12-1973

Disclaimers as an Estate Planning Tool

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Most lawyers are familiar with the importance and function of post-mortem estate planning in estates where:

- There has been no pre-death planning;

- The pre-death planning was bad or went awry; or

- Far-sighted estate planning counsel has left the plan flexible and open-ended in order to more accurately accomplish the goals of his client by making provision for certain post-mortem elections.

This article will focus on one tool that is being used with ever increasing frequency in all phases of the post-mortem estate planning process—the disclaimer.

How a Disclaimer Functions

A disclaimer is the act indicating that a party refuses to accept an estate which has been conveyed to him. It is quite different from either an assignment or a release, which are methods of transfering one's own property, since the essence of the disclaimer is that the disclaimant is viewed as never having had any interest in the property that was disclaimed.

Disclaimers can be used to accomplish a variety of goals like:

- Reducing probate fees;

- Eliminating some administrative expenses; and

- Defeating the rights of a beneficiary's creditors.

The primary use of disclaimers, however, is to lower the burden of federal estate and gift taxes, which are imposed only on the *transfer* of property.

Consider the simple case of a Grandfather who dies intestate, leaving Father as his sole heir. If Father gives the subject matter of the inheritance to Only Son, there have been two property transfers—Grandfather to Father and Father to Only Son—and thus exposure to two transfer taxes. In many cases, a properly executed disclaimer will preclude what for all practical purposes is a transfer of property from being treated as a transfer for federal estate and gift tax purposes. If Father disclaimed the inheritance from Grandfather, and as a result, the disclaimed inheritance passed to Only Son, the same ultimate taker now has the property. Yet, there has been only one transfer—Grandfather to Only Son—and thus there is exposure to only one transfer tax, instead of the payment of two that would occur if Father accepted his inheritance and then gave it away.

The Applicable Treasury Regulation

The key language in the gift tax regulations that makes this tax savings possible reads as follows:

"Where the law governing the administration of the decedent's estates gives a beneficiary, heir, or next-of-kin a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent (whether the transfer is effected by the decedent's will or by the law of descent and distribution of intestate property), a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer." Treas. Reg. §25.2511-1(c) (1958)

The following illustrations that will attempt to demonstrate the potential for disclaimers in post-mortem estate planning assume that:

- Local law permits disclaimers to be made in all estates, whether testate or intestate;
- Partial disclaimers are permitted; and
- Disclaimers take effect pursuant to the lapse approach, with the disclaimant being treated as having predeceased the decedent, and the property interest involved being distributed in the same manner that a lapsed bequest or devise would ordinarily be.

Thus, in those cases where the decedent has died intestate, the ultimate taker is going to be determined by reference to the appropriate statute of descent and distribution. Where the decedent died testate, the progression to be followed in determining the ultimate taker is: First look to any specific provision in the decedent's will that deals with lapsed or disclaimed dispositions; if none was made, then apply the local antilapse statute; if the statute is not applicable, then the property will ordinarily be governed by the residuary clause, unless the residuary gift is being disclaimed, in which case the ultimate taker is determined by the statute of

descent and distribution.

It should be noted, though, that while the size of a disclaimer can be tailored, the disclaimant cannot specify who will take after him. That is predetermined by law. However, the decedent can make any alternative provision in his will that he desires, providing, for instance, that "any legacies disclaimed hereunder shall go to the XYZ Charity instead."

Intra-Family Redistribution

Disclaimers can save gift, estate, and income taxes in the following situations:

- Where testator failed to provide for one of his adult children due to the child's wealth, which was lost subsequent to the execution of the will, a disclaimer may be used by the other children to pass a share to the omitted child without any gift tax consequences.
- Where testator made extra provision for one of his children due to some need that no longer existed when testator died, a disclaimer may redistribute this excess among the other children without the payment of a gift tax.
- One of the drawbacks in an inter-vivos giving program is the chance that one of the donee children may die young and the donor parents will thus inherit what they had given away, with a consequent exposure to double taxation. By executing a disclaimer, the parents can "transfer" the property tax-free to the deceased child's brother and sisters.

