STATE OF NORTH CAROLINA | **BEFORE THE SECRETARY OF REVENUE**

COUNTY OF WAKE

IN THE MATTER OF:

The Proposed Assessment of Gift Tax for)
the Taxable Year 1997 by the Secretary of)
Revenue of North Carolina)
) **FINAL DECISION**
vs.) Docket No. 2001-68
)
[Taxpayer])

This matter was heard before the Acting Assistant Secretary of Administrative Hearings, Marilyn R. Mudge, in the city of Raleigh on April 18, 2001, upon an application for hearing by [Taxpayer], wherein he protested the proposed assessment of gift tax, penalties, and interest for the taxable year 1997. The hearing was held under the provisions of G.S. 105-260.1 and was attended by Taxpayer; [Taxpayer's Representative]; [Taxpayer's Brother]; [a Witness]; Gregory B. Radford, Assistant Director of the Personal Taxes Division; and Alexandra M. Hightower, Associate Attorney General.

Pursuant to G.S. 104-241.1, a Notice of Tax Assessment proposing an assessment of gift tax, penalties, and accrued interest totaling $35,919.00 was mailed to Taxpayer on October 4, 2000. Taxpayer objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.

ISSUE

The issue to be decided in this matter is as follows:

Is the assessment of gift tax, penalties, and interest proposed against Taxpayer for the taxable 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 from E. Norris Tolson, Secretary of Revenue, to Marilyn R. Mudge, Acting Assistant Secretary of Administrative Hearings, dated March 13, 2001, a copy of which is designated as Exhibit PT-1.

2. Notice of Tax Assessment for the taxable year 1997 (identified as the tax year 1998 in error) dated October 4, 2000, a copy of which is designated as Exhibit PT-2.

3. North Carolina [General Warranty Deed] recorded by [a county] Register of Deeds on July 21, 1995, a copy of which is designated as Exhibit PT-3.

4. North Carolina [General Warranty Deed] recorded by [a county] Register of Deeds on December 15, 1997, a copy of which is designated as Exhibit PT-4.

5. [A County] Property Tax Record for property at issue for the tax years 1992 through 1999, a copy of which is designated as Exhibit PT-5.

6. Property Tax Value Record for the property at issue, a copy of which is designated as Exhibit PT-6.

7. Letter from D. A. Hall, Tax Auditor in the Office Examinations Division, to Taxpayer dated August 24, 2000, a copy of which is designated as Exhibit PT-7.

8. File Notes of a telephone conversation between D. A. Hall and Brother, a copy of which is designated as Exhibit PT-8.

9. Letter from Witness to D. A. Hall dated August 29, 2000, a copy of which is designated as Exhibit PT-9.

10. Letter from [a Certified Public Accountant] to D. A. Hall dated August 30, 2000, a copy of which is designated as Exhibit PT-10.

11. Letter from D. A. Hall to [Certified Public Accountant] dated September 1, 2000, a copy of which is designated as Exhibit PT-11.

12. Letter from Representative to the Department of Revenue dated October 30, 2000, with related attachments, copies of which are collectively designated as Exhibit PT-12.

13. Letter from Michael A. Hannah, former Assistant Secretary of Revenue, to Taxpayer dated December 4, 2000, a copy of which is designated as Exhibit PT-13.

14. Letter from Michael A. Hannah to Taxpayer dated December 27, 2000, a copy of which is designated as Exhibit PT-14.

At the hearing, Representative presented the following evidence:

1. Power of Attorney appointing Taxpayer as Attorney-in-Fact over Brother's property and estate dated April 7, 1995, a copy of which is designated as Exhibit TP-1.

2. Agreement between Brother and Taxpayer dated July 21, 1995, regarding the deeding of the property at issue, a copy of which is designated as Exhibit TP-2.

3. Series of canceled checks written on the account of [a business] to insurance companies and mortgage holders in 1995, 1996, and 1997, copies of which are collectively designated as Exhibit TP-3.

4. Brother’s 1995, 1996, and 1997 United States individual income tax returns, copies of which are collectively referred to as Exhibit TP-4.

