

STATE OF NORTH CAROLINA  
COUNTY OF WAKE

BEFORE THE  
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessment of Additional )  
Gift Tax for the Taxable Year 1997 by the )  
Secretary of Revenue of North Carolina, )  
 )  
vs. )  
 )  
[Taxpayer] )

**FINAL DECISION**  
Docket No. 2000-422

This matter was heard before the Assistant Secretary of Revenue, Michael A. Hannah, in the city of Raleigh on October 26, 2000, upon an application for a hearing by [Taxpayer], wherein she protested the proposed assessment of additional gift tax for the taxable year 1997. The hearing was held by the Assistant Secretary of Revenue under the provisions of G.S. 105-260.1 and was attended by [Taxpayer's Representative;] Gregory B. Radford, Assistant Director of the Personal Taxes Division; and Glenn B. Cox, Jr., Audit Unit Supervisor in the Examinations Division.

Taxpayer timely filed a North Carolina gift tax return for the tax year 1997 to report gifts to four children. Taxpayer claimed the annual exclusion, resulting in no gift tax due. On April 5, 1999, the Department of Revenue received an amended 1997 gift tax return on which Taxpayer reported additional gifts to the four children. Each gift was a 25% undivided interest in the remainder of the property held by the [Taxpayer's] Qualified Personal Residence Trust (QPRT). Taxpayer reported a value of \$30,572.00 for each gift and calculated additional tax due of \$224.00. Payment of that amount was received with the amended return.

Upon examination, the Department of Revenue increased the value of each gift of remainder interest to \$55,579.00. A Notice of Tax Assessment – Gift Tax reflecting additional gift tax plus a 10% late-payment penalty and interest of \$2,604.86 was mailed to Taxpayer on April 24, 2000. Representative objected to the assessment on behalf of Taxpayer and timely requested a hearing.

## ISSUE

The issues to be decided in this matter are as follows:

- 1) Has the Secretary of Revenue abused her discretion by not reducing the value of the gift of a residence through a QPRT by the value of the contingent reversion interest?
- 2) Is the proposed assessment of additional gift tax, penalty, and interest for the tax year 1997 lawful and proper?

## EVIDENCE

The evidence presented by Gregory B. Radford, Assistant Director of the Personal Taxes Division, consisted of the following:

- 1) Memorandum dated April 18, 1996, from Muriel K. Offerman, Secretary of Revenue, to Michael A. Hannah, Assistant Secretary of Revenue, a copy of which is designated as Exhibit PT-1.
- 2) Taxpayer's North Carolina Gift Tax Return for the taxable year 1997, a copy of which is designated as Exhibit PT-2.
- 3) Taxpayer's amended North Carolina Gift Tax Return for the taxable year 1997, a copy of which is designated as Exhibit PT-3.
- 4) Notice of Tax Assessment – Gift Tax for the taxable year 1997 dated April 24, 2000, a copy of which is designated as Exhibit PT-4.
- 5) Letter from Representative to Kenneth R. Biser, Auditor in the Examinations Division, dated May 22, 2000, a copy of which is designated as Exhibit PT-5.
- 6) Letter from Gregory B. Radford to Representative dated July 6, 2000, a copy of which is designated as Exhibit PT-6.
- 7) Letter from Representative to Gregory B. Radford dated July 29, 2000, a copy of which is designated as Exhibit PT-7.
- 8) Letter from Michael A. Hannah to Representative dated August 8, 2000, a copy of which is designated as Exhibit PT-8.

During the hearing, Representative presented the following evidence:

- 1) Selected pages from the QPRT trust agreement established by Taxpayer, copies of which are designated as Exhibit T-1.
- 2) North Carolina General Statute 105-195, a copy of which is designated as Exhibit T-2.
- 3) North Carolina General Statute 8-46, a copy of which is designated as Exhibit T-3.
- 4) Life Expectancy Table from Internal Revenue Service Publication 590, a copy of which is designated as Exhibit T-4.
- 5) Proposed calculation of Taxpayer's gift of her residence through the QPRT using a 6% interest rate and a contingent reversion interest, a copy of which is designated as Exhibit T-5.

