



Advanced Planning Strategies

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Dear Reader,

Congress completed the Energy Bill before the summer recess but did not make much headway on other economic agendas. We expect that the Social Security debate and tax reform will heat up again in the fall, but it is difficult to get a focus on the priorities. There are some issues that need to be addressed and since 2006 is an election year, progress would seem more likely this fall rather than later.

The Senate did not bring the federal estate tax amendments to a vote before the summer recess, despite predictions to the contrary. The debate will be taken up this fall concerning the necessity of amending the current status quo. The law will almost undoubtedly be changed sometime prior to 2009. The estate tax is scheduled to provide an increased exemption of \$2 million per decedent in 2006 through 2008, followed by an increase to \$3.5 million in 2009, and total repeal of the tax in 2010. In 2011, the tax would be reinstated with a \$1 million exemption. Most practitioners believe that the government cannot allow the timing of an individual's death to so dramatically affect the tax burden.

With this issue in mind, it may be interesting to discuss a recent report from the Congressional Budget Office (CBO): "Effects of the Federal Estate Tax on Farms and Small Businesses." The report looked at federal estate tax return data from 1999 and 2000 and projected results based on the estate tax exemption levels as currently enacted. Fewer than 2 percent of decedents' estates had to file a return. Over one-half the estates that filed returns did not owe estate taxes. The business assets represented only 22 percent of all assets of returns as a whole, while over 60 percent of the assets of estates filing returns represented liquid assets. In 2000, only 5 percent of estates had tax bills that exceeded the estate's liquid assets. For farmers' estate tax returns, 8 percent had a liquidity shortfall. This liquidity problem may be mitigated further because the return data incorporate only assets included in the tax base. For example, life insurance owned by an irrevocable trust or held by an heir is not included in the liquidity data.

We will continue to provide updates and planning summaries of any important tax developments as they occur.

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 who receives an inheritance believes that it can simply be transferred to children or grandchildren. Or a child receives informal directions from his or her parent to take care of a sibling with the money and property the parent leaves 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 who refuses or shifts the wealth. The unsuspecting and well-meaning individual might find himself or herself in a position of having to file a gift tax return. In addition, state property and probate rules may have some effect 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, because more wealth is transferred at death than through lifetime gifts. 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 Sec. 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 receives the interest after the disclaimer.

EXAMPLE OF HOW DISCLAIMERS CAN ACCOMPLISH ESTATE PLANNING OBJECTIVES

Suppose a decedent had an estate valued at \$3 million. He dies in 2005 and leaves only \$1 million 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. If we assume that the surviving spouse has an estate of \$500,000 in addition to what she receives from the marital trust, she could save a minimum of \$230,000 (assuming her death occurs in 2006) of federal and state estate taxes on her estate by disclaiming \$500,000 of her marital trust property and allowing her husband's credit shelter trust to fully use the \$1.5 million unified credit equivalent available in 2005.

PLANNING FOR DISCLAIMERS

Although disclaimers are usually 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 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 postdeath 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 on the individual or entity designated as beneficiary. For example, a surviving spouse as beneficiary provides potentially the most income tax advantages because 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's 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. Therefore, appropriate predeath

beneficiary choices are essential. Again, this type of disclaimer is complicated and poses traps for the unwary so qualified professional advice is required. With retirement benefits, it is critical that the beneficiary designation include language that the contingent beneficiary will receive the benefits if the primary beneficiary predeceases the participant or disclaims the benefits. Some issues associated with the disclaimer of retirement plan benefits were recently clarified in Rev. Rul. 2005-36, 2005-26 I.R.B. 1368.

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. The tax regulations cover this issue in Sec. 25.2518-2(c)(4).
- 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. One recent favorable private ruling illustrates the disclaimer of a portion of undivided property (Ltr. 200503024).
- 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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