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Hemphill v. Department of Revenue,
Thurston County Superior Court Cause No. 02-2-01722-1
Washington Estate Tax

HISTORY

The *Hemphill* class action was filed to enforce an Initiative which the Department of Revenue attempted to ignore.

State of Washington voters in 1981 by affirmative vote of more than 67% adopted Initiative 402.[1] Section 83.100.160(1) of the Initiative repealed all existing statutes relating to inheritance taxation and gift taxation by the State of Washington. The Initiative instead imposed an estate tax by stating:

> A tax *in an amount equal to the federal credit* is imposed on the transfer of the net estate of every resident. Section 83.100.030(1). (Emphasis supplied.)

On page 1 of the Initiative, Section 83.100.020(3), "federal credit" was defined as follows:

> 'Federal credit' means the maximum amount of the credit for -state death taxes *allowed* by Section 2011 for the decedent's net estate. (Emphasis supplied.)[2]

The Initiative, therefore, established in unambiguous language the Washington estate tax as exactly that amount the federal estate tax law would permit to be offset, that is, the "credit" for state death taxes. It created what is commonly described as a "pick-up" tax, because the total amount of tax paid by the estate is not increased by the Washington tax. Washington merely "picks up" the amount the estate saves on the federal return as a result of the credit. Thus, if no federal tax return need be filed by a Washington estate, there would be no "credit" for state death taxes paid and no estate tax due the State of Washington. The Initiative, in Section

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[1] Chapter 7 of Washington Laws, 1981, 2nd Extraordinary Session.

[2] Section 83.100.020(12) defined "Section 2011" as "Section 2011 of the United States Internal Revenue Code of 1954, as amended or renumbered."

83.100.050(1) merely required the Personal Representative to furnish to the State Department of Revenue a copy of the federal estate tax return and a "report" for taxes due the State of Washington. Section 83.100.050(3) provided:

> No Washington report need be filed if the estate is not subject to the tax imposed by this chapter.

Ballot Title. The Initiative's ballot title prepared by the Attorney General was:

> Shall inheritance and gift taxes be abolished, and state death taxes be restricted to the federal estate tax credit allowed?

Voter's Pamphlet. The required "Voter's Pamphlet" contained an explanatory statement by the Attorney General of the effect of the proposed measure should it be approved. It read as follows:

> **THE EFFECT OF INITIATIVE 402, IF APPROVED INTO LAW:**
>
> This initiative would repeal the state's existing inheritance and gift tax laws and would substitute, in their stead, a tax on the transfer of the net estate of a resident decedent and on the transfer of certain in-state property of a non-resident decedent. *Only estates liable for federal estate tax would be subject to tax under the initiative and the amount of the tax would be limited to the credit allowable against the federal tax.* (Emphasis supplied.)

The Washington Legislature has never amended nor repealed the portions of the Initiative quoted above.

From and after the effective date of Initiative 402, the Department of Revenue required estates to file with it a 2-page Washington estate tax return together with a copy of the estate's federal return as filed. The Washington estate tax imposed was, in accord with the Initiative, the amount of the federal credit allowed on the federal return. No state return was required unless a federal return was filed.

ESTATE AND TRANSFER TAX ACT OF 1988

By Chapter 64 of the Laws of 1988, the Washington legislature adopted the "Estate and Transfer Tax Act of 1988." This legislation, though containing many provisions relating to estate tax, did not amend the provisions of the Initiative quoted above. Section 3(1) repeated verbatim the language of the Initiative, providing that "A tax in an amount equal to the federal credit is imposed...." This legislation also provided in Section 6(1)(b):

No Washington return need be filed if no federal return is required.

In the years following the 1988 legislation, the Department of Revenue continued to require estates to file the two-page Washington Estate Tax Return together with a copy of the federal return filed by the estate. The tax collected was limited to those estates required by federal law to file a federal return as well as limited to the amount of credit for state death taxes allowed on the federal return.

ESTATE OF TURNER V. DEPT. OF REVENUE

In 1986, the Washington Supreme Court decided *Estate of Turner v. Dept. of Revenue*.[3] The Turner Estate sued for refund of Washington estate taxes paid, relying on Initiative 402. The estate had filed a federal return, but had not received any credit for state death taxes on it. This was because the estate had reduced its federal tax liability to zero by using another federal credit to which it was entitled, for tax paid on prior transfers (IRC §2013(a)). The Estate's position was stated in the opinion:

> The Turner Estate contends that Washington residents, in enacting Initiative 402, intended that a state estate tax would be due only if and when an estate tax was payable to the United States.

The court agreed, pointing to the importance of the official Voter's Pamphlet, and quoting from it:

> Only estates liable for federal tax would be subject to tax under the Initiative...

