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Disclaimers: A Critical Post-Mortem Tax Planning Tool

Proving to be invaluable to clients

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Disclaimers are an appealing and effective post-mortem estate planning tool that often proves to be invaluable in minimizing a client's overall tax exposure and effectuating their intent. There are many reasons why the use of a disclaimer is critical. These include maximizing the use of the applicable exclusion amount, the marital deduction and/or the generation-skipping transfer tax exemption, protecting against Internal Revenue Service revaluations, qualifying for a charitable deduction, curing drafting errors and changing the disposition of assets.

Internal Revenue Code ("IRC") Section 2518 requires that a "qualified disclaimer" be made within nine months of the transfer creating the interest being disclaimed, that the disclaimer be in writing, the disclaimant has not accepted any of the benefits of the disclaimed interest, and the interest passes without any direction on the part of the person making the disclaimer. If these conditions are satisfied, the disclaimant is treated as having never received the interest. The property interest will pass to whoever would have received the assets had the disclaimant not been alive as specified in the governing instrument or by operation of law, and will not be considered as a gift or transfer by the disclaimant.

If utilized properly, the qualified disclaimer is perhaps one of the only techniques that allow a decedent's estate plan to be analyzed retrospectively so that necessary adjustments may be made based upon the current circumstances of the estate's beneficiaries. Ultimately, qualified disclaimers can create flexibility in the administration of an individual's estate plan.

Maximizing the Use of the Applicable Exclusion Amount

In 2008, every individual has a $2,000,000 applicable exclusion amount. In 2009, this amount is currently scheduled to increase to $3,500,000. $1,000,000 of this applicable exclusion amount may be used to offset lifetime gifts, and the remaining balance may be used after death against estate taxes.

To many, it may seem logical to have the first spouse's entire estate pass to the surviving spouse free of federal and state estate tax. This is not always the best plan as it may partially or entirely waste the predeceasing spouse's applicable exclusion amount. In addition, where there are sufficient funds in the surviving spouse's name or for the surviving spouse to live comfortably, it may be unnecessary to have all of the assets pass outright to the surviving spouse as they will be taxed upon the surviving spouse's death. It is important to note that estate taxes are progressive in nature and that even if the total value is the same, one large estate will pay more in estate taxes than two smaller estates.

Therefore, to optimize the use of the decedent's applicable exclusion amount, the surviving spouse should, within nine months of her spouse's death, determine how much to disclaim, up to the $2,000,000 exclusion amount, to disclaim so that such amount will pass to the next generation estate tax free. By utilizing a disclaimer, the decedent's estate will maximize the use of the decedent's exclusion amount while reducing the surviving spouse's eventual estate. This will result in a lower estate tax liability upon the survivor's passing.

It should also be noted that under New Jersey law, there is a state estate tax imposed on assets in excess of $675,000 passing to someone other than a spouse. This could result in the imposition of a state estate tax on the death of the first spouse to die if the first spouse took advantage of the full amount of the federal applicable exclusion available to him or her. While a New Jersey tax may have to be paid, this may still be the route to follow if it results in the federal estate tax being significantly reduced on the death of the surviving spouse.

To take advantage of the applicable exclusion amount, clients' wills should

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provide for disclaimer trusts. Disclaimer trusts are designed to take advantage of the applicable exclusion amount upon the death of the first of the two spouses. By using this disclaimer technique, the surviving spouse would have the opportunity to disclaim that amount which he or she deems appropriate to eliminate or at least minimize the estate tax liability at the survivor's death, and to decide if he or she wants to pay or avoid the New Jersey estate tax.

Maximizing the Use of the Marital Deduction

Disclaimers can cure trusts intended to qualify for qualified terminable interest property ("QTIP") treatment but that did not meet all of the requirements under IRC §2056(b)(7). For instance, beneficiaries other than the spouse can disclaim their beneficial interests in a trust and if this leaves the spouse with the sole right to all of the income annually, the trust may then qualify for QTIP treatment.

