POST-MORTEM PLANNING
Die Now – Elect Later

Tulsa Estate Planning Board

May 19, 2009

A. Stephen McDaniel
Williams, McDaniel, Wolfe & Womack, P.C.
5521 Murray Avenue
Memphis, Tennessee 38119
901-767-8200
smcdaniel@wmww.com
March 10, 2009

A. Stephen McDaniel

A. Stephen McDaniel is the senior attorney with Williams, McDaniel, Wolfe & Womack, P.C., having joined the firm in 1975. Mr. McDaniel's practice is limited to estate, charitable and business continuation planning, and probate and trust administration. He is the managing attorney for the firm's estate planning/probate section.

Mr. McDaniel is a Fellow in the American College of Trust and Estate Council and a member of the Memphis Estate Planning Council. He is a Certified Estate Planning Specialist by the Tennessee Commission on Continuing Legal Education and Specialization and is an Accredited Estate Planner (AEP) and holds an Estate Planning Law Specialist (EPLS) designation awarded by the Estate Law Specialist Board, the only approved American Bar Association program which certifies specialists in the field of estate planning.

Mr. McDaniel was selected by *Worth Magazine* in 2008 as one of the top 100 estate planning attorneys in the country, his second annual award from the magazine. He is included in the 2008 edition of the *Best Lawyers in America* and was once again named in the 2009 edition of *Business Tennessee Magazine* as one of the top 150 attorneys in the State of Tennessee.

Mr. McDaniel is the Past President of the National Association of Estate Planners and Councils, an organization representing nearly 200 estate planning councils across the country with over 20,000 members. He is the Past President of the Memphis Estate Planning Council. Mr. McDaniel served as an adjunct professor in Estate Planning and Estate Gift Taxation at the University of Memphis School of Law for more than 10 years. He also served as an adjunct professor of the University of Memphis School of Business where he taught Business Law and Real Estate law. He is a former attorney for the Internal Revenue Service.

Mr. McDaniel has lectured on estate planning topics across the country and most recently presented programs in California, New Jersey, South Carolina, Colorado, Arkansas, Mississippi, Alabama, Virginia, Mississippi, Florida, Delaware, Arizona, Oklahoma and Tennessee. He is a co-author of *A Grandparent's Guide to Gifted Children* published in 2004, a contributor to Leimberg Information Systems (LISI) newsletters and has been quoted in *Kiplinger's Personal Finance* and *USA Today*.

Mr. McDaniel is a graduate of the University of Memphis (BBA 1968) and the University of Memphis School of Law (JD 1973). He is licensed to practice law in Tennessee and Missouri.

Mr. McDaniel is a member of the Memphis Bar Association and the Tennessee Bar Association. He is a Fellow in the Memphis and Shelby County Bar Foundation.

Chapter One
Disclaimers

I. Introduction

A. Introduction and Comments.

These materials are generally intended to address the use of disclaimers under §2518 of the Internal Revenue Code. The statute was created by the Tax Reform Act of 1976. References to statutes, cases and rulings before 1977 are for informational purposes only.

B. Disclaimers – A Historical Review.

1. The Concept of a Refusal -- Intestacy. The concept of refusing an inheritance is not as basic as one might assume. In *Hardenbergh v. Commissioner*, 198 Fed. 2d 63 (8th Cir. 1952), *cert. denied*, 344 U.S. 836 (1952), the Court noted that "the general rule as to intestate succession is that the title to the property of an intestate passes by force of the rule of law . . . and that those so entitled by law have no power to prevent the vesting of title in themselves." The Court found that absent a statute to the contrary, an heir entitled to inherit by intestacy cannot renounce property. Thus, a renunciation of property passing by intestacy results in a gift from the renouncing party to the takers in default.

2. Beneficiaries Under a Will. The general rule as to devisees or legacees under a will has generally been that the recipient can refuse the inheritance. *See*, *Brown v. Routzahn*, 63 F.2d 914 (6th Cir. 1933), *cert. denied*, 290 U.S. 641 (1933).

3. Gifts. In the case of a disclaimer of a gift, the concept is simple. The basic elements of a gift are (1) intent, (2) delivery, and (3) acceptance. Without acceptance, there can be no completed gift. But without acceptance why does the gift not fail with the property returned to the donor? The disclaimer of a gift assumes the fact that the donor has relinquished dominion and control of the gifted property and the gifted property must therefore pass as contemplated by the donor or as by law.

4. State Statutes. By statute most states have replaced the common law specifically authorizing disclaimers. Unfortunately, consistency in state statutes is lacking.

5. Current Law. The disclaimer world changed in 1976 with the enactment of Internal Revenue Code §2518. This outline addresses issues relating to post-1976 disclaimers. The reader is warned that cases and rulings prior to the passage of §2518 may produce wrong conclusions regarding the law.

C. Purposes of Disclaimers. These materials will review many purposes of disclaimers. However, as a general rule, all disclaimers have one or perhaps two specific purposes.

1. Tax Purposes. Tax purposes to be achieved through a disclaimer include, but are not limited to: correcting provisions in a will or estate plan resulting from a failure of the testator to contemplate changes in the tax law, correcting mistakes of the drafting attorney, increasing or decreasing a marital deduction, qualifying an estate for special tax elections, planning to fit state inheritance tax needs and generation skipping planning.

2. Non-Tax Purposes. Non-tax purposes include, but are not limited to: rewriting a will, avoiding creditors, terminating a trust, and avoiding environmental problems. Thus, even if the estate tax should be repealed, disclaimers will remain a valuable estate planning tool.

3. Repeal of Estate Tax. Repeal of the estate tax, should it come to be, will alter the use of disclaimers but they will continue to be used for state inheritance tax and non-tax purposes. Planning for disclaimers may become more common because of the uncertainty of the estate tax law.

D. The Disclaimer – Definitions.

1. Definition. A disclaimer is a refusal or renunciation by an estate beneficiary or a donee of a gift of a transfer to the beneficiary during life or at death, by will, trust or otherwise.

2. The Missing Transfer.

a. What makes a disclaimer possible is that a disclaimer, if properly accomplished, is not a "transfer." Without a "transfer" there can be no gift. §25.2518-1(b).

b. Gift taxes are imposed on “the transfer of property by gift.” §2501(a)(1). It is the word “transfer” that distinguishes disclaimers and allows these “non-transfers” to escape gift taxation even though the transaction otherwise fits within the general scheme which the gift tax law is designed to tax.

c. Long before the current disclaimer statute existed, the Sixth Circuit in *Brown v. Routzahn*, 63 F.2d 714, 917 (6th Cir.), *cert. denied*, 290 U.S. 641 (1933), held that a disclaimer was not subject to gift tax and recognized the distinction between a “transfer” and an “exercise of a right to refuse a gift.” The regulations confirm this philosophy. §25.2511-1(c).

d. The non-transfer concept was incorporated into §2518 which was enacted in 1976 by providing “the disclaimed interest in property is treated as if it had never been transferred to the person making the qualified disclaimer.” §2518-1(b).

e. The result of §2518 is that in the case of a qualified disclaimer, no transfer is deemed to be made from the person making the disclaimer. §2518(a); 25.2518-1(b).

3. Relation Back Theory.

a. Not only does a qualified disclaimer not result in a transfer, it operates retroactively from the date of the disclaimer to cause the disclaimed property to be transferred to the secondary beneficiary as of the date of the original transfer – the date of death or date of gift. *See, e.g.,* Rev. Rul. 83-27.

b. *Estate of Leona Engelman*, 121 T.C. No. 4, (7/24/03). Husband and wife established a joint living trust. At the death of the first spouse to die, the trust was to be divided into two trusts, Trust A and Trust B. Trust A was designed to qualify for the marital deduction. The surviving spouse was given a general power of appointment over Trust A. Trust B was designed to receive an amount equal to the unified credit equivalent. The trust provided that all assets would pass into Trust A upon the death of the first spouse except for any amounts disclaimed by the surviving spouse. Disclaimed assets would pass into Trust B. Husband died. A month later wife exercised her power of appointment by executing a document that directed the disposition of the corpus of Trust

A. Wife died a month thereafter. Two months later wife's Executor disclaimed $600,000.00 worth of wife's interest in Trust A. The IRS held that wife's exercise of her power of appointment was an acceptance of the property and the disclaimer was not qualified. The estate argued that the effect of the disclaimer and the Relation-Back Doctrine caused the assets to be disclaimed as of the death of the first spouse, thereby negating the exercise of the power of appointment, citing §25.2518-(2)(b)(4), ex. 7. The Court held that the Relation-Back Doctrine does not negate the exercise of the power of appointment and that the exercise of the power of appointment constituted acceptance which negates the ability to make a qualified disclaimer.

4. Qualified Disclaimers. In order for a disclaimer to avoid gift tax liability for the disclaiming party it must be a "qualified disclaimer." §2518(b). A disclaimer is "qualified" only if it meets all requirements of §2518(b). The result of a qualified disclaimer is that no transfer is deemed to be made as a result of the disclaimer for gift or estate tax purposes.

5. Non-Qualified Disclaimers. The only definition of a non-qualified disclaimer is a disclaimer of property that does not meet the requirements of §2518. Accordingly, such a disclaimer will be treated as a taxable gift by the disclaiming party for federal gift tax purposes. The failure to qualify a disclaimer does not result in no disclaimer or transfer being accomplished. Rather, it simply taxes the transfer under the gift tax rules. The transfer is thus taxed twice, once when the first transfer is made (gift or inheritance) and again at the time of the disclaimer. The rules are unforgiving. Can you say "malpractice" if you do it wrong?

E. Qualified Disclaimers.

1. The Code. The entire disclaimer law is outlined in a single Code section, §2518, which is reprinted below. The section is deceptively simple in appearance.

§2518. Disclaimers

(a) General rule. -- For purposes of this subtitle, if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person.

(b) Qualified disclaimer defined. – For purposes of subsection (a), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property but only if –

(1) such refusal is in writing,

(2) such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of –

(A) the day on which the transfer creating the interest in such person is made, or

(B) the day on which such person attains age 21,

(3) such person has not accepted the interest or any of its benefits, and

(4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either –

(A) to the spouse of the decedent, or

(B) to a person other than the person making the disclaimer.

(c) Other rules. -- For purposes of subsection (a)

(1) Disclaimer of undivided portion of interest. – A disclaimer with respect to an undivided portion of an interest which meets the requirements of the preceding sentence shall be treated as a qualified disclaimer of such portion of the interest.

(2) Powers. – A power with respect to property shall be treated as an interest in such property.

(3) Certain transfers treated as disclaimers. – A written transfer of the transferor's entire interest in the property –

(A) which meets requirements similar to the requirements of paragraphs (2) and (3) of subsection (b), and

(B) which is to a person or persons who would have received the property had the transferor made a qualified disclaimer (within the meaning of subsection (b)),shall be treated as a qualified disclaimer.

2. The Regulations. Like the single Code section, the Regulations are very simple on their face, containing only three major sections. The most interesting aspect of the Regulations is the large number of examples. There are 62 examples to assist in understanding the requirements of a qualified disclaimer, the uses of same and the pitfalls to be avoided.

3. State Laws.

   a. Section 2518(c)(3) indicates that a written transfer of the transferor's entire interest in property which has the same legal effect as a qualified disclaimer under §2518(b) is treated as a qualified disclaimer. The purpose of this section, which was added in 1981, was to eliminate problems where a disclaimer is not permitted by state law or because of inconsistent state laws. This is clearly indicated in §25.2518-1(c). This section states that a transfer will be treated as "qualified" if under local law the property interest passes to someone other than the disclaimant without any direction from the disclaimant.

   b. State law is still extremely important, if not for the purpose of outlining specific requirements that may be needed under the state law and to meet state disclaimer rules, if any, but more importantly in determining who will receive the disclaimed property. State law is especially important in a state which has its own gift tax. In those states, failure to follow both the federal and the state law in accomplishing a disclaimer can result in state gift tax even if no gift is made for federal gift tax purposes.

   c. PLR 200612001 represents an excellent example of why state law is important. Decedent's estate planning documents created a typical marital and non-marital trust. The surviving spouse, through an attorney in fact under a power of attorney, executed a disclaimer. The disclaimed marital property passed to the decedent's descendants. A federal estate tax return (Form 706) was filed on behalf of the estate. A QTIP election was made as to the Marital Trust property which was not disclaimed. Thereafter, under state law, the disclaimer was declared to be invalid. Because the disclaimer was invalid, the disclaimed assets were returned to the Marital Trust. Because no QTIP election was made on the 706 as to the disclaimed assets, the IRS refused to allow the marital deduction. The position of the IRS is once a QTIP election is made it is irrevocable.

