

# Disclaimers: Post-Mortem Creativity

By Bruce D. Steiner

**D**isclaimers can be used very effectively as post-mortem estate planning devices. The purpose of this article is to illustrate some practical uses of disclaimers in different contexts.

For purposes of this article, it is assumed that each disclaimer meets all the requirements of both tax law and state law, so that the disclaimant is not treated as having made a transfer for gift tax purposes. Although the disclaimant cannot control how the disclaimed property will pass, it is assumed that the disclaimed property will pass as desired in each case, either under state law or under the terms of the governing instrument.

**1. Marital deduction too small—children disclaim:** Alan had a \$2 million estate. He left \$1 million to his wife Beth and \$1 million, minus estate taxes, to his children.

Alan's taxable estate is \$1 million and his estate tax is \$153,000. If Alan's children disclaim \$400,000 so that Beth receives \$1.4 million and the children receive \$600,000, Alan's taxable estate will be \$600,000 and there will be no estate tax on Alan's death.

**2. Marital share too large—spouse disclaims:** Carol had a \$2 million estate which she left to her husband David. There is no estate tax in Carol's estate. However, the entire \$2 million will be included in David's estate (unless he consumes it during his lifetime). If David's estate is \$2 million, the estate tax at his death will be \$558,000.

David can disclaim \$600,000 and take advantage of Carol's unified credit. There will still be no estate tax in Carol's estate. David's estate will then be \$1.4 million and his estate tax will be \$320,000. Thus the disclaimer saves \$268,000 of estate tax in David's

estate. The actual savings may be even more than \$268,000, since all the income and growth on the disclaimed property during David's lifetime will also be excluded from his estate.

**3. Disclaimer by spouse of an income interest:** Edward had a \$6 million estate. He left \$5.4 million to his wife Fran and \$600,000 to a credit shelter trust of which Fran receives all the income. Even though the principal of the trust will not be included in Fran's estate, all of the accumulated net income of the credit shelter trust during Fran's lifetime will be included in her estate.

To avoid this result, Fran can disclaim her income interest in the credit shelter trust.

**4. Disclaimer by spouse of a general power of appointment:** Isaac intended to create a credit shelter trust but inadvertently gave his wife Jane a general power of appointment. Some examples of this are a right of withdrawal not limited by an ascertainable standard, or a right of withdrawal in excess of \$5,000 or 5% of the value of the trust.

Jane can keep the trust from being taxed in her estate by disclaiming the general power of appointment.

**5. Disclaimer by child to avoid tax in child's estate:** Karen leaves \$1 million to her son Larry. Larry already has a large estate of his own. Larry can disclaim the bequest and let the property go to his children, thus keeping it out of his estate.

If all of the decedent's children disclaim, so that the estate passes to the decedent's grandchildren, the lawyer should determine whether the grandchildren will take per capita or per stirpes under the governing instrument or under applicable state law. The generation-skipping transfer tax (GSTT) should also be considered.

**6. Disclaimer to avoid state inheritance taxes:** In some states, the state inheritance tax rates depend on the relationship of the recipient to the decedent. For example, in New Jersey, the inheritance tax is 15% on transfers to unrelated persons, but zero on transfers to a spouse or issue.

Michael, a resident of New Jersey, leaves property to his daughter Nancy and his son-in-law Oswald, equally, or in full to the survivor of the two. Oswald can disclaim so as to avoid the New Jersey inheritance tax.

**7. Disclaimer to reduce income tax:** Peter leaves his qualified plan or IRA benefits to his son Quincy, who is in a high income tax bracket. Quincy's daughter Robin, who is the contingent beneficiary, is in a lower income tax bracket. Quincy can disclaim in order to save income taxes.

**8. Disclaimer by spouse to equalize two estates:** Sam has a \$5 million estate. He leaves \$4.4 million to his wife Tzipora and \$600,000 to his children. If Tzipora's estate is \$4.4 million, her estate tax will be \$1,868,000.

If Tzipora disclaims \$1.9 million so that Sam's estate passes \$2.5 million to Tzipora and \$2.5 million (minus estate taxes) to his children, Sam's estate tax will be \$832,200. If Tzipora's estate is \$2.5 million, her estate tax will also be \$832,200, for a total estate tax in both estates of \$1,664,400. This is \$203,600 less than the \$1,868,000 of estate tax if Tzipora did not disclaim.

