

Your clients can help heirs cope with an uncertain tax future by arranging for the use of disclaimers in their estate plans

# LET'S PLAY KEEP AWAY

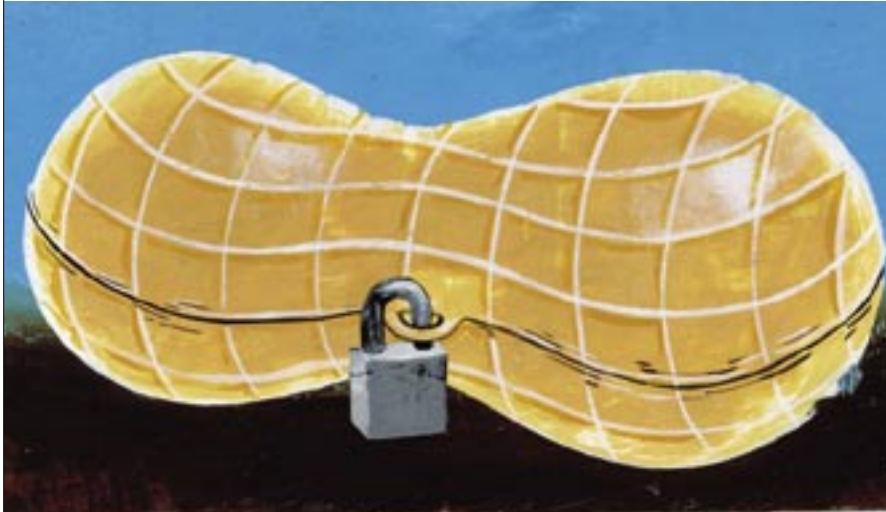
By Deborah L. Jacobs

## ADVISERS TRYING TO HELP A CLI-

ent prepare for unknown estate-tax consequences recently devised a strategy for some elaborate reshuffling of the client's family fortune. The plan relies on two key elements: a daisy chain of five trusts varying slightly in their terms that all benefit the client's wife—and in some cases the couple's children—and an estate-planning technique known as a disclaimer, whereby a beneficiary basically turns down an inheritance.

The idea, according to William LaPiana, professor of wills, trusts, and estates at New York Law School, who wasn't involved in the plan, is to give the wife the option to keep disclaiming property from trust to trust until it ends up in the trust most favorable under the estate-tax regime in effect when the husband dies. In other words, LaPiana says, the advisers are trying to help their clients "cope with the misery" of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which gradually increases the estate-tax exemption and lowers the tax rates between now and 2009, then the tax is suspended entirely in 2010 only to reinstate in 2011. Before finalizing their wills, however, the couple asked the Internal Revenue Service to bless the plan with a favorable private-letter ruling: without such a ruling, the advisers were unsure whether the wife could repeatedly disclaim





## THE RULE RESTRICTING DISCLAIMANTS FROM ACCEPTING AN INTEREST IN AN ASSET OR ANY OF ITS BENEFITS—SUCH AS COLLECTING LIFE INSURANCE PROCEEDS—GIVES INDIVIDUALS THE MOST TROUBLE

the same property. The IRS approved of the arrangement October 15, 2004, in PLR 200442027, which, like all private-letter rulings, applies only to the parties to whom it is issued.

Such exercises, says LaPiana, have become necessary as a result of “the terrible uncertainty brought about” by the 2001 tax act. Fluctuations in the applicable exclusion amount that people can give away at death without triggering estate tax—which ranges from \$1.5 million this year to \$3.5 million by 2009, then goes to \$1 million when the tax springs back in 2011—prevent advisers from knowing what the conditions will be when a particular client dies and, therefore, make it difficult to plan ahead to shelter assets from tax. Building disclaimers into the estate plan enables beneficiaries to defer decisions about asset distribution until after the client dies, says Barbara Sloan, a lawyer with McLaughlin & Stern in New York.

