WELLS FARGO Advisors

Understanding disclaimers

Important estate planning information

A disclaimer is an irrevocable refusal to accept a transfer of property. In simple terms, the person making a disclaimer is saying, "I don't want it — let it go to whomever is next in line." When a valid disclaimer is made, the effect is as though the "intended" transfer never happened — the person who made the disclaimer is regarded as never having received ownership, possession, or control of the property.

When you name someone as a beneficiary of your estate, you would usually expect them to gratefully accept the assets in question after your death. However, that's not always the case. In fact, there may be instances when a beneficiary will decide to irrevocably refuse, or disclaim, an asset that your estate plan indicated they should receive. That's why it's important to understand what disclaimers are and how they work.

In the post-death estate settlement process, disclaimers are sometimes used because they give an heir or beneficiary the limited ability to "rearrange" the distribution of assets to help achieve practical or tax objectives. It's important to understand that the person making the disclaimer (the "disclaimant") does not have any power to specify where the property goes. Instead, the transfer is made as though the disclaimant had died prior to the original owner (the person making the transfer).

Here are examples of situations in which a disclaimer might be considered:

- John dies, and his will leaves his modest estate "to my daughter Susan, or her descendants per stirpes." Susan is a successful business owner and already has a large estate of her own that's likely to be subject to estate taxes after her death. She feels she doesn't need the inheritance herself and would prefer that the assets go directly to her children, who are young adults. Instead of accepting the inheritance and then making a taxable gift, she would prefer to disclaim the inheritance so it passes directly from her father to his grandchildren.
- As she became older, Mary's eyesight began declining. Her daughter, Karen, helped her with running errands, going grocery shopping, and paying bills. For convenience, Mary put Karen's name on one of her accounts as "joint tenants with right of survivorship." Mary also has two other children; all three are equal beneficiaries under Mary's will. After Mary's death, Karen believes it was not her mother's intention to leave the joint tenancy account only to her. She asks her attorney if disclaimers can be used so a portion of the account can pass to her siblings.

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- Mark named his brother, Tom (age 75), as primary beneficiary of his IRA and Tom's son, Michael (age 45), as contingent beneficiary. Tom is already taking required minimum distributions (RMDs) from his own IRA and does not want the additional taxable income that would come with distributions from an inherited IRA. Because Michael is in a lower tax bracket and could use the extra funds, allowing the IRA to pass directly to him would benefit both Tom and Michael. Tom asks his CPA if it would be possible for him to disclaim his interest in Mark's IRA.
- Bob and Susan, a married couple, have a $16 million taxable estate. They expect their estate will continue to grow, so they are concerned about planning for possible federal estate taxes. They read an article that described how a will or trust could be designed with an outright distribution of all assets to the surviving spouse after one of them dies, but also provide that in the event of a disclaimer by the surviving spouse, a "credit shelter" trust would be funded with any disclaimed assets. Using this strategy could help reduce, or even eliminate, any federal estate taxes owed after they both die, and could allow for maximum allocation of generation-skipping exemption to help keep more assets outside of their children's taxable estates. Bob and Susan ask their attorney about this idea, who explained that this approach could provide additional flexibility but would also involve risk (For more information, see below.)

Affluent married couples face unique estate planning complexities

Married couples like Bob and Susan in the example above who have estates that could incur federal estate taxes face issues that single individuals in the same situation don't. Here's a simplified overview of these issues that you may find helpful when meeting with your estate planning attorney.

Not surprisingly, federal estate tax laws are complex, but in essence, the IRS imposes estate taxes on the amount of an individual's estate that exceeds $11,700,000 (the "applicable exclusion") in 2021. However, when a married individual dies, the surviving spouse can receive an unlimited amount of assets from the deceased without incurring estate taxes. That's a big benefit, of course, but without proper planning, the couple's beneficiaries could end up paying unnecessary estate taxes after the surviving spouse dies.

Here's why: Let's say Bob dies before they do their estate planning, leaving Susan with a $16 million estate. A year later, Susan dies. Because Bob and Susan hadn't planned, her beneficiaries would owe the IRS estate taxes at the 40% rate on the value of her estate that exceeds her applicable exclusion because Bob's exclusion essentially went to waste. However, with planning, they could have allowed their beneficiaries to take advantage of both exclusions, resulting in no estate taxes being incurred.

One planning strategy they could consider is the one they read about in the article. Susan could make a disclaimer, and their estate planning documents could be drafted to provide that in the event of a disclaimer by the surviving spouse, the disclaimed assets would flow to a credit shelter trust — a strategy that allows married couples to take advantage of both applicable exclusions. This would use Bob's exclusion and result in Susan having a smaller taxable estate.

On the other hand, they could plan for the executor of Bob's estate to make a "portability" election, which would transfer Bob's applicable exclusion to Susan, doubling her exclusion. While this may seem like a simple strategy, it raises a number of complexities you should discuss with your estate planning attorney.

Whether they decide to use either a disclaimer or a portability election, someone has to be "awake at the switch" after Bob's death. If Susan fails to make a timely disclaimer or the executor of Bob's estate doesn't file for the portability election, she could end up leaving a much larger taxable estate because Bob's exclusion would go to waste — which was what their planning was designed to avoid.

