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No. 64613-3-I

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON

In re the Matter of the:

ESTATE OF BARBARA J. NELSON,

WILLIAM C. NELSON, BRIAN S. NELSON and JANET MCCANN,
Personal Representatives of the Estate of Barbara J. Nelson,

Appellants,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE

Respondent.

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REPLY BRIEF OF APPELLANTS

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I. SUMMARY

Application of the new Stand Alone Tax[1] to William C. Nelson's irrevocable trusts in Barbara Nelson's Estate is an unfair retroactive tax. The Washington pickup tax was substantially phased out as of William's death on September 14, 2004[2] and completely eliminated on December 31, 2004. Even though the new Stand Alone Tax applies prospectively by its own terms, only to estates of decedents dying on or after May 17, 2005, the DOR is retroactively imposing an entirely new 19% tax burden on William's Trusts, for which there is now no federal credit or reimbursement. The DOR is trying to reach back, invoke a pre-Act federal election, and recapture taxes that the Supreme Court in *Hemphill* and *Turner* declared could not be imposed. To accomplish this end, the DOR uses the backdoor of IRC § 2044 – a federal tax fiction. This is not what the legislature intended. The new Stand Alone Tax is only applied fairly, consistently, harmoniously and in a manner that comports with the limitations on legislative power, when pre-Act estates and trusts are excluded from its reach.

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[1] "Stand Alone Tax" is used for Laws of 2005, Ch. 516, to distinguish Washington's new estate tax from the eliminated "pickup tax" statutory scheme. "Stand alone" is the legislature's own phrase. *See* RCW 83.100.040(3). The Stand Alone Tax is also referred to herein as the "Act."

[2] All capitalized terms and names in this Reply Brief are the same as those used in Appellant's Opening Brief.

II. ARGUMENT

A. Applying the New Stand Alone Tax to William's Pre-Act Trusts Imposes a New Tax Burden in Violation of *Hemphill* and *Turner*.

The DOR's suggestion that the Nelson Estates[3] are trying to avoid a "deferral" of Washington state estate tax is misleading for several reasons. *See* Resp. DOR Br., at 1-2. *First*, there was no actual deferral. William's QTIP Trust was created under the former pickup tax regime, which had no deferral provisions. The DOR cites federal QTIP provisions as the basis for a deferral, but IRC §§ 2056 and 2044 are *federal* statutes that defer *federal* taxes, not *state* taxes. No corresponding state QTIP provisions existed prior to May 17, 2005.

Second, to the extent that the federal QTIP provisions had the *indirect* effect of deferring *some* Washington estate tax, this indirect deferral was correspondingly matched with a "deferred" federal reimbursement. Washington's pickup tax was *predicated upon* a federal reimbursement. As the Supreme Court explained in *Hemphill* and *Turner*:

> **[P]ickup statutes "do not increase the amount of the combined state and federal tax liability**, but merely authorize the state to share in the proceeds of the federal estate tax to the extent of the allowable credit...."

[3] William's Estate and Barbara's Estate are referred to herein as the "Nelson Estates."

Estate of Hemphill v. Dep't of Revenue, 153 Wn.2d 544, 547, 105 P.3d 391 (2005) (emphasis added); *Estate of Turner v. Dep't of Revenue*, 106 Wn.2d 649, 655, 724 P.2d 1013 (1986) (quoting 42 Am. Jur. 2d, Inheritance, Estate and Gift Taxes § 244, at 452 (1969)). "The estate tax scheme in Washington as currently written, though not automatically adopting specific federal law, must be administered complementary to federal law to guarantee that a separate state tax does not burden estates." *Hemphill*, 153 Wn.2d at 551; *Turner*, 106 Wn.2d at 653-54. "All state estate tax due must be fully reimbursed as a current federal credit." *Id.*

Thus, when William executed his Will on December 21, 2001 and Codicil on August 20, 2003 (CP 858, 239) under the pickup tax regime (which tax law had not changed prior to his death), he knew and expected that the state estate tax obligation would be fully absorbed and reimbursed by a matching federal credit, so that the combined state and federal tax obligation would not be greater than the federal tax bill alone. *See Hemphill*, 153 Wn.2d at 552. The net effect to the Washington estate would be as if the state tax had been zero.

Third, the state estate tax was completely eliminated shortly after William's Trust's were created. As of January 1, 2005, there was no Washington estate tax. *See* C. Mitchell & F. Mitchell, 26B Wash. Prac., Probate Law and Practice § 7.21 (2009). Washington's estate tax was eliminated because EGTRRA (P.L. 107-16, § 531) phased out and eliminated the federal death tax credit for states. *Hemphill*, 153 Wn.2d at 548-49 (otherwise, the amount of the combined state and federal tax liability would impose an impermissible increase to the total tax burden). From January 1, 2005 to May 17, 2005 (the "Repeal Period"), no Washington state estate tax existed, and none could be assessed against any Washington estate. *See id.*

The DOR's deferral argument is turned on its head for QTIP trusts made during the Repeal Period. No Washington estate tax could have been imposed on estates of decedents dying during the Repeal Period. However, under its interpretation of the new Act, the DOR will now impose a tax on the estates of surviving spouses dying on or after May 17, 2005 under the new Stand Alone Tax for all QTIP Trusts created during the Repeal Period. The facts in the Nelson Estates present a close example. William died on September 14, 2004, when Washington's tax was 75% eliminated. At his death, William's Estate would have owed, at most, a 4% tax, *i.e.*, only 25% of the maximum Washington pickup tax rate of 16%[4] (which would also have been reimbursed through a federal credit). Shortly after William's death, the Washington estate tax was completely repealed. However, now the DOR is imposing a 19% Stand

[4] *See* IRC § 2011 (2001), attached to this Reply Brief as Appendix A.

