Capstone: Justin and Heather Hodges Case 1 of 3

NOTE*: There are three cases that will take a client through a full life-cycle. All the data and events will move through the years from first employment to midlife to retirement. Data from Case #1 will be updated in Cases #2 and #3. The questions for each case will pertain only to that case, not prior case data.*

Case #1
Justin and Heather are age 29.

Case #2
Nineteen years have passed. Justin and Heather are now age 48.

Case #3
Twelve more years have passed. Justin and Heather are now age 60. Justin is retiring.

Justin
Justin is age 29. He has a law degree from a prestigious school. After graduation he was offered a position with a 100-person law firm. Although only with the firm for 5 full years, he is handling a substantial case load of litigation cases. His annual salary is supplemented with successful litigation revenues. The attorney firm is an LLC and he hopes to be a member shortly (Hamilton, Lancaster and Smith, LLC).

Justin's parents are in their 50's. His father owns a construction business. Justin didn't have an interest in his father's business. Fortunately, his older brother is currently running the business, so Justin wasn't pressured to join the company (Hodges Construction, Inc.).

Heather
Heather is age 29. Justin met her at the university where he completed his undergraduate degree. She has both an undergraduate and master's degree in English Literature. She currently works for a book publisher (Riverside, Inc.). They found time to get married after she completed her master's degree but before he got his law degree. They have been married for 6 years. Justin and Heather have never been faced with any financial hardships as Justin's parents were supporting him prior to them getting married?

Unfortunately, that wasn't always true for Heather. Heather's father died when she was a teenager and her mother used up all the family assets before Heather went to college. Heather was an in-state student who qualified for scholarships, grants, and loans. She pieced this together with some part-time work at the university. All the student loans have been paid off. Heather got Justin to agree to help support her mother with a monthly check. Currently, her mother has no job or income and doesn't qualify for Social Security. This is a sore point between Justin and Heather. Their cash flow is increasing due to salary increases and bonuses, so the monthly payments to Heather's mother are part of their lifestyle.

Children
Justin and Heather have one daughter, Meredith, who is age three. Heather hired a weekly nanny housekeeper. Miss Jessy Lancaster was a terrific find for Heather. She manages to take care of Meredith in addition to the household chores.

Heather isn't certain she wants a second child, but Justin would like to try for a boy. They would like to wait at least a year or two.

Justin and Heather
Justin and Heather's closest relative is her mother.

Justin wants to sell their track-type home and move into a more exclusive gated community. Heather is paying all the bills, including her mother's monthly check and is getting concerned with their lack of savings. It seems every time Justin gets a bonus, federal and state taxes consume a significant portion of the bonus.

Economic Environment
The current economic environment exhibits low short-term rates, medium long-term rates, low economic growth, rising unemployment, and escalating inflation.

Justin and Heather live in a common law state. The state has a state income tax of 5%. The state is heavily in debt and is cutting back on local services. The city where they live has proposed both a city tax and an Increase in property taxes to fund necessary services.

Real estate values did fall and there is still a glut of home foreclosures affecting the market.
NOTE: 2023 tax law applies

Justin and Heather Hodges
Statement of Financial Condition

Assets		Liabilities	
Cash/Cash Equivalents (JT)	$ 10,000	Credit Cards[6]	$ 5,000
		Residence Loan[7]	190,000
		College Loans	
			-0-
			$195,000
Invested Assets			
Bond Mutual Fund[1] (JT)	25,000		
Target Benefit Plan[2] (Justin)	12,000		
Profit-sharing 401(k)[3] (Heather)	22,000		
Hodges Construction, Inc.[4] (Justin)	60,000		
	$119,000	**Net Worth**	$264,000
Use Assets			
Residence[5]	$250,000		
Personal Property	50,000		
Automobiles	30,000		
	$330,000		
TOTAL ASSETS	$459,000	**TOTAL LIABILITIES AND NET WORTH**	$459,000

[1]Fund currently paying 5.5%
[2]Current account value (not 100% vested)
[3]Defers 6%, company match is 3%
[4]Mr. Hodges is gifting shares of stock to Justin each year. Justin will receive a K-1 for $5,000 loss this year.
[5]Purchased for $250,000, four years ago, land was valued at $75,000
[6]Paid off monthly
[7]Original loan $200,000, 30 -year, 5% fixed

Justin and Heather Hodges
Projected Cash Flow Statement

Inflows	
Justin's Salary	$ 180,000
Heather's Salary[1]	47,000
Justin's Bonus[2]	+
Bond Fund	1,375
Total Inflows	$228,375+
Outflows	
Federal Income Tax[3]	$ 45,000
State Income Tax[3]	8,000
FICA/Medicare Taxes	13,000
Mortgage PITI[4]	?
Food	12,000
Utilities	5,000
Transportation	10,000
Clothing	5,000
Entertainment /Travel	6,000
Heather's Mother[5]	18,000
Medical Cost	3,000
Dependent Care (Jessy)	24,000
Miscellaneous	20,000
TOTAL OUTFLOWS	?

