View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by University of North Carolina School of Law

North Carolina Law Review

Volume 27 | Number 1 Article 13

12-1-1948

Planning for North Carolina Death and Gift Taxes

William J. Adams Jr.

Follow this and additional works at: http://scholarship.law.unc.edu/nclr

Part of the Law Commons

Recommended Citation

William J. Adams Jr., *Planning for North Carolina Death and Gift Taxes*, 27 N.C. L. Rev. 114 (1948).
Available at: http://scholarship.law.unc.edu/nclr/vol27/iss1/13

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

PLANNING FOR NORTH CAROLINA DEATH AND GIFT TAXES

WILLIAM J. ADAMS, JR.*

I. THE PLACE OF STATE DEATH AND GIFT TAXES IN ESTATE PLANNING

A. Unlike certain other states which levy death taxes designed merely to absorb the 80% federal credit, or which have relatively nominal rates, North Carolina levies an inheritance tax of such proportions that it can be a substantial factor in computing the tax bill for an estate plan.

B. Where both federal and state death tax liability will be incurred, the higher federal rates usually make a federal tax plan the primary consideration. However, in some cases it is possible to make property dispositions which will minimize both federal and state taxes at the same time; and since the enactment of the federal Revenue Act of 1948, the state death tax is of added interest and importance because of its effect on the marital deduction permitted under the new federal estate tax amendments. Furthermore, with respect to the smaller estates where no federal death tax liability will be involved, a familiarity with the state law can make possible definite tax savings.

C. In planning for state taxes, the first question to be asked about any plan is whether it is inadvisable for federal tax reasons.

D. In state tax planning, *all* state taxes must be considered. However, because of limitations of time, this discussion will be limited almost entirely to the possibilities of planning with respect to state death and gift taxes. A general familiarity with the state death and gift tax laws will be assumed, and this discussion will be directed toward suggesting certain basic approaches in minimizing state death and gift taxes, in emphasizing certain differences between the state and federal laws, and in analyzing some of the provisions which offer opportunities for tax savings. No attempt will be made to cover many of the tax saving techniques which may be used under both the federal and state laws, it being the purpose of this discussion to focus attention largely on the special and unique provisions of the state laws.

E. It is obvious that one must look for possibilities of saving state death and gift taxes to the following factors: (1) the exclusion of the property involved from the taxing jurisdiction of the state; (2) the exclusion of the property involved from the gross taxable estate; (3) the obtaining of the maximum available exemptions; (4) the obtaining

* Member of the Greensboro North Carolina Bar.

of the maximum available deductions; and (5) the obtaining of the lowest available rates. An attempt will be made to point out the major possibilities for tax savings inherent in each of the above factors.

II. Taxing Situs and Jurisdiction

A. Since a state is limited in its jurisdiction to levy taxes of any kind, it is important to bear in mind the basic principles. Frequently clients have business interests in more than one state, or are contemplating a change of domicile, and in such situations problems of working out the most favorable state tax results come to the forefront. In all such cases, the importance of securing the exact and detailed facts cannot be over-emphasized.

B. The North Carolina inheritance tax may constitutionally be, and is, levied on the receipt of:

1. Real property and tangible personal property located in this state, regardless of the residence of the decedent. Real and tangible personal property located out of the state is not taxed. Of course, tangible personalty which is only casually or temporarily in the state at the decedent's death, and has a bona fide permanent location elsewhere, is not to be considered as located in this state.

2. All the intangible personal property of a person domiciled in North Carolina, regardless of whether another state may also tax.

3. Intangible personal property owned by a decedent not domiciled in North Carolina if it has a commercial or business situs in this state. But the law specifically provides that intangibles held in trust shall not be considered as having a taxable situs in North Carolina "merely because the trustee is a resident, or if a corporation, is doing business in this state, unless the same be employed in or held or used in connection with some business carried on in whole or in part in this state."

