WebsterBank

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Trusted Insights

WEALTH MANAGEMENT

The "lock-in" debate is back again

In this issue of Trusted Insights you'll find a brief summary of "For the 99.5%," the latest estate tax reform legislation from Senator Bernie Sanders. In earlier proposals Senator Sanders included a top estate tax rate of 77%, justifying it as historically effective. Now the proposed top rate is 65%, perhaps indicating a move toward compromise. Given the Democrats' control in Washington, D.C., some estate planners are advising their wealthiest clients to take another look at "locking in" today's larger exemption with sizable taxable gifts. To read Senator Sanders' own summaries of this law, you can start here: https://www.sanders.senate.gov/press-releases/sanders-and-colleagues-introduce-legislation-to-end-rigged-tax-code-as-inequality-increases/.

Also in this issue, one might think that the legal duty a donor-advised fund owes to donees is sharply limited after a donation is complete, but a recent case suggests otherwise.

We are ready to assist you and your clients in any way that we can. Please call upon us whenever the question of fiduciary services arises in your practice.

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What happens after a gift to a donor-advised fund?

DONOR-ADVISED FUNDS (DAFS) HAVE EMERGED IN RECENT YEARS AS A POWERFUL FORCE IN CHARITABLE GIVING. DONORS GET THE BENEFIT OF IMMEDIATE TAX DEDUCTIONS FOR MAJOR CHARITABLE GIFTS WHILE DEFERRING THE DECISIONS ON WHICH CHARITIES SHOULD BE BENEFICIARIES, AND HOW MUCH AND WHEN THEY SHOULD RECEIVE THAT SUPPORT.

A gift of appreciated securities to a DAF is especially attractive, as the donor avoids income tax on the capital gain while securing a deduction for full fair-market value.

The Tax Cuts and Jobs Act may have contributed to DAF growth. With the doubling of the standard deduction, some taxpayers salvaged their charitable deduction by bunching contributions some years and skipping the alternate years. The DAF provided a mechanism for preserving the tax deduction while keeping philanthropic support steady.

The DAF is not required to follow the donor's advice in future years. That loss of donor control is what justifies the tax treatment. Yet as a practical matter, DAFs are unlikely to upset donors if they can avoid it. However, a recent case sheds new light on the post-gift obligations of DAFs to their donors [*Fairbairn v. Fidelity Investments Charitable Gift Fund*, Case No. 3:18-cv-04881-JSC, U.S. Dist. Ct. N.D. Cal. (Feb. 26, 2021)].

> "A gift of appreciated securities to a DAF is especially attractive, **as the donor avoids income tax on the capital gain while securing a deduction for full fair-market value.**"

Backstory

Malcolm and Emily Fairbairn were successful hedge fund managers. In anticipation of a significant tax obligation, the Fairbairns decided to make a sizeable charitable gift in 2017. They considered but rejected the idea of a private foundation, as it would require too much time and attention to manage. In early 2017 they began discussing a donation of appreciated assets to DAFs sponsored by Fidelity Charitable and JP Morgan, which they had contributed to previously. They chose Fidelity, they later testified, because the person they dealt with promised that the donated shares would be sold gradually and not until 2018, so as to not depress the values by selling at once in a large block. However, that agreement was not reduced to writing, and in fact was contrary to Fidelity's published policies for DAF donations.

The Fairbairns owned shares of Energous, which they purchased before its IPO at share prices from $3 to $12. Energous was developing technology for wireless recharging at a distance, and they expected FCC approval in 2017. In fact, that approval arrived on December 20, 2017, and the news became public on December 26. The price of Energous stock shot up on the news. The Fairbairns transferred 700,000 shares to the Fidelity DAF on December 28, and another 1.23 million shares on December 29.

Contrary to the couple's expectations, Fidelity sold the entire 1.93 million-share position on the afternoon of December 29. The donation secured an income tax charitable gift deduction of $55 million for the Fairbairns.

The lawsuit

On August 18, 2018, the Fairbairns filed a lawsuit claiming that the sale of the shares in one day violated four separate promises that had been made to them to induce them to choose Fidelity:

- that the sale would not represent more than 10% of the daily trading volume;
- that sophisticated, state-of-the-art methods would be used to liquidate the stock;
- that the Fairbairns would be allowed to advise on a price limit for the sale; and
- that the liquidation would be delayed until 2018.

The couple also alleged that, apart from the promises made, the sale of the entire block of stock in one afternoon was negligent and violated a duty of care owed to them.

Fidelity moved for summary judgment, on the theory that once the transfer was complete the only duty owed to the Fairbairns was the acceptance of their advice on charitable distributions. To the surprise of many observers, that motion was denied, and a trial was ordered.

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Victory for the DAF

The Fairbairns lost their case. As to the unkept promises, the Court found that the sale of 1.93 million shares was actually less than the 10% of daily trading volume on December 29, 2017. The other promises were either unproven or reliance upon them was not reasonable. The Fairbairns needed that tax deduction, the Court reasoned, and by the end of December they had no other option for securing it. Their motivation therefore could not have been the promises made to them.

As to the negligence claim, Fidelity's actions were consistent with their published policies. The Court also noted that the average sale price of donated shares was $22, the highest price ever until December 27, 2017. The shares never traded above $23 in 2018 or later. By the time the opinion was written, those shares were trading at about $5.

This case suggests that DAFs may have legal obligations to their donors that continue to be actionable after a donation is made, even though the plaintiffs lost in this case. Sponsoring organizations need to be very careful about their promises to potential donors. Donors ought to keep in mind that if they retain legal rights or controls over a donation, it could very well undermine the charitable deduction that they are hoping to secure.

"For the **99.5% Act**"

IN MARCH SENATOR BERNIE SANDERS INTRODUCED MAJOR ESTATE TAX REFORM LEGISLATION.