[1]Her $50,000 is salary net of 401(k) 6% deferral
[2]Bonus amount is always uncertain, but it is subject to a marginal federal tax rate of 28% plus a state tax rate of 5%
[3]Estimates only
[4]Part of multiple-choice questions to solve (***NOTE****: The property tax is $3,500*)
[5]Gifting $1,500 per month or more

Justin and Heather Hodges
Insurance Information

Homeowner's Policy	
Type of Policy	HO-3
Dwelling Coverage	$160,000
Personal Property	$80,000
Personal Liability	$100,000
Deductible	$1,000 per event
Premium	$1,000 per year

Automobile Policy

Type of Policy	Personal auto policy*
Bodily Injury/Property Damage	$300,000 combined single limit
Uninsured Motorist	$300,000 single limit
Collision	$250 deductible
Other than Collision (Comprehensive)	$100 deductible
Premium	$1,000 every 6 months

**Justin's car is rated for business use*

Life Policy - Justin

Type of Policy	15-year term level
Face Amount	$500,000
Owner	Justin
Beneficiary	Heather, if living; if not, children of the insured
Premium	$400 per year

Life Policy - Heather

Type of Policy	15-year term level
Face Amount	$750,000
Owner	Heather
Beneficiary	Justin, if living; if not, children of insured
Premium	$480 per year

Comprehensive Major Medical Policy - Justin

Type of Policy	Group health - provided by LLC
Deductible	$500 per person, per family
Co-insurance	Plan pays 80%, insured pays 20% of the next $5,000 (per Person); then the plan pays 100%
Premium	LLC pays for Justin's premium

Group Life Policy

Type of Policy	Group term life
Face Amount	2 times salary ($200,000 cap)
Beneficiary	Heather, if living; if not, children of the insured
Premium	LLC pays full premium

Comprehensive Major Medical Policy - Heather	
Type of Policy	Group Health - Riverside, Inc.
Deductible	$200 per person, maximum of 3 persons per family
Co-insurance	Plan pays 80%, insured pays 20% of the next $5,000 (per person); then the plan pays 100%
Premium	Riverside, Inc. pays for Heather's premium; Heather pays $150 a month for Meredith
Group Life Policy Type of Policy	Group term life
Face Amount	2 times salary
Beneficiary	Justin, if living; if not, children of insured
Premium	Heather pays $10 per month for coverage

Capstone: Hodges Case1 – Exam Questions

1. Should Justin and Heather invest in a municipal bond fund (their state of residence) that pays 4%?

   A. Yes, the municipal bond fund would have a taxable equivalent yield of 5.66%
   B. Yes, the municipal bond fund would have a taxable equivalent yield of 5.97%
   C. No, the corporate bond fund has a tax-exempt yield of 3.96%
   D. No, the corporate bond fund has a tax-exempt yield of 3.69%

2. If they sell their residence for a net of $240,000 after selling expenses, can they take the difference between the original purchase price and selling price as a capital loss?

   A. Yes, because if they sold the residence for a gain, the gain is a capital gain.
   B. Yes, but only $3,000 per year is LTCL.
   C. No, losses on home sales are not allowed.
   D. No, because they didn't own and live in the home for the required 5 years.

3. How much is their PITI on their current residence?

   A. $12,883.68
   B. $16,383.48
   C. $17,330.25
   D. $17,383.68

4. Are they saving money based on their budget, not including a bonus?

   A. Yes, they are saving approximately 18% of their inflows.
   B. Yes, they are saving approximately 15% of their inflows.
   C. No, they only have $10,000 of cash and $25,000 in the bond mutual fund.
   D. No, their budget is fiction.

5. If Heather is writing the check to her mother, will she have to file a gift tax return?

   A. Yes, the gift is in excess of the annual exclusion.
   B. Yes, a gift requires the filing of a 709 gift tax return.
   C. No, the check is coming from the joint checking account.
   D. No, the gift is less than $32,000.

6. Justin's parents have opened up a 529 plan for Meredith. What is the minimum college funding Justin and Heather should do?

   A. Contribute to a UTMA account because they cannot do a 529.
   B. Contribute to a Coverdell ESA.
   C. Contribute to a 529 state prepaid tuition program.
   D. Contribute to a Roth IRA.

7. Can Heather and Justin claim Heather's mother as an exemption on their tax return?

   A. Yes, because she has no personal income.
   B. Yes, because she meets the four tests to be dependent.
   C. No, because she doesn't live with Heather and Justin.
   D. No, because exemptions have been eliminated.
   E. No, because she is collecting under Social Security.

8. Can either Justin or Heather do an IRA or Roth IRA?

   A. They can do a Roth IRA only.
   B. Only Heather can do a Roth IRA.
   C. Only Heather can do a deductible IRA.
   D. They can only do non-deductible IRAs.