If Tzipora dies before Sam's estate tax return is filed, Tzipora's executors can disclaim on her behalf so as to equalize the two estates, assuming that the property will pass to the same ultimate recipients.

A common misconception is that the unlimited marital deduction re-

sults in a benefit from the time value of money due to the additional income or growth earned during the surviving spouse's lifetime on the money not used to pay estate taxes in the first estate. However, except to the extent the surviving spouse consumes or gives away the property during her lifetime, this argument is fallacious. The income and growth on the marital share is included in the spouse's estate, while the income and growth on the nonmarital share are not included in the spouse's estate.

If the surviving spouse is elderly, the effectiveness of a disclaimer should be weighed against the advantages of the credit for previously taxed property in the wife's estate (if the credit is available). See Example 12 in this article.

**9. Disclaimer by spouse to use decedent's \$1 million GST exemption:** Ursula had a \$4 million estate. She left \$3.4 million to her husband Vincent and \$600,000 to a credit shelter trust over which Vincent has a special power of appointment. Ursula's executors can allocate \$600,000 of her \$1 million GST exemption to the trust. However, if the marital share passes to Vincent outright, the remaining \$400,000 of Ursula's GST exemption is wasted.

To maximize the benefit of the wife's GST exemption, Vincent can disclaim \$659,649 of the marital share. Ursula's entire \$1 million GST exemption can then be allocated to the nonmarital trust.

As a result of this disclaimer, Ursula's estate will have to pay \$259,649 of estate tax (taxable estate of \$1,259,649 minus estate tax of \$259,649).

**10. Spouse disclaims to utilize credit for state death taxes:** The unified credit is equivalent to an estate and gift tax exemption of \$600,000. However, by using the credit for state death taxes, the exemption equivalent can be increased from \$600,000 to \$642,425, thus sheltering an additional \$42,425 (less the amount of the state death taxes).

Of course, in order to use the credit for state death taxes, the state

death taxes must be paid. In a state with estate tax rates in excess of the credit for state death taxes, the marginal cost of using the state death tax credit may be relatively small. For example, the New York estate tax on a taxable estate of \$600,000 is \$25,500, while the New York estate tax on a taxable estate of \$642,425 is \$28,052. Thus, for an additional \$2,552 of New York estate tax (at a 6% tax rate), an additional \$42,425 can be sheltered from federal estate tax.

Wendy, a New York resident, has an estate of \$2 million. She leaves \$1.4 million to her husband Xavier and \$600,000 to their children, under a formula which does not take the credit for state death taxes into account. Xavier can disclaim \$42,425 from federal estate tax, at a cost of \$2,552 of additional New York estate tax in Wendy's estate tax.

**11. Children disclaim to utilize credit for state death taxes:** Yolanda, a Florida resident, has a \$2 million estate. She leaves \$1,357,575 to her husband Zvi and \$642,425 to her children under a formula which takes into account the credit for state death taxes.

In order to utilize the credit for state death taxes, Yolanda's estate will have to pay \$15,697 of Florida estate tax. The children can disclaim \$42,425, so that Zvi will receive \$1.4 million and the children will receive \$600,000. This eliminates the \$15,697 of Florida estate tax, at a cost of increasing Zvi's estate by \$42,425 (plus the income and growth thereon during his lifetime).

**12. Spouse can disclaim if estate can use the credit for tax on prior transfers or the foreign tax credit:** The estate tax credit for the tax on prior transfers (the TPT credit) is available if the prior transferor died within 10 years of the decedent's death. The TPT credit should be considered whenever a decedent received any property by reason of the death of another person within the preceding 10 years. The TPT credit is available not only for property which passed to the decedent outright, but also for the actuarial value of income interests in trust for the decedent's benefit.

Amy had an estate of \$2 million. She left \$1.4 million to her husband Bill and \$600,000 to her children. There is no federal estate tax by reason of the unified credit. If Amy inherited property from a person who died during the previous 10 years, the TPT credit is available. In such a case, Bill can disclaim all or part of his share so as to permit Amy's estate to take advantage of the TPT credit.

Similarly, if Amy's estate includes property subject to a foreign estate or inheritance tax, Bill can disclaim so that Amy's estate can take advantage of the foreign tax credit.

**13. Disclaimer to avoid creditors:** Cathy leaves property to her son Daniel. If Daniel accepts the property, his creditors will get it. Daniel can disclaim the property and allow it to pass to his daughter Ellen, free of the claims of his creditors. (Note that with proper planning Cathy could have left the property to Daniel in trust in such a way that it would not have been available to Daniel's creditors.)

