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TAX & TRANSACTIONS BULLETIN

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- A Qualified Disclaimer is a technique which can help accomplish Family estate planning goals
- If a person makes a Qualified Disclaimer of an asset, the Federal Gift, Estate, and Generation-Skipping (GST) Taxes are applied as if the asset had never been transferred to that person
- A Qualified Disclaimer of Joint-Property owned by Dad and Mom may reduce tax
- One set of rules applies to the disclaimer of joint-property *other than* bank, brokerage, and investment accounts
- An entirely different set of rules applies to the disclaimer of jointly-owned bank, brokerage, and investment accounts

TAX PLANNING WITH DISCLAIMERS

Many U.S. Families have accumulated significant wealth. Family goals and objectives often focus on preserving this wealth. Specifically, Family goals and objectives often include: (a) keep assets within the Family; (b) protect assets from creditors; (c) reduce income and estate tax taxes; (d) resolve Family disputes quickly (avoid intra-Family litigation); and (e) avoid probate and guardianship proceedings.

A Qualified Disclaimer[1] is a technique which can help accomplish these goals. After a death in the family, the surviving family members initially may be disorganized. Tax planning for the Estate may not begin for several months. A Qualified Disclaimer allows surviving family members to make decisions which re-direct assets and reduce tax, even where those decisions are made several months after death.

If a person makes a Qualified Disclaimer of an asset, the Federal Gift, Estate, and Generation-Skipping (GST) Taxes are applied as if the asset had never been transferred to that person.[2] Assume Dad's Estate bequeaths real estate to Mom or, if Mom disclaims, to Daughter. Mom disclaims the real estate. The result of Mom's Qualified Disclaimer is:

1. Daughter receives the real estate.
2. Mom is not treated as making a taxable gift to Daughter.
3. Dad's Estate is treated as transferring the real estate directly to Daughter.[3] This recharacterization of the transaction can increase or decrease Dad's Estate Tax.[4]

Qualified Disclaimers are often used to reduce Estate tax. Under current law, Dad and Mom are each entitled to a Federal Estate Tax Credit of $2 Million. The Credits assist

[1]To constitute a "qualified disclaimer" under Code Section 2518, a disclaimer must satisfy the following requirements: (1) It must be irrevocable and unqualified; (2) It must be in writing; (3) The writing must be delivered within nine months after the transfer creating the disclaimed interest or the disclaimant's twenty-first birthday; (4) The disclaimant must not have accepted the interest before disclaiming it; and (5) The disclaimed interest must pass to an alternative taker without any direction by the disclaimant.

[2]See IRS Regulation § 25.2518-1(a)(1).

[3]Mom's role in shifting the real estate to Daughter is disregarded. Dad is treated as making no transfer to Mom.

[4]For example, Mom's disclaimer typically would *increase* Dad's Estate Tax, since the real estate would no longer qualify for the marital deduction. However, if Mom were not a U.S. citizen (and thus no marital deduction would have been allowed anyway) and if Daughter also disclaimed so that the real estate was distributed to Dad's favorite Charity named in his Revocable Trust as residuary beneficiary, then the real estate bequest may qualify as a tax-deductible charitable contribution and the final result would be to *reduce* Dad's estate tax. *The key point is that a Qualified Disclaimer causes a recharacterization of the transaction which can increase or decrease Gift, Estate, and GST Tax.*

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TAX PLANNING WITH DISCLAIMERS (cont'd)

a married couple in providing assets for each other during their joint lifetimes, and then transferring up to $4 million[5] to their children tax-free. However, certain assets do not qualify for this Tax Credit. For instance, Joint-Property[6] owned by Dad and Mom is ineligible for the Credit.[7]

A Qualified Disclaimer may remedy these tax issues. A Qualified Disclaimer of Joint-Property owned by Dad and Mom may reduce tax. A Qualified Disclaimer can transfer a portion of Joint-Property to a Family Trust for Mom's benefit, while utilizing Dad's Credit.[8] Thus, a Qualified Disclaimer may help achieve a central goal of modern estate planning: that Mom and Dad provide assets for each other during their joint lifetimes, and then transfer up to $4 million to their Children tax-free.

The following Examples illustrate the advantages of a Qualified Disclaimer of Joint-Property owned by Dad and Mom:[9]

I. Joint-Property Other Than Bank, Brokerage, and Investment Accounts

For all joint-property *other than* bank, brokerage, and investment accounts (e.g. real estate owned jointly), the surviving joint tenant may disclaim the one-half (½) survivorship interest in property held in joint tenancy with right of survivorship or tenancy by the entirety within nine months of the date of death of the first joint tenant to die. The disclaimed interest is deemed to be a one-half (½) interest in the property. These rules apply: (1) regardless of the portion of the property attributable to consideration furnished by the disclaimant;[10] (2) regardless of the portion of the property that is included in the decedent's gross estate under Code Section 2040; and (3) regardless of whether the property was owned in joint tenancy with right of survivorship or tenancy by the entirety.