9. Considering the case data, do Justin and Heather have an adequate emergency fund?

   A. No, they should have at least 6 months of fixed and variable expenses in a liquid account.
   B. No, they should have at least 3 months of fixed and variable expenses in a liquid account.
   C. Yes, they both work and have non-physically demanding jobs.
   D. Yes, they both work, Justin's father would provide support and they have adequate disability insurance programs.

10. What type(s) of investments are considered suitable for an emergency fund?

    I. Bond Mutual Funds
    II. CDs
    III. Savings Accounts
    IV. Money Market Mutual Funds
    V. REITs

    A. All of the Above
    B. II, III, IV, V
    C. II, V
    D. III, IV
    E. III

11. Hamilton, Lancaster and Smith, LLC have a target benefit plan. What percentage of the pension plan is vested?

    A. 50%
    B. 60%
    C. 75%
    D. 80%
    E. 100%

12. How should Justin and Heather treat Jessy's wages?

    I. Like all good U.S. citizens, just pay her the money and let her worry about it.
    II. Report it on a Form W-2.
    III. Report it on a Form 1099 Miscellaneous.
    IV. Withholding and pay FICA wages
    V. Report and pay required employment taxes on Schedule H of their own Form 1040.

    A. I
    B. II, IV, V
    C. III, IV, V
    D. III
    E. V

13. What type of tax credit programs are they eligible for based on the case data?

    I. Child Dependent Care
    II. Child Tax Credit
    III. Lifetime Learning Credit
    IV. Foreign Tax Credit
    V. Personal Energy Credits

    A. All of the Above
    B. I, II, IV, V
    C. I, II
    D. I
    E. II

14. If Justin's father's company is an S corporation, how is Justin treated if the company declares a gain or loss?

    A. Active Participation
    B. Material Participation
    C. Passive Participation
    D. The gain is LTCG and the loss is LTCL limited to $3,000.

15. Based on the case data given, what is their AGI based on the projected cash flow statement?

    A. $223,375+
    B. $228,375+
    C. $230,000+
    D. $231,375+

16. Should they take a standard deduction or itemize for income tax purposes?

2023 Standard Deductions	
Single	$ 13,850
Married filing jointly	$ 27,700
Married filing separately	$ 13,850

    A. Not enough information given
    B. They should take a standard deduction.
    C. They should itemize.
    D. They are subject to itemize deduction phaseout; they should take the standard deduction.

17. In regards to Justin's group term coverage, how much income will be reported to Justin on his W-2 if the table rate is .06 per $1,000 per month?
    NOTE*: Ignore for purposes of answering question 15.*

    A. $93.60
    B. $108.00
    C. $129.50
    D. $144.00

18. If Riverside, Inc. did an FSA plan and allowed dependent care, what is the maximum tax-free reimbursement Heather could claim?

    A. Any amount - no limit
    B. Up to $5,000
    C. Up to $3,050
    D. Up to Jessy's salary

19. Meredith had a "slip and fall" accident while outside. Heather took her to an emergency clinic. Heather was stunned when the bill for services was $2,000. How much of the claim will her medical plan pay?

    A. $560
    B. $1,440
    C. $1,200
    D. $800

20. Based on the following facts:
    - PITI for a larger home should be less than 28% of their gross income (use $225,000)
    - Taxes on a larger home would be $5,000
    - Insurance on a larger home would $2,000

    30-year mortgage rates are 6% (use annual). How large a home could they buy if they put 20% down?

    A. $770,830
    B. $867,184
    C. $963,537
    D. $1,083,980

21. What type of simple estate planning do you suggest they do under current tax law?

    I. Durable powers of attorney and living wills
    II. Simple wills with guardianship provisions
    III. Irrevocable trusts to hold existing life insurance and new purchases of life insurance
    IV. 2503(c) trust for Meredith

    A. All of the Above
    B. I, II, IV
    C. I, II
    D. II, III

22. Justin, especially, needs a disability insurance policy. Which provision of a policy would be most important to him?

    A. Presumptive disability
    B. Non-cancellable versus guaranteed renewable
    C. Definition of disability
    D. Residual benefits rider versus partial disability rider

23. How would you rank Justin and Heather's priorities based on the case information and test questions?

    I. Wills with guardianships and other basic documents
    II. Retirement funding
    III. Education funding
    IV. Justin's disability insurance needs
    V. Justin and Heather's life insurance needs

    A. I, V, IV, II, III
    B. II, III, I, V, IV
    C. III, II, IV, V, I
    D. IV, V, III, I, II
    E. V, IV, II, I, III

Capstone: Hodges Case 1 – Answer Key

1. Answer: B
   Taxable equivalent yield = $\frac{4.00}{[1-(.28+.05)]}$
   TEY = $\frac{4}{.67}$ = 5.97%

   Answer B answers the question. The tax-exempt interest on the corporate bond is 5.5% x [1-(.28+05)] = 3.69%. Answer D would be true if it said yes rather than no.
   ***NOTE**: 1 - marginal tax rate includes both federal and state income taxes.*

