 2013 Act on constitutional grounds. The Supreme Court consolidated for argument two of those appeals—the appeals filed by the estates of Helen Hambleton and Jessie Campbell MacBride. *See Hambleton*, 335 P.3d at 403. The Supreme Court rejected all of the estates' arguments and held that the 2013 Act was constitutional. *Hambleton*, 335 P.3d at 416.

III. ARGUMENT

The Legislature may pass a law that directly impacts a pending court case. *Hambleton*, 335 P.3d at 408-09; *Washington State Farm*

Bureau Fed'n v. Gregoire, 162 Wn.2d 284, 304, 174 P.3d 1142 (2007). Appellate courts apply the new law in deciding the case "even if the new law alters the outcome." *Port of Seattle v. Pollution Control Hearings Bd.*, 151 Wn.2d 568, 627, 90 P.3d 659 (2004) (citing *Plaut v. Spendthrift Farms, Inc.*, 514 U.S. 211, 226-27, 115 S. Ct. 1447, 131 L. Ed. 2d 328 (1995)). The Supreme Court's holding in *Hambleton* that the 2013 Act was a valid and constitutional exercise of legislative authority "is binding on all lower courts in the state." *1000 Virginia Ltd. P'ship v. Vertecs Corp.*, 158 Wn.2d 566, 578, 146 P.3d 423 (2006). Under *Hambleton*, the Estate is not entitled to the estate tax refund it is seeking.

A. *Hambleton* Is Controlling And Resolves This Appeal In Favor Of The Department.

Hambleton involved two estates (Hambleton and Macbride) that challenged the 2013 Act on constitutional and equitable grounds. The Supreme Court unanimously rejected all of the estates' arguments and concluded that the Department was entitled to judgment in both cases as a matter of law.

The Mesdag Estate asserts all of the same constitutional arguments that were rejected in *Hambleton*. Specifically, the Estate challenged the retroactive application of the 2013 Act on separation of powers and due process grounds, and also claimed that the Act violated the contracts

clauses of the federal and Washington constitutions and imposed an unconstitutional "direct tax" on the QTIP assets. *See* Br. of Resp. at 15-38. As explained in *Hambleton*, none of these arguments has any merit.

1. *Hambleton* holds that retroactive application of the 2013 Act does not violate the separation of powers doctrine.

The 2013 Act retroactively amended the statutory definitions of "transfer" and "Washington taxable estate" to make clear that QTIP is subject to the Washington tax. These amendments did not "impede upon the court's right and duty to apply [the] new law to the facts" of a case being litigated, did not "dictate how the court should decide a factual issue," and did not "affect a final judgment." *Haberman v. Wash. Pub. Power Supply Sys.*, 109 Wn.2d 107, 144, 744 P.2d 1032, 750 P.2d 254 (1987). Instead, as the Court explained in *Hambleton*, the Legislature "was careful not to affect the rights of any parties to a prior judgment, reopen a case, or interfere with any judicial functions," and it "did not violate the separation of powers doctrine when it passed the retroactive amendments" to the estate tax code. *Hambleton*, 335 P.3d at 406, 409.

The Court's analysis was guided by the "principles and reasoning" of *Hale v. Wellpinit School District No. 49*, 165 Wn.2d 494, 198 P.3d 1012 (2009), and *Lummi Indian Nation v. State*, 170 Wn.2d 247, 241 P.3d 1220 (2010). *See Hambleton*, 335 P.3d at 408. In both *Hale* and *Lummi*

Indian Nation the Supreme Court "firmly rejected the contention that just because an appellate court's statutory interpretation relates back to the time the statute was originally adopted, any retroactive amendment of that statute violates separation of powers." *Id.* (quoting *Lummi Indian Nation*, 170 Wn.2d at 262). And just as in *Hale* and *Lummi Indian Nation*, the Legislature did not offend the separation of powers doctrine when it retroactively amended the Washington estate tax code in response to a Supreme Court decision interpreting the prior law. *Id.*

The Supreme Court's holding that the 2013 Act does not violate separation of powers principles "is binding on all lower courts in the state." *1000 Virginia Ltd.*, 158 Wn.2d at 578. Consequently, the Estate's separation of powers argument must be rejected under settled and controlling law.

2. *Hambleton* holds that retroactive application of the 2013 Act does not violate due process.