Taxpayer, Brother, and Witness each testified at the hearing. The following is a summary of their testimonies.

When Brother was incarcerated in 1995, he gave Power of Attorney (Exhibit TP-1) to Taxpayer to manage Brother’s affairs. Taxpayer was subsequently notified by an insurance carrier that it would no longer cover Brother’s residence. At Witness’s suggestion, Brother deeded the residence to Taxpayer so Taxpayer could maintain insurance on the residence. Witness also prepared an Agreement (Exhibit TP-2) that stated the intent of the parties in this transaction. The agreement is dated July 21, 1995, the same date the property was transferred. The intent of the parties was for Taxpayer to hold the property in trust for Brother until Brother was released from prison. However, the deed did not reflect that the transfer was in trust because that would have defeated the purpose of the transfer, which was to maintain insurance on the property.

The insurance company still refused to cover the property so Taxpayer obtained insurance from another insurance carrier. The insurance policy identified Taxpayer as the insured. When the term of the insurance policy on the business property expired, the same transactions took place so Taxpayer could maintain insurance on the business property. It was necessary to maintain insurance on the two properties because each property was mortgaged. Brother’s indictment was well publicized in his hometown and Brother would have received considerably less than fair market value if he had sold the properties.

Taxpayer did not live in or rent the residence while the property was deeded to him. He did not pay any of the expenses of the properties deeded to him by Brother. The mortgage and insurance premiums were paid from a bank account for a business owned by Brother (Exhibit TP-3). Rents received from the business property were deposited into Brother’s bank account. Rental income was reported on Brother’s individual income tax returns (Exhibit TP-4). If Brother died while in prison, Taxpayer was to keep the business property while Brother’s daughter was to receive the residence.

Taxpayer had a will prepared by Witness in 1996 (Exhibit PT-12). The will, which was Taxpayer’s first will, expressly stated Taxpayer’s intent that the property Brother had deeded to him be returned to Brother upon Taxpayer’s death since it was Brother’s property anyway and Taxpayer was only holding the property in trust while Brother was incarcerated.

The mother and sisters of Taxpayer and Brother, as well as an employee of the Internal Revenue Service’s Criminal Investigations Division, also knew of the trust agreement between Brother and Taxpayer.

When Brother was released from prison, the properties were transferred back to him by Taxpayer.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Acting Assistant Secretary 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. Brother was incarcerated in 1995 and gave Taxpayer Power of Attorney to manage his affairs.

3. Taxpayer was notified by an insurance company that the company would no longer insure Brother's residence.

4. Brother deeded the residence to Taxpayer on July 21, 1995. The deed shows that no excise stamp tax was paid. Brother and Taxpayer signed an agreement that provided that Taxpayer would hold the property in trust for Brother while Brother was incarcerated.

5. Taxpayer was still unable to secure insurance on the residence from the current carrier; therefore, insurance was obtained from another carrier. Taxpayer was named as the insured on the policy.

6. Taxpayer was notified by an insurance company that the company would no longer insure Brother's business property. Brother deeded the business property to Taxpayer in November of 1995 and Taxpayer obtained insurance on that property from another carrier.

7. Taxpayer did not live in the residence or rent the residence after the residence was deeded to him. The insurance and mortgage on the residence were paid with funds from Brother's business bank account. Taxpayer deposited all rental income from the business property in Brother's bank account. The insurance and mortgage on the business property were also paid with funds from Brother's business bank account.

8. Taxpayer signed a Last Will and Testament on August 16, 1996. Article II of the Will reads "I will, devise and bequeath to my brother … all of the property he has heretofore deeded to me. This being his property anyway that I have only held in trust while he has been incarcerated."

9. Brother was released from prison in late 1997. On December 11, 1997, Taxpayer deeded the residence and business property to Brother. The deed did not reflect the payment of any excise stamp tax.

10. Property tax records between July 21, 1995, and December 11, 1997, reflect Taxpayer as the owner of the residence.

11. According to property tax valuation records, the tax value of the property deeded by Taxpayer to Brother on December 11, 1997, was $268,730.00.