2. Answer: C
   Capital losses on home sales are not allowed.

3. Answer: D
   Original loan was $200,000, 30-year, 5% fixed

10B	**12C**
12P/YR	$200,000 CHS PV
$200,000 ±PV	5 ÷ 12 i
5i	30 x 12 n
30 gold P/YR	= $1,073.64 (End mode)
= $1,073.64 (End Mode)	

PMT $1,073.64 x 12	= $12,883.64
Property taxes	3,500
Property insurance	1,000
	$17,383.68

4. Answer: A
   Based on projected cash flow statement they are saving at least $41,992 ($228,375 - 186,383*) or approximately 18%. Yes, answers C and D are probably true, but that is not what the question asked.
   **Includes PITI*

5. Answer: C
   The only checking account is a joint checking account. A check from a joint checking account up to two times the annual exclusion is exempt from filing the 709 gift tax return. The most important factor is that the check is coming from the joint checking account. The dollar amount shown is $18,000 per year or $1,500 per month (*cash flow statement*).

6. Answer: C
   Answer A is false because they can do a 529 plan. Answer B is false because they are above Coverdell phaseout limits, and Coverdell's only allow $2,000. Answer D is also false because they are above Roth phaseout limits.

7. Answer: D
   Starting in 2018, exemptions have been eliminated under the TCJA.

8. Answer: D
   Since they both have defined contribution plans, they are subject to IRA phaseout. In addition, with an AGI at least above $228,375, they are above Roth IRA phaseout.

9. Answer: A
   Answer A is a better safe answer than answer B. Their salaries are unequal, both salaries are needed to live on and Justin wants Heather to have another child. Be prudent for exam questions.

10. Answer: D
    The CDs have to say with short maturities. Bond mutual funds and REITs are long term investments. Answer V makes A, B, and C incorrect.

11. Answer: D
    In year one, he was not eligible. He has been with the firm 5 full years. Year 2 is 20%, year 3 is 40%, Year 4 is 60%, and Year 5 is 80%. The footnote says he is not 100% vested. It cannot be cliff vesting. It must be graded (default mode).

12. Answer: B
    This is the so called "nanny tax". Yes, all the answers are correct.

13. Answer: C
    The child tax credit is phased out above $400,000 AGI. There is no indication in the case material that answers III, IV, or V apply.

14. Answer: C
    Justin doesn't render any personal service to the business (material participation). The income or loss will be considered passive.

15. Answer: B
    The bond fund is a corporate bond fund (taxable). The $3,000 deferral ($50,000 - $47,000) is not subject to income tax but is subject to FICA. The Hodges ($5,000) loss is passive, not deductible. They cannot do deductible IRAs. Their AGI is too high ($228,395).

16. Answer: B
    Three numbers are known. State income taxes are $8,000 property tax are $3,500 (limited to $10K), and the PI of PITI is $12,883.74. Without breaking down the $12,883.74 into principal and interest, the interest is probably $8-9,000. This would make their itemized deductions close to $20,000.

17. Answer: B
    The plan is not discriminatory (2 times salary with a $200,000 limit). Therefore $50,000 of the benefits will be tax- free.
    $\$150{,}000 \times \dfrac{.06}{1{,}000} \times 12 = \$108$

    If you used $130,000 ($180,000 - 50,000) you got answer A. If you used $200,000 you got answer D.

18. Answer: B
    The maximum tax-free reimbursement under an FSA for dependent care is $5,000 per year. Medical FSA is $3,050.

19. Answer: B

	Insured	**Insurance**
Deductible	$200	-
Coinsurance	$360 (20%)	1,440 (80%)
	$560	$1,440
She paid $560.		

20. Answer: C
    You have to go backwards.

28% of 225,000	$ 63,000
less taxes	5,000
less Insurance	2,000
$ 56,000	

56,000 PMT (end)
6i
30n
PV = $770,830

But they are putting 20% down.
$770,830 ÷ 80% = $963,537

This is a tough question/answer.

21. Answer: C
    An ILIT doesn't seem necessary for an estate of the size this year. Also consider their ages. A 2503(c) trust is used with young children to accumulate income for education. A 529 plan works better. The 2503(c) trust is subject to tax at the trust level. The best answer is C.

22. Answer: C
    The most important provision of a disability policy is the definition of disability. Although the others are important, I would have to use answer C.

23. Answer: A
    I have to rank the basic estate planning first followed by the insurance needs. Education funding seems least important (Meredith is age 3), and Justin's parents already have set up a 529 plan.

Justin and Heather Hodges -Trilogy Case 2 of 3

NOTE*: There are three cases that will take a client through a full life cycle. All the data and events will move through the years from first employment to midlife to retirement. Data from Case #1 will be updated in Cases #2 and #3. The questions for each case will pertain only to that case, not prior case data.*

Case #1
Justin and Heather are age 29.

Case #2
Nineteen years have passed. Justin and Heather are now age 48.