The court then quoted from the Instructions to the Washington estate tax return:

> The only sum to be collected on the estate by Washington will be that amount which the federal government allows to be deducted from the federal estate tax when a tax is paid to the decedent's state. *This credit (or deduction) is a revenue sharing feature of the Federal Government and does not add to the total tax paid by the taxpayer.*

Ultimately the court held, ordering refund:

> ...the Turner estate is not required to pay a state estate tax. To hold otherwise would defeat any revenue sharing purpose since the federal government does not require any tax payment. Furthermore, a state estate tax in this case would add to the total tax obligation of the estate since it is not required to pay federal estate tax.

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[3] 106 Wn.2d 649, 724 P.2d 1013 (1986).

DOR had argued that a WAC it had promulgated (WAC 458-57-560(6)) required disregarding other federal credits in computing Washington estate tax, the regulation stating:

> ...the amount of state estate tax shall not be reduced by the amount of any credit for tax on prior transfers, foreign death taxes or death taxes on remainders.

As a part of the court's decision, this rule was declared invalid.

ECONOMIC GROWTH & TAX RELIEF RECONCILIATION ACT (EGTRRA)

Congress amended federal estate tax laws by the enactment of Public Law 107-16, effective June 7, 2001. This legislation, entitled the Economic Growth & Tax Relief Reconciliation Act (EGTRRA) provided (summarizing):

a. Where the death occurs in 2002 or 2003 estates with a gross value of less than $1 million are not required to file a federal estate tax return; and,

b. Internal Revenue Code §2011 (26 USC §2011) was amended, to phase out and eliminate the credit for state death taxes that estates receive on their federal estate tax return. The credit had previously been based upon a graduated table, IRC §2011. Public Law 107-16 did not change the graduated table but provided that for deaths occurring during 2002 only 75% of the table would be allowed as a credit. For deaths occurring during 2003, 50% of the table would be allowed as a credit and for deaths occurring in 2004, 25% of the table would be allowed as a credit. After December 31, 2004, there would be no credit, merely a deduction permitted under IRC §2058.

Because Washington estate tax was a "pick-up" tax, imposing nothing more than the amount of credit for state death taxes allowed on the federal return, the Department of Revenue foresaw the reduction in estate tax collections resulting from the phase-out of the credit with the DOR employees exchanging emails that estimated a reduction in estate revenue of up to $140 million over several years.

INITIATIVE UNAMBIGUOUS

By early June, 2001, the Department of Revenue faced a dilemma--the Initiative, the holding in *Turner*, and the Estate and Transfer Tax Act of 1988 limited the State to pick-up of the credit allowed on the federal return and no Washington estate tax could be imposed on an estate not liable for federal tax. This meant a significant reduction in Department of Revenue estate tax collections was predictable for 2002, 2003 and 2004, with a complete phase-out of estate tax collections beginning in 2005. Any efforts by the Department of Revenue to avoid the revenue loss would collide with the unambiguous language of the Initiative, the *Turner* decision and the 1988 Act. Faced with this, the Department of Revenue went through a series of reversals of position and conflicting public announcements[4] on the effect of the Congressional phase out of the state death tax credit. Persons in the DOR suggested that Washington could ignore the

[4] During discovery on this case we obtained the documents showing the confusion in DOR.

federal changes in EGTRRA and adopt a threshold of $700,000 (and not $1 million) and impose tax in years 2002 and 2003 on estates in excess of $700,000.

However, Cindy Evans, the "Tax Policy Specialist" in the Department of Revenue prepared an analysis of the legal position of the Department of Revenue if it attempted to do that (imposing tax on estates that do not have to file a federal return and creating a "threshold" for imposition of estate tax at $700,000). She analyzed four options, describing this as the "fourth option" and she concluded in her own words that the results of attempting this were:

- Collection of estate tax above what the federal estate tax statutes authorize.

- Risks violating the intent of Initiative Measure No. 402 approved November 3, 1981. The intent of the Initiative was to allow the state to collect the amount of tax equal to the federal state death tax credit (no additional tax burden on the estate, merely shifting tax owed from the federal to the state government).

- Invitation to litigation and/or immediate legislative action. An attempt to collect more tax than allowed by the current federal estate tax statutes would probably be unsuccessful. This is because the entire estate tax chapter must be construed as a whole. Looking at 83.100.020, .030 and .040, the court could reasonably hold that the state may not collect more than the current federal state death tax credit allows.

Despite this warning from Cindy Evans, this is exactly the program DOR followed, in absence of legislation, beginning at the close of the 2002 legislative session.