> ***Example I:*** *On February 1, 1990, Dad purchased real property with Dad's funds. Title to the property was conveyed to "Dad and Mom, as tenants by the entirety." Mom dies on May 1, 1998, and is survived by Dad. On January 1, 1999, Dad disclaims the one-half (½) survivorship interest in the property to which Dad succeeds as a result of Mom's death. Assuming that the other requirements of section 2518(b) are satisfied, Dad has made a qualified disclaimer of the one-half (½) survivorship interest (but not the interest retained by Dad upon the creation of the tenancy, which may not be disclaimed by Dad). The result is the same whether or not Dad and Mom are married and regardless of the proportion of consideration furnished by Dad and Mom in purchasing the property. The result is also the same if the Co-Owners are not married and own the property as joint tenants with right of survivorship.*[11]

[5]The Credit reduces tax on a dollar-for-dollar basis. A Credit thus permits tax-free transfers of Family wealth. The Credits assist a married couple in providing assets for each other during their joint lifetimes, and then distributing property to their children and grandchildren. Careful planning with Credits can maximize Family tax savings.

[6]"Joint-Property" refers to assets owned by Dad and Mom (i) in joint tenancy with right of survivorship or (ii) in tenancy by the entirety.

[7]Jointly-owned assets automatically pass to the surviving spouse and typically qualify for the unlimited marital deduction, thus "wasting" the decedent's $2 million Tax Credit. Failure to use the Credit is costly, since Mom and Dad forfeit the ability to transfer up to $4 million to their children tax-free. (Note: an IRA/401(k) Account which designates the surviving spouse as primary beneficiary may also be ineligible for the Estate Tax Credit, unless a disclaimer is made).

[8]A Disclaimer of Joint-Property may help a married couple transfer up to $4 million to their children tax-free.

[9]One set of rules applies to the disclaimer of joint-property *other than* bank, brokerage, and investment accounts. An entirely different set of rules applies to the disclaimer of jointly-owned bank, brokerage, and investment accounts. The Examples illustrate these two (2) different sets of rules.

[10]I.e., regardless of the proportion of the purchase price furnished by the disclaimant. In short, the surviving joint tenant may disclaim ½ of real estate which he previously purchased entirely with his own funds.

[11]See IRS Regulation 25.2518-2(c)(4)(i); and 25.2518-2(c)(5) Examples (7) and (8).

TAX PLANNING WITH DISCLAIMERS (cont'd)

This rule means that a married couple may own their Home as Tenants by the Entirety and receive certain Estate Tax benefits. Tenancy by the Entirety is a form of ownership which protects the Home from certain creditors.[12] If Dad dies, Mom may disclaim her one-half (½) survivorship interest in the Home. The disclaimed one-half (½) interest is transferred through Dad's estate (pursuant to his Will and Revocable Trust) to a Family Trust for Mom's benefit. This transfer uses Dad's Estate Tax Credit, helping to achieve the goal of providing assets for Mom during her lifetime and then transferring up to $4 million to the children tax-free. In short, Mom and Dad have protected their Home from certain creditors, provided financial security to each other and their children, and received Estate Tax benefits.[13]

II. Jointly-Owned Bank, Brokerage, and Investment Accounts

In the case of a transfer to a joint bank, brokerage, or other investment account (e.g., an account held at a mutual fund), if a transferor may unilaterally regain the transferor's own contributions to the Joint Account[14] without the consent of the other cotenant, such that the transfer is not a completed gift,[15] then the transfer creating the survivor's interest in the decedent's share of the account occurs on the death of the deceased cotenant. Accordingly, if a surviving joint tenant desires to make a Qualified Disclaimer with respect to funds contributed by a deceased cotenant, the disclaimer must be made within 9 months of the cotenant's death. However, the surviving joint tenant may not disclaim any portion of the Joint Account attributable to consideration furnished by that surviving joint tenant.