Case #3
Twelve more years have passed. Justin and Heather are now age 60. Justin is retiring.

Justin
Justin is age 48. After 24 years with the attorney firm, he is now a senior member (partner). The firm has even added his name. It is now Hamilton, Lancaster, Smith and Hodges, LLC (HLSH). The firm is now a 200+ person law firm with many partners with offices in various states. Justin only handles multi-million-dollar litigation cases. His annual salary is now supplemented by a percentage of successful litigation revenues.

The workload has taken a toll on his health. He gained a fair amount of weight. This led to various health problems such as hypertension and borderline diabetes. He has been told he needs to watch his diet and exercise more.

His health problem is compounded by the fact that his father died at age 60 due to a heart attack. His mother is in poor health at age 73. When his father died, he inherited additional shares of Hodges Construction, Inc. Justin now owns one-third, his brother one-third and his mother one-third. His brother would like to own a controlling interest. Justin is in favor of that since he feels his brother has efficiently run the company through good and bad times.

Heather
Heather is age 48. She still works for the book publisher, Riverside, Inc., but she is ready to quit and go out on her own. Recently she was passed over for an interesting new division of the company. She felt it was a case of senior management assigning this position to one of their own. Over the years she has had day-to-day involvement with authors who have made the best seller lists. Many of them are unhappy with their agents and dealing with the financial terms Riverside imposes.

Heather and Jane Thomas (another employee) feel they can open their own agency. Both live in the suburbs and commuting to the city has become costly in time and money. They feel they can work out of a small office with a small staff (2-3 in addition to themselves). Heather still has problems with her mother. Since Justin and Heather supported her, she never tried very hard to get a job. Now in her early 60's, she is still dependent on Heather. The amount of money Heather gives her mother doesn't affect their lifestyle, but Heather feels Justin has had it with gifting to her mother. Somehow, she is going to find something her mother can do when she opens up the agency.

Children
Meredith is now 22 and completing her last year of undergraduate college. She plans to go on to medical school. Fortunately, Justin and Heather have only had to come up with limited college funds thanks to the generous contributions over the years by Justin's parents, and their own contributions to a Coverdell ESA and a separate 529 plan. Heather and Justin have two more children. John (named after Justin's father) is 16. He is an all-around athlete. Justin hopes he can get a sport scholarship at the state university. John is interested in coaching.

Heather waited too long to have the third child. Beth, age 9, has some mental problems. Beth has an IQ well below 100. Fortunately, she is a loving person. She goes to a special school, since Heather felt the normal private schools with their competitiveness would be too much for Beth. Justin and Heather want to make sure she is always cared for and financially independent should anything happen to them.

Justin and Heather's Estate Planning

After Justin's father died a few years ago and the doctors warned Justin about his health, he finally had his firm prepare a complete estate plan:

- Revocable trusts with credit shelter provisions
- Durable powers of attorney and living wills
- Pour-over wills with guardianship provisions for the children
- Life Insurance trust for his life policy benefiting Heather
- Life insurance trust for their last-to-die (survivorship) life policy to provide liquidity for estate taxes.

Economic Environment

The current environment exhibits high real short-term rates (15%), and high real long-term rates (12%), very high economic growth, very low unemployment and high inflation (18%). College costs are inflating at 20%.

Changes in the Last 19 Years

- The top marginal bracket for income taxes is 50%.
- The state income tax is 8%.
- There is no AMT tax.
- Applicable credit amount for estate and GST tax is $5.0 million
- Flat tax of 50% applies above $5.0 million for both estate and GST tax. Step-up in basis applies for income tax
- Applicable credit amount for gift tax is $2.0 million
- Annual exclusion for gifts is $20,000 per donee

NOTE*: All other rules regarding Insurance, investments, income tax, retirement plans, and estate planning remain unchanged.*

Justin and Heather Hodges
Statement of Financial Condition

Assets		**Liabilities**	
Checking (JT)	$ 20,000	Credit Cards [11]	$ 15,000
Money Market (Justin's Trust) [1]	150,000	Residence Loan[12]	55,000
Money Market (Heather's Trust) [1]	150.000		$70,000
	$ 320,000		
Invested Assets			
Bond Mutual Fund (JT)[2]	150,000		
Money Manager[3]	2,000,000		
Target Benefit Plan[4] (Justin)	1,500,000		
Profit-sharing 401(k)[5] (Heather)	400,000		
Hodges Construction, Inc.[6] (Justin)	5,000,000		
H LSH[7] (Justin's)	3,000.000		
	$12,050,000		
		NET WORTH	$14,850,000
Use Assets			
Residence (JT)[8]	1,500,000		
Personal Property (JT)[9]	900,000		
Transportation (JT)[10]	150,000		
	$ 2,550,000		
TOTAL ASSETS	$14,920,000	TOTAL LIABILITIES AND NET WORTH	$14,920,000

NOTE*: JT is tenancy by the entirety*

[1]The money market accounts are invested in government securities (short-term bills) paying almost 15%. They are not insured.