Generally, whenever a wealthy person inherits property, the possibility of executing a disclaimer should be explored to determine if a desirable intra-family transfer might thereby be obtained without the tax exposure that must follow a later transfer, whether inter-vivos or testamentary.

Accelerating a Future Interest

Where a life tenant or tenant for a term does not need the income interest, and it is desirable for the remainderman to come into possession due to necessitous circumstances or in order to shift an income tax burden from a high bracket taxpayer to a taxpayer in a lower bracket, a disclaimer of the preceding estate can accelerate the future interest without any gift tax consequences.

Shifting an Income Tax Burden

Income tax savings can be obtained by an income beneficiary disclaiming when he is in a higher bracket than the alternate beneficiary.

The net income tax burden can be decreased within a family unit where a disclaimer would increase the number of taxpayers and thus increase the number of exemptions.

When a trustee or beneficiary of a trust has a power exercisable solely by himself to vest the corpus or income therefrom in himself, he is treated as the owner of the trust and taxed on its income if the settlor is not subject to taxation. INT. REV. CODE OF 1954 (IRC) §678(a). The same section also provides that if the trustee or beneficiary disclaims the power of invasion within a reasonable time after he first becomes aware of its existence, he will not be considered the owner of the Trust. IRC §678(d).

Fiduciary fees and commissions are ordinarily taken as a deduction by the estate. Where the fiduciary is also the sole beneficiary, his net tax burden may be reduced by disclaiming all fiduciary commissions. By giving up an estate deduction, he will prevent the inclusion of the fees in his income for income tax purposes. For instance, if the estate tax bracket is 20 per cent and the fiduciary-sole beneficiary is in the 35 per cent bracket for income tax purposes, disclaiming a $5,000 fiduciary fee will result in a savings of $750. His disclaimer must normally be made within six months after the appointment and before any prior inconsistent conduct on his part. Rev. Rul. 66-167, 1966-1 *Cum. Bull.* 20.

GENERATION SKIPPING

Where a parent is the recipient of a devise or bequest, under most anti-lapse statutes a disclaimer will cause the property to pass to the issue of the parent, without any present gift tax consequences and without the estate tax consequences that would result if the property remains in the parent's estate to be inherited by his issue later.

ENLARGING THE CHARITABLE DEDUCTION

Federal tax law expressly provides for a charitable deduction for any property that passes from a decedent's estate to a charity as a result of a disclaimer. IRC §2055(a). The disclaimer must be made within the period of time when the estate tax return must be filed. Treas. Reg. 20.2055-2(c)(1).

Prior to the Tax Reform Act of 1969, life beneficiaries could qualify charitable remainders for the charitable deduction by disclaiming their encroachment powers. *Estate of Harry C. Jaecker,* 58 T.C. 166 (1972). Now, of course, charitable remainders must be part of an annuity trust, unitrust, or pooled income fund in order to qualify for the charitable deduction. IRC §2055(e).

Where a person wants to benefit a charity but is mindful of a duty to someone near, like a spouse, and is unsure of the size of the estate he will leave at his death, a receptacle gift may provide the solution. For example: "I bequeth One Hundred Dollars ($100) to the ABA Charity, along with all property that would have passed under this will to my wife, Mary, but for any disclaimer executed by her." If there are sufficient assets at his death to provide for Mary and leave a surplus, she can disclaim. However, Mary might do better accepting the inheritance and then making an intervivos gift, because the income tax deduction gained from the gift could more than offset the estate tax deduction lost by the disclaimer.

AFFECTING THE MARITAL DEDUCTION

Where the surviving spouse is not left enough to enable the estate to claim the maximum marital deduction, IRC §2056(d)(2) specifically provides that an interest in property that passes to the surviving spouse as a consequence of a disclaimer "is considered as passing from the decedent to the surviving spouse" and qualifies for the marital deduction, provided that the disclaimer is made before the date prescribed for filing the estate tax return.

