

No. 84114-4

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COURT OF APPEALS
DIVISION ONE
JAN 19 2010

IN THE SUPREME COURT OF THE STATE OF WASHINGTON

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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DIVISION ONE

STATEMENT OF GROUNDS FOR DIRECT REVIEW BY THE
SUPREME COURT

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I. INTRODUCTION

The Personal Representatives of the Estate of Sharon M. Bracken seek direct review in the Supreme Court of the ruling by Judge John P. Erlick of the King County Superior Court granting the Department of Revenue's motion for summary judgment. This matter involves the application of the new Washington Estate and Transfer Tax Act, chapter 83.100 RCW, effective May 17, 2005. Specifically at issue is the Act's application to an irrevocable QTIP trust established prior to May 17, 2005. The trial court held that the new estate tax applies to assets held in such a trust. This issue affects hundreds and potentially thousands of estates where the first spouse died before the effective date of the new Washington estate tax, leaving a trust for the benefit of the surviving spouse, who is either still living or who has died after that date.

II. ISSUE PRESENTED FOR REVIEW

Does the Department of Revenue's attempt to tax property held in an irrevocable trust created before the enactment of Washington's new stand-alone estate tax violate the terms of the Washington Estate and Transfer Tax Act, chapter 83.100 RCW, the Department's regulations as adopted in 2006, chapter 485-57 WAC, and the United States and Washington State Constitutions.

III. NATURE OF CASE AND DECISION

A. The New Washington Estate and Transfer Tax Act

In 1981, the voters of Washington approved a Washington estate tax that was tied to the amount of a federal credit allowed on a decedent's federal estate tax return for state estate taxes paid. Laws of 1981, 2nd Ex. Sess., ch. 7 (Initiative No. 402, approved Nov. 3, 1981), codified as RCW 83.100.030(1); *Estate of Hemphill v. Dept. of Revenue*, 153 Wn.2d 544, 547-48, 105 P.3d 391 (2005). This was commonly called a "pickup tax," and was a mechanism for sharing estate tax revenue between the federal and state governments without actually increasing the amount of estate tax paid by the estate. *Hemphill*, 153 Wn.2d at 547. When the federal credit was to be phased out under the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), P.L. 107-16, § 531, the Department of Revenue ("Department") sought to continue to impose the state estate tax by not updating the state statute's reference to the new federal law. This Court rejected the Department's approach in *Hemphill*, stating that "until or unless the legislature revises RCW 83.100.030 to specifically and expressly create a stand alone estate or inheritance tax," the state's estate tax would remain a pickup tax. *Hemphill*, 153 Wn.2d at 551-52.

On May 17, 2005, the legislature enacted the new Washington Estate and Transfer Tax Act (the "Act"), which imposes an estate tax "on

every transfer of property located in Washington.” Laws of 2005, ch. 516; RCW 83.100.040(1). As the Supreme Court had suggested in *Hemphill*, the legislature expressly created a new stand-alone estate tax and completely changed the character of the tax from a pickup tax to an independently operating Washington estate tax. Laws of 2005, ch. 516, § 1 (RCW 83.100.040 note); *Hemphill*, 153 Wn.2d at 551. 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 prior tax imposed no additional tax burden on Washington residents as it merely shifted a portion of the federal estate tax revenue to the state government. *Hemphill*, 153 Wn.2d at 550. The new estate tax is an entirely new tax, imposing a new tax burden on residents of the State of Washington.

B. QTIP Trusts

In determining the “taxable estate” for federal estate tax purposes, a decedent’s estate is allowed an unlimited “marital deduction” from the federal gross estate for property that passes to the decedent’s surviving spouse in a qualified manner. I.R.C. § 2056(b)(7). Property placed in trust for the benefit of a surviving spouse may qualify for this deduction if the trust requires that (1) the surviving spouse receive all of the net income from the trust at least annually, and (2) no principal is distributed to