[2]The bond fund is currently paying 11% annually. Heather continues to make deposits into the fund from time to time (*See fund performance*). The basis of the fund is $125,000.

[3]Justin and Heather decided years ago that they didn't have the time, knowledge or inclination to manage their savings. Justin's trust has $1.0 million, and Heather's has $1.0 million in her trust *(See money manager performance*).

[4]The target benefit plan is very age weighted. Justin is getting more substantial contributions, but the benefits percentage has been cut back twice to reduce HLSH’s yearly exposure. The beneficiary is Heather, if living; if not, Justin's revocable trust.

[5]Heather continues to defer 6% of her salary, and the company matches 3%. The beneficiary is Justin, if living; if not, Heather’s revocable trust.

[6]From his father's estate, Justin received a sizable inheritance. The inheritance received a step-up in basis. The basis is $3.0 million. Justin owns the stock outright. Hodges Construction, Inc. is an S Corporation.

[7]The Hamilton, Lancaster, Smith and Hodges, LLC is a professional LLC. Justin’s basis is $2.0 million.

[8]The residence was purchased almost 14 years ago for $750,000. The value has fluctuated dramatically. After a big downturn in the real estate market, prices stabilized but now home prices are increasing at 20%.

[9]Justin has an antique gun collection and Heather has a collection of rare books.

[10]Automobiles no longer exist. The world supply of oil is greatly diminished. Transportation vehicles are powered by electricity from batteries powered by household electrical current or solar.

[11]Paid off monthly. Interest charges are 25%.

[12]The original mortgage was a 15-year fixed mortgage at 5%. The house was bought almost 14 years ago. The current mortgage money ls 15%.

Justin and Heather Hodges
Projected Cash Flow Statement Inflows

Inflows		
Justin's Salary		$ 1,000,000
Heather's Salary[1]		200,000
Justin's Bonus[2]		1,500,000+
Investment Income[3]		100,000
	Total Inflows	$ 2.800.000+
Outflows		
Federal Income Tax[4]		$1,200,000+
State Income Tax[4]		160,000+
FICA/Medicare Taxes [4]		100,000+
Mortgage PITI[5]		85,000
Food		45,000
Utilities		30,000
Transportation		50,000
Charity		25,000
Entertainment/Travel		100,000
Heather's Mother[6]		80,000
Medical Cost[7]		10,000
Miscellaneous		200,000
	Total Outflows	$2,085,000+[8]

[1]Out of her salary Heather defers 6% and the company matches 3%.
[2]Justin's bonus has been fairly consistent.
[3]The income comes from the money market and bond funds. The money manager tries to be tax efficient.
[4]Taxes are a big concern, consuming nearly 50% of their income.
[5]Mortgage is nearly paid off. Property taxes are $18,000.
[6]The gifting has been above the annual exclusion because Heather also purchased a health policy for her mother. The payment is coming from their joint account.
[7]Medical cost consists mainly of high blood pressure medication for Justin, doctor visits, and miscellaneous medical bills.
[8]Even after Heather added $200,000 to "Miscellaneous," she cannot figure out where the $700,000 difference went. They are saving about 12-15% of their gross income not including Heather's 401(k) contribution. She assumed the difference is money to purchase collectibles.

Justin and Heather Hodges
Insurance Information

Homeowner's Policy	
Type of Policy	H0-5
Dwelling Coverage	$1,000,000
Personal Property	$500,000
Personal Liability	$2,000,000
Deductible	$1,000 per event
Premium	$10,000

**Justin and Heather have taken out a $100,000 rider to cover their collectibles.*

Transportation Policy	
Type of Policy	Transportation
Bodily Injury/Property Damage	$500,000 combined single limit
Uninsured Motorist	$500,000 single limit
Collision	$1,000 deductible
Other than Collision (comprehensive)	$1,000 deductible
Premium	$10,000 per year

ILIT - Justin	
Type of Policy	Variable Universal Life
Face Amount	$2,000,000
Cash Value	$200,000
Owner	Irrevocable life insurance trust
Beneficiary	ILIT benefiting Heather
Premium	$20,000 per year (paid 7 years)

ILIT - Joint Lives	
Type of Policy	Universal Life
Face Amount	$2,000,000
Cash Value	$150,000
Owner	Irrevocable life insurance trust
Beneficiary	ILIT for estate planning
Premium	$15,000 per year (paid 7 years)

Riverside, Inc. - Medical Policy	
Type of Policy	Point of Service (POS)
Deductible	$50 HMO provider per claim $100 preferred provider per claim $1,000 other provider per claim
Co-insurance	None
100% Clause	None
Premium	Riverside, Inc. has been paying Heather's premium. Heather is paying $700 per month for her children's coverage

HLSH, LLC Medical Policy

Type of Policy	HSA
Deductible	High deductible for individual or family
Premium	HLSH, Inc. pays Justin's premium

HLSH, LLC - FSA

Type of Plan	Health and dependent care FSA
Health	Medical and dental expenses
Dependent Care	Before-and after-school programs, babysitting, nursery school, pre-school and summer day camp

***NOTE**: All group life and group disability programs have been terminated due to escalated wages and insurance company premiums.*

Mutual Fund Performance Data

High Yield Corporate Bond Fund

Fund Category: **General Domestic** Fund Classification: **High Current Yield**

Last Trade	Redemption Fee	Expense Ratio	Max Sale Load
25.70	2.00%	1.79%	---

Strategy for High Yield
Corporate Bond Fund

The Fund seeks to invest at least 65% of total assets in corporate debt securities and up to 25% of total assets in equity securities, under normal market conditions.

