AN OVERVIEW
OF
FEDERAL AND NORTH CAROLINA
TRANSFER TAX SYSTEMS

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I. Introduction.

This paper will provide the reader with a basic overview of the federal and North Carolina transfer taxes, including the estate tax, the gift tax and the generation-skipping transfer tax. It will further highlight the most notable provisions of the Economic Growth and Reconciliation Act of 2001 (the "2001 Tax Act").

Part II of this outline will provide a general overview of the three (3) types of federal transfer taxes (the gift tax, the estate tax and the generation-skipping tax) and will discuss the de-unification of the federal gift and estate taxes under the 2001 Tax Act.

Part III of this paper will review how the 2001 Tax Act has changed the landscape of federal transfer taxation.

In Part IV, we will review the Section 1014 federal and state income tax basis step-up rules.

Part V of this paper will review the federal gift tax system.

In Part VI, we will discuss the federal estate tax system applicable to assets passing to heirs at death.

In Part VII, we will provide a brief overview of the federal generation skipping transfer tax system.

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Part VIII of the manuscript will provide a general overview of applicable North Carolina transfer tax systems which includes an estate tax, a gift tax and a generation-skipping tax.

Part IX will examine the North Carolina Federal Estate Tax Apportionment Statute.

The last part of this paper contains a brief outline of how to effectively use the marital deduction and the applicable credit amount with some basic estate planning techniques. Finally, this paper examines some of the most frequently used trusts in estate planning.

II. **The General Scheme of the Federal Transfer Tax System.**

A. Three Types of Federal Transfer Taxes. When one makes a transfer of property, whether in life or at death, that transfer may be subject to some type of federal transfer tax. Under the current federal transfer tax system, three (3) types of federal transfer taxes will be assessed on the value of any gratuitous transfers of property:

1. The federal estate tax (Chapter 11 of the Internal Revenue Code);

2. The federal gift tax (Chapter 12 of the Internal Revenue Code); and

3. The federal generation-skipping transfer tax (Chapter 13 of the Internal Revenue Code).

B. The "De-Unification" of the Federal Estate and Gift Tax Systems. The purpose of the federal estate tax is to impose an excise tax on the transfer of property at death. To ensure that taxpayers do not avoid imposition of the federal estate tax by making gratuitous transfers of property during lifetime, the federal transfer tax system also imposes a federal gift tax. Currently, the estate and gift tax rates begin at 37% and reach their maximum at 48%. (IRC § 2001). The greater the amount of transfers one makes, the greater the tax assessed.

From 1976 through 2001, the federal estate and gift tax were part of a "unified" system. Although the federal gift tax and estate tax rules are provided in different chapters of the Internal Revenue Code, the same graduated tax rate schedule applied to lifetime, as well as to testamentary, transfers on a cumulative basis. In addition, the minimum exemption from federal estate and gift taxes allowed to an individual was also unified and could be used during lifetime or at death.

The Economic Growth and Reconciliation Act of 2001 has effectively severed this unified system and proposes to repeal the estate tax completely by the year 2010. This Act and its effects are detailed more fully in Section III of this paper.

C. Applicable Exclusion Amount and Applicable Credit Amount Schedule. Once the tentative tax on a transfer is calculated according to the tax rate schedule set forth in Section 2001, the transferor is allowed an "applicable credit" depending upon the year of the gift or year of death. The applicable credit amount is designed to ensure that a certain minimum amount of property, known as the applicable exclusion amount, may pass estate or gift tax free during lifetime or at death.

III. Changes to Federal Transfer Tax Systems Under The Economic Growth and Reconciliation Act of 2001.

After months of uncertainty, negotiations and promises of an estate tax repeal, the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") was signed into law on June 7, 2001. The 2001 Tax Act phased in a total repeal of the federal estate tax by gradually lowering estate tax rates and increasing exemptions until the estate tax is finally repealed in 2010. However, the sunset provision included in the Act makes it somewhat questionable as to whether the repeal will be permanent.

A. Estate Tax Rate and Applicable Exclusion Changes. Under the 2001 Tax Act, the top tax rate dropped from 55% to 50% in 2002, and has dropped another one percent each year thereafter, down to 45% in 2007. The top tax rate then remains unchanged until complete repeal occurs in 2010. Act §§ 511(a)-(c), 521(a).

As the tax rates decrease, the exemptions allowed for estates will gradually increase. In 2001, the applicable exclusion amount per person was $675,000. Under the 2001 Tax Act, the exclusion amount was raised to $1,000,000 in 2002, $1,500,000 in 2004, $2,000,000 in 2006, and will be raised to $3,500,000 in 2009. Thus, in 2007, a married couple can pass up to $4 million dollars tax free with proper planning and documents.

B. Gift Tax. One of the greatest changes under the 2001 Tax Act, and perhaps the most telling, is a switch from the current unified system which taxes lifetime transfers the same as transfers at death to a system that treats transfers at death more favorably than those transfers made during life. Thus, even though the estate and generation-skipping transfer taxes are being phased out and eventually repealed, **the gift tax will be retained**. The gift tax exemption is raised to one million dollars ($1,000,000.00) for the year 2002

and will remain at that level indefinitely. Act § 521(b). In addition, in 2010, the top gift tax rate is reduced to 35% which is also the maximum individual income tax rate. The gift tax system is otherwise left intact.

One stated reason Congress opted to keep the gift tax in place (while simultaneously repealing the estate tax) is to discourage taxpayers from making "income-splitting" transfers. In other words, gift tax will be imposed on life-time transfers in order to prevent transfers to related persons in a lower income tax bracket from being as beneficial as holding assets until death and allowing them to pass via one's estate. Another unstated, yet probable, reason for retaining the gift tax is to prevent wealthy families from giving too much wealth away before Congress can decide whether or not the estate tax repeal should be permanent (see the "Sunset" discussion below).

C. Generation Skipping Tax. In addition to the estate tax, the federal government imposes a tax known as the generation skipping transfer (GST) tax on transfers made to persons who are two or more generations below the donor. For example, when a grandparent makes a gift to a grandchild, the transfer is one that skips a generation and, therefore, will incur generation skipping transfer tax (unless covered by the GST exemption). Currently the GST exemption amount allows a taxpayer to pass $1,500,000 in a generation-skipping manner before the taxpayer must actually pay any GST tax.

The GST exemption likewise has experienced an increase beginning in 2004. The GST exemption in effect prior to the 2001 Act was $1 million dollars per taxpayer, but under the 2001 Act, the GST exemptions will raise and be subject to periodic adjustments for inflation. The GST exemption amount will be $1,500,000 in 2004, $2,000,000 in 2006 and $3,500,000 in 2009. The GST tax is scheduled to be repealed in 2010.

The generation-skipping transfer tax (GST) undergoes other significant technical modifications under the new Act of 2001. One of the major changes is the automatic deeming of one's unused GST exemption when a lifetime transfer is made which involves an indirect skip to a GST trust. One may elect out of this automatic deeming on his/her gift tax return in the same calendar year as the transfer is made. Other changes in these rules go beyond the scope of this article.

D. Summary of Estate and GST Tax Rules. The chart below details the maximum estate tax rates and the GST exemption amount under the existing tax rules.

Prior Law:				New Law:			
Prior Law:				New Law:			
Year	Exemption	Maximum Estate Tax Rate	GST Exemption	Year	Exemption	Maximum Estate Tax Rate	GST Exemption
2001	$675,000	55%	$1,060,000	2001	$675,000	55%	$1,060,000
2002	$700,000	55%	$1,060,000*	2002	$1,000,000	50%	$1,060,000*
2003	$700,000	55%	$1,060,000*	2003	$1,000,000	49%	$1,060,000*
2004	$850,000	55%	$1,060,000*	2004	$1,500,000	48%	$1,500,000
2005	$950,000	55%	$1,060,000*	2005	$1,500,000	47%	$1,500,000
2006	$1,000,000	55%	$1,060,000*	2006	$2,000,000	46%	$2,000,000
2007	$1,000,000	55%	$1,060,000*	2007	$2,000,000	45%	$2,000,000
2008	$1,000,000	55%	$1,060,000*	2008	$2,000,000	45%	$2,000,000
2009	$1,000,000	55%	$1,060,000*	2009	$3,500,000	45%	$3,500,000
2010	$1,000,000	55%	$1,060,000*	2010	N/A	N/A	N/A
2011	$1,000,000	55%	$1,060,000*	2011	$1,000,000 ?	55% ?	$1,060,000* ?

*Plus an inflation adjustment

E. State Death Tax Deduction. Even with the new legislation, careful estate planning will still be necessary since other changes in the law under the new 2001 Tax Act are not so beneficial. One of the side effects of the estate tax repeal was that the credit for state death taxes has been eliminated. Now only a deduction for state death taxes actually paid will be allowed. The phase out has resulted in higher overall estate tax being paid by many estates.

Many states rely on the state death tax credit for the production of a substantial amount of annual revenue (exceeding two percent (2%) of a state's annual budget in some cases). By 2005, the elimination of the state death tax credit was completed and now only a deduction for state death taxes actually paid is allowed. Act § 532.

The deduction will be allowed only for such taxes actually paid and claimed as a deduction before the later of (1) four years after the filing of the estate tax return; or (2) if a timely petition for redetermination of a deficiency has been filed with the Tax Court, 60 days after the Tax Court decision becomes final; or (3) if an extension of time has been granted under § 6161 or § 6166 for payment of the estate tax, or of a deficiency, the expiration date of the extension period; or (4) if a timely claim for refund or credit of an overpayment of estate tax has been filed, the latest of (i) 60 days after the Service mails a notice of the disallowance of the claim, (ii) 60 days after a court decision becomes final with respect to the timely suit instituted upon the claim, or (iii) two years after a notice of the waiver of disallowance of the refund claim.

In response to the elimination of the state death tax credit, North Carolina changed its own estate tax to provide that the North Carolina estate tax will continue to be equal to the state death tax credit that was allowable under the estate tax laws as they existed prior to the 2001 Tax Act. In essence, North Carolina's change is designed to make sure that its estate tax is not changed by the 2001 Tax Act's elimination of the state death tax credit. The NC Estate Tax is discussed in more detail later in this paper.

F. Income Tax Basis. Another lost benefit under the new 2001 Act is the full step-up in tax basis (for income tax purposes) allowed for inherited property. Under prior law, most property passing through an estate was assigned an income tax basis equal to the fair market value of the property at the date of death. **Beginning in 2010**, inherited property in excess of $1,300,000 (or $3,000,000 in the case of property passing to a spouse) will receive a modified carryover basis, meaning the basis of the recipient will be the lesser of (1) the basis which the decedent had in the property prior to death or (2) its fair market value at the date of death. Act § 541. The spousal property basis increase will only apply to "qualified spousal property", meaning property which is transferred outright or as qualified terminable interest property. Property transferred outright must not fail or terminate upon the happening of a contingency, lapse of time, or the failure of an event or contingency. Qualified terminable interest property means property in which the surviving spouse receives an interest which entitles him/her to all of the income from the property, payable annually or more frequently and no one has the power to appoint the property to anyone other than the surviving spouse.

Not all property is eligible for a step-up in basis under the 2001 Tax Act for decedents dying in 2010 and years thereafter. Included in this list of properties ineligible for the step-up in basis for decedents dying in 2010 and years thereafter are: (1) property not owned by the decedent at the time of his/her death; (2) property acquired by the decedent by gift within three (3) years of death; (3) property consisting of stock or securities in certain foreign

entities or domestic international sales corporations; and (4) property that gives a right to receive income in respect of a decedent under § 691.