4. Oklahoma Statutes. Title 84 of the Oklahoma Statutes, Chapter 1, Sections 22 through 31 govern disclaimers in Oklahoma.

   a. The statute defines a "disclaimer" as a written instrument which declines, refuses, releases, renounces or disclaims an interest which would otherwise be succeeded to by a beneficiary. It provides that the instrument must define the nature and extent of the interest disclaimed which must be "signed, witnessed and acknowledged by the disclaimant in the manner provided for deeds of real estate." Section 22, paragraph 3.

   b. The statute provides for disclaimers of legal or equitable interest in real and personal property, fractional disclaimers and disclaimers of powers of appointment and other rights, powers, privileges relating thereto. Section 22, paragraph 2.

   c. A guardian, executor, administrator or other personal representative of the estate of a minor, incompetent or deceased beneficiary "if he deems it in the best interest of those interested in the estate of such beneficiary . . . and not detrimental to the best interests of the beneficiary, with or without an order of the Probate Court, may execute and file a disclaimer." The statute apparently gives an attorney in fact under a Power of Attorney the authority to execute a disclaimer. Section 23.

   d. The law utilizes the same nine months as provided in the federal rules but appears to give contingent beneficiaries, that is, individuals whose rights have not been "indefeasibly fixed" the right to disclaim nine months after their interest has been "finally ascertained" or "indefeasibly fixed." Section 24.

   e. Disclaimers are to be filed in the District Court in which the estate of the person by whom the interest was created or from whom it would have been received is or has been administered or if no probate administration is commenced, then in the District Court of any county as provided in the Oklahoma statutes as the place for probate administration of the estate. Section 25.

f. If an interest in or relating to real estate is disclaimed, the original of the disclaimer or a certified copy must be filed in the Office of the County Clerk in the county where the real estate is situated. Section 25.

g. Disclaimed interests are distributed in the same manner as if the disclaimant had died immediately preceding the death or other event which caused the beneficiary to be indefeasibly fixed. The statute makes it clear that intestate shares may be disclaimed. Section 26.

h. The Uniform Fraudulent Conveyance Act is not abrogated by the disclaimer statute. Section 27.

i. The right to disclaim exists without regard to any spendthrift provisions in the document. Section 28.

j. Trust interests may be disclaimed by the Trustee and income beneficiary without judicial approval and without liability of the Trustee to persons having an interest after the death of the income beneficiary. Section 31.

II. The Qualified Disclaimer – The Basics

A. <u>Irrevocable and Unqualified</u>.

1. <u>It Is What It Is</u>. The first requirement for a disclaimer to be "qualified" is that it be "irrevocable and unqualified." It must constitute a refusal by a person to accept an interest in property distributable to a person by gift or by reason of the death, termination of trust or otherwise. §2518(b), 25.218-2(a)(1), -3(a)(1)(i). There are no special rules regarding the structure of the disclaimer other than perhaps the need to declare it to be "irrevocable and unqualified."

2. <u>Continuing Gifts</u>. An interesting question is presented in the case where an irrevocable trust is established and additional gifts are made over a period of time (*e.g.*, an irrevocable life insurance trust with Crummey provisions and continuing premium obligations).

One would assume that the right to disclaim begins again with respect to each and every gift. *See*, PLR 9210014 where the beneficiary of an irrevocable trust disclaimed an "interest" in the trust attributable to the subsequent gifts.

3. Irrevocable. Making a disclaimer irrevocable is easily accomplished by a declaration in the document evidencing that the disclaimer is irrevocable. No definition of "irrevocable" is given. One could logically assume that the guidelines and rules associated with §2038 "Revocable Transfers" in the estate tax law would be applicable. Thus, where the disclaimer is subject to any exercise of a power to alter, amend, revoke or terminate the disclaimer one could logically assume that the disclaimer would not be irrevocable.

4. Unqualified. No definition of "unqualified" is given. It is logical to assume that any disclaimer that is contingent upon another event, such as a disclaimer by yet another party, would not be an unqualified disclaimer.

B. In Writing. The second requirement for a disclaimer to be "qualified" is that it must be in writing. §2518 (b)(1), §25.2518-2(b)(1). No specific form is required. However, reference should be made to any specific state law requirements.

1. The Internal Revenue Code. The Code provides that the written disclaimer must be "received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates." §2518(b)(1). Note the word "or" as opposed to the word "and."

2. Legal Representative. The term "legal representative" is not defined. *See*, Reg. §25.2518-2(b)(1). One can assume that the legal representative would be any executor or personal representative for the estate of decedent, any court appointed fiduciary, including a conservator or guardian, an attorney in fact under a power of attorney, and a trustee under any trust which has or may have a relationship with the disclaimed interest or property.

3. Delivery to Holder of Legal Title. The disclaimer may also be delivered to "the holder of the legal title to the property." In PLR 9012026, the IRS approved a disclaimer of an annuity under a pension plan where the notice was delivered to the corporate employer and to the plan trustee.

C. Timing Rules. The third requirement for a disclaimer to be "qualified" is that the disclaimer must be received by the transferor or his legal representative no later than nine months of the date on which the transfer creating the interest in such person is made. §2518(b)(2)(A). The first problem with this requirement is determining the date of the transfer.

1. The Transfer.

a. Section 25.2518-2(c)(3) defines a "transfer" as an otherwise taxable transfer that creates the disclaimant's interest. For gifts, the date on which the transfer creating the interest in the disclaimant is generally the day the gift is deemed to be complete.

b. *See, e.g.*, PLR 9001062. In this ruling, the Grantor retained the right to revoke a trust in conjunction with others. The IRS ruled that there was no completed gift and the disclaimer time period had not started upon the establishment of the irrevocable trust because no completed gift had occurred.

2. Regulation Examples. In §25.2518-2(c)(5), exs. 1-4, the IRS points out situations whereby a transfer made at death or which becomes irrevocable at death is a transfer which is effective as of the date of the decedent's death which triggers the qualified disclaimer time limitations.

a. On May 13 in a transfer which constitutes a completed gift, A creates a trust providing income to B for life. B has a limited testamentary power of appointment over the corpus of the trust. The power may be exercised in favor of the issue of A or B. If no issue survive at B's death or if the power is not exercised, the corpus passes to E at B's death. On May 13 A and B have two surviving children, C and D. If B, C, D or E wishes to make a qualified disclaimer, the disclaimer must be made no later than nine months after May 13. §25.2518-2(c)(5), ex. 1.

b. Assume the same facts in the preceding example except that B is given a general power of appointment over the corpus of the trust. B exercises the general power after B's death on June 17 in favor of C upon B's death. C may make a qualified disclaimer no later than nine months after June 17.

If B had died without exercising the general power of appointment, E would have nine months after B's death on June 17 to make the disclaimer. §25.2518-2(c)(5), ex. 2.

c. F creates a trust on April 1. F's child, G, is to receive the income from the trust for life. Upon G's death, the corpus of the trust is to pass to G's child, H. If either G or H wish to make a qualified disclaimer, it must be made no later than nine months after April 1. §25.2518-2(c)(5), ex. 3.

d. A creates a trust on February 15 in which B is named the income beneficiary for life. The trust provides that upon B's death the assets pass to C if then living. If C predeceases D, the proceeds pass to D or D's estate. If either B, C, or D wishes to make a qualified disclaimer, it must be made no later than nine months after February 15. §25.2518-2(c)(5), ex. 4.

3. Transfer Creating the Interest. Section 25.2518-1(a) utilizes the term "transfer creating the interest" as the event which establishes a date for determining the nine month time limitations of the disclaimer. Note that the term "taxable transfer" is not used. See, for example, references to QTIP Trusts and "String Transfers" below.

4. Knowledge of Interest. No reference is found in the law which provides for a beginning point with knowledge of the existence of a transfer. Lack of knowledge does not suspend the nine month statute. §25.2518-2(c)(1). Any such references to knowledge being a requirement apply to pre-1976 law. But how can you make a disclaimer if you do not know of the transfer? And how can a gift be complete without delivery of the gift to the donee?

5. Power of Appointment – Holder of Power. The date a power of appointment is created is the disclaimer starting date for the holder of the power to disclaim the power. §25.2518-2(c)(3).

6. Powers of Appointment – Beneficiary of Power. The distinction between the starting date for a beneficiary to disclaim an interest in the trust where a third party holds a power of appointment is important.

a. Where the holder of the power of appointment has a general power of appointment, the starting date for the beneficiary (recipient of the property under the power) is the date of death (or exercise or termination of the general power of appointment) of the holder of the power.

b. In the case of a limited power of appointment (even one with an extremely broad definition for potential donees), the starting date is the date of the creation of the power.

c. Contingent remainder beneficiaries are treated the same as vested remainder beneficiaries. *See*, §25.2518-2(c)(3) and (5), ex. (1) and (2).

7. QTIP Disclaimer. Section 25.2518-2(c)(3) addresses the time period for a remainder beneficiary to disclaim an interest in a QTIP trust properly qualified under §2056(b)(7). One might wrongly assume that since the QTIP trust is included in the estate of the deceased spouse, that the nine month period for the remainder beneficiary to disclaim would begin running at the date of the surviving spouse's death when the assets are properly includable in the estate of the deceased spouse. The IRS holds otherwise stating that the remainder beneficiaries must disclaim within nine months after the death which creates the QTIP trust and therefore creates the interest in the beneficiary.

8. Revocable Trusts. The date a revocable trust becomes effective (usually the date of death of Grantor) is the disclaimer starting date. PLR 8008078, 8003020. We find no authority to support an argument that the starting date could be the date the Grantor is incapacitated or declared to be incompetent.

9. Irrevocable Trusts. In the case of an irrevocable trust, the starting date is the date the trust is created even if the interests of the beneficiaries are uncertain and not vested. PLR 9027026.

10. Retirement Plans. The date of death of the owner of a retirement plan is the disclaimer starting date. PLR 8012129. WARNING: Be sure to remember that if the disclaimer causes the plan assets to pass to the estate of the plan participant, an extended payout of the planned assets will not be available. *See*, PLR 200327059.

11. Contingent Remainder Interests. Transfers such as the one that creates a life estate for a beneficiary with a remainder interest, even a contingent remainder interest, must be disclaimed within nine

months of the date of the original transfer rather than the date of the termination of the life interest. §25.2518(c)(3).

12. Inclusion in Estate – String Sections. An interesting question is raised regarding the starting date for a disclaimer where the asset, although transferred during life, returns to the estate at death by reason of §§2035-2038. The Regulations hold the starting date to be the date of the gift or the first transfer. The fact that the assets are included in the estate is of no consequence. §25.2518-2(c)(3).

13. Mailing/Delivery Rules. The Code establishes the standard IRS mailing/delivery rule by stating that timely mailing is timely delivery if the mailing rules of §301.7502-1 are met. The first day following a Saturday, Sunday or legal holiday is technically the due date. §301.7502-1; §2518(b)(2).

14. State Law. If state law requirements designate who should receive the disclaimer, the disclaiming party should comply with both federal and state rules. A number of states require the disclaimer to be filed in the court where the probate of the estate is conducted or would have been conducted if a probate estate had been opened.

15. Special Rules for Minors. Section 2518(b)(2)(B) provides an exception to the nine month rule with respect to a beneficiary who has not attained the age of 21. This exception is applicable even though the state law may declare the disclaiming party to be an adult at age 18. This exception is applicable even if the minor (under 21) received benefits prior to attaining age 21.