anyone other than the surviving spouse during his or her lifetime, and an election is made to take the deduction on the decedent's federal estate tax return. I.R.C. § 2056(b)(7). Commonly referred to as a "QTIP trust," if an election was made to take a deduction at the first spouse's death, any property remaining in the QTIP trust at the time of the surviving spouse's death (the "QTIP property") is included in the surviving spouse's federal gross estate for federal estate tax purposes. I.R.C. § 2044(b)(1)(A). The remaining QTIP property is included in the survivor's federal taxable estate only because a federal deduction was allowed for the QTIP property at the time of the first spouse's death. The new Washington Estate and Transfer Tax Act incorporates the federal concept of an unlimited marital deduction and allows a marital deduction for state estate tax purposes for property passing to the surviving spouse. RCW 83.100.047. Under the Act, the Washington marital deduction for QTIP trusts is separate and distinct from the federal marital deduction. *Id.*

C. 2006 Washington Estate and Transfer Tax Regulations

The Act provides that the Department may promulgate rules to make a separate QTIP election on the Washington estate tax return. RCW 83.100.047(1) & .200. The Act also provides that these regulations are to have the same force and effect as if they were specifically set out in chapter 83.100 RCW. RCW 83.100.200. Pursuant to the legislature's

direction, the Department adopted regulations to provide guidance on the application and interpretation of chapter 83.100 RCW which became effective on April 9, 2006 (“2006 Regulations”). See chapter 458-57 WAC. Under the Act and the Department’s regulations, the calculation of the Washington taxable estate begins with the “federal taxable estate.” RCW 83.100.020(13); WAC 458-57-105(3)(q). The 2006 Regulations then direct that certain adjustments be made to the federal taxable estate. These regulations provide that any QTIP property that is included in the decedent’s federal taxable estate under I.R.C. § 2044 is to be removed from the Washington taxable estate. It is to be added back into the Washington taxable estate only if a marital deduction for that property was taken on a prior Washington estate tax return. WAC 458-57-105(3)(q)(vi), WAC 458-57-115(2)(d)(vi). The 2006 Regulations that the Department adopted are consistent with the legislative direction that the new state estate tax is to be applied prospectively only and that it only be applied to transfers by the decedent whose estate is being taxed.

D. The 2009 Amendments to the Estate Tax Regulations

Shortly after the 2006 Regulations were issued, the Department learned from estate tax practitioners that the state estate tax return form was inconsistent with the Department’s own regulations. The problem was that the estate tax return form directed estates to *include* all QTIP

property in the Washington taxable estate if it is included in the decedent's federal taxable estate under I.R.C. § 2044. The Department sought to remedy the apparent inconsistency between the regulations and the state estate tax return form by amending its regulations in February 2009 ("2009 Amendments"). The Department amended subsection (vi) of WAC 458-57-105(3)(q) and -115(2)(d) by adding the underlined clause: "(vi) Less any amount included in the federal taxable estate pursuant to IRC § 2044 (inclusion of amount for which a federal QTIP election was previously made), from a predeceased spouse that died on or after May 17, 2005." The estate at issue here filed its tax return prior to the 2009 Amendments.

E. The Sharon M. Bracken Estate

Sharon M. Bracken's husband, Jim, predeceased her on November 23, 1984. Pursuant to Jim's estate plan, his personal representative elected to qualify a QTIP trust that was created by his will for the federal estate tax marital deduction under I.R.C. § 2056(b)(7). Since the new Washington estate tax did not then exist, no deduction was taken for the QTIP property on a Washington estate tax return. No such election was possible.

Sharon, a Washington resident, died on September 24, 2006. Pursuant to I.R.C. § 2044, Sharon's federal taxable estate included the

federal QTIP property from the trust established by Jim's estate.

However, in determining Sharon's "Washington taxable estate," her estate excluded the federal QTIP property as was specifically required by the 2006 Regulations. WAC 458-57-105(3)(q)(vi); 458-57-115(2)(d)(vi).

The Department issued a deficiency notice stating, contrary to its own regulations, that Sharon Bracken's Estate needed to include in her Washington taxable estate the assets of the pre-May 17, 2005, federal QTIP trust established by her predeceased husband. The Estate declined to pay the amount cited in the deficiency notice and the Department filed findings under RCW 83.100.150. The Estate timely filed verified objections to the Department's findings.