> ***Example II:*** *On July 1, 1990, Dad opens a bank account that is held jointly with Mom, Dad's spouse, and transfers $50,000 of Dad's money to the account. Dad and Mom are United States citizens. Dad can regain the entire account without Mom's consent, such that the transfer is not a completed gift under §25.2511-1(h)(4). Dad dies on August 15, 1998, and Mom disclaims the entire amount in the bank account on October 15, 1998. Assuming that the remaining requirements of section 2518(b) are satisfied, Mom made a qualified disclaimer under section 2518(a) because the disclaimer was made within 9 months after Dad's death. Under state law, Mom is treated as predeceasing Dad with respect to the disclaimed interest. The disclaimed account balance passes through Dad's probate estate and is no longer joint property includible in Dad's gross estate under section 2040. The entire account is, instead, includible in Dad's gross estate under section 2033. The result would be the same if Dad and Mom were not married.*[16]

[12]Illinois statute provides: "Any real property, or any beneficial interest in a land trust, held in tenancy by the entirety shall not be liable to be sold upon judgment entered on or after October 1, 1990 against only one of the tenants, except if the property was transferred into tenancy by the entirety with the sole intent to avoid the payment of debts existing at the time of the transfer beyond the transferor's ability to pay those debts as they become due." See 735 ILCS 5/12-112. Also, ownership as Tenancy by the Entirety is limited to the married couple's principal residence. See 750 ILCS 65/22.

[13]By permitting the married couple to protect their Home from creditors and receive Estate Tax benefits, this strategy permits the married couple to "have their cake and eat it too."

[14]A "Joint Account" includes each of the following: (1) a jointly-held bank account; (2) a jointly-held brokerage account; or (3) a jointly-held investment account. The disclaimer rules apply identically to each of these 3 types of accounts.

[15]See IRS Regulations §25.2511-1(h)(4); 25.2518-2(c)(4)(iii).

[16]See IRS Regulation 25.2518-2(c)(5) Examples (12) and (13). Note: if Mom, rather than Dad, dies on August 15, 1998, then Dad may not make a qualified disclaimer with respect to any of the funds in the bank account, because Dad furnished the funds for the entire account and Dad did not relinquish dominion and control over the funds.

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TAX PLANNING WITH DISCLAIMERS (cont'd)

This rule may help Mom and Dad to remedy tax issues associated with owning a Joint Account.[17] For instance, Mom and Dad may own a Joint Brokerage Account,[18] unaware of the inherent tax issues. If each spouse contributed equally to the Joint Account, and if each spouse could unilaterally withdraw his or her contributions from the Joint Account at any time prior to death, then each spouse's contributions to the Joint Account are incomplete gifts until Dad's death. Consequently, the transfer creating Mom's survivorship interest in Dad's share of the Joint Account occurred at Dad's death.[19] Mom has 9 months after Dad's death to disclaim any part of her survivorship interest in Dad's share.

If Mom makes a Qualified Disclaimer of her survivorship interest in Dad's share of the Joint Account, Mom is treated as predeceasing Dad with respect to the disclaimed property. Consequently, the disclaimed property is treated as passing to Dad from the Brokerage Account by right of survivorship. Assuming Dad previously established a traditional estate plan, the disclaimed assets will then be distributed (pursuant to Dad's Will and Revocable Trust) to a Family Trust for Mom and the Children.[20] The Qualified Disclaimer is valid even though: (i) Mom is a Trustee of the Family Trust;[21] (ii) Mom receives all income from the Family Trust quarterly; (iii) Mom may receive principal from the Family Trust; and (iv) Mom has the annual right to withdraw the greater of $5,000 or 5% of Family Trust principal.[22] The Qualified Disclaimer thus assists a married couple in providing assets for each other during their joint lifetimes, and then transferring up to $4 million to their children tax-free.

[17]After Dad's death the Joint Account generally will not utilize Dad's Estate Tax Credit, unless a qualified disclaimer is made. Jointly-owned assets automatically pass to the surviving spouse and typically qualify for the unlimited marital deduction, thus "wasting" Dad's $2 million Tax Credit. Failure to use the Credit is costly, since Mom and Dad forfeit the ability to transfer up to $4 million to their children tax-free. (Note: an IRA/401(k) Account which designates the surviving spouse as primary beneficiary may also be ineligible for the Estate Tax Credit, unless a qualified disclaimer is made).

[18]See IRS Private Letter Ruling 200503024 (01/21/2005).

[19]Since the spouses contributed equally, Dad owns a one-half (½) share of the Joint Account. [Note: if the spouses contribute approximately equal amounts, the IRS may concede to a 50% - 50% allocation. See IRS Private Letter Ruling 200503024].

[20]The "Family Trust" is also known as the credit shelter trust.

[21]Mom's power as Trustee to distribute assets must be limited by an ascertainable standard. Further, Mom should also disclaim all Powers of Appointment she possesses over assets in the Family Trust.

[22]Generally, for purposes of IRS Regulation 25.2518-2(e)(1) and (2), Mom is not treated as directing the beneficial enjoyment of the disclaimed property due to her interests as a beneficiary of the credit shelter trust or her power as co-trustee of that trust. See IRS Private Letter Ruling 200503024; See Examples 4, 5, 6, and 7 of Regulation 25.2518-2(e)(5).

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