16. Extensions of the Federal Estate Tax Return. One might incorrectly assume that where the estate tax return is extended, the period for filing a disclaimer should likewise be extended. There is no such provision in the law which allows for same.

17. Extensions of Time to File Disclaimer. THERE ARE NO EXTENSIONS AVAILABLE FOR MAKING DISCLAIMERS. NO COURT CAN GRANT AN EXTENSION.

D. Non-Acceptance of Interest or Benefits.

1. No Acceptance. The fourth requirement for a disclaimer to be "qualified" is that the person making the disclaimer must not have accepted the interest of the disclaimed property or any of its benefits. §2518(b)(3).

2. Consideration Given for Disclaimer. Consideration given by a third party for making the disclaimer disqualifies the disclaimer and constitutes acceptance of benefits. §25.2518-2(d)(4).

a. It is tempting, in the case where Party A gives a disclaimer with the expectation that Party B will take a desired action to place such language in the disclaimer or to assure the required actions through another agreement. Any such planning will result in the disclaimer being "unqualified" under §2518(b)(3).

b. In *Monroe Estate v. Commissioner*, 104 T.C. 352 (1995), the tax court ruled that disclaimers were not qualified because the decedent's husband indicated that he would "take care of" the disclaiming parties. He thereafter made a cash gift to the disclaiming parties approximating their disclaimed interest. The appellate court reversed the trial court stating that actual consideration rather than an expectation or implication seemed to be the test and that a disclaimer would stand or fall on the factual issues. 124 F.3d 699 (5^{th} Cir. 1997).

c. If the disclaimer is part of a "plan" and if following the disclaimer the party who benefits from the transaction makes a gift back to the disclaiming party or others, the IRS can easily apply the substance vs. form argument or the step-transaction arguments in asserting that there was an actual agreement and thus consideration given for the disclaimer.

d. It is suggested that if there is an informal plan, as much time as possible should pass between the date of the disclaimer and the date of any subsequent gift or other transaction that might be construed to be consideration given for the disclaimer.

3. Accepting Benefits. A qualified disclaimer cannot be made with respect to an interest in property if the disclaimant has accepted the interest or any of its benefits, expressly or impliedly, prior to the

making of the disclaimer. §25.2518-2(d)(1). The regulations require that acceptance be manifested by an affirmative act which is consistent with ownership of the interest of the property. This includes using the property or the interest in property, accepting dividends, interest or rents, or directing others to act with respect to the property. It does not include "merely taking delivery of an instrument of title." The fact that real property vests immediately in the disclaimant upon the death of the decedent does not constitute acceptance. §25.2518-2(d)(1).

a. Accepting benefits can be difficult to define. In the case of residential property held in joint tenancy, a joint tenant is not considered to have accepted the joint interest merely by residing in the property before disclaiming his interest. §25.2518-2(c)(5), ex. (10).

b. Acting as a fiduciary, unless the fiduciary has the power to direct payment of the disclaimed interest, is not an acceptance of benefits. §25.2518-2(d)(2).

c. Paying real estate taxes on real property is not an acceptance of benefits. §25.2518-2(d)(4), ex. (3).

d. Especially troubling are examples (4) and (5) of §2518-2(d)(4) which provide that exercising control over property, even where the disclaimant does not have the legal power to exercise that control, may be deemed an acceptance of benefits.

(1) Pursuant to A's will, B inherited a farm. B requested the Executor to sell the farm and give the proceeds to B. The Executor followed the request. B then disclaimed $50,000 of the proceeds from the sale of the farm. The disclaimer is not qualified. Requesting that the Executor sell the farm, even though the Executor may not have been obligated to comply, constituted acceptance by B. §25.2518-2(d)(4), ex. 4.

(2) Assume the facts in the immediate preceding example except that B pledged the farm as security for a loan which was paid off by B prior to receiving the distribution from the estate. B disclaimed his interest in the farm. By

pledging the farm as security, B accepted the farm. §25.2518-2(d)(4), ex. 5.

e. Withdrawing funds from a joint brokerage account prohibits a later disclaimer. Returning the funds does not help. PLR 9012053. However, see PLR 199932042 where the spouse deposited an income check from the brokerage account into her joint bank account and then transferred it to the estate account. Such an action did not constitute acceptance.

f. Exercising powers to control and manage a business entity may be deemed an acceptance of benefits. TAM 9123003.

g. Withdrawing a portion, but not all, of property in a brokerage account may not constitute a disclaimer if the remaining property and the post death income generated from the remaining property are all properly segregated. *See*, §25.2518-3(d), ex. 17. *See also*, PLR 9036028.

h. Payment of a spouse's personal bills from the estate account precluded the spouse's disclaimer of estate assets. TAM 8405003.

i. In the case of a minor, accepting benefits prior to age 21 does not preclude a disclaimer made within nine months following the beneficiary attaining the age of 21 so long as the beneficiary does not accept any benefits after attaining the age of 21. *See*, §25.2518-2(d)(4), exs. 9, 10 and 11 and PLR 200333023, 200348011.

j. *See*, *Estate of Engelman* (¶ I.D.3. above) where the Court ruled that the exercise of a power of appointment constituted acceptance of benefits and precluded a subsequent qualified disclaimer.

k. PLR 200503024 is an excellent example of a disclaimer that works even though the spouse accepted benefits from the disclaimed property and took control of some of the assets. Husband died owning a brokerage account. Wife, upon advice of stock broker, directed the broker to transfer title into her name. Wife directed the sale of securities. Wife withdrew cash from the account. Six months later, on advice of counsel, Wife directed that the brokerage account be divided into separate accounts. Assets over which Wife had exercised control were placed in her account. Other assets were placed in the estate account. Wife then disclaimed the estate account assets. The IRS ruled favorably on the disclaimer based on the fact that the assets in the account were severable. Read the PLR carefully before relying upon it.

E. Distribution of Disclaimed Property.

1. No Direction or Control. The fifth requirement for a disclaimer to be "qualified" is that the interest which is disclaimed must pass to another without any direction or control by the disclaimant. §2518(b)(4); §25.2518-2(e)(1).

2. Precatory Language.

a. Precatory language is tempting to use in a disclaimer. It is especially valuable where there is concern that the persons reviewing the disclaimer (e.g., the insurance company) will misconstrue the effect of the disclaimer and incorrectly distribute the property. It helps a bank, insurance company, or brokerage company know who to pay. The Regulations specifically allow precatory language in a disclaimer. §25.2518-2(e)(4).

b. Example (8) in §2518-2(e)(5) addresses a situation where language contained in the disclaimer expressed the intention of the disclaiming party that assets disclaimed would be shared equally by children as the result of the disclaimer. The Regulations allow for precatory language which has no legal effect. *See*, TAM 9509003. Be very careful with such language. Be careful to specifically refer to it as "precatory" language.

3. Five and Five Powers. The no direction rule is not violated by reason of a five and five power held by a spouse who is the beneficiary of a trust estate funded for the spouse by reason of a disclaimer by the spouse. For example, B's will creates a marital trust and a non-marital trust. Spouse C is income beneficiary of both trusts. Spouse C has a $5,000 or 5% (whichever is greater) limited withdrawal power over principal. C disclaims a portion of the marital trust. The disclaimed assets pass into the non-marital trust.

The retention of the five and five power over the non-marital trust does not defeat the disclaimer. §25.2518-2(e)(5), ex. 7.

4. Multiple Interests.

a. Perhaps the most common example of failure to comply with the no direction requirement is the situation where A creates a trust naming B and C as income beneficiaries with D as a remainderman. D is the Trustee and as the Trustee has a discretionary power to invade principal for the benefit of B and C. If D disclaims his remainder interest but retains the discretionary power of invasion, even for B and C, D has not made a qualified disclaimer. On the other hand, if the distributions to B and C are based on ascertainable standards under §2041, the disclaimer can be qualified. §25.2518-2(e)(5), ex. (11) and (12).

b. Multiple interests can come in unexpected ways. For instance, where a disclaimer by X causes the assets to pass into a Charitable Trust (foundation) administered by X as Trustee, the power of the Trustee to designate charities to receive distributions violates the "no direction or control" rules. However, see Private Letter Ruling 200649023 below.

5. Agreement by Parties. Any expressed or implied agreement that the disclaimed interest in property is to thereafter be distributed or transferred by the recipient in some specified way is a retention of control and will cause the disclaimer to be disqualified and can create secondary gift tax issues. §25.2518-2(e)(1).

6. Thinking Outside the Box. PLR 200649023 provides an excellent example of a disclaimer avoiding the no direction and control rule. Parent established a trust giving Daughter a limited power of appointment over a portion of the trust. The effect of the disclaimer was to cause assets to pass into a charitable foundation which Daughter administered as Trustee. Thus, Daughter's disclaimer of the power of appointment caused the assets to pass into a trust which she, as Trustee, controlled. Counsel for Daughter avoided violating this rule by amending the charitable foundation to provide that the disclaimed assets would be held in a separate section of the trust administered by a Special Trustee other than Daughter thereby causing Daughter to relinquish the ultimate control over the disclaimed assets that passed into the foundation.

7. The Circular Disclaimer. The disclaimed property must pass to someone other than the disclaiming party. §2518(b)(4)(B). Beware of the boomerang disclaimer. Section 2518(b)(4) requires that as a result of the disclaimer, the property must pass, without any direction on the part of the person making the disclaimer, to a person other than the person making the disclaimer. Consider the following examples:

a. A makes a specific bequest to B of $200,000 and leaves the balance of the estate into a trust for B for life and then to B's children, C and D. B disclaims the $200,000 thereby causing the property to be distributed under the residuary paragraph into the trust for B for life and then his children, C and D at B's death. In this case, the effect of the disclaimer is to cause the assets to pass into a trust in which B has an interest as a beneficiary. Such a disclaimer is not qualified. But what is the value of the gift? The remainder interest?

b. A dies leaving a will directing all assets to daughter B. A also names B as the beneficiary of A's life insurance policy. B desires for the life insurance proceeds to pass to B's children. B disclaims the proceeds of the insurance. The proceeds pass not to B's children but to A's estate because the life insurance policy did not have a contingent beneficiary designation. B must also disclaim B's interest in A's estate to accomplish a qualified disclaimer.

c. *The Estate of David Katz*, T.C. Memo 2004-166 (71404), is a classic circular disclaimer case where things went wrong. Husband's will established a pecuniary credit shelter trust to be funded with the federal estate tax exemption equivalent that provided that the amount of the credit shelter trust could not be reduced by reason of any disclaimer by the wife. That language proved to be fatal. The residue was distributed to the wife. In the residuary distribution portion of the will, it stated that if the wife disclaimed any assets distributable outright to her, they would pass into the credit shelter trust. Wife disclaimed specific assets and further disclaimed all interest in the credit shelter trust. Because of the language in the will, the assets in the disclaimed part of the credit shelter trust passed to the wife and thus were returned to the credit shelter trust. The specific assets in the residue disclaimed by the wife were paid to the credit shelter trust. The result was disastrous. The disclaimers accomplished nothing except to increase the credit shelter trust to an amount in excess of the unified credit (by reason of the specific assets disclaimed). The result was to produce tax when no tax otherwise could have resulted. This is a classic case where the draftsman failed to appreciate how disclaimers worked and the attorney who structured the disclaimers failed as well.