F. The Trial Court's Decision

Sharon Bracken's Estate was consolidated with two other similarly situated estates for purposes of discovery and trial on the objections. On cross motions for summary judgment, the trial court granted the Department's motion and denied the three estates' motion. The trial court ruled that Jim Bracken, the predeceased spouse who died on November 23, 1984, is a "decendent" for purposes of the new Washington estate tax, despite the Act's specific direction that it applies "only to estate of decedents dying on or after May 17, 2005." Laws of 2005, ch. 516, § 20.

The trial court ruled that only the Act and not the 2006 Regulations applied to the estates, despite the Department's own regulations' direction that they apply to deaths occurring on or after May 17, 2005. WAC 458-57-105(1). Without ever articulating any ambiguity in the Act, the trial court gave deference to the Department's interpretation that its own 2006 Regulations do not apply to these estates. Finding that the exclusion of the pre-enactment federal QTIP property, as required by the 2006 Regulations, was a "deduction," the trial court construed the regulations against the estates. The trial court also concluded that the estates were not entitled to the "deduction." The trial court also stated that it did not find the amended regulations an unconstitutional retroactive application of the tax, and it ruled that the tax enacted on May 17, 2005, was not a new tax. Based on these rulings the court granted the Department summary judgment.

The trial court subsequently denied the estates' motion for reconsideration and entered judgment against Sharon Bracken's Estate in favor of the Department. The Estate satisfied that judgment. The Sharon Bracken Estate now seeks review of the trial court's decision and an order that the amount paid on the judgment be refunded to the Estate.

G. The Department Seeks to Tax Property the Decedent Never Owned, Controlled or Transferred

The issue in this case is whether property held in a separate trust established by Jim Bracken in 1984 is subject to the new Washington estate tax enacted May 17, 2005. The property in that trust was *not* owned or controlled by Sharon Bracken. *See Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996); *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (U.S. Tax Ct. 1999). All Sharon Bracken had was the right to receive benefits from the trust during her lifetime. On her death, the remaining property passed automatically to the successor beneficiaries of that trust.

Washington's new estate tax act applies specifically to the "transfer of property" by a decedent. RCW 83.100.040(1) (tax is imposed on every transfer of property in a decedent's estate). If there is no transfer of property by the decedent, the remaining provisions of the statute are inapplicable. That estate tax applies "only to the estates of decedents dying on or after May 17, 2005." Laws of 2005, ch. 516, § 20. The regulations at issue in this case state that they only apply to "deaths occurring on or after May 17, 2005." WAC 458-57-105(1) and WAC 458-57-115(1). Because there was no "transfer" of the QTIP property by Sharon Bracken, the assets of the trust were not subject to the Washington

stand-alone estate tax at her death. RCW 83.100.040(1); I.R.C. § 2001(a); *Coolidge v. Long*, 282 U.S. 582, 597, 51 S. Ct. 306, 75 L.Ed. 562 (1931)

H. The Regulations Are Clear on their Face and Apply to the Bracken Estate

The legislature directed the Department to promulgate regulations that are necessary to carry out the effect of the Act. RCW 83.100.047 & .200. But here the Department argued, and the trial court agreed, that the Department's own 2006 Regulations did not apply to Sharon Bracken's Estate despite the clear and plain language that the regulations apply to all estates of decedents dying after May 17, 2005. The Department may not repudiate its own regulations. *Tesoro Refining & Marketing Co. v. Dept. of Revenue*, 164 Wn.2d 310, 322, 190 P.3d 28 (2008); *Group Health Coop. v. Washington State Tax Commission*, 72 Wn.2d 422, 428, 433 P.2d 201 (1967).

The Department did not show, and the trial court did not find, any ambiguity in the 2006 Regulations. Yet, the trial court resorted to, and misapplied, various rules of statutory construction. *Tesoro*, 164 Wn.2d at 317 (only after court determines that statute is ambiguous may it resort to tools of statutory construction); *City of Spokane v. Dept. of Revenue*, 145 Wn.2d 445, 452 n.5, 38 P.3d 1010 (2002) (if regulation is unambiguous, no need to resort to rules of construction). The trial court should not have deferred to the Department's interpretation that its own regulations do not

apply to Sharon Bracken's Estate when by their plain language they do.

