Disclaimer Trusts in the Post-ATRA Age: Drafting Disclaimers, Clayton QTIPs and OBITs to Overcome Portability Limitations

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Using Qualified Disclaimers: Optimizing Estate & Income Tax Planning After ATRA

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Agenda

• Review of IRC § 2518 and Regulation requirements
• State Law Variations and Nuances, Community Property Disasters
• Clayton QTIPs and Comparing, Contrasting and Synthesizing Disclaimer and Clayton QTIP Planning
• Cascading “Waterfall” Spousal Disclaimers
• Reducing estates and/or increasing basis w/disclaimers
• Unique Features of Optimal Basis Increase Trusts
• Post Mortem “Fixes” via disclaimer
• Post–Mortem “Fixes” to IRA “see through trusts”
• Contrasting Non-Qualified Disclaimers and Releases
• Asset Protection Effects (and Traps) of Disclaimers
• Common Drafting Tools and Traps to Avoid
Challenge for Sub $10.9 Million Estates

• Bypass trusts and do we even need trusts for 99% is being questioned by popular financial press, CFPs, CPAs, and attorneys

• Most common “solutions” cited are to ditch the trust altogether, use disclaimer or Clayton QTIP funding, or use an “all marital” approach – all of these have significant issues and flaws – but we can improve them.
Challenge for Sub $10.9 Million Estates

• How do we build flexibility into plans to adapt to changes in tax law as well as client’s financial situations?

• How do we analyze the decision post-mortem, and what checklists and criteria should we use for best practices?

• How do disclaimers (both qualified and perhaps non-qualified) fit into strategy?

• Alice Sims was the beneficiary of two estates (her sister, who died first, and mother’s) and the PR for both of them.
• She hired attorney to assist her with her sister’s then mother’s estates.
• The trial court found attorney was negligent in failing to counsel Alice and her mother on their ability to file a qualified disclaimer of her sister’s estate, causing additional estate taxes, and awarded Sims $191,543 in actual damages.
• The appellate court affirmed. Attorney’s initial ignorance of size of mom’s estate was unavailing.
How Hard Could it Be?

• It’s only one tax code section!

• Unlike many Regs, (that add nothing to help understand the law), there are 62 examples in the 2518 regulations that are much more helpful than most. See attachments.

• As noted, the estate and GST code sections incorporate this gift tax code section.
Qualified Disclaimer Basics - IRC § 2518

Disclaimer is an irrevocable, unqualified refusal to accept a property interest and must be:

1. In writing
2. Within 9 months
3. No acceptance of the interest or any of its benefits, and
4. Interest passes without any direction on the part of the person making the disclaimer and must pass to either the decedent’s spouse or to a person other than the disclaimant.
Qualified Disclaimer Basics - IRC § 2518

- **In writing** – state law may vary on exact requirements, but why not send certified mail return receipt requested?

- Delivery – usually this is only necessary to the trustee, but it may be necessary to file with probate court, executor or other custodian (e.g. IRA custodian, qualified plan trustee, etc.)
Qualified Disclaimer Basics - IRC § 2518

Within 9 months of completed gift (death)

• No 6 month extension!!!

• Exception for potential disclaimants under age 21, who have until 9 months after reaching that age to disclaim (but, has anyone ever run into a 21 year old who will disclaim???)

• It is the completed gift (death) of the settlor, not the death of spouse or other prior beneficiary, which starts the clock, unless the beneficiary has a general power of appointment. Similar for life estates.
Qualified Disclaimer Basics - IRC § 2518

- **Example 1:** John Doe funds an ILIT for the children during his lifetime. His children have to disclaim within 9 months of each complete gift, not his death.

- **Example 2:** At John’s death, he establishes a bypass trust and QTIP trust for his wife Mary for her life, then their children. His children have within 9 months of John’s death. Mary’s date of death is irrelevant.

- **Example 3:** John establishes a marital trust or optimal basis increase trust granting Mary a testamentary general power of appointment, the children may disclaim within 9 months of her death.
Qualified Disclaimer Basics - IRC § 2518

No acceptance of the interest or any of its benefits,

• Important to understand this concept more than most – mere retitling or naming a revocable beneficiary of an account is not “acceptance”.

