



Disclaimer Trust

Introduction

A disclaimer is a refusal to accept money or other property by someone who would otherwise be your beneficiary according to your will, trust, gift, insurance policy, retirement account, or your state's intestacy laws. The person who disclaims the property (the "disclaimant") is treated as if he or she predeceased you and never received the property.

There are several situations where a potential beneficiary might want to forgo property to which he or she is entitled. Often, these situations can be anticipated, and a disclaimer trust can be created to receive disclaimed property, which is then administered and distributed according to the terms of the trust.

Why use a trust?

Without a disclaimer trust, the disclaimed property would pass directly to other individual beneficiaries according to your state's laws. Planning with simple disclaimers (i.e., where no trust is used) can be appropriate in many situations. In those situations, you can simply specify in your will that any disclaimed property go directly to someone else (e.g., "If my spouse disclaims any bequest, the bequest shall pass in equal shares to my three children"). However, there are some situations where directing the disclaimed property to a specific individual should be avoided.

Providing for a child with special needs

What if one of your adult children was receiving state-funded benefits for special needs? A sudden windfall could disqualify the child for state aid, resulting in at least a temporary interruption in his or her care. To avoid this situation, you could provide that some or all of the disclaimed property would go to a disclaimer trust for the benefit of the child with special needs.

Caution: Drafting this type of trust requires particular legal expertise to ensure that the child with special needs remains entitled to government benefits under your state's laws.

Marital bypass planning

A disclaimer trust is often used as an alternative to a bypass trust (also known as a credit shelter trust) in order to provide more flexibility. Bypass planning is designed to both minimize federal estate taxes for married individuals, and allow the surviving spouse to benefit from the family's wealth during his or her continuing life. This can be accomplished by taking full advantage of the applicable exclusion amount, which protects up to \$3.5 million in 2009 from estate tax, and the unlimited marital deduction, which allows spouses to transfer property between themselves gift and estate tax free. Here is a typical scenario where bypass planning is needed:

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Example(s): In 2002, Edward died with a net taxable estate of \$4.5 million, which he left to his wife, Sonia. Edward's estate paid no federal estate tax because of the unlimited marital deduction. Edward's estate did not use any of his applicable exclusion amount (\$1 million in 2002). Sonia dies seven years later in 2009. Her net taxable estate is valued at \$4.5 million. She leaves her estate to her son, Max. Sonia's applicable exclusion amount exempts \$3.5 million of her property from tax. Sonia's estate owes estate tax on \$1 million.

To avoid this situation, the couple in the above example could have used a bypass trust. With a bypass trust, property is transferred from the estate of the first spouse to die to the bypass trust such that his or her applicable exclusion amount is fully used. The remainder of the assets of the first spouse to die is then transferred directly to the surviving spouse or to a marital trust for the surviving spouse's benefit. To prevent inclusion of the bypass trust in the estate of the surviving spouse, he or she is given only certain rights and limited control over the assets in the trust. The surviving spouse may receive income from the trust or may be given the right to invade the trust principal for his or her health, education, maintenance, or support. The surviving spouse may also be given a limited power of appointment over the assets in the bypass trust. A limited power of appointment permits the power holder to direct that the assets in the trust ultimately pass to a limited class of beneficiaries that does not include himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate.

Example(s): Edward died in 2002 with a net taxable estate of \$4.5 million. His will directs that an amount equal to the applicable exclusion amount (\$1 million) pass to a bypass trust. The rest of his estate (\$3.5 million) passes directly to Sonia. No estate tax is due at Edward's death; the \$3.5 million going to the trust is exempt under the applicable exclusion amount, and the \$1 million going directly to Sonia is tax free under the unlimited marital deduction. During the remainder of Sonia's life, she receives all the income from the trust and is able to access the principal for her health, education, maintenance, and support. Sonia dies seven years later in 2009. Her net taxable estate is valued at \$3.5 million, which passes to her son, Max, tax free under Sonia's applicable exclusion amount. Max also receives any property remaining in the bypass trust.

A married couple who wishes to set up a bypass trust should first divide up ownership of their assets. After the division, each spouse should own in his or her own name an equal share of the couple's total assets. If one spouse owns all the assets alone or all their assets are owned jointly, the couple may not be able to fully use the applicable exclusion amount of each spouse. If one spouse owns all the assets alone, and the other spouse dies first, the applicable exclusion amount of the first spouse to die will be wasted as there will be no assets in the estate to which it can be applied.

Correspondingly, the estate of the surviving spouse may be overqualified (i.e., have more than the applicable exclusion amount in the estate). Similarly, if both spouses own all assets jointly, when one spouse dies, the other spouse

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automatically owns all of the assets. When the surviving spouse then dies, his or her estate may be overqualified. If ownership of their assets is split up between the married couple, each individual will have assets to which his or her applicable exclusion amount can be applied.

As an alternative to the bypass trust, which forces (1) the couple to divide their assets, and (2) the estate of the first spouse to die to fund the trust with a specific amount, a disclaimer trust (1) lets the couple own property jointly, and (2) gives the surviving spouse the option to fund the trust with an amount that makes sense, or not to fund the trust at all. The surviving spouse can base his or her decision on the circumstances that then exist. A disclaimer trust is structured like a bypass trust; the surviving spouse receives all the income and can dip into the principal to the extent necessary for his or her health and support.

Technical Note: The estate tax applicable exclusion amount is \$3.5 million in 2009. In 2010, the estate tax is scheduled to be repealed. In 2011, the estate tax is scheduled to be reinstated with an applicable exclusion amount of \$1 million.

Disadvantages

Surviving spouse may fail to make the disclaimer

The surviving spouse must act quickly to fund a disclaimer trust, generally within nine months of death. If the surviving spouse does not make the disclaimer in a timely fashion, or otherwise fails to make an effective disclaimer (there are several requirements), this post-mortem planning device will fail to meet your planning objectives.

Heirs of the first spouse to die are not guaranteed a share of deceased spouse's estate

With a disclaimer trust, the decision to fund the trust lies with the surviving spouse. If the surviving spouse does not disclaim or fund the trust, the heirs of the deceased spouse may not receive any of the decedent's estate. Therefore, this type of trust may not be appropriate if a spouse wants to ensure a legacy to his or her heirs. This may be the case, for instance, when there is a second marriage and there are children from a previous marriage.

Disclosures – Important – Please Review

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