8. Formula Disclaimer Fails but Taxpayers May Win. *Estate of Christiansen v. Commissioner*, 130 T.C. No. 1 (2008) is important for two reasons. First, it represents an IRS victory and confirms that a taxpayer (other than a spouse) cannot disclaim property and have it come back to the taxpayer. That is no surprise. The surprise is that the Tax Court approved a formula disclaimer in a ruling inconsistent with *McCord* (120 T.C. 358 (2003)) and *Procter* (142 F.2d 824 (4th Cir. 1944)). The decedent made a specific bequest to daughter. Daughter disclaimed a fractional share of the estate to the extent that it exceeded $6.35 million. The disclaimed assets passed 75% to a CLAT and 25% to a foundation (also the beneficiary of the CLAT). The CLAT was payable back to the daughter at the end of the term. The IRS increased the fair market value of the estate from $6.5 million to $9.6 million which caused the disclaimer to increase the amount that passed to the CLAT and the foundation. The Court disqualified the disclaimer of that portion of the estate passing to the CLAT, effectively defeating any charitable deduction on the basis that the assets disclaimed cannot return to the disclaiming party. Section 2518(b)(4)(B). The remaining portion of the estate passed to the foundation which did qualify for the charitable deduction. The disclaimer contained a "savings clause" attempting to save the disclaimer if any portion was otherwise unqualified. The IRS position was that the savings clause saved nothing. The formula disclaimer was structured so that any increase in the value of the estate as determined for federal estate tax purposes would pass to charity but the disclaimer did not accomplish that as to the CLAT for reasons other than the savings clause itself. The Court then noted what may be the true taxpayer victory. The Court stated that "the incentive to the IRS to audit returns affected by such disclaimer language will marginally decrease if we allow the increased deduction for property passing to the foundation" to qualify for the charitable deduction utilizing savings language. The Commissioner argued that such language would increase the likelihood of taxpayers under valuing the estate to cheat charities with no ability on the part

of the IRS to collect additional taxes in the event of an audit since the savings language would cause the increase in the value of the estate to pass to the charity. The IRS relied upon *McCord* and *Procter*. The Court found that the Executors and Trustees of an estate are fiduciaries and owe a duty to settle or distribute the assets under the terms of the Will and that such savings language does not violate public policy and should be allowed. Do not look for the IRS to acquiesce to this case but it does remind us that the war is not over and disclaimers are tricky at best.

9. <u>Spousal Exception – A Spouse Can Disclaim and Still Benefit</u>.

a. An important exception to the rule is made for the spouse of a decedent. Section 2518(b)(4)(A) provides that property may, as the result of a disclaimer by a spouse, pass to or for the benefit of the spouse. Thus, a disclaimer by a spouse into a trust in which the spouse is a beneficiary is not only authorized, it is a specific estate planning tool which should be utilized in the drafting of estate planning documents in an uncertain period of estate tax exemptions.

b. The surviving spouse may not retain the right to direct the beneficial enjoyment of the disclaimed property to others in a transfer that is not subject to federal estate or gift tax (as Trustee or otherwise) unless the power is limited by an ascertainable standard. §25.2518-2(c)(2). For instance, A leaves x property to spouse B and also creates a trust for B (managed by B as Trustee) and Child C. A's powers as Trustee to distribute income or principal must be limited by an ascertainable standard.

c. The spousal exception produces some excellent estate planning opportunities. These are discussed in section IV. below.

III. The Qualified Disclaimer Special Rules

A. <u>What Can Be Disclaimed</u>? Section 2518(b) specifically requires that the disclaimer be irrevocable and unqualified. The term "unqualified" does not mean that all property must be disclaimed. A partial disclaimer is possible if the property or the interests are severable.

B. <u>Separate Parts</u>. The disclaimer regulations §25.2518-3(a)(1)(i) address the disclaimer of "property which can be divided into separate parts each of which, after severance, maintains a complete and independent existence."

C. <u>Fraction or Percentage</u>. Section 25.2518-3(b) defines an undivided interest as a fraction or percentage of each and every interest owned. Any disclaimer must extend over the entire interest of the disclaimant's property where a partial disclaimer is desired.

D. <u>Examples of Disclaimers of Less than Entire Interest</u>. Some examples of severable property and non-severable property which can or cannot be disclaimed are as follows:

1. An income interest and a remainder interest in the same trust are separate interests and either can be disclaimed. For example, E died September 13. E's will leaves E's stock into trust with income currently payable to F and G until F attains the age of 45 at which time the trust terminates with the trust assets being divided equally between F and G. F disclaims the income interest retaining the remainder interest in the corpus. G disclaimed the remainder interest in the corpus retaining the income interest. Both disclaimers are qualified. §25.2518-3(d), ex. (8).

2. Contrast the above with a non-trust bequest of a fee simple interest in real property to B. B disclaims the remainder interest but retains the life estate. This bequest is not qualified. A disclaimer of some specific rights (the remainder interest) while retaining the other rights (the life interest) is not a qualified disclaimer of an "undivided portion" of the disclaimant's interest in property. §25.2518-3(b).

3. A power of appointment is treated as a separate interest in property and may be disclaimed. §25.2518-3(a)(1)(iii). *See also*, PLR 20003023. For instance, a disclaiming party may disclaim a power of appointment retaining an income interest. §25.2518-3(d), ex. (21).

4. The disclaimer of a portion (percentage) of a general power of appointment over a trust leaving a right to appoint the remaining portion is specifically allowed. §25.2518-3(d), ex. (21).

5. A fractional interest in death benefits under a pension plan can be disclaimed. PLR 9016026.

6. The right to amend or revoke a trust can be disclaimed. PLR 9818008.

7. Fractional interests may be disclaimed. PLR 8326033 and 9016026. Fractional interests, including a fractional share formula similar to a marital deduction formula, may be disclaimed. PLR 8502084. §25-2518-3(b).

8. Pecuniary disclaimers are specifically allowed. §25.2518-3(c).

9. A trust beneficiary may <u>not</u> disclaim income from specific assets that remain in a trust. In order for such a disclaimer to be effective, it would require that the asset itself be removed from the trust and distributed to other beneficiaries. §25.2518-3(a)(2).

10. A portion of funds in a bank account can be disclaimed. PLR 8015014.

11. Fifty of 100 shares of stock, even though represented by a single stock certificate, can be disclaimed. §25.2518-3(a)(1)(ii).

12. A fractional interest in employee pension plan benefits can be disclaimed. PLR 9016026.

13. See *Estate of Christiansen v. Commissioner* at II.E. above.

E. <u>Disclaimers of Joint Property</u>.

1. <u>Joint Property</u>. Disclaimers of jointly held property changed substantially after AOD 1990-06 and final regulations which were issued in 1997. The disclaimer of jointly held property can best be summarized and understood by looking at joint tenancies that can be unilaterally severed and those that cannot and by dividing the property into types: (1) Bank, investment and brokerage accounts and (2) other assets.

2. <u>Bank, Brokerage and Investment Accounts</u>.

a. The case of a transfer of a joint bank, brokerage or investment accounts (e.g., an account held at a mutual fund or brokerage company) if the transferor may unilaterally regain the transferor's own contributions to the account without the consent of the other co-tenant, such that the transfer is not a completed gift, the transfer creating the survivor's interest in the decedent's share of the account occurs on the death of the deceased co-tenant. Accordingly, the surviving joint tenant in order to make a qualified disclaimer with respect to the funds contributed by the deceased co-tenant, must complete the disclaimer within nine months of the co-tenant's death. §25.2518-2(c)(4)(iii).

b. The surviving joint tenant may not disclaim any portion of the joint account attributable to consideration furnished by the surviving joint tenant. §25.2518-2(c)(4)(iii). This is the case even if only half of the funds in the account are included in the estate by reason of Section 2040(b).

3. <u>Other Property</u>.

a. With the exception of joint bank, brokerage and investment accounts referenced above which can be unilaterally regained, the surviving joint tenant may disclaim the one- half survivorship interest in all other property held in joint tenancy with right of survivorship within nine months of the date of the death of the first joint tenant to die. This is the rule regardless of whether the property can be unilaterally severed. The disclaimed interest is the one-half interest in the property, regardless of the property attributable to the consideration furnished by the disclaimant and the percentage of the property included in the gross estate under Section 2040. §25.2518-2(c)(4)(i).

b. With respect to the interest which the disclaimant receives upon the creation of the tenancy, the disclaimer must be made within nine months after the creation of the tenancy. §25.2518-2(c)(4)(i).

c. On February 1, 2000, A purchased real property with A's funds. Title to the property was conveyed to A and B as joint tenants with right of survivorship. Under applicable state law, the joint interest is unilaterally severable by either tenant. B dies on May 1, 2004, and is survived by A. A disclaims (within nine months) the one-half survivorship interest in the property to which A succeeds as a result of B's death. A has made a qualified disclaimer of the one-half survivorship interest but not the interest retained by A upon the creation of the tenancy. The result is the same whether or not A and B are married and regardless of the proportion of the consideration furnished by A and B in purchasing the property. §25.2518-2(c)(5), ex. (7). The result is the same even if the state law does not allow unilateral severance. §25.2518-2(c)(5), ex. (8).

F. IRA Rules.

1. Safe Harbor Rules.

a. A common problem in estates occurs where a decedent was required to take a minimum required distribution (MRD) from his IRA in the year of death but has not made the MRD withdrawal prior to death. To avoid penalty, the named beneficiary of the account must withdraw the MRD (or any remaining balance where the decedent made a partial withdrawal) before the end of the year. For instance, X dies October 1. X historically withdraws from his IRA the required MRD in December. The IRA is payable to spouse. Spouse only has three months to make the MRD withdrawal or face a penalty.

b. In the example above, by making the required MRD the spouse has "accepted" the MRD amount. One would assume that such acceptance of benefits prohibits a later disclaimer within the nine month period allowed by the statute.

c. In Rev. Rul. 2005-36, the IRS provides a safe harbor for disclaiming an IRA by stating that accepting the MRD in the year of death does not constitute acceptance of the entire account.

d. It should be noted that Rev. Rul. 2005-36 requires the IRA beneficiary who makes an MRD distribution to also take the income earned post-death on that portion of the IRA which makes up the MRD. This portion cannot be disclaimed.

2. Disclaiming an IRA. Disclaiming an IRA payable to a primary beneficiary (spouse) in order to cause benefits to be distributable to the Trustee of a trust and allow the required minimum distributions to be paid over the lifetime of the trust beneficiary is addressed in PLR 200522012.

3. Fixing the Beneficiary Designation. Where the beneficiary form on an IRA did not reflect the intentions of the IRA owner, the IRS allowed in PLR 200837046 state law to override the actual designation. Wife, Alice, had two sons. Wife established an IRA naming husband as primary beneficiary and son A as contingent beneficiary. Wife failed to name Son B as contingent beneficiary along with Son A. Wife divorced spouse. Wife executed a Will establishing a trust for sons with provisions consistent with paying the IRA into the trust. Alice was advised by her estate planning attorney to change the beneficiary. She did not do so. Spouse did not inherit because state law terminated his rights by reason of the divorce. Son A disclaimed a one-half interest in the IRA and any interest in the IRA passing into the trust for his benefit. That portion of the IRA thus passed into the trust for the benefit of Son B. Interestingly enough, the IRS relies heavily on state law in approving the end result even though it previously ignored state law in a prior ruling. *See*, PLR 200742026.

G. Community Property Rules.

In the case of a community property state where husband and wife take title to real property as community property and not as joint tenants with right of survivorship, upon the death of the husband, wife can disclaim that portion of the property which is husband's share of the community property but she cannot disclaim her share originally acquired years earlier. §25.2518-2(c)(5), ex. 11; PLR 9507017.

IV. Planning for Disclaimers

A. The Disclaimer Trust. Section 2518(b)(4)(A) provides a unique opportunity when planning an estate to specifically plan for the utilization of a disclaimer during this period of uncertainty as to the amount that will pass tax free for federal estate tax purposes and amount that will or should pass into a credit shelter type trust. Remember that rules which limit a disclaimer which results in the property passing to or for the benefit of the disclaimed party do not apply to the spouse.

1. Example. Consider the husband and wife with a collective estate of $3 million. The value of the estate is less than the current exemption equivalent in 2009 ($3.5 million). The value is less than the exemption which will be in effect in the future. No tax planning is needed today for federal estate tax purposes. What if the estate tax should be eliminated? What if the exemption returned to $1 million?

a. There are several uncertainties with respect to this estate.

i. The first uncertainty is when will death of each spouse occur.

ii. The second uncertainty is the value of the assets in the estate at death; either now or in the future.

iii. The third uncertainty is Congress and the law. What will they do?

iv. Do state inheritance taxes (if any) play a role?

b. This produces a unique problem for the estate planner. We must know when the clients will die, what their assets will be worth at that time, and what the law will be in that year. Only through large quantities of alcohol can we possibly know the answers to these questions.

