



Advanced Planning Strategies

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Dear Reader,

Following the recent elections, it is difficult to predict the actual tax provisions that will ultimately be enacted. Clearly, President Bush will attempt to make the 2001 tax cut permanent by eliminating the 2010 sunset provisions. The law requiring the 60-vote plurality in the Senate may no longer be applicable, but normal filibuster rules still potentially create a 60-vote threshold. It is possible that some compromise legislation may be in the offing for late 2002 or early 2003.

The inflation-indexed income tax figures have been estimated for 2003 and should be finalized by the IRS by the time you read this letter. Generally, the estimates are accurate. The standard deduction amount will rise for married taxpayers filing jointly to \$7,950 (\$4,750 for individual taxpayers). The personal exemption will be phased out for marrieds filing jointly at \$209,250 (\$139,500 for single taxpayers). The maximum 38.6 percent income tax rate will be reached at \$311,950 of taxable income for marrieds filing jointly and single taxpayers (\$9,350 for trusts and estates). Qualified adoption expenses will be allowable as an income tax credit up to \$10,160.

For planning purposes, will provide some of the inflation-indexed or statutory changes for certain estate, gift or generation-skipping transfer tax thresholds expected in 2003.

<u>Provision</u>	<u>2002 Amount</u>	<u>2003 Amount</u>
Unified Credit Equivalent against Estate or Gift taxes	\$1 million	\$1 million
Generation-Skipping Transfer Tax Exemption	\$1.1 million	\$1,120,000
Annual Gift Tax Exclusion	\$11,000	\$11,000
Annual Gift Tax Exclusion for transfers to Noncitizen Spouses	\$110,000	\$112,000
Maximum Federal Estate or Gift Tax Rate	50%	49%

We look forward to keeping you abreast of the important tax development in the upcoming year.

Knowledge is not power. Only knowledge in use is power.

DISCLAIMERS CAN BE USEFUL TOOL IN ESTATE PLANNING

We often see individuals attempting to accomplish estate-planning objectives without adequate knowledge or information about the tax, property, and/or probate laws. Frequently, an individual receiving an inheritance will believe that the inheritance could be simply transferred to children or grandchildren. Or a child will receive informal directions from his or her parent to take care of a sibling with the money and property the parent will leave to the child. Unfortunately, there are gift tax laws that could cause the informal shift of the inherited wealth to become a taxable transfer by the party refusing or shifting the wealth. The unsuspecting and well-meaning individual might find himself or herself in a position requiring the filing of a gift tax return. In addition, state property and probate rules may have some affect on the attempted transfer. Fortunately, there is a method to refuse a gift or inheritance and accomplish these estate-planning objectives without gift tax problems. Such a refusal is known as a qualified disclaimer.

Disclaimers are ordinarily not considered until after the estate owner's death. The sophisticated estate planner, however, often takes into account during lifetime the potential use of a disclaimer after death. Disclaimers can make options or alternatives available to the beneficiaries of an estate that might not otherwise be available.

What is a disclaimer? Code Section 2518 defines a "qualified disclaimer" as an "irrevocable and unqualified refusal to accept an interest in property." A very important note: A disclaimer that is not qualified will be treated as a taxable gift by the disclaimant. For a disclaimer to be "qualified," it must meet these additional requirements:

- It must be in writing.
- It must be received by the transferor or by his or her legal representative or the holder of legal title of the property interest.
- The refusal must be received within 9 months after the transfer is made, such as the date of the decedent's death, or when a donee or beneficiary attains age 21.
- It must be made prior to the acceptance of the property interest or any of its benefits.
- The disclaimant cannot direct who gets the interest after the disclaimer.

EXAMPLES OF HOW DISCLAIMERS CAN ACCOMPLISH ESTATE PLANNING OBJECTIVES

Suppose a decedent with an estate of \$3 million left her entire estate in four equal shares to her children. Her will provides that the share of a child who predeceases her or disclaims his or her inheritance shall be held in trust for the children of the predeceased or disclaiming child. One child owns a closely held business and has a substantial estate of his own. In addition, the business poses an asset protection issue since the services performed by the child in the operation of the business may give rise to personal injury claims. If the child disclaims, the inheritance is kept in trust for his children (the decedent's grandchildren). This could reduce the family's total tax burden and will protect the inheritance from future claims of the child's creditors.

Suppose a decedent had an estate valued at \$2.5 million. He died in 2001 and left only \$600,000 to his credit shelter trust and the rest of his estate to his wife in a marital trust. Assume that any share disclaimed from the marital trust is poured into the credit shelter trust. She could save a minimum of \$180,000 of federal and state estate taxes on her estate by disclaiming \$400,000 of her marital trust property and allowing her husband's credit shelter trust to fully use the \$1 million unified credit equivalent.

