Renunciations, Disclaimers, and Net-Gift Agreements, Oh My!

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Take-Away: Planning with *qualified* disclaimers, and sometimes even non-qualified disclaimers, can produce interesting transfer tax results. This is especially the case with a disclaimer of an income interest in a QTIP Trust.

Background: *Qualified* disclaimers are frequently used to 'transfer' assets without incurring a gift tax. There are also occasions when a non-qualified disclaimer of an interest in a trust can produce a good tax outcome, or some surprising tax consequences, depending on the interest that is subject to the non-qualified disclaimer. Such was the case in a recent IRS Private Letter Ruling which reached some predicable tax consequences along with a couple of surprises.

Private Letter Ruling 202339008 (September 28,2023)

Facts: The decedent husband had a revocable Trust which used a fairly standard funding formula to first fund a credit shelter trust and then with any excess assets passing to a QTIP marital trust, i.e. a 'reduce-to-zero' funding formula. The husband had fully used his available applicable exemption amount at the time of his death, which meant that *all* of the Trust assets passed to the QTIP trust for his wife's lifetime benefit. The husband's estate filed a federal estate tax return and it timely elected to treat the transfer of Trust assets to the QTIP trust as qualified terminal interest property. The widow later renounced her interest in the QTIP trust, which caused the *all* of the Trust's assets to pass to the credit shelter trust. The widow also renounced her lifetime interest in the credit shelter trust. The result was that *all* of the decedent's Trust assets passed out of the credit shelter trust and to their children. As a condition of the widow's renunciation of her interests in these two trusts, her children agreed to pay any gift taxes that were imposed under a net gift agreement; the widow also negotiated the right to recover from her children any gift tax that might be imposed on her.

IRS Rulings: A series of rulings were made by the IRS, many of which dealt with technical provisions of the Tax Code.

Non-Disclaimer- the 9-Month Rule: The widow's disclaimer was called a renunciation by the IRS. The renunciation of the widow's interest in the QTIP trust was not a *qualified disclaimer* because it was not made by the widow within 9-months of her husband's death, when his revocable Trust became irrevocable. Consequently, the widow was treated as making a taxable gift of her interest in the QTIP trust to the credit shelter trust.

Qualified Disclaimer- Timing: The widow's release of her interest in the credit shelter trust was treated as a *qualified* disclaimer by her because that 'release' occurred within 9-month of the date of the taxable gift, which was when she renounced her income interest in the QTIP trust- which, in turn, was when the credit shelter trust was funded. [Regulation 25.2518-2(c)(3).] In short, her *qualified* disclaimer of her interest in the credit shelter trust was immediately after the QTIP trust assets that flowed into the credit shelter trust resulting from her renunciation. In contrast, if Trust assets had passed directly into the credit shelter trust after the husband's death, or if the renunciation by the widow's interest in the QTIP trust had been a *qualified* disclaimer, then the 9-month period in which to disclaim her interest in the credit shelter trust would have begun starting with her husband's death, not the later date on which she renounced her interest in the QTIP trust.

Gift of QTIP Income Interest: The widow's taxable gift was her income interest in the QTIP trust. [IRC 2511.] As a result of the gift of her income interest in the QTIP trust, the widow is treated as having gifted of *all* of the assets held in the QTIP trust, not just her qualifying income interest in the QTIP trust. [IRC 2519.] IRC 2019 is one of those often overlooked Tax Code provisions, but as noted in the comment below, can also be a planning strategy, too.

Net Gift Agreement: As noted, the widow's renunciation [QTIP trust] and *qualified* disclaimer [credit shelter trust] were contingent on her children agreeing to pay any gift tax imposed under IRC 2511, in anticipation of the widow having made a taxable gift caused by IRC 2519 that imposed a gift tax on *all* of the QTIP trust assets which resulted from her disclaimer/renunciation of her income interest in the QTIP trust. However, the federal gift tax liability that the children agreed to pay under the net gift agreement reduced the value of the widow's gift, the result of which was less federal gift tax paid.

Sale-Capital Gain: Because the children agreed to pay the gift tax on their mother's gift of her income interest in the QTIP trust, the transfer of her income interest is treated as a sale by her, and the gift tax the children paid is the 'consideration' for that sale. Revenue Ruling 72-243 provides that the proceeds received by the life tenant of a testamentary trust, in consideration for the transfer of their entire interest in the trust to the remaindermen of the trust, are to be treated as an amount realized from the sale or exchange of a capital asset [IRC 1223.] The widow's (life tenant's) tax basis attributable to her life interest is considered to be zero ($0.00.) Thus, the entire gift tax paid by the children is treated as a capital gain to their mother.

Widow's Estate Exposure: Finally, the widow wanted some confirmation from the IRS of the impact of her renunciation/*qualified* disclaimer/net-gift agreement on her own future estate tax exposure.

-Generally-No Estate Inclusion: The IRS confirmed that the property that was held in either the QTIP trust (released-gifted) or the credit shelter trust (timely disclaimed) would not be includible in the widow's own taxable estate on her death. [IRC 2033, 2036 or 2038.]

-But-the 3-Year Look Back Rule Applies: However, the gift tax paid by the widow's children under the net-gift agreement with their mother would be includible in the widow's gross estate at the time of her death if she died

within 3 years of 'her' gift, i.e., her renunciation of her interest in the QTIP trust, even though her children actually paid the federal gift tax, not her. [IRC 2035.]

Planning Observation: IRC 2519(a) is one of those unusual rules that not too many are familiar with under the Tax Code. A gift of all or part of a qualified income interest for life in any property to which IRC 2519 applies, i.e. a QTIP Trust, is treated as a transfer of all interests in the property other than the qualifying income interest.

Example: On Darin's death in 2023 he left his entire estate in a QTIP Trust for the benefit of his widow Samantha . The QTIP Trust holds $10,000,000 . Samantha has the right to receive all income under the QTIP Trust, which is a QTIP Trust requirement. It is 2025. Samantha decides to transfer/release her right to receive 1% of the QTIP Trust's income. Samantha is treated as having made a taxable gift of $10,000,000. Samantha's decision to transfer/release her right to receive 1% of the QTIP Trust's income is to intentionally cause a taxable gift by her of $10,000,000 using a large part of her$14,000,000 applicable exemption amount while it remains available. Samantha will continue to enjoy the right to receive 99% of the income that is generated by the $10 million of assets held in the QTIP Trust for the rest of her lifetime. If Samantha waits until 2026, then she arguably will have a taxable estate on her death caused by the QTIP Trust's assets that are included in her taxable estate, but Samantha's applicable exclusion amount after 2025 will be around $6.0 million, resulting in an estate tax due on her death causes by the $4.0 million that will not be sheltered by her applicable exclusion amount.

Conclusion: Planning with *qualified* disclaimers can effectively move assets without incurring a federal gift tax. Releasing income interests in a QTIP Trust can create a gift tax liability which could either come as a big surprise to the QTIP Trust's income beneficiary, or it could be effectively use the income beneficiary's currently large *bonus* applicable exclusion amount while it still exists. Using a net-gift agreement with the donee can actually reduce the amount

of federal gift tax that will be owed. Lots to think about as we ponder the *bonus* applicable exclusion amount's *sunset date.*