Alone Tax on the QTIP trust created by William's Estate, which is no longer entitled to a federal credit. RCW 83.100.040(2).

Thus, not only is the implied deferral argument inaccurate, the truth is that the new Stand Alone Tax, if applied as advocated by the DOR, would impose an entirely *new* tax on QTIP Trusts created prior to the May 17, 2005 enactment date.

B. The Language of the New Stand Alone Tax Demonstrates that the Legislature Did Not Intend to Impose a New Tax on Irrevocable QTIP Trusts Created Prior to May 17, 2005.[5]

1. The state legislature was clear that the New Stand Alone Tax Act is to be applied prospectively only, not retroactively, only to estates of decedents dying on or after May 17, 2005.

The primary objective of any statutory construction inquiry is "to ascertain and carry out the intent of the Legislature." *Homestreet, Inc. v. Dep't of Revenue*, 166 Wash.2d 444, 210 P.3d 297 (2009); *Rozner v. City of Bellevue*, 116 Wn.2d 342, 347, 804 P.2d 24 (1991). When the state legislature enacted the new Stand Alone Tax, it emphasized its clear mandate that the Act operates **"<u>prospectively only</u>**

[5] The DOR attempts to reframe this issue as one of a statutory deduction. Resp. DOR Br., at 3. The issue is not whether the Appellants are taking an unauthorized "deduction," but whether these pre-Act trusts are simply "nontaxable" at all. *See Crown Zellerbach Corp. v. State*, 45 Wn.2d 749, 756, 278 P.2d 305 (1954) (contrasting a deduction for the intrastate wholesaling of particular goods, which is *taxable*, with the activity of wholesaling particular goods in interstate commerce, which "is simply *nontaxable*.")

and not retroactively.[6]" To ensure that this intent was crystal clear, the legislature also said specifically that "[Sections 2 through 17 of this act] "**apply only to estates of decedents dying on or after May 17, 2005.**[7]" The DOR does not dispute this unmistakable legislative intent. Neither does the DOR dispute that the new Stand Alone Tax applies only to transfers made on or after May 17, 2005.

Nevertheless, the DOR argues that it can apply provisions of the Stand Alone Tax retroactively to a pre-Act trust. The DOR first contends that William's QTIP Trust must be added to Barbara's "Washington taxable estate" under RCW 83.100.020(13)&(14) solely by operation of IRC § 2044.[8] *See* Resp. DOR Br., at 18-19. IRC § 2044 is the federal tax code provision that adds back into a surviving spouse's *federal* taxable

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[6] Laws of 2005, ch. 516, § 20 (codified in part at RCW 83.100.040).

[7] Laws of 2005, ch. 516, § 20. Sections 2 through 17 of the new session law include the changes to RCW 83.100.020, 83.100.040 and 83.100.047.

[8] The path from "IRC § 2044" to "Washington taxable estate" is not a short one. The DOR starts with the heading "Washington taxable estate" atop the left column of the table in RCW 83.100.040(2). Washington taxable estate is defined in RCW 83.100.020(13) as "federal taxable estate" less a $1.5 million exemption for decedents dying before January 1, 2006 (and $2 million after) and any RCW 83.100.046 deduction. "Federal taxable estate" in turn means the taxable estate under the Internal Revenue Code, without regard to the sunset termination of the federal estate tax or the deduction for state death taxes. RCW 83.100.020(14). The DOR then identifies IRC § 2051 (not specifically called out by section number in the Act or any of its definitions), which provides that "the value of the taxable estate shall be determined by deducting from the value of the gross estate the deductions provided for in this part." The "gross estate" is further defined in IRC § 2031 as "determined by including to the extent provided in this part [IRC §§ 2031-2046], the value at the time of [the decedent's death] of all property...." Neither IRC § 2051 nor § 2031 point specifically to IRC § 2044; however, IRC § 2044(a) provides that "the *value* of the gross estate shall include the *value* of any property to which this section applies." (ital. added).

estate for *federal* tax purposes all marital property deducted by a predeceasing spouse's estate under IRC § 2056(b)(7). Then the DOR concludes that because IRC § 2044 property is included in the surviving spouse's federal taxable estate, there is a "transfer" under RCW 83.100.040(1) subject to Washington estate tax. In other words, the DOR is not arguing that William's Trusts should be taxed at the state level because they are transfers; rather, the DOR argues they are transfers only because they are taxed at the federal level (under IRC § 2044)[9].

Section 2044[10] of the Internal Revenue Code (which had no Washington state counterpart before May 17, 2005) does not exist in isolation. It is inextricably linked to the prior action of the executor of a predeceasing spouse's estate in making certain elections, including the election under IRC § 2056(b)(7) [11] ("this section applies to any property if . . . a deduction was allowed . . . under section 2056 by reason of subsection (b)(7) thereof"). Sections 2044 and 2056(b)(7) work in tandem, and IRC § 2044 property does not exist but for, and only as a

[9] As is explained below, this is not a transfer because the termination of a surviving spouse's terminable lifetime interest on her death leaves nothing to be transferred at all.
[10] Entitled "Certain Property For Which Marital Deduction Was Previously Allowed."
[11] Section 2044 property may also arise from a prior deduction under IRC § 2523 in some instances (*i.e.*, gifts to spouse). The automatic inclusion of § 2044 property in the Washington taxable estate of a donee on the basis of a prior gift under § 2523 results in the unlawful imposition of a gift tax. As discussed herein, Washington state has no gift tax.

result of, a prior § 2056(b)(7) election.[12] In short, the only reason IRC § 2044 is implicated in Barbara's Estate at all is that a § 2056(b)(7) election was previously made in William's Estate.

