Price & Farrington's Estate and Tax Planning *Fast*Faxts

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Estate, Tax , Business and Wealth Planning for Advisors and Clients

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Washington Supreme Court Invalidates Estate Tax: *The Whys and Wherefores*

Happy Valentine's Day!

In a major decision creating glee among taxpayers and concern among state budget balancers, the Washington State Supreme Court upheld a challenge to the validity of Washington's estate tax, ruling it unconstitutional under state law.

On February 3, in a unanimous decision (Estate of Hemphill et al vs. State Revenue et al), the Supreme Court threw out Washington's estate tax, causing an estimated $431 million loss, which includes a refund of about $150 million in revenues collected by the Department of Revenue since January 1, 2002 and $277 million more that was expected to be collected by the state from 2005 to 2007.

The court granted a direct review from the trial court, which had ruled that Washington's estate tax law (RCW 83.100) refers specifically to the Internal Revenue Code (IRD) as of *January 1, 2001*, and not to current tax law, and the court upheld the constitutionality of the state tax. About 3,000 Washington estates were joined in a class action appealing the lower court's ruling. The Supreme Court heard oral arguments on September 30, 2004.

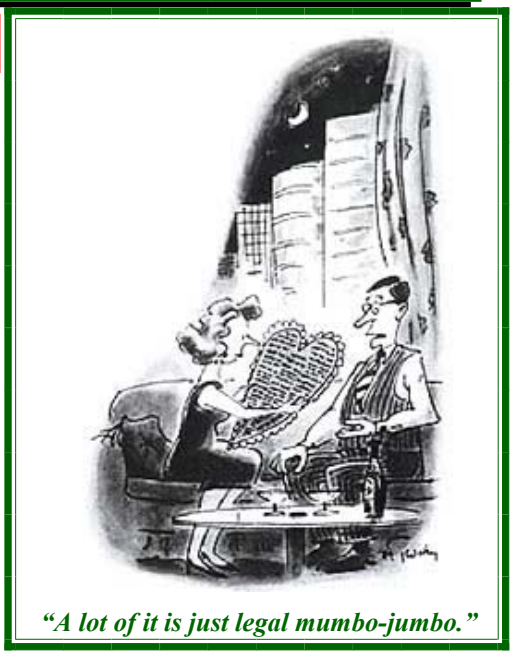
Background. On November 6, 1981, Washington voters approved Initiative Measure 402, which read: *"Shall [state] inheritance and gift taxes be abolished, and state taxes be restricted to the federal estate tax credit allowed?"* The initiative was codified as law at Chapter 83.00 RCW expressly limiting the Washington estate tax to *"an amount equal to the federal credit"* (RCW 83.100.030(1)).

Pickup and Decouple. Under that law, the estate tax was received by the state not as a separate tax, but through a *tax credit* established by the internal revenue code. The credit reduced the estate's total *federal* estate tax due and "transferred" the amount of credit to the *state*. Many states, including Washington, codified their estate tax by equating the *state* tax to the total credit allowed to them by the *federal* government. By 2001, 38 states relied exclusively on this "pickup" type of tax to receive their estate taxes. In this way, states were able to receive their estate tax without creating any additional tax burden on the decedent's estate.

In 2001, the Washington legislature enacted revisions to RCW 83.100 and made reference to *"the United States Revenue Code of 1986, as amended as of January 1, 2001"*. This essentially separated or "decoupled" the state estate tax from the federal tax. But the catch is that the federal code has changed since 2001 and the Washington statute has not matched those changes. In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was enacted by Congress. EGTRRA ends the federal estate tax and fully repealed (by January 1, 2005) the federal estate tax credit for state estate taxes. EGTRRA basically ends the estate tax revenue sharing between the federal government and the states. The Washington Department of Revenue argued that the state tax scheme imposes an estate tax *equal to the federal credit as of January 1, 2001,* prior to the implementation of EGTRRA.

The decision. The Supreme Court stated its mission in Hemphill: *"We have to decide whether the legislature's inaction in not revising the statutory definitional references has changed the character of our estate tax, which has been a 'pickup' tax based on current federal law. We hold it has not changed."*

The court cites its 1986 decision



"A lot of it is just legal mumbo-jumbo."

