

WASHINGTON STATE ESTATE TAX OPTIONS

Background

Until 1981, Washington levied an inheritance tax measured by the amounts passing to beneficiaries according to three classes based on the relationship of the beneficiary to the decedent.¹ This tax was repealed by a voter initiative in November 1981, leaving in its place an estate tax² equaling only the amount of the federal estate tax credit for state death taxes.

Washington's current estate tax is referred to as a "pick-up" tax because it consists of the maximum amount of credit that has been allowed to the taxpayer's estate under federal estate tax law for state death taxes (commonly called the "federal credit"). Thus, Washington's estate tax does not constitute an additional tax on the estate; it merely shifts revenues from the federal government to the state. In other words, the state "picks up" the dollars that would otherwise have remained with the federal government.

Washington's Estate and Transfer Tax Act, Chapter 83.100 RCW, relies heavily on the federal estate and gift tax statutes and refers to several sections of the Internal Revenue Code (IRC) as it existed on January 1, 2001.³ Since 1990, Washington's estate tax statutes have been periodically amended by the Legislature so that Washington's statutes conform to the IRC.⁴

How does the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) impact Washington Estate tax?

Because Washington's estate tax statutes refer to the IRC as of January 1, 2001, the amendments made by the EGTRRA will not have an impact on Washington's estate tax revenue stream unless Washington's estate tax statutes are amended to conform to the current IRC. The federal amendments made by the EGTRRA include:

- Increasing the gross estate value subject to tax from \$700,000 to \$1 million on January 1, 2002. The exclusion amount continues to increase to \$3,500,000 by 2009.
- Reducing the maximum tax rate from 55% to 50% (in 2002) and yearly 1% reductions until it is 45% in 2007.
- Repealing the 5% surcharge on taxable estates between \$10,000,000 and \$17,184,000.

¹ The inheritance tax, originally enacted in 1901 (Chapter 55, Laws of 1901), was levied on all estates. There were limited dollar amounts exempted for certain lineal ancestors.

² An estate tax is one that is levied on the right to transfer property and an inheritance tax is levied on the right to receive property. Under an estate tax, the estate pays the tax and under an inheritance tax program, the tax is levied on and paid by the heir/beneficiary of the property.

³ For example, RCW 83.100 refers to sections 2011, 2031, 2032A(c), 2604, 2611, and 2652 of the IRC. RCW 83.100.020(15) states, "'Internal Revenue Code' means, for the purposes of this chapter and RCW 83.110.010, the United States Internal Revenue Code of 1986, as amended or renumbered as of January 1, 2001."

⁴ The original definition section of the initiative repealing the inheritance tax referred to the "United States Internal Revenue Code of 1954, as amended or renumbered." The incorporation of *future* federal statutes or regulations into Washington statute is an unconstitutional delegation of legislative power under Article 2, §1 of Washington's Constitution. *State v. Dougall*, 89 Wn. 2d 118, 122-23, 570 P.2d 135 (1977). The definition section of RCW 83.100.020 was first amended in 1990 to refer to the IRC as of a specified date.

- Reducing the graduated state death tax credit by 25% per year starting in 2002. The federal state death tax credit is eliminated for deaths occurring after December 31, 2004.
- Broadening the definition of land that qualifies for a conservation easement.
- Adding to the list of entities that qualify to pay the estate tax in installment payments.

What are the options available to the Legislature?

The following limited number of options are those assumed to be the most likely alternatives, and assumes that an estate tax is preferable to an inheritance tax. The Legislature could consider any number of different approaches.

Option #1 Washington continues to operate under the IRC as it existed on 1/1/2001, collecting 100% of the state death tax credit.

Projected collections under current law:

FY 2002	\$102,833,400
FY 2003	\$105,699,100
FY 2004	\$105,558,000
FY 2005	\$109,827,300
FY 2006	\$113,881,800
FY 2007	\$122,370,800

The above estimates do not reflect the additional costs that the Department would incur to be able to collect a state-administered estate tax.