The DOR's brief recognizes how integral the pre-Act Section 2056(b)(7) (QTIP) election is to the framework of its analysis in this case. In its brief, the DOR points out that "[w]hile this case involves the estate tax treatment of QTIP included in the taxable estate of Barbara Nelson, facts pertaining to the QTIP election made by Barbara's husband William Nelson [sic—made by executors of William Nelson's estate], <u>are important</u>." Resp. DOR Br., at 3, III.A (underline added). Of course these facts are important. If the DOR is not able to reach back, point to, and rely upon the election of the estate of a decedent dying before the May 17, 2005 enactment date, the DOR has no case. This pre-Act application in the estate of a post-Act decedent violates the express intent of the statute.

2. RCW Ch. 83.100 can only be read in harmony for end dates generally and the statute's stated effective date provision by excluding IRC § 2044 property in the case of pre-enactment QTIP trusts.

There is no legislative intent that IRC § 2044 property (which is not cited or mentioned in the new Tax Act and is an artificial tax law construct for purposes of the federal estate tax regime) would automatically be incorporated into every Washington taxable estate, including pre-

[12] It can also arise as the result of an IRC § 2523(f) election, discussed herein.

enactment QTIP trusts created before the May 17, 2005 enactment date, whether by death or otherwise. On the other hand, the legislature anticipated the potential conflict caused by its use of certain provisions of the federal Internal Revenue Code. While the legislature provided the new stand alone tax would be "independent of the federal tax obligation,[13]" the statute also calls out certain specific sections of the Internal Revenue Code for reference purposes, including IRC §§ 2001 and 2031. To reconcile this paradox, RCW 83.100.040(3) provides in part that the new Stand Alone Tax "**incorporates only those provisions of the Internal Revenue Code . . . that do not conflict with the provisions of [the new Tax Act].**" (emphasis added).

One conflict arising out of the "automatic IRC § 2044 property incorporation" argument is the conflict between IRC § 2044 and RCW 83.100.047.[14] RCW 83.100.047 provides for a separate Washington QTIP election. When a separate Washington QTIP election is made under

[13] RCW 83.100.040(3).

[14] RCW 83.100.047(1) provides that:

> If the federal taxable estate on the federal return is determined by making an election under section 2056 or 2056A of the Internal Revenue Code, or if no federal return is required to be filed, the department may provide by rule for a separate election on the Washington return, consistent with section 2056 or 2056A of the Internal Revenue Code, for the purpose of determining the amount of tax due under this chapter. The election shall be binding on the estate and the beneficiaries, consistent with the Internal Revenue Code. All other elections or valuations on the Washington return shall be made in a manner consistent with the federal return, if a federal return is required, and such rules as the department may provide.

RCW 83.100.047, IRC § 2044 property must necessarily be excluded[15] - *even though the statute does not expressly provide*. If IRC § 2044 property were incorporated *automatically* as the DOR argues, RCW 83.100.047 would be superfluous. Constructions that would render a portion of a statute "meaningless or superfluous" should be avoided. *See State v. Keller*, 143 Wn.2d 267, 277, 19 P.3d 1030 (2001). Thus, the addition of RCW 83.100.047 is a legislative recognition that IRC § 2044 property will not always be added back into the Washington taxable estate, but must be excluded from the calculation of the Washington taxable estate in *some* instances.

Similarly, the "automatic IRC § 2044 property incorporation" argument also leads to the imposition of unauthorized gift tax through the backdoor of IRC § 2044(b)(1)(B). As is the case in most states, Washington has no gift tax. *See* WAC 458-57-105(2)(b) ("the state of Washington does not have a gift tax"). However, if the DOR's logic that IRC § 2044 property is automatically added into the Washington taxable estate is accepted, the DOR will also end up taxing certain gifts. For federal tax purposes, a deduction is allowed for a spouse who transfers property to a "gift QTIP trust" for the lifetime benefit of a spouse. *See*

[15] The DOR's own 2006 Regulations and 2009 Regulations acknowledge that IRC § 2044 property **is not** included in the calculation of the taxable estate in every single case and without exception.

IRC § 2523(f). Although the donor spouse is entitled to a deduction for inter vivos transfers to a gift QTIP trust, the donee spouse's estate must later add gift QTIP trust property to the recipient spouse's total taxable estate under IRC § 2044(b) for federal tax purposes. Under the DOR's logic, gift QTIP trust property would also be added back into the donee spouse's *Washington* taxable estate under RCW 83.100.020(12) and taxed at the donee spouse's death. Thus, notwithstanding there is no Washington gift tax, the DOR effectively creates such a tax by automatically including IRC § 2044(b) property in the Washington taxable estate. The legislature cannot have intended to permit an unauthorized tax in this manner. This is further illustration that the legislature did not intend to automatically or mechanically import, add back and impose Washington tax on IRC § 2044 property, but that certain exceptions apply.

Another example of the flaw in the "automatic IRC § 2044 property incorporation" argument is the taxation of IRC § 2044 property arising from QTIP elections made by a non-Washington decedent's estate for out of state property. Washington could not have imposed an estate tax on out of state property when the QTIP election was made, so the corresponding IRC § 2044 property should not be automatically included in the estate of the surviving spouse (who later dies a Washington resident).

Finally, the automatic incorporation of IRC § 2044 property for pre-Act QTIP Trusts leads to an inconsistent and unfair application of RCW 83.100.047. Where *both* the federal QTIP-electing spouse (*i.e.*, the first dying spouse's estate making the election under IRC § 2056(b)(7)) and the surviving spouse charged with resulting IRC § 2044 property died *before May 17, 2005*, neither the new Stand Alone Tax in RCW 83.100.040 nor the state QTIP election in RCW 83.100.047 would apply. Where both spouses die *on or after* May 17, 2005, both RCW 83.100.040 and 83.100.047 would apply. However, where the federal QTIP-electing estate is for a spouse who died before May 17, 2005, but the surviving spouse with IRC § 2044 property dies on or after May 17, 2005, the DOR applies one statutory section but not the other: it would impose the new tax in RCW 83.100.040 but would not permit the use of the corresponding state QTIP rights under RCW 83.100.047.