12. Taxpayer did not file a North Carolina Gift Tax Return for the tax year 1997 to report the gift of property to Brother.

13. The Department of Revenue determined that Taxpayer made a gift to Brother of $268,730.00, equal to the county tax value of the property. The Department determined the taxable value of the gift to be $258,730.00, equal to the county tax value of the property less the $10,000.00 annual exclusion.

14. A Notice of Tax Assessment was mailed to Taxpayer on October 4, 2000, proposing an assessment of gift tax; a twenty-five percent late filing penalty; a ten percent late payment penalty; and accrued interest totaling $35,919.00. The assessment reflected the tax year as 1998; however, the correct tax year is 1997.

15. Taxpayer objected to the proposed assessment and timely requested an administrative tax hearing before the Secretary of Revenue.

CONCLUSIONS OF LAW

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

1. North Carolina gift tax is imposed on the transfer by gift of real property located in North Carolina or personal property that has acquired a taxing situs in North Carolina. The gift tax applies whether the gift is in trust or otherwise and whether the gift is direct or indirect.

2. The gift tax does not apply to the passing of property in trust where the donor is vested with the power to revest title to the property.

3. Where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration shall be deemed a gift.

4. If the gift is made in property, the fair market value of the property at the date of the gift is considered the amount of the gift.

5. Gifts, other than gifts of future interests, are subject to an exclusion of $10,000.00.

6. The gift tax rates are based on the relationship between the donor and the donee. Where the donee is the brother or sister of the donor, the proper gift tax rate is the rate for Class B donees.

7. Gift tax is due on April 15 of the calendar year following the calendar year in which the gift was made. The gift tax return is due on or before the date the tax is due.

8. A late filing penalty of five percent of the tax for each month, or fraction of a month, the return is late (minimum $5.00, maximum twenty-five percent) is imposed if a gift tax return is not timely filed. A late payment penalty is imposed for failure to pay tax when due. The penalty is equal to ten percent of the tax (minimum $5.00). Interest accrues on tax from the date the tax was due until the tax is paid.

9. North Carolina's gift tax laws are not tied to the federal gift tax laws as is the case for individual income tax; however, the State gift tax laws are similar to the federal laws in many respects, including the determination of what is a gift. The federal courts have held that to be a gift, a transfer must include the basic property law gift elements, which are: (i) a donor competent to make the gift; (ii) clear and unmistakable intention by the donor to make it; (iii) a conveyance, assignment, or transfer sufficient to vest legal title in the donee without power of revocation at the donor's will; (iv) relinquishment of "dominion and control" over the gift property by delivery; and (v) acceptance by the donee.

10. Although donative intent is one of the basic property law gift elements, donative intent is not an essential element in the application of the gift tax to a transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. However, there are certain types of transfers to which the tax is not applicable. It is applicable only to a transfer of a beneficial interest in property. It is not applicable to a transfer of bare legal title to a trustee.

11. In North Carolina, a party may submit evidence of a parol trust to counter the apparent granting of property by deed (1) where the trust is sought to be established in favor of a third party, not the grantor or grantee; or (2) in favor of the grantor, but only where it is alleged that the grantor gave up his right to the property as a result of mistake, fraud, or undue influence. Where a grantor executes a deed reciting that he transferred the property for value received he is not allowed to challenge it later.

12. A resulting trust can arise where a person makes or causes a disposition of property under circumstances which raise an inference that he does not intend for the grantee to have a beneficial interest in the property; e.g., one person pays money for the property but title goes into the name of another. But the resulting trust is created by operation of law and arises from the character of the transaction and not necessarily from a declaration of intention.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Acting Assistant Secretary of Revenue finds the proposed gift tax assessment for the tax year 1997 to be lawful and proper and is hereby affirmed.

At issue is whether the transfer of property by deed in December of 1997 was a gift from Taxpayer to Brother. Taxpayer had acquired the property by transfer from Brother in 1995. The answer hinges upon whether Taxpayer was the owner of the property or whether he was holding the property in trust for Brother. Therefore, the transfer of the property from Brother to Taxpayer in 1995 must be examined.

