Disclaimer Update, 2004

By Robert L. Moshman

It is simple, traditional, has clearly defined requirements, and still gets the job done. The disclaimer is one of the last best chances to redirect an estate for tax saving or asset protection purposes. Although the use of disclaimers is well established and continues, for the most part, with little change, the disclaimer must now be seen in light of recent developments.

Regulations have affected disclaimers of joint interests. The Uniform Disclaimer of Property Interests Act has been adopted in eight states over the past five years. The use of disclaimers, like other techniques, has also been affected by the changes in the area of transfer taxation that have dramatically shifted planning objectives. There are also numerous letter rulings which, while not to be relied upon officially, provide insight as to what uses of disclaimers the IRS will approve.

The Disclaimer Mechanism

The disclaimer concept is very simple. By refusing to accept an interest created by a will or trust, a beneficiary causes that interest to be distributed to an alternate beneficiary. The disclaimant is treated as having predeceased the grantor or testator.

A disclaimer must be in writing, signed by the potential recipient of the interest to be disclaimed, and received by the transferor of the interest. Disclaimed assets must be specifically identified.[1]

Disclaimers must be made within nine months after the later of a) the date on which the transfer creating the interest is made, or b) the day on which the transferee turns 21. A testamentary transfer generally takes place as of the date of death as opposed to when a will is probated.

Not exercising a disclaimer in time nullifies its use. Where a surviving spouse attempted to exercise a disclaimer of her beneficial interest in a trust more than nine months after her husband's death, no qualified disclaimer was made. As a result, the spouse's renunciation of her interest in the trust was considered a gift by the surviving spouse to her sons, who were the remainder beneficiaries. This was true even though the surviving spouse's share of the trust was contingent on her exhausting other a marital trust and was subject to the trustee's discretion.[2]

Ten Disclaimer Strategies

In the following examples, testator T has made bequests to his surviving spouse S and beneficiary B:

1. T neglects to utilize a bypass trust and thereby fails to exhaust his unified credit. After T's death, S can disclaim a portion of the assets bequeathed to her. This removes assets from the protective umbrella of the marital deduction. T's unified credit is used instead of being wasted. The exercise of a disclaimer by S then can keep assets, and any appreciation on them, out of her estate. This avoids estate and inheritance tax as well as probate expense.
2. S or B can exercise disclaimers to shift income-bearing assets to a beneficiary who is in a lower income tax bracket.
3. Disclaimers can equalize estates to save taxes. For example, if T has named S as beneficiary of retirement accounts, insurance, or other assets passing outside of the will,

the total of assets passing under the marital deduction at the death of the first spouse might be much larger than the amounts passing to other beneficiaries and to which T's applicable exclusion is being applied. If T dies in 2009 when the applicable exclusion is scheduled to rise to $3.5 million, much of T's exclusion could be wasted.[3]

4. If S were to die shortly after T, a disclaimer made by her executor could serve to reduce local tax and probate expenses.

5. B can disclaim assets so that they pass to S and qualify for the marital deduction. B may also want to increase the assets received by S based on her needs. Or, once the marital deduction is secured, S can distribute assets to B and B's children over time in amounts that qualify for the annual gift tax exclusion.

6. In the instance of a split-interest bequest to S and a charity that fails to qualify for marital or charitable deductions, a disclaimer by S could help salvage the estate tax charitable deduction.[4]

7. Where a charity is named as an alternate beneficiary, a disclaimer by the intended transferee enables the assets to pass from the estate to the charity and therefore qualify for the estate tax charitable deduction.

8. Disclaiming a power of appointment disposes of an interest that offers no current benefit yet will be included in the recipient's estate. A disclaimer of a power of appointment can enable property to quality for the marital deduction as as well as a QTIP election.

9. B's disclaimer may enable assets to reach other beneficiaries while avoiding tax liens and creditors (subject to local law).

10. If grandchildren of T are beneficiaries, their disclaimer could avoid the generation-skipping transfer tax. Assuming such assets flowed instead to B, gifts could be made using the annual gift tax exclusion.

Disclaimer Trusts

In anticipation of disclaimers being used, a professionally administered trust can be established. Such a trust can provide alternate beneficiaries who would benefit in the event one of the beneficiaries of the will disclaims assets.

A trust can also provide guidance on how assets will be invested, supervised, and, ultimately, distributed. And if disclaimed assets are in a trust to begin with, they can remain in the trust-providing complete continuity of administration.