- The Department would face significant administrative challenges and additional administrative costs attempting to administer the estate tax program. Under present law, the Department has very limited administrative authority. For example, the Department has no authority to audit.
- The Department may face an increased litigation risk since the collection of more than the federal credit (pick-up tax) may be viewed as violating the original intent of the 1981 initiative that repealed the inheritance tax. Legal opinions vary widely on the result of such a challenge.
- Washington’s estate tax ceases to be merely a pick-up tax and becomes an estate tax that adds an additional tax burden to all estates.
- Taxpayers would be required to file and pay tax to Washington that are not required to file or pay a federal estate tax.
- There will likely be significant taxpayer confusion because Washington’s estate tax will be relying on an obsolete version of federal estate tax code. Tax planning will be complicated.

Option #2 The Legislature amends Washington’s Estate and Transfer Tax Act to conform to the federal estate tax statutes as amended by EGTRRA. (Current bills before the Legislature - HB 2897/SB 6762)

There would be negative state revenue impacts for the years following FY 2002.

FY 2002	- -
FY 2003	\$25,292,000
FY 2004	\$51,843,000
FY 2005	\$76,628,000
FY 2006	\$101,782,000
FY 2007	\$110,372,000

- Estate tax revenue ceases in FY 2007. The Department would continue to receive estate tax returns until March 2006. This is because federal law requires an executor to complete and file the federal estate tax and gift return within nine months but the Internal Revenue Service routinely gives a six-month extension to file. The result is a fifteen-month delay between the death of the decedent and the filing of most federal estate and gift tax returns.
- There will be no administrative impacts on the Department.
- There would be consistency for taxpayers.
- Failing to conform to the federal phase out of the estate tax will result in considerable opposition by newspapers, farms, and small business owners.

Option #3 The Legislature amends Washington's Estate and Transfer Tax Act to conform to the federal estate tax statutes as amended by EGTRRA for one year. The legislation would sunset on December 31, 2002, with the reference to the IRC reverting back to the IRC as it existed on January 1, 2001.

The projected fiscal impact of this option is a combination of the previous two, whereby the state would advance the conforming date with the IRC but only for the first year. It is assumed that on January 1, 2003, the state tax would revert to what was provided under the January 1, 2001, IRC and that the state would administer this tax. Under this scenario, the reduction in estate tax revenues on the basis of cash receipts would be:

FY 2002	- -
FY 2003	\$80,407,100 (105,699,100 – 25,292,000)
FY 2004	\$105,558,000
FY 2005	\$109,827,300
FY 2006	\$113,881,800
FY 2007	\$122,370,800

- There would be no administrative impacts on the Department for the estates of decedents who die between January 1, 2002, and December 31, 2002.
- This option would provide the Legislature with additional time to determine the direction the state wants to take regarding the estate tax.
- Tax planning will be complicated.
- Failing to completely conform to the federal phase out of the estate tax will result in considerable opposition by newspapers, farms, and small business owners.

Option #4 Conform to all of the amendments made to the IRC by EGTRRA, except for 26 U.S.C. § 2011 (Section 2011), which would be tied to the IRC as it existed on January 1, 2001. Washington would continue to collect 100% of the federal credit. (Current bill before the Legislature – SB 6785)

Assumptions:

1. Section 2011 contains the “credit for state death tax” (federal credit) provisions.
2. The other estate tax changes made to the IRC by the EGTRRA would be available. These include the increased unified credit (26 U.S.C. § 2010), the new federal provisions for qualified conservation easements (26 U.S.C. § 2031), and the provisions for installment payment plans (26 U.S.C. § 6166).
3. For Washington estate tax purposes, the federal credit for state death taxes would not be phased-out over three years and the Department would continue to collect 100% of the federal state death tax credit.
4. For Washington estate tax purposes, the state death tax credit would not be terminated for decedents dying after December 31, 2004.
5. The federal and state estate tax programs cease for those decedents who die after December 31, 2009, unless Congress acts to extend the federal estate tax program.

The negative fiscal impacts of this option are projected at:

FY 2002	\$0
FY 2003	\$8,278,000
FY 2004	\$11,093,000
FY 2005	\$18,795,000
FY 2006	\$18,477,000
FY 2007	\$25,001,000

- Preferred approach of Senate Ways and Means Committee.
- The Department does not anticipate additional administrative costs for this option.
- Failing to completely conform to the federal phase out of the estate tax will result in considerable opposition by newspapers, farms, and small business owners.

Option #5 The Legislature replaces the current estate tax with a new estate tax that is independent from the federal estate and gift tax program.

