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Sometimes It's Right to Say 'No Thanks' to Inheritance

TAX REPORT |

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Disclaimers are one way to tackle tax and family wealth-planning issues posed by inherited IRAs

If you're an older saver coping with tax planning for a large, traditional IRA—or even a smaller one—you might have over--looked a useful tool.

It's called a disclaimer. In essence, it's a strategic rejection of an inherited asset by an heir.

The result is that part or all of the inheritance passes to someone else, often a child or grandchild. The move can save taxes and accomplish other goals for families. It can be used with IRAs and other inherited assets.

"Disclaimers are a great way to provide flexibility for making smart decisions after a death," says Diane Thompson, an attorney with Pender & Coward who has worked on about 1,000 disclaimers.

I'm betting many older savers are overlooking disclaimers as an IRA tax-planning tool. I was one of them. However, I recently disclaimed part of a traditional IRA I inherited, and it worked out well. My adult children received a legacy from a relative they loved, and the overall taxes will be lower.

As a result, I'm struck by how useful disclaimers can be for retirees and preretirees who have traditional IRAs far larger than they expected. Thanks to diligent saving, 401(k) rollovers and market growth, these accounts are often a retiree's largest asset. While this is a great problem to have, it poses dilemmas for savers trying to minimize income taxes.

For example, traditional IRAs have minimum payouts called RMDs that begin at age 73 and increase annually. They're 3.8% of IRA funds at 73, 5% at 80 and 8.2% at 90. These forced withdrawals are payback for years of valuable tax deferral and are taxed at ordinary income rates.

RMDs have ripple effects. They can push savers into higher Medicare income surcharges known as Irmaa and help raise the 3.8% surtax on net investment income, while shrinking the medical-expenses deduction. If one spouse dies and the other inherits the IRA, that can raise the survivor's top tax rate.

Often, disclaimers can help with such issues. Of course, people contemplating disclaimers have to be willing to give up money for themselves. That's the price of family wealth planning.

Here's a simplified example of how this can work. Grandpa had a large, traditional IRA he left to Grandma. At his death, she rolled it into her name. She died a year later.

Grandma's daughter, who is in her 50s, is set to inherit the IRA. But she is in a fairly high incometax bracket, and withdrawing the funds within 10 years as required by law could push it higher.

However, the daughter has two young-adult children in lower tax brackets, and they're listed as "contingent beneficiaries" on Grandma's IRA form. In that case, the daughter could disclaim all or part of the IRA and have it go directly to her children.

The children will also have 10 years to empty the account, and they'll have to take annual withdrawals if Grandma had to. But the family's income taxes will likely be lower than if the daughter kept the account. Even if the disclaimed funds are larger than the annual gift-tax exemption of $19,000, the daughter won't have gift-tax issues because the funds were never hers.

Of course, the daughter doesn't have to do a disclaimer. Perhaps the grandchildren can't handle an inheritance, or she worries she'll need the funds. The point, says Thompson, is that disclaimers enable postdeath moves based on current circumstances long after an estate has been planned.

Disclaimers are a vast legal topic, but sometimes they're simple and low-cost—as mine was. Here's more to know.

The basics. A disclaimer is a legal document in which someone renounces an asset that was set to be inherited. The asset then passes to another heir typically designated by documents such as a beneficiary form or a will, or by law. In effect, the person who disclaims never owned the asset.

For federal law, the deadline to do a disclaimer is nine months after death. State laws vary as to who receives the document. Sometimes it must be filed with a court, so be sure to check.

For a disclaimer to be valid, the person disclaiming an asset must not have benefited from it, say, by spending the dividends from a stock. Once a disclaimer is done, it can't be undone.

What's flexible. Heirs have great freedom regarding what assets to disclaim, and how much. "Within an IRA, you can disclaim one fund but not another, or some of the Apple shares but not all of them," says Bruce Steiner, an estate lawyer with Kleinberg, Kaplan, Wolff & Cohen, who says he does disclaimers in a large percentage of estates he handles.

What's not flexible. The heir has no freedom to designate the recipient of the disclaimed asset, as in, "I want this disclaimed amount to go to person X but not person Y." The law treats people who disclaim as though they died, and looks to their designated beneficiaries and the law as to who inherits next.

About naming heirs. Sometimes disclaimers can work even if the asset owner didn't specify an heir. Much better is for the owner to designate tiers of heirs.

For example, the primary beneficiary of an IRA might be the spouse, but the form would also name children as secondary beneficiaries and perhaps grandchildren after that. Financial firms such as Fidelity, Vanguard and Charles Schwab said they routinely allow qualified disclaimers, but some sponsors might not.

Be careful with disclaimers to minors. Do your homework if you're thinking of naming a minor— say, a grandchild— to receive disclaimed IRA funds. In your state, would a court need to appoint a guardian? In addition, income to the minor might be taxed at the parents' rates via the socalled Kiddie Tax. And some minor children who inherit IRAs must take annual withdrawals from them.

Keep charities in mind. For some people, a favorite charity can be a good secondary beneficiary. Donations of IRA assets are triple-tax-free because no federal income tax is due on contributions, growth or withdrawals.

If an IRA owner wants to maintain flexibility—and trusts the heirs' judgment—he or she could leave them the IRA, and they could disclaim to the charity if appropriate.

Note that donations of IRA assets at death can be to a donor-advised fund, or DAF, while qualified charitable distributions made during life can't, under current law.