MAY/JUNE 2021

PLANNING THOUGHTS

DAF NOTES

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 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.

Of course, 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.

A RECENT CASE SHEDS NEW LIGHT ON THE OBLIGATIONS OF DAFS TO THEIR DONORS.

THE FACTS

Malcolm and Emily Fairbairn were successful hedge fund managers. For seven years they avoided income taxes on their compensation from offshore funds. A change in the tax law in 2007 meant that they had to recognize that income by 2017. The amount of the income came to about $250 million.

In anticipation of this major tax obligation, the Fairbairns decided to make a major 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, with which they had donated earlier. 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 violated four separate promises that had been made to them to induce them to choose Fidelity:

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

THE JUDGMENT

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.

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DAF NOTES CONT...

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.

The 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 should be aware that if they retain legal rights or controls over a major donation, it could very well undermine the charitable deduction that they are hoping to secure.

CASES AND RULINGS

THE LIMITS OF TRUST DECANTING; TRUSTEES HELD PERSONALLY LIABLE FOR COSTS.

Hodges, Jr. v. Johnson, No. 2019-0319, Supreme Court of New Hampshire (Sept. 23, 2020)

In 2004 David Hodges, Sr., established two irrevocable trusts, one exempt from the generation-skipping transfer tax and the other not exempt. His business associates served as trustees. The beneficiaries of the trusts were his then wife, his three biological children, and his two stepsons. Five years later, David had second thoughts about his earlier generosity. His lawyer explained that though the irrevocable trust could not be amended, it could be decanted into a new trust, and the successor trust did not have to have identical beneficial interests.

David liked that idea—he liked it perhaps too much. In a 2010 decanting the interests of the stepsons were extinguished. A 2012 decanting removed one of the biological sons. The 2013 decanting removed the interest of the now ex-wife. At no time did the trustees raise an objection or even consult with independent counsel on the propriety of their actions.

In 2014 the beneficiaries who had been cut out of the trusts brought a lawsuit to have all the decantings declared void, and they won. Interestingly, although the facts suggested that David may have retained effective control of the trusts, the courts declined to void the decantings on that basis, as it would have had major federal tax consequences. Rather, they ruled that the trustees had failed to give proper weight to the interests of all of the beneficiaries or to the original purpose of the trust, and so they failed in their fiduciary duties.

New trustees were appointed for the trusts. The former trustees then filed a motion to recover the costs they had incurred in defending the decantings. The new trustees not only resisted that request, they demanded that the former trustees personally pay the costs incurred by the trust in getting the decantings set aside! Given the extent of their breach of fiduciary duty, the court ordered the former trustees to pay up, and the New Hampshire Supreme Court now affirms.

A TRUSTEE'S "UNLIMITED DISCRETION" DOES NOT EXTEND TO TAKING ALL OF THE TRUST ASSETS FOR HIMSELF.

Roenne v. Miller, No. 120,054, Court of Appeals of Kansas

Sonja's estate consisted of farm real estate and equipment and an oil lease. She bequeathed the farm property to her two sons, Brad and Mark, and created a trust for all five of her children to hold the oil lease. Brad was the trustee of the trust. Mark later assigned his interest in the land to Brad.

Brad managed the farm and used all of the trust income to pay down debt on the property and fund the agricultural operations. He effectively treated the trust as his own, never distributing anything, not even an accounting, to the other trust beneficiaries, his siblings. The trust income came to $1.3 million over the years. In 2013 and 2014 Brad conveyed the mineral rights in the trust to himself personally, leaving nothing in the trust.

The other beneficiaries filed suit in 2015. They lost. The trial court held that the trust instrument was clear and unambiguous. Brad as the trustee was given "absolute discretion" over the uses of trust principal and income. Viewing Sonja's will and trust documents together, the trial court concluded that Brad was only doing what she would have wanted.

The appellate court now reverses, holding that the trial court failed to take into account settled trust law. "Absolute discretion" does not trump a trustee's fiduciary duties of loyalty to all the beneficiaries, the duty to act in good faith and with impartiality. The interests of the other beneficiaries may not be simply ignored, as Brad did.

The case was remanded for further consideration, including possible remedies.

WASHINGTON TALK

Now that the Covid-19 relief package has been enacted, the Biden administration is expected to turn to an infrastructure spending program coupled with major tax hikes. "Anybody making more than $400,000 will see a small to a significant tax increase," President Biden said during a televised interview that aired on March 17.

Bloomberg reports that key tax increases could include:

- a 33% increase in the corporate tax rate, going from 21% to 28%;
- higher income tax rates for those earning more than $400,000;
- for those earning more than $1 million, taxing capital gains as ordinary income; and
- expanding the reach of the estate tax.

The estate tax could be expanded by cutting the federal exempt amount, or some interests that are currently not included in the federally taxable estate might become included. The administration has stated that it does not favor the wealth tax ideas being put forward by some in Congress.