Senator Sanders believes many billionaires have unfairly used legal estate planning strategies to gain control over their transfer tax exposure, and has proposed legislation which includes an array of changes to both increase estate taxes and decrease the opportunities for planning. The bill is named "For the 99.5% Act" because it purportedly only would affect 0.5% of American families. Key provisions of the law include:

- reducing the exemption from the federal estate tax to $3.5 million;
- reducing the exemption from the federal gift tax to $1.0 million;
- increasing tax rates (see table)
- denying the generation-skipping transfer tax exemption to any trust that may last for more than 50 years;
- requiring a 10-year minimum term for grantor-retained annuity trusts;
- limiting the annual exclusion for gifts to trusts;
- restricting valuation discounts for family business interests.

The changes in exemptions and tax rates would take effect beginning next year, while many other provisions would become effective on the date of enactment. Note that the marital deduction and the Deceased Spouse's Unused Exemption (DSUE) amount would not be affected.

Senator Sanders states that the families of 657 billionaires would owe up to $2.7 trillion in estate taxes under his proposal. According to the Joint Commitee on Taxation, the bill would raise $430 billion through 2031. When he introduced similar legislation in 2019, the Tax Foundation cast doubt on the net revenue projections [https://taxfoundation.org/bernie-sanders-estate-tax/]. The Tax Foundation report suggested that estate taxes impose significant compliance costs, and increasing estate taxes imposes a substantial burden on investment and economic growth. Lower growth leads to lower tax revenue.

Estate tax rate structure of For the 99.5% Act

From	To	Estate tax rate
$0	$3.5 million	None
$3.5 million	$10 million	45%
$10 million	$50 million	50%
$50 million	$1 billion	55%
Over $1 billion		65%

Source: https://www.sanders.senate.gov/wp-content/uploads/For-the-99.5-Summary.pdf

Discussions with clients

As dramatic as this proposal may seem at first blush, it is actually largely drawn from proposals made by the Obama administration. As such, it may fall within the mainstream of Democratic thinking. On the other hand, some centrist Democrats have shown resistance to increasing estate taxes in the past, and most Republicans are expected to oppose it. Given the narrow Democratic majorities in Congress, passage is far from certain.

Still, some estate planners are taking the legislation very seriously, and advising their clients to move ahead with their estate planning strategies promptly, while there is still time to do so. Anyone who wants to "lock in" the higher gift tax exemptions available today will need to take action soon.

Short takes

Priority of **pay-on-death accounts**

Jerry had an account with Wells Fargo that was payable on death (POD) to his son Tony. When Jerry and his wife Victoria later borrowed $80,000 from Wells Fargo, he pledged the account as collateral. Jerry and Victoria sold property in Texas to a family member on an installment basis. The installment payments roughly matched the debt service on the loan and were used for that purpose.

Jerry died, and Victoria became his estate's personal representative. She had her lawyer send a letter to Wells Fargo directing them to invade the POD account to pay off the $77,000 balance of the loan. Tony then filed suit alleging that Victoria had breached her fiduciary duties and that other estate assets should have been used to pay off the loan before his account was so used.

The trial court ruled that Victoria had acted reasonably and that Jerry's estate was worth only some $69,000, of which only $2,425.61 was in liquid assets. The Colorado Court of Appeals now reverses that portion of the trial court judgment, holding that the executor should have used those liquid assets first, before going to the POD account. Tony had further argued that the installment payments should have continued to be used for the debt service, so that no invasion of the POD was warranted at all. The appellate court rejected that argument, as the trial court did, because doing so would have unduly delayed the settlement of Jerry's estate [*In re Estate of Treviño*, 474 P.3d 223 (Colo. App. 2020)].

Marital rights found to an IRA

Under ERISA, spouses acquire rights in their partner's employer-sponsored retirement plans. Nonspouse beneficiaries may not be named without the written consent of the spouse. If an individual joins a retirement plan when single and later marries, the spouse gains those rights regardless of what the old beneficiary designation says.

This rule does not generally apply to IRAs, however.

Terry Carmack opened his IRA in 2002, naming his wife, Marilyn, as its beneficiary. That status continued until 2016, when Marilyn's health deteriorated and she began to develop dementia. In August 2016 Marilyn was relocated to a long-term care facility. In September, Terry named his siblings as the beneficiaries of his IRA. He then asked Marilyn's daughter to file an application for Medicaid for Marilyn to help with the nursing home expenses. The decision does not reveal what became of that application, but Marilyn returned home to live with Terry.

Terry died in 2018, and Marilyn survived him. His estate then consisted of $94,450 worth of housing, vehicles, and bank accounts, and $386,031 in the IRA. Marilyn filed suit, alleging that the change of IRA beneficiary was a gift in fraud of her marital rights, which reduced her intestate share of Terry's estate. The trial court agreed, and the intermediate court of appeals now confirms that judgment.

> "**Although the state law appears to apply to lifetime transfers,** the court held that the fact that the transfer did not happen until death, **and that the IRA is a nonprobate asset not part of the estate, is immaterial.**"

Although the state law appears to apply to lifetime transfers, the court held that the fact that the transfer did not happen until death, and that the IRA is a nonprobate asset not part of the estate, is immaterial. Had there been no beneficiary designation at all the IRA would have been part of Terry's estate, subject to Marilyn's marital rights.

The trial court held Terry's "intent was to render [Wife] destitute in an ill-conceived effort to make the state and federal governments pay for his wife's care instead of him or his children." The appellate court agreed and cited this as further evidence that Terry's change of beneficiary was intended to defeat her marital rights [*Carmack v. Carmack*, 603 S.W.3d 900 (Mo. Ct. App. 2020)].