Before disclaiming, Daniel should make sure that the disclaimer is valid against his creditors under the applicable state law. In particular, if Daniel is receiving Medicaid benefits, the disclaimer may be treated as a transfer by Daniel for Medicaid purposes.

**14. Disclaimer to avoid foreign government restrictions:** Frank leaves property to his daughter Ginger. Ginger lives in a country which has severe exchange control laws, inheritance taxes or other restrictions which prevent her from enjoying the benefit of the property.

Ginger can disclaim the property so that it passes to her daughter Holly, free from the laws of Ginger's home country. (Note that Frank could have left the property to Ginger in trust so that it would not be subject to the laws of Ginger's home country.)

**15. Disclaimer to permit ownership of shares of an S corporation:** A qualified Subchapter S trust (QSST) can own shares of an S corporation. There can be only one income beneficiary of the trust and no distributions

of principal can be made to anyone other than the income beneficiary.

Irving leaves shares of an S corporation in trust with the income payable to his daughter Judy and principal payable to Judy or her husband Keith, in the trustees' discretion. Keith can disclaim his interest in the trust so that Judy can make a QSST election.

Alternatively, assume that Irving leaves his shares to Judy, a nonresident alien. Nonresident aliens are not permissible S corporation shareholders. Judy disclaims so that the shares pass to Keith, a United States citizen.

**16. Disclaimer of undistributed income to permit QTIP election:** Lorraine leaves a bequest in trust for her husband Marc. Marc receives all the income of the trust, except that the undistributed income at his death passes to his son Nathan, who is single and childless.

In Notice 89-4, the IRS established an interim procedure whereby Lorraine's estate can obtain the marital deduction for the trust, even though the undistributed income is not payable to Marc's estate. However, if the IRS withdraws this procedure, Nathan can disclaim his interest in the undistributed income upon Marc's death, so that the trust will qualify for the QTIP election.

**17. Parents disclaim estate of a child:** Ora dies intestate without leaving a spouse or issue. Her parents, Penny and Quentin, have large estates of their own. They can disclaim their interests in Ora's estate so that it will pass to her siblings.

**18. Children disclaim because surviving spouse needs the money:** Rachel has an estate of \$300,000. She leaves \$150,000 to her husband Steven and \$150,000 to her son Thomas, who is single and childless. Steven has no other assets of his own. Thomas can disclaim, so that the entire estate will pass to his father.

Assuming that Steven's estate will not be more than \$600,000 on his subsequent death, the disclaimer, and the resulting loss of the credit shelter in Rachel's estate, will not result in any additional estate tax.

Thomas' disclaimer may reduce the state death taxes. For example, New York has an estate tax with an unlimited marital deduction and a credit which is equivalent to an exemption of \$108,333. The New York estate tax on a taxable estate of \$300,000 is \$9,500. However, there is no New York estate tax if the amount exceeding \$108,333 passes to the spouse.

**19. Disclaimer to permit alternate valuation:** Ulysses had a \$3 million estate. He used a zero-tax pecuniary formula at date of death values to leave \$2.4 million to his wife Violet and \$600,000 to his children. As of the alternate valuation date, the value of his estate was \$2.5 million. Without alternate valuation, the decrease in value falls on the residuary estate, so that Violet still receives \$2.4 million, while the children only receive \$100,000.

If the estate is valued at \$2.5 million using alternate valuation, Violet receives \$1.9 million and the children receive \$600,000. This shifts the decrease in value to Violet, thus reducing Violet's estate and the estate tax payable on Violet's death.

In order to use alternate valuation, the estate must reduce both the gross estate and the estate tax. If Violet disclaims a small percentage of her marital bequest, there will be a small estate tax which will be reduced by alternate valuation.

**20. Disclaimer by income beneficiary to defeat a remainder beneficiary:** Wanda leaves property in trust for Abe if he survives her. Abe receives the income of the trust and the remainder goes to Betty on Abe's death. If Abe does not survive Wanda, the bequest lapses and the property passes to Charlie as the residuary beneficiary. Abe can defeat Betty's remainder interest by disclaiming so that the property will pass to Charlie.

**21. Disclaimer to obtain a charitable deduction:** Dena left property in trust, with income to Esther and remainder to charity. If Esther does not survive Dena, the property passes to

charity outright. The trust is not a charitable remainder unitrust or annuity trust, so that the value of the charity's remainder interest does not qualify for an estate tax deduction.

