Clayton Elections vs. Qualified Disclaimers in Estate Planning

Post-mortem flexibility is imperative for Elder Law practitioners and their clients. Careful attention must be given to potential income, estate and gift tax issues and potential disqualifying transfers for Medicaid. What is favorable from a tax perspective can be detrimental for Medicaid eligibility. Decisions made today may be judged years in the future.

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This concept is paramount when designing an estate plan. Retaining flexibility is critical when state estate taxes may be a concern and protecting the surviving spouse should Medicaid be needed. This article examines the effects of partial QTIP elections versus Qualified Disclaimers in both the estate planning and Medicaid contexts.

Background

The Tax Reform Act of 1976 introduced the concept of the Qualified Disclaimer by creating Section 2518 of the Internal Revenue Code. For the first time post-mortem decisions addressed tax and inheritance issues. Practitioners no longer had to decide years before death without considering changes in facts and law.

A Qualified Disclaimer can determine the ultimate disposition of an estate including fixing the Marital Deduction amount; however, the requirements for Qualified Disclaimers are stringent and present problems of their own.

Qualified Disclaimer

A Qualified Disclaimer must be valid under state law and meet a four-prong test under the Internal Revenue Code:[1]

1. **Written Test:** The disclaimer must be in writing and describe the property being disclaimed;

2. **Nine Month Test:** The disclaimer must be received by the transferor, her legal representative or the holder of legal title to property no later than nine months after the later of: (a) the date on which the transfer creating the interest in the claimant is made; or (b) the date on which the disclaimant turns 21 [emphasis added];

3. **No Benefit Test:** The disclaimant must not have accepted the property or any benefits from it; and

4. **Passage Test:** The property must pass, without direction from the disclaimant, to either: the transferor's spouse; or a person other than the disclaimant.

If the above tests are met, the disclaimed property passes as if the disclaimant predeceased the decedent.

While the tests may appear straight forward, there are perils. For the Nine Month Test, the disclaimer must be made within nine months of the creation of the interest. This is an inflexible rule; even lack of knowledge in the interest is not relevant.[2] There is no extension available, even if an extension to file the estate tax return is granted.[3] In probate estates, intestate estates, and revocable trusts, the decedent's date of death is the date of creation of the interest and the Nine Month Test begins that date. Contrast this to the treatment of an irrevocable trust; should the remaindermen of an irrevocable trust wish to make a Qualified Disclaimer, it must be done within nine months of the creation of the trust.[4]

The *Clayton* Election

The Qualified Disclaimer was essentially the only post-mortem planning tool until the creation of the Qualified Terminal Interest Property Trust (QTIP) by the Economic Recovery Tax Act of 1981.[5]

For the first time, the QTIP Trust allowed a decedent to pass an interest in property for the surviving spouse's lifetime without the decedent's losing the ability to control the disposition of such property upon the death of the surviving spouse. It also allowed an executor or trustee to make a partial election to qualify QTIP property for the marital deduction. In this respect, the final effect was the same as the Qualified Disclaimer – a decision to make use of the marital deduction can be made after the death of a decedent.

However, the partial QTIP election presented its own set of issues, mainly the disposition of the trust property not covered by the QTIP election. The original position of the IRS was if there was a QTIP election for a portion of a trust, the marital deduction was not available for the entire trust unless the terms of the trust holding the non QTIP property were identical to the terms of the QTIP trust; the surviving spouse must remain the sole income and principal beneficiary of the trust.

The initial Tax Court decision in *Estate of Clayton v. Commissioner*[6] held the surviving spouse had a qualifying income interest for life despite passing an income interest in the property to the surviving spouse was contingent upon the executor's QTIP election as to such property and was therefore subject to the executor's power to appoint the property to someone other than the surviving spouse. The Tax Court concluded that the surviving spouse did not have a "qualifying income interest for life" over the trust containing the property not covered by the QTIP election and that the property therefore was not QTIP.

The IRS examined the *Clayton* decision and its aftermath in *Clack v. Commissioner*[7] and held any property for which QTIP treatment was not elected can have a different distribution plan without disqualifying property covered by the QTIP election.[8] Although

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the IRS acquiesced with *Clack*, the entire concept of the partial QTIP election was named after the parent case and is known as the "*Clayton* Election" or "Clayton QTIP."

