PROFESSIONAL Tax & Estate Planning NOTES

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1 Use of Qualified Disclaimers in Estate Planning

This issue of *Professional Notes* focuses on the use of the qualified disclaimer in estate planning. Often overlooked when drafting a will, the qualified disclaimer can be thought of as a "post-mortem" planning device, but one that should be considered in advance. It allows your clients to give their heirs the flexibility to determine whether they need assets long after a will is written when circumstances may have changed. And if a qualified disclaimer is used to provide for a charity, such as The New York Community Trust, it has the added advantage of reducing the taxable estate.

A disclaimer is a renunciation of property passing upon another's death, whether the assets are to pass by will, pension or insurance beneficiary designation, or by state intestacy laws. For Federal estate, gift, and generation-skipping transfer tax purposes, the renounced property is treated as if it had never been transferred to the person making the qualified disclaimer (the disclaimant). Under New York law, the property passes as if the disclaimant predeceased the decedent. The disclaimed property then passes, either outright or in trust, to the named alternate beneficiary.

To be effective for both state property law purposes and for Federal gift tax purposes (i.e., the transfer is not treated as a gift), the disclaimer must comply with both the provisions of the applicable state disclaimer statute and Section 2518[1] of the Internal Revenue Code. For Federal gift tax purposes, a qualified disclaimer is defined in Section 2518(b) as an irrevocable and unqualified refusal by a person to accept an interest in property, but only if:

(1) the refusal or disclaimer is in writing;

(2) the written refusal is received by the transferor of the interest or his legal representative (usually the executor) not later than nine months after the date on which the transfer creating the interest in the disclaimant is made (generally the date of death), or, if later, after the disclaimant's 21st birthday;

(3) the disclaimant has not accepted the interest or any of its benefits; and

(4) as a result of the refusal, the interest passes, without any direction by the disclaiming person, to either the spouse of the decedent or a person, including charity, other than the disclaimant.

If these requirements of Section 2518(b) are not met, the renouncing person will be deemed to have received the assets and to have made a taxable gift. An exception under Section 2518(c) provides that a renunciation that is valid under state law and meets requirements similar to those set forth under Section 2518(b) will be treated as a qualified disclaimer.

By Jane L. Wilton, General Counsel, The New York Community Trust
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[1] All "Section" references are to the Internal Revenue Code of 1986, as amended.

General Use of the Qualified Disclaimer. The qualified disclaimer can be used to renounce an interest in any type of property passing upon another's death. It might be used, for example, when a husband dies leaving all his assets to his wife, or if she does not survive, to their children. If the wife concludes she does not need all of the assets, she may wish to disclaim a portion of her interest in her husband's estate. By disclaiming assets worth up to $1,500,000, the Federal estate tax exclusion amount for 2004, the disclaimed portion does not become part of the wife's estate, and no Federal estate tax will be due on the assets passing to the children.[2]

Or the husband might have planned for the possibility of a disclaimer, providing in his will that any disclaimed part would go into a trust that pays income to his wife for her life. The trustee may have the power to invade the trust principal to support the wife, and the remainder could then be distributed to their children or to designated charities. As in the prior example, if the wife disclaims assets up to $1,500,000, the husband's estate can take advantage of the Federal estate tax applicable exclusion amount and the disclaimer trust assets will not become part of the wife's estate.[3]

Effective January 1, 2004, the New York and Federal estate tax statutes no longer work in tandem, and the exclusion amount recognized for purposes of the New York estate tax is only $1,000,000.[4] Thus, by establishing a trust of $1,500,000 to take advantage of the maximum Federal exclusion amount, a New York estate tax of $64,400 will be incurred. In 2006, when the Federal exclusion amount is increased to $2,000,000 (and the New York exclusion remains at $1,000,000) a New York estate tax of $99,600 will be incurred if a trust of the maximum Federal exclusion amount is established. By providing the surviving spouse with the discretion to determine how much to disclaim into a trust, the decision about the amount to go into the trust can be deferred until the death of the first spouse, so that the surviving spouse can evaluate at that time whether it is preferable to incur otherwise avoidable state estate tax at the death of the first spouse in order to substantially reduce the Federal estate tax payable at the surviving spouse's death.

A disclaimer may be made of all of an interest passing at death, or of an undivided portion of the interest. For example, a beneficiary might renounce 40 shares of a block of 100 shares of stock bequeathed to him, or he might renounce an undivided 40 percent interest. Or a disclaimer might be made of a specific dollar amount; for example, the residuary beneficiary might disclaim $40,000 of the residuary estate.

A survivorship interest also may be disclaimed. At one time, the Internal Revenue Service had taken the position that a survivorship interest had to be disclaimed within nine months of the transfer creating the joint tenancy. In 1990, the Service conceded that in states such as New York, where a joint tenant can partition property at will, the interest is deemed created when the interest *vests*, and not when the joint tenancy first occurred. Therefore, the nine-month period for making the disclaimer begins at the death of the joint tenant.

Use of the Qualified Disclaimer to Benefit Charity. As indicated earlier, if the disclaimed assets pass to charity, the estate will benefit from an estate tax charitable deduction. As combined Federal and state estate tax rates can still exceed 50 percent, the savings can be significant. However, the statutory restriction against redirection or control of the disclaimed property by the disclaimant, either directly or indirectly, is given a broad interpretation by the IRS. The testator must designate in his or her will the charity to which a disclaimed interest is to pass; the testator may not provide the disclaimant with any discretion in that decision. In addition, the testator must be careful about the relationship of the potential disclaimant to the designated charity.