It may be possible to have the state courts reform the trust so as to obtain an estate tax deduction for the charity's interest. Alternatively, Esther can disclaim her income interest, so that the entire property will pass to charity and qualify for a charitable deduction.

Dena left other property to Fred, with a charity as the contingent taker. Fred can disclaim so that the property will pass to charity, thus giving Dena's estate a charitable deduction.

**22. Disclaimer to permit retention of shares under a shareholders' agreement:** Gary was a shareholder of a closely held corporation. His shares are subject to a shareholders' agreement. He left his shares to his brother Henry, who is not a permitted transferee under the agreement. If Henry disclaims, the shares will pass to Henry's son Ira, who is a permitted transferee. If the shares do not pass to a permitted transferee, Gary's estate must sell Gary's shares to the corporation (or to the remaining shareholders) at a price which is less than the unrestricted fair market value of the shares.

Henry can disclaim the shares, so that they will pass to Ira, a permitted transferee.

**23. Disclaimer to force sale of shares under a shareholders' agreement:** Jack was a shareholder of a closely held corporation. His shares are subject to a shareholders' agreement. He left his shares to his daughter Kelly, who is a permitted transferee. If Kelly disclaims, the shares will pass to Kelly's daughter Linda, who is not a permitted transferee. If the shares do not pass to a permitted transferee, Jack's estate must sell Jack's shares and the corporation (or the remaining shareholders) must purchase Jack's shares at a price which is more than the fair market value of the shares. However, if the shares pass to a permitted transferee, he or she does not have a put

option to require the purchase of the shares.

Kelly can disclaim the shares so that they will pass to Linda, from whom the shares must be purchased.

**24. Disclaimer by specific legatee to permit redemption under Section 303:** Michele specifically bequeathed her shares of a closely held corporation to her daughter Natalie. Her will directed that all estate taxes be paid out of her residuary estate. The shares cannot be redeemed from Natalie under Section 303 because Natalie does not have to pay any estate taxes on the shares.

Natalie can disclaim so that the shares will pass to Michele's residuary estate, thus permitting the shares to be redeemed under Section 303.

**25. Disclaimer to permit a redemption to qualify for exchange treatment under Section 302:** Ophelia left her shares of a closely held corpo-

ration to her daughter Polly. If the shares are redeemed from Polly, the redemption would not qualify for exchange treatment under Section 302 because of the stock ownership by Polly and related shareholders.

Polly can disclaim so that the shares will pass to Robert, from whom a redemption will qualify for exchange treatment.

**26. Disclaimer to permit special use valuation:** Sarah leaves property to Timothy. Since Timothy is not a qualified heir, the property is not eligible for special use valuation.

Timothy can disclaim so that the property will pass to Vicki. Since Vicki is a qualified heir, the property is eligible for special use valuation.

**27. Disclaimer of a power:** Alice creates a trust in which Barbara has the power to withdraw all the principal of the trust. As a result of this power, Barbara is taxable on the income (including capital gains) of

the trust under Section 678. Barbara disclaims her power of withdrawal to avoid being taxable on the income of the trust.

### Conclusion

This article is not intended to cover all disclaimer possibilities. There are many other situations in which a disclaimer may be used. When handling an estate, the lawyer should examine the will carefully and analyze the result if any beneficiary desires to disclaim. A similar analysis should be made for each asset passing outside the will, such as life insurance and qualified plan and IRA benefits. This analysis should be made as soon as possible after death, since a beneficiary cannot disclaim after he or she has accepted the interest to be disclaimed or any of its benefits.

An understanding of the uses of disclaimers is helpful in drafting wills and trusts. Instruments should address the possibility of disclaimers. For example, a testator could provide that any property his wife disclaims will pass to a trust of which she receives all the income, and that if she disclaims her interest in that trust, the property will pass to a trust of which she is a discretionary beneficiary.

On the other hand, disclaimers should not be a substitute for proper estate planning. Even with the best of drafting to facilitate disclaimers, there are two major obstacles to the use of disclaimers. First, the potential disclaimant may not disclaim. Second, the implementation of a disclaimer may result in reduced flexibility. For example, if the spouse disclaims in favor of a credit shelter trust of which the spouse is a beneficiary, the spouse cannot have a power of appointment over the trust. However, if the credit shelter trust exists without the disclaimer, the spouse can have a power of appointment over the trust. Accordingly, the disclaimer should be viewed primarily as a post-mortem planning technique.

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