2. Funding of Disclaimer Credit Shelter Type Trust. A disclaimer trust established under §2518(b)(4)(A) offers a unique opportunity to the surviving spouse to fund a credit shelter type trust at death or not fund it, depending on the law and other circumstances that exist at the first death. If the assets are valued at $3 million at the time of death and if the exemption is $1 million, the surviving spouse might disclaim $1 million or more into the disclaimer trust which operates

much like a credit shelter trust. If the exemption is $3.5 million at the death of the spouse or if the estate tax has been repealed, such a disclaimer is unnecessary.

3. Problems with the Spousal Disclaimer Trust.

a. For this technique to work, the spouse must make the disclaimer. There is a hesitancy to disclaim assets that are payable outright to the spouse. The bird in the hand is much more attractive than the bird in the trust. For disclaimer planning to work, the spouse must make a timely and correct decision.

b. Unfortunately, family and friends all become tax experts at death. More than one needed disclaimer never materialized at death because family and friends warned the spouse not to give up control of the assets.

c. A disclaimer trust is not feasible where the spouse has no incentive to make the disclaimer. For instance, if the spouse is not the mother of the children who will inherit, the spouse will not likely disclaim and give up control of the assets and the right to redirect the assets as he/she might later desire. When given the choice between leaving assets to those we wish to receive them and pay taxes vs. leaving the assets to those who we do not wish to receive the assets tax free, tax considerations will no longer be a factor.

d. Flexibility can be built into a planned credit shelter type trust which cannot be put in the disclaimer trust. This includes giving the spouse a limited *inter vivos* or testamentary power of appointment to alter the ultimate distribution of the trust assets (e.g., shifting assets between children, delaying or accelerating distribution of the trust assets, or bypassing children in favor of grandchildren). In the case of the disclaimer trust, because the spouse cannot retain the right to control or modify the ultimate benefit and enjoyment of the disclaimed assets, care must be taken in structuring the disclaimer trust to take into account all potential changes in family circumstances. No limited power of appointment can be built into the disclaimer trust. The spouse cannot have the right, as Trustee or otherwise, to direct the income or principal of the trust to family members unless the power is limited by an ascertainable standard. §25.2518-2(e)(2).

B. Other Disclaimers. There are a number of other reasons why we might plan or utilize disclaimers. They are as follows:

1. Killing a Trust. Disclaimers can be used to eliminate a trust. For instance, if the beneficiary entitled to receive all income for life disclaims the interest, the remainder interest in the trust is accelerated which will result in the trust being distributed to the remainder beneficiaries where the trust provisions called for termination following the death of a life tenant. *See*, PLR 8402121, TAM 8851002 and 8804004.

2. Adjusting Shares. An equal division of assets between children may be desirable, but in the case of one child who is extremely wealthy, the normal disclaimer process which would result in the disclaiming child's share passing to his/her children might not be the desired result. Providing in the document that if Child A disclaims, the assets pass to Child A's siblings gives the parent the ability to defer in favor of the wealthy child a decision as to whether the parents' wills might properly not divide the estate equally but, rather, leave the estate to the children with fewer assets. *See*, Beans, "Connecticut Disclaimers," 2 Conn. Probate Law Journal 47 (1986).

3. Increasing the Marital Deduction. Perhaps the first place where disclaimers are found to be attractive is to preserve the marital deduction that would otherwise be lost.

Where the decedent died without a will, leaving property by intestacy equally to a spouse and two children, a disclaimer by the children of all or a portion of their intestate share might cause the assets to be distributable to the spouse by intestacy. This will increase the marital deduction for larger estates and provide necessary assets for the spouse in smaller estates. Note grandchildren would be required to disclaim, too. A disclaimer by a minor might not be possible. Court approval might not be granted. *See*, PLR 8409089, 8514095, 8729008 and 9301005. *See also*, TAM 8701001 and 8926001.

4. Decreasing the Marital Deduction. In the case of a simple will which leaves all assets to the surviving spouse, a disclaimer by the

spouse of an amount up to the exemption equivalent will operate to reduce second death tax.

5. Common Disasters. In the case of a common disaster or where there is a relative short period of time between the deaths, the proper utilization of disclaimers may minimize overall estate and inheritance taxes or maximize GST elections. *See*, PLR 8749041 and *Accord Estate v. Comm'r*, 93 T.C. 1 (1989).

6. Fixing Malpractice.

   a. In the case of a defective QTIP trust, such as a QTIP trust containing a limited *inter vivos* power of appointment, the effective use of a disclaimer of that power saves the marital deduction when it would otherwise be lost.

   b. In the case of a defective credit shelter trust such as a trust that includes a general power of appointment, the disclaimer of the "power" protects the trust assets from taxation at the death of the surviving spouse. PLR 8603030.

   c. In the case of a marital trust containing provisions for a beneficiary other than the spouse, proper use of disclaimers saved the marital deduction and the drafting attorney as well. PLR 8337069.

7. Buying Peace in the Family.

   a. In PLR 8908022, the decedent left the entire estate to one sibling to the exclusion of the other siblings. Through the proper use of disclaimers, the sibling caused the entire estate to be shared by all siblings without gift tax consequences.

   b. In PLR 8702024, the decedent's sister was named the sole beneficiary of a life insurance policy. Proper use of disclaimers resulted in the insurance proceeds being distributed to the decedent's daughter.

8. Shifting Tax Burdens. A disclaimer of the benefits provided under a tax apportionment paragraph (§2207A) was declared to be a qualified disclaimer. PLR 200127007.

9. The Oops Child. In PLR 20028020, the decedent's spouse and two children and other family members gave disclaimers in order to protect the interest of a third (pretermitted) child not included as a remainder beneficiary of a marital and residuary trust.

10. If It Glows in the Dark. Consider a disclaimer by a beneficiary and/or fiduciaries where property may be environmentally hazardous. *See*, Vaughn, "Environmental Dangers to Fiduciaries," 16 ACTEC Notes 77 (1990).

11. Fixing Old Wills. Consider an old will with a 50% marital deduction clause and a residuary trust for the benefit of the spouse but with powers (limited *inter vivos* powers) or provisions (for children) which make a QTIP election of the residuary trust impossible. Disclaimers may allow you to fix the problem. *See*, PLR 8637044, 8704023, 0906036 and TAM 8546007, 9003007, 9247002. *See also*, *Lassiter Estate v. Comm'r*, T.C. Memo 2000-324.

12. Defective Charitable Trusts. A defective charitable trust (not a CRUT or CRAT) established for a beneficiary for life with a remainder to charity may be saved through disclaimers coupled with reformations of the trust. *See, e.g.*, PLR 9004011, 9532026 and 200010019.

13. One to Think About. In the case of the death of husband and wife within a short period, a disclaimer may be used to not only decrease the taxable estate of the survivor but also to increase the credit for tax on prior transfers. This is an unexpected benefit because the value of the income rights to the nontaxed portion of the credit shelter trust in the estate of the second spouse to die is taken into account in the computation of the credit based on the actuarial value of the life estate. TAM 8512004. This will not work where the deaths are simultaneous. *See*, *Carter Estate v. U.S.*, 921 F.2d 63 (5th Cir. 1991).

14. Poor Planning. Consider a case of poor planning. Husband's estate was $4.5 million. Wife's estate was $10 million. Husband prepared a will which left all assets to the two daughters thinking that Wife's sizeable estate would be sufficient to provide for her. At his death in 2009, the daughters learned that the total federal estate tax on the $3 million bequest was $450,000, leaving $4,050,000 for the daughters. The daughters and their adult children (there were no minor

descendents to complicate the disclaimer) disclaimed $1 million. Thus, the daughters received $3.5 million free of federal estate tax. The mother took the $1 million balance of the estate by intestacy (the daughters and their issue disclaimed their intestate shares as well) thereby qualifying for the marital deduction and producing no first death federal tax liability. Sometime after the disclaimers were completed, the mother then made a gift (Surprise!) to the daughters of $1 million using her entire federal exemption equivalent. The daughters received the entire $4.5 million federal tax free. The mother's net worth was not affected. Everyone was happy. Taxes can be paid later.

15. More Poor Planning. The preceding example operates equally as well in a situation where the estate is larger and the gift is larger. Consider the following:

Assume the same facts above except Husband dies in 2009 leaving a $5 million estate to the daughters. The death tax would have been $675,000 leaving the daughters with $4,325,000. The daughters disclaim $1.5 million which passes to the spouse and qualifies for the marital deduction. Sometime after the disclaimer is complete, the spouse gives $1,353,000 to the daughters using the $1 million gift exemption and leaving $353,000 subject to gift tax. The federal gift tax is $147,000. Thus, the total tax consequence has been reduced by $528,000 to the benefit of the daughters without any direct monetary detriment to the mother.

16. Poor Execution. One problem with a disclaimer is a failure to appreciate the full impact of the disclaimer. Consider the following:

Dad dies in 2009 leaving an estate of $7 million to wife. Wife has sufficient assets and desires to disclaim $3.5 million. It is counsel's belief that this will qualify for the exemption and there will be no taxes resulting from the transfer to the daughters.

It is learned after death and after the disclaimer is made that Dad made a few taxable gifts in his lifetime, specifically, $200,000. The additional tax due as a result of the disclaimer is about $90,000. Wrong. The additional tax due is actually about $170,000. The tax provisions in the will provide for the payment of all taxes before the distribution of the residue to the spouse. Thus, the taxes come out of the share distributable to the spouse. This reduces the marital deduction and therefore further increases the taxes through an interrelated calculation.

17. Falling Markets. Consider the recent stock market. Jack dies in mid-2008 with an estate of $8 million made up mostly of S & P 500 stock. By January of 2009 (the alternate valuation date), the stock is down and the estate is worth $5.8 million. The Will has a pecuniary marital deduction ($6 million) with a credit shelter residue. Thus, if the trust is funded today, nothing goes into the credit shelter trust. What to do? What about an alternate valuation election with a disclaimer? The spouse disclaims a percentage of the marital share based on date of death values large enough to generate a taxable estate as of the date of death of $4.2 million which would produce $990,000 in tax due. This would leave the marital deduction at $3.8 million. The pecuniary marital deduction is funded leaving $2 million to pass into the credit shelter trust. *See,* "Dawkins, Another Bite of the Apple: Using the Alternative Valuation Election to Restore a Credit Shelter Trust," *Probate and Property*, January/February 2002.

C. Miscellaneous Disclaimer Issues.

1. Tax Liabilities. Avoiding the IRS through a disclaimer will not work. *See*, *Drye v. U.S.* 528 U.S. 49 (1999), *aff'g,* 152 Fed. 3rd 892 (8th Cir. 1998).

2. Creditors. There is a split of authority as to whether a disclaimer can be used to avoid creditors with many states holding that such is an act to defraud creditors. *See, e.g., Stein v. Brown*, 480 N.E.2d 1121 (Ohio 1985) citing California decision, *In Re. Kalt's Estate* 16 Cal 2^{nd} 807, 108 P.2d 401 (1940), which was subsequently overruled by statute (Cal. Prob. Code Sec. 283). *See also*, *Hoesley v. State*, 243 Neb. 304, 498 N.W.2d 571 (1993). *See*, Oklahoma Statutes Title 84, Chapter 1, Section 27.

a. Alabama Code § 43-8-295(a) renders a disclaimer ineffective to protect the disclaimant's creditors. *See*, *Pennington v. Bingham*, 512 So.2d 1344 (Ala. 1987).

b. Although there is no Georgia statute, *Jordan v. Trower*, 431 S.E.2d 160, 162 (1993) appears to protect creditors.

c. Fla. Stat. §§ 732.801(6)(a) and 689.21(b) invalidates a disclaimer if the disclaimant is insolvent.

d. Mississippi Code Annotated § 89-21-11 protects a secured creditor but not an unsecured creditor.

e. Missouri Revised Statutes state that a disclaimer is not subject to the claims of any creditor. §469.010. However, as to intestate disclaimers, common law may make them not valid as to creditors. *See*, *Bostian v. Milens*, 193 S.W.2d 797 (1946) and *Sanders v. Jones*, 147 S.W.2d 424.

f. New Jersey statutes §§ 3B:9-9(e) and 46:2E-9 make a disclaimer ineffective if "in fraud of creditors."

g. Virginia has no statute. However, see *Abbott v. Willey*, 479 S.E.2d 578 (1977) which permitted a disclaimer to avoid creditors.