There has been considerable political concern expressed about the widening gap between the richest Americans and the poorer ones. It consists primarily of unrealized capital gains in shares held by the owners of very successful companies, especially the founders. As such, that wealth is tricky to tax, given that the decision to realize a capital gain is voluntary. What's more, many billionaires have turned philanthropist, giving appreciated shares of stock to private foundations where they escape taxation forever.

The answer that Senate Finance Committee Member and former candidate for President Elizabeth Warren came up with is a wealth tax. The bill, named the Ultra-Millionaire Tax Act, would apply an annual 2% tax to wealth from $50 million to $1 billion, and 3% on wealth owned in excess of $1 billion. Supporters of the tax suggest it would have raised $114 billion in 2020 alone.

How does that burden fall upon some of our more famous billionaires? Business Insider calculated that Jeff Bezos would have owed $5.7 billion, Elon Musk $4.6 billion, Bill Gates $3.6 billion, and Mark Zuckerberg $3.0 billion.

Of course, these gentlemen don't have that kind of cash on hand or in the bank. They would most likely have to sell stock, realizing taxable gains, and then have to sell more stock to raise the money to pay the capital gains taxes.

Then they would have to do it again the following year.

One of the selling points of the wealth tax, according to its advocates, is that it would only affect about 100,000 American families. Opponents wonder how long that limitation would last.

No estimates have been provided for the nontax costs of implementing a wealth tax. Setting a value for publicly traded stocks and bonds is easy enough, of course. Finding an accurate value for closely held businesses, real estate, and fine art is another matter. Appraisers and tax lawyers could look forward to years of profitable employment in aiding with wealth tax compliance.

However, a study done by the Tax Foundation and reported in The Wall Street Journal came to a surprising conclusion about the biggest beneficiaries of an American wealth tax. Selling billion-dollar-size lots of stocks is no simple matter. According to the study, foreign billionaires would be the most likely buyers of those assets, and they would likely purchase them at fire-sale prices. Perhaps this is why most of the countries that have tried wealth taxes have already abandoned the experiment.

Is it possible that the wealth tax proposal will simply be leverage for raising the existing federal estate tax rate and lowering the exemption amount?

SECURE 2.0. In 2019 many estate plans were upended by the Setting Every Community Up for Retirement Enhancement Act, generally known as the SECURE Act. The Act's liberalizations of some rules were "paid for" by severe restrictions on the use of "stretch IRAs" in estate planning.

In 2020 Ways and Means Committee Chair Richard Neal and ranking Republican Kevin Brady introduced Secure 2.0. Observers believe it has a chance of passage in 2021. The key item of interest to estate planners is that required minimum distributions could be delayed until age 75.

Legislative gestures. Senator Ted Cruz introduced S. 126, which would make permanent the personal tax changes of the Tax Cuts and Jobs Act, including the doubling of the amount exempt from the federal estate and gift tax. In the absence of such legislation these provisions will sunset at the end of 2025.

Representative Bob Latta introduced the Permanently Repeal the Estate Tax Act of 2021. The bill would not affect the gift tax but would retain stepped-up basis at death.

S. 617 in the Senate, the Death Tax Repeal Act of 2021, would end the estate and generation-skipping tax but preserve the

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federal gift tax, with a permanent lifetime exemption of $10 million plus inflation adjustments since 2011. That bill is silent on basis step-up at death. The bill, introduced by Senator John Thune, has more than 20 co-sponsors.

None of the bills are expected to advance this year.

The IRS released a one-sheet summary of highlights of the federal estate tax filings. As expected, the number of estate tax returns fell following the doubling of the amount exempt by the TCJA in 2017. In 2019, the year in which most returns for 2018 decedents were filed, the number of returns was 6,409, and the total estate tax revenue was just over $13.2 billion.

California had the most taxable estates in 2019, half again as many as runner-up Florida. But when one looks at the number of estate tax returns per 100,000 of population, a different picture emerges. Wyoming is the leading producer of estate tax returns by that metric, followed by the District of Columbia. Florida is third, California fourth, and South Dakota comes in fifth. Perhaps that explains Senator Thune's strong interest in repealing the federal tax at death.

LOCATIONS

COLUMBIA - John Bailey
720 E. Broadway, 4th Floor | Columbia, MO 65201 | 573.874.8490

JEFFERSON CITY - Jill Dobbs
111 E. Miller St., 2nd Floor | Jefferson City, MO 65101 | 573.634.1397

KANSAS CITY - Andy Holmes
11900 College Blvd., Suite 200| Overland Park, KS 66210 | 913.901.3282

LAKE OZARK - Trenny Garrett
1860 Bagnell Dam Blvd., 2nd Floor | Lake Ozark, MO 65049 | 573.302.2474

LAWRENCE, KS - Andy Holmes
300 W. 9th St. | Lawrence, KS 66044 | 785.865.1064

SPRINGFIELD - Andrea McKinney
3333 S. National Ave., 3rd Floor | Springfield, MO 65807 | 417.883.3838

ST. LOUIS - Andrew Rzonca
7707 Forsyth Blvd., 2nd Floor | St. Louis, MO 63105 | 314.219.0405