• Selling/buying/rebalancing, or spending or reinvesting dividends from stock or pledging assets for a loan is acceptance.

• Taking cash from a brokerage account does not preclude disclaiming the stock or bonds in the account (unless traceable to dividends, etc.) See PLR 2005-03024 in additional material for example.
Qualified Disclaimer Basics - IRC § 2518

No acceptance of the interest or any of its benefits,

- Also important, joint tenants who reside or use property in which they inherit the remainder of are not precluded from disclaiming.
- Accepting role as trustee/fiduciary is OK
- Paying real estate taxes does not preclude disclaimer
- De facto ordering trustee/executor about how to manage property might well be, even if no right to
- Taking a decedent’s RMD does not preclude disclaiming the rest of the plan/IRA – see Rev. Rul. 2005-36 and the highlighted portions in appendix
Qualified Disclaimer Basics - IRC § 2518

• Interest passes without any direction on the part of the person making the disclaimer
• Cannot retain spray power, powers of appointment (except as noted later herein)
• There can be no quid pro quo, but let’s mention the surprising outcome of the *Monroe* and *Lute* cases...
Qualified Disclaimer Basics - IRC § 2518


- The tax court ruled that disclaimers were not qualified because the decedent’s husband indicated that he would “take care of” disclaiming parties (but no binding contract).
- He thereafter made a cash gift to the disclaiming parties approximating the value of their disclaimed interest.
- Appellate court (with one dissent) surprisingly reversed the trial court, stating that actual consideration rather than an expectation or implication was required and that a disclaimer would stand or fall on the factual issues.

124 F.3d 699 (5th Cir. 1997).
Qualified Disclaimer Basics - IRC § 2518


- Taxpayer favorable.
- Mr. Lute, Sr.’s son dies at age 48.
- He disclaims his interest in his estate so that it all passes to his son’s widow.
- Days later, the widow places the inherited property in trust with her and Mr. Lute as two of four trustees (herself and children beneficiaries), and the trust thereafter has ranch and cattle business dealings with various family partnerships so he later effectively controls the disclaimed property.
- The IRS tried to deny the qualified disclaimer on grounds that oral contract or understanding made it not “unqualified” (quid pro quo) but like _Monroe_, the court found for the taxpayers.
Qualified Disclaimer Basics - IRC § 2518

• Can be an undivided portion of an interest (e.g. 44 of 100 shares of stock, 40 of 100 acres of land, etc)
• Must be a vertical, not horizontal slice (not, 5 years of income, etc.)
• Powers of appointment can be separately disclaimed from interests in the assets they pertain to
Qualified Disclaimer Basics - IRC § 2518

• Disclaimer can clearly be by formula (also see the Christiansen case in additional material):

Treas. Reg. 25.2518-3, Ex (20):

• “A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A's surviving spouse, W. The numerator of the fraction disclaimed is the smallest amount which will allow A's estate to pass free of Federal estate tax and the denominator is the value of the residuary estate. B's disclaimer is a qualified disclaimer.”
Qualified Disclaimer – State Law Variations

• Some states have passed the Uniform Disclaimers of Property Act
  – See commentary for interpretation if you live in AK, AZ, AR, CO, DE, DC, FL, HI, IN, IA, MD, MN, NV, NM, ND, OR, TX, VA, WV

• Fiduciaries may disclaim:
  – Caution - state laws will vary on this point. E.g. see Ohio R.C. 5815.36(c) and (B)(4).

• Some may require language in document or petition in local probate court.
Disclaimer Example

- Disclaimer must be *Qualified* Disclaimer to Avoid Taxable Gift (and possibly income tax)

Spouse Disclaims

Spouse Cannot Act as Trustee w/ Discretionary Spray unless HEMS

Trust FBO Children
Disclaimer Example - IRA

- "Designated Beneficiary" Status – Trust is Irrevocable
- No Separate Share Treatment
- Life Expectancy of Oldest Beneficiary
- Mother disclaims 100%
- Oldest Child is now Designated Beneficiary Whose Life Expectancy is Used for RMDs, but Testing for Accumulation Trusts can be Tricky
Disclaimer Planning – Example IRA