These changes in the income tax basis rules mean a trade-off of the estate tax for new liability in the form of income tax on capital gains and losses. A practical example of how this new method for determining basis will work is as follows:

> **Prior Law Before 2010**: If Sally paid $100,000 for XYZ stock in 1976 which now has a fair market value of $200,000.00 upon her death in 2007, then her daughter who inherits the stock will have a basis in the stock for tax purposes of its fair market value or $200,000.00. If the daughter sells the stock one year later for $250,000, she has realized a taxable gain of $50,000 (i.e., Sale Price - Basis = Taxable Gain).
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> **New Law After 2009**: Under the same facts as above, but with Sally dying in 2010, her daughter would receive a basis equal to Sally's basis of $100,000. If the daughter then sells the stock for $250,000.00, she has realized a taxable gain of $150,000.

The new 2001 Act does include provisions to help relieve this harsh result to some extent, but the new basis rules will also create incredible recordkeeping complexities due to new rules requiring a donor to now provide documentation of his basis in property upon transfer, even when the transfer is at death. (Note that carryover basis rules were imposed in 1976 and then retroactively repealed a few years later because they were impossible to comply with or enforce).

G. <u>The "Sunset" of the Repeal</u>. If the estate tax repeal only becomes fully effective in 2010, what happens in 2011 and thereafter? Included in the 2001Act is a "sunset" provision which essentially "repeals the repeal" unless some affirmative action is taken to reinstate it. This means there is a strong possibility that if the repeal actually occurs, it will only last for one year.

A number of things could take place between 2001 and 2011 that will effect whether or not the repeal is permanent, or whether it will really happen at all. Attempting to predict what might happen between now and 2010 would be premature. There will be as many as two more Presidents to take office during that time period, and we can only speculate at this point about the effect the estate tax repeal will have on government revenue and the economy generally.

What we do know is that if the 2001 Act is not extended or replaced with another bill making the repeal permanent, then in 2011 the estate and gift tax plan which is currently in effect will be revived. The allowable exemption would go back to $1,000,000 for both the estate and the gift tax; the basis values would change again, and so on. Such major changes also mean major changes for many estate plans (during and after this decade).

IV. Section 1014 Income Tax Basis Rules.

Notwithstanding the changes discussed above in the Economic Growth and Reconciliation Act of 2001, the **current** rule under Section 1014(a) of the Internal Revenue Code states that, upon a decedent's death, all assets in the decedent's gross estate for federal estate tax purposes will be entitled to a "step up" for income tax basis purposes, so that the recipient of the decedent's property will inherit the bequeathed property with an income tax basis equal to the estate tax (fair market) value of the decedent's property at death. Please note that Section 1014(e) **denies** a "step-up" in tax basis where a transferor transfers property to a decedent within one year of the decedent's death, and that same property passes back to the original transferor at the decedent's death.

The Section 1014 basis step-up rules operate to "forgive" unrealized capital gains taxes that otherwise would have been assessed if heirs had sold inherited property the day after the decedent's death. On the other hand, under Section 1015, the income tax basis to the donees of gifted property is equal to the donor's "carryover" adjusted tax basis in the gifted property. **Thus, donees who receive property via lifetime gifts receive no income tax basis step up.**

The differing income tax basis rules applicable to inherited property versus gifted property must be considered whenever the estate planner weighs the advisability of having a client make lifetime gifts, as opposed to allowing property to pass through an estate. **Normally, because the effective federal estate tax rates generally exceed the applicable capital gains tax rates, it is preferable to avoid estate taxes through lifetime gifts.** On the other hand, for small estates (those under the applicable exclusion amount thresholds), lifetime gifts can have devastating income tax consequences. Therefore, if the estate planner anticipates that the client's estate will not exceed the applicable exclusion amount threshold, then prudent tax planning may indicate that lifetime gifts should be avoided.

> **Note:** Obviously, there are many non-tax considerations that come into play whenever lifetime gifts are contemplated. For example, Medicaid planning techniques often incorporate the use of lifetime gifts to ensure that the donor will qualify for federal nursing home assistance.

V. An Examination of the Federal Gift Tax System.

A. **Statutory Provisions and Nature of the Federal Gift Tax.** Chapter 12 of the Internal Revenue Code contains the rules for application of the federal gift tax. The federal gift tax is an excise tax which is imposed on the gratuitous transfer of property during lifetime. As discussed above, the purpose of the

federal gift tax is to prevent taxpayers from circumventing application of the federal estate tax by making lifetime transfers of property prior to death.

As discussed further below, a transfer by a donor to an individual, a partnership, a corporation or to a trust may cause imposition of the federal gift tax. Thus, the identity of the donee/recipient generally is irrelevant for purposes of determining whether or not a gift has been made. On the other hand, however, certain gifts to a spouse or to charity may be completely exempt from application of the gift tax.

B. <u>Party Liable for Paying the Gift Tax</u>. Under Section 2502(c), the donor is primarily liable for the payment of any gift tax assessed on a gift, although any unpaid gift tax may operate as a lien on the gifted property. Section 6901. Because the payment of gift tax is assessed on the donor and not the donee, lifetime gifts can be effectively used to lower the effective transfer tax rate applicable to transferred property. This is because the federal gift tax is "tax exclusive," while the federal estate tax is "tax-inclusive."

> **Example:** Assume that Donor owns property with a value of $900,000 and that the applicable transfer tax rate is 50% on Donor's gifts (whether gift tax or estate tax). If Donor dies and bequeaths $900,000 of assets to his Son, the federal estate tax will generate an estate tax liability of $450,000, which will leave only $450,000 passing to Son at death. On the other hand, if Donor had made a lifetime gift of $600,000 to Son, then the applicable federal gift tax would only have been $300,000 (50% times $600,000). Since Donor's remaining assets would have been exhausted through the payment of gift tax, the effective gift tax rate in this case would be 33-1/3% ($300,000 over $900,000) which is must less than the applicable 50% estate tax rate.
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> **Note:** The use of this "trick," of making lifetime gifts to avail the donor of lower effective gift tax rates, will **not work** if the donor dies within three years of making the gift, since Section 2035(d) will cause inclusion in the donor's gross taxable estate of any gift tax paid on gifts within three years of death.

C. <u>When is a Gift a Gift</u>? Section 2501 of the Internal Revenue Code imposes the gift tax on the "transfer of property by gift....." Under the gift tax systems, a gift tax will arise whenever there is a transfer during lifetime of property for less than full and adequate consideration. The gift tax regulations broadly define the term "gift" as any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed to make a gift.

Thus, a gift will be deemed to have been made for gift tax purposes as long as the following four (4) tests are met:

a. The gift is made by a competent donor;

b. Legal title vests in the donee with no retained power by the donor to revoke the transfer;

c. The donor has relinquished dominion and control over the gifted property; **and**

d. The transfer is for less than full and adequate consideration.

As a result of the four above rules, gifts can result in surprising circumstances.

1. Gifts Without Donative Intent. Without question, under the gift tax system, a gift may be a taxable gift regardless of whether the donor has any donative intent at the time the transfer is made. In the Supreme Court case of Commissioner v. Wenyss (324 U.S. 303 (1945)), the Supreme Court stated that donative intent on the part of the transferor is not required to establish a taxable gift. In this case, the Court stated as follows:

> Congress chose not to require an ascertainment of what too often is an allusive state of mind. For purposes of the gift tax, it not only dispensed with the test of "donative intent," it formulated a much more workable external test: that where "property is transferred for less than adequate and full consideration in money or money's worth," the excess in such money value "shall, for the purpose of the tax imposed by this title, be deemed a gift."

Thus, the application and the gift tax is based upon the objective facts of the transfer and the circumstances under which the gift is made, rather than upon the subjective motives of the donor. In fact, even an incompetent individual may make a taxable gift as long as the transfer was voluntary, and as long as the donor understood the nature of what was transferred and the objects of his bounty.

2. Gifts to Corporations and Partnerships. Even where a donor owns an interest in a corporation or partnership, he/she may be deemed to have made a taxable gift to the business where the other partners or shareholders do not make similar pro rata contributions. Although capital contributions to a partnership or corporation may not generate income tax consequences, gift tax consequences nevertheless may arise. See Regulation 25.2511-1(h)(4).

3. Payment of a Donee's Obligation. A gift may also arise where a donor pays a legal obligation of the donee, such as where a parent pays an income tax obligation of a child.

4. **Forgiveness of Debts.** Forgiveness of indebtedness often creates unexpected gift tax consequences.

> **Example:** Assume that Father loans $50,000 to Son and Daughter-in-law, so that they may make a down payment on their first home. When Son and Daughter-in-law apply for their mortgage, the bank refuses to approve the mortgage on the basis that Son and Daughter-in-law have not really contributed any funds toward the down payment. To ensure that Son and Daughter-in-law qualify for the mortgage, Father decides to forgive the $50,000 indebtedness. Here, Father has made a gift which must be reported for federal and North Carolina gift tax purposes.

5. **Allowing Statue of Limitations to Expire on Loans.** A similar result may apply where a donor fails to enforce repayment of a loan.

> **Example:** Assume that Father makes a $50,000 loan to Son and Daughter-in-law payable one year from the date of the loan. Son and Daughter-in-law execute a promissory note obligating them to repay Father at the expiration of one year. Son and Daughter-in-law fail to repay Father for the loan. Father will be deemed to have made a taxable gift to Son and Daughter-in-law once the statute of limitations on the loan expires.

6. **Below Market Loans.** Adverse income and gift tax consequences may also arise where a taxpayer makes an interest free, or below-market interest, loan. Unless the loan reflects adequate interest under Section 7872 of the Internal Revenue Code, a below market interest loan results in the following tax consequences:

(a) For income tax purposes, the donor is treated as having received taxable interest income based upon the minimum applicable federal interest rate under Section 7872; and

(b) For gift tax purposes, the donor is treated as having made a taxable gift to the donee of the foregone interest. **Note:** A certain de minimis exception is provided for gift loans that do not exceed $10,000. Section 7872(c)(2).

7. **Exercise and Release of General Power of Appointment.** An individual holds a "general power appointment" where the power holder has a power of appointment exercisable over certain property in favor of the power holder, his estate, his creditors, or the creditors of his estate. If someone has a general power of appointment over property and exercises that power for the benefit of a third party, a gift is deemed to be made. Section 2524(b). Likewise, if an individual releases a general power of appointment, the release

of that general power of appointment will constitute a gift to the lapse recipient to the extent that the value of the property subject to the general power of appointment exceeds the greater of (a) $5,000 or (b) 5% of the value of the assets subject to the lapse power. Section 2514(e).

However exercise and releases of limited or special powers of appointment do not generate gifts. A limited or special power of appointment is a power of appointment which cannot be exercised in favor of the power holder, his estate, his creditors or the creditors of his estate or which is subject to an ascertainable standard such as health, maintenance and support.

8. Dispositions of Qualifying Income Interests in Qualified Terminal Interest Property. As discussed further below, a decedent or donor may transfer property to his or her spouse, in trust, free of federal or gift taxes - as long as the gift or bequest to the trust qualifies for the marital estate or gift tax deduction. Frequently, testators and donors use the benefits of a "qualified terminable interest property" trust to receive gifts and bequests of assets for the benefit of a spouse. Because the donor or testator receives a marital deduction for the full fair market value of assets passing to a QTIP trust, the recipient spouse must include the full fair market value of the QTIP trust assets in the estate of the spouse upon his or her death. Section 2044. As a result of these rules, if the surviving spouse then gifts her qualifying income interest in the trust to an outside third party, the spouse is deemed to have made a taxable gift to the outside third party equal to the full fair market value of the trust assets at that time. Section 2519.

D. Transfers Not Subject to the Gift Tax. Although the federal gift tax can easily be triggered whenever property is gifted during lifetime, there are several important exceptions to the federal gift tax system.