Historically, lawyers have recommended disclaimers chiefly after the fact, so-called fix-up disclaimers used as a postmortem tool to repair estate-planning oversights with negative tax consequences. But since the passage of EGTRRA, lawyers have greatly expanded their reliance on disclaimers by

employing them as an affirmative planning tool, Sloan and others say.

The primary motivation for disclaiming property is to eliminate or reduce any estate tax or generation-skipping transfer (GST) tax that the ultimate recipients will have to pay, says Ronni Davidowitz, a lawyer with Katten Muchin Zavis Rosenman in New York. When someone makes a valid disclaimer, that person, known as the disclaimant, is generally treated as if he or she predeceased the original owner of the property. That is, under Section 2518 of the Internal Revenue Code, disclaimants are treated as if they never received the inheritance, so there’s no

### CREDITOR LOCKOUT

**CHRISTOPHER M. RISER’S NO. 1 RULE WHEN DRAFTING WILLS AND TRUSTS IS “NEVER**

leave anything to anybody outright.” Riser, a lawyer with his own firm in Raleigh, N.C., and coauthor of *Asset Protection: Concepts & Strategies for Protecting Your Wealth* (McGraw-Hill), would most like to see clients transfer property through discretionary trusts, which protect assets from creditors, while giving trustees broad powers to make distributions. When he can’t sell clients on this idea, Riser says the next best alternative is using disclaimer planning with trusts. Under this approach, the client would make an outright bequest but give the inheritor the option of disclaiming into a trust. Assuming the money never touched the inheritor’s hands, the transfer wouldn’t be considered a fraudulent conveyance—an illegal transfer to avoid creditors—under most state laws, so the assets would be protected from the individual’s creditors (see “Going Under Cover,” page 82). The result is different if the creditor is the federal government, however: In *Drye v. United States*, the Supreme Court ruled in 1999 that inheritors who owe back taxes can’t use a disclaimer to avoid them.

Riser thinks that disclaimer planning for asset protection is preferable to the sort of trusts that stagger payouts at certain ages and ultimately distribute the principal outright. With many of these trusts the entire sum has been paid out by the time the beneficiaries are in their 30s. But creditor problems tend to arise later, once people have become successful in their careers and are the targets of lawsuits or are involved in divorces, he explains.

An outright bequest with the option to disclaim into a trust gives heirs an easy out if creditor problems exist, Riser says. But the trust must have been set up before the client died and cannot benefit the disclaimant in any way. Often the trust beneficiaries are the inheritor’s own children or siblings. By disclaiming into this trust, the inheritor gives up control over the assets forever but keeps them out of the hands of creditors.

—DLJ

taxable gift when the property then goes to someone else. Depending on how the estate plan is set up, the disclaimed asset can pass outright or in trust.

For example, Bruce Steiner, a lawyer with Kleinberg, Kaplan, Wolff & Cohen in New York, recently recommended a fix-up disclaimer to help a family correct an oversight in their estate plan. In this case, the grandchildren inherited an estate worth more than the amount exempt from GST tax. Right now, each person can give away \$1.5 million during life or at death without incurring this tax. Rather than immediately triggering the tax, the adult grandchildren disclaimed the excess over the exempt

amount, which in this case pushed part of the inheritance back up a generation to their parents. By doing so, the grandchildren were able to avoid triggering tax until their parents died. The parents' estate might also wind up not being taxable. But if it is, the grandchildren can do some other kind of estate planning during their lives to make the tax bite less severe, Steiner says.

Given the uncertainty of the tax environment EGTRRA created, many clients might want to include disclaimers in their estate plans to fund bypass, or credit shelter, trusts. These trusts are often used to take advantage of the applicable exclusion amount when the first spouse dies. Gener-

ally, they pay income for life to the surviving spouse—assume it's the wife—with whatever's left going to other family members after she dies. If the trust is funded up to the husband's exclusion amount, no tax will be due on the assets when he dies or when his wife dies, because the funds were never part of her estate. But some individuals may want to give their surviving spouse more flexibility. In that case, rather than automatically funding the credit shelter trust, individuals might instead leave the entire estate to the surviving spouse with instructions that any amount the surviving spouse decides to disclaim will be used to fund the credit shelter trust, says Sloan.