For example, a testator divides his estate between his wife and his wealthy son. The testator's unified credit has been exhausted. A disclaimer by the son causes the funds to go to a trust for the testator's wife. Since the assets are therefore covered by the marital deduction, no transfer tax is due. The testator's wife can then transfer assets to her son or others using annual gifts and her own unified credit.

If the surviving spouse lives beyond 2009, it is possible that her estate can pass to the son with no transfer taxes. Naturally, the potential exposure of the assets to creditors of the surviving spouse's estate must be considered in making the decision to disclaim assets.

Note that a fiduciary can be empowered to exercise certain disclaimers. As a practical matter, nine months following a death can pass very quickly. Planning a disclaimer ahead of time and empowering an executor, rather than a surviving family member, to exercise the disclaimer (as in a Clayton trust) can help an estate accomplish a disclaimer in timely fashion while remaining flexible.[5]

Regulatory Change Re Joint Ownership

In the past, the IRS required joint tenants to disclaim assets within nine months of the formation of a joint tenancy. In recent years, the regulations on disclaiming jointly owned property were relaxed, giving surviving spouses more latitude in disclaiming assets. The formation of the joint tenancy is no longer the event triggering the disclaimer decision.

The death of one of the joint tenants is now interpreted as the "transfer creating the interest" and that is what starts the clock. For disclaimers made by surviving joint tenants after December 31, 1997, the amended final regulations of §2518 allow a surviving tenant to disclaim one-half of joint assets within nine months of the joint tenant's death.

The disclaimed interest can then pass through the decedent's estate so that the decedent's unified credit can be fully utilized. Note that the new regulations simplify things by treating joint tenants of real estate the same way whether they are married or not. Thus, a disclaimer by a joint tenant of jointly held real estate is treated the same way whether the joint ownership is by the entireties, joint ownership with right of survivorship, or where the joint owners are not married. No more than 50% can be disclaimed, regardless of how much of the property each owner contributed.

Disclaimers of joint tangible personal property are generally treated the same way as disclaimers of jointly held real estate. By contrast, a surviving spouse may disclaim 100% of jointly held intangible assets such as a joint bank or investment account where the surviving spouse did not contribute funds to the joint account.

Disclaimer Uniformity

Prior to the enactment of §2518 as part of the Tax Reform Act of 1976, disclaimers were considered valid if they were unequivocal and effective under local law. Compliance with local law remains a relevant concern, notwithstanding §2518(c)(3)(B). Along with federal disclaimer rules, there are separate disclaimer statutes in each of the 50 states.

Discrepancies in state disclaimer laws prompted the National Conference of Commissioners on Uniform State Laws (NCCUSL) to produce the Uniform Disclaimer of Property Interests Act in 1999 (UDPIA). In 2002, the UDPIA was incorporated into the Uniform Probate Code at §§2-1101-17.

Eight states have adopted the UDPIA: Arkansas, Hawaii, Indiana, New Mexico, North Dakota, Oregon, Virginia and West Virginia. Note, however, that six of the states have adopted modifications of the UDPIA.

A recent article has identified several areas of the uniform law that might require modification by states contemplating adoption of the UDPIA. These areas include the use of conditional disclaimers, restoring the role of courts in supervising trustees who are granted the power to disclaim on behalf of competent beneficiaries, allowing a custodial parent of a minor child to disclaim on behalf of their child so long as the parent does not benefit thereby, and eliminating the UDPIA provision allowing disclaimers to be executed electronically.

The article also points out a glitch in the UDPIA. In cases of disclaimers of remainders not contingent on surviving to the time of distribution, such as interests in living trusts, disclaimed interests pass as if the disclaimant had died just prior to distribution. This causes assets to pass to the disclaimant's heirs as opposed to a rule treating the disclaimant as having predeceased the benefactor. Apparently the UDPIA was designed to work in conjunction with the Uniform Probate Code (UPC) rule that makes remainders in trust contingent on survival.[6]

Current IRS Rulings

The timing of disclaimers for older trusts can be somewhat complex. For example, Donor created a trust in 1955. Upon a designated termination date, the corpus of the trust was to be distributed among Donor's then living descendants, per stirpes. One potential distributee of the assets upon the termination date was Donor's great-grandchild, B, who had previously received discretionary distributions from the trust.