Under the *Clayton* Election, if the personal representative of an estate partially elects QTIP treatment for an estate, the disposition of the balance of an estate will not affect the QTIP Election even if such property passes to someone other than the surviving spouse.[9]

The *Clayton* Election must be made on the last estate tax return filed by the executor by the due date of the return, including extensions or, if a timely return is not filed, the first estate tax return filed by the executor after the due date.

To facilitate the *Clayton* Election, the marital deduction trust should include language instructing the trust can be divided into QTIP and non-QTIP property, and the personal representative must declare this on the estate tax return.

Disclaimers for the Elder Law Practitioner

With the Omnibus Reconciliation Action on August 10, 1993 ("OBRA '93"), the federal administration of the program provided that "waving the right to receive an inheritance" was a disqualifying transfer for Medicaid benefits. While every state adopted its own administrative rules, Medicaid agencies denied benefits to those who made a Qualified Disclaimer and their spouses.

When planning for a couple, the attorney must plan for maximum tax protection while ensuring the tactic used is not a disqualifying transfer for Medicaid.

In upholding the denial of benefits to a recipient who disclaimed, a New York appellate court held renunciation was the equivalent of a transfer as her family would benefit from the money. The court cited public policy considerations as a justification for Medicaid to be permitted to force a recipient to accept an inheritance and spend it down.[10]

In a recent Rhode Island case, the court cited to and upheld the oft-cited case of *Troy v. Hart*[11] and found that a Medicaid recipient's inheritance and subsequent disclaimer of two real properties was an improper and uncompensated transfer of assets. The court upheld the Medicaid ineligibility as the real property was an available resource for the applicant to use to pay for the cost of her medical care.[12]

The primary use of a Qualified Disclaimer in the context of Elder Law planning allows the surviving spouse to file a Qualified Disclaimer and allow the disclaimed property to pass to a testamentary trust for the benefit of the surviving spouse. This enables the surviving spouse the use of the unified credit and gives the surviving spouse the benefit of the disclaimed property without having the property taxed at his or her death.

Benefits of a *Clayton* Election

When planning for a couple, the attorney must plan for maximum tax protection while ensuring the tactic used is not a disqualifying transfer for Medicaid. This can best be accomplished by using a *Clayton* Election.

Both the Qualified Disclaimer and *Clayton* Election allows assets to be shifted, post-mortem, and accomplish the estate tax goals. However, a *Clayton* Election has major benefits over a Qualified Disclaimer:

1. The *Clayton* Election will not be a disqualifying transfer;
2. The property not covered by the *Clayton* Election can be held in a Supplemental Needs Trust;
3. The surviving spouse can be given a special power of appointment over property not covered by the *Clayton* Election;
4. There is no hard and fast deadline for making the *Clayton* Election.

An Elder Law attorney is tasked with the obligation of creating a plan that is flexible, as the unknown future could create havoc and significant financial burdens. The Elder Law practitioner must be prepared to change her plan from tax planning to long-term care planning. While using a *Clayton* Election is not a perfect solution, the additional flexibility and protection from disqualifying transfers makes it a superior tool to use when both long-term care and state estate taxes are on the horizon.

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1. 26 U.S.C. § 2518 (b) (2013).
2. PLR 200339021 (9/26/2003).
3. *Fitzgerald v. U.S.*, 94-1 USTC 60,152 (W.D. La. 1993).
4. Reg. § 25.2518-2(c)(5) Example 3.
5. Pub. L. 97-34.
6. \97 T.C. 327 (1991).
7. Action on Dec. CC-1996-011, AOD 1996-011, 1996 AOD LEXIS 5 (I.R.S. 1996).
8. 1996-2 C.B. 1; 1996 IRB LEXIS 404.
9. *Estate of Robertson v. Comm'r*, 98 T.C. 678 (1992); *Estate of Spencer v. Comm'r*, T. C. Memo. 1992-579, rev'd, *Estate of Spencer v. Comm'r*, 43 F.3d 226 (6th Cir. 1995).
10. *Molloy v. Bane*, 214 A.D.2d 171 (2d Dept. 1995).
11. *Troy v. Hart*, 697 A.2d 113 (Md. Ct. Spec. App. 1997).
12. *Lapointe v. R.I. Dept. of Human Servs.*, 2013 R.I. Super. LEXIS 80 (Apr. 26, 2013) (R.I. Super. Ct. 2013).