The Gift Tax in North Carolina

A Review Of Recent Events

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North Carolina imposes a gift tax regime that is in certain respects distinct from federal law.[1] North Carolina advisors are aware of the $100,000 state gift tax exemption[2] and the possibility that a gift can trigger state gift taxes although no federal gift taxes are owed (the current federal gift tax exemption is $1,000,000). North Carolina advisors are also aware that the North Carolina gift tax rates differ depending on whether the gift is made to a Class A, B, or C beneficiary.[3] Although North Carolina gift tax law is not "piggy-backed" on the federal system (as is the case with the North Carolina income and estate tax regimes), North Carolina case law and tax statutes acknowledge a relationship between federal and North Carolina gift tax law. The North Carolina Supreme Court has stated " . . . generally it is preferable that state taxation statutes be interpreted consistently with their federal counterparts. This is especially important when the statute involved is one of technical taxation law and not involving a common law issue . . . " **Stone v. Lynch,** 312 N.C. 739, 745, 325 S.E.2d 230, 234 (N.C. 1985). The North Carolina gift tax statutes preserve the annual exclusion (with a reference to the federal inflation-adjusted exclusion amount) and the marital deduction for transfers to qualified terminable interest property (with a reference to the relevant portion of the Internal Revenue Code). However, the extent of the relationship between federal and North Carolina gift taxes is at times unclear.

For this article, we wanted to review the North Carolina gift tax treatment of two common estate planning techniques in light of recent positions taken by the North Carolina Department of Revenue (the "NCDOR"). The NCDOR has recently interpreted the North Carolina gift tax statutes in a way that creates unintended North Carolina gift taxes for taxpayers in two separate planning situations. The positions taken by the NCDOR are in direct contrast to the treatment of the transactions under federal gift tax law. Because North Carolina gift tax rates reach 17 percent, the stakes are significant for North Carolina taxpayers and their advisors. These two planning situations are as follows:

1. **QPRTs.** First, with respect to qualified personal residence trusts (which shall be referred to as a "QPRT"), the NCDOR has interpreted N.C.G.S. Section 105-195 to allow the NCDOR to ignore the value of a retained right of the settlor of the QPRT to reacquire the residence if the settlor dies during the term of the QPRT.

2. **Incomplete Gifts.** Second, with respect to trusts in which the settlor has retained a special power of appointment with the intention of creating an incomplete gift for gift tax purposes, the NCDOR has indicated it will treat the transfer as a completed gift for North Carolina gift tax purposes.

Qualified Personal Residence Trusts

In the typical QPRT, the settlor transfers his personal residence to an irrevocable trust and retains the right to live in the residence for a specified number of years (this retained right is also referred to as the "income interest"). After the specified number of years, the residence passes to the settlor's children or an irrevocable trust for the benefit of the children. In the typical QPRT, the QPRT also provides that if the settlor does not survive the specified term, the residence will be distributed to the estate of the settlor (this retained right is also referred to as a "reversion"). Pursuant to the valuation rules set forth in Chapter 14 of the Internal Revenue Code, the amount of the taxable gift for federal gift tax purposes is determined by calculating the fair market value of the residence and subtracting the value of (i) the right to live in the residence rent-free for the term of years and (ii) the right to reacquire the residence if the client dies during the term of the QPRT. The ability of a settlor to reduce the taxable gift by the value of these retained interests makes the QPRT an effective estate planning technique that is sanctioned by the IRS.

North Carolina gift tax law contemplates the valuation of retained interests. N.C.G.S. Section 105-195 states in part:

"If the gift subject to said tax be given to a donee for life or for a term of years, or upon condition or contingency, with remainder to take effect upon the termination of the life estate or term of years or the happening of the condition or contingency, the tax on the whole amount shall be due and payable as in other cases, and said tax shall be apportioned between such life tenant or tenant for years and the remainderman, such apportionment to be made by computation based upon the mortuary and annuity tables set out in G.S. 8-46 and 8-47 of the General Statutes, and upon the basis of six per centum (6%) of the gross value of the property for the period of expectancy of the life tenant or for the term of years in determining the value of the respective interests."

Despite this language referring to a gift "upon condition or contingency," the NCDOR has relied on N.C.G.S. Section 105-195 to disregard the value of the reversion (the value of the right to reacquire the residence if the settlor dies during the term of the QPRT). The NCDOR initially asserted this position on the audit of a gift tax return disclosing a QPRT. The taxpayer litigated the issue and the NCDOR eventually prevailed when the North Carolina Supreme Court affirmed the case. See **Downs v. State,** 159 N.C. App. 220, 582 S.E.2d 638 (N.C. App. 2003), affirmed 358 N.C. 213, 593 S.E.2d 763 (N.C. 2004). The portion of N.C.G.S. Section 105-195 relied on by the NCDOR reads as follows:

"When property is transferred or limited in trust or otherwise, and the rights or interests of the transferees or beneficiaries are dependent upon contingencies or conditions whereby they may be wholly or in part created, defeated, extended, or abridged, a tax shall be imposed upon said transfer at the highest rate, within the discretion of the Secretary of Revenue, which on the happening of any of the said contingencies or conditions would be possible under the provisions of this section, and such tax so imposed shall be due and payable forthwith by the donor, and the Secretary of Revenue shall assess the tax on such transfers."