Requirements for a valid disclaimer

In order to be a "qualified disclaimer" recognized for federal estate- and gift-tax purposes, a disclaimer must meet several qualifications:

- It must be irrevocable and unconditional.
- It must be in writing.
- It must be delivered to the executor, trustee, or person in possession of the property no later than nine months after the later of the date the transfer takes place (typically the date of death) or the day on which the disclaimant reaches age 21.
- The person making the disclaimer may not have accepted the property or any benefits of owning the property.
- As a result of the disclaimer, the property must pass (without any direction on the part of the person making the disclaimer) to either:
  - The deceased's spouse
  - A person other than the disclaimant

Keep in mind that it's possible to disclaim a portion of an interest, for example, a specific dollar amount, percentage, or a specific number of shares.

Individual states may have disclaimer rules that differ from federal law. It's important to consult an attorney in your state to determine whether a disclaimer will be effective under both federal and state law. In particular, a few states do not have a nine-month limit for making disclaimers. In those states, it would be possible to make a disclaimer that is effective under state law, even if it's not recognized for federal estate tax and gift tax purposes. Such a disclaimer might result in a "taxable gift" — but with the federal lifetime gift exclusion* set at $11,700,000 for 2021, there might be circumstances in which the practical benefits could still outweigh possible adverse gift-tax consequences.

*Simply stated, the lifetime gift exclusion is the amount you can gift during your lifetime without incurring gift-tax implications. However, the rules for using up your exclusion are complex; for more information, consult your tax advisor.

This discussion is only a broad-brush outline of rules that commonly apply to making a disclaimer. It's important to work closely with a knowledgeable attorney because there are many additional detailed rules, exceptions, and interpretations in statutes, regulations, and case law. A disclaimer itself may be a fairly short legal document, but the applicable rules are far from simple.

Key points to consider

Because disclaimers are irrevocable and irreversible, you should always consult with your attorney and tax advisor before making a disclaimer to be sure you fully understand the consequences.

A disclaimer usually should be drafted by an experienced attorney. If a "form" disclaimer is used, it's important to obtain guidance from an attorney and tax advisor who can explain the consequences of the choices being made.

Before making a disclaimer, it's important to verify exactly where the property would go if a disclaimer is made. What would the will or trust provide if there is a disclaimer? For an IRA, insurance policy, or annuity contract, who are the contingent (or default) beneficiaries? (Remember, these designations supersede what you have indicated in your will or trust.) How would a disclaimer affect possible estate taxes, income taxes, the allocation of generation-skipping exemption, or probate costs? You want to be sure that a disclaimer will not produce unexpected or unwanted results.

You cannot accept or take control of an asset and then disclaim it. This rule is not as simple as it might seem. For example, accepting a dividend or interest payment or rent check could result in losing the ability to disclaim a stock, bond, or parcel of real estate. On the other hand, the IRS has ruled that a beneficiary can distribute the deceased owner's RMD for the year of death and still retain the ability to disclaim the remaining account. As a result, it's important to work closely with your attorney and CPA during the period when you are deciding whether to make a disclaimer. Also remember that because of this rule, there may be market risk during the time that an asset is sitting in an unclaimed or unmanaged state while the beneficiary is deciding whether to make a disclaimer. In addition, other decisions by an executor or trustee might be delayed pending a determination by a potential recipient about whether to disclaim. Even though the potential recipient has nine months to decide, there are practical reasons why it might be advantageous to make a decision sooner so the overall settlement process is not unduly delayed.

For traditional IRAs and Roth IRAs, additional tax considerations come into play. It's important to work with an experienced tax advisor who understands these complex rules because multiple deadlines may be involved. For example:

- If the deceased IRA owner had begun taking RMDs but at the time of death had not yet taken his or her required distribution for the year, that distribution must be made by December 31 of the year of death.
- The deadline for making a qualified disclaimer is nine months after the date of death.
- A 10-year required payout applies for most non-spouse beneficiaries, with some very narrow exceptions.

Advance planning may be preferable to a disclaimer

As you can see, disclaimers involve many complex rules. The opportunity to make a disclaimer can be lost because of lack of awareness or procrastination. In addition, disclaimers are very limited in what they can do — at best, you can only cause the assets to pass to the "next in line" beneficiary.

Even "planned" disclaimers, such as the one Bob and Susan were considering in our last example, involve risk. A surviving recipient could be incapacitated and unable to make a disclaimer, could procrastinate and miss a deadline, could take a distribution and inadvertently lose the opportunity to disclaim, could get bad advice or be confused about what to do, or could simply decide not to make a disclaimer.

These limits highlight the importance of keeping your estate plan up to date and doing beneficiary designation reviews on a regular basis. Take a look at the beneficiary designations you have on file for assets such as IRAs, retirement plans, annuities, and life insurance policies. Verify that the named beneficiaries are still the ones you want. Be sure you have named both primary and contingent beneficiaries. Get professional advice before naming your "estate" or a trust as a beneficiary.

Summary

Disclaimers can often provide a limited opportunity to "rearrange" part of an estate distribution after death. They can sometimes help to "fix" beneficiary designations that would otherwise produce an unwelcome result. At the same time, it's essential to get legal and tax advice from a qualified professional, because of the complex tax and legal rules surrounding disclaimers.

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