1. Transfers for Full and Adequate Consideration. Since the gift tax only applies for partially or fully gratuitous transfers, there can be no gift if the transferor exchanges property for full and adequate consideration. Section 2512(b). Thus, sales, exchanges or other transfers of property in an arms length transaction in which the transferor receives consideration, equal to the full economic equivalent of the transferred property, will be considered a transfer for full and adequate consideration. Regulation Section 25.2512-8.

For this reason, a frequently employed estate planning technique involves the sale of property from a senior family generation member to a younger generation family member (or to a trust for younger generation members). This is particularly true where the transferred property is likely to appreciate in value in the future, or where the transferred property produces cash flow. For this reason, installment sales of closely-held business interests are frequently used in estate planning.

2. **Incomplete Gifts.** Some types of gifts are deemed to be "incomplete" for purposes of the federal gift tax, even though the transferor is divested of legal title to the transferred assets. Under the gift tax rules, for example, if the transferor retains a power of appointment over transferred assets (such that the timing of the gift or identity of the donee will not be determined until a later point in time), the gift will not be complete until the donor exercises the power of appointment, or the power of appointment otherwise lapses.

> **Example:** Assume that Father transfers stock to a trust which names XYZ Bank as trustee. During Father's lifetime, the trustee has discretion to distribute income from the trust to Father's issue. However, Father retains a power to appoint the principal of the trust at any time during his lifetime to any of his children or grandchildren. In this case, although the transferred property may no longer be used for Father's benefit, Father has not made a completed gift, since he has retained the power to redirect the trust property among his children and grandchildren.

3. **Qualified Disclaimers.** Qualified disclaimers are frequently used by a transferee wishing to refuse acceptance of property or interests in property. Although qualified disclaimers are most frequently utilized after a transferor's death, certain property interests subject to a gift can (and often must) be disclaimed. Qualified disclaimers are most frequently used in the following circumstances:

(a) In order to avoid augmenting the estate of the transferee;

(b) In an ***attempt*** to prevent transferred property from becoming subject to the transferee's creditor claims (although a disclaimer usually will not be effective to avoid creditor claims); and

(c) To prevent disastrous income or estate taxes that otherwise would result but for the disclaimer.

> **Example:** Mark Millionaire has a substantial estate by virtue of his strong work ethic (and stock market luck). Soon after Mark's aunt dies, Mark learns that he will inherit a substantial sum of money from his aunt. Since Mark has already paid substantial sums of money to his attorneys for estate planning assistance, Mark may wish to "disclaim" his interest in his aunt's estate in order to prevent Mark's estate from increasing by this newly acquired wealth.

Internal Revenue Code Section 2518 provides that, if the following requirements are met, an interest in property may be disclaimed without the disclaimant being deemed to have made a taxable gift to the takers in default:

(a) The disclaimer is in writing;

(b) The writing is received by the donor (or his executor) within nine months after the date of transfer (the date of the gift or the date of death);

(c) The disclaimant has not accepted any benefits of the disclaimed property; and

(d) The disclaimed interests passes without any direction by the disclaimant to a person other than the disclaimant. (Note: Under the tax rules, a spouse may disclaim property and yet remain a beneficiary of a trust that receives the disclaimed property. Section 2518(b)(4)(A)).

4. **<u>Medical and Educational Gifts</u>.** Certain transfers for medical and educational purposes will not be deemed to be a gift. Under Section 2503(e), payments of tuition to an educational organization or payments to a medical care provider for an individual's medical care are not gifts. Please note, however, that the exclusion will not apply unless payment is made directly to the medical care provider or to the educational institution. Thus, the medical and educational expense exclusion does not apply to reimbursements paid to an individual who has already incurred these expenses. Also, for purposes of the educational exclusion, the term "tuition" is construed restrictively, and does not include books, school supplies or living expenses.

5. **<u>The $12,000 (Formerly $10,000) Annual Gift Tax Exclusion</u>.** Section 2503(b) provides for $12,000 annual exclusion gifts to an unlimited number of donees completely free of gift tax each year. Thus, one of the principal components of effective estate planning involves use of $12,000 annual exclusion gifts. As long as a gift to a donee in a calendar year does not exceed $12,000, the donor's gift does not begin utilizing the donor's federal applicable exclusion amount. Obviously, however, birthday gifts and Christmas gifts must be considered when making $12,000 annual exclusion gifts.

a. **<u>Present Interest Gifts</u>.** The $12,000 annual exclusion only applies to "present interest" gifts. Thus, gifts of a future interest do not qualify for the $12,000 annual exclusion. This rule makes it very difficult to have transfers in trust qualify for the $12,000 annual exclusion gift, although the use of "Crummey" or "5 x 5" powers may allow a portion of the gift to trust to qualify for the $12,000 annual exclusion. These "Crummey" powers allow the beneficiary to demand an immediate trust distribution from the trust upon a gift being made to the trust. See the case of <u>Crummey v. Commissioner</u>, 397 F.2d 82 (9th Cir. 1968).

b. **<u>Gifts to Qualified Minors Trusts</u>.** As discussed above, most gifts to a trust will not qualify for the $12,000 annual exclusion. However, Section 2503(c) provides for a limited exception where the transfer is made to a qualifying trust for the benefit of a minor under the age of twenty-one. Section 2503(c) provides that, a gift otherwise in trust, may qualify for the $12,000 gift tax annual exclusion if the following requirements are met:

1. The property (and the income earned thereon) may be expended for the benefit of the donee prior to his or her reaching age twenty-one; and

2. To the extent that any such property is not used for the benefit of the donee prior to the age of twenty-one, the property passes

to the donee at age twenty-one (or to the donee's estate if he or she dies before reaching age twenty-one).

c. **Indexing the $12,000 Exclusion Amount for Inflation.** The $12,000 annual exclusion amount is scheduled to increase over the next several years based upon inflationary increases.

E. **Deductions from the Gift Tax.** There are several important deductions against the amount of taxable gifts that enter into the computation of gift tax liabilities.

1. **Spousal Gift Splitting.** Under the federal gift tax rules, spouses may elect to have gifts made by one spouse as having being made one-half by each spouse. Under the gift splitting system, each spouse reports one-half of the gift on his or her separate gift tax return, and then applies his or her annual exclusions and applicable exemption amounts against these gifts. Please note that the gift splitting election must be made on a gift tax return. Section 2513.

2. **Unlimited Marital Deduction Gifts.** There is an unlimited marital deduction for certain gifts made for the benefit of a spouse. Outright gifts to a spouse are easy to qualify for the marital deduction, however, certain gifts to trusts may (or may not) qualify for the unlimited marital deduction. If a gift in trust for a spouse constitutes a "terminable" interest, the gift will not qualify for the marital deduction unless a QTIP election is made on a timely filed gift tax return. Section 2523.

3. **Charitable Gifts.** Gifts to qualifying charitable organizations are deductible for gift tax purposes without any dollar or percentage limitation on the amount of the deductible gift. The amount of the deduction may be limited where the gift is a "split interest" gift for the benefit of both charitable and non-charitable donees.

F. **Computation of Gift Tax.**

1. **Valuation Rules.** Under the gift tax rules, the gift tax is calculated based upon the "value" of the gift as of the date of transfer. Reg. 25.2512-1. Thus, the value of the transferred property is based upon the value of the property based upon a hypothetical willing buyer and willing seller. Under this "willing buyer and willing seller" test, the value of transferred property is equal to the value that a **willing buyer and a willing seller** would place on the transferred property, neither of whom are under any compulsion to buy or sell, and both having reasonable knowledge of all the relevant facts. Regulation Section 25.2512.1. Both the seller and buyer are hypothetical persons, rather than the specific transferor or transferee. Bright v. U.S., 658 F2d. 999 (5th Cir. 1981). Therefore, any familial relationships between the

transferor and transferee should not be relevant in determining value. Rev. Rul. 93-12, 1993-1 C.B. 202.

2. Cumulative Gift Tax Calculations. As discussed above, the gift tax is assessed on a cumulative basis, which means that subsequent gifts are subject to a higher graduated gift tax rate based upon cumulative gifts made during lifetime. Thus, the gift tax payable during a specific year must be determined based upon prior gifts made during lifetime.

G. Filing of Gift Tax Returns.

1. **Due Date and Extensions.** The federal gift tax return is due on April 15 in order to report gifts made during the previous calendar year. The donor may request an extension for filing the gift tax return by filing a Form 4868 to extend the due date until August 15, and by filing a Form 2688 for extending the due date until October 15. However, underpayment penalties and interest will accrue on any gift tax which is paid after April 15.

> **Note:** Although tax practitioners often assume that extensions will freely be granted by the IRS, we have experienced certain situations in which the IRS has denied an extension request where the taxpayer had outstanding tax delinquencies (of gift tax or income tax) when the extension request was filed.

2. **Statute of Limitation Issues.** Before the Taxpayer Relief Act of 1997, the statute of limitations on challenging gift valuations did not begin to run until gift tax was actually paid. Thus, in the case of $12,000 annual exclusion gifts, or in the case of gifts that did not exceed the aggregate exemption equivalent amount, the IRS was free to revalue gifts for gift tax purposes or for estate tax purposes at any time regardless of how old the gift was. These rules meant that for most gifts, there was no such thing as a gift tax statute of limitations.

The Taxpayer Relief Act of 1997 provided for a new gift tax statute of limitations for reported gifts, regardless of whether any gift tax was actually paid. The new proposed regulations under 20.2001-1 and 25.2504-2 and 301.6501 provide as follows:

(a) Gifts made prior to August 6, 1997. If a gift tax has been paid or assessed during the year and the statute of limitation on assessment for that calendar year has expired, the value of gifts on the calendar cannot be adjusted even as to gifts not disclosed on the gift tax return for that period. However, the value of those gifts during that period can be adjusted for determining adjusted taxable gifts for estate tax calculation purposes.

(b) Gifts made after August 5, 1997. If gifts are "adequately disclosed" on a gift tax return, the value of the gifts cannot be adjusted for gift tax purposes or estate tax purposes once the three year statute of limitation has expired.

VI. <u>The Federal Estate Tax</u>.

A. The Statutory Scheme and Nature of the Federal Estate Tax. The federal estate tax provisions are contained in Chapter 11 of the Internal Revenue Code beginning with IRC Section 2001. The federal estate tax operates as an excise tax assessed against a decedent's estate on the transfer of property from a decedent to his or her heirs.

B. Party Liable for Paying Estate Tax and the North Carolina Federal Estate Tax Apportionment Statute. The executor of a testate estate (or the administrator of an intestate estate) is primarily responsible for the payment of the federal estate tax. However, any unpaid estate taxes become a lien on inherited property. Notwithstanding the general rule that the executor is primarily responsible for payment of the estate tax, North Carolina statutory law and the federal estate tax laws may provide a decedent's estate with a "right of recovery" against the heir or beneficiary of an estate in certain circumstances. See Part IX below.

C. Definition of The "Gross Estate". Virtually every type of property interest held by the decedent at death will be subject to the estate tax. IRC Regulation Section 20.2033-1(a). Thus, the gross taxable estate may include much more than simply the probate estate for North Carolina probate purposes. §§ 2031-2033 of the Internal Revenue Code determines what is included in the gross estate. The following discussion will highlight some of the property interests of a decedent which will be subject to the federal estate tax.

1. Real Estate. All real property owned by the decedent as of the date of death will be reported on Schedule A of the Form 706, except for certain survivorship property (such as tenants by the entirety property or joint tenancy with right of survivorship) which will be reported on Schedule E.