Both RCW 83.100.040 and RCW 83.100.047 should apply here or both should not apply. To force the Marital Trusts to bear the new, independent, Stand Alone Tax under RCW 83.100.040, but bar the same Trusts from the opportunity to benefit from a separate Washington QTIP election (or nonelection) pursuant to RCW 83.100.047 is unfair, inconsistent, and further demonstrates that the new Stand Alone Tax was intended to apply only to estates where both decedents have died on or after its May 17, 2005 effective date.

The Nelson Estates have been deprived of the protections of RCW 83.100.047. The DOR's interpretation unfairly forces the effect of an affirmative Washington QTIP election on William's Estate, and as a result of this forced imposition of Washington QTIP treatment, William's Trusts are subject to tax at the maximum 19% tax rate under Washington's new Stand Alone Tax. When William's Estate made its federal QTIP election, effective September 14, 2004,[16] William's Estate's Washington pick up tax rate was less than 4%.[17] Had William's Estate been able to choose not to elect Washington QTIP tax treatment (as is clearly permitted per RCW 83.100.047 for estates of decedents dying after May 17, 2005), the maximum 4% Washington tax rate would have applied, and the Marital Trust property, valued at just over $8,000,000 in the federal estate tax return in Barbara's Estate (as of her date of death 25 months later [*see* CP 208, 109]), would not have been taxed at all in her Estate under the new Stand Alone Tax.

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[16] This election was made on the Estate's timely filed (with extension) federal estate tax return dated December 13, 2005, at a time when the effect of the *Hemphill* decision and the resulting Stand Alone Tax effective May 17, 2005 were well known to the executors of William's Estate.

[17] In 2004, the federal state death tax credit was 75% phased out and so the maximum rate was 75% of the maximum state death tax credit rate of 16%, or an applicable maximum rate of 4%. *See* IRC § 2011 (2001), at Appendix A to this Reply Brief.

This Court has held that all related provisions of a statute are to be read together so as to "achieve a harmonious and unified statutory scheme that maintains the integrity of the respective statutes." *State v. Chapman*, 14 Wn.2d 436, 448, 998 P.2d 79 (1999); *In re Personal Restraint of Brady*, 154 Wn. App. 189, 193, __ P.2d __ (2010). It is also a "golden rule" of statutory interpretation that unreasonableness of the result produced by one among alternative possible interpretations of a statute is reason for rejecting that interpretation in favor of another which would produce a reasonable result. *State v. McDougal*, 120 Wn.2d 334, 351, 841 P.2d 1232 (1993), citing 2A N. Singer, Statutory Construction § 45.12 (4th ed. 1984). A statute held invalid as applied is not void on its face or incapable of valid application in other circumstances. *See Foundation for the Handicapped v. Dep't of Soc. & Health Serv. of Washington*, 97 Wn.2d 691, 695, 648 P.2d 884 (1982), citing 1 J. Sutherland, Statutory Construction § 2.06 (4th ed. 1972).

The interpretation that pre-Act QTIP trusts of decedents dying before May 17, 2005 are not taxable in the Washington estates of decedents dying on or after the enactment of the new Stand Alone Tax Act: (i) harmoniously reconciles and unifies all of the statutory intent provisions (including "prospective only and not retroactive," "applied only to estates of decedents dying on or after May 17, 2005"); (ii) leads to consistent applications of all provisions of the statute; and (iii) avoids unjust, unfair and unreasonable results. Section 2044 property arising from pre-Act QTIP trusts should be excluded from the Stand Alone Tax.[18] The statute as a whole is preserved in this manner.

C. The Expiration of Barbara's Terminable Life Interest on Her Death Is Not a Transmission of Wealth that Is Subject to Taxation by the State of Washington.

Most of the argument in the DOR's brief is devoted to the contention that there are "two transfers" in this case. The first transfer was from William C. Nelson, via his Estate, to his Marital Trusts. There is no dispute as to this transfer. The DOR also concedes that Barbara had only a lifetime interest in the Trusts, which interest terminated at Barbara's death.[19] *See* Resp. DOR Br., at 3 ("lifetime beneficiary") and 26 (Ms. Nelson's life interest "extinguished"). At her death, Barbara had no interest in the Trusts.

However, the DOR alleges a "second transfer of property" from Barbara J. Nelson at her death. This "second transfer" is a red herring intended to confuse the court. There is absolutely no support for a second transfer as that concept is generally applied—the death of the beneficiary

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[18] Because IRC § 2044 is a federal fiction, it can also be disregarded where appropriate. "The [QTIP] fiction is like a scaffolding in that it can be removed with ease." *See* D. Irwin, *Removing the Scaffolding – The QTIP Provisions and the Ownership Fiction*, 84 Neb.L.Rev. 571, 572 (2005)

[19] Indeed, the DOR concedes that William's Trusts each qualify as a "QTIP," which requires that the surviving spouse lifetime interest be "terminable." *See* Resp. DOR Br., at 12, citing IRC § 2056(b)(7)(B)(i).

of a terminable lifetime interest (not created by the beneficiary for herself) has <u>never</u> been held to be a *second* transfer of wealth.

The Fifth Circuit explained this fundamental principle *Clayton v. Comm'r*, 976 F.2d 1486, 1491-92 (5th Cir. 1992). The court noted that after *Fernandez v. Wiener,*[20] Congress created a Marital Deduction in the Revenue Act of 1948 to equalize the disparity between community property and common-law jurisdictions. *Id.* at 1491. The Marital Deduction as applied to terminable interests created a problem for Congress, however, because "**[a]n interest that terminates does not form part of the death estate of the surviving spouse**." (emphasis added). "If a terminable interest in property were deductible in the first estate, such property would escape tax in the estates of *both* spouses," because it would not be taxable at the death of the surviving spouse. *Id.* at 1491. This is because, by definition, a "terminable interest" is simply not property owned by the second spouse.

