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ESTATE PLANNING

Disclaimer Trusts and the Clayton QTIP

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Introduction

An essential aspect of estate planning is that circumstances are subject to change, especially when it comes to applicable tax law. We currently face considerable uncertainty regarding the law applicable to the estate, gift, generation-skipping transfer (GST), and capital gains taxes. Presently, there is no federal estate, gift, or GST tax on transfers under $11.7 million (the Exemption Amount), or $23.4 million for married persons.

Most assets receive a tax basis adjustment for capital gains tax purposes equal to the asset's fair market value at death (commonly referred to as the "stepped up" basis). However, under current law, the Exemption Amount is scheduled to reset to $5 million per person on January 1, 2026 (but will be adjusted for inflation). There is an additional concern that a Democrat-controlled Congress and President might reduce the Exemption Amount sooner or even reduce it to $3.5 million. There are also concerns about changes to the stepped-up basis rule.

Amid the uncertainty, a good estate plan offers flexibility for modification when faced with the potential for changed tax circumstances. Revocable trust plans for married persons can achieve tax advantages by utilizing either qualified "disclaimer" planning or the "Clayton QTIP" election.

Disclaimers

A disclaimer is the refusal to receive property or assets gifted through a will or other document. Under federal gift tax laws, a property disclaimer will not be treated as a taxable gift by the disclaimant (the individual disclaiming the property) to the person or entity to whom the property passes.

Under §2518 of the Internal Revenue Code, a "qualified disclaimer" must meet the following conditions:

- The disclaimer must be in writing;
- The disclaimer must be within nine months of the transfer date (typically the date of death or gift date) or the day on which the disclaimant attains age 21, whichever is later;
- The disclaimant must not accept any of the benefits of the disclaimed property; and
- The interest must pass to the decedent's spouse—or a person other than the disclaimant—without any direction from the disclaimant.

Using Disclaimers

Qualified disclaimers provide:

- time to determine a family's most suitable course considering estate laws,
- creditor protection issues, and
- the estate's distribution objectives.

A disclaimer allows the surviving spouse to use the tax exemptions of the deceased spouse, remove subsequent growth from a taxable estate, and protect creditors.

Under certain circumstances, the survivor can elect to accept a bequest to obtain greater control and flexibility over subsequent distributions from the estate. Assets retained receive a second stepped-up basis upon the surviving spouse's death.

Additionally, the survivor may still be able to utilize the estate tax exemption of the first spouse under a concept known as exemption portability. This approach gives the surviving spouse maximum flexibility regarding whether to create a disclaimer trust and the extent to which to fund the trust.

Benefits of a "Clayton" QTIP Election

A qualified terminable interest property (QTIP) trust enables the trust creator to provide income for a surviving spouse while maintaining control of asset distribution after the surviving spouse passes away.

First authorized in *Estate of Clayton,* 976 F.2d 1486 (5th Cir. 1992), and later accepted by the IRS in Treas. Reg. 25- 2518-2(e)(5), Example 5, the Clayton QTIP offers a variation on the conventional testamentary QTIP trust and flexibility in anticipating future tax law updates.

Requirements for a QTIP trust include:

1. The surviving spouse must be the trust's only lifetime beneficiary;
2. Income must be distributed to the surviving spouse annually at regular intervals;
3. During the surviving spouse's life, no one can assign any part of the property to any other person; and,
4. The deceased spouse's executor must elect to treat all or a specified portion of the trust property as qualified terminable interest property.

Assets under a QTIP trust receive a step-up basis at the survivor's death, which helps heirs avoid capital gains taxes. Furthermore, when estate tax exemption portability is available, estate taxes can be reduced or eliminated.

Rather than conferring all power to a surviving spouse (as occurs under the disclaimer option), the Clayton QTIP gives a decedent's executor or personal representative discretion in determining what share of the estate to pass to a QTIP, based on an assessment of assets and the tax landscape. The portion not given to the QTIP then passes to a non-marital trust share also established for the survivor's lifetime benefit.

Other QTIP Advantages

The Clayton QTIP approach offers some advantages over a disclaimer trust. First, there is no danger of waiving the disclaimer by the surviving spouse's acceptance of the property with the Clayton election. And, unlike in a disclaimer trust, there is no problem with giving the surviving spouse power of appointment over the remainder interest.

The decision to make the Clayton QTIP election is typically that of an independent personal representative, avoiding any gift tax exposure to the surviving spouse and placing the decision-making in the hands of a third party to account for a blended family situation.

Moreover, it is often difficult to explain to a surviving spouse that they must "give up" some assets to have a better tax outcome. Survivors often find that difficult to embrace within nine months of losing a spouse while handling personal finances.

Lastly, while a disclaimer is due within nine months after the deceased spouse's death, a QTIP election can be made 15 months afterward (a nine-month estate-tax-return-filing deadline plus a six-month extension).

Conclusion

While tax laws may fluctuate with any congressional cycle, remember that many conventional planning techniques may provide flexibility in estate planning. Conventional marital trust planning devices, such as qualified disclaimers and the Clayton QTIP election, may help determine the best course of action regardless of future tax law changes.

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