2. Stocks and Bonds. Not surprisingly, the value of corporate stocks and bonds and other securities held by the decedent at death are included in the gross estate, even if the bonds are tax-exempt bonds.

3. Cash and Notes Receivable. The full value of notes payable to the decedent at death are included in the gross estate, in addition to cash on hand or on deposit at various banking institutions. Amounts payable to the decedent as of the date of death (such as accrued rent and accrued interest) are also included in the decedent's estate, even if these amounts are not collected until after death. Likewise, compensation payable to the decedent will also be included even if the compensation is not received until after death.

4. Life Insurance. Under Section 2042, the death benefit proceeds of life insurance payable by reason of the decedent's death may (or

may not) be included in the decedent's estate. It is important to note that Section 2042 requires gross estate tax inclusion of the entire death benefit proceeds and not just the cash surrender value of the policy as of the date of death.

Generally, the death benefit proceeds of life insurance will be included in decedent's estate in the following situations:

a. <u>**Life Insurance Payable to the Decedent's Estate**</u>**.** Regardless of who owns the policy, if the proceeds are received by or for the benefit of the estate, all of the death benefits will be included in the decedent's taxable estate.

b. <u>**Decedent Held Incidents of Ownership in Insurance Policy At Death**</u>. Where the proceeds of the policy are receivable by other beneficiaries but, at the time of the decedent's death, the decedent possessed incidents of ownership in the life insurance policy, the death benefit proceeds will be included in the taxable estate. "Incidents of ownership" include the right of the decedent to any economic benefits of the policy as well as the power to change beneficiaries or to assign a policy or pledge a policy for security of a debt. Likewise, under Section 2042, a decedent can be deemed to own prohibited "incidents of ownership" in a policy held in trust where the decedent had broad powers over disposition of trust property, even if the decedent himself had no beneficial interest in the trust.

c. <u>**Corporate-Owned Life Insurance**</u>**.** Oftentimes, a corporation will own life insurance on its principals. If an insured is a controlling shareholder (more than 50%) of the corporation which owns a policy of life insurance on his or her life, the corporation's incidents of ownership of the policy will be attributable to the shareholder where the policy proceeds are payable to a beneficiary other than the corporation. In this event, by virtue of the attribution of ownership of the policy to the insured-controlling shareholder, **all** the death benefit proceeds will be included in his taxable estate.

If the death benefit proceeds are payable directly to the corporation (instead of an outside third party), the proceeds will not be included in the decedent's estate under Section 2042; instead, the value of the death benefit payable to the corporation at the shareholder's death will be considered an asset of the corporation which will be taken into consideration in determining the value of the corporate stock in the decedent's estate.

d. <u>**Gifts of Life Insurance Within Three Years of Death**</u>**.** Under Section 2035(d), if the decedent transfers or releases his interest in any life insurance that otherwise would be included in the taxable estate under

subparagraphs a, b or c above, the death benefits any such life insurance gifted within three years of death will be brought back into the taxable estate.

5. **Jointly-held Property.**

a. **Non-Spousal Joint Tenancies.** Under Section 2040(a), where the joint owners are not husband and wife, the **full value** of all jointly-owned property (such as stocks, bonds, real estate, and bank accounts) is included in the estate of the first joint owner to die, except to the extent that the estate can prove the amount of consideration paid by the other co-owner for the property.

> **Example:** Assume that Father owns a joint bank account with Son. The bank account is held by Father and Son as "joint tenants with the right of survivorship." Although Son could have exercised his right as joint tenant to withdraw all funds from the bank account, the full bank account balance will be includable in Father's gross estate, unless Son can establish that he contributed part of the funds held in the joint account.

b. **Post-1977 Spousal Joint Tenancies.** An important exception to the general rules of Section 2040 applies for certain "qualified joint interests" between a husband and a wife. Under Section 2040(b), with respect to "qualified joint interests" between a husband and wife, only one-half (1/2) of the joint property is included in the estate of the first spouse to die, regardless of which spouse furnished the consideration to purchase the jointly-held property. If, however, the jointly-held property was acquired from a third person (by gift or inheritance), then only the decedent's fractional interest in the spousal joint property is included in the decedent's estate.

c. **Pre-1977 Spousal Joint Tenancies versus Post-1977 Spousal Joint Tenancies.** Because of a "glitch" in the legislative history pertaining to Section 2040(b), different rules apply with respect to spousal joint tenancies created before 1977. If the qualified joint interest between a husband and wife was created prior to 1977, all of the jointly-held property is included in the estate of the first spouse to die, except to the extent the surviving spouse furnished consideration to purchase the jointly-owned property. The distinction between pre-1977 and post-1977 joint tenancies is important for purposes of applying the Section 1014 basis step-up rules, although the estate tax consequences are identical by virtue of the unlimited federal estate tax marital deduction. In other words, the surviving spouse acquires pre-1977 jointly-held spousal property with a **full fair market value basis step-up** under Section 1014, except to the extent the surviving spouse furnished consideration to purchase the jointly-owned property. On the other hand, with respect to post-1977 joint interests between a husband and wife, the surviving spouse only receives a **one-half basis step-up** for the inherited property under Section 1014, regardless of which party furnished the consideration to purchase the property. Patten v. United States, 80 AFTR 2d 5108 (4th Cir. 1997); Anderson v. U.S., 96-2 USTC 60,235 (May 29, 1996); Hahn v.

Commissioner, 110 TC 140 (1998); and Gallenstein v. U.S., 91-2 U.S.T.C. 60,088 (1991).

6. **Closely-held Business Interests.** As with other similar investment assets, all closely-held business interests owned by decedent at death are includable in the gross estate. However, valuing such closely-held business interests for purposes of the estate tax can be much more problematic.

7. **Lifetime Transfers with Certain Retained Interests**. In some cases, gifts made during lifetime will nevertheless be brought back into the taxable estate for estate tax purposes where the decedent retained some prohibited interest in the transferred property.

a. **Section 2036 Retained Interest in Transferred Property.** Under Section 2036, the value of property gifted away during lifetime will be included in the decedent's estate to the extent that the decedent transferred property but yet retained the possession, enjoyment, or the right to income from the transferred property, or where the decedent retained the right to determine who would enjoy the transferred property (or the income from the transferred property). Thus, for example, where the donor transfers real property to a third party but retains a life estate in the transferred property, the full value of the real property will nevertheless be includable in the decedent's estate at death under Section 2036.

b. **Section 2037 Transfers Taking Effect at Death.** Under Section 2037, the gross estate will include the value of any transferred property (a) where the donee may receive the possession or enjoyment of the property only by surviving the decedent, or (b) where the decedent retains a "reversionary interest" in the transferred property and the reversionary interest has a value at the time of death which exceeds 5% of the value of the transferred property.

c. **Section 2038 Revocable or Amendable Transfers.** Under Section 2038, property transferred by a decedent during lifetime will nevertheless be included in the taxable estate if the decedent retained the power to alter, amend, revoke, or terminate the transfer at any time thereafter.

> **Note:** Sections 2036 through 2038 will cause inclusion of transferred assets in the gross estate only to the extent that the transfer was for less than full and adequate consideration.

8. **Transfers Within Three Years of Death.** Contrary to popular belief, even deathbed gifts may escape application of the estate tax as long as the transfer takes effect before death. Thus, deathbed gifts generally are effective means of reducing a decedent's potential taxable estate. However, Section 2035 may operate to bring back certain property transfers that occurred within three years of the decedent's death, regardless of whether the gift was made in contemplation of death.

For example, under Section 2035(a), any life insurance gifted within three years of death will be brought back into the taxable estate. Likewise, the release of any prohibitive power over, or retained interest in, gifted assets under Sections 2036, 2037, or 2038 of the Internal Revenue Code will be brought back into the taxable estate where the decedent released the tainted retained interest within three years of death.

Likewise, Section 2035(b) will also require the estate to include the amount of federal gift tax paid on gifts within three years of death. Thus, if the donor made a $1 Million taxable gift on January 1, 2001, and gift tax of $240,000 was paid on April 15, 2002, the full amount of the gift tax paid on the year 2001 gift tax return ($240,000) will be brought back into the donor's taxable estate if the donor dies at any time before January 1, 2004.

9. Powers of Appointment. Under Section 2041, the decedent's estate will include the full value of any property over which the decedent held a general power of appointment as of the date of his or her death. A general power of appointment is defined as any power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. Section 2041 requires inclusion for such powers of appointment regardless of whether the power of appointment was exercised by the decedent at death or whether the power of appointment simply was allowed to lapse.

On the other hand, special or limited powers of appointment over certain property will not require inclusion back into the taxable estate. Generally, a limited power of appointment constitutes a power which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent or which cannot be exercised in favor of the power holder, his estate, his creditors or the creditors of his estate.

> **Example:** Assume a third party creates a trust for the benefit of the decedent and the decedent's children. Under the terms of the trust, the decedent has a testamentary power of appointment over the transferred property which will allow the decedent to appoint the trust property to the decedent's estate, his creditors, or the creditors of his estate. Under the facts of this example, at the decedent's death, the full fair market value of the trust will be includable in his taxable estate since he held the general power of appointment over the trust assets. On the other hand, in this example, if the decedent simply held the power to invade trust principal or income for his health, maintenance, and support, this would constitute a special or limited power of appointment which would not require inclusion in his or her taxable estate.

10. **Qualified Terminable Interest Property - Section 2044.** As discussed further below, the federal estate tax rules permit an unlimited marital deduction for certain property interests left to a trust for the benefit of a surviving spouse where the trust meets the requirements of a qualified terminable interest property trust. Since the estate of the first spouse to die gets the unlimited marital deduction for the full fair market value of the QTIP trust property, the surviving spouse must include the full fair market value of the trust property in his or her taxable estate upon his or her subsequent death. Section 2044.

D. Valuation Rules.

1. **General Valuation Rules.** Under the general valuation rules of Section 2031, property included in the decedent's gross estate is valued based upon its highest and best use fair market value as of the date of death. As with the federal gift tax, fair market value is defined at the price at which the inherited property would change hands between a willing buyer and a willing seller. Section 20.2031-1(b). Once again, under this "willing buyer and willing seller test," the value of transferred property is equal to the value that a **willing buyer and a willing seller** would place on the transferred property, neither of whom are under any compulsion to buy or sell, and both having reasonable knowledge of all the relevant facts. Regs. 20.2031-1(b). Both the seller and buyer are hypothetical persons, rather than the specific transferor or transferee. Bright v. U.S., 658 F2d. 999 (5th Cir. 1981). Therefore, any familial relationships between the transferor and transferee should not be relevant in determining value. Rev. Rul. 93-12, 1993-1 C.B. 202.

2. **Alternate Valuation Date.** Notwithstanding the general rule of Section 2031 (which provides for date-of-death valuation for estate tax purposes), under Section 2032, an executor may elect to value all assets of the gross estate based upon their fair market value as of six months after the date of death. The alternate valuation date rules may be useful where a substantial portion of the gross estate consists of marketable securities which have declined in value since the date of death.

However, there are two important limitations on the alternate valuation date rules. First of all, if the alternate valuation date is used, then all assets of the estate must be valued under the alternative valuation date method. Thus, the executor is not given leeway to simply "pick and choose" whether to value certain assets based upon their values as of date of death versus the six month alternate valuation date. Second, the alternate valuation date will be accelerated for any assets disposed of prior to the six-month alternate valuation date. That is, if any assets are sold prior to six months after date of death, then the value as of the date of sale must be used for federal estate tax purposes.