The US Supreme Court in *May v. Heiner* also recognized this concept. *May v. Heiner*, 281 U.S. 238, 243, 50 S.Ct. 286, 74 L.Ed. 826 (1930). In *May*, the Supreme Court held that nothing was includable in the gross estate of an income beneficiary of a trust, even though she was

[20] *Fernandez v. Wiener*, 326 U.S. 340, 66 S. Ct. 178, 90 L. Ed. 116 (1945), involved the peculiarities of Louisiana community property law, not the extinguishment of a lifetime beneficiary's interest in an irrevocable trust, and does not control this case.

the grantor of the trust as well as a beneficiary, because "at [her] death, . . . no interest in the property . . . passed from her to the living; title thereto had been definitely fixed by the trust deed. The interest therein which she possessed immediately prior to her death was obliterated by that event." *Id.* at 243. In *May*, the value of the trust estate was not includable in the decedent's gross estate: "Indeed, this principle is so deeply entrenched in the structure of the federal estate tax that formal judicial and administrative pronouncements to this effect are unnecessary and hard to find.[21]" *See* 5 B. Bittker & L. Lokken, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 125.5, at 125-11 (1993) (herein, "Bittker"); *see also*, *U.S. v. Field*, 255 U.S. 257, 41 S. Ct. 256, 65 L.Ed. 617 (1921); *Helvering v. Safe Deposit & Trust Co.*, 316 U.S. 56, 62 S. Ct. 444, 86 L.Ed. 1266 (1942) (cases that construe the termination of such trusts to not be transfers of an interest in property when the surviving spouse dies).

[21] Estate tax treatises universally recognize that there is no transfer at the death of a lifetime beneficiary of a trust that also contains a remainder interest. *See* R. Stephens, G. Maxfield, S. Lind, D. Calfee & R. Smith, FEDERAL ESTATE AND GIFT TAXATION ¶ 4.05[5][b], at 4-157 (8[TH] ed. 2002) (where A grants B a life estate in Blackacre or lifetime beneficiary interest in a trust, subject to a remainder interest, "B has no interest that B can transmit to others at B's death"). This is because the death of the lifetime beneficiary is a neutral tax event because the estate and gift taxes are exactions on the transmissions of wealth. *Id.* n.51. There is no transmission of wealth by the lifetime beneficiary whose interest terminates at death. *Id.* This is also consistent with the Mertens treatise discussion of the concept of transfer cited by the DOR, which concludes that "a basic element is that the decedent must have an interest in property which is capable of transfer." *See* 1 J. Mertens, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION § 1.04, at 11 (1959). The beneficiary of a terminable lifetime interest has no interest in property capable of transfer at death, and the lifetime beneficiary's interest is also not a taxable interest at death. *Id.*

Section 2044 was created as a federal legislative fiction to serve as a necessary counterpart for § 2056(b)(7) in order to provide that deductibility by the estate of the spouse creating a QTIP Trust would also be matched with includability in the surviving spouse's federal estate, by virtue of the IRC § 2044 definition.[22] Because the only right the surviving spouse has is the lifetime receipt of income, which interest terminates at her death, there is otherwise no interest in the surviving spouse's estate to be taxed with respect to a QTIP Trust. If the termination of a surviving spouse's life estate *were* a taxable event standing *on its own* because it constituted a "shifting economic interest" as the DOR says, it would have been unnecessary for Congress to enact IRC § 2044. Thus, there is no independent, second transfer at the death of a surviving spouse who held only a terminable lifetime beneficial interest.

D. A State Cannot Impose a New Tax On an Irrevocable Trust that was Completely Vested Prior to the Enactment of a New Tax.

The holding in *McGrath's Estate* that the state cannot impose or collect an estate tax on a pre-enactment vested right remains good law and has not been overruled. *In re McGrath's Estate*, 191 Wash. 496, 71 P.2d 395 (1937), *cert. denied*, *Washington v. McGrath*, 58 S.Ct. 749, 82 L.Ed. 1111. The DOR correctly notes in *McGrath's Estate* that the

[22] *See also*, *Estate of Bonner v. Comm'r*, 84 F3d 196, 199 (5th Cir. 1996); *Estate of Mellinger v. Comm'r*, 112 T.C. 26, 36 (1999) acq. 1999-2 CB.

Northwestern Mutual insurance policies were fully vested in the beneficiary before the enactment of the new tax law and could not be changed by McGrath, unlike the Union Central policies, which could be changed during McGrath's life or after the enactment of the new tax law. Resp. DOR Br., at 23; *McGrath's Estate*, at 502-03. Similarly here, William's Marital Trusts were fixed as of the creation of the Trusts, effective as of the date of his death. Barbara could not change the terms of the Marital Trusts or the class of beneficiaries during her life or at her death. When she died, she had no property interest in the Trusts and nothing to transfer. The rights of William's Trusts were irrevocably fixed as of the date of his death.