In cases of overqualification, where the entire estate was left to the surviving spouse, IRC §2056-(d)(1) recognizes the efficacy of a disclaimer to reduce the share going to the surviving spouse. While there would be no tax savings to the decedent's estate, the size of the surviving spouse's estate would be reduced, thus lowering the estate taxes at the time of her death without any increase in the tax burden at the time of the decedent's death.

While partial disclaimers are not specifically mentioned in the Regulations under the marital deduction section of the IRC, they should be effective if they are recognized under local law.

A marital deduction trust may be defective due to the existence of a power of diversion that permits the trustee to distribute money to a third party under certain circumstances. This defect may be cured if the beneficiary disclaims his interest. Probably the trustee should join in the disclaimer.

POWERS OF APPOINTMENT

When a life estate is coupled with a general power of appointment, the power may clearly be disclaimed in whole and possibly in part without disclaiming the life estate. Treas. Reg. 20.2041-3(d)(6).

ADMINISTRATIVE POWERS

Sometimes a trustee will be given administrative powers that are so broad as to cause the loss of a charitable deduction or the marital deduction. While local law may differ, the common law rule is that a trustee cannot disclaim a part of a trust; he must accept or disclaim in the entirety. 2 Scott, Trusts §102.4 (3rd ed. 1967). The draftsman of a trust may, however, include a clause authorizing the trustee, in the exercise of his discretion, to disclaim a power that he considered burdensome, unnecessary, or unwise.

Timing of Disclaimers

If a jurisdiction has a disclaimer statute, the statute will specify a period within which the disclaimer must be made. However, the mere fact that the disclaimer has been made within the statutory period prescribed by local law does not necessarily satisfy the federal requirements. In a number of instances, a specific time limitation is established by federal law. See IRC §2056(d)(2); Treas. Reg. 20.2055-2(c)(1). If the situation is not covered by a specific time limit, the Regulations require a beneficiary to disclaim within a reasonable time after learning of the existence of the transfer. Treas. Reg. 25.2511-1(c).

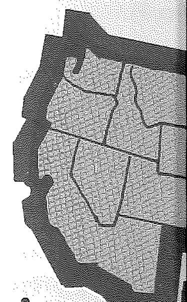
A "reasonable time" can be quite long in some cases. The will of John MacMillan, who died in 1944, created a trust for the benefit of his wife for life, and left the remainder to two sons in equal shares. Although these remainders were vested, they were subject to divestment if the sons predeceased their mother. Nineteen years later, in 1963, testator's wife died. Approximately five and one-half months afterwards, Son A, who now had a vested remainder with possibility of divestment extinguished, and was also vested in possession, made a disclaimer of his one-half interest in the trust.

The Internal Revenue Service argued, and the Tax Court agreed, that even though the disclaimer was recognized by local law, it was not made within a "reasonable time" after Son A learned of the existence of the transfer, which occurred on the date of John MacMillan's death in 1944. *Pauline Keinath,* 58 T.C. 352 (1972).

Reversing this decision, the Court of Appeals held that the "reasonable time" did not begin to run until the possibility of divestment expired in 1963, because Son A did not have the option to accept or disclaim beneficial ownership until that year. Therefore, the disclaimer made within five and one-half months of the mother's death was made within a "reasonable time." *Keinath v. C.I.R.,* 480 F.2d 57 (8th Cir., 1973).

Conclusion

Counsel who masters his own local law of disclaimers and develops the habit of examining all estates for the potential application of disclaimers will regularly identify situations that are ripe for tax savings.



Qualifying Land Sales for Limited Offerin

DAVID G. MARTIN, of the Cha

On September 4, 1973, th fice of Interstate Land Sales tration of the Department of ing and Urban Develop ("HUD") revised the Regula that were published in 24 C §1700 (1972) pursuant to Interstate Land Sales Full D sure Act (the Act), 15 U §§1701-20. The revised Re tions in 38 Fed. Reg. 2 (1973) are designed to give b of subdivision lots more info tion relating to their purch

For a developer of limited f cial means, the assembly o the information required by th vised Regulations may be tremely burdensome. Noneth the penalties for failure to co

Editor's Note: This article is b