

Chapter 15:

Trusts Funded by Disclaimers

Just Say “No!”

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IN THIS CHAPTER . . .

you'll learn that a disclaimer is a form of postmortem estate planning in which beneficiaries decline to accept an inheritance. Refusing a gift of value is contrary to human nature, but a creative use of disclaimers can confer familial benefits in the long run.

Why Disclaim?

Disclaiming—in effect, saying “no” to a gift—can help accomplish a number of estate planning goals, which include reducing a combined taxable estate or shielding assets from an inheritor’s creditors. Disclaimed assets must flow as if the person disclaiming them had predeceased the person from whom they are inheriting.

How Disclaimers Work

An effective disclaimer must adhere to certain technicalities, both state and federal, to avoid being treated as a taxable gift. The disclaimer must be made in writing within nine months of the death that triggers the inheritance. During the nine-month period, the person disclaiming must not take any benefit or exercise any control over the assets disclaimed. For example, the disclaiming individual cannot cash dividend or interest checks or reinvest lapsed certificates of deposit that are part of the disclaimed assets. The person disclaiming also cannot direct the asset flow in any direction other than where the assets would have gone had they not survived.

Here is an example of a basic disclaimer, without any Trusts: Mom dies without a Will, unmarried, and survived by her two adult children, a son (Child One) and a daughter (Child Two). The children are 50/50 intestate beneficiaries in most states. Child One has three children of his own, while Child Two has no children. If Child One disclaims, his interest in the inheritance passes to his children outright in equal shares. Even if he has historically favored one child over the others, the intestate formula directs the asset flow as if he had not survived Mom. If married Child Two disclaims, no interest passes to her husband, because he is not an intestate heir of Mom. Instead, her share is distributed to Child One, who can further disclaim and allow his sister’s assets to flow to his children.

Estate Tax Disclaimer Strategy for Spouses

Married couples can ease estate tax uncertainty by weaving disclaimer planning into their Trusts. Picture a combined spousal estate below the \$15 million basic exclusion amount (BEA) threshold for federal estate taxes on a single individual (or below the state estate tax threshold if that's a factor in your state). Absent estate tax or control concerns, the survivor can inherit outright or in Trust with general powers of appointment. It's easy to plan that way as the survivor treats the inherited assets as their own, does not have to segregate those assets from their own and there will be a second basis step-up upon the survivor's death, eliminating potential capital gains taxes on the inheritance.

If, upon the first spouse's death, it turns out that the combined estate exceeds the estate tax threshold, that's when a disclaimer may be used postmortem by the surviving spouse to shelter state and federal estate taxes, potentially in tandem with portability over the deceased spouse's unused exclusion (DSUE), to reduce the survivor's federal taxable estate. The decision whether to disclaim belongs to the surviving spouse. It can be a partial disclaimer, applying to some but not necessarily the entire inheritance, based upon the size of the surviving spouse's estate and the desire for assets to be sheltered from future estate tax.

This type of planning works best between spouses who share a commonality of interests. They generally have that commonality when they have children together and neither have children from a previous relationship. This is because a surviving spouse faced with an informed decision as to whether to disclaim an outright gift or general power of appointment Trust, will usually look to see who would automatically receive assets upon disclaiming, which is the contingent beneficiary who would have inherited if the first-to-die spouse had instead been the survivor, then died. If the assets would go to children shared by the spouses, that's the way the strategy is supposed to work, going to those persons who both parties would choose as beneficiaries while potentially lessening estate taxes.

Alternately, if the assets upon disclaiming would instead go to contingent beneficiaries different from those whom the surviving spouse would choose, then there is little incentive for the survivor to disclaim, regardless of tax savings upon the survivor's death. Disclaiming is therefore typically not an estate tax planning strategy to be relied upon by blended families.

The outright gift/disclaimer method described here places few, if any, controls on the surviving spouse, but the strategy may not be advisable if the combined marital estate exceeds the threshold for estate taxes. In that situation, a regular shelter Trust, as per Chapter 13, is often a better option. When choosing the optimal strategy for your situation, other factors must be weighed beyond whether you and your spouse have a commonality of interests.

On one hand, assets left outright and subject only to disclaimer give the survivor total freedom. The survivor in that instance can decide not to disclaim the inheritance so they are able to invest, spend, and bequeath it in any manner they desire, along with the basis step up; or the survivor may choose to disclaim to avoid future estate tax.

On the other hand, while a shelter Trust created by a disclaimer conveys some benefits associated with all shelter Trusts, such as shielding assets from estate tax, a shelter Trust created by disclaimer is more restrictive than a regular shelter Trust because the disclaiming beneficiary can never exercise a lifetime power of appointment to make gifts of the disclaimed assets and lacks the ability to redirect those assets further down the line with testamentary powers of appointment.

Imagine that your spouse and your three children survive you. After your death, your spouse becomes the trustee of a continuing shelter Trust. Your spouse will receive Trust income and can take from the principal for their HEMS or the HEMS of your descendants.