An agency interpretation that conflicts with a statute or regulations is to be given no deference. *Nelson v. Appleway Chevrolet, Co.*, 160 Wn.2d 173, 185, 157 P.3d 847 (2007); *Bostain v. Food Express, Inc.* 159 Wn.2d 700, 153 P.3d 846 (2007) (where statute is unambiguous, no deference is due agency interpretation that conflicts with statutory mandate).

Moreover, the adjustment under WAC 458-57-115(3)(d)(vi) or - 115(3)(q)(vi) to determine the Washington taxable estate relate to the calculation of the tax and is not a "deduction." Although the regulations would exclude § 2044 property from computing the Washington taxable estate, it is not because this is an exemption or deduction, but rather because the State of Washington cannot constitutionally tax this pre-enactment federal QTIP property in the first place. Even if the statute or regulations were ambiguous, a finding never made by the trial court, it should have construed the regulations against the Department, rather than against the estate because if any doubt exists as to the meaning of a tax law, the law must be construed most strongly against the taxing power and in favor of the taxpayer. *AgriLink Foods, Inc. v. Dept. of Revenue*, 153 Wn.2d 392, 396, 103 P.3d 1226 (2005); *Hemphill*, 153 Wn.2d at 552; *First American Title Ins. Co. v. Dept. of Revenue*, 144 Wn.2d 300, 303, 27

P.3d 604 (2001). The trial court failed to honor this Court's direction to favor the taxpayer in these types of cases.

I. The Trial Court's Ruling Results in an Unconstitutional Retroactive Tax

The Department's effort to assess the new Washington estate tax on the federal QTIP property remaining in Sharon Bracken's Estate is unconstitutional. The only taxable transfer of federal QTIP property that has occurred for Washington law purposes was the transfer by Jim Bracken to the QTIP trust in 1984. That transfer pre-dates the new Washington estate tax by more than 20 years and any attempt to tax this transfer now violates the United States' and Washington State Constitution's due process clauses and prohibition on impairment of contracts. U.S. Const. art I, §§ 3 & 10; Wash. Const. art I, §§ 3 & 23; *Coolidge*, 282 U.S. at 597; *Dot Foods Inc. v. Dept. of Revenue*, 166 Wn.2d 912, 923, 215 P.3d 185 (2009); *In re McGrath's Estate*, 191 Wash. 496, 504-05, 71 P.2d 395 (1937).

IV. GROUNDS FOR DIRECT REVIEW

This case is appropriate for direct review by the Supreme Court based on RAP 4.2(a)(4) (the public issues factor). The case presents an issue of sufficient importance to the citizens of this state and to the Department to require resolution by this Court. This is a matter of statewide importance regarding the estate tax and involves a fundamental

and urgent issue of broad public import that requires prompt and ultimate determination.

Sharon Bracken is likely one of hundreds, if not thousands, of Washington residents whose spouse died prior to May 17, 2005, and who established a federal QTIP trust as part of their estate plan. Since the surviving spouses of these decedents may continue to live for decades, the identity and number of these estates will also not be known for many years. When the surviving spouses die, their estates will face the exact same issue that is presented in this case.

Sharon Bracken's Estate was one of three estates consolidated in the King County action.¹ Several other estates in King, Kitsap, Pierce, Clark and Thurston counties currently are faced with the same question.² The decision in this case will affect how these estates, and hundreds (and perhaps thousands) of other estates will be taxed. Ultimately, this Court

¹ One of the other estates has appealed the trial court's ruling to the Court of Appeals, Division I. Estate of Barbara Nelson, No. 06-4-05865-5 SEA (King Cty. Supr. Ct.). The other estate did not appeal. Estate of John Toland, No. 07-4-03335-9 SEA (King Cty. Supr. Ct.).