THE LORE (LURE?) OF THE LAW

- ***Common sense makes good law.***
- ***Lawyers: Persons who write 10,000-word documents and call them briefs.***
- ***A judge is merely a lawyer who has been benched.***
- ***He who has the judge for his father goes into court with an easy mind.***
- ***A lean compromise is better than a fat lawsuit.***
- ***Justice, though she's painted blind, is to the weaker side inclined.***
- ***If it doesn't fit, you must acquit.***

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in *Estate of Turner vs. Department of Revenue*. There, it concluded that when an estate pays no federal tax, *"there is no obligation to pay any estate tax". "[In Turner], we expressly rejected the Department's...argument that our statute imposes an independently operating Washing estate tax". "The Department [of Revenue] maintains that an estate not obligated to file a federal form must obtain a newly created state estate tax form, file taxes and pay completely independent taxes. Such calculations are contrary to what we held in Estate of Turner".* (Hemphill)

Conclusion. In logic and fairness, any ambiguity in a tax law is interpreted *against* the government and in favor of the taxpayer. Accordingly, the court concluded: ***"Until or unless the legislature revises [state law] to specifically and expressly create a stand-alone estate...tax, [it] remains as a pickup tax. We find no indication...that the legislature changed the pickup character of the tax and created an independently operating Washington estate tax. A new tax burden can be created only by law that states such a purpose. Any amount of a state estate tax not fully absorbed by a current federal credit is an invalid independent tax. Appellants are due a refund."*** (Hemphill)

So, based on the original Washington initiative that created the tax statute, the court's past interpretation of the statute, and the current wording of the law that shows Washington still has a pickup tax based on federal law, the court concludes that any amount of a state estate tax that is not "fully absorbed" by a current federal credit is an independent tax that is invalid.

The Supreme Court ordered a refund of all Washington estate taxes collected since January 1, 2002. The Washington state Department of Revenue and the trial court will be developing procedures for refunds, which will obviously vary depending on the size of the estate. For example, heirs to a $1 million estate would have paid Washington $33,200 and would have sent $82,800 to the federal government.

Where to now? Fear of estate taxes on the federal level, and more recently on the state level, has been a major bugaboo for our clients, providing a strong motive for them to sit down with a qualified attorney to do the estate planning they should be doing on their family's behalf anyway.

We have always counseled our clients on plan designs that minimize taxes. But tax avoidance is really only one of many different critical estate planning concerns. Often, even with larger, taxable estates, our clients' tax planning is not the most critical aspect of their family's estate plan. Tax minimization is often a means to achieve much larger planning ends that might have nothing to do with taxes.

Back in February, 2001, we wrote a *Fast*Faxts article that we believe is as relevant and important today as it was then: "29 (And More) Non-Tax Reasons To Do Your Estate Planning: *Avoiding Complacency after Estate Tax 'Repeal'"* [*See* February, 2001 Estate and Tax Planning *Fast*Faxts, in the *Fast*Faxts archive on our website at www.pricefarrington.com.] The list of planning opportunities in that article could be twice as long as it is, and has nothing to do with tax planning. Check it out . ■

Where there's a Will: *The New "Lockbox":*

Wills get lost, misplaced, and-destroyed. Lawyers who maintain the originals retire, die, misplace them or lose contact with their clients. This can cause huge problems for everyone.

A new law went into effect in Washington in June of 2004 (RCW 11.12.265). It allows any person who has custody or control over an original will to deposit it under seal with the clerk of any Washington superior court. The purpose of the law is to provide a safe place to hold a testator's (will maker's) will.

A deposited will is treated as a sealed document by the court clerk and can be released without court order only to the testator. Any other person - including a testator's agent or guardian - can seek a court order to withdraw the original will upon a showing of good cause.

"Not one crummy Valentine."

A will that is deposited with the court clerk can still be challenged on the testator's death. The fact that a court clerk holds a will in its repository doesn't mean the will is valid. It must have been executed properly and the testator must have demonstrated "testamentary capacity".

In King County, a party wishing to deposit an original will of a living person must complete a *Will Repository Cover Sheet* available at the clerk's office or online. A filing fee of $20 is required. Any other filing, such as of a codicil (will amendment), also requires payment of the $20 fee.

The testator may withdraw the will upon verification of identity. Anyone else must secure a court order. After the death of the testator, and upon request and presentation of a certified copy of the death certificate, the will will be unsealed. The clerk will retain deposited wills or their withdrawal records for 100 years. ■

We wish you good planning!

Glenn D. Price