

SENATE BILL REPORT

SB 5939

As of May 31, 2013

Title: An act relating to the estate tax.

Brief Description: Concerning the estate tax.

Sponsors: Senators Hill and Braun.

Brief History:

Committee Activity: Ways & Means: 5/31/13.

SENATE COMMITTEE ON WAYS & MEANS

Staff: Juliana Roe (786-7438)

Background: In 1981 Initiative 402 repealed the state inheritance tax and replaced it with an estate tax equal to the amount allowed under federal law as a credit against the federal estate tax. This is commonly referred to as a "pick-up" tax. A pick-up tax is not an additional tax on the estate but merely shifts revenues from the federal government to the state. Federal law phased out state pick-up taxes (i.e. federal sharing), with a complete termination in 2005.

On February 3, 2005, the state Supreme Court invalidated Washington's estate tax by holding that Washington's "pick-up" tax was based on current federal law, which had ended state-sharing, and Washington law did not impose an independently operating Washington estate tax. Until the Legislature expressly created a stand-alone tax, the tax remained a pick-up tax that must be fully reimbursed by the federal credit.

In response to the state Supreme Court decision, Washington created a stand-alone estate tax in 2005. The tax took effect May 17, 2005. The current Washington estate tax is imposed on every transfer of property located in Washington at the time of death of the owner. The term "property" includes real estate and other property located in this state, as well as intangible assets owned by a Washington resident, regardless of location.

The measure of the tax is based on the taxable estate as determined under federal law, as it existed on January 1, 2005. For Washington decedents dying on or after January 1, 2006, a deduction of \$2 million is allowed from the taxable estate. The value of property used for qualifying farming purposes is also deductible.

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

After subtracting any applicable deductions (e.g., the \$2 million statutory deduction and the value of qualifying farm property), the remaining Washington taxable estate is subject to a graduated rate schedule ranging from 10 to 19 percent.

As previously mentioned, the federal taxable estate is the starting point for determining Washington's estate tax. Federal law allows an unlimited marital deduction for property passed outright to a surviving spouse. Federal law also allows certain transfers of property to marital trusts to qualify for the unlimited marital deduction even though the surviving spouse does not have total control of the property. This property is referred to as qualified terminable interest property (QTIP). The QTIP is included in the federal taxable estate of the surviving spouse upon the surviving spouse's passing. Under both federal and state law, the personal representative of the first spouse to die can make a QTIP election to qualify the property for the marital deduction. Since the current Washington estate tax did not take effect until May 17, 2005, an issue arises as to whether the Washington estate tax applies to QTIP when the first spouse passed away prior to May 17, 2005.

On October 18, 2012, the state Supreme Court held in *In re Estate of Bracken*, 175 Wn.2d 549, 290 P.3d 99 (2012), that QTIP included in the federal taxable estate where the federal QTIP election was made prior to May 17, 2005, is not subject to Washington estate tax when the surviving spouse passes away after May 17, 2005. The Court reasoned that Washington's estate tax is specifically triggered by the transfer of property of the decedent and with QTIP, the actual transfer occurs when the first spouse passes away. The surviving spouse is an income beneficiary of QTIP, but upon the surviving spouse's death, no actual transfer occurs. Under federal law, a fictional transfer of QTIP occurs when the second spouse dies based on the original QTIP election by the first spouse. However, since the current Washington estate tax did not exist until May 17, 2005, no state QTIP election could have been made prior to this time.

Summary of Bill: The bill as referred to committee not considered.

Summary of Bill (Proposed Substitute): The definition of "transfer" is amended to specifically include property where the decedent economically benefitted in the property, i.e., property in a QTIP marital trust. A commensurate change is made to the definition of the "Washington taxable estate" to specifically include an interest in QTIP, regardless of whether the decedent acquired the interest in the property prior to May 17, 2005.

The applicable exclusion amount is increased by \$1 million each year starting in 2015 until it reaches the federal exclusion amount, as it existed on January 1, 2013, for decedents dying in calendar year 2017 and thereafter. The federal exclusion amount established on January 1, 2013, is \$5.25 million and increases annually by the national consumer price index.

The tax rate imposed on the transfer of property in the decedent's estate is reduced by 5 percent per year, over a five-year period, beginning in calendar year 2018 and ending in calendar year 2022, culminating at 75 percent of the current tax rate.

The changes in the act apply prospectively as well as retroactively to decedents dying on or after May 17, 2005.

The changes in the act do not impact the parties involved in the *Bracken* decision.

Appropriation: None.

Fiscal Note: Requested on May 29, 2013.

Committee/Commission/Task Force Created: No.

Effective Date: The bill contains an emergency clause and takes effect immediately, except for section 5, relating to qualified terminable interest property, which takes effect January 1, 2014.

Staff Summary of Public Testimony: CON: Education is more important than tax reform. We should not be reducing revenue because that money is needed in our schools. This tax was voted on by the people who resoundingly voted in favor of the tax knowing that it is a high tax. Increasing the threshold helps millionaires and effectively decreases funding for education. These changes will make the estate tax further regressive. This is terrible public policy. It sets a precedent that has a chilling effect on business interests in this state.

The state Supreme Court has ruled on this issue and the Department of Revenue (DOR) should have already sent out refunds to the estates in question. It is an injustice to not refund these estates.

OTHER: The Supreme Court in *Bracken* ruled that the estate tax does not apply to the surviving spouse in a QTIP. An unintended consequence resulted from that decision - that married couples do not owe the estate tax, but single people do. This is a fundamental issue of equity. The *Bracken* case must be addressed to avoid a \$160 million impact on the current biennium. If it is not addressed, DOR will begin to process refunds on June 3. Once those refunds are sent out, they can not be recovered. DOR does not have a position regarding the thresholds or rates as these are policy decisions for the Legislature.

To say that the Legislature's intent was to impose the estate tax only on single persons is absurd. That was not how the voters believed the tax would be applied either.

The Legislature has the authority to retroactively enact curative legislation to remedy recent court cases. This has been done by the Legislature for taxes as well as exemptions in the past.

There are two retroactive pieces to this bill. The first piece clarifies the law from 2005 to the present where the QTIP is created after 2005. The second retroactive piece applies the tax prior to its existence. The Washington State Bar Association (WSBA) believes that the tax still applies to those QTIPs created after 2005.

There is ambiguity in the language of this bill.

Persons Testifying: CON: Michael Mitchell, Washington State Budget and Policy Center; Amber Carter, Association of Washington Business; Shawn Lewis, Washington Education Association; Ramona Hattendorf, Washington State PTA; Nick Federici, Our Economic

Future Coalition; Ryan Spiller, Barbara Mesdag Trust; Lonnie Johns-Brown, League of Women Voters; Patrick Connor, National Federation of Independent Business.

OTHER: Drew Shirk, DOR; Kathryn Leathers, WSBA; Claudia Gowan, Estate and Gift Tax Committee, WSBA Tax Section; Julie Murray, Office of Financial Management, Office of the Governor.