- There is no way to estimate any state-level estate tax below \$600,000 because no federal or state data exist on smaller estates, since these estates have not been historically subject to tax. The estimates reflect the average relationship between gross estate values and the net value after deduction of debts and charitable contributions, based on federal information. Listed below are three possible flat rate estate taxes with differing levels of thresholds. Also, two graduated rate state taxes are outlined.

Annual Revenue Yield Compared to
Projected Collections for FY 2002

A. Flat Rate 5% Estate Tax:		
Threshold of \$600,000		\$96.6 million (-6.2 million)
Threshold of \$750,000		\$90.4 million (-12.4 million)
Threshold of \$1,000,000		\$72.2 million (-30.6 million)
B. Flat Rate 10% Estate Tax:		
Threshold of \$600,000		\$193.1 million (+90.3 million)
Threshold of \$750,000		\$180.7 million (+77.9 million)
Threshold of \$1,000,000		\$144.3 million (+41.5 million)
C. Flat Rate 15% Estate Tax:		
Threshold of \$600,000		\$289.7 million (+186.9 million)
Threshold of \$750,000		\$271.1 million (+168.3 million)
Threshold of \$1,000,000		\$216.5 million (+113.7 million)
D. Graduated Rates: 5% - 15%:		\$259.2 million (+156.4 million)
Below \$600,000	no tax	
\$600,000 - \$750,000	5%	
\$750,000 - \$1,000,000	10%	
Above \$1,000,000	15%	
E. Graduated Rates: 10% - 20%:		\$355.8 million (+253 million)
Below \$600,000	no tax	
\$600,000 - \$750,000	10%	
\$750,000 - \$1,000,000	15%	
Above \$1,000,000	20%	

- The above estimates are based on the following assumptions:
 1. The tax would be an “estate tax.” An estate tax is one that is imposed on the right to transfer property by death. The tax is levied on the decedent’s estate and not on the heir receiving the property. Under an estate tax system, the tax is levied on the estate and paid by the personal representative prior to the distribution of assets. An inheritance tax is levied on the right to receive property. Under an inheritance tax program, the tax is levied on and paid by the heir/beneficiary of the property. From an administrative prospective, an estate tax is superior to an inheritance tax because the state would secure payment from the personal representative rather than the possible numerous heirs.
 2. The net taxable estate passing to the surviving spouse of the decedent would be exempt from taxation. This policy allows the surviving spouse to not bear the additional financial burden of an estate tax. The estate of the first spouse to die would be required to file an estate tax return but because of the exemption there would be no tax due. The estate tax would be levied on what remains of the estate upon the death of the surviving spouse.

3. The determination of the threshold for paying an estate tax should be based on the amount of revenue to be generated and the policies behind estate taxation. The revenue generated by the tax is a function of the threshold for filing/paying and the tax rate. One of the policies to be considered is what level of wealth should be subject to the tax. If a lower threshold is considered then the total exemption for an estate passing to a surviving spouse becomes even more important. (See number two above.) This is because the value of a family home could exceed a lower threshold for filing and may require the surviving spouse to sell or mortgage the family home to pay the tax if the estate did not have any other assets. Three thresholds have been selected as samples of revenue generated: \$600,000.00, 750,000.00, and \$1,000,000.00.
 4. The tax rate could be flat or graduated. A flat tax is easier to administer but not progressive. The estimates provided are based on a flat tax at several different rates: 5%, 10%, and 15%. There are two estimates for a graduated tax rate system. One where the rate between \$600,000 and \$750,000 is at 5%, between \$750,000 and \$1,000,000 at 10%, and everything at one million dollars plus at 15%. The second graduated tax rate estimate is where the rate between \$600,000 and \$750,000 is at 10%, between \$750,000 and \$1,000,000 at 15%, and everything at one million dollars plus at 20%.
 5. All estates would be required to secure a release from the Department prior to distributing a decedent's assets, including those estates where an estate tax return would not have to be filed. Estates not filing an estate tax return would submit an affidavit stating the value of the decedent's estate and that it did not exceed the filing threshold.
- Electing this option would ensure continuing estate tax revenue when the federal credit is eliminated for decedent's dying after December 31, 2004.
 - There would be significant initial administrative costs.
 - Enacting a replacement estate tax will result in considerable opposition by newspapers, farms, and small business owners.