PLANNING FOR DISCLAIMERS

Although disclaimers are normally a postmortem planning technique, advance planning can often maximize their flexibility and effectiveness. When drafting a will or arranging other types of property transfers, the estate owner and his or her advisers should always consider the potential for disclaimers. The estate owner could even leave instructions to his or her heirs suggesting the possible alternatives that disclaimers present.

One critical question in planning disclaimers is, What happens to the disclaimed property? This is certainly very important to both the estate owner and the disclaimant. One of the rules for a qualified disclaimer is that the disclaimant cannot direct to whom the property interest is transferred. A brief summary of the effect of a disclaimer is as follows:

- A disclaimed lifetime gift causes the property to be returned to the donor.
- The disclaimer of property received by beneficiary designations (for example, from life insurance policies or retirement plans) causes the property to go to the contingent beneficiary of the contract. If no contingent beneficiary is named, the proceeds become payable to the estate.
- A disclaimed specific bequest becomes payable to the residuary estate.
- A disclaimed interest in a testamentary trust causes the trust to pass to (or be held in trust for) the remainder beneficiaries.
- The disclaimant of inherited property is generally treated as if he or she predeceased the decedent. (Note: Some state laws provide a different result. Thus, it is important to check the terms of the will and state law where the decedent was domiciled or the disclaimed property is located to determine the outcome of a particular disclaimer.)

DISCLAIMER TRUSTS

A popular method for handling disclaimers by a surviving spouse is the disclaimer trust. In this instance, the will is drafted to contemplate the surviving spouse's disclaimers, and the disclaimer trust is treated as the alternate beneficiary of property the surviving spouse disclaimed. Thus, if the surviving spouse and his or her advisers determine that a disclaimer is wise, the disclaimed property does not pass to the decedent's children (or other heirs) but is transferred to the disclaimer trust. Ordinarily, the disclaimer trust will provide the surviving spouse with all trust income and give the trustee the ability to invade principal for the surviving spouse's support, health, and maintenance. A disclaimer trust can be sheltered from estate taxes by the deceased spouse's unified credit.

A disclaimer trust is a good planning method to give the surviving spouse the flexibility to reduce estate taxes if the will transfers too much property directly to the survivor. The surviving spouse and his or her advisers have 9 months after the deceased spouse's death to determine whether to make a disclaimer and which assets to disclaim.

DISCLAIMERS AND RETIREMENT BENEFITS

One important use of a disclaimer is to adjust the post-death distributions from qualified retirement plan or IRA benefits. Recent changes to the minimum distribution regulations have made disclaimers more prominent for such assets. First, these plans are payable at death to a designated beneficiary. The participant or account owner should always name a designated beneficiary and at least one successor or contingent beneficiary. The

required payout (the applicable distribution period) depends upon the individual or entity designated as beneficiary. For example, a surviving spouse as beneficiary provides potentially the best income-tax advantages since the account can be rolled over and distribution delayed in some instances. The estate as designated beneficiary generally provides the worst income-tax result. The new regulations provide for the beneficiary to be identified for such plans or accounts by September 30 of the year following the year of the participant or account owner's death to determine the applicable distribution period. Thus, the family has time to get advice about these assets and a timely (as described above) disclaimer (or disclaimers) could cause the shift of the benefit to the most desirable beneficiary. The beneficiary ultimately selected must have been on the list of contingent beneficiaries to receive the benefits, so appropriate pre-death beneficiary choices is essential. Again, this type of disclaimer is complicated and poses traps for the unwary so qualified professional advice is required.

ANSWERS TO SOME DISCLAIMER QUESTIONS

- Can the beneficiary of a life insurance policy disclaim his or her interest in the policy? The answer is yes, unless the beneficiary designation is **irrevocable**. (Under these circumstances, the disclaimer would have to have been made within 9 months of when the beneficiary designation was made.)
- Can a joint tenant disclaim his or her interest within 9 months after the death of the other tenant? The answer to this is maybe. Careful investigation should be done on a specific joint property interest. The answer may depend on state law, the type of joint interest created, and when the joint interest was created.
- In what terms must a partial disclaimer be made? When making a partial disclaimer, it is essential that it be in terms of dollars, a fraction, or a percentage.
- Do state laws follow the 9-month rule? State law concerning disclaimers may dictate a time window greater or less than 9 months. Be aware that (1) state law must be complied with for a disclaimer to be effective, and (2) the 9-month period cannot be exceeded or the disclaimant will be treated as making a taxable gift for federal gift tax purposes.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients
for the future*



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