## PASSING RETIREMENT ASSETS DOWN THE LINE

### THE MOST COMMON USE OF DISCLAIMERS IN CONNECTION WITH

retirement assets is to fund what Natalie Choate, a lawyer with Bingham McCutchen in Boston and author of *Life and Death Planning for Retirement Benefits* (Ataxplan Publications), calls a "disclaimer-activated credit shelter trust." This strategy may be particularly beneficial to married couples with substantial assets in retirement accounts because it enables them to make full use of the applicable exclusion amount. The tradeoff of using individual retirement account (IRA) assets, for example, to fund a bypass, or credit shelter, trust is that the surviving spouse loses various income tax advantages, most notably the right to roll over the assets into an IRA of his or her own and defer distributions until reaching age 70½. Most clients won't want to go this route unless they don't have any other assets they can use to fund the trust.

To keep all options open, Choate says the client can name the spouse—assume it's the wife—as the primary beneficiary of the retirement benefits and name the credit shelter trust as the contingent beneficiary. That enables the wife to decide, based on financial circumstances when her husband dies, whether to disclaim the benefits and let them flow to the credit shelter trust.

Beverly Budin, a lawyer with Ballard Spahr Andrews & Ingersoll in Philadelphia, routinely uses a three-part beneficiary designation that gives spouses maximum flexibility. For the wife's IRA, the form might stipulate the following: "To my husband if he survives me. If he disclaims, the IRA goes to the credit shelter trust of which the husband is beneficiary. If he dies before me, the IRA goes outright to the children."

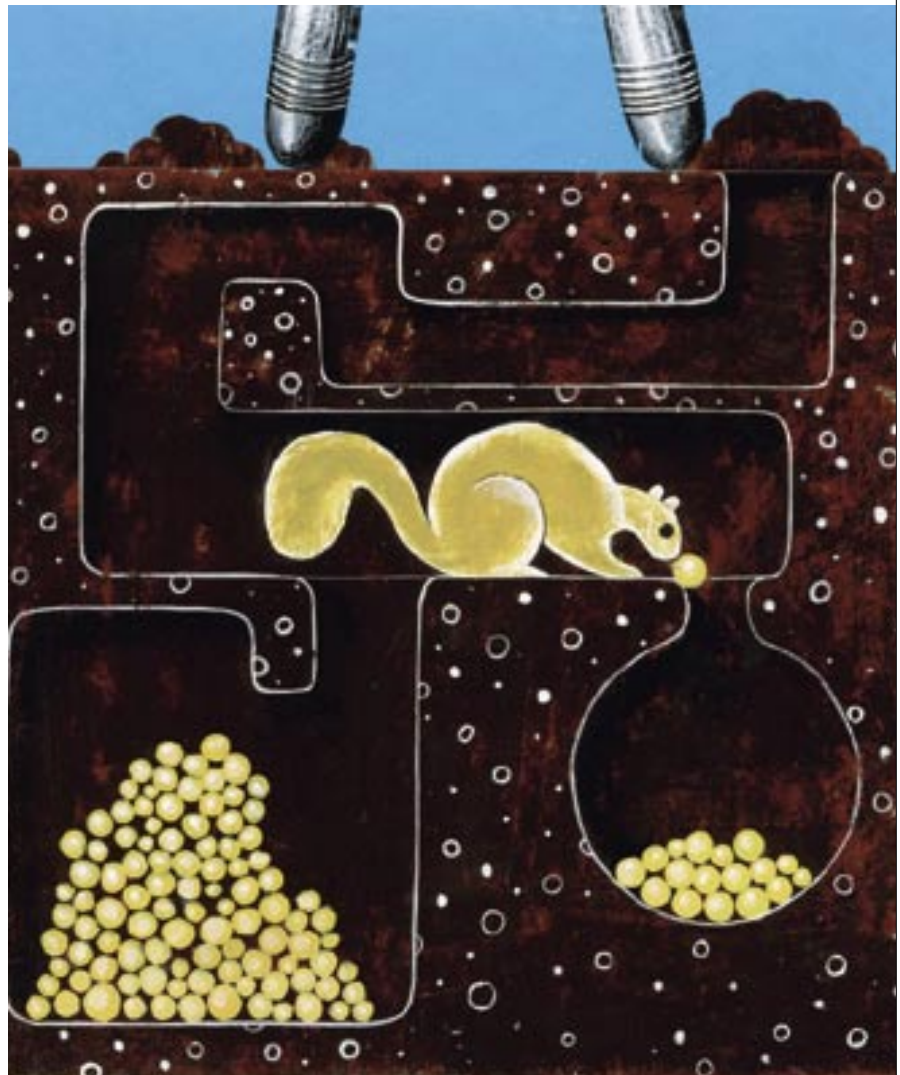
Some clients will want to make their children the primary beneficiaries of their IRA but leave open the possibility of their disclaiming to the grandchildren or even to a charity. Whether the clients succeed in doing this will depend on how they fill out the beneficiary designation form, Choate says. For example, if the form leaves the benefits equally to the client's three children without saying more, the client can't assume that the assets will automatically go to the grandchildren if one child disclaims. Under many IRA custodial agreements, the assets would go instead to the other two siblings. A client who wants to avoid this result must clearly indicate on the beneficiary designation form that each child can disclaim to his or her own children.