In **Downs**, the North Carolina Department of Revenue argued that (i) the right of the settlor to reacquire the residence if the settlor dies during the term of the QPRT is a contingent right, (ii) N.C.G.S. Section 105-195 allows the NCDOR to value the transfer upon the happening of any of the possible contingencies, and (iii) the NCDOR is therefore authorized to assume the settlor survives the term of the QPRT and ignore the value associated with the reversion retained by the settlor.

Example. In December of 2005, client, age 70, transfers personal residence to a QPRT. The fair market value of the residence is $1 million. Pursuant to the terms of the QPRT, the client retains (i) the right to live in the residence for a term of 15 years, and (ii) the right to reacquire the residence

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if he dies during the 15-year term. The applicable Section 7520 rate is 5.4 percent.

Federal Gift Tax Consequences. Under federal gift tax law, the current taxable gift is calculated after taking into account the interests the client has retained. First, client retained the right to live in the residence for 15 years (this is referred to as the "income interest"). Second, under the terms of the QPRT, client retained the right to reacquire the resident if client dies during the 15-year term (this is referred to as a "reversion"). Using the assumptions in the example, the value of the income interest is $426,410 and the value of the reversion is $371,300. The total value of the retained interests is $797,710 (426,410 + 371,300). Thus, client has made a current federal gift of $202,290 ($1,000,000 fair market value of residence less $797,710 value of retained interests). Client can shield this taxable gift from federal gift taxes by using a portion of his $1,000,000 federal gift tax exemption.

N.C. Gift Tax Consequences. Under the NCDOR's methodology, the value of the client's gift cannot be reduced by the value of the reversion. The NCDOR does allow the gift to be reduced by the value of the income interest, as calculated pursuant to N.C.G.S. Section 8-47. The North Carolina gift would be calculated as follows:

Fair Market Value of Residence:	$1,000,000
Annual Income (FMV x 6 percent) per N.C.G.S. Section 8-47:	$60,000
Present Value of $1.00 for a term of 15 years:	x 9.712
Value Retained by Client (Annual Income x Present Value):	$582,720
Value of Gift (FMV of Residence - Value Retained):	$417,280

The amount of the gift for North Carolina purposes ($417,280) is more than double the amount of the gift for federal purposes ($202,290). Under the NCDOR's methodology and assuming the gift is to a Class A beneficiary and the client has previously used his $100,000 gift tax exemption, the QPRT will trigger $21,187 in North Carolina gift taxes.

Is An Incomplete Gift Possible in North Carolina?

Under certain estate planning and asset protection techniques, a settlor may desire to make a transfer (in trust or otherwise) that is treated as an incomplete gift for gift tax purposes. Under federal gift tax law, if the settlor retains a special power of appointment the gift will be incomplete for federal gift tax purposes. The retention of a special power of appointment is often used as part of a self-settled trust sitused either in a state that purports to provide creditor protection for self-settled trusts (such as Alaska, Delaware, and Nevada) or in a foreign jurisdiction that provides creditor protection for such trusts.

The NCDOR has recently stated that a retained special power of appointment created in conjunction with a gift will be ignored for North Carolina purposes and the entire amount of the gift will be taxed. This is in direct contrast to federal law. It is the authors' understanding that this position is in part motivated by a desire to curb certain types of Medicaid planning which rely on transfers of assets outright or in trust with a retained special power of appointment and which are often structured as incomplete gifts so that there are no gift tax consequences.

The NCDOR asserted this position in a case involving a North Carolina taxpayer who executed a gift deed transferring a 99 percent undivided interest in a tract of North Carolina real estate. The gift deed specified that the taxpayer retained a testamentary special power of appointment. The NCDOR has assessed North Carolina gift taxes on the transfer. The NCDOR stated their position as follows:

"With regard to a special power of appointment, G.S. 105-188.1(c) provides that neither the exercise nor the relinquishment of a special power of appointment with respect to an interest in property shall be deemed to constitute a gift of such interest in such property. Because the statute provides the exercise or relinquishment of the power would not constitute or "complete" a gift, then the gift must be complete at the time of the transfer of the property subject to the power. Consequently, for State gift tax purposes, the gift occurs when the property is transferred subject to the special power of appointment rather than upon the relinquishment or termination of the power."

The NCDOR initially treated the transfer as one to a Class A beneficiary and allowed the $100,000 gift tax exemption. However, because the special power of appointment retained by the taxpayer included potential appointees who were not Class A beneficiaries, it is the authors' understanding that the NCDOR is taking the position that the transfer is one to a Class C beneficiary, thereby taxing the transfer at the higher rate schedule and precluding the use of the $100,000 gift tax exemption.