25.70	**+1.22**	**+8.56**
Net Asset Value	30 Day Performance	YTD Performance
1.79%	**11.32%**	**49.00%**
Total Expenses Ratio	Dividend Yield	Portfolio Turnover
362.8 Million		
Total Net Assets	New York, NY 10010	800-000-000
Team Managed		**09/01/1998**
Fund Manager	Tenure	Inception Date

Minimums

Initial	1000
Additional	50
IRA	1000
Additional IRA	50

SEC Performance
Cumulative Performance

	1 Yr	5 Yr	10 Yr
SEC Performance	11.00	9.00	8.00
Fund after Tax Pre-Liquidation	11.56	9.42	8.15

5 Largest Domestic Equity Holdings

Company	Percent of Holdings
Corporate Notes/Bond…	73.7%
Fgn. Currency Denominations	10.0%
Common Stock	3.7%
Preferred Stock-Non…	1.2%
Convertible Securities	0.9%
Percent of all Holdings	**89.5%**

Money Manager's Performance Data

	MM	S&P 500
Current	5.19%	1.32%
Year One	16.98%	5.50%
Year Two	5.91%	15.79%
Year Three	6.30%	4.89%
Year Four	10.15%	10.87%
Year Five	50.31%	28.69%
Year Six	-13.60%	-22.12%
Year Seven	9.10%	-11.92%
Year Eight	62.42%	-8.82%
Year Nine	17.69%	20.66%
Year Ten	31.67%	28.58%

Justin and Heather's Goals and Objectives

1. Reduce federal and state income taxes
2. Reduce estate taxes
3. Retire in 12 years
4. Fund for college and graduate level education with low-cost dollars
5. For Heather to be able to leave Riverside, Inc. and start her own business with Jane

Case 2 of Justin and Heather Hodges Trilogy Exam Questions

1. How many exemptions do Justin and Heather get this year?

   A. 0
   B. 4
   C. 5
   D. 6

2. Based on a gift of $80,000, how much of their gift tax exemption are they each using up each year? ***NOTE****: Look at Cash Flow #6 footnote.*

   A. $10,000
   B. $20,000
   C. $40,000
   D. $80,000

3. If Justin sells $2,500,000 of his $5,000,000 of Hodges Construction, Inc. stock to his brother on a 10-year installment sale, what amount of capital gain will he have to report yearly?
   NOTE*: Look at footnotes*

   A. $100,000
   B. $120,000
   C. $150,000
   D. $180,000
   E. $200,000

4. Based on their net worth, how much estate tax would be due if they both died in an accident and their bypass trusts were fully funded? (*Ignore adjustable taxable gilts*)

   A. $2,425,000
   B. $2,462,500
   C. $4,850,000
   D. $4,925,000

5. Considering Answer 4, and a possible growth to their estate, should they purchase an additional last-to-die (*survivorship*) life insurance policy?

   A. Yes, but Justin is uninsurable
   B. Yes
   C. No, they have enough life insurance between Justin's ILIT and the last-to-die ILIT.
   D. No, they should do more estate planning like CRATs, GRATs or FLPs.

6. Justin's firm decided many years ago not to buy any Errors and Omissions insurance. If Justin and the firm are sued for errors in handling a faulty litigation case, which of his assets could be reachable if the firm loses the case?

   A. The ownership of the HLSH, LLC
   B. His target benefit plan assets
   C. Their residence
   D. The Hodges Construction, Inc. stock

7. If the standard deduction for the year was $30,000, should they take the standard deduction or itemize?

   A. Their itemized deduction exceeds their standard deduction
   B. They could lose 80% of their itemized deductions
   C. Claiming itemized deductions will subject them to AMT

Questions 8 through 14 have to do with Heather quitting Riverside, Inc. and starting her own agency with Jane Thomas.

8. If Heather quits Riverside, can the health benefits for Heather and her family members be extended?

   A. 12 months for the family under COBRA because she voluntary terminated
   B. 18 months under COBRA for her and the children
   C. 29 months under COBRA for all family members
   D. 36 months under COBRA for her and the children
   E. Since the medical plan is self-funded, no COBRA provision exists

9. If Heather quits Riverside, what should she do with her existing 401(k)?

   A. Leave it with Riverside
   B. Roll it into an IRA
   C. Roll it into a Roth IRA
   D. Start a 401(k) with the new firm and roll it into the new 401(k)

10. Heather and Jane estimate it will take up to $500,000 (total) to fund their new business until it becomes profitable. What is the best asset she should use?