² See, e.g., Estate of Barbara Haygard Mesdag, No. 09-4-00804 (Kitsap Cty. Supr. Ct.); Estate of Janet Skadan, No. 06-4-05085-9 (King Cty. Supr. Ct.); Estate of Elizabeth Parsons, No. 06-4-00823-2 (King Cty. Supr. Ct.); Estate of Gordon Mowat, No. 05-4-04460-5 (King Cty. Supr. Ct.); Estate of Douglas Peek, No. 06-4-02582-0 (King Cty. Supr. Ct.); Estate of Olga Ootkin, No. 06-4-01525-1 (Pierce Cty. Supr. Ct.); Estate of Elaine Eldridge-Green, No. 06-4-00986-7 (King Cty. Supr. Ct.); Estate of Jeannette Schmidt, No. 06-4-00367-0 (Thurston Cty. Supr. Ct.); Estate of Merwin Mackie, No. 05-4-05488-1 (King Cty. Supr. Ct.); Estate of Jessie Campbell Macbride, No. 09-2-10365-8 (King Cty. Supr. Ct.); Estate of Elaine B. Green-Eldridge, No. 09-2-19306-1 (King Cty. Supr. Ct.); Estate of Helen M. Hambleton, No. 07-4-00574-0 (Clark Cty. Supr. Ct.).

will be required to resolve this legal question. It is better to do so now. Absent a decision by this Court, uncertainty will continue to exist over the Department's authority to assess the new stand-alone estate tax on property held in irrevocable QTIP trusts that were established before the enactment of the new estate tax act. This uncertainty also makes planning for individuals more difficult, since it is not now possible to accurately determine what state estate taxes may be payable at the time of death.

In the past, this Court has granted direct review of important state estate tax cases such as this. For example, this Court accepted direct review of *Estate of Hemphill v. Dept. of Revenue*, 153 Wn.2d 544, 105 P.3d 391 (2005), in which the Court, rejecting the Department's interpretation of the prior estate tax statute, held that as the federal tax credit for state estate taxes was phased out, so was the state estate tax. This Court also accepted direct review of *Estate of Turner v. Dept. of Revenue*, 106 Wn.2d 649, 724 P.2d 1013 (1986), in which the Court, again rejecting the Department's position, held that under the prior pickup tax, the state estate tax was limited to those estates that were required to pay federal estate tax.

This Court also has accepted direct review of other important tax cases. *See, e.g., Ford Motor Co. v. City of Seattle*, 160 Wn.2d 32, 156 P.3d 185 (2007) (direct review of challenge to cities' assessment of B&O

tax affecting numerous wholeseller and Washington cities); *Washington Public Ports Assn. v. Dept. of Revenue*, 148 Wn.2d 637, 62 P.3d 462 (2003) (direct review of constitutional challenge to Department's regulations assessing leasehold excise tax affecting numerous publicly owned facilities); *W.R. Grace & Co. v. Dept. of Revenue*, 137 Wn.2d 580, 973 P.2d 1011 (1999) (direct review of constitutional challenge to state's B&O tax on numerous interstate manufacturers and wholesalers); *Digital Equipment Corp. v. Dept. of Revenue*, 129 Wn.2d 177, 916 P.2d 933 (1995) (direct review of constitutional challenge seeking refund of B&O taxes applicable to numerous multistate sellers); *Tyler Pipe Industries, Inc. v. Dept. of Revenue*, 105 Wn.2d 318, 715 P.2d 123 (1986) (direct review of constitutional challenge seeking refund of B&O taxes affecting numerous multistate sellers).

Like this case, each of those cases affected numerous taxpayers. Without an immediate resolution of the issues presented in this case the citizens of this state will be unable to conclude pending estate proceedings, requiring estates to remain open for possibly years longer than would otherwise be required.

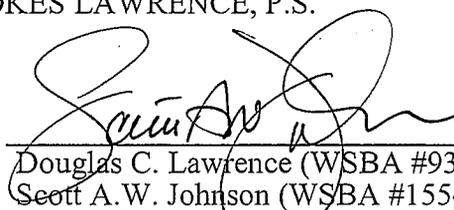
V. CONCLUSION

The trial court's decision is incorrect. It directly impacts all taxpayers in the State of Washington whose spouse died before May 17,

2005, and at the time of his or her death placed assets in a federal QTIP trust for the benefit of the surviving spouse. Direct review is merited. RAP 4.2(a)(4).

Respectfully submitted this 19th day of January 2010.

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