- Contrast – if Beneficiary Designation Form pays to spouse, then 50% to trust for child 1, and 50% to trust for child 2. Use separate trusts, not merely separate shares.
- Assume spouse disclaims
- Life expectancy of each child may be used (if so drafted) for RMD calculations
Disclaimer Planning – Common Problem with IRA Beneficiary Designations

- Many IRA beneficiary designation forms (BDFs) do NOT default to “per stirpes”
- Assume child #1 disclaims, hoping her children can benefit from longer stretch
- Default under many forms is to send the IRA to Child #2!!
- Obviously, change of BDF can prevent this. Check each account’s defaults.
Fixing Plans with Community Property IRAs

• IRS takes the position that a court order granting a surviving spouse 50% of an IRA that was community property is ineligible for a rollover!

• PLR 2016-23001:
  • Decedent left 100% of his community property IRA to his son, not wife. In settling estate, court ordered a portion (probably 50%) of IRA to wife. She asked IRS to rule that it was not a taxable event. DENIED.
  • IRS held: it would be taxable to son because Section 408(g) provides that § 408 “shall be applied without regard to any community property laws.” No rollover permitted, nor can wife be designated beneficiary.
  • Three lessons:
    1. Had son simply filed a qualified disclaimer, it would have likely passed via intestacy and spouse would have been entitled to rollover! If son had minor children, and they were contingent, then state law would likely permit guardian to make disclaimer. But, we do not know son/wife’s relationship in this PLR.
    2. Check the BDF- naming spouse as 50% of IRA avoids the issue
    3. Prevention is cheaper than PLRs!
Disclaimer Trust Planning for Spouses

• A “wait-and-see” approach where estate taxes may be a consideration

• **Essence:**
  • All to Marital Share, with disclaimed amount to Non-marital share

• **Advantages:**
  • Maximum discretion to surviving spouse
  • Marital Share distribution flexibility

• **Disadvantages:**
  • Surviving spouse cannot have a limited power of appointment over the disclaimed assets (Bypass Trust)
  • Surviving spouse may blow the disclaimer
Disclaimer Example

• Alex dies at age 70. Alex’s wife disclaims amount of Alex’s unified credit to bypass trust for benefit of herself and their children.
  • Within 9 months from date of death
  • Must be provided to Trustee
    • If IRA, served on IRA custodian
Disclaimer Example

Bypass Trust
To residuary beneficiaries
Disclaimer Example

Bypass Trust; or To residuary beneficiaries
Clayton QTIP Election

• Twist on Disclaimer Trust
• All to a QTIP designed trust
  • Any portion not elected to qualify for estate tax marital deduction funds the Non-Marital Share
  • Option to fund with only that portion elected not to qualify for both federal and state marital deduction
  • Usually recommended that spouse not be the executor making the QTIP election (otherwise IRS may consider a gift)
Clayton QTIP Election

Advantages:

- Not subject to disclaimer requirements
  - Up to 15 months to decide if 6 mo. extension filed
- Spouse can keep limited testamentary power of appointment over Bypass or QTIP Trust
- Spouse can keep lifetime powers over Bypass
- Reliance on action of someone other than surviving spouse (if someone else is executor)
- Added flexibility to exploit portability
Clayton QTIP Election

Disadvantages:

- Marital Share must be a QTIP
  - Option to give spouse a demand right after 16 months
- Finding a fiduciary (and spouse agreeing), willing to make the QTIP election
- If no Form 706 is filed, property will not be included in surviving spouse’s estate
- Unlike qualified disclaimer, must file 706 to make QTIP election
- Unclear result for IRA see through trusts if not done by the beneficiary designation date (September 30 of year after death)
Clayton Election Example

Bypass Trust; or
To residuary beneficiaries
Disclaimer & Clayton Election

• Disclaimer & Clayton Election provides flexibility of a second-look at death of surviving spouse
• Does require action on death of first spouse to die
  • Filing of a 706 with appropriate QTIP elections
  • Requires a close analysis of:
    • Current assets
    • Likely growth of assets until death of survivor
    • Survivor’s plans for assets (hold or sell)
Marital Trusts – The Clayton QTIP and “One Lung Trusts”