The trust was governed by Reg. §25.2511-1(c)(2) because it was established prior to 1977. B was able to disclaim the interest in trust corpus following the trust's termination because the disclaimer was exercised within nine months of B's attaining majority age. Note that state law permitted the disclaimer of the separate interest in the property and that no benefits in the property being disclaimed were accepted.[7]

In another recent Letter Ruling, the IRS concluded that a child's disclaimer of an interest in his father's estate was qualified even though the disclaimer came more than nine months after the child turned 18 but before the child turned 21. This was true because under the applicable state law, disclaimers are considered effective upon the written consent of all interested parties. In the case under consideration, the only interested party was the child's sister, who was serving as the personal representative of the father's estate. Thus the disclaimer was 1) in writing; 2) delivered within nine months of the disclaimant's 21st birthday and 3) valid under state law (assuming the sister consented).[8]

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Once property has been accepted, it cannot be disclaimed. This makes it important to coordinate the actions of beneficiaries and fiduciaries. In a recent Letter Ruling, the IRS rejected an executor's attempt to disclaim assets two months after a decedent's death where the surviving spouse had already exercised a power of appointment over the assets. Nor did the executor's actions "relate back" prior to the spouse's actions under California's relation back doctrine.[9]

Regarding time-sensitive acts whose performance may be postponed under §7508 (relating to those serving in the Armed Forces in a combat zone) and §7508A (relating to disasters, terrorist actions, or military actions declared by the President), the IRS has included disclaimers on its updated list of applicable actions along with filing a claim for a credit of state death taxes, filing a claim for foreign death taxes, electing alternate valuation on a late-filed estate tax return, and commencing a judicial proceeding to change an interest into a qualified interest.[10]

Note: As part of its legal obligation to reduce paperwork, the IRS recently solicited comments concerning Reg. §25.2518-2(b) involving the disclaimer of property interests received by gift or inheritance.

Charitable Deductions

Recent Letter Rulings have also accepted the use of disclaimers in reforming trusts and qualifying assets for charitable deductions. Thus, an estate was able to claim a charitable deduction for a remainder interest in a trust. The trust was created to benefit Decedent's brother and his wife and left a remainder interest to a charity. After Decedent's death, executors of the estate petitioned to reform the trust to comply with charitable remainder unitrust requirements under §664(d). Decedent's brother had died and the brother's wife disclaimed the right to receive principal distributions.

The wife's disclaimer was qualified since the right to corpus was considered a separate interest under §2518. As reformed, the trust met the requirements of §2055(e)(3)(C). The reformation was valid because 1) it was effective as of Decedent's death; 2) the wife's interest terminated at the same time regardless of the reformation; and 3) the difference between the actuarial value of the reformable interest and the qualified interest after reformation was less than five percent of the actuarial value of the reformable interest.[11]

In another case, gifts of QTIP assets qualified for a charitable deduction. Parties with an interest in the QTIP trust severed it into two QTIP trusts. Decedent's surviving spouse renounced her income interest in one of the qualified terminable interest property (QTIP) trusts. Following her death, the remaining marital trust property was to fund a charitable remainder unitrust (CRUT).

As a result of her renunciation, the assets of the renounced trust passed to the CRUT. The IRS concluded that the wife was making a gift of her income interest in the renounced trust, and that amounts passing to the CRUT due to the renunciation qualified for a gift tax charitable deduction under §2522(a). The other unrenounced trust qualified as a QTIP trust.[12]

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TECHNICAL REFERENCES

1 IRC §2518(b) and Reg. §25.2518.

2 *Letter Ruling 200339021.*

3 Dudley and Wallace, "A Client's Death Doesn't Mean All Planning Must Rest In Peace", 17 *Property & Probate* 3, p. 42 (May/June, 2003).

4 *Rev. Rul. 89-31, I.R.B. 1989-9, 32;* and *Rev. Rul. 89-27, 1988-C.B.331.*

5 *Estate of Clayton v. Comm'r.*, U.S. Court of Appeals, 5th Cir. (1992).

6 Hirsch and Gans, "Perfecting Disclaimer Reform: Suggestions for a Revised Uniform Act", 31 *Estate Planning* 4, p. 185 (April, 2004). This article advocates amending the UDPIA rather than having each state make its own modifications: "Once NCCULSL has promulgated a new Uniform Act, its drafter often seem keener on celebration than on cerebrations. * * * Yet no state can afford to ignore the technical glitches, policy misjudgments, and even constitutional uncertainties that blemish this Act."

7 *Letter Ruling 200238039.*

8 *Letter Ruling 200333023.*

9 *Engelman Est.*, 121 T.C. __ (July, 2003).

10 *Rev. Proc. 2004-13.*

11 *Letter Ruling 200302029.*

12 *Letter Ruling 200324023.*

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