McGrath's Estate is also distinguishable from *Helvering v. Hallock*, 309 U.S. 106, 60 S.Ct. 444, 84 L.Ed. 604 (1940) and *Fernandez v. Wiener*, 326 U.S. 340, 66 S. Ct. 178, 90 L. Ed. 116 (1945). Resp. DOR Br., at 24. In *Hallock*, the grantor of property to a trust reserved a right on a condition subsequent, *i.e.*, the possibility of a reverter. *Hallock*, 309 U.S. at 115. The Supreme Court held that the reversionary interest would be valued and included in the decedent's gross estate. *Id.* at 119-20. In other words, *some* interest was retained by the decedent. *Klein v. U.S.*, 283 U.S. 231, 51 S. Ct. 398, 75 L.Ed (1931), cited as supporting authority in the DOR's Motion, is also inapposite because the real property conveyed in

Klein "remained vested" in the grantor during his lifetime. 283 U.S. at 233-34. In *West v. Oklahoma Tax Comission,* 334 U.S. 717, 68 S.Ct. 1223, 92 L.Ed. 1676 (1948), "the decedent had a vested interest in his Osage [Native American mineral rights]," and his death caused a shifting of interests. *Id.* at 727. Appellants' arguments are unaffected by the holdings in *Hallock, Klein* and *West.*

The DOR also cites *US v. Mfrs. Nat'l Bank of Detroit,* 363 U.S. 194, 80 S. Ct. 1103, 4 L.Ed.2d 1158 (1960) as support. In *Bank of Detroit,* a new tax was imposed on the proceeds of life insurance policies. *Id.* at 195. However, even in *Bank of Detroit* the Supreme Court drew a distinction between proceeds allocated to premiums paid after the new tax law and those proceeds attributable to premiums paid before the new law, which were properly excluded from income, because the new tax law applied to estates of decedents dying on or after the new law. *Id.* at 195.

The DOR suggests that *Fernandez v. Wiener's* "shifting economic interests" extends taxation to terminable life interests in irrevocable trusts. This is not the law. *Fernandez* did not address the expiration of a spouse's terminable lifetime interest but rather the inclusion of the entire community in a husband's gross estate on his death. *Fernandez,* 326 U.S. at 348-49. The Supreme Court highlighted the idiosyncrasies of Louisiana community property law in the 1940s, where "the wife has no control over community property. She may not give it away, nor sell it, and in general, may not bind it for the payment of her debts." *Id.* at 349. The death of the husband terminates his control over the wife's share, and "for the first time" transfers to her full and exclusive possession, control and enjoyment under Louisiana law.[23] *Id.* at 355-56. *Fernandez* did not hold that the surviving spouse with only a lifetime income interest has no interest in an irrevocable marital trust to convey on her death. In fact, the treatise cited by the DOR concedes that, even after *Fernandez v. Wiener*, the modern concept of transfer requires "that decedent ha[ve] an interest in property at death." 1 J. Mertens, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION § 1.04 (1959). Barbara had no interest in William's Trusts at Barbara's death.

Thus, *McGrath's Estate*[24] remains good law. The QTIP Trust interests created by William's Estate were defined, fixed and vested as of

[23] To contrast, Washington law is different. Under *In re Coffey's Estate*, 195 Wash. 379, 81 P.2d 283 (1938), which cited *McGrath's Estate* with approval, only the husband's one-half interest therein may be included in his gross estate. *Id* at 385-86.

[24] In a footnote, the DOR suggested that *Japan Lines v. McCaffree*, 88 Wn.2d 93, 96-97, 558 P.2d 211 (1977), specifically limited the holding in *McGrath's Estate* as it pertains to retroactive tax statutes. Resp. DOR Br., at 27 n.17. To the contrary, the 1977 Washington Supreme Court in *Japan Lines* reaffirmed *McGrath's Estate*, holding that "[w]e have imposed narrow and specific limits on the legislature's broad powers in regard to a retroactive tax" under prior cases, including *McGrath's Estate*. *Japan Lines*, at 96-97. The *Japan Lines* court said that a statute would be stricken as retroactive when it taxed a privilege which had formerly been freely enjoyed, or changed the expectation of the parties. As explained in the opening of this Reply, Washington's pickup tax, which required a matching federal reimbursement, was repealed, and William's Estate had an expectation under *Hemphill* that it would not be burdened by a new layer of state tax unaccompanied by a federal reimbursement. The DOR's new tax would impose an entirely new, unexpected tax burden.

the date of William's death on September 14, 2004. Barbara's lifetime interest in these Trusts terminated at her death, and she had therefore no interest to shift. The legislature cannot reach back and impose a wholly new tax on William's irrevocable trusts.

E. A New Tax Cannot Be Imposed Upon a Pre-Enactment Irrevocable Trust Under the Impairment Clause.

Washington courts have honored Washington's Impairment Clause by providing that "a statute may not be given retroactive effect, regardless of the intention of the legislature, where the effect would be to interfere with vested rights. Thus, a statute may not operative retroactively where the result would be to impair the obligation of a contract." *Gillis v. King County*, 42 Wn.2d 373, 376, 255 P.2d 546, 548 (1953); *Hearde v. Seattle*, 26 Wn. App. 219, 611 P.2d 1375 (1980); *In re Heilbron's Estate*, 14 Wash. 536, 45 P. 153 (1896).

The DOR argues that the three tests of *Carlstrom*[25] are not met. *See Carlstrom v. State*, 103 Wn.2d 391, 694 P.2d 1 (1985). The third test is not applicable because a public contract is not at issue. *Carlstrom* is satisfied here. However, the first two tests are clearly met. First, trusts create contractual relationships. *See Farrell v. Mentzer*, 102 Wash. 629,

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[25] "First, the court must determine whether a contractual relationship exists; second, the court must determine whether the legislation substantially impairs the contractual relationship; third, when a state impairs its own contracts, the court must determine if the impairment was reasonable and necessary to serve a legitimate public purpose." *Carlstrom v. State*, 103 Wn.2d 391.

174 P. 482 (1918) ("express trusts are created by contract of the parties"); *In re Estate of Bodger*, 130 Cal. App. 2d 416, 279 P.2d 61 (2d Dist. 1955) (act of trust creation "is nothing more than a third party beneficiary contract). Trusts have long been held to be within the constitutional provisions regarding impairment of the obligation of contracts. *Adams v. Plunkett*, 274 Mass. 453, 175 N.E. 60 (1931). Second, retroactive application of the new Stand Alone Tax substantially impairs the relationship between the parties to William's Trusts. The beneficiaries do not receive what they are entitled to, because they are subject to a tax that did not exist upon creation of the trust.