• Issues and Solutions to exploiting Clayton QTIPs:
  • Is spouse executor? Often so.
    • Some claim there may be a gift tax issue.
    • Can’t we simply get around it? e.g. the bypass trust initially has the same “all net income” provision, without a spray, so the IRS cannot claim that the spouse’s election is somehow a gift, because the spouse gives up NOTHING (nor could creditors claim it was a gift and therefore somehow funding a self-settled trust).
  • Then, spouse simply disclaims the right to all net income. Voila! Now income can be sprayed to lower bracket beneficiaries! No gift issue.
  • This would require the QTIP election be made within nine months. Note, this kind of disclaimer would blow a QTIP election if made over the QTIPped Trust.
Marital Trusts – The Clayton QTIP and “One Lung Trusts”

• Issues and Solutions to exploiting Clayton QTIPs:
  • Might asset protection be affected if spouse’s actions cause the bypass to be funded? Very doubtful – not “asset” per UFTA, nor would the trust typically be included in bankruptcy estate under 11 USC 541(c)(2).
  • “Waterfall disclaimers” – spouses can keep disclaiming successive interests and it can pass through several iterations. There is no limit on the number of estates/trusts/foundations the asset can pass through via spousal disclaimer, provided that the spouse otherwise qualifies.
Using Disclaimers to Increase Basis

• Disclaimers 201: Exploiting Qualified Disclaimer Rules for Joint Bank, Brokerage and Investment Accounts that are joint with right of survivorship
• Putting your spouse on an account as joint with right of survivorship is generally not a completed gift (US citizens), unless/until the spouse takes funds out or you die, because until then you can get the funds back
• This affects qualified disclaimers – the time to disclaim runs from date of death, not time placed on account
• Spouses may disclaim any percentage/amount except to the extent the disclaimant contributed to the account. If spouse did not contribute, this is 100%
• Let’s review one of the examples from article.
Using Disclaimers to Increase Basis

- John Doe provides all the funding for a joint bank/brokerage account (not community property), containing:
  - Fund Q: $1.6 million, basis of $1 million
  - Fund X: $1.2 million, basis of $800,000
  - Fund Y: $800,000, basis of $1 million
  - Fund Z: $400,000, basis $500,000
- Typically when John dies, IRC § 2040 includes 50% in his estate ($2 million), and his wife now gets a partial step up in basis for funds Q and X, and a partial step down in basis for funds Y and Z: $3.65 million
- Contrast, if Mary disclaims Funds Q and X, 100% is now in John’s estate, therefore these are stepped up to $1.6 million/$1.2 million, total basis $4.15 million.
Using Disclaimers to Reduce Estate Tax

• Like the prior example, we can use a disclaimer to affect estate taxation of a decedent.
• In prior example & for 99% of estates, we probably want to INCREASE the taxable estate to attain basis.
• Can exploit IRC 2040 and its opt-out of FMV rules, coupled with a disclaimer, to reduce the estate.
• Extreme example:
  • John and Mary own a $13 million JTWROS property.
  • John dies in 2016, followed by Mary. You represent Alice, their daughter (remember the Sims case???).
  • If you do nothing (assume $100,000 costs), $12.9 million estate will cost $800,000 estate tax ($2 million over Mary’s applicable exclusion amount w/DSUE)
Using Disclaimers to Reduce Estate Tax

• With *Sims* case in mind, you counsel Alice to make a qualified disclaimer, as executor of her mother Mary’s estate.

• Result:
  • A 50% tenancy in common interest will get a valuation discount (cases range 15%-60%, likely to be on the low end).
  • Assume appraiser comes in at 15% - the value of a 50% TIC being $6.5 million x 0.85 = $5.525 million.
  • Alice inherits that 50% from her father’s estate, then remaining 50% from her mother’s estate, and voila, $800,000 estate tax saved! (the attorney charged a bit more in fees for the clever disclaimer planning).
  • Her basis, however, is $11.05 million, rather than $13 million. Even if she sold right away, used no CRUT or installment sale, the capital gains would be much less.
Beware Spousal Disclaimers Reducing Basis

• Be careful to advise spouses who have joint tenancy real estate that disclaiming 50% to fund a bypass or marital trust or simply fund a non-taxable gift to children can lead to reduced basis.