The Court in *Hambleton* also rejected the estates' due process challenge to the 2013 Act, holding that retroactive application of the law meets the rational basis standard that applies to economic legislation. *Hambleton*, 335 P.3d at 409. Under that rational basis test, a court will uphold the retroactive application of tax legislation if it serves a legitimate legislative purpose furthered by rational means. *United States v. Carlton*,

512 U.S. 26, 30-31, 114 S. Ct. 2018, 129 L. Ed. 2d 22 (1994). The 2013 Act served the legitimate legislative purpose of preventing the adverse fiscal impact of the *Bracken* decision, and "[t]he period of retroactivity [was] rationally related to preventing the fiscal shortfall." *Hambleton*, 335 P.3d at 411. Consequently, "the retroactive period meets the due process clause's rational basis test." *Id.*

The Court also rejected the estates' claims that the 2013 Act imposed a "wholly new tax" and "impairs a vested right" acquired under the prior law. *Hambleton*, 335 P.3d at 412. Although beneficiaries of a QTIP trust have a vested right to the trust property upon the death of the second spouse, the 2013 Act properly taxes the "shift in interest" that occurs when the second spouse dies. *Id.* "The estate tax does not deprive the remainder of their interest in the property or change the nature of their interest. It simply taxes the transfer of assets." *Id.*

Retroactive application of the 2013 Act does not violate due process. The Mesdag Estate's arguments to the contrary were expressly rejected in *Hambleton* and must be rejected here.

3. *Hambleton* holds that taxing QTIP when the second spouse dies does not violate the contracts clause.

Both the federal constitution and the Washington constitution protect citizens from state laws that impermissibly impair contracts. This

constitutional protection has limits: "The contracts clause does not prohibit the states from repealing or amending statutes generally, or from enacting legislation with retroactive effects." *Hambleton*, 335 P.3d at 413 (quoting *Haberman*, 109 Wn.2d at 145). Before a state law will be held invalid under the contracts clause, the person challenging the law must establish a substantial impairment to a contract. *Id.* If that threshold inquiry is met and the contract is between private parties, the courts must then determine whether the enactment was reasonably necessary. *Id.*

The 2013 Act did not violate the contracts clause. As explained in *Hambleton*, amending the Washington estate tax code to prevent QTIP from escaping the Washington tax did not substantially impair a contract. *See id.* (the prior law as interpreted in *Bracken* was not a promise and "it was reasonable for the Estates to expect that the estate tax law would change."). In addition, the 2013 Act was reasonably necessary because it "prevented the fiscal shortfall created by *Bracken*." *Id.* Therefore, the 2013 Act would not violate the contracts clause even if it had resulted in a substantial impairment to a contract.

The Court's holding that the 2013 Act did not violate the contracts clause is binding in this appeal and clearly resolves this issue in favor of the Department.

4. *Hambleton* holds that taxing QTIP when the second spouse dies does not result in an unconstitutional direct tax.

Prior to the Supreme Court's decision in *Hambleton*, the Mesdag Estate argued that *Bracken* and an earlier 1930s Supreme Court decision demonstrate that "if 'transfer' is interpreted as the Department would have it, the estate tax is an unconstitutional direct tax on property rather than a constitutionally permissible excise tax." Br. of Resp. at 19 (citing *Bracken* and *In re McGrath's Estate*, 191 Wash. 496, 71 P.2d 395 (1937)). The Supreme Court in *Hambleton* rejected this argument, explaining that the estate tax is an excise tax imposed on "a particular use or enjoyment of property or the shifting from one to another of any power or privilege incidental to the ownership or enjoyment of property." *Hambleton*, 335 P.3d at 414 (quoting *Fernandez v. Wiener*, 326 U.S. 340, 352, 66 S. Ct. 178, 90 L. Ed. 116 (1945)). In other words, the Washington estate tax—like the federal estate tax—is not a direct tax on property. As a result, constitutional limitations that apply to "direct" taxes do not apply to the Washington or the federal estate taxes. *Id.*; *see also Knowlton v. Moore*, 178 U.S. 41, 81-82, 20 S. Ct. 747, 44 L. Ed. 969 (1900) (rejecting claim that the federal estate tax is an unconstitutional direct tax on property).

The Court in *Hambleton* also emphasized that a "transfer" under the federal estate tax code is "broadly construed" and is not limited to a

direct transfer of property by the decedent. *Hambleton*, 335 P.3d at 414. And while the Court in *Bracken* narrowly construed the Washington estate tax, the Legislature acted well within its authority to amend the definition of "transfer" to make the Washington tax consistent with the federal tax. As amended by the 2013 Act, a "transfer" subject to the Washington estate tax includes QTIP passing at the death of the second spouse. *Id.* The Estate's claim to the contrary is incorrect and must be rejected.