3. Medicaid Planning. Questions are continually raised as to the effect of the disclaimer with respect to Medicaid planning, specifically the five-year disqualification provisions under the law for transfers by an individual who seeks to qualify for Medicaid benefits. If a disclaimer is not a "transfer," then surely a disclaimer will protect disclaimed assets from being taken into consideration as though they were transferred by the Medicaid recipient. Wrong. 42 U.S.C. 1396p(e) provides that the term "assets" used to determine income and resources of an individual or the individual's spouse includes any income or resources which the individual "is entitled to but does not receive because of action by any person, including any court or administrative body, acting at the direction or upon the request of the individual or such individual's spouse." In administering the Medicaid statute, most state governments take the position that a disclaimer constitutes an "action" and that for Medicaid purposes, a disclaimer is a transfer. Note the distinction between a disclaimer which requires an action and a refusal to take an elective share which is a non-action. Using a disclaimer trust might be beneficial in an uncertain world with respect to Medicaid planning. Might a spouse disclaim into a trust which is specifically designed by the deceased spouse for the purpose of protecting assets should the surviving spouse end up in a nursing home and need to qualify for Medicaid benefits? The answer is probably no. *See, Tannler v.*

State Department of Health, 557 N.W.2d 434 (CA9) and *Estate of Heater*, 640 N.W.2d 654 (Ill. App. 9).

4. Shifting of the Malpractice Burden. Note that knowledge of disclaimer rights gives the estate attorney the ability to correct malpractice by the original estate planner. Might the estate attorney become responsible for failing to find ways to correct problems created by the drafting attorney?

5. Do Not Assume. In disclaiming assets which pass by contract, do not assume that you know the proper disposition under the contingent paragraphs in the document. Demand copies of beneficiary designations before making such disclaimers. Consider the example of a proposed disclaimer where the attorney was advised verbally that there was no secondary beneficiary on a life insurance policy thereby causing the assets disclaimed by the primary beneficiary to pass to the estate of the deceased. After the disclaimer is made, it is actually discovered that there was a secondary beneficiary and the secondary beneficiary was not the desired recipient of the disclaimed property.

6. A Final Thought. No review of disclaimers is complete without a warning that state law may impact the disclaimer in unexpected and disastrous ways. The most important issue to be determined is who gets the disclaimed property. Understanding whether the disclaimed property passes under provisions of the will or beneficiary designation or by intestacy is crucial to an effective disclaimer.

H:\smcdaniel\OUTLINES\DISCLAIMER OUTLINES\STS 09 POST MORTEM PLANNING.doc

Chapter Two
Income Tax Elections

I. Determining the Tax Year End vs. Fiscal Year End

A. Estate/Trust Fiscal Year End. The due date for the fiduciary income tax return (Form 1041) is the 15^{th} day of the 4^{th} month following the close of the tax year, except for deadlines on Saturday, Sunday or Holiday's, IRC § 6072, Reg. 1.6072-1(b). Estates may select any tax year-end up to and ending with the eleventh month after the month of death. Example: D's death occurred June 15, 2006. The longest month end tax deferral would end the fiscal year on May 30, 2007. If the fiscal tax year is to end on May 30, 2007, the Form 1041 is due by September 15, 2007. All trusts must use the calendar year-end, IRC § 1640, unless an election on Form 8855 is made before the due date for the Form 1041.

B. Failure to File the Form 1041 by the Due Date. If a fiscal year is to be chosen the Form 1041 must be filed timely. If the Form 1041 is not timely filed, the position of the IRS is that the tax year end for the estate/trust will be a calendar year end.

Example: A date of death of June 15, 2006 with a desired fiscal year end of May 30, 2007 would require the Form 1041 to be filed on or before September 15, 2007. If the 1041 is filed later than September 15, 2007, then it is the position of the IRS that the estate/trust automatically elected a calendar year end and a tax return will be due for the period June 15, 2006 – December 31, 2006 (this return should have been filed by April 15, 2007.)

C. Factors to be Considered.

1. Expected duration of the estate.

2. Timing of income and deductions.

3. Convenience of Executor or tax preparer.

II. When Should a Fiduciary File a Form 1041? A fiduciary must file Form 1041 if:

A. The trust (other than a 501(a) exempt trust) has any taxable income for the tax year.

B. The estate has gross income of $600 or more for the tax year or has taxable income.

C. A beneficiary of the estate/trust is a non-resident alien.

D. An individual's bankruptcy estate under Ch. 7 or Ch. 11 has income in excess of the personal exemption and standard deduction, IRC § 6012.

E. The goal is to pass through excess deductions in year of termination or allocate estimated tax payments to the beneficiaries of an estate in final tax year.

F. The goal is to file a tax return with the IRS to report no income under entity number for information purposes.

III. Extending the Time to File a Tax Year End for the Estate/Trust – Form 7004

A. <u>Form 7004.</u>

Form 7004 (Application for Automatic 6 Month Extension of Time to File Certain Business Income Tax, Information and Other Returns) on or before the due date for the filing of the first tax year end. This is a NEW FORM beginning in 2006.

1. <u>Purpose of Form 7004</u>. Apply for the automatic six (6) month extension of time to file the return.

2. <u>Pay the estimated tax with the extension by the due date for filing Form 1041</u>. An extension to file the tax return grants extra time to file the Form 1041 but <u>not</u> to post-pone the payment of the taxes due.

3. <u>No blanket requests</u>. Each entity requesting an extension to file must file a separate Form 7004.

4. <u>Due Date for Form 7004</u>. File on or before the due date for the tax return.

5. Where to File for Extension:

   a. Electronic filing allowed starting with tax year 2005 – www.irs.gov/efile - check on efile for tax professionals.

   b. By Mail (1041) – Depends upon decedent's/trust/ residence/situs. Tennessee, Mississippi, Arkansas, Mississippi, Alabama, Georgia, Florida and Louisiana address is: IRS, Ogden, Utah 84201-0045.

6. Extension Due Date. Automatically gives the estate/trust six (6) months from the original due date of the Form 1041.

7. Keep a copy for your files. Recommend certified mail return receipt requested if mailed – date stamped at the post office.

B. Preparation of Form 7004.

1. Enter the name exactly as reported on the last tax return or SS-4.

2. Choose correct code for entity:

   (04) – Estate
   (05) –Trust

3. If Form 7004 is for short tax year indicate reason:

   Initial Return
   Final Return

IV. Election to Treat a Qualified Revocable Trust as part of an Estate -- Form 8855

A. Purpose of Form. Purpose of Form is for Trustees of a Qualified Revocable Trust and the Executor of related estate, if any, to make a IRC § 645 election. This election allows a Qualified Revocable Trust (QRT) to be treated and taxed as part of the decedent's estate during the election period.

1. Qualified Revocable Trust. Qualified Revocable Trust means any trust (or portion) which is treated under IRC § 676 as owned by the decedent of the estate by reason of a power to revoke in the decedent Grantor.

2. Decedent's Power to Revoke. Under IRC § 676 the Grantor is treated as the owner of any portion of a trust where at any time the

power to revest in the Grantor title to such property is exercisable by the Grantor or a non-adverse party or both.

3. <u>Executor</u>. The Executor is an Executor, Administrator or Personal Representative that has been granted letters of appointment to administer decedent's estate through formal or informal appointment. This does <u>not</u> include a person with actual or construction possession of decedent's property.

4. <u>Ancillary Administration</u>. Only the primary or domiciliary proceeding is the Executor for this election.

5. <u>Related Estate</u>. A related estate is the estate of the decedent who was treated as the owner of the QRT on decedent's date of death.

6. <u>Filing Trustee</u>. The Filing Trustee is the Trustee of an electing trust who, when there is no Executor, is appointed by the Trustees of all other electing trusts to file forms 1041 for the combined electing trusts. If there is no Executor and there is only one (1) QRT making the 645 election, the Trustee of the electing trust is the filing Trustee. The trust for which the filing Trustee files is the filing trust.

7. <u>Filing Trust</u>. The Filing Trust an electing trust whose Trustee was appointed as the filing Trustee by all electing trusts if no Executor.

8. <u>Electing Trust</u>. An Electing Trust is a "QRT" for which a valid 645 election has been made. Election is valid throughout the entire election period.

9. <u>Election Period</u>. Is the period of time during which the electing trust is treated and taxed as part of the related estate. The electing trust can file fiscal year end returns, the same as decedent's estate instead of a calendar year end. The election period begins on decedent's date of death and terminates on the earlier of:

   a. The day the electing trust and estate, if any, have distributed all its assets; or

   b. The day before the "applicable date."

10. <u>Applicable Date</u>. If a Form 706 is required to be filed then it is the later of:

   a. Two (2) years after the decedent's date of death; or

b. Six (6) months after the final determination of liability or estate tax.

11. When to File. File Form 8855 by the due date for the Form 1041 (including Extensions) for the first tax year of the related estate or filing trust. This form must be filed even if there is not sufficient income to warrant the filing of a Form 1041. When there is no Executor, treat the filing trust as an estate for purpose of determining the tax year.

12. Extension. If the estate/trust files on Extension Form 7004, an extension to file Form 8855 is also granted.

13. Where to File. Alabama, Florida, Georgia, Missouri, Louisiana, Tennessee, Arkansas and Mississippi estates/trust: Mail Form 8855 to: IRS Center, Ogden, UT 84201.

14. Who Must Sign. If there are Co-Executors or Co-Trustees only one (1) Executor and one (1) Trustee must sign on behalf of the entity unless required by applicable local law or the governing document. If there is more than one (1) electing trust, each trust must sign election.

15. Copy. Keep a copy of Form 8855. Recommend mailing certified mail return receipt requested, date stamped by post office.

16. Benefit of Form 8855. During the election period, all electing trusts and the related estate, if any, file one (1) combined income tax return. They are treated as one (1) estate. For example, the electing trusts can be treated as part of decedent's estate for adopting the tax year end and for determining whether estimated tax payments are required.

17. Executor Appointed After Filing Form 8855. An amended election must be made within 90 days of appointing the Executor. Write "Amended" at the top of Form 8855. A failure to file an amended Form 8855 terminates the election period the day before the Executor is appointed.

B. Completing Form 8855.

1. Part I. The Executor, or if none, the filing Trustee attests to making the § 645 election and the conditions for a valid election. The entity making the election must have a valid EIN to complete this form.

2. Part II. Completed by the Executor or filing Trustee if no Executor.

3. Part III. The Trustees of all QRT joining in the election complete this section.

V. Administrative Expenses – Estate Tax vs. Income Tax.

A. Administrative expenses and casualty and theft losses are deductible for federal estate tax purposes on the Form 706 under §§2053 or 2054. In the case of an estate which is under the amount required in order to produce actual federal estate tax liabilities or in the case where, because of the Marital Deduction or Charitable Deduction, no federal estate tax liability exists, it may be better to consider deducting such expenses against income on the fiduciary income tax return filed for the estate utilizing Form 1041.

B. If an election is made to deduct administrative or casualty losses for income tax purposes rather than estate tax purposes, the fiduciary must file a statement (in duplicate) under §642(g) waiving the right to deduct the expenses or loss on Form 706. The statement must be timely filed.

C. An example of expenses qualifying for a deduction on either Form 706 or Form 1041 would be attorney fees, accountant fees, court costs, appraisal fees, etc. Funeral expenses, properly deducted on Form 706 may not be deducted on the 1041.

D. An example of the form utilized to be filed with the timely filed 1041 (in duplicate) follows at the end of this chapter.