C. While there have been very few court decisions dealing with the jurisdiction of the state to levy gift taxes, it would seem that, since the North Carolina gift tax is levied upon the share of a donee in all property within the jurisdiction of the state which passes by gift, the same principles stated above with reference to death taxes would apply with respect to gift taxes.

III. Property Includable in the Gross Estate

A. The North Carolina death tax is almost as comprehensive as is constitutionally possible, and like the federal estate tax reaches not only transfers by will or intestacy, but also substitutes for such transfers,

such as transfers intended to take effect in possession or enjoyment at or after death, and gifts in contemplation of death.

B. With respect to *gifts in contemplation of death*, there is a rebutable presumption that a gift is in contemplation of death as to every transfer within *three* years prior to death if such transfer is (1) of property exceeding 3% of the estate, or (2) is in the nature of a final disposition or distribution of the estate, and if in either case the transfer is without an "adequate valuable consideration." This is in contrast to the federal provision that any transfer of a material part of the estate within *two* years prior to death without adequate consideration shall be deemed to have been made in contemplation of death unless shown to the contrary.

C. With respect to *powers of appointment:*

1. The state law, unlike the federal law, does not recognize any difference between a *general* and a *special* power.

3. If the power is exercised by the donee of the power, the rate of tax is based on the relationship between the donor of the power and the beneficiary ultimately receiving the property.

3. If the donee of the power fails to exercise it, the property covered by the power is nevertheless includible in the gross estate of the donee at the donee's death just as if the donee had exercised the power in favor of those becoming entitled to it; and in such event, apparently the rate of tax is determined by the relationship of the *donee* of the power to the beneficiaries ultimately receiving the property.

4. Under the new federal law, one of the exceptions to the rule that the marital deduction is not allowed where limited or terminable interests pass is where a decedent sets up a trust whereunder his or her spouse is to receive the income for life, with at least annual distributions of income, and the spouse has a power of appointment over the corpus, exercisable in favor of herself, in favor of her estate, or in favor of herself or her estate. INT. REV. CODE §812(e)(1)(F). The North Carolina law does not harmonize with this provision of the federal law in view of N. C. GEN. STAT. §105-2(6)(1943), the apparent effect of which is that where, in order to obtain the marital deduction benefits of the federal law, a person creates a trust, giving his or her spouse the income for life, with power of appointment to the extent allowed in INT. REV. CODE §812(e)(1)(F), under the North Carolina law *two* taxes would be levied on the right to receive the remainders—one at the death of the donor of the power and the other upon the exercise or termination of the power.

5. The principles governing the taxable situs of property subject

to a power of appointment are generally the same as those applicable to property not covered by a power.

D. *Jointly Owned Property with Right of Survivorship*

1. Under the federal estate tax, land held as an estate by the entireties is fully taxable in the estate of a decedent tenant, except to the extent that the property is traceable to the survivor. Under the North Carolina law, however, only one-half of the value of the property is taxable, regardless of the consideration furnished by the respective tenants in acquiring the property.

2. Where there is a mortgage on an estate by the entireties, the question whether under the state law it may be deducted as a debt of a decedent tenant is dependent on who was the primary obligor for the mortgage debt. If the decedent tenant was the primary obligor, the full amount of the debt is deductible from the one-half value of the estate by the entireties includible in the decedent tenant's gross estate. If the surviving tenant is the primary obligor, none of the debt is deductible, and if both tenants are equally liable, one-half is deductible.

3. With respect to jointly owned bank accounts, building and loan shares, stocks and bonds, and other intangibles where there is a contractual right of survivorship the state follows the federal rule that the portion of the property purchased with funds or consideration furnished by the decedent will be taxed in the decedent's estate. As to the death taxation of war bonds the state also follows the federal rule.

