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DISCLAIMER DANGER: IRS DEEMS DISCLAIMER OF TRUST INTEREST NOT SUBJECT TO GIFT TAX

November 25, 2018

Authors: Brianna L. Marquis and Andrew M. Nerney

Trusts & Estates Magazine Website

Andrew M. Nerney and Brianna L. Marquis, attorneys in the Private Clients Group, wrote an article for *Trusts and Estate Magazine* Website entitled "Disclaimer Danger" which was published November 26, 2018.

For a link to this article, please click here.

Disclaimer Danger

IRS deems disclaimer of trust interest not subject to gift tax.

A disclaimer, in the most basic estate planning sense, is a refusal to accept an interest in property. But why would someone ever reject an interest in a trust or an inheritance? There's actually several reasons. The disclaimed property may be unwanted by the disclaimant (that is, the person making the disclaimer). For example, if the disclaimant has creditor issues, declining to accept the property is a way to preserve it for other beneficiaries who might enjoy it. There's nothing for creditors to take if the disclaimant never receives the property. In addition, there may be tax reasons why the disclaimant doesn't keep the property. For some, an inheritance could increase their assets significantly and put them over the estate tax exemption thresholds, causing an estate tax liability on their subsequent deaths. By disclaiming the interest, the value is shifted elsewhere (often to a younger generation). As a result, the disclaimant is able to benefit their eventual beneficiaries without the inclusion of such disclaimed property as part of their future taxable estate.

It's important to remember, however, that the disclaimant doesn't have control over where the assets go after they decline them. It's up to whatever document gave them the assets to begin with, such as a trust or a will. Whatever the reason to reject an interest in property, the disclaimant must take care to ensure the disclaimer is done properly according to state and federal law, to be a qualified disclaimer. Otherwise, the intention of the disclaimant may go unrealized and end up creating an unintended taxable gift.

Taxpayer an Eligible Beneficiary of Two Trusts

Private Letter Ruling 201845002 (released Nov. 9, 2018) involved two funded irrevocable trust agreements that the taxpayer's grandfather and great-grandfather executed before 1977, before the taxpayer was born. The taxpayer was eligible to receive income and principal distributions from both trust agreements in the discretion of the trustee. On the termination of the trusts, the taxpayer was also a potential recipient of some remainder interests in both trusts.

As of the date the request for a PLR was made, the taxpayer hadn't yet reached the age of majority, according to the relevant state law. In addition, the taxpayer hadn't received any income or principal distributions from either trust. Ultimately, the taxpayer wanted to disclaim the contingent rights to receive trust principal on the termination of both trusts. This disclaimer is made on reaching the age of majority.

The Taxpayer Desires to Disclaim

The taxpayer requested a PLR finding that disclaiming the property on attaining the age of majority wouldn't constitute a transfer subject to federal gift tax.

Most disclaimers are subject to the rules of Internal Revenue Code Section 2518. A "qualified disclaimer" under this section requires: (1) the disclaimer be made in writing; (2) the disclaimer be received by the holder of legal title within nine months of the interest arising or the disclaimant turning 21, whichever is later; (3) such disclaimant hasn't accepted the interest or any of its benefits; and (4) the interest passes to someone other than the disclaimant without any direction on the part of the disclaimant.

IRC Section 2518, however, doesn't govern disclaimers made with respect to pre-1977 transfers. Generally, a disclaimer of this interest must be: (1) made within a reasonable time after knowledge of the existence of the transfer creating the interest to be disclaimed; (2) unequivocal; (3) effective under local law; and (4) made before the disclaimant has accepted the property (Treasury Regulations Section 25.2511-1(c)(2)). When the property at issue is an interest in a trust, the disclaimer must normally be made within a reasonable time after the trust is established rather than when the interest actually vests to the disclaimant. See *Jewett v. Commissioner*, 455 U.S. 305 (1982). However, the time limitation for making a disclaimer can't run until the disclaimant has attained the age of majority and is no longer under a legal disability to disclaim. See *Ibid.* at 318; see also IRC Section 2518(b)(2)(B) and Treas. Regs. Section 25.2518-2(c)(1)(ii).

Proposed Disclaimer Not Subject to Federal Gift Tax

Assuming the taxpayer doesn't receive any benefit from the terminating distributions of the trusts and the disclaimer is made in a timely manner under the relevant state law, the Internal Revenue Service finds that the disclaimer by the taxpayer of the interest arising in trust won't result in a taxable transfer that will become subject to the federal gift tax.

A savvy practitioner would note that this ruling specifically dealt with the disclaimer of the contingent interest in these two trusts. In fact, the IRS specifically distinguished between the present interest the taxpayer had to receive income and principal from the contingent interest on the termination of the trusts and pointed out that these interests may be disclaimed separately. See Treas. Reg. Section 25.2518-3(d), Example (11). While the taxpayer's proposed disclaimer of the contingent interest would constitute a qualified disclaimer and not be subject to federal gift tax, a question remains as to what would happen if the taxpayer accepted a distribution of income or principal from either trust after the disclaimer. The IRS didn't comment or shed any light on this ambiguity.

What to Take With You

As we move forward in time, it becomes less likely that practitioners will be faced with the opportunity to advise clients on how to disclaim interests created pre-1977. Nevertheless, it remains important to realize that the IRC and regulations thereunder offer two different rules for making disclaimers of interests based on the time the interests are created. What may be a rule for disclaiming one interest may not be the same for another interest. In advising clients, practitioners must remain vigilant to distinguish the different interests so as to ensure there are no unintended gift tax consequences.