3. **Special Use Real Property Valuation Rules**. Notwithstanding the general requirement under Section 2031 that assets be valued based upon their "highest and best" use, under certain circumstances, an estate may elect to value certain farmland and closely-held business real property based upon its "actual" use, rather than based upon its highest and best value. Section 2032A contains numerous statutory requirements that must be met in order for an estate to use the special use valuation rules of Section 2032A. Examples of statutory requirements include the requirement that the property pass to a member of the decedent's family, and that the property must have been owned or used as a farm or as business property for five of the last eight years. In addition, under Section 2032A, the value of the family farm or family business includable in the estate must exceed 50% of the adjusted gross estate. Section 2032A also imposes certain recapture penalty provisions if the subject realty is disposed of within the ten-year period subsequent to death.

E. **Deductions from The Gross Estate.** Once the gross estate is determined based upon the estate tax inclusion rules and based upon the valuation rules discussed above, certain deductions are then allowable in order to determine the decedent's taxable estate. The following discussion will highlight the most relevant estate tax deductions.

1. **Administration and Funeral Expenses.** Funeral expenses are deductible as a deduction from the gross estate as are other administrative expenses, such as executor's fees, legal fees, court costs, etc., to the extent that the expenses are reasonably incurred in connection with the administration of the estate. Also, debts of the estate will also be deductible.

2. **The Charitable Deduction.** Section 2055 allows for an estate tax charitable deduction for the value of certain property passing to qualifying charitable organizations.

3. **The Unlimited Marital Deduction.** The most significant estate tax deduction is the unlimited marital deduction which will allow an unlimited deduction for property passing to a surviving spouse outright and free of trust. However, a similar unlimited marital deduction will also be available for certain interests passing to a surviving spouse in trust:

a. **General Power of Appointment Trust.** Property passing to a General Power of Appointment Trust will qualify for the full marital deduction. A General Power of Appointment Trust is a trust wherein the spouse has the right to receive the entire annual trust net income each year and the spouse has a general power of appointment over the entire trust property exercisable either during lifetime or at death.

b. <u>QTIP Trust Property</u>. Under Section 2056(b)(7), the full unlimited marital deduction is also allowable for property passing to a qualified terminal interest property trust. A terminal interest is an interest which terminates at some future event, such as the death of the surviving spouse. Although the surviving spouse's interest will terminate at his or her death, a bequest to a QTIP trust will still qualify for the unlimited marital deduction as long as the following requirements are met:

1. All income is payable to the surviving spouse annually;

2. No person (other than the surviving spouse) has any interest in the trust during the surviving spouse's lifetime; and

3. No person (including the surviving spouse) has a power to appoint any part of the trust property to a person other than the surviving spouse during the surviving spouse's lifetime (although a testamentary power appointment exercisable by the spouse over the trust property will not disqualify the property from qualifying for the QTIP trust election).

4. <u>State Death Tax Deduction</u>. A federal estate tax deduction for state death taxes actually paid is allowed.

F. <u>Computation of The Federal Estate Tax</u>. Once the taxable estate has been determined, the following steps must be taken in order to determine the estate tax assessed at death.

1. All taxable gifts of the decedent during lifetime are added to the value of the net taxable estate.

2. A tentative tax on the amounts computed above are calculated based upon the tax rate schedule.

3. The applicable credit amount is then subtracted from the gross tax to determine the actual tax assessed.

G. <u>Tax Credits</u>. There are several important credits against the estate tax.

1. <u>Applicable Credit Amount</u>. The most important is the applicable credit amount applicable to the year of death.

2. <u>Credit for Prior Transfers</u>. Finally, the estate may also be entitled to a credit for estate taxes paid on prior estates where the decedent

died owning property inherited from another estate which was also subject to estate tax in that estate.

H. Payment of The Federal Estate Tax. The federal estate tax return is due nine months after date of death, although six-month extensions are routinely granted to extend the time for filing the estate tax return. Even so, late payment penalties and interest will be assessed for any estate tax delinquencies not paid within nine months after date of death.

Finally, it is also important to note that, under Section 6166, if more than 35% of the decedent's gross estate consists of closely-held business interests, it may be possible to defer the payment of the estate tax on the closely-held business interests over a 15-year period. This Section 6166 deferral election provides for interest-only payments during the first five years after death with the tax being payable over ten years thereafter. A below-market interest rate may also apply on estate taxes paid on closely-held business interests.

VII. The Federal Generation-Skipping Tax.

A. Statutory Provisions and Nature of The Generation-Skipping Tax. Whereas the federal gift tax system prevents donors from avoiding the federal estate tax by making lifetime gifts, the federal generation-skipping tax prevents donors from avoiding application of the federal estate tax in succeeding generations by assessing a generation-skipping tax on transfers of assets beyond the next generation of family members. Thus, the purpose of the generation-skipping tax is to insure that the federal estate tax is assessed on each generation of transferees. It is important that the generation-skipping tax is assessed as **an additional excise tax** over and above application of the federal estate and gift taxes.

The tax code provisions of the federal generation-skipping tax ("GST" Tax) are contained in Chapter 13 of the Internal Revenue Code, Sections 2601 and thereafter.

B. Definition and Types of Taxable Transfers. The GST tax is imposed on "generation-skipping" transfers, including transfers during lifetime or at death or transfers outright or in trust, to certain "skip persons" as defined in the Internal Revenue Code. A "skip person" is defined as a person two or more generations below that of the transferor. In addition, a trust may be a "skip person" in those cases where trust distributions may only be made for the benefit of a skip person.

There are three types of generation-skipping transfers that are subject to the generation-skipping tax:

1. **Taxable Terminations.** A taxable termination is a taxable event that occurs at the termination of an interest in property held in trust. For example, where a father transfers property to a trust for the benefit of the father's children with the remainder interest passing to grandchildren, a taxable termination occurs at the death of the children. Section 2612(a).

2. **Taxable Distribution.** A taxable distribution is any distribution from a trust to a skip person. For example, Father transfers property in trust for the benefit of children and grandchildren. Any distribution from the trust to a grandchild is a taxable distribution. Section 2612(b).

3. **Direct Skips.** A direct skip is a transfer of an interest in property to a skip person (i.e., a grandchild). Thus, if Father makes a $100,000 gift to grandchild, this is a direct skip. Similarly, if Father leaves $100,000 in his will to his grandchild, this bequest is a direct skip.

C. **Excluded Transfers.** Certain transfers are excluded from application of the GST tax. The most significant exclusions are as follows:

1. **General Excluded Transfers.** The generation-skipping tax will not apply to any transfer from a trust where the person in a first generation below the transferor is subject to estate or gift tax liability with respect to the transfer.

> **Example:** Father creates a trust for the benefit of Son during Son's lifetime. At Son's death, the remaining trust assets will pass to the Son's child, Grandchild. However, Son is given a general power appointment over the trust assets exercisable during lifetime or at death. In this example, since all of the trust assets will be included in Son's taxable estate (by virtue of Son's general power appointment over the trust assets), the GST tax will not apply when the trust terminates and all the trust property is distributed to Grandchild.

2. **Transfers For Educational and Medical Expenses**. A similar exception applies with respect to transfers for educational or medical expenses of the transferee, such as where a grandfather pays medical expenses or educational expenses directly to an educational institution or to a medical care provider for the benefit of the grandchild.

3. **Predeceased Child Exception.** Likewise, there is no generation-skipping tax assessed where property is transferred to a skip person whose parent is already deceased.

4. **$12,000 GST Excluded Gifts for Direct Skips**. The GST tax will not apply to direct skip gifts of $12,000 or less made outright (and not in trust) to a skip person.

D. **The $2 Million Dollar Generation-Skipping Tax Exemption and GST Exemption Allocation Rules.** Every individual is allowed a generation-skipping exemption from the GST tax. This GST exemption may be used during lifetime or at death. The generation-skipping tax exemption is indexed for inflation, and is currently $2,000,000.

The GST tax and its allocation rules are quite complicated. Because this paper deals mainly with the federal and state gift and estate taxes, the discussion of the GST tax will be very elementary.

E. **Computation of Generation-Skipping Tax.** Regardless of whether the GST tax is assessed upon taxable terminations, taxable distributions or direct skips, the applicable GST tax will be equal to the taxable amount of the transfer times the applicable tax rate. The applicable tax rate will be equal to the maximum federal estate tax rate times the "inclusion ratio." Under Section 2641, the "inclusion ratio" is equal to a fraction which compares the allocated generation-skipping exemption amount to the value of the transferred property.

VIII. The North Carolina Transfer Tax Systems.

A. **Introduction.** Prior to 1999, North Carolina remained as one of the few states that assessed both an Inheritance Tax and an Estate Tax.

In 1998, North Carolina repealed the North Carolina inheritance tax, and replaced it with an Estate Tax which is now equal in amount to the full amount of the Federal State Death Tax credit in effect as of 2001. However, the North Carolina gift tax was not repealed, and thus the North Carolina gift tax remains. The Gift Tax is assessed at different tax rates based upon the relationships between the decedent and the heir (Class A, B and C beneficiaries).

B. **North Carolina Inheritance Tax Replaced with North Carolina Estate "Pick-up" or "Sponge" Tax Equal to Federal State Death Tax Credit.** The North Carolina Estate tax is reported on Form A-101, and is equal to 100% of the federal state death tax credit in effect in 2001.

1. **Calculating the North Carolina Estate Tax**. As discussed above, North Carolina assesses an estate tax equal to the federal state death tax credit in effect as of 2001, and therefore, the amount of the North Carolina estate tax is calculated as follows:

Federal Taxable Estate (Form 706, line 3)	$ A
Less Exemption Adjustment	<$60,000>
Federal Adjusted Taxable Estate	$ B

Use Table B from Form 706 (Page 10 of Instructions)
to calculate State Death Tax Credit
= Table B % x Federal Adjusted Taxable Estate (B)
= Federal State Death Tax Credit
= NC Estate Tax Liability

2. **North Carolina Only Partially Conforms to 2001 Federal Tax Act Changes**. It is important to note that the amount of the North Carolina estate tax is actually greater than the federal state death tax credit. As discussed in Part III above, under the Federal 2001 Tax Act, the federal state death tax credit was reduced and was replaced with a deduction in 2005. The following chart illustrates the available federal state death tax credit:

Year of Death	Federal State Death Tax Credit
2001	100% of credit
2002	75% of credit
2003	50% of credit
2004	25% of credit
2005	Credit replaced by deduction

Unfortunately, when the Federal 2001 Tax Act was enacted, the North Carolina Legislature did not fully adopt conforming changes to the Federal 2001 Tax Act with respect to the phase-out of the federal state death tax credit. Instead, the North Carolina Legislature has adopted a North Carolina estate tax equal to the maximum federal state death tax credit in effect in 2001, based upon the federal estate tax exemption in effect for the year of death.

This means that estates of decedents dying in 2006 with an estate **over** $2.0 Million will pay North Carolina estate tax equal to 100% of the federal state death tax credit that would have applied to the estate based upon the normal federal state death tax credit in effect in 2001. In other words, the North Carolina estate tax is equal to the state death tax credit before applying the percentage reduction to the federal state death tax credit under the Federal 2001 Tax Act. Thus, decedents dying in North Carolina in 2006 with an estate over $2.0 Million will owe North Carolina estate tax.

3. **Calculating North Carolina Estate Tax for Residents Owning Property Outside of North Carolina; "Net-to-Net" Value Proration Replaced by "Gross-to-Gross" Value Formula for Decedents with Property in More than One State.** Although the North Carolina estate tax calculation normally is very simple, the estate tax calculation historically has been much more complex where a North Carolina resident died owning encumbered property outside North Carolina. Since the Federal State Death Tax Credit is then apportioned among the subject states, a conflict may arise between two or more states as to how the credit should be apportioned for state death tax purposes.