• Extreme example Revisited:
  • Use the same 15% discount.
  • John’s wife Mary decides she will disclaim 50% to either fund a bypass or marital trust or allow it to pass to her daughter.
  • The new basis for the 50% is not 50% of $13 million, it is 85% of 50% of that. Maybe good for taxable estates, but for others??
  • Whereas if Mary had inherited outright, JTWROS, it would be undiscounted 50% ($6.5 million), pursuant to IRC § 2040.

• An overlooked advantage to using portability for jointly held real estate interests, but JTWROS is a lousy option for many blended families for non-tax reasons.
We have all been taught that spouses using any disclaimer funding have to disclaim any powers of appointment in trusts receiving disclaimed assets.

This is wrong, or at least, overbroad.

A POA that can only trigger estate/gift tax, or that is limited by ascertainable standard, CAN BE retained. Optimal Basis Increase Trust (OBIT) clauses meet this requirement.
Understanding Powers of Appointment

• Powers of appointment have TREMENDOUS income tax planning potential for both stepping up basis (at death, aka testamentary) and spraying income (lifetime). Powers can be limited, capped, targeted.

• General POA (GPOA):
  • power to appoint to yourself, your estate, or creditors of either – can be lifetime, or testamentary (only effective at death)
  • triggers estate inclusion (§ 2041), which is favorable for 99.8% of the population that does not pay tax but would prefer the basis increase afforded under IRC § 1014

• Limited POA (LPOA):
  • power to appoint that excludes power to appoint to self, estate, or creditors or either
  • usually does NOT trigger gift tax or estate inclusion, except special circumstance, such as the Delaware Tax Trap
Traditional AB Trust - Basis Effect

**John and Mary Doe Trust**
(could be joint or two separate trusts)

**At John’s Death**
- **John Doe Bypass Fbo Spouse (& children?)**
  - < $5.45mm (or basic exclusion amount)
- **John Doe Marital Trust Fbo spouse only,**
  - > $5.45mm (or basic exclusion amount)

**At Mary’s Death**
- **Trust for children**
  - **No change in basis** for any asset (when children/trust sell property, capital gains on any post-death appreciation)
- **Trust for children**
  - **All new basis** except IRAs, Qualified plans, annuities (including step down)
Optimal Basis Increase Trust – Basis Effect

At John’s Death

John Doe Trust
(could be joint trust)
w/optimal basis provisions

John Doe OBIT
Fbo Spouse (& children?)
< $5.45mm (or basic exclusion amount)

Trust for children
Step up in basis for assets w/basis < FMV
(up to spouse’s AEA)

John Doe Marital Trust
Fbo spouse only,
> $5.45mm (or basic exclusion amount)

Trust for children
All new basis (including step down)

At Mary’s Death

Trust for children
No change in basis (IRD, assets w/ basis => FMV, no step down)

Uses GPOA or LPOA, Section 2041, capped to not cause estate tax,
To trigger estate inclusion and therefore Section 1014 step up
Mary cannot be trustee w/discretionary spray power, has no lifetime or testamentary power of appointment (or disclaims it)

Traditional AB Trust – Disclaimer Plan/Effect

At John’s Death
Usual Method

To Mary Outright

After Mary’s Disclaimer

John Doe Bypass Trust fbo Mary (& children?) < $5.45 million. No LPOA, no power to “rewrite” via testamentary POA to adapt trust.

Alternate Method

John Doe Marital Trust Fbo Mary
“OBIT” Trust – Disclaimer Plan/Effect

Mary has fiduciary POA limited by HEMS, “taxable” LPOAs to shift income (life), testamentary GPOA power to increase basis (at death)

Key Private Bank
Children cannot make a qualified disclaimer, unless Mary happened to die shortly after John. They have nine months from John’s death, not Mary’s. Exception for those under 21.
OBIT – Disclaimer at 2\textsuperscript{nd} Death

At John’s Death
Usual Method

John Doe Trust
(could be joint trust)