The Impairment Clause analysis in *McGrath's Estate* has not been overruled.[26] *In re McGrath's Estate*, 191 Wash. 496, 71 P.2d 395 (1937). The new Stand Alone Tax impairs the Marital Trusts' beneficiaries' contractual rights because they receive less than they would have received under the pickup tax regime. *Id.* at 508-09; *see also Blodgett v. Holden*, 275 U.S. 142, 147, 48 S. Ct. 105, 72 L. Ed. 206 (1927).

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[26] The impairment clause analysis of *Coolidge* was also not overruled in subsequent cases. Appellants reluctantly acknowledge that the U.S. Supreme Court has not struck down an economic regulation or law for violating substantive due process since 1937. The impairment clause, however, has continued strong vitality in the same context. *See Allied Structural Steel v. Spannaus*, 438 U.S. 234, 98 S.Ct. 2716, 57 L.Ed.2d 727 (1978) (Court invalidated an attempt by Minnesota that would have expanded the existing pension obligations of certain Minnesota employers).

F. If RCW 83.100.040 Applies, the 2006 Regulations Must Also Apply as Written.

As discussed above, if RCW 83.100.040 applies to pre-Act QTIP trusts, then RCW 83.100.047 and the 2006 Regulations should apply as well, and as plainly written. The 2006 Regulations correctly exclude IRC § 2044 (that would include amounts for which a <u>federal</u> QTIP election was previously made) from the computation of Washington taxable estate. WAC 458-57-105(3)(q) (2006); WAC 458-57-115(2)(d) (2006) (the "2006 Regulations"). Where a rule is unambiguous, a court does not speculate as to its intent, nor question the wisdom of a particular regulation. *Multicare Med Ctr. v. Dep't of Soc. & Health Servs.*, 114 Wn.2d 572, 790 P.2d 124 (1990). The DOR's 2006 Regulations are entirely consistent with the "prospective only" admonition in the statute and avoid the inconsistent incorporation of IRC § 2044 as applied to pre-Act trusts. However, if this Court determines that RCW 83.100.047 and the 2006 Regulations do not apply to pre-Act QTIP trusts, then, as argued above, the tax under RCW 83.100.040 should not apply, either.

G. Taxing Statutes Must be Strongly Construed Against the DOR and in Favor of the Taxpayer.

The courts of this state have repeatedly held that if *any* doubt exists as to the meaning of a taxing statute, "the statute must be construed most strongly against the government and in favor of the taxpayer." *Agrilink*

Foods, Inc. v. Dep't of Revenue, 153 Wn.2d 392, 103 P.3d 1226 (2005); *Ski Acres, Inc. v. Kittitas County*, 118 Wn.2d 852, 857, 827 P.2d 1000 (1992); *Dep't of Revenue v. Hoppe*, 82 Wn.2d 549, 552, 512 P.2d 1094 (1973); *see also*, *Gould v Gould*, 245 US 151, 38 S.Ct. 53, 62 L.Ed. 211 (1917) ("in the case of doubt [tax laws] are construed most strongly against the government, and in favor to the citizen"). To the extent that this Court concludes that the statutes or regulations can be read as having two meanings, the taxpayers prevail under this rule.

III. CONCLUSION

For the reasons set forth above, the trial court's orders should be reversed, and summary judgment should be entered in favor of the Estate of Barbara J. Nelson.

Respectfully submitted this 20TH ~~day of~~ August 2010.

By: ____________________________

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PROOF OF SERVICE

I, Rhys Farren, the undersigned, hereby certify and declare under penalty of perjury under the laws of the State of Washington that the following statements are true and correct:

On this date, I caused to be served a true copy of the document entitled REPLY BRIEF OF APPELLANTS to which this is attached, by First Class U.S. Mail and electronic mail on the following:

Washington State Department of Revenue
David M. Hankins, WSBA #19194
Charles Zalesky, WSBA #37777
Donald F. Cofer, WSBA #10896
Office of the Attorney General, Rob McKenna
PO Box 40123
Olympia, WA 98504-0123
360.586.0756

Executed at Bellevue, Washington this 20th day of August, 2010.

Rhys Farren

APPENDIX A

2000 and 2001	$675,000
2002 and 2003	$700,000
2004	$850,000
2005	$950,000
2006 or thereafter	$1,000,000

P.L. 107-16, §901(a)-(b), provides:

SEC. 901. SUNSET OF PROVISIONS OF ACT.

(a) IN GENERAL.—All provisions of, and amendments made by, this Act shall not apply—

(1) to taxable, plan, or limitation years beginning after December 31, 2010, or

(2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.

(b) APPLICATION OF CERTAIN LAWS.—The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

• **1997, Taxpayer Relief Act of 1997 (P.L. 105-34)**

P.L. 105-34, §501(a)(1)(B):

Amended Code Sec. 2010 by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) a new subsection (c). Effective for estates of decedents dying, and gifts made, after 12-31-97.

[Sec. 2010(d)]

(d) LIMITATION BASED ON AMOUNT OF TAX.—The amount of the credit allowed by subsection (a) shall not exceed the amount of the tax imposed by section 2001.

Amendments

• **1997, Taxpayer Relief Act of 1997 (P.L. 105-34)**

P.L. 105-34, §501(a)(1)(B):

Amended Code Sec. 2010 by redesignating subsection (c) as subsection (d). Effective for estates of decedents dying, and gifts made, after 12-31-97.

• **1990, Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508)**

P.L. 101-508, §11801(c)(19)(A):

Amended Code Sec. 2010 by redesignating subsection (d) as subsection (c). Effective 11-5-90.