E. It is foolish (no, just plain stupid) to claim deductions for administrative expenses on a federal estate tax return which cannot result in any actual tax liability when those same deductions can be used to reduce taxable income to the estate.

F. In the case of a taxable estate, it is important under “Hubert” Regulations § 2056(b) for you to differentiate between estate “management” expenses and “transmission” expenses.

VI. Sample 642(g) Notice

Tax Year Ending ______________________________

Taxpayer ID Number___________________________

Estate of ________________________________

Address: ________________________________

____

ELECTION TO WAIVE THE RIGHT TO CLAIM ADMINISTRATION EXPENSES (OR THEFT OR CASUALTY LOSSES) ON FORM 706

Pursuant to IRC Section 642(g) and Regulation 1.642(g)-1, the taxpayer elects to deduct the following expenses on Form 1041 for the year ended _________. These expenses have not been claimed under IRC Section 2053 or 2054 on Form 706; and further, the taxpayer hereby waives the right to deduct the expenses at any time for estate tax purposes under IRC Section 2053 or 2054.

Description	Amount
	$
	$
	$
	$
	$
Total	$

Signed:___________________________, Executor
Date: ___________________________

FILE IN DUPLICATE

VII. The 2% Rule

For the last several years, the IRS has continued its attack on trust administrative expense deductions under § 67. Specifically, the battle relates to whether such expenses are fully deductible or are only deductible to the extent they exceed 2% of income. Some history is in order.

A. *O'Neil.*

In *O'Neil Irrevocable Trust v. Comm'r*, 98 T.C. 227, (1992) rev'd, 994 F.2d 302 (6th Cir. 1993), nonacq., the trial court stated that only costs "unique" to an estate or trust can be deducted from gross income without regard to the 2% floor and that investment advisor fees were not "unique.

"Unique" items included "fees paid to the Trustee and trust accounting fees mandated by law or the Trust." The Court of Appeals noted that the Trustee would be liable to beneficiaries for failure to meet the prudent investor duties and found such fees were unique and the 2% Rule did not apply.

B. *Scott*.

In *Scott v. U.S.*, 186 F.Supp.2d 664 (E.D. Va. 2002) Aff'd, 328 F.2d 132 (4th Cir.), under a very similar set of facts to *O'Neil*, the Court noted that under Virginia law the Trustee had immunity from liability as long as the Trustee selected investments from a legalist and thus employing an investment advisor was not "unique." Any investor might do the same.

C. *Mellon*.

In *Mellon Bank v. U.S.*, 2000-2 U.S. Tax Ct. (CCH), ¶ 50,642, Aff'd, 265 F.3d 1275 (2001), the Court of Claims suggested a case by case determination of whether the expenses would or would not have been incurred if no trust existed. The *Mellon* lower court wanted Trustees to "unbundle" fees. The Court of Appeals said that all Trustee fees are deductible but that only those fees that would not have been incurred had there been no trust should be fully deductible. For example, investment advisor/management fees are not unique to a trust and are subject to the 2% Rule. It should be noted that *Mellon* resulted not from an audit but from a claim for a refund based on *O'Neil*.

D. Proposed Regs. -- § 1.67-4.

Issued July 2007 provide that only "unique" expenses are exempt from the § 67 2% Rule. Unique items include: fiduciary accountings, judicial or quasi-judicial filings, fiduciary income tax returns, estate tax returns, Will/Trust construction/contest matters, bonds and communicating to beneficiaries regarding trust/estate matters.

E. *Rudkin*.

1. In *Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 149 (2d Cir. 2006), now *Knight v. Comm'r*, 502 U.S. _______________ (2008), the Court did not adopt the unbundling requirement but does generally follows *Scott* and *Mellon*. It refers to costs that "could" not be incurred if the property were held individually as being not subject to the 2% Rule; thus substituting "could" for "would." The U.S. Supreme Court resolved the issue in a unanimous decision ruling that investment advisory fees are subject to the 2% floor. Trustees may need to unbundle their fees.

2. The Court stated:

> In applying the statute, the Court of Appeals below asked whether the cost at issue *could* have been incurred by an individual. This approach flies in the face of the statutory language. The provision at issue asks whether the costs "would not have been incurred if the property were not held" in trust, *ibid.*, not, as the Court of Appeals would have it, whether the costs "could not have been incurred" in such a case, 467 F. 3d, at 156. The fact that an individual could not do something is one reason he would not, but not the only possible reason. If Congress had intended the Court of Appeals' reading, it easily could have replaced "would" in the statute with "could," and presumably would have. The fact that it did not adopt this readily available and apparent alternative strongly supports rejecting the Court of Appeals' reading.

3. The Court left open deductions for unique objectives or special charges applicable only to fiduciary accounts. There is more to come.

F. *Notice 2008-32.*

This Notice provides guidance regarding the treatment of "bundled" fees that are grouped together as one fee paid by a Trustee or Executor as follows:

1. The Notice applies to tax years beginning January 1, 2008.

2. For prior years, the entire bundled fee is deductible without regard to the 2% floor.

3. Payments to third parties such as advisory fees readily identifiable must be treated separately from bundled fees and are subject to the 2% floor.

VIII. Liability for a Decedent's Income and Gift Taxes

A. Section 6905 of the Code provides that in the case of income or gift taxes of the decedent (the final return or any gift tax returns for the decedent filed by the Executor), if the Executor makes written application (filed after the return with respect to such taxes is made) for release from personal liability of such taxes, the IRS may notify the Executor of the amount of such taxes. Upon payment of the amount of taxes, or nine (9) months after receipt of the application if no notification is made by the IRS before such date, the Executor shall be discharged from personal liability with respect to any deficiency in the tax thereafter found to be due.

B. Section 6501(d) provides that where a return is required in the case of a decedent, whether the decedent's final return or a fiduciary return for the estate, upon written request by the Executor or other fiduciary representing the decedent or the estate, an assessment of tax must be made by the IRS within eighteen (18) months after the written request. This effectively shortens the statute of limitations for the examination of returns of a decedent from the normal three (3) year statute to eighteen (18) months.

IX. Decedent's Medical Expenses

A. Medical expenses of the decedent which are paid by the estate within one year after death will be deducted on the decedent's personal income tax return for the year in which they were incurred. This is apparently true for years prior to the year of death if the statutory period for amending the return is still open. Section 213(d).

B. Consistent with the election for certain administrative expenses, the Executor must file a statement agreeing that the expenses have not been and will not be claimed on the 706. The election is not required to be made for all such expenses and the Executor can claim some on the decedent's 1040 and some on the 706.

C. The general rule should be that the deductions should be claimed on the tax return which produces the best taxable result. Thus, in a nontaxable estate, the medical expenses should be claimed on the decedent's 1040.

X. Accrued Interest on Savings Bonds

A. Most individuals do not report accrued interest on government savings bonds (Series E, EE, H or HH) each year they wait until the bond is cashed to report the income all at once. This results in substantial untaxed bond interest at the time of death.

B. The estate of the decedent can elect to report all of the accrued interest on the decedent's final 1040. This avoids taxing the accrued interest when the bonds are cashed by the estate or the estate beneficiaries.

C. Note that paying the interest on the decedent' final income tax return will increase the decedent's income tax liability for the year which may serve as a valuable deduction on the 706.

D. Note that government bond accrued interest is IRD under §691(a). A deduction may be available for income taxes paid on IRD items.

XI. Joint Return with Spouse

A. Section 6013(a)(2) allows for the filing of a joint tax return by the decedent's estate and the surviving spouse who does not remarry before the end of the taxable year. This section is not applicable to non-resident alien spouses and spouses with different tax years.

B. It is suggested that the tax in the year of death should be calculated showing both a joint return and separate returns in order to determine the most favorable tax result.

C. It may be necessary to allocate the tax between the estate and the surviving spouse. Note that to insure the decedent's portion of the tax liability in the year of death is deductible on the 706, the Executor should determine the relative amounts due from the decedent and the surviving spouse based on a formula in Regulation §20.2053-6(f).

Chapter Three
Federal Estate Tax Return Elections

I. Alternate Valuation Election – Section 2032

A. Purpose of Election.

In general, § 2032 provides for the valuation of a decedent's gross estate at a date other than the date of the decedent's death. Specifically, if the Executor elects, the alternate valuation method under § 2032, the property included in the decedent's gross estate on the date of death is valued as of the date six (6) months after the date of the decedent's death. Thus, in the case of an estate with substantial stocks, if the stock market falls between the date of death and the date six (6) months thereafter, the election allows the estate to be taxed at the lesser alternate valuation date. Section 20.2032-1(a).

B. How the Election Works.

1. The election applies to all estate property. You do not pick and choose which assets you wish to value on the date of death and which assets you wish to value six (6) months thereafter.

2. In the case of property distributed, sold, exchanged, or otherwise disposed of within six (6) months after the decedent's death, such property shall be valued as of the date of distribution, sale, exchange, or other disposition. Section 2032(a)(1). Thus, if the alternate valuation date as elected, that property remaining in the estate six (6) months after the date of death is valued on that date. Property distributed, sold, exchanged or disposed of is valued as of that applicable date.

C. Special Rules.

1. The election must decrease the gross estate and the estate tax. No election can be made to increase the gross estate (thereby increasing the step up in basis under § 1014) nor can the election be made if there is no tax paid. Section 2032(c).

2. Once the election is made, it is final. Section 2032(d)(1).

3. No election may be made if the return is filed more than one (1) year after the due date (including extensions). Section 2032(d)(2).

D. How to Make the Election.

The election is made by checking the box for question 1 in Part 3 of the federal estate tax return (Form 706). Once you check the box and file the return, you have made the election.

II. Special Use Valuation Election – Section 2032A

A. Purpose of Election. The purpose of this election is to allow the estate to value certain farm and business property at its "use value" as opposed to its fair market value.

B. How the Election Works.

1. Qualified Real Property. Section 2032 allows certain "qualified real property" passing from the decedent to a "qualified heir" to be valued using its use value if:

   a. 50% or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, and was acquired from or passed from the decedent to a qualified heir of the decedent, and

   b. 25% or more of the adjusted value of the gross estate consists of the adjusted value of the real property which meets the requirements of the statute, and

   c. During the eight (8) year period ending on the date of the decedent's death there have been periods aggregating five (5) years or more during which such real property was owned by the decedent or a member of the decedent's family and used for a qualified use by the decedent or a member of the decedent's family and there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business.

2. Qualified Use. The term "qualified use" means that the property was used as a farm for farming purposes or used in a trade or business other than farming.

3. Qualified Heirs. Qualified heirs generally mean a member of the decedent's family who acquires an interest in the property from the decedent. Qualified heirs must be an ancestor, a spouse, a lineal

descendant of the decedent or the decedent's spouse or of a parent of the decedent or a spouse of any lineal decedent, ancestor or descendant of the decedent.

4. Active Management. In order to qualify for the election, the decedent (unless exempted by reason of age or disability) or an eligible qualified heir must have materially participated in the farm or business and following the election the qualified heir must continue to materially participate. Material participation by the decedent and family members is crucial to securing and maintaining the election.

C. Recapture of Tax. Once the election is made, the farm or family business must continue to be run by qualified heirs who materially participate for ten (10) years. Otherwise, the tax saved will be recaptured.

D. Valuation Method. The valuation method used with respect to most elections (family farms) is determined by first ascertaining the average annual gross cash rental for comparable land used for farming purposes located in the locality of such farm, less the average annual state and local real estate taxes applicable to the real property and dividing same by the average annual effective interest rate for all new federal land bank loans. Averages are determined using the five most recent calendar years ending before the date of the decedent's death.

E. Maximum Benefit. The maximum benefit to the estate, that is, the reduction in the fair market value of the real property qualifying for special use valuation, is set under the Code at $750,000 (§2032A(a)(2)). However, since 1998, the amount has been indexed for inflation. The 2008 maximum benefit is $960,000.