To John Doe Bypass Trust

John Doe QTIP Trust Fbo Mary

After Mary’s Death

Children would have power to disclaim per IRC § 2518, any assets subject to GPOA

Children can make a qualified disclaimer within nine months of Mary’s death over any assets that were subject to a GPOA
Ordinary “A/B” Trust – Ongoing Tax Effect

At John’s Death

Tax Effect to Spouse and Doe Family, during spouse’s lifetime

Above rates refer to trust income above $12,400 in 2016 (top rates), ignoring state income tax, AMT, or special tax rates for collectibles, depreciation recapture
Income Tax Efficient Trust—Ongoing Tax Effect

At John’s Death

Tax Effect to spouse and Doe Family during spouse’s life
Contrast Non-Qualified Disclaimers, Releases

- Many states may permit a disclaimer after nine months. This may be a useful disclaimer under state law, but not a qualified disclaimer under IRC 2518.
- For federal tax law, non-qualified disclaimers and their close counterpart, a common law release, causes a taxable gift, but be careful of effect on any Roth IRA/IRA type benefits.
- A common law release may also be available, e.g., even after some benefits have been accepted. For example, a surviving spouse may no longer need a bypass trust and might be fine if a release causes a taxable gift based on the actuarial value of their interest (or, with a QTIP, the entire amount pursuant to IRC 2519). But verify it does vest!
- For a clever use of such technique, consider PLR 2012-03033, where it was too late to make qualified disclaimer, but before the beneficiary finalization date, the beneficiary w/ a GPOA disclaimed the right to appoint to all but individuals younger than the power holder to keep DB status for see through trust.
Common Post-Mortem Fixes Via Disclaimer

- Terminating a trust if remaindermen inherit outright
- Adjusting an unintended unequal division of estate
- Increasing marital deduction to save state or federal estate tax, e.g., if others disclaim rights to enable trust to make a QTIP election.
- Decreasing the marital deduction (e.g. disclaiming a general testamentary power of appointment in marital trust, Clayton QTIP, allowing distribution to children, etc)
- Fixing estate plans thwarted by common disasters or close in time deaths
- Enabling younger generation to use “stretch” for IRA/QPs.
- Disclaiming environmentally suspect CERCLA property
- Helping an excluded or needier child, sibling
- Fixing defective charitable trusts to achieve deductions
Asset Protection Issues of Disclaimers

- General rule in vast majority of states is that disclaimer “relates back” and is not a fraudulent transfer (but MN, FL may prevent if disclaimant is insolvent)
- Beware – it’s still an improper transfer for Medicaid!
- Also, it cannot get around federal tax liens which attach at the time the interest is created (gift/death). *Drye v. U.S.* 528 U.S. 49 (1999). Should executors/trustees investigate beneficiaries’ tax problems prior to distribution?
- If an intended beneficiary has tax debts, either help them pay their taxes (some might be discharged in bankruptcy) or disinherit them completely, don’t use a HEMS or even discretionary trust or disclaimer plan! See *Duckett v. Enomoto*, Case No. CV-14-01771-PHX-NVW. (D. AZ, April 18, 2016)
- Even though there is favorable case law that disclaimers may not be a fraudulent transfer in bankruptcy, *In re Costas*, 555 F.3d 790 (9th Cir. 2009), beware that it may prevent a discharge if done within one year of filing, which in some cases may be even worse! *In re White*, 2014 Bankr. LEXIS 578 (Bankr. D. Neb. Feb. 12, 2014)
Conclusions – Qualified Disclaimers

• Communicate to clients and their advisors the acceptance rule ASAP to prevent inadvertent disqualification.

• Very important for IRA “see through trust” planning, not only to help fix trusts, but to allow income tax shifting and longer “stretch” deferral when disclaimed assets pass to younger generation, through trust or not. Be careful – default beneficiaries vary greatly in IRA BDFs.

• Watch out for bank, brokerage, investment account opportunity to disclaim for a higher basis in separate property states

• Consider what “optimal basis increase” powers of appointment may be added and kept post-disclaimer for more powerful planning.
Questions?

• Updated material on basis and income tax planning will be periodically added to the Optimal Basis Increase Trust white paper at http://ssrn.com/abstract=2436964

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