E. *Proceeds of Life Insurance Policies*

1. Prior to March 3, 1943, the state inheritance tax law purported to tax the proceeds of all life insurance policies payable at or after the death of the insured when the premiums have been paid by the insured and whether payable to his estate or to a named beneficiary. In the Spring Term of 1942, the North Carolina Supreme Court held, in *Wachovia Bank & Trust Company v. Maxwell,* 221 N. C. 528, 20 S.E. 2d 840 (1942), that life insurance proceeds were non-taxable where the insured's wife applied for and secured the issuance of the insurance, and all incidents of ownership of the policies were vested in the wife, although the insured voluntarily paid all premiums on the policies during his life. As a result of this decision, the section of the Revenue Act taxing insurance proceeds was revised.

2. Under the revised statute and subsequent amendments, proceeds from life insurance policies on the life of the decedent are taxable as follows:

a. When the proceeds are receivable by the personal repre-

sentative or estate of the decedent, regardless of whether the decedent paid the premiums.

b. Proceeds not receivable by the decedent's personal representative or estate are nevertheless taxable to the extent that premiums or consideration are paid or furnished by the decedent, directly or indirectly (however, the law permits one form of indirect payment, as pointed out below).

c. Even if the proceeds are not receivable by his personal representative or estate, and even if he does not furnish any of the premiums or consideration, the proceeds are nevertheless taxable if at his death the decedent possessed any of the incidents of ownership other than a reversionary interest.

3. The state law is now modeled closely after the federal law, and under both laws if the proceeds are not payable to the decedent's personal representative or estate, and further if the decedent has divested himself of all incidents of ownership, and further if the decedent has not directly or indirectly paid any of the premiums, the proceeds would not be taxable in his estate.

4. There is an important provision in the state law which does not appear in the federal law, and which offers tax savings possibilities. Under this provision, a person may procure the issuance of a policy of insurance upon his life, payable to a beneficiary other than his personal representative or estate, divest himself immediately of all incidents of ownership in the policy, make a gift to the beneficiary of money or property sufficient to enable the beneficiary to pay the premiums (or make such periodic gifts), pay the gift tax, if any, that is due, and thus place the proceeds beyond taxation in his estate at death.

5. Apparently there has been no definite ruling as to the extent, if any, to which the 1943 amendments will be applied to policies issued prior to the effective date of the amendments—March 3, 1943. The question would become important in a situation like that presented in the *Harris* case, cited above, where the insured is still living or did not die until after March 3, 1943. It is possible that a tax would be asserted on part of the proceeds pro-rated on the basis of the premiums paid after March 3, 1943 in relation to total premiums paid.

6. If a gift tax is paid with respect to the gift of an insurance policy, the amount of the gift tax so paid is credited against the amount of the inheritance tax due on the proceeds of the policy, and if there is more than one beneficiary, the credit is pro-rated in accordance with the beneficiaries' respective interests.

IV. Exemptions

A. *General exemptions* are as follows:

Widows receive an exemption of $10,000 in addition to all other exemptions. Furthermore, if all or substantially all of a decedent's property passes to his widow, and there are minor children, the widow receives an additional exemption of $5,000 for each such child.

Each minor child of the decedent receives an exemption of $5,000.

All other Class A beneficiaries receive an exemption of $2,000 each, with these special provisions:

When the parent of a grandchild (or grandchildren) of the decedent is deceased, or does not share in the estate, the grandchild (or grandchildren) may use the parent's exemption, or pro rata parts thereof, as the case may be.

Any part of an exemption not applied to the parent's share may be applied to the share of a grandchild (or grandchildren) of such parent.

B. Exemptions against *life insurance proceeds* are as follows:

Of the total insurance proceeds payable to named beneficiaries who are Class A beneficiaries, $20,000.

Of proceeds payable to Class B and C beneficiaries, the first $2,000 of such proceeds *when* the exemption allowed to Class A beneficiaries is less than $2,000, and *then only to the extent* that such amount is not allowed to Class A beneficiaries.

Insurance proceeds and proceeds of Adjusted Service Certificates paid by the federal government to the estate or beneficiaries of any person who has served in the armed services of the United States or in the merchant marine during the first or second World War are fully exempt. Insurance proceeds to the extent of $10,000 upon the life of any person whose death was caused by enemy action during the second World War are also exempt.