F. How to Make the Election. The first step in making the election is to check the box for question 2 in Part 3 of the estate tax return (Form 706). Next, Schedule A-1 of the 706 must be completed. The qualified real estate should be identified by a notation of §2032(A) valuation on the applicable property schedule. Last, the Executor must complete Parts 1 through 3 of Schedule A-1. The qualified heirs (generally members of the decedent's family) all must sign an irrevocable agreement consenting to the imposition of the recaptured tax if there is a disposition of the qualifying property or a termination of the qualified use within ten (10) years after death.

G. WARNING. The agreement which must be signed by the decedent's family and the obligations of the family to comply with the provisions of the Code produce the most common problems for taxpayers. Do not attempt to make such an election without a careful review of the Code, the Regulations and the instructions printed in conjunction with the Form 706.

H. Planning Opportunity. Many practitioners find utilization of the special use valuation elections to be overly complicated and not worth the trouble and effort. Where there is a genuine belief that the estate might qualify for the special use valuation election and, at the same time, there is concern that the appraisals at fair market value may be less than adequate, consideration might be given to making a protective special use valuation election on the estate tax return. The effect of the protective election might be to cause the estate tax examiner to reconsider opening the estate for audit to argue over fair market value of real property. If the examiner believes that if the real estate values will be increased the estate will offset the increase by making the special use election and produce no tax deficiency, such an election might head off an audit before it occurs. This technique is not a substitute for good appraisals.

III. Election for Installment Payments. Section 6166.

A. Purpose of Election. Section 6166 of the Code provides that if the value of an interest in a closely-held business meets certain criteria, an election may be made to defer that portion of the estate tax attributable to the closely held business for five (5) years and thereafter to pay the tax attributable to the value of the interest in the closely-held business over a period of ten (10) years.

B. Closely Held Business. A closely-held business is defined as: (1) any interest as a proprietor in a business carried on as a sole proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 45 or fewer partners, and the decedent owned at least 20% of the partnership; or (3) stock in a corporation if the corporation has 45 or fewer shareholders, and if the decedent owned 20% or more of the voting stock. IRC § 6166(b)(1).

C. Requirements. The qualifications of § 6166 appear at first to be simple: (1) the decedent must be a U.S. citizen or resident and (2) the value of the estate's interest in a closely-held business (without regard to the attribution rules) must exceed 35% of the adjusted gross estate. However there are also various other rules that may help the estate meet the 35% test and as such, Section 6166 should be studied closely if the election is contemplated.

D. Anti-abuse Rules. This election is further complicated by two anti-abuse rules:

1. The estate must pass the 35% test both before and after inclusion of all gifts made within three years of death as if the pre-1981 rule of § 2035 still applied. IRC § 6166(k)(5).

2. The second anti-abuse rule excludes from the closely-held business amount any passive assets held in a closely-held business. Passive assets are assets that are not used in carrying on a trade or business and, with exceptions, include any stock in another corporation. IRC § 6166(b)(9).

E. Making The Election. The election is made by checking the box for question 3, in part three of the estate tax return (Form 706). Additionally, a "Notice of Election" containing six items must be attached to Form 706: (1) the decedent's name and social security number; (2) the amount of tax to be paid in installments; (3) date of first installment; (4) number of annual installments elected (always elect 10 because the number of installments cannot be increased but the tax can be prepaid); (5) identification of the § 6166 property items by cross reference to the respective Form 706 schedules and line item numbers; and (6) a narrative of facts supporting the basis for the conclusion that the estate qualifies for § 6166 relief. Regs. § 20.6166-1(b) and (d).

F. IRS Notice 2007-9. Following *RGSKI v. Comm'r*, 128 T.C. No. 10 (2007), the IRS will now determine on a case by case basis whether security will be required to protect the government's right to all payments of estate tax when a §6166 election is made. Previously, the IRS required surety bonds, or special liens, in all cases.

G. Warning. The above discussion is intended as an overview only and due to the complexity of this Code section, anyone contemplating making this election should fully review § 6166 and the regulations before doing so.

IV. Extension of Time for Paying Tax § 6161

General Rule. It is not uncommon for an estate, because of its complexity, to request an extension of time to file the federal estate tax return. Note that an extension of time to file the estate tax return does not necessarily result in an extension of time to pay the tax. Section 6161 addresses extensions of time for paying tax. It provides that the IRS may, for reasonable cause, extend the time for the payment of estate tax for a reasonable period not in excess of ten (10) years from the date that the tax is due. If the tax cannot be paid when due and no other extensions apply, a § 6161 extension request should be made in order to avoid failure to pay penalties.

V. Election to Postpone Tax on Reversions or Remainders - § 6163

This election is made by checking the box for question 4, in part three of the estate tax return (Form 706). Also, a letter must be sent to the Cincinnati Submission Processing Center, enclosing a certified copy of the instrument creating the reversion or remainder along with the birthdate(s) and name(s) of any intervening life or lives. Regs. § 20.6163-1(b).

This election allows the estate to postpone paying the estate tax attributable to reversions or remainder interests that are included in the gross estate until six months after the reversion or remainder becomes possessory to the decedent's estate or heirs.

VI. QTIP Election § 2056(b)(7)

A. Purpose. The purpose of the qualified terminable interest property (QTIP) election is to allow a qualifying marital trust (or other life interest) in the surviving spouse to qualify for the marital deduction.

B. The Election. Terminable interests passing to a spouse do not qualify for the marital deduction. One such exception is a QTIP trust. The election for a QTIP trust to qualify for the marital deduction is made automatically if there is a qualifying trust listed on Schedule M. On the prior version of schedule M, a box had to be checked in order to make the QTIP election. Due to the numerous private letter ruling requests from Executors who had inadvertently forgotten to check the box, the form was changed to an automatic election where the election is presumed to be made if the property is listed on Schedule M. An Executor can still opt out of the election by checking the box for question 3 on Schedule M.

C. Late Return. The election may be made on a return filed late, so long as it is the first return filed. § 2056(b)(7)(B)(v).

D. Partial Election. A partial, formula election is allowed. Regs. § 20.2056(b)-7(b)(2)(i).

E. Election Irrevocable. The election is irrevocable once made. § 2056(b)(7)(B)(v). However, a QTIP election may be revoked or modified on a subsequent Form 706 filed on or before the due date of the return, including extensions. Regs. § 20.2056(b)-7(b)(4)(ii).

F. Protective Election. A protective election is allowed but only in limited circumstances, and, once made the protective election is irrevocable. The regulations authorize a protective QTIP election only if the Executor reasonably believes, at the time the federal estate tax return is filed, that there is a bona fide issue that concerns 1) whether an asset is includible in the decedent's gross estate, or 2) the amount or nature of the property the surviving spouse is entitled to receive. The protective election must identify either the specific asset, group of assets, or trust to which it applies and the specific basis for the protective election. Regs. § 20.2056(b)-7(c).

VII. QDOT Election - § 2056A

A. Purpose. The purpose of the election is to allow a qualifying domestic trust (QDOT) for the benefit of a non-U.S. citizen spouse to qualify for the marital deduction.

B. The Election. The marital deduction is not available for assets passing to a non-U.S. citizen unless the assets pass in a qualified domestic trust (QDOT). Additionally, the Executor must elect for the QDOT to qualify for the marital deduction. The election is made by listing the QDOT and the entire value of the trust property as a deduction on Schedule M to Form 706. The Executor is presumed to have made the QDOT election if the trust or trust property is listed and its value is deducted. In addition, the following information should be provided for each QDOT on an attachment to Schedule M: (1) name and address of each Trustee; (2) a description of each transfer passing from the decedent that is the source of the property placed in the QDOT; and (3) the employer identification number of the QDOT.

C. Late Return. The election to treat a trust as a QDOT must be made on the last federal estate tax return filed before the due date (including extensions actually granted) or, if a timely return is not filed, on the first estate tax return filed after the due date. Regs. § 20.2056A-3(a). However, the election may not be made on an estate tax return filed more than one year after the time prescribed (including any extensions) for filing the return. § 2056A(d); Regs. § 20.2056A-3(a).

D. Partial Election. A partial QDOT election is not permitted. However, the trust may be severed in accordance with Regs. § 20.2056(b)-7(b)(2)(ii) before the due date for the election, and a QDOT election may be made for any one or more of the severed trusts. Regs. § 20.2056A-3(b).

E. Election Irrevocable. Once made, the QDOT election is irrevocable. Regs. § 20.2056A-3(a).

F. Protective Election. A protective election may be made with the estate tax return if the Executor reasonably believes there is a bona fide issue concerning either the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether an asset is includible in the decedent's gross estate, or the amount or nature of the property that the surviving spouse is entitled to receive. The protective election is made by attaching a written statement to Form 706, that is signed by the Executor under penalties of perjury, and which and sets out the specific basis for the protective election. Regs. § 20.2056A-3(c).

VIII. Early Determination of Liability -- § 2204

Under §2204 of the Code, the Personal Representative has the right to request an early determination of liability. The election, if made, requires the IRS to notify the Personal Representative within nine (9) months of the later of the date of the filing of the estate tax return or the due date of the amount, if any, of any estate tax liability for which the IRS can hold the Personal Representative personally liable. A §2204 request requires the IRS to give notice of the maximum amount for which the Personal Representative may be responsible in taxes. This allows the Personal Representative to make distributions to the beneficiaries without fear of unexpected personal liability being imposed on the Personal Representative. If no notice is received by the Personal Representative within nine (9) months from the date of the notice (assuming it was filed on the last day provided by law), the Personal Representative has no such liability.

Chapter Four
Miscellaneous Tax Elections to be Considered

I. Basis Adjustment for Deceased Partner's Interest in Partnership Property

A. A partnership interest included in a decedent's estate will receive a basis adjustment under §1014(b) to its value at the date of death. However, this adjustment does not affect the basis of the underlying partnership assets unless the partnership makes an election under §754. If the election is made, the adjusted basis of the decedent's proportionate interest in the partnership property will be increased or decreased to its value as if it were directly in the decedent's estate and not held inside the partnership.

B. Elections, if made, must be made on the partnership's first income tax return filed after the year of death. Once the election has been made for any partner, it is in effect for any other partners dying the same year and remains in effect for partners dying in subsequent years unless the partnership revokes the election.

C. It is important to inquire whether such an election is in effect and, if not, whether the partnership should make the election.

II. Subchapter S Stock

A. If closely held stock is held in an estate which has made an election under Subchapter S, it is important to allocate the stock to the correct beneficiaries and not inadvertently terminate the Subchapter S election.

B. Tax consequences of holding Subchapter S stock in a trust must be considered. The preferred shareholder of Subchapter S stock is a QSST or Qualified Subchapter S Trust. Section 1631(b). Such a trust must:

1. Have only one beneficiary at a time who must be an individual who is a U.S. citizen or resident.

2. Pay all income at least annually to the beneficiary.

3. Permit no distributions to a person other than that one beneficiary.

4. Terminate on the beneficiary's death or in favor of the beneficiary during life.

C. A QTIP Trust is a trust that generally meets the requirements of a QSST Trust. Most other trusts do not qualify.

D. If it is not possible to allocate stock to an individual beneficiary or to a QSST Trust, then allocating stock to any other trust may require an election to treat the trust as an Electing Small Business Trust or an ESBT. Section 1361(e).

E. Most trusts are eligible for ESBT treatment. However, the disadvantage is that the income is taxed at the highest applicable rate to the trust without any alternative minimum tax exemption and without any deduction for distributions. Section 641(c).

F. Note that an estate can retain S stock pending the distribution to the beneficiaries or a trust without causing a disqualification of an S election. Accordingly, if there are no suitable takers under the Will to receive the S stock without an unacceptable loss of the S election, keeping the estate open long enough to arrange a sale to a permissible shareholder may be desirable.

III. Reformation of Documents

As a general rule, it is not possible to reform a document that is defective. However, §2055(e) permits reformation of certain provisions of Charitable Trusts and §2056(d)(5) allows for judicial reformation of a trust to qualify as a QDOT. Accordingly, if a trust is defective in any way and if other techniques, such as disclaimers, will not cure the defect, reforming certain types of trusts may be an alternative to be considered.