Until recently, North Carolina law applied a "net-to-net" formula for allocating the federal state death tax credit among competing states. N.C.G.S. § 105-32.2(b). The following examples illustrate allocation problems that frequently arose under "old" North Carolina law.

Example 1. Assume a NC Resident dies owning the following unencumbered property:

	NC Property	Other State Property
Value of Property	$1,000,000	$1,000,000
Mortgage	-0-	-0-
Net Value	$1,000,000	$1,000,000

Total Federal Taxable Estate	$2,000,000
Federal State Death Tax Credit	$ 99,600
NC Estate Pick-up Tax (½ x $99,600)	$ 49,800

Example 2. Now assume the NC Resident dies owning the following encumbered property:

	NC Property	Other State Property
Value of Property	$1,000,000	$1,000,000
Mortgage	-0-	< 750,000>
Net Value	$1,000,000	$ 250,000

Total "Net" Value = $1,250,000

Under "old" North Carolina law, the federal estate death tax credit would be apportioned between North Carolina and the other state according to the following allocation formula:

Total Federal Taxable Estate	$2,000,000
Federal State Death Tax Credit	$ 99,600
NC Estate Pick-up Tax ($\frac{1,000,000}{1,250,000}$ x $99,600)	$ 79,690

This meant that a conflict could arise between the North Carolina and the other state departments of revenue if the other state applied a "gross to gross" formula.

Fortunately, however, N.C.G.S. 105-32.2(b) has been revised (S.B. 1416) to replace the old "net to net" formula with a "gross to gross" formula. Of course, conflicts still may arise between the departments of revenue of North Carolina and another state that imposes a "net to net" formula. The new changes are effective for decedents dying after January 1, 2002.

4. Order of Liability for Unpaid NC Estate Tax. The primary responsibility for payment of the North Carolina estate tax falls upon the estate assets. N.C.G.S. § 105-32.3(a). However, the recipient of property from an estate may be held personally liable for any unpaid estate tax. N.C.G.S. § 105-32.3(a). Furthermore, if the North Carolina estate tax is not paid within two (2) years after the tax was due, the estate personal representative may be held personally liable for payment of the tax, although the personal representative's liability is limited to the value of assets under the personal representative's control. N.C.G.S. § 105-32.3(b). Finally, even the Clerk of Court can be held liable for payment of the North Carolina Estate Tax where the Clerk accepts the final accounting without an estate tax payment certification from the personal representative or the North Carolina Department of Revenue. N.C.G.S. § 205-32.3(c).

5. Due Date for Form A-101 and Payment of Tax. Under N.C.G.S. § 105-32.4(a), the North Carolina Estate Tax Return is due on the same date the federal estate tax return is due. Please note that an extension of time to file the federal estate tax return automatically operates to extend the time for filing the

North Carolina Estate Tax Return. N.C.G.S. § 32.4(c). However, the North Carolina Estate Tax is still due nine months after the date of death, although the North Carolina Secretary of Revenue may, upon application, extend the time for paying the North Carolina estate tax. N.C.G.S. § 105-32.4(c) and N.C.G.S. § 105-263.

6. Late Payment and Late Filing Penalties. Under N.C.G.S. § 105-236(3), a late filing penalty of 5% per month (maximum of 25%) may be assessed. In addition, the 10% underpayment penalty under N.C.G.S. § 105-236(4) will be assessed for late tax payments.

7. PR may make Federal Section 6166 Election for NC Tax. A personal representative who makes a Federal Section 6166 election to pay federal estate tax in installments may also file an election with the North Carolina Department of Revenue to pay the North Carolina Estate Tax in installments. N.C.G.S. § 105-32.5.

C. North Carolina Gift Tax. North Carolina remains one of the few states with a gift tax.

1. Class Beneficiaries. The North Carolina gift tax has a class donee system. The North Carolina gift tax is assessed at different tax rates based upon the relationships between the donor and the donee. Under N.C.G.S. § 105-188(f), gift donees are classed into one of three classes: Class A, B and C donees. Class A donees include ancestors and lineal issue, and adopted children and stepchildren (but not foster children). Class B donees include siblings, aunts and uncles, and nieces and nephews (but not cousins). Class C donees are cousins and everyone else other than Class A and Class B donees.

For gift tax purposes, daughters-in-law and sons-in-law will **never** qualify as Class A beneficiaries. Thus, Class A gifts are limited to ancestors, children and other descendants.

2. Marital Exemption (G.S. Section 105-188(h)). North Carolina allows an unlimited marital exemption from the gift tax for the value of all property given to a spouse. The exemption is applicable to marital gifts made on or after January 1, 1986. As of January 1, 1997, a gift to an irrevocable QTIP trust may also qualify as an exempt transfer.

3. Gift Tax Rates. The gift tax rates for Class A donees begin at 1% (taxable gifts under $10,000), and reach as high as 12% for taxable gifts over $3 Million. Gift tax rates for Class B and Class C donees range from 4% to 16%, and 8% to 17%, respectively. In addition, the gift tax rates apply to each donee separately.

4. **$12,000 Annual Gift Tax Exclusion.** North Carolina now allows a $12,000 per donee annual exclusion for present interest gifts made to any one donee in any calendar year. The $12,000 annual exclusion, however, will not apply if the gift is a gift of a future interest. However, G.S. Section 105-188(d) permits use of the $12,000 annual exclusion for transfers into trusts for the benefit of minors. This exception is similar to the rule for gifts to minors under Internal Revenue Code Section 2503(c).

North Carolina now allows a nondonor spouse to consent to allow the donor spouse to use the nondonor spouse's $12,000 annual exclusion for gifts made to third parties during each calendar year. However, as discussed below, gift-splitting in excess of the annual exclusion is not permitted.

Also, for North Carolina gift tax purposes, spouses may share annual exclusions only if this election is made on a timely filed gift tax return.

5. **$100,000 Lifetime Specific Exemption.** North Carolina allows a $100,000 lifetime exemption, effective for gifts after January 1, 1986, for gifts to Class A donees. **This exemption is only available for Class A beneficiaries.** Gifts prior to 1986 were subject to a $30,000 lifetime exemption. The $100,000 lifetime specific exemption may be used in one year, or it may be spread over a period of years. When the exemption or any portion thereof is applied to gifts to more than one donee in any **one calendar year**, it is apportioned against the gifts in the same ratio as the gross value of the gifts to each donee is to the total value of said gifts in a calendar year in which the gifts are made.

> **Note:** In contrast to the federal unified credit, allocation of the North Carolina gift tax specific exemption is optional. In each calendar year a taxable gift is made, the donor can elect whether to use the $100,000 lifetime specific exemption, or elect to use only a portion of the exemption (and paying tax on the unexempt portion).
>
> **Example**. In 1996, Taxpayer makes $30,000 cash gifts to three of his four children. In March 1997, before Taxpayer files his North Carolina gift tax return, Taxpayer decides to gift a large tract of real property (valued at $500,000) to his fourth child. In this case, the Taxpayer may wish to defer allocation of the $100,000 specific exemption to the 1997 gifts to child number 4.

6. **Taxable Transfers.** The tax is generally imposed upon the transfer of property by gift during the calendar year. It applies whether the property is real, personal, or mixed, and applies whether the gift is in trust or otherwise and whether the gift is direct or indirect.

7. **Examples of Transfers Subject (or Not Subject) To North Carolina Gift Tax.**

a. **Tuition and Medical Payments (G.S. Section 105-188(i)).** As with the federal gift tax, the North Carolina gift tax does not apply to tuition payments made on behalf of an individual to an educational institution that maintains a regular faculty and curriculum and has a regularly organized body of students in attendance where educational activities are conducted. Also, medical payments made on behalf of an individual to a provider of medical care are exempt from the gift tax.

b. **Revocable Trusts (G.S. Section 105-188(c)).** Revocable trusts are generally not subject to gift taxes. However, if the Grantor releases his power of revocation, this act may constitute a completed gift and thus a transfer subject to gift taxes.

c. **Transfers for Less than Adequate and Full Consideration (G.S. Section 105-189).** If a transfer is for less than adequate and full consideration in money or money's worth, the value of the property transferred in excess of the value given is considered a gift.

d. **Powers of Appointment (G.S. Section 105-188.1).** The creation of a general or special power of appointment by a donor is a taxable event. Also, the exercise or lapse (in excess of the "5 and 5" exclusion, discussed above) of a general power of appointment by a donee is a taxable event. G.S. Section 105-188.1(d) provides that if a donor gives a special power of appointment with respect to gifted property, the donor shall be deemed to have given the interest to not more than two persons among the possible appointees and takers in default of such appointment. These takers may be designated by the donor or his executor on the gift tax return.

e. **Temporary Transfer to Avoid Creditors Was Taxable Gift.** The conveyance of property to a family member during the taxpayer's divorce proceedings was subject to North Carolina gift tax because the property was transferred in fee simple by a written deed. The oral agreement between the parties, prior to the transfer, stating that the property would be conveyed back to the taxpayer-transferor immediately after the conclusion of the divorce proceeding was irrelevant. The deed was considered the final agreement of the parties and it did not establish that the former owner maintained practical ownership of the property throughout the transfer by reserving the right to recover the property to himself. (Joines v. Anderson, North Carolina Court of Appeals, No. COA02-179, November 18, 2003).

f. **Gift to Daughter-in-Law Taxed as Class C Donee Gift.** In Secretary of Revenue Decision 2003-381 (January 30, 2004), the donor transferred three parcels of real property to his son and daughter-in-law. Although the donor and son asserted that the donor's gift was intended to solely benefit the donor's son, the Secretary of Revenue concluded

that gift tax was properly assessed on the portion of the gift to the daughter-in-law, as a Class C donee. Also, since one-half of the gift was to a Class C donee, the portion of the gift to the daughter-in-law did not qualify fo the $100,000 specific gift tax exemption. Since the son and daughter-in-law were spouses, the gift created a tenancy-by-the-entirety, which meant that the value of the gift would be equally divided between the son and daughter-in-law. Arguably, however, the value of the gift to the daughter-in-law should have been subject to a "fractional interest" valuation discount.

8. **Valuation (G.S. Sections 105-190 and 105-195).** The gift tax is assessed on the fair market value of the property at the time of the gift.

9. **Major differences Between the Federal Gift Tax and the State Gift Tax.** There are several important differences between the Federal and the North Carolina Gift Tax Systems.

a. **Gift Splitting.** There is no true gift splitting concept under the North Carolina gift tax law. The North Carolina rule, which allows a non-donor spouse to consent to allow a donor-spouse to use the non-donor spouse's $12,000 annual exclusion, does not extend to treat gifts in excess of the annual exclusion of both spouses as being made one-half by each spouse. The same result, however, can be obtained by an outright transfer to a spouse (covered by the marital exemption) to allow both spouses to make gifts directly to the donee.

> **Note:** Because of the progressive nature of the North Carolina gift tax rates, this technique is critically important.