The proposed program was initially rejected by DOR, agreeing with Cindy Evans that it wouldn't work and would violate the Initiative. A DOR publication entitled "Estate Tax News," (sent to Bar and CPA publications[5] published in the DOR's "Tax Facts," and added to the DOR website) announced a position entirely in accord with plaintiff's contentions in the class action:

> The state death tax credit will be phased out between now and January 1, 2005. To phase out the credit, the reporting thresholds will go up while the percent of current state credit allowable will be reduced. For instance, 2002 deaths will have a reporting threshold of $1,000,000 and the percent of the current state credit will be 75% (versus $675,000 and 100% for 2001).

Following promulgation of this "Estate Tax News," the Department of Revenue continued its concern over the loss of revenue. The final estimate showed the revenue impact on the State as a result of phase out of the credit. The estimate was a cumulative loss at $19.7 million for 2003, $50.7 million for 2004 and $79 million for 2005.

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[5] The "Estate Tax News" went to the Bar and CPAs in the fall of 2001.

REVENUE DEPARTMENT CHANGE OF POSITION, NOVEMBER 1, 2001

There was a sharp change in the position of the Department of Revenue beginning November 1, 2001. The Revenue Department at that point adopted a rationale that because Chapter 320 of the Laws of 2001 defined the Internal Revenue Code in RCW 83.100.020(15) as "United States Internal Revenue Code of 1986 as amended or renumbered as of January 1, 2001":

(a) The Department of Revenue was entitled to ignore the later enacted provision of EGTRRA phasing out the credit for state death taxes because the Washington Legislature had not "incorporated" the EGTRRA changes;

(b) The statutory language in RCW 83.100.050 reading "no Washington return need be filed if no federal return is required" now meant that an estate with a death in 2002 or 2003 (when the federal exemption is $1 million) must still file a return with the State of Washington if the estate exceeds $700,000. DOR suggested that this was because under the Internal Revenue Code as it was in 2001, that estate *would have been required* to file a federal return;

(c) Estates for persons dying after December 31, 2001 with a taxable estate of over $700,000, are required to pay the full amount of the credit listed in the graduated table in Internal Revenue Code Section 2011 *whether or not they file any federal return and whether or not they receive any credit on a federal return.*

By mid-December of 2001 the Department of Revenue resolutely declared that it would adhere to what had previously been described as the "fourth option," taxing estates that are not required to file a federal return. Despite Cindy Evans' cautionary analysis of June 13, 2001, that such a course would risk violating the intent of Initiative 402, and constitute an "invitation to litigation and/or immediate legislative action," the Department plowed ahead and "corrected" the previous Notice. This correction was sent to the CPAs and attorneys by issuing the following:

CORRECTION OF ESTATE TAX NEWS

> ...the federal Economic Growth and Tax Relief Reconciliation Act of 2001 *will not* effect (sic) Washington's current estate and transfer taxes. The Department will continue to operate under the provisions of the Internal Revenue Code as it existed on January 1, 2001 unless there is intervening action by the Washington State Legislature...the threshold for filing a Washington estate tax return will be $700,000 and the state death tax credit due to Washington will remain at 100% even though the IRC only allows 75% of the state death tax credit as a deduction...We regret any confusion our earlier notice may have caused.

TAXES THE DEPARTMENT OF REVENUE IMPOSED ON ESTATES WHERE THE DEATH OCCURRED AFTER DECEMBER 31, 2001

1. *Estates between $700,000 and $999,999.* These estates did not file a federal return. These estates for the years 2002 and 2003 were exempt from filing a federal return if under $1 million. The estates accordingly received no credit for state death tax on a federal return. DOR imposed a Washington estate tax on these estates in the amount of the table in IRC §2011 which, for an estate of $999,999 is $33,200 in Washington estate tax. DOR by doing this completely changed the meaning of the words "federal credit" in the Initiative and in the Estate and Transfer Act of 1988.[6]

2. *Estates over $1 million* . These estates filed federal returns. Some of the federal returns received credit for state death taxes and some did not. These estates fell into two categories:

(a) Estates that are at or over $1 million, that, because of other factors owe no federal tax and accordingly receive no "credit for state death taxes" on the federal return. These estates do not need, nor receive, any credit for state death taxes on the federal return. Yet, DOR, ignored the Initiative, which limits the tax to the amount of the federal credit allowed, imposed Washington estate tax in the full amount of the IRC §2011 table. DOR again merely looked at what could be available in the table in IRC §2011 and imposed this tax.

(b) The other category is estates over $1 million that received credit for state death taxes on the federal return but were assessed Washington estate taxes in excess of that amount. DOR, again looking not at the credit allowed but rather what could be available in the table in IRC §2011, imposed a state tax in excess of the credit allowed.

