

The Use Of Disclaimers In Estate Planning

Disclaimers are very useful estate planning tools. However, in order to use disclaimers effectively, it is essential to understand how they operate and the risks involved in using them.

What Is A Disclaimer?

A disclaimer is essentially a refusal to accept property that has been given to you. Thus, if someone makes a gift to you, either while they are still alive or at their death, you may "disclaim" (that is, refuse to accept) that property. No one can legally force you to accept a gift or transfer of property.

Why Would Anyone Disclaim Property?

Most of us look forward to receiving gifts, so why would anyone disclaim property someone wanted to give them? There are a variety of reasons why people disclaim property, but the most important one is to avoid unnecessary estate taxes. For example, if a person dies with an estate valued over a certain amount, called the exclusion amount, (\$2,000,000 currently and increasing to \$3,500,000 in 2009), both federal and Virginia estate taxes will be assessed against that property. If the property is left to a surviving spouse, those taxes will be postponed until the surviving spouse passes away, utilizing the unlimited marital deduction. However, when the surviving spouse passes away, anything he or she owns -- whether received from the predeceased spouse or not -- will be taxed if it exceeds the applicable exemption amount.

Because of the extraordinarily high estate tax rates (45%), many people try to arrange their affairs so that their estates will not exceed the exemption amount. One way to do this is to "disclaim" property other people give them. Used effectively, disclaimers can significantly reduce, and even completely eliminate estate taxes on combined estates of married couples of up to \$4,000,000 (in 2006). This can result in tax savings of 45% of the items disclaimed.

What Happens If A Person Disclaims Property?

If a person disclaims property, that property passes as if that person were deceased. Often, the giver of the property will have specified what is to happen if the receiver is no longer alive or if they "disclaim" the property. Generally, therefore, what happens to the property is determined by

the terms of the legal document (for example, the Will or Trust) in which the gift is made. In estate planning for married couples, it is quite common for the Will or Trust in which the gift is made to specify that the disclaimed property is to pass to a special trust designed to protect the property from estate taxes upon the surviving spouse's death. (This type of trust has various names, such as a "By-Pass Trust", "Credit Shelter Trust", "B Trust", "Family Trust", etc.).

How Do You Make A Disclaimer?

A disclaimer is made by the person to whom the property is given executing a legal document in which they identify the property being disclaimed and state their refusal to accept it. A copy of that document must be provided to the giver of the gift (or their executor or trustee, if they are deceased). Sometimes the document has to be recorded in the local Circuit Court. All of these steps must be completed within nine (9) months of the gift becoming effective for federal estate and gift tax purposes. If the gift is effective upon the gift-giver's death (for example, if it is a gift under a Will), the process must be completed within nine (9) months of that person's death. In addition, the person to whom the gift is given (that is, the person making the disclaimer), must not have received anything in exchange for making the disclaimer.

Finally, the person making the disclaimer must not have received the property, or any of its benefits, before making the disclaimer. To paraphrase, "you can't have your cake (or even any of the frosting) and disclaim it too!"

What Are The Risks In Using Disclaimers?

There are two significant risks in using disclaimers. First, there is the risk that the person to whom the property is given will not complete all of the necessary steps before the nine (9) month deadline. Especially if the gift is made upon someone's death, a grieving person to whom the gift is given may simply forget to take the necessary action within nine (9) months. While a disclaimer made after nine (9) months may be effective in Virginia, many of the federal estate tax benefits will be lost.

The second major risk is that the person to whom the property is given will receive the property (or a benefit from the property) before executing the disclaimer (Remember, "you can't have your cake and disclaim it too"). For example, if a person cashes a check for life insurance, or even simply sends the insurance company a form claiming the money for themselves, they cannot later disclaim the insurance proceeds. Or if they "roll over" their spouse's IRA or other retirement plan into their own IRA, they cannot later disclaim the IRA. (Since IRA rollovers must take place within 60 days of the first spouse's death, these accounts can pose even greater risks than other assets). Or if a person receives income (for example, interest, dividends, or rent) earned on the property, they cannot later disclaim the underlying asset.

How Can A Person Avoid These Risks?

The single most important thing a person can do to avoid these risks is to contact a qualified estate tax attorney promptly after the effective date of the gift. In the estate process, this usually means promptly after the first spouse's death. It is critical that this contact take place not only within nine (9) months of the date of death, but also before any of the property (or any of its benefits) has been received or claimed.

This article was prepared by Midgett & Preti PC and is intended to provide general advice only. For answers relating to a specific situation, you should consult a competent estate-planning lawyer.