C. *The Charitable Exemption.*—Caution must be exercised in connection with the exemption of property passing to religious, charitable, educational or benevolent institutions or organizations. The deduction under the state law *is limited to:*

1. Property passing to such institutions and organizations "located" in North Carolina.

2. Property passing to such institutions or organizations created or administered under the laws of another state *only if* such other state levies no inheritance or estate taxes on property passing from residents of such state to such institutions or organizations created or administered under the laws of North Carolina, *or if* such institutions and or-

ganizations are ones receiving and disbursing funds donated in North Carolina for charitable purposes.

V. Deductions

The allowable deductions from the gross estate in computing the net estate may be readily ascertained by glancing at the statute, and no special comment seems necessary. However, it might be pointed out that the full federal estate tax is not deductible, but only the basic federal estate tax assessed under the 1926 Revenue Act.

VI. The Rates

The fact that, unlike the federal estate tax, the North Carolina inheritance tax is levied on the privilege of receiving property from the decedent, and that accordingly the rates vary with the relationship of the beneficiary to the decedent, offers one of the principal means of minimizing the state death tax. A net disposition (after all allowable exemptions and deductions) of $100,000 to a Class A beneficiary (spouse, lineal issue, lineal ancestor, adopted child, stepchild of the decedent) would incur a tax of $3,150; to a Class B beneficiary (brother or sister, decendant of brother or sister, or uncle or aunt by blood of the decedent), a tax of $7,100; and to a Class C beneficiary (related to the decedent in some way other than those stated above, or a stranger in blood, or a body politic or corporate), a tax of $10,150. Actually, Class A beneficiaries are favored even more than the above figures indicate, since they are entitled to exemptions not accorded to Class B and Class C beneficiaries.

As already pointed out, a widow receives the largest exemption accorded any one beneficiary, and a minor child receives the next largest.

The differentials arising from these rates and exemptions are well worth detailed study in planning with respect to state taxes. The possibilities of taking advantage of these differentials after death and before the settlement of the estate are limited. Formerly, the state law permitted the tax to be computed in accordance with a compromise settlement of a contest between beneficiaries under a will. However, this provision was repealed in 1941, and such agreements are now of no avail to shift the burden of the tax. However, a formal renunciation by a legatee, devisee, heir or distributee, filed in the probate court, will probably be recognized by the Revenue Department, and in some cases such renunciations will have the effect of making the renounced property pass to a beneficiary in a lower bracket.

VII. The Marital Deduction and the North Carolina Iheritance Tax

In planning for the use of the "marital deduction" provided for by the 1948 amendments to the federal estate tax law it must be borne in mind (1) that property exempt from federal estate taxation as coming within a permissible marital deduction is not thereby exempt from the state death tax, since North Carolina has no provision for a marital deduction, and (2) that the amount of the state death tax has a direct relation to the amount of the allowable marital deduction, for the reason that where the property passing to the surviving spouse is chargeable with any state, federal or foreign death taxes, the taxable portion of the estate is increased by the amount of such taxes payable out of the interest of the surviving spouse, and the marital deduction is thus reduced. For these reasons, it is obviously desirable to minimize the taxes due the state in such situations. Fortunately, the rates and exemptions of the state tax favor property dispositions to a spouse—particularly to a wife. Then, too, the $20,000 insurance exemption to a spouse named as beneficiary in a policy or policies should be used to full advantage. And finally, the holding of real property in estates by the entireties will be helpful in this connection, since under the state law, only 50% of the value of property so held is taxable in the estate of a decedent spouse.