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If one of the children develops special circumstances after you die, the limited powers of appointment of a regular shelter Trust would allow your surviving spouse to increase or decrease the child's contingent share or subject it to new conditions. The surviving spouse can also make lifetime gifts to children or grandchildren, equally or not, from a regular shelter Trust.

In contrast, the shelter Trust created via disclaimer is not always as adaptable to changing conditions because, as noted previously, it comes with no power of appointment for the beneficiary (your surviving spouse). As a result, your spouse cannot use the Trust to provide extra support to a child in need.

Consider the following side-by-side comparison of a Regular Shelter Trust for a married couple vs. a Shelter Trust created by disclaimer for a married couple:

Regular Shelter Trust	Shelter Trust Created By Disclaimer
Automatically created upon death and funded pursuant to the structure of the assets. Surviving spouse must live with its terms.	Created only if the surviving spouse decides to create it and follows the rules of disclaiming, within nine months of the first spouse's death. If the Trust is created, assets must flow as if the disclaiming inheritor had predeceased the person from whom they are inheriting.
Like a pachinko machine. Remove a barrier (disclaim) and let the ball (inheritance assets) fall where it may.	Like a pinball machine. When triggered, flippers (limited powers of appointment) may redirect the ball (inheritance assets).
Surviving spouse may be the trustee.	Surviving spouse may be the trustee.
Trustee/spouse may distribute income and principal while still living to him- or herself and/or to other contingent beneficiaries, based on HEMS.	Trustee/spouse may distribute income and principal while still living only to him- or herself, based on HEMS.
Spouse may make lifetime or testamentary gifts equally or unequally to a defined class of people (usually, descendants) or charities during the surviving spouse's lifetime.	No appointment (gifts) can be made from the Trust to anyone during the surviving spouse's lifetime.
Spouse may change testamentary distribution and add new Trust conditions governing the ultimate beneficiaries' shares following the surviving spouse's death.	Whatever is left in Trust upon the surviving spouse's death is distributed to the contingent beneficiaries named, and that distribution cannot be changed by the surviving spouse.

Letting Children Decide Later If They Need a GST Trust (Chapter 14) to Protect Their Inheritance"

Trusts drafted with disclaiming in mind can provide your child with the ability to convert an inherited non-GST Trust into a GST tax-exempt Trust after you die. When doing your estate planning, if you are not certain that the child wants or needs their inheritance subject to GST tax-exempt Trust or if they may prefer to take part of a gift outright and convert part of the gift to a GST tax-exempt Trust, depending on the child's circumstances at the time of your death, your gift in Trust to the child can include a general power of appointment with the ability by the child to disclaim to a more restrictive GST tax-exempt Trust within 9 months of your death.

The child's reasoning may turn on whether, at the time of the inheritance, they are subject to potential lawsuits or if the child determines their own estate is sufficiently large that the inheritance would cause their estate to be subject to estate tax. In either situation, with proper drafting, the disclaimed assets can flow to a separate GST tax-exempt Trust within the same document that they can control and use if needed for the health, education, maintenance and support (HEMS) (Chapter 11) of both the child and their family. The inheriting child may find this flexible arrangement to be better than one where the disclaimed assets automatically go outright to the child's descendants or someone else, depriving the child of lifetime control.

Nonjudicial Settlement Agreements and Decanting

Other options to convert a non-GST tax-exempt Trust into a GST tax-exempt Trust may be a nonjudicial settlement agreement (NJSAs), used to resolve Trust disputes and resolve Trust ambiguities without having to go to court or, in some states, by decanting (discussed in Chapter 16). By adding provisions to make a Trust more restrictive at the behest of both the beneficiary and trustee, a trustee and all affected beneficiaries, working together, may convert a non-GST tax-exempt Trust into a GST tax-exempt Trust. Unlike a disclaimed Trust, decanting and NJSAs may include limited powers of appointment and are not subject to strict time limits. Though both methods envision a change to irrevocable Trust terms without the need for judicial involvement, there may be reasons to get the stamp of court approval. NJSAs differ in various states and decanting is not available in all states.

Timeshare Treatment

If you happily own vacation timeshares, particularly those that are deeded, you may wish to transfer ownership of those interests to a Trust so that your heirs can inherit them and avoid probate in the states where the timeshare deeds are legally established.

If, however, you (or your heirs) would prefer to walk away from your timeshares rather than paying the yearly maintenance fees, simply putting the shares in your Trust may not be the optimal choice, as that could cause the Trust to be on the hook for such expenses. Instead, you could decide to not add the shares to your Trust; in that case, they ultimately become unclaimed probate assets upon your death. Another option would be to name the timeshare company that sells them (or to whom you write your yearly maintenance check) as the contingent beneficiary in your Trust. That way, if the heirs disclaim the inherited timeshares, they go back to the timeshare company.

Pearls of Wisdom

I learned that disclaimers can be used as a postmortem maneuver (along with portability, as discussed in Chapter 13 for a surviving spouse) to reduce future estate taxes and protect an inheritance from creditors. Nonjudicial settlement agreements and decanting are also useful postmortem tools in some circumstances.