P.L. 101-508, §11821(b), provides:

(b) SAVINGS PROVISION.—If—

(1) any provision amended or repealed by this part applied to—

(A) any transaction occurring before the date of the enactment of this Act,

(B) any property acquired before such date of enactment, or

(C) any item of income, loss, deduction, or credit taken into account before such date of enactment, and

(2) the treatment of such transaction, property, or item under such provision would (without regard to the amendments made by this part) affect liability for tax for periods ending after such date of enactment,

nothing in the amendments made by this part shall be construed to affect the treatment of such transaction, property, or item for purposes of determining liability for tax for periods ending after such date of enactment.

• **1976, Tax Reform Act of 1976 (P.L. 94-455)**

P.L. 94-455, §2001(a)(2), (d)(1):

Added Code Sec. 2010. Effective for estates of decedents dying after 12-31-76.

[Sec. 2011]

SEC. 2011. CREDIT FOR STATE DEATH TAXES.

[Sec. 2011(a)]

(a) IN GENERAL.—The tax imposed by section 2001 shall be credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia, in respect of any property included in the gross estate (not including any such taxes paid with respect to the estate of a person other than the decedent).

Amendments

• **1976, Tax Reform Act of 1976 (P.L. 94-455)**

P.L. 94-455, §1902(a)(12)(B), (c)(2):

Deleted "or Territory" in Code Sec. 2011(a). Effective for gifts made after 12-31-76.

• **1958, Technical Amendments Act of 1958 (P.L. 85-866)**

P.L. 85-866, §102(c), (d):

Amended Code Sec. 2011(a) by striking the words "or any possession of the United States," after the words "District of Columbia". Effective for estates of decedents dying after 9-2-58.

→ Caution: Code Sec. 2011(b), below, was amended by P.L. 107-16. For sunset provision, see P.L. 107-16, §901, in the amendment notes.

[Sec. 2011(b)]

(b) AMOUNT OF CREDIT.—

(1) IN GENERAL.—Except as provided in paragraph (2), the credit allowed by this section shall not exceed the appropriate amount stated in the following table:

If the adjusted taxable estate is:	*The maximum tax credit shall be:*
Not over $90,000	$\frac{8}{10}$ths of 1% of the amount by which the adjusted taxable estate exceeds $40,000.
Over $90,000 but not over $140,000	$400 plus 1.6% of the excess over $90,000.
Over $140,000 but not over $240,000	$1,200 plus 2.4% of the excess over $140,000.

If the adjusted taxable estate is:	*The maximum tax credit shall be:*
Over $240,000 but not over $440,000	$3,600 plus 3.2% of the excess over $240,000.
Over $440,000 but not over $640,000	$10,000 plus 4% of the excess over $440,000.
Over $640,000 but not over $840,000	$18,000 plus 4.8% of the excess over $640,000.
Over $840,000 but not over $1,040,000	$27,600 plus 5.6% of the excess over $840,000.
Over $1,040,000 but not over $1,540,000	$38,800 plus 6.4% of the excess over $1,040,000.
Over $1,540,000 but not over $2,040,000	$70,800 plus 7.2% of the excess over $1,540,000.
Over $2,040,000 but not over $2,540,000	$106,800 plus 8% of the excess over $2,040,000.
Over $2,540,000 but not over $3,040,000	$146,800 plus 8.8% of the excess over $2,540,000.
Over $3,040,000 but not over $3,540,000	$190,800 plus 9.6% of the excess over $3,040,000.
Over $3,540,000 but not over $4,040,000	$238,800 plus 10.4% of the excess over $3,540,000.
Over $4,040,000 but not over $5,040,000	$290,800 plus 11.2% of the excess over $4,040,000.
Over $5,040,000 but not over $6,040,000	$402,800 plus 12% of the excess over $5,040,000.
Over $6,040,000 but not over $7,040,000	$522,800 plus 12.8% of the excess over $6,040,000.
Over $7,040,000 but not over $8,040,000	$650,800 plus 13.6% of the excess over $7,040,000.
Over $8,040,000 but not over $9,040,000	$786,800 plus 14.4% of the excess over $8,040,000.
Over $9,040,000 but not over $10,040,000	$930,800 plus 15.2% of the excess over $9,040,000.
Over $10,040,000	$1,082,800 plus 16% of the excess over $10,040,000.

(2) REDUCTION OF MAXIMUM CREDIT.—

(A) IN GENERAL.—In the case of estates of decedents dying after December 31, 2001, the credit allowed by this section shall not exceed the applicable percentage of the credit otherwise determined under paragraph (1).

(B) APPLICABLE PERCENTAGE.—

In the case of estates of decedents dying during:	*The applicable percentage is:*
2002	75 percent
2003	50 percent
2004	25 percent.

(3) ADJUSTED TAXABLE ESTATE.—For purposes of this section, the term "adjusted taxable estate" means the taxable estate reduced by $60,000.

Amendments

• 2001, Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16)

P.L. 107-16, §531(a)(1)-(3):

Amended Code Sec. 2011(b) by striking "CREDIT.—The credit allowed" and inserting "CREDIT.—(1) IN GENERAL.—Except as provided in paragraph (2), the credit allowed", by striking "For purposes" and inserting "(3) ADJUSTED TAXABLE ESTATE.—For purposes", and by inserting after paragraph (1) a new paragraph (2). Effective for estates of decedents dying after 12-31-2001.

P.L. 107-16, §901(a)-(b), provides:

SEC. 901. SUNSET OF PROVISIONS OF ACT.

(a) IN GENERAL.—All provisions of, and amendments made by, this Act shall not apply—

(1) to taxable, plan, or limitation years beginning after December 31, 2010, or

(2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.

(b) APPLICATION OF CERTAIN LAWS.—The Internal Revenue Code of 1986 and the Employee Retirement Income Security