

Effective Use of Disclaimers in a Will Provides Flexibility and Tax Savings

by Charles E. Falk

The inclusion of a “qualified disclaimer” (“QD”) in a will can provide significant flexibility and tax savings. If you have a will, you should consult with your tax or financial advisor as to whether a QD is an appropriate estate planning strategy for you, especially if you are married. If it is, you should determine if your will provides for a QD, and if not, whether your will should be revised. If you don’t have a will, now is a good time to have a will drawn with a QD. Many wills drawn before 2000 may not provide for a QD, which can lead to harsh results. Further, as a recent federal case, *Christainsen v. CIR*, and a recent New Jersey state tax case, *Stevenson v. Director* illustrate, QDs must be drafted with care.

What is a Qualified Disclaimer

A “disclaimer” is a refusal on the part of a beneficiary of an estate to accept some or all of the bequest from a decedent. Under state law this is sometimes referred to as a “renunciation.” What makes the disclaimer “qualified” is that it is done in accordance with IRC §2518. Under IRC §2518 a disclaimer will only be “qualified” (and therefore in accordance with IRC §2518) if the disclaimer constitutes “an irrevocable and unqualified refusal by a person to accept an interest in property” and if:

- Such refusal is in writing;
- Such writing is received by the legal representative (Executor), not later than 9 months after the death of the decedent;
- The beneficiary has not accepted the interest or any of its benefits;
- As a result of the disclaimer the bequest passes without any direction on the part of the person making the disclaimer and passes either (1) to the spouse of the decedent, or (2) to a person other than the person making the disclaimer.²

A QD may not constitute a “renunciation” under state law and vice versa. Thus, it is important that the federal requirements in IRC §2518 be complied with. Interestingly, although jointly held property with a right of survivorship passes automatically to the survivor upon the death of a person, and therefore not in accordance with the decedent’s will, such rights that the decedent is considered to have owned and which pass to surviving joint tenant can be disclaimed for federal tax purposes under IRC §2518.

Why Make a Qualified Disclaimer

A qualified disclaimer can add flexibility and tax savings to any estate plan. For example, suppose a husband (“H”) and wife (“W”) both age 45 have two children, ages 11 and 9, respectively. Assume that H and W each have \$2 million in net assets and \$4 million in net assets combined. They would prefer to have the survivor of them receive all of the assets of the other spouse if the other spouse dies, but they are concerned that a sizeable federal, and perhaps state, death tax would arise if their respective wills merely provided that the other spouse received everything from the decedent spouse and they died in a common disaster like a plane crash.³ Further, they would like to make decisions regarding the death of one or both of them at the time when the first spouse dies and not at the time that their respective wills are executed, because their financial condition, their family condition and the law might have changed since their wills were executed. Are these goals mutually exclusive and can they be attained in a will? By adding a disclaimer to their respective wills, H & W, in the event of a joint death, can have their entire estate pass to their children federal estate tax free because the executor of their respective estates can

make an election for the survivor of them to disclaim the assets bequeathed to such survivor by the spouse who is considered first to die.⁴ Further, if only one of them dies, the survivor can receive all of the assets of the decedent spouse tax free. The following example illustrates how the federal tax can be avoided on a joint death and yet all of the assets can pass to the survivor of them if only one of them dies.

Example: First assume that wills are drawn that simply leave all of the asset of one spouse to the other spouse and no disclaimer is provided for in the will. If both spouses die the surviving spouse is deemed to own \$4 million in assets at his/her death, which is a moment after the death of the first spouse. The federal tax on a \$4 million taxable estate with a full \$2 million exemption is \$900,000. If, instead, a disclaimer is added to the will, the \$2 million that passes from the first of them to die is disclaimed by the survivor (or the survivor's executor if the survivor dies during the 9 months after the first to die), then no federal estate tax will arise in either estate since each can pass \$2 million (\$3.5 million in 2009) without incurring a federal estate tax.⁵ Further, if only one of them dies, then the surviving spouse can still receive all of the assets from the decedent spouse. Thus, both objectives are attained.

What Happens to the Bequest Disclaimed

Property that is disclaimed must pass without direction by the disclaiming survivor, and cannot generally benefit the disclaiming survivor. An exception to the second part of the preceding sentence, that a person disclaiming cannot benefit from the disclaimed property, is that a surviving spouse can benefit from the property disclaimed (the surviving spouse cannot direct where the property passes, but can benefit from such property). Typically, disclaimers by a surviving spouse are structured so that the property disclaimed passes to a trust for the benefit of the spouse. The surviving spouse can be given an unrestricted power to appoint or remove a trustee so long as the surviving spouse is prohibited in the will from appointing the surviving spouse or a person who is related or subordinate to the surviving spouse under IRC §672(c).⁶

A second instance where disclaimers are often used is where a child of the decedent would prefer that his/her share of the estate pass to his/her children. This is usually done where the child is well-off and does not want to enlarge his/her estate. A critical difference between a disclaimer by a spouse and a disclaimer by a child (or anyone else) is that in the case of a disclaimer by a child (or anyone else) the disclaiming person cannot potentially benefit from such a disclaimer. For example, the disclaimed property cannot pass to a trust where the disclaiming child is a beneficiary, even a contingent beneficiary. In the recent case of *Christensen v. CIR*⁷, the United States Tax Court held that a purported disclaimer was not a QD because the disclaimed property passed to a trust where the disclaiming person was a contingent beneficiary. Thus, where the property passes and who are the beneficiaries must be carefully drafted.