Example. Client is interested in asset protection. Client transfers cash and marketable securities with a fair market value of $10 million to a self-settled trust sitused in Nevada. Because the client does not want to pay federal gift tax on the transfer, client retains a testamentary special power of appointment.

Federal Gift Tax Consequences. Under federal law, the retention by the client of a special power of appointment should make the gift incomplete for federal gift tax purposes. Client is required to disclose the incomplete gift on a federal gift tax return but no taxable gift has occurred.

North Carolina Gift Tax Consequences. For North Carolina purposes, NCDOR has taken the position that the transfer is a completed gift. Under the NCDOR's methodology, North Carolina gift tax would be owed based on a gift of $10 million. Assuming the transfer is to a Class C beneficiary, the North Carolina gift tax would be $1,640,650.

The "Deemed" Transfer

N.C.G.S. Section 105-188.1(d) is an intriguing statute because it contemplates a "deemed" transfer for North Carolina gift tax purposes and appears to allow the taxpayer to designate the donee of the transfer solely for purposes of calculating the North Carolina gift tax. The relevant statutory language reads as follows:

"If in connection with any gift of property the donor shall give to any person a special power of appointment with respect to any interest in such property, the donor shall be deemed for gift tax purposes to have given such interest in equal shares to those persons, not more than two, among the possible appointees and takers in default of appointment whom the donor or his executor or administrator may designate in the gift tax return filed with respect to such gift. But the tax shall be computed according to the relationship of the donee of the power to the person designated if:

(1) The possible appointees and takers in default of appointment include any persons more closely related to the donee of the power than to the donor, and

(2) Such computation would produce a higher tax."

Many gifts are made to irrevocable trusts. Many irrevocable trusts contain special powers of appointment in which the permissible appointees exclude the powerholder, the powerholder's creditors, the powerholder's estate or the creditors of the powerholder's estate. If the class of appointees includes charities or the spouse of the donor, a literal reading of N.C.G.S. Section 105-188.1(d) appears to present a planning opportunity to avoid North Carolina gift taxes (see example below). Although the application of this statute appears clear upon an initial reading, the authors' suggest that advisors proceed with caution if they are planning to fall within the statute. This is particularly true in light of the last sentence of the statute which contemplates situations in which the transfer will be taxed according to the relationship of the donee of the special power of appointment to the person designated.

Example. For estate planning purposes, client makes a gift of $1,000,000 in closely-held stock to an irrevocable trust for the benefit of his wife and children. The irrevocable trust grants an unrelated party a lifetime special power of appointment and is drafted so that the class of appointees includes the wife of the client.

Federal Gift Tax Consequences. Client has made a taxable gift of $1,000,000. Client pays no federal gift tax because client has his $1,000,000 federal gift tax exemption available to shield the gift from federal gift taxes.

North Carolina Gift Tax Consequences. Client files a North Carolina gift tax return and "designates" his wife as the designated appointee under the special power of appointment. Pursuant to N.C.G.S. Section 105-188.1(d), client is "deemed" for North Carolina gift tax purposes to have made a $1,000,000 gift to his wife. This "deemed" transfer is entitled to a marital deduction and no North Carolina gift tax should be owed. Absent the designation on the North Carolina gift tax return, the North Carolina gift tax on a $1,000,000 gift would be $61,150, assuming the gift is to a Class A beneficiary and the donor has previously used his $100,000 gift tax exemption.

Conclusion

North Carolina taxpayers and their advisors should be aware of the distinctions between the federal and North Carolina gift tax regimes. Based on recent actions taken by the NCDOR, it appears that the NCDOR is interpreting the North Carolina gift tax regime in a way that ignores established federal gift tax principles and increases the distinctions between federal and North Carolina law. By ignoring established federal gift tax principles, the NCDOR is making the administration of the state gift tax unpredictable.

North Carolina gift tax laws should either be repealed or amended so that North Carolina law follows federal law in determining when a gift has occurred and the value of a gift. If the North Carolina gift tax law is not repealed, the authors suggest that the state gift tax exemption be increased to equal the federal gift tax exemption (currently $1,000,000). A bill was introduced in the North Carolina legislature in 2005 to amend N.C.G.S. Section 105-195 to provide that the fair market value of a gift in North Carolina would be determined based on federal gift tax principals. The bill, which was supported by this Section, has not been enacted as of the date of this article. ■

Endnotes

1. For reference, the North Carolina statutes covering gift taxes can be found in N.C.G.S. § 105-188 through § 105-197.1. A mortality table can be found in N.C.G.S. § 8-46 and an annuity table can be found in N.C.G.S. § 8-47.

2. The $100,000 state gift tax exemption is only available for gifts to Class A beneficiaries. No exemption is available for gifts to Class B or Class C beneficiaries.

3. Class A beneficiaries include children, grandchildren, stepchildren, and parents. Class B beneficiaries include brothers, sisters, aunts, uncles, nieces and nephews. Class C beneficiaries include all other donees.

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