For example, a decedent had provided that a bequest to her daughter would pass to the family's private foundation in the event the daughter disclaimed all or part of her interest. The IRS ruled that the disclaimer qualified under Section 2518 only because the foundation's bylaws were amended to pro-

[2] The Federal estate tax applicable exclusion amount currently is scheduled to increase to $2,000,000 in 2006 and $3,500,000 in 2009.

[3] Despite the requirement that a disclaimant not accept any benefit from the property, Section 2518(b) allows a spouse—and only a spouse—to disclaim property and get an interest in the same property in a different way.

[4] Other states where the state's estate tax exclusion amount is less than the Federal exclusion amount include New Jersey, Massachusetts, Maine, Vermont, Rhode Island, Pennsylvania and Maryland.

hibit the daughter and her husband (as two of the directors of the foundation) from participating in the distribution of the bequeathed funds and, instead, conferred the sole authority of disposition upon the foundation's two independent directors. *See* PLR 9141017 and PLR 9317039. *See also* PLR 200149015.

Such problems can be avoided if the testator directs potential disclaimed assets to a community foundation, such as The New York Community Trust. In Private Letter Ruling 9532027, a father provided for property held in trust to pass to his two sons at his death, or if they predeceased him, to their children. Under the terms of the trust, if either son refused his interest, his share of the property was to go to a fund the decedent established at a community foundation, and the disclaiming son was permitted to serve as the advisor with respect to grants from the fund.

The Service ruled that the irrevocable refusals by the sons constituted qualified disclaimers even though the sons could make recommendations to the community foundation regarding distributions from the fund that received the disclaimed property. The Service concluded that neither disclaimant had the power to direct the redistribution, because any grant recommendations were merely advisory in nature. One of the sons was a member of the community foundation's board of directors, but in accordance with the private letter rulings mentioned earlier, he could not vote on distributions from the fund he advised.

This private letter ruling offers a substantial planning opportunity. A client may provide for a gift to his or her children, which, if refused, would be distributed to a fund at The New York Community Trust, reducing the taxable estate. The Trust offers a professional grant staff to carry out the donor's charitable interests, and, if desired, the children (or other heirs) would have the opportunity to suggest grants from the fund.

Other Uses of Qualified Disclaimers. A qualified disclaimer also may be used with respect to interests outside the probate process, including interests in life insurance and employee benefit plans.

For example, a participant in a retirement plan may wish to name his or her spouse as the primary designated beneficiary of the plan and a charity as the contingent successor beneficiary. After the death of the plan participant, if the surviving spouse determines that he or she does not need the funds from the retirement plan, the surviving spouse can disclaim his or her interest and the funds will instead pass to charity. If the surviving spouse wishes, he or she can make a partial disclaimer of only a portion of the funds. Since funds in a retirement plan may be subject to both estate tax and income tax when passing to individual beneficiaries, such funds are often a good choice of asset for satisfying a plan participant's charitable goals.

CONCLUSION

Advising your clients about the qualified disclaimer when they are planning for their estates can provide flexibility when it is needed and reduce the taxable estate. If your clients have charitable interests, they can name a charitable successor beneficiary, benefiting charity and ensuring that their philanthropic concerns are honored, while reducing the taxable estate at the same time.

For further reference, see:
IRC Section 2518, Qualified Disclaimers
IRC Section 2055, Estate Tax Charitable Deduction
IRC Section 2010, Unified Credit
Revenue Ruling 72-522, 1972-2 C.B. 525
Private Letter Ruling 9532027
Private Letter Ruling 200149015
NYS EPTL Sec. 2-1.11

For more information, call:
Jane L. Wilton, General Counsel, at (212) 686-2563.

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About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust, with assets of more than $1.7 billion, is an aggregate of funds set up by individuals, families, and businesses to support charitable organizations.

A fund in The Trust can help your clients carry out their charitable objectives while qualifying for the maximum tax deduction. Funds can be set up during lifetime or by will and often are an essential part of financial and estate planning. In addition to gifts of cash and publicly traded securities, funds can be established with a wide variety of assets including closely held stock, limited partnerships, mutual funds shares, retirement plan assets, and copyrights.

Because of our administrative efficiency, we are able to offer our services for a very low fee—three-tenths of 1%, i.e., 30 basis points; investment fees are also low. Expert financial management of funds is not tied to any one company or investment vehicle; investments are matched to each donor's grant-making plans.

Trust staff are always available to advise donors about grantmaking opportunities and ensure that their charity will be carried on beyond their lifetimes. Donors can recommend grants to qualified charities anywhere in the U.S., with assurance that each nonprofit is carefully scrutinized for its fiscal and programmatic soundness.

2 Park Avenue, New York, NY 10016
T: 212-686-0010 F: 212-532-8528
www.nycommunitytrust.org

Long Island Community Foundation
Elias Hicks House, 1740 Old Jericho Turnpike
Jericho, NY 11753
(516) 681-5085

Westchester Community Foundation
470 Mamaroneck Avenue, Suite 304
White Plains, NY 10605
(914) 948-5166