VIII. Miscellaneous Comments

A. *Property Previously Taxed.*—In contrast to the federal provision allowing a deduction for the value of property included in the gross estate of a decedent which was acquired by him within *five* years prior to his death by gift, devise or inheritance and with respect to which a death or gift tax has been paid, the state law provides that when property has been once taxed for death tax purposes in this state such property shall not again be taxed on account of a transfer of like kind occurring within *two* years from the death of the first decedent. However, the exemption is available only if the beneficiaries are Class A or Class B beneficiaries to the latter decedent. The property is entirely exempted, regardless of value, if it can be substantially identified. This exemption does not apply if the property was previously taxed in another state.

B. *Remainders and Contingencies.*—In planning for the use of estates for life or for a term of years, the following principles should be borne in mind.

1. The tax on the value of the entire property is due at the death of the testator, but the tax is apportioned between the life tenant or tenant for years and the remaindermen on the basis of the mortality

and annuity tables set forth in N. C. GEN. STAT. §§8-46, 47 (1943) and upon the basis of 6% of the gross value of the estate for the period of expectancy of the life tenant, or for the period of the term of years.

2. Where the transfer of property involves contingencies or conditions whereby the rights and interests of transferees or beneficiaries may be created, defeated, extended or abridged, the state may impose a tax at the highest rate which would be possible on the happening of any of the contingencies or conditions.

C. *Valuation*

It is clearly established under the state law that values are to be established as of the decedent's death. Hence, there is no possibility of a valuation one year later, as permitted by the federal law.

The basic standard of valuation is the same under the state as under the federal law—i.e., fair market value, in spite of the fact that the state law uses such terminology as "clear market value".

Where a return has been or will be filed for federal estate tax purposes, the state will tend to follow the valuations for federal purposes in the absence of clear reasons to indicate that the federal valuations are erroneous.

IX. THE GIFT TAX

A. Federal gift tax rates are established at 75% of the estate tax rates, and this tends to encourage the making of *intervivos* gifts to remove the donated property from higher death tax brackets. However, the state has not adopted this philosophy. Since the enactment of the gift tax in this state, the inheritance and gift tax rates have been exactly the same, although the annual exclusions and the exemption to Class A beneficiaries have made the effective gift tax rates lower than the death tax rates. Then, too, (prior to the 1947 amendment referred to below) by spreading gifts over a period of years, property could be removed from a high inheritance tax bracket and placed in the lower gift tax brackets, since the gift tax started again each year with the lower rate. The General Assembly of 1947 made tax savings through the making of *intervivos* gifts less possible by providing for a cumulative computation of the tax, beginning in 1948. The purpose of the amendment was to attempt to remove the differential produced by the annual exclusions and the exemption, and to make the gift and death tax rates as nearly alike as seemed practically possible.

B. The cumulative computation is made as follows:

1. Determine the aggregate sum of the net gifts to the donee for the calendar year and for each preceding calendar year since January 1, 1948.

2. Compute the tax upon the aggregate sum by use of the rate tables.

3. From the sum thus computed, deduct the total gift tax, if any, paid on gifts to the same donee in any prior years since January 1, 1948. The sum thus determined is the tax due.

The general effect of the cumulative computation is, of course, to raise the over-all tax where gifts over a period of years are concerned, since the applicable rates are stepped up with each new computation, instead of starting again each year with the lowest bracket.

C. The following other points regarding the state gift tax law should also be observed:

1. The rates are set up on the same degrees of relationship as in the inheritance tax.

2. The annual exclusion as to each donee is $1,000 instead of $3,000, as under the federal law.

3. The specific exemption is $25,000, instead of $30,000, as under the federal law, and is available only to Class A beneficiaries.

4. Unlike the federal law, the state law does not deny the annual exclusion when there are gifts of "future interests".

5. The same limitations exist with respect to gifts to charitable, religious, educational, and benevolent institutions and organizations as with respect to transfers to such institutions and organizations under the death tax law. These have already been noted.

6. Taxes paid on the gift of any property are credited against any death tax subsequently levied against the same property.

In spite of the fact that the 1947 amendment to the gift tax law restricts the possibilities of tax savings in making gifts, such possibilities still exist in particular cases.