5. The Estate's equal protection argument has no merit.

The Estate has raised an equal protection challenge to the 2013 Act. *See* Br. of Resp. at 39-41. This issue was not raised in *Hambleton*. However, the Estate's equal protection argument has no merit and should be rejected for the reasons explained in the Department's reply brief. *See* App. Reply Br. at 21-24. Under controlling Supreme Court authority, "nonsuspect classifications in tax laws are subject to minimal scrutiny" and are presumed constitutional. *City of Seattle v. Rogers Clothing for Men, Inc.*, 114 Wn.2d 213, 234, 787 P.2d 39 (1990). The Legislature has "extensive authority to make classifications for purposes of legislation and even broader discretion in making classifications for taxation . . . ." *Id.* A person attacking a revenue statute on equal protection grounds "bears the burden of showing there is no reasonable basis for the questioned

classification, the test being whether any state of facts can be conceived that would sustain the classification." *Id.*

The Estate has failed to show that the Legislature lacked a reasonable basis for amending the Washington estate tax code with respect to QTIP but not with respect to property placed into a credit shelter trust. *See* Resp. Br. at 39-40 (arguing that the 2013 Act violates equal protection because that Act amended the law as it applied to QTIP trusts but not credit shelter trusts). The Legislature amended the estate tax in 2013 to make the tax as applied to QTIP consistent with the federal estate tax, which is imposed on the transfer of QTIP occurring when the second spouse dies. *See* I.R.C. § 2044. There was no need to amend the Washington tax as applied to property passing through a credit shelter trust because the Washington tax code was already consistent with the federal tax treatment of credit shelter trusts. The Legislature acted rationally, and the Estate's claim to the contrary is clearly incorrect.

B. The Court Is Not Required To Address Issues That The Estate Did Not Raise Below Or In Its Appellate Briefing.

The Department anticipates that the Estate may argue for the first time in its supplemental brief that it is entitled to a refund of interest even though it is not entitled to a refund of any of the estate tax at issue. The Estate did not raise this issue to the trial court in its motion for judgment

on the pleadings, or to this Court in its response brief. *See* CP 49-51 (no alternative argument in Estate's motion for judgment on the pleadings pertaining to refund of interest even if tax is owed); Resp. Br. at 8-49 (no alternative argument in Estate's respondent's brief pertaining to refund of interest even if tax is owed). Consequently, the Court is not required to address the Estate's new argument. *See* RAP 2.5(a); RAP 12.1(a); *see also State v. Kirwin*, 137 Wn. App. 387, 395, 153 P.3d 883 (2007) (a party wishing to make an argument that has not been briefed should file a motion for supplemental briefing under RAP 12.1(b)).

In addition, nothing in the record suggests that the Estate presented this alternative claim to the Department for its consideration. *See* AR 78 (Estate's administrative refund claim). Under the Administrative Procedure Act, a person seeking review of agency action generally must raise all its issues in the agency proceeding. RCW 34.05.554(1). "This rule is more than simply a technical rule of appellate procedure." *King County v. Boundary Review Bd.*, 122 Wn.2d 648, 668, 890 P.2d 1024 (1993). Rather, it serves the important policy goals of "(1) discouraging the frequent and deliberate flouting of administrative processes; (2) protecting agency autonomy by allowing an agency the first opportunity [to rule]; (3) aiding judicial review by promoting the development of facts during the administrative proceeding; and (4) promoting judicial economy

by reducing duplication, and perhaps even obviating judicial involvement." *Id.* at 669 (quoting *Fertilizer Inst. v. United States Envtl. Protection Agency*, 935 F.2d 1303, 1312-13 (D.C. Cir. 1991)).

There are several exceptions to the general rule in RCW 34.05.554(1), but none applies in this case. And even if an exception did apply, the remedy would be for the Court to remand the matter to the Department for determination. *See* RCW 34.05.554(2); *Olympic Stewardship Found. v. W. Wash. Growth Mgmt. Hearings Bd.*, 166 Wn. App. 172, 200, 274 P.3d 1040 (2012). Thus, the Estate is not entitled to de novo review of any new argument it may raise in its supplemental brief. Instead, the Estate must file a refund claim with the Department setting out the facts and legal arguments supporting its claim, thereby allowing the Department to either grant or deny the claim in the first instance.

C. Because All Issues In This Appeal Are Clearly Controlled By Settled Law, The Court Should Decide This Case Without Oral Argument.

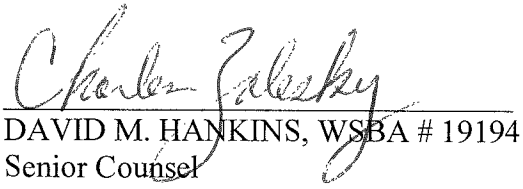
All issues pertaining to whether the Estate owes estate tax on the value of QTIP included in its gross estate have been decided in *Hambleton* or are clearly controlled by settled law. As a result, the Court should decide this appeal without oral argument. *See* RAP 11.4(j).

IV. CONCLUSION

Under the Washington estate tax code as amended, the Estate is not entitled to deduct QTIP in computing the Washington tax. The amended law is constitutional and controlling. For this reason, the Court should reverse the judgment below and remand the case with instructions to enter judgment in favor of the Department.

RESPECTFULLY SUBMITTED this 8th day of December, 2014.

ROBERT W. FERGUSON
Attorney General



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

DATED this 8th day of December, 2014 at Tumwater, WA.

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December 08, 2014 - 11:00 AM

Transmittal Letter

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