HEMPHILL V. DEPARTMENT OF REVENUE

We filed the Hemphill case during the first week of October, 2002 on behalf of three classes as described above in 1, 2(a) and 2(b).

The trial court, over the objection of the defendants, certified the plaintiffs' claims as class claims pursuant to CR 23(b)(2), a so-called "mandatory" class action. Accordingly there was no opportunity for an estate to opt out of the litigation, with the court ruling that all estates of Washington residents where death occurred after December 31, 2001, that had paid Washington estate tax were members of the classes certified. The court approved three classes:

a. Estates that had filed federal estate tax returns and paid federal estate tax and had received credit for state death taxes on the federal return, but were required by

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[6] For over 20 years, DOR's interpretation of "federal credit" was in accord with the Initiative and meant the amount of the credit allowed on the federal return. DOR's new meaning was the amount on the IRC Section 2011 table, whether or not any credit is allowed on a federal return and whether or not the estate has even filed a federal return.

Washington state to pay Washington estate tax in excess of that credit (the "Hemphill class");

b. Estates that had filed federal estate tax returns but had received no credit for state death taxes on the federal return but were nevertheless required to pay Washington estate tax (the "O'Brien class"); and

c. Estates that were not required to file and did not file any federal estate tax return but were nevertheless required to pay Washington estate tax (the "Shea class").

The trial court decided all issues in the case on cross motions for summary judgment, argued and decided on October 29, 2003. The trial court based its decision on legislative intent, concluded that the statutory scheme was not ambiguous and adopted the argument of the Department of Revenue that the definition of "Internal Revenue Code" in RCW 83.100.020(15) adopted by the Legislature in 2001 was controlling. The trial judge held that since the Washington Legislature had not "incorporated" the federal changes to the §2011 credit, Washington was entitled to impose estate tax in the full amount of the §2011 table. The trial court also held that the Washington estate tax is no longer a "pickup" tax but rather a "stand-alone" tax. Plaintiffs' argument that to interpret the statutory 2001 "updating" of the definition of IRC to permit imposition of new and additional Washington estate tax would render the statute unconstitutional was not addressed by the trial court.

We filed appeal of the trial court ruling and obtained direct review by the State Supreme Court. The Supreme Court argument was held on September 30, 2004.

CLASS MEMBERSHIP FOLLOWING SUMMARY JUDGMENT HEARING

The written order on the October 29th hearing was entered on December 19, 2003.

The trial court ruled that the only estates that are to be members of the class and bound by the trial court's December 19th decision are those estates falling within the definition of the classes and having paid estate taxes on or before December 19, 2003.

At our request, the court signed a second order on December 19th permitting the classes to expand during the pendency of any appeal by the Personal Representative signing and mailing to plaintiffs' attorneys a separate "Request to Join Class Action as Member." Over 900 estates joined the class action in this manner.

SUPREME COURT DECISION OF FEBRUARY 3, 2005

On February 3, 2005 the Supreme Court unanimously ruled in favor of the plaintiff classes, holding that Washington's estate tax is still merely a "pickup" tax based on current federal law.

The opinion written by Justice Charles Johnson recognized the Department of Revenue contention that the statutory language (the definition of Internal Revenue Code "as of January 1, 2001") tied the Washington estate tax to federal law as of January 1, 2001. However, the opinion pointed out:

a. Washington's estate tax is received not as a separate tax but through "a tax credit established by the federal code;"

b. The issue is whether the Legislature's inaction in not revising the statutory definitional references has changed Washington estate tax from a "pickup tax based on current federal law;"

c. The *Turner* decision pointed out that in the Initiative Voter's Pamphlet "only estates that are liable for federal estate tax would be subject to tax under the Initiative" and *Turner* held that "pickup" 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 to the extent of the allowable credit;"

d. *Turner* rejected the Department of Revenue position that Washington estate tax statutes impose an independently operated Washington estate tax;

e. Unless and until the Washington Legislature revises the statutes to *expressly* create a stand-alone estate or inheritance tax, DOR cannot follow an interpretation that total tax obligations exceed federal obligations; and,

f. Our statute says (and has said since 1988) "no Washington return need be filed if no federal return is required." Accordingly, it is not possible to accept the Department of Revenue argument that the reference in the statute to the Internal Revenue Code as of January 1, 2001 can mean that a state return is required even though no federal return is required. This would create, at best, an ambiguity in the statutes requiring resolution of the conflict in favor of the taxpayer.

The practical effect of the decision was be a refund of taxes paid that were in excess of the federal credit allowed on the estate's federal return.

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