New Jersey Considerations

New Jersey restricts the amount that can pass to all persons (including children), free of New Jersey estate taxes to \$675,000, except where a bequest to a surviving spouse qualifies for the marital deduction. Amounts above this amount that do not qualify for the marital deduction result in an approximate 8% New Jersey estate tax, even if there is no federal estate tax.⁸ Thus, a person disclaiming \$2 million to take advantage of the maximum federal exemption will cause the decedent's estate to incur a New Jersey estate tax of about \$100,000. When determining whether to pay the New Jersey tax and receive the maximum federal exemption, criteria such as age and health are important considerations. Where a surviving spouse is in poor health or is quite old, it is often better to disclaim the maximum federal amount and pay the New Jersey estate tax.⁹ Alternatively, where the person

surviving is relatively young, a disclaimer to maximize the federal exemption and paying the New Jersey tax may not be attractive.¹⁰ In any event, when a disclaimer is made it is important to provide in the decedent's will that any death taxes, including the New Jersey estate tax, be drawn from the disclaimed amount and not from any share passing to the surviving spouse or otherwise qualifying for the marital deduction. Otherwise, the state taxes are drawn from the marital share which in turn reduces the marital share for New Jersey purposes and causes an increase in the New Jersey estate tax. This phenomenon (the so called "circular computation rule") was recently affirmed by the New Jersey Tax Court in *Stevenson v. Director* (decided January 4, 2008). In *Stevenson* the New Jersey taxes were taken from the marital share, which in turn increased the New Jersey estate taxes due. Thus, the decedent's estate was required to pay a greater amount of New Jersey estate taxes.

Conclusion

Qualified Disclaimers often provide for important flexibility and tax benefits when a person dies. Everyone needs to examine their will and to consult with their tax advisor to determine if their respective will effectively provides for the use of a QD where such use is appropriate.

¹ *This article is not intended to give legal advice and any statement, illustration or conclusion herein is only for discussion purposes and any action regarding the contents of this article should only be made after a consultation with a licensed legal and tax professional.*

² *Please note that the four bullet points in the text are specifically applicable to disclaimers made with regard to wills. "Qualified Disclaimers" can also be made for gifts and persons who receive a bequest from a person without a will. The points set out in the text are for summary purposes only and should not be relied upon to make a "qualified disclaimer" without consulting a tax professional.*

³ *Regarding a joint death from a common disaster, they are concerned that such an event will cause the survivor of them (considered surviving for only a moment after the death of the first of them) to have \$4 million in assets.*

⁴ *In determining who dies first, where it cannot be determined who actually died first, a presumption is made in the will or under state law.*

⁵ *H & W may want to have the entire amount pass to the survivor if the survivor lives and chance that the survivor will not die soon after the death of the first spouse. In the example in the article, both H & W are 45 years of age. Thus, they each have a life expectancy of 35 years. They may want the survivor of them to have control of the entire assets that they own rather than a trustee, even if the survivor of them has indirect control over the trustee through a power or removal. This may be based upon the fact that they have young children to raise, educate, etc. and they do not want to have a trustee involved in the survivor's life. This is not unusual. Also, by having a disclaimer in place, the decision to accept or not accept assets by the surviving spouse is made at the death of the first spouse and not when the will is executed. Further, if one of them survives, there may be good planning reasons to disclaim part or all of the bequest because of conditions that exist at the death of the first spouse that did not exist when the wills were executed.*

⁶ *If the surviving spouse has the ability to appoint herself/himself, the property will be included in the estate of the surviving spouse regardless of whether the surviving spouse makes such an appointment. Thus, the terms of the instrument must prohibit the spouse from appointing herself of a related or subordinate person.*

⁷ *130 T.C. No. 1 (2008).*

⁸ *The computation of the New Jersey estate tax is complicated and your tax advisor should be consulted for precisely how it is done.*

⁹ *For example, if only \$675,000 is disclaimed to avoid the New Jersey estate tax, a larger amount will pass to the surviving spouse outright and such larger amount will cause a federal estate tax in the surviving spouse's estate at a might higher rate.*

¹⁰ *A younger person may desire not to pay any taxes and only disclaim that amount that will not cause either the federal or New Jersey tax to apply. The strategy is that a younger person has more time to deal with the assets that he or she has, more time to do estate planning and may want to hope that the exemption amount will increase or the federal estate tax will be repealed in its entirety.*