There is no dispute that Brother was incarcerated at the time of the transfer in 1995; that the deed does not reflect that the transfer was in trust; and that the property was transferred because the insurance company carrying policies on Brother's residence and business property would no longer insure the property. Taxpayer argues that he and Brother verbally agreed that Taxpayer would hold the property in trust until Brother was released from prison. An agreement between Taxpayer and Brother stating that the property was to be transferred in trust, dated on the same day as the date of transfer of the property, was presented as evidence at the hearing. Although the question arises as to the authenticity of this document, I do not find it necessary to determine its authenticity, as the application of the law determines that the transfer was a gift regardless of the authenticity of the agreement.

In North Carolina, a party may submit evidence of a parol trust to counter the apparent granting of property by deed (1) where the trust is sought to be established in favor of a third party, not the grantor or grantee; or (2) in favor of the grantor, but only where it is alleged that the grantor gave up his right to the property as a result of mistake, fraud, or undue influence. (See *Day v. Powers,* 86 N.C. App. 85 (1987); *Burton v. Burton,* 123 N.C. App. 153 (1996).) As to the first condition, although Brother testified that Taxpayer was instructed to give the residence to Brother's daughter if Brother died before being released from prison, there is no third party seeking to establish the trust. Any rights Brother's daughter may have had in the residence via a parol trust were extinguished when Brother was released from prison and the property was transferred to him by Taxpayer. As to the second condition, this case bears significant similarities with *Day*. In both cases, the grantor transferred property to a relative without any indication on the deed that the property was to be held in trust. No written trust agreement was executed in either case. In both cases, the grantor continued to pay the expenses of the property and report the income from the property for individual income tax purposes. In *Day*, the Court held that "except in cases of fraud, mistake, or undue influence, a parol trust, to arise by reason of the contract or agreement of the parties thereto, will not be set up or engrafted in favor of the grantor upon a written deed conveying to the grantee the absolute title, and giving clear indication on the face of the instrument that such a title was intended to pass." Taxpayer argues that the failure of the deed to reflect the true nature of the transfer from Brother to him as being one in trust was a mutual mistake between the parties. Equitable remedy of reformation of deed will be granted when it is shown by clear, cogent, and convincing evidence that due to the mutual mistake of the parties the deed does not express the actual agreement made between the parties (*Nelson v. Harris*, 232 S. E.2d 298, N. C. App. 1977). However, the testimony indicates that there was no mutual mistake in this case. The deed was drafted without reference to a trust agreement deliberately; for the purpose of obtaining insurance on property when Taxpayer otherwise may not have been able to secure the insurance. Brother certainly benefited from this deception. Because he was able to maintain insurance and mortgages on the properties he was not forced to sell the properties. Because of the publicity generated by his indictment, Brother realized that he would receive low offers if he were forced to sell the properties. Where a grantor executes a deed reciting that he transferred the property for value received, he is not allowed to challenge it later, particularly because it is usually done for "some sinister purpose, to defraud creditors or deprive a wife of dower" (*Gaylord v. Gaylord,* 150 N.C. 222 (1909)).

Although it may not have been Brother's intent to make a gift of the property to Taxpayer in 1995, the substance of the transaction is just that. Donative intent is not an essential element in the application of the gift tax to a transfer (U.S. Treas. Reg. § 25.2511-1(g)(1)). Taxpayer was presented as the owner of the property to insurance companies; any third party, upon review of the deed, would have recognized Taxpayer as the owner. Taxpayer and Brother cannot undo now what they deliberately did then.

Because the transfer of property from Brother to Taxpayer in 1995 was a gift, the transfer of the property from Taxpayer back to Brother in 1997 is likewise a gift. The proposed assessment of gift tax, penalties, and interest against Taxpayer for the tax year 1997 is lawful and proper and is hereby sustained in its entirety and immediately due and collectible, together with interest as allowed by law.

Made and entered this _15th_ day of _May_, 2001.

Signature______________________________________

Marilyn R. Mudge
Acting Assistant Secretary of Administrative Hearings