Maximizing the Use of the Generation-Skipping Transfer Tax Exemption

Disclaimers can be also used to transfer wealth from one generation to another. For instance, often times children who already have substantial estates of their own inherit from their parents. If the will of the decedent provides that the children's issue shall take in the event the child predeceases the decedent, then the child can use a disclaimer to allow assets to pass directly to the younger generation. There will be no gift tax consequences for the disclaimant provided that it is a qualified disclaimer and there will be no generation-skipping tax for the decedent's estate provided part of the $2,000,000 generation-skipping tax exemption is available to allocate to the transfer. In other words, the disclaimer can avoid estate taxes being paid in the estates of the children.

Use of Formula Disclaimers to Protect Against a Later IRS Revaluation

If an estate consists of assets that can be subjectively valued or where discounts can be utilized (i.e., real estate, closely held business interests, etc.) and such assets are earmarked for disclaimer, it is important to prepare the disclaimer using a formula so that if the values of the disclaimed assets are ever challenged and/or adjusted, those adjustments will be taken into consideration so as not to unnecessarily trigger an unwanted estate tax.

Qualifying for or Enlarging a Charitable Deduction

Individuals with charitable inclinations often make bequests that establish a life estate for an individual with the remainder passing to a qualified charity. The estate will not get a charitable deduction for the value of the remainder passing to the charity unless the estate establishes a charitable remainder trust. However, an immediate charitable deduction can be obtained if a bequest immediately passes to the charity. If the beneficiary of the life estate disclaims her interest, the bequest is accelerated and the remainder will automatically pass to the charity, allowing the estate to take advantage of the full charitable deduction.

Making Corrections

In some instances, a will or other testamentary document should have been updated due to changes in circumstances or the law, or due to errors made in drafting which remained unnoticed. These flaws may be corrected by use of a qualified disclaimer.

For example, Mr. Smith had a will which he thought created a credit shelter trust for the benefit of his surviving spouse, children and their issue. Such a trust, if drafted properly, would maximize the applicable exclusion amount by providing for the mandatory funding of the available exclusion amount into a trust for the benefit of younger generations, while at the same time allowing for income to be paid to the surviving spouse without including the trust corpus in the spouse's estate upon her death. Unfortunately, Mr. Smith's will also provided the spouse with a general power of appointment over the trust, thereby making the value of the trust includable in her estate upon her death. If the surviving spouse makes a qualified disclaimer of the general power of appointment, this issue can be corrected.

When contemplating using qualified disclaimers, there are many issues to consider. A practitioner must be familiar with the local law of the jurisdiction(s) in which the disclaimer must be filed. Deadlines must be watched carefully as there is no opportunity for an extension for federal tax purposes.

Oftentimes, in order to achieve the desired result, multiple disclaimers by various parties are necessary. One should be aware of such multiple transactions and ensure that all parties are involved. It is also extremely important to review who will receive the property if a disclaimer is made. For instance, a practitioner should be sensitive to the contingent beneficiary(s) of life insurance policies, retirement plans, and other assets that pass outside of the will. A disclaimer may have tax benefits for the disclaimant, yet create serious adverse effects for those who will receive the property. For example, if the ultimate recipient of the property is a grandchild and there is no remaining generation-skipping tax exemption to allocate to the bequest, unforeseen taxes may be imposed on the estate.

Although disclaimers are generally a post mortem planning technique, estate practitioners should also be aware that many state statutes do not provide automatic powers of disclaimer for fiduciaries (such as trustees and executors), so such powers must be specifically granted within the estate planning documents. Failure to specifically grant these powers could result in having to institute costly court proceedings.

There are many situations in which qualified disclaimers may and should be utilized. Although this article is not all inclusive, it does illustrate the broad scope of this flexible planning tool. If the factors mentioned here are taken into consideration, the qualified disclaimer can be extremely useful and save clients a significant amount in taxes. ■