At the conclusion of the hearing, the Assistant Secretary allowed Representative additional time until November 27, 2000, to submit further arguments and evidence for the record. The Assistant Secretary enters into the record the following:

- 1) Letter from Michael A. Hannah to Representative dated October 26, 2000, a copy of which is designated as Exhibit S-1.
- 2) Taxpayer's Brief, a copy of which is designated as Exhibit T-6.

### **FINDINGS OF FACT**

Based on the foregoing evidence of record, the Assistant Secretary of Revenue makes the following findings of fact:

- 1) Taxpayer is and at all material times was a natural person, sui juris, and a citizen and resident of North Carolina.
- 2) In 1997, Taxpayer made gifts of a 1.6% interest in a limited partnership to each of her four children. The value of each gift was \$9,000.00. Taxpayer also established a QPRT and contributed her interest in a personal residence to the trust. She gave a 25% interest in the remainder of the property held by the trust to each of the children. Taxpayer determined a value of \$30,572.00 for each gift.
- 3) The QPRT was established on September 12, 1997, for a term of five years. Taxpayer was 82 years of age at the time the trust was established.
- 4) Taxpayer timely filed a 1997 gift tax return to report the gifts of the partnership interests. Taxpayer claimed the annual exclusion for each gift, resulting in no gift tax due.

- 5) On April 5, 1999, the Department of Revenue received an amended 1997 gift tax return on which Taxpayer reported the gifts of the remainder interests in the property held by the QPRT. Taxpayer calculated additional tax due of \$224.00 and remitted that amount with the amended return.
- 6) Upon examination, the Department of Revenue increased the value of each gift of remainder interest to \$55,579.00. This change increased the additional tax due from \$224.00 to \$2,269.60. The amount of the gift was calculated as follows:

Fair market value of residence	\$297,500.00
Annual income (FMV X 6%)	\$17,850.00
Present value of \$1.00 for term of five years	X <u>4.212</u>
Value retained by donor (Annual income X present value)	\$75,184.20
Value of gift (FMV of residence – value retained)	\$222,315.00
Each donee's share of gift (value of gift/4)	\$55,579.00

- 7) A Notice of Tax Assessment – Gift Tax reflecting additional gift tax plus a 10% late-payment penalty and interest of \$2,604.86 was mailed to Taxpayer on April 24, 2000.
- 8) Representative objected to the assessment on behalf of Taxpayer and timely requested a hearing.

### CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary of Revenue makes the following conclusions of law:

- 1) A gift tax is imposed on the transfer of property, real or personal, for less than full consideration.
- 2) North Carolina's gift tax laws are similar to the federal gift tax laws in many respects. However, the State gift tax laws are not identical to or tied to federal gift tax laws as is the case for individual income tax purposes. Instead, North Carolina's gift tax laws stand alone from the federal gift tax laws and are sufficient to determine the State gift tax liability.
- 3) The first \$10,000.00 of present value gifts to each donee in a year is exempt from gift tax. This exclusion does not apply to gifts of future interests.
- 4) A donor is entitled to a lifetime exclusion of \$100,000.00 for gifts to Class A donees.
- 5) A Class A donee includes the lineal issue, lineal ancestor, adopted child, or stepchild of the donor.
- 6) G.S. 105-195 provides that, in determining the value of a gift of a future interest, the value of the property is apportioned between the life tenant or tenant for years and the remainderman based

upon the mortality tables set out in G.S. 8-46 and 8-47, using a 6% interest rate for the period of expectancy of the life tenant or for the term of years in determining the value of the respective interests. When property is transferred or limited in trust or otherwise, and the rights of the transferees or beneficiaries are dependent upon contingencies or conditions whereby they may be wholly or in part created, defeated, extended, or abridged, the tax shall be imposed upon said transfer at the highest rate, within the discretion of the Secretary of Revenue, that would be possible upon the occurrence of any of the contingencies or conditions.

- 7) The valuation of Taxpayer's gift must be determined using the tables set forth in G.S. 105-195.
- 8) G.S. 8-46 is a mortality table setting forth the life expectancy of an individual from zero years of age to eighty-four years of age. G.S. 8-47 is a present worth table setting forth the cash value of an annuity of \$1 for the number of years the annuity is to run, from one year to sixty-seven years.
- 9) The gift tax return and payment of any tax liability are due on April 15 following the year of the gift.
- 10) A late-payment penalty of ten percent of the tax is imposed for failure to pay the tax when due. The penalty does not apply when the amount of tax shown as due on an amended return is paid when the return is filed.
- 11) Interest accrues on unpaid tax from the date the tax is due until the date the tax is paid.
- 12) The proposed assessments of additional gift tax, penalties, and interest for the tax year 1997, to the extent herein modified, is lawful and proper.