The key, in all these instances, is for clients to plan in advance who the primary beneficiary might disclaim to and name those individuals as contingent beneficiaries on the beneficiary designation form, Choate says. Inheritors will be limited by the terms of this form—they can't disclaim to whomever they please. If no contingent beneficiary has been named and the primary beneficiary disclaims, the assets are treated as part of the estate, which could have "very disastrous" income tax consequences, Choate says. For example, if very young people ultimately inherit IRA assets that way, they would not be entitled to make withdrawals over their life expectancies, Choate says. The worst-case scenario is if clients died before reaching age 70½, when they are required to start taking yearly minimum distributions. In that event, the inheritors would be required to withdraw all the funds within five years of the IRA owner's death.

—DLJ

Federal regulations allow individuals to disclaim portions of jointly held property, LaPiana says. This is important, he notes, because many married couples, even those with well-crafted estate plans, jointly own their home and bank and brokerage accounts as nonprobate assets—meaning that they pass outside the will. When the first spouse dies, such property goes automatically to the survivor, leaving no probate estate to soak up the deceased spouse's exclusion amount. Under federal regulations, the survivor can disclaim half the jointly held property—for example, half the house—and force it through the estate of the deceased spouse, where it could be used to fund a bypass trust, LaPiana says.

Disclaimers are also gaining popularity as useful tools for asset protection (see "Creditor Lockout," page 46) as well as for addressing problems arising from the decoupling of the federal and state death tax systems. Among other things, EGTRRA cut state revenues tied to the federal estate tax. As a result, many states have imposed a state tax on top of the federal tax. The state exemption in some states, including New York, New Jersey, and Massachusetts, is less than the federal one. Clients using bypass trusts in these states face a dilemma, Sloan says. If they use their entire federal credit to fund the trust, beneficiaries would incur state estate tax on the difference between the federal exemption amount of \$1.5 mil-



## A SURVIVING SPOUSE CAN DISCLAIM THE DECEASED SPOUSE'S HALF OF JOINTLY HELD PROPERTY AND FORCE IT THROUGH THE DECEASED SPOUSE'S ESTATE, WHERE IT COULD BE USED TO FUND A BYPASS TRUST

lion and the lower state amount. If clients fund the trust only up to the state exemption, they would lose part of the federal credit. In New York, for example, where the exemption is \$1 million, clients who cap their exemption at the amount that can be protected from both federal and New York state estate tax waste \$500,000 of federal credit (\$1.5 million minus \$1 million).