> **Note: The election to share a spouse's annual gift tax exclusion must be made on a timely filed North Carolina gift tax return.**

b. **No Unified System.** The North Carolina estate tax is not unified with the North Carolina gift tax. Thus, there is no benefit in "saving" the North Carolina $100,000 lifetime specific exemption until death.

c. **"Gross-Up".** The federal estate tax law requires any federal gift tax (but not state gift tax) paid with respect to gifts made within three years of death to be added back ("grossed-up") to the gross estate thereby creating a "tax on a tax." However, state gift tax paid within three years of death is not added back to the gross estate for federal estate tax purposes. Nevertheless, since the North Carolina estate tax operates independently from the North Carolina gift tax, a large "death bed gift" should produce a tax penalty since state gift taxes otherwise would have been avoidable.

d. Split-Interest Gifts. When "split interest" gifts are made, North Carolina always applies a 6 percent (6%) interest rate when valuing split interest gifts. This differs from split interest valuation for federal tax purposes, since the Applicable Federal Rate is used to value split interest gifts for federal gift tax purposes.

i. Valuation of Split Interest Gifts for Federal Tax Purposes. In calculating the values of split interest gifts, the federal tax laws provide for a discount rate equal to the Applicable Federal Rate in effect at the time of the split interest transfer. In addition, for federal tax purposes, to determine the value of any split interest gifts to remainder beneficiaries, the donor is permitted to take **mortality factors** into consideration since it is always possible that the grantor will die during the trust term which would cause the trust property to revert back to the grantor's taxable estate. These **mortality factors** will further reduce the value of any deemed transfers to remainder beneficiaries for federal gift tax purposes.

ii. North Carolina Valuation of Split Interest Gifts. For purposes of determining the value of split interest gifts, North Carolina assumes a **6% discount rate**. Since the federal rule provides that the discount rate will be equal to the Applicable Federal Rate, a split interest gift will almost always have a higher gift tax value for North Carolina tax purposes than it will for federal tax purposes since the AFR is almost always greater than the North Carolina discount rate of 6%.

Moreover, it is also important to realize that the IRS uses a "Probability Table" containing mortality factors to further reduce the transfer tax associated with split interest transfers. Currently, the North Carolina Department of Revenue takes the position that, for North Carolina tax purposes, gift tax values are **not reduced** based on any "probability" that the grantor may die during the trust term and hence have the trust property revert to the grantor's estate. Reynolds vs. the State of North Carolina Department of Revenue, 582 S.E. 2d 638 (July 15, 2003).

As a result, whenever split interest gifts are made for estate planning purposes, the split interest gift must be valued differently for federal tax purposes than for state tax purposes. This is one of the most common mistakes that practitioners make when filing North Carolina Gift Tax Returns.

10. Filing of Gift Tax Return and Liability for Payment of Tax. Under G.S. Section 105-197, a gift tax return is due on or before April 15th following the year of the gift where the total value of the gift exceeds the $12,000 annual exclusion amounts.

Although the donor is primarily responsible for the payment of the gift tax, G.S. Section 105-193 provides that, if the gift tax is not paid by the donor, each donee shall be personally liable for the gift tax to the extent of the gifts received.

11. <u>Extensions of Time to File North Carolina Gift Tax Returns and Extensions of Time to Pay North Carolina Gift Tax</u>.

a. <u>25% Late Filing Penalties</u>. Under N.C.G.S. § 105-236(3), a late filing penalty will be assessed whenever a North Carolina Gift Tax Return is not timely filed. The late filing penalty is equal to 5% of the Gift Tax due for each month the return is filed late - up to a maximum penalty of 25%.

b. <u>Late Payment Penalty</u>. Under N.C.G.S. § 105-236(4), a late payment penalty will be assessed whenever the full amount of North Carolina Gift Taxes are not paid by the original due for filing the North Carolina Gift Tax Return. The late payment penalty is 10% of the amount of taxes due with the original North Carolina Gift Tax Return.

c. <u>Assessment of Both the 25% Late Filing Penalty and the 10% Late Payment Penalty</u>. The North Carolina Department of Revenue can assess both the 25% late filing penalty and the 10% late payment penalty which may generate a total penalty equal to 35% of the tax which was originally due.

d. <u>How to Obtain an Extension of Time to File the North Carolina Gift Tax Return</u>. In order to obtain an extension of time for filing the North Carolina Gift Tax Return, the taxpayer must file Form D-410 with the North Carolina Department of Revenue by the original due date for filing the gift tax return. In addition, the taxpayer must also **specifically denote** on the Form D-410 that the taxpayer is requesting an extension of time to file the North Carolina Gift Tax Return by marking the appropriate "box" marked "gift tax."

As an alternative to filing the Form D-410 with the North Carolina Department of Revenue, the taxpayer may instead file a copy of the U.S. Form 4868 which has previously been filed with the Internal Revenue Service. However, once again, the taxpayer must **specifically designate** on the Form 4868 that the taxpayer is requesting an extension of time to file the North Carolina Gift Tax Return.

In many cases, taxpayers and tax practitioners have mistakenly assumed that an extension of time to file the North Carolina Gift Tax Return will be granted simply:

-where the taxpayer files a North Carolina extension request for filing a **North Carolina** **<u>income</u>** **tax return**, or

-where the taxpayer only files a **federal gift tax extension** request with the Internal Revenue Service.

Therefore, in order to avoid the late filing and late payment penalties, tax practitioners should always make sure that the client files a **separate** North Carolina Gift Tax Return extension request in addition to the North Carolina income tax extension request **and** in addition to the Federal Gift Tax extension request.

> **Note:** Although, N.C.G.S. 105-237(a) allows the North Carolina Department of Revenue the discretion to waive late filing and late payment penalties where the taxpayer's failure to timely file a return, or failure to timely pay the full amount of taxes owed, is due to reasonable cause, the North Carolina Department of Revenue has adopted a very strict approach to viewing penalty abatement requests.

12. <u>Payment of North Carolina Gift Tax: New Legislative Change</u>. Before 1997, in order to secure an extension of time for filing the North Carolina Gift Tax Return, the taxpayer had to pay the full amount of expected gift taxes due with the extension application request.

However, Senate Bill 784, enacted by the General Assembly in June 1997, has amended G.S. Section 105-263 to now provide that a taxpayer may secure an extension for filing a North Carolina gift tax return even if the taxpayer fails to pay the full amount of expected gift tax. Nevertheless, the late payment penalty will still apply if the gift tax is not fully paid by April 15.

13. <u>Tax Lien (G.S. 105-193)</u>. A tax lien attaches to gifted property for ten (10) years after the date of the gift. If the gifted property is later sold to a bona fide purchaser (BFP) for full and adequate consideration, the lien is divested from the gifted property, but attaches to the sale proceeds and after-acquired property held by the donor.

14. <u>Statute of Limitations (G.S. 105-241.1(e)</u>. The statute of limitations is three years, beginning with the date the return if filed. If the donor dies within three years of the filing date, the statute of limitations may be extended until the final settlement of the donor/decedent's inheritance tax return.

D. <u>North Carolina Generation Skipping Transfer Tax</u>.

1. **In General.** North Carolina imposes a generation skipping tax upon generation skipping transfers which are subject to the federal generation skipping tax under Chapter 13 of the Internal Revenue Code, in an amount equal to the amount allowable as a credit for state generation skipping taxes under Internal Revenue Code Section 2604. (See G.S. Section 105-7.1).

2. **Resident and Non Resident Transferors**. If the "original transferor [was] a resident of [North Carolina] at the date of the original transfer" the tax is equal to the "residual differential" between the maximum 2604 credit and the aggregate amount of taxes actually paid to all states other than North Carolina (G.S. Section 105-7.1(a)). If the original transferor was not a resident of North Carolina at the date of the original transfer but the transfer includes real or personal property with a situs in this state, the tax is allocated on a "ratio" basis in which a fraction with a numerator equal to the value of North Carolina taxable transfer and a denominator equal to the value of all taxable transfers is applied to the maximum State Credit (G.S. Section 105-7.1(b)). If the original transferor was not a resident of North Carolina at the date of the original transfer and the transfer does not include any real or personal property with a situs in this state, no tax is imposed.

3. **Returns and Due Date and Party Liable for Tax.** No North Carolina generation-skipping tax form is required; instead, the statute provides that the persons required to file the federal return shall file a duplicate copy with the Secretary of Revenue on or before the last day prescribed for filing the federal return (G.S. Section 105-7.1(c)). The persons liable for the federal tax are made liable for the North Carolina tax (G.S. Section 105-7.1(d)). If the IRS assessment represents an increase or decrease from the federal tax liability reported, the person who filed the North Carolina return should file an amended return with the Secretary of Revenue within 30 days thereafter (G.S. Section 105-7.1(e)). If this deadline is not met, additional tax may be assessed at anytime; otherwise, the standard three year statute of limitations on assessment would apply.

IX. North Carolina Statute to Apportion the Federal Estate Tax.

The North Carolina Act to Apportion the Federal Estate Tax (enacted by the 1986 Legislature and amended by the 1987 Legislature) is having a significant impact on estate planning and estate administration in North Carolina.

A. **Statutory Scheme.** The North Carolina apportionment statute generally provides that, unless a decedent's Will provides for a method of apportionment different from the method provided in the statute, the federal estate tax (including any interest and penalties imposed thereon) must be "apportioned among all persons interested in the estate in the proportion that

values of the interest of each person interested in the estate bears to the total value of the interests of all persons interested in the estate." The statute provides that values as finally determined for federal estate tax purposes shall be used for the purpose of this computation. The new statute further provides that, in the event a decedent's will does provide for a method of apportionment different from that prescribed under the statute, the method described in the Will shall control.

Generally, however, practitioners will use "form" Wills which provide for the payment of the federal estate tax out of the "residuary" estate. This type of residuary payment clause will normally prevent the NC Apportionment statute from applying to that estate. However, the statute provides that a **general direction** in a Will executed after October 1, 1986, that taxes shall not be apportioned, but shall be paid from the residuary portion of the estate, shall not, unless specifically stated otherwise, apply to taxes imposed on assets which are includable in the valuation of the decedent's gross estate for federal estate tax purposes only by reason of Sections 2041 [powers of appointment], 2042 [proceeds of life insurance] or 2044 [certain property for which a marital deduction was previously allowed] of the Internal Revenue Code of 1986 or corresponding provisions of any subsequent law. The new statute provides that, unless specifically stated otherwise in the Will, in the case of property subject to tax by reason of inclusion in the taxable estate under those Code Sections, apportionment shall be made against such assets and the tax so apportioned shall be recovered from the persons receiving such assets as provided in Sections 2206, 2207 or 2207A of the Code.

With respect to Wills executed before October 1, 1986, a general direction in a Will that taxes not be apportioned will be sufficient to avoid the effect of the North Carolina apportionment statute.

After establishing the foregoing general statutory scheme for apportionment, the new statute deals with several specific issues relating to apportionment as explained below.

1. No Apportionment Between Temporary and Remainder Interests (G.S. 28A-27-6). The statute provides that there is to be no apportionment as between a temporary interest (e.g. a life estate or a term of years) and the remainder interest. Thus, where there are split-interests in property, the tax is apportioned against the entire corpus of the property or funds subject to the split-interests.

2. Adjustment For Fault (G.S. 28A-27-3). In addition, the Statute provides that if the Personal Representative of the decedent finds that it is inequitable to apportion interest and penalties imposed in connection with the

estate tax in the manner generally provided under the Statute because such interest or penalties were imposed due to the fault of one or more of the persons interested in the estate, the Personal Representative may direct apportionment thereon in the manner he finds equitable. The Statute does not indicate what procedure a Personal Representative is to follow in order to document such a finding of fault, nor does it provide any mechanism for supervision of such a finding. Accordingly, the Personal Representative is placed in the position of being subject to suit in any case where penalty and interest are assessed, either by the beneficiary to whom such "fault" has been determined, or by the remaining beneficiaries if no "fault" is so determined.

3. **Apportionment of Expenses Incurred In Connection With Apportionment (G.S. 28A-27-3).** The Statute further provides that the expenses reasonably incurred by the Personal Representative in connection with the apportionment of the tax "shall" be apportioned along with the apportionment of the tax itself. However, the Statute further provides that if the Personal Representative finds that it is inequitable to apportion such expenses because such expenses were incurred because of the "fault" of one or more of the beneficiaries, he may direct another, more equitable means of apportionment. Again, the Personal Representative is placed in a precarious position as a result of this provision.