### **DECISION**

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary of Revenue finds the proposed assessment for the tax year 1997 to be lawful and proper except that the late payment penalty was assessed in error. The proposed assessment, modified to withdraw the late payment penalty, is hereby affirmed.

At issue during this hearing is the proper determination of the value of gifts of remainder interests in a personal residence through the use of a Qualified Personal Residence Trust (QPRT). Taxpayer established the QPRT when she was 82 years of age. The trust was for a term of five years or her

lifetime, whichever was shorter. If Taxpayer dies before the end of the term, the property reverts to her estate and is subject to federal and State estate tax. There is no dispute as to the fair market value of the property or the present value of Taxpayer's retained income interest in the property. Taxpayer and the Department of Revenue disagree as to whether the value of the remainder interest must be further reduced by a retained contingent reversion in the property.

For federal gift tax purposes, the fair market value of the donated property is reduced by both the present value of the grantor's retained income interest and the grantor's retained contingent reversion interest because there is a possibility that the grantor will die before the fixed term expires. The value of the contingent reversion interest is calculated using a table based on national actuarial statistics.

For State gift tax purposes, the value of a gift of a future interest is determined under the provisions of G.S. 105-195. The statute provides that "[i]f the gift subject to said tax be given to a donee for life or for a term of years, or upon condition or contingency, with remainder to take effect upon the termination of the life estate or term of years or the happening of the condition or contingency, . . . said tax shall be apportioned between such life tenant or tenant for years and the remainderman, such apportionment to be made by computation based upon the mortuary tables set out in G.S. 8-46 and 8-47 of the General Statutes, and upon the basis of six per centum (6%) of the gross value of the property for the period of expectancy of the life tenant or for the term of years in determining the value of the respective interests. When property is transferred or limited in trust or otherwise, and the rights of the transferees or beneficiaries are dependent upon contingencies or conditions whereby they may be wholly or in part created, defeated, extended, or abridged, a tax shall be imposed upon said transfer at the highest rate, within the discretion of the Secretary of Revenue,

which on the happening of any of the said contingencies or conditions would be possible under the provisions of this section....” Representative suggests that the contingency in this case is that Taxpayer dies before the end of the term, thereby causing the beneficiaries’ rights to the property to be defeated. I believe that the contingency intended by the statute is whether Taxpayer dies before the term expires. If Taxpayer outlives the term, the beneficiaries’ rights to the property are created; if not, their rights are defeated. Upon that conclusion, the next question is whether the Department of Revenue abused its discretion in taxing the gift under the premise that Taxpayer survives the term of the trust.

If the gift tax were not determined until all of the contingencies were resolved, there would be no issue before me. However, the gift tax is imposed on an annual basis and a determination of the value of the gift must be made by the due date for filing the gift tax return. The law clearly gives the Secretary of Revenue the discretion to impose the tax at the highest rate, considering all of the possible contingencies or conditions. I believe that the Department has the administrative authority to reduce the value of the gift by a contingent reversion interest, but I do not believe that it has abused its discretion in not doing so in this case. A QPRT is generally used as an estate-planning tool to transfer a residence to the grantor’s children at a significantly reduced gift tax and with no estate tax, and yet allow the grantor to continue to live in the residence for the term of the trust. If the grantor dies before the term expires, the property reverts to the grantor’s estate. Therefore, the term is usually set as one the grantor is likely to survive. Such was the case here. Taxpayer was 82 years of age and used a term of five years. G.S. 8-46 sets forth a life expectancy of 7.5 years for a person 82 years of age. Therefore, it is likely that Taxpayer will survive the term of the trust. Under those facts, I find that the Department of Revenue acted reasonably and did not abuse its discretion in calculating the gift tax by presuming Taxpayer would survive the term of the trust.

The proposed assessment for the tax year 1997, modified to withdraw the late payment penalty, is hereby sustained and is determined to be final and collectible, together with interest as allowed by law.

Made and entered this 12<sup>th</sup> day of December, 2000.

Signature\_\_\_\_\_

Michael A. Hannah  
Assistant Secretary of Revenue