NC Justice Center
Opportunity and Prosperity for All

BTC Brief

NC BUDGET & TAX CENTER

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Give it away, Give it away, Give it away now:
Should North Carolina do away with the state gift tax?

Timely, accessible, and credible analysis of state and local budget and tax issues

Overview

North Carolina currently levies a state gift tax. The gift tax is applied when assets such as money or property are given from one person to another if the value of the gift exceeds certain allowable exclusion amounts. The amount of the tax varies depending on the type of relationship between the donor and the recipient and the size of the gift. There is no tax on gifts to spouses and the tax is lower on gifts to direct descendents such as children and grandchildren than to those less closely related to the giver.

The gift tax raises approximately $18 million annually in general fund revenue. The primary purpose of the state gift tax is to prevent the erosion of estate tax revenues. Without a gift tax, owners of large estates can avoid estate tax liability by giving away significant portions of their estates over time. Eliminating or significantly changing North Carolina's gift tax will have implications for the state's estate tax collections, the ability of the state to finance services now and in the future and the fairness of the state's tax system. The passage of Senate Bill 1756, which will now be considered by the House of Representatives, signals the need for full consideration of the implications of this potential policy change.

How does the tax work?

Individuals are allowed to give up to $12,000 ($24,000 per couple) tax free to each direct descendent per year. In addition to this annual exclusion amount, individuals are also able to give an additional $100,000 ($200,000 per couple) in the course of a lifetime tax free. For example, a couple with two children and four grand children would be able to give $144,000 per year tax free to these descendants. In addition, this couple could given another $200,000 tax free either all at one time or spread out over several years in which they were also benefiting from the annual exclusion amounts. If individuals give gifts above the annual limit and have exhausted the additional lifetime exclusion then a tax is owed. The amount of the tax ranges from 1% on the first $10,000 of the taxable property transferred up to 12% on the taxable amount of gifts above $3 million. The $12,000 exclusion amount is tied to the federal gift tax exclusion and is therefore subject to periodic adjustments to account for inflation.

The annual exemption amounts and the rates applied are higher if the recipient is not a direct descendent. In addition, gifts to nonprofit charitable, religious, or educational corporations and political subdivisions within the state are exempt.

The gift tax is a complement to the North Carolina estate tax. Under current law estates are taxable upon death when their value exceeds $2 million. Families can reduce the size of their estates for tax purposes by giving away portions of their estates to descendents prior to their death. In doing so, they reduce the taxable value of their estate and thereby can transfer large sums of wealth over time to family members in order to avoid estate tax liability.

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Should the tax be eliminated?

Reasonable arguments can be made that the tax needs to be simplified and perhaps liberalized somewhat. However, the tax plays an important role in the state tax system and should not be eliminated outright for the following reasons:

- **The long-term fiscal impact is understated** – The immediate impact of eliminating the gift tax is a loss of the approximately $18 million in annual general fund revenue that the tax generates. However, over time as individuals who have the potential to have a taxable estate upon death begin giving away larger amounts this will reduce their ultimate estate tax liability. The North Carolina estate tax generated $163 million in general fund revenue in fiscal year 2006-07.
- **The tax already has generous exclusions and low rates**. – The current gift tax already allows the first $12,000 (or $24,000) given annually to each direct descendent to be given tax free. Moreover, the additional lifetime exclusion amount of $100,000 ($200,000 per couple) ensures that the vast majority of families are able to give generous gifts to descendents without pay a tax on those gifts.
- **The tax discourages "deathbed" gifts** – Maintaining a state gift tax discourages taxpayers from giving large sums of wealth away to family members and others for the sole purpose of avoiding estate tax liability. The federal gift tax is still in place and serves to discourage the largest of such gifts, but eliminating the state gift tax would create an additional incentive to use gifts as a way to avoid estate tax liability.
- **Eliminating the tax does not effectively target taxpayers with greatest tax responsibility** – Previous analysis by the Institute on Taxation and Economic Policy has demonstrated that low- and middle-income taxpayers in North Carolina contribute larger shares of their incomes in state and local taxes than wealthy taxpayers. In fact, the bottom 20% of income earners in North Carolina pay approximately 10.7% of their incomes in state and local taxes while the state's top 1% of income earners pay 7.1%. Increasing the refundable state Earned Income Tax Credit would be a better way to target tax cuts to low- and middle-income taxpayers. Furthermore, an increase in the state Earned Income Tax Credit is a proven economic stimulus policy because low-income working families are more likely to immediately spend their refund checks in their local communities on basic necessities.

Conclusion

In 2001 when the federal government began phasing-out the federal estate tax, North Carolina's state leaders had the wisdom and the courage to maintain a state estate tax. Having that tax in place generates more than $150 million annually in state revenues, makes our state and local tax system less regressive and helps to slow down the trend of increasing wealth and income concentration taking place in North Carolina. Maintaining a state gift tax raises additional revenue in a progressive manner and discourages so-called "deathbed" gifts that erode estate tax revenues in the long-term and reduce the other potential societal benefits of taxing inherited wealth. North Carolina's leaders should carefully consider the full ramifications of potentially eliminating the gift tax and should first look to reform the tax to make it simpler and fairer before opting to eliminate this beneficial element of the tax code.

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