B. **Exemptions, Deductions and Credits (G.S. 28A-27-5).** The Statute provides that any interest in property for which a deduction or exemption is allowed under the Code (such as a marital deduction or charitable deduction) is not to be included in the computation of apportionment. When such an interest is subject to a prior present interest which is not allowable as a deduction or exemption (such as a "lead" interest in a charitable remainder trust), such present interest shall not be included in the computation for apportionment and no tax shall be apportioned to or paid from principal.

Any federal credit for property previously taxed or for gift taxes or death taxes payable to a foreign country generally inure to the proportional benefit of all beneficiaries of the estate in determining apportionment. However, if the tax which gives rise to such a credit has in fact been paid by a particular beneficiary or group of beneficiaries, the benefit of the credit shall inure to the beneficiary or beneficiaries paying the tax. Any credit for estate, inheritance, succession or similar taxes generally inures to the benefit of all of the beneficiaries of the estate in determining the apportionment.

C. **Administrative Provisions.** The Statute contains several important administrative provisions.

1. **Uncollected Tax (G.S. 28A-27-4).** The Statute provides that the Personal Representative of the decedent is not under a duty to initiate any

action to recover tax apportioned to any beneficiary until the expiration of six months next following the final determination of the tax. In addition, a Personal Representative who initiates such action within a reasonable time after the six month period is not subject to any liability or surcharge as a result of the fact that a portion of the tax apportioned to any beneficiary has become uncollectible. If the Personal Representative cannot collect the tax apportioned to any beneficiary, the amount not collected is to be apportioned among the other beneficiaries of the estate, on a pro rata basis.

2. **Rights and Duties of the Fiduciary (G.S. 28A-27-7).** The Personal Representative can withhold from any beneficiary the amount of tax apportioned to the beneficiary's interest. If the Personal Representative is not in possession of the property subject to apportionment which passes to any beneficiary, the Personal Representative may recover the beneficiary's share of the tax from the beneficiary.

In addition, the Personal Representative may require a beneficiary to provide a bond or other security for the determination and apportionment liability if property held by the Personal Representative is distributed prior to the date of final apportionment of tax. Any such bond would require the approval of the Clerk of Court having jurisdiction over the estate.

D. Observations Regarding the Apportionment Statute. The Apportionment Statute initially received mixed reviews from the estate planning community. The Statute was submitted through the office of the Revisor of Statutes of North Carolina without input from the North Carolina Bar Association. The Statute is effective for estates of decedents dying on or after October 1, 1986.

The Act has been recognized as providing for a definite means of apportionment to provide significant guidance to a Personal Representative where such guidance was not contained in a Will. Thus, the Personal Representative can avoid disputes which might arise without the benefit of the statute. However, as discussed above, the Personal Representative may be placed in an undesirable position as a result of the statutory provisions granting "equitable" apportionment in cases where a beneficiary or group of beneficiaries are at fault in causing penalties and interest to be imposed upon the estate or in causing expenses to be incurred in connection with apportionment.

X. Practical Planning and the Use of Trusts.

A. Estates Under the Applicable Exemption Amount. Estates that are below the applicable exemption amount ($2,000,000 in 2007) do not generally require sophisticated estate planning. Thus, a simple will, naming

the surviving spouse as the beneficiary and the children as alternate beneficiaries, will be sufficient to allow the applicable exclusion amount to pass free from estate tax. Furthermore, an unlimited amount of property can pass to a spouse tax free. Of course, if the estate at the second to die is greater than the applicable exclusion amount, federal estate tax will be assessed at the second death.

B. **Estates Over the Applicable Credit Amount**. In 2007, if the assets of both spouses exceed $2,000,000 but are less than $4,000,000, federal estate tax should be avoidable by utilizing the applicable credit of each spouse and the marital deduction. While estates exceeding the combined applicable credit amounts of the spouses will likely incur some tax, proper planning can minimize this tax. Currently, anyone planning for estates of $2,000,000 or more must be cognizant of the 2001 Tax Act and the effect that the quickly changing credit amounts, repeal and probable reinstatement of the estate tax and lower applicable credit amounts may have. Practitioners must draft carefully with this in mind.

C. **Types of Trusts**.

1. **Revocable Trust.** Beyond the simple will, one can use a revocable trust as a will substitute. While the revocable trust does not provide any tax benefits, it does allow the assets in the trust to avoid probate and probate fees. Another advantage of the revocable trust is that it can protect one's privacy because it does not become part of the public record as a will does upon probate. A revocable trust as described above is often called a "living" trust.

Generally, the revocable trust appoints the grantor as the trustee and gives the grantor broad powers to change the trustee and to amend or change the trust in whole or in part. It usually provides for distributions of income and principal for the benefit of the grantor and his or her family members. Upon the death of the grantor, the trust becomes irrevocable. After the death of the grantor, the trustee may be directed to give outright distributions to the beneficiaries or may be directed to continue holding assets in trust for their benefit.

While the trust is revocable, all income produced by the trust is taxed to the grantor. It will further be taxed when the trust becomes irrevocable. If the trust becomes irrevocable during the lifetime of the grantor, then gift tax will be assessed, but if the trust becomes irrevocable at death, then the trust will be included in the grantor's estate for estate tax purposes.

2. Irrevocable Life Insurance Trusts. Often times estate planners use irrevocable life insurance trusts (ILIT) to shelter the proceeds of an insurance policy from taxation in the donor's estate. Some of the benefits to using the life insurance trust over gifting a policy outright are listed below:

1. The proceeds can be used to support the insured's spouse for the spouse's lifetime;
2. The proceeds can be used to pay estate taxes at the death of the insured or the insured's spouse;
3. The proceeds can fund a buy-sell agreement with respect to the insured's closely-held business;
4. It can avoid immature children wasting the proceeds;
5. It can avoid the funds being distributed in an undesired way if a child should die or get divorced after the insured's death;
6. Gifts to the trust can be structured to take advantage of the $10,000 annual exclusion.

In most ILITs the trustee is authorized to purchase or otherwise acquire life insurance on the grantor's life (or on the life of the grantor's spouse). If future gifts are made to the trust the trustee is generally directed to advise all beneficiaries of the trust that they have the right to withdraw a certain part of the gift (usually expressed as a pro rata share of the gift subject to an annual limitation of $5,000 per donee). The beneficiary's power of withdrawal (also known as a "demand right" or "Crummey" power) is usually designed to lapse if not exercised within a given period of time. This immediate right allows the contribution to qualify for the annual exclusion as a present interest gift. If no one exercises the demand right, the trustee can use the gift to pay the insurance premiums.

For income tax purposes, most ILITs are drafted so that during the grantor's life, all income earned by the trust is taxable to the grantor. For transfer tax purposes, the "Crummey" provision will allow up to $12,000 to qualify for the annual exclusion. However, any Crummey right in excess of $5,000 will be considered as if the beneficiary withdrew the excess and made a gift back to the ILIT. Due to this treatment, the beneficiary becomes a partial grantor to the trust which can have negative tax consequences. Most ILITs limit the power of withdrawal to $5,000 in order to avoid the above result.

ILITs can be a wonderfully effective tool in saving transfer taxes. In order to ensure the ILIT is effective, one must be extremely careful to adhere to all formalities. For instance, the grantor should not (i) be a trustee, (ii) have a power of removal or replacement over the trustee, or (iii) have any other rights over the trust. No part of the trust should ever revert to the grantor under any circumstances. Therefore, it is advisable to name a contingent beneficiary in case all of the beneficiaries and the grantor die.

3. **Credit Shelter Trusts.** The Credit Shelter Trust (also known as the "Family Trust") is designed to take advantage of the applicable exemption amount. An amount equal to the taxpayer's exemption amount will be held in the trust for the benefit of the surviving spouse and then pass to the children or grandchildren at the death of the surviving spouse. While the grantor may wish to give the surviving spouse substantial powers over the trust, the drafter must take care not to make the trust includable in the surviving spouse's estate because of these powers. The surviving spouse may have the right to receive all of the income from the trust and discretionary distributions of principal for his/her health, maintenance, or support. He/she may also be allowed to withdraw up to five percent of the principal for any reason, maintain a special power of appointment, and even serve as trustee or co-trustee.

> **NOTE**: If the trustee is given the power to make discretionary distributions, the surviving spouse cannot act as trustee and be a beneficiary, unless the power is subject to an ascertainable standard.

A properly drafted credit shelter trust can not only avoid estate tax at the grantor's death by using his/her applicable exemption amount, but should also avoid inclusion in the surviving spouse's estate. If the surviving spouse was given a right to withdraw a percentage of principal, that amount will be included in the surviving spouse's estate.

4. **Qualifying Marital Trust.** The marital trust is most often used in conjunction with the credit shelter trust (known as an A-B Plan) for estate planning purposes. While one can qualify assets for the marital deduction by outright gift, a trust allows the grantor to retain more control over the management of the assets. This type of trust allows a deferral in estate tax until the death of the surviving spouse instead of avoidance of tax as in the credit shelter trust discussed above. There are three types of marital trusts described in this section—(i) the Qualifying terminable interest property trust (QTIP), (ii) a General Power of Appointment Marital Deduction Trust, and (iii) an Estate Trust.

a. QTIP Trust. The QTIP trust provides that the surviving spouse has a "qualifying income interest for life" as defined by IRC § 2050(b)(7). The surviving spouse must have the right to receive all income currently and be the only beneficiary of the trust during the surviving spouse's lifetime. No one other than the surviving spouse may receive distributions during the surviving spouse's lifetime, nor can anyone (including the surviving spouse) have the power to appoint any part of the trust to someone other than the surviving spouse. The surviving spouse must have the power to direct the trustee to convert non-income producing property into income-producing property. Finally, the personal representative of the grantor must make an election on the grantor's federal estate tax return in order to qualify for QTIP treatment. The election causes the full value of the trust to be included in the taxable estate of the surviving spouse.

b. General Power of Appointment Trust. This type of trust is similar to the QTIP trust except that the surviving spouse must be given a general power of appointment to direct distribution of the trust assets, either during life or at death, to anyone, including the surviving spouse, his/her creditors, estate and the creditors of the estate. There is no need to make an election here since the trust automatically qualifies for the marital deduction. This trust puts a great deal of power into the hands of the surviving spouse, and is not often used.

c. Estate Trust. The Estate Trust does not require the trustee to make current distributions to the surviving spouse. Instead, the trustee must distribute all of the remaining trust assets to the probate estate of the spouse. This trust is not often used as it gives the grantor the least amount of long-term control over the trust.

D. Equalizing the Estates.

Although the combined use of the credit shelter and marital trusts can provide an effective way to minimize the estate tax, the plan may not work if only one spouse holds the majority of the assets or if the assets are held jointly with survivorship rights. Property held with the spouse with survivorship rights will pass free of estate tax because of the marital deduction, the tax will only be deferred and the applicable exclusion amount could be wasted. As part of the planning for a married couple, it may be necessary to change the ownership in certain assets so that each spouse has enough assets to utilize his or her entire exclusion amount.

E. Powers of Attorney.

Powers of Attorneys can be crucial in carrying out your clients estate planning or asset protection plan if he or she should become

incapacitated. A general durable power of attorney can allow the attorney-in-fact to make gifts to himself or others, but only if specifically set forth in the power of attorney. Checking the gifting provision on the statutory short form is not generally sufficient as it is limited to the person's personal history of gift-giving. For estate planning purposes, we often want our client to have the ability to give up to the annual exclusion amount each year. Additionally, if Medicaid planning is needed, an unlimited gifting power may be necessary. These issues should be discussed thoroughly with the client and drafted carefully to meet the particular goal of the client.