To solve this problem, clients can cap the credit at the state exemption amount and

leave the balance to the surviving spouse, Sloan says. The client would then stipulate in his or her will that if the surviving spouse disclaims, the difference between the state exemption amount and the federal amount would go into a credit shelter trust or some other trust.

There are several important caveats concerning the use of disclaimers. First, concerning the use of bypass trusts, the Internal Revenue Code prohibits disclaim-

ants from having control over the property, a restriction that has been interpreted to mean that a surviving spouse can't be a sole trustee with discretionary powers over the bypass trust, LaPiana says. What's more, disclaimants normally can't have any interest in the disclaimed property either, but there's an exception to this rule for surviving spouses. This exception permits a spouse to receive income and principal, for example, from property disclaimed into a

bypass trust, LaPiana notes.

Another drawback of using disclaimers and trusts, Sloan says, is that the surviving spouse cannot be given what's known as a power of appointment—the right to determine who gets the property after his or her interest ends. Such a provision would prevent the disclaimer from qualifying for favorable tax treatment under Section 2518.

A number of other restrictions may also trip up clients using disclaimers in various contexts. For example, clients must move swiftly—a disclaimer must generally be made nine months from the date of death, and there are no extensions. But the rule restricting disclaimants from accepting an interest in the asset or any of its benefits gives individuals the most trouble, says E. Diane Thompson, a lawyer with Williams Mullen in Norfolk, Va. Individuals have tainted disclaimers by making innocent mistakes that include depositing a dividend check in the disclaimant's own account, changing the way an IRA is invested, or collecting life insurance proceeds, Thompson says. To help clients avoid similar problems, Thompson puts a warning on the front of any disclaimer-planning documents she prepares advising heirs to see a lawyer before doing anything with the assets.

When clients disclaim property down a generation in order to benefit the grandchildren of the deceased, they face still another potential problem: GST tax may apply on top of any estate tax, says Lloyd Leva Plaine, a lawyer with Sutherland Asbill & Brennan in Washington, D.C. To stay within the \$1.5 million GST exemption, Plaine recommends disclaimers be expressed as a formula, such as “an amount equal to the decedent's available GST exemption.” And before taking any action it's important that beneficiaries find out who else in the family is disclaiming, Plaine says. If three children all want to disclaim, for instance, they should coordinate with one another to stay within the exemption.

State laws impose additional requirements on disclaimers, and they vary tremendously, Sloan notes. In many states

individuals who intend to disclaim assets must give notice not only to the executor of the estate, but also to the beneficiaries and the surrogate's court or its functional equivalent. When minors are involved, many states require that individuals obtain court permission before disclaiming any property, says Thompson. And under the laws of most states a disclaimer could disqualify the disclaimant for Medicaid just as if the person had given away other property in an effort to qualify for public assistance, LaPiana says.

Finally, never recommend a disclaimer until you are sure where the property is going to end up, says Glen Yale, a lawyer with Holland & Knight in San Antonio. If the estate plan is silent on the subject or doesn't cover all the parameters, state property law default rules apply and the result may not be what the client wants. When disclaiming retirement assets, the client must consider income tax as well as estate-planning strategies (see “Passing Retirement Assets Down the Line,” page 48). As a safety net, Yale says he always has a disclaimer reviewed by another lawyer to be sure it accomplishes the desired result.

Still, no matter how carefully advisers plan for disclaimers, one wild card is whether the client's family will put them into practice. For instance, even though it's clear that disclaiming would save taxes, a surviving spouse who prefers to have property in hand rather than in a trust might never “do the tax planning that the [husband and wife] sat in the lawyer's office and talked about,” says Davidowitz.

Useful as disclaimers can be, they are tricky in practice. Although they provide welcome flexibility in today's uncertain environment, it's unwise for clients “to set up an entire estate plan on the assumption that everything can be fixed with disclaimers after death,” says Natalie Choate, a lawyer with Bingham McCutchen in Boston. There are just too many things that can go wrong.

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