    A. The money market because it is producing 15%, but the income is subject to federal and state taxes
    B. The bond fund because of its lack of performance and high basis for income tax purposes (less taxes)
    C. The money under management because of its lack of performance
    D. Refinance the loan on the residence to create more tax deductions
    E. From cash flow

11. If Heather and Jane establish an agency, which of the following business forms seem most appropriate?

    A. Partnership
    B. Regular Corporation
    C. S Corporation
    D. LLC

12. Under which of the following entities is income subject to self-employment tax?

    I. Partnership
    II. Regular Corporation
    III. S Corporation
    IV. LLC

    A. All of the Above
    B. I, III
    C. I, IV
    D. II, III

13. If Heather and Jane form a corporate type entity (regular Corporation or S Corporation), what type of business insurance should they obtain?

    I. Workers' Compensation
    II. Business Owners Policy (BOP)
    III. Life insurance to fund a cross-purchase buy-sell agreement
    IV. Business Owners Expense (BOE)
    V. Business umbrella

    A. All of the Above
    B. II, V
    C. III, V
    D. II
    E. V

14. After they leave Riverside, if Heather and Jane establish an HSA immediately upon establishing their firm, would medical pre-existing conditions apply to the new HSA?

    A. Yes, because it will be a new plan
    B. No, because of the HIPAA 63-day rule/ACA
    C. Yes, because COBRA would apply
    D. No, because they established it immediately

15. What types of additional estate planning should Justin and Heather consider?

    I. QTIP Trust
    II. Charitable Remainder Trust (CRAT)
    III. Dynasty Trust
    IV. Qualified Personal Residence Trust (QPRT)

    A. All of the Above
    B. II, III, IV
    C. II, III
    D. None of the Above

16. What is the Taxable Equivalent Yield (TEY) of the corporate bonds?

    A. 5.5%
    B. 11%
    C. 11.96%
    D. 22%
    E. 26.19%

17. With inflation at 18%, how much after-tax money will they need for the first year of retirement (begin) if they need $1 million in after-tax money in "today's dollars"?

    A. $1,425,760
    B. $2,012,196
    C. $7,287,592
    D. Not enough information

18. If the firm HLSH, LLC does a buy-sell, how should the buy-sell be structured if life insurance is involved?

    A. As an Entity Purchase
    B. As a Cross-Purchase
    C. LLCs cannot do buy-sell agreements; there is no stock to purchase

19. HLSH, LLC has an FSA with dependent care. Can Justin elect to have a dependent care FSA to cover Beth's special school needs?

    A. Yes, up to $5,000
    B. Yes, because she cannot go to a public school
    C. No, Justin and Heather are already deducting the expenses as a dependent care credit
    D. No, private school cost is not an eligible expense

20. What kind of planning should they consider for Beth?

    A. A 529 plan
    B. A Special Needs Trust
    C. A 2503(c) Trust
    D. An irrevocable trust with Crummey provisions

21. If Heather employed her mother full-time in her new agency business, which of the following statements would be false?

    A. The business could pay her mother an income, relieving Heather of giving after-tax dollars
    B. Heather could enroll her mother in the company's group health plan
    C. Heather could claim her mother as an exemption
    D. If her mother worked more than 40 quarters (or credits), she might qualify for higher Social Security benefits at her NRA than under her decreased husband's benefits.

22. John, their son, has $100,000 in a 529 plan that has been accumulating at a rate of 10%. Even with getting a scholarship. Justin estimates it will cost $100,000/yr. in "today's dollars" just to fund for 4 years of college. How much needs to be in the 529 plan at the beginning of college in 2 years with a scholarship?

    A. $394,583
    B. $563,038
    C. $566,743
    D. $568,199
    E. $659,414

23. HLSH, LLC still has a target benefit plan. Which of the following is false?

    A. Justin will get the account balance at retirement
    B. Contributions are still based on the original actuarial assumption
    C. The maximum contribution he can receive is the lesser of 100% of compensation or the 415 limit
    D. The investment risk falls on Justin not HLSH, LLC

Case 2 of Justin and Heather Hodges Trilogy Answer Key

1. Answer: A
   Under TCJA, exemptions have been eliminated starting in 2018.

2. Answer: B
   The gift is coming from their joint checking account therefore it qualifies for a split gilt ($20,000 each). Therefore, they are each using $20,000 ($40,000 total) of their gift tax exemption. The annual exclusion is $20,000 per "changes in the last 19 years."

3. Answer: A
   $\frac{\text{Sale}}{\text{Current Value}} \times \text{basis} = \text{Sale Basis}$

   $\frac{\$2{,}500.000}{\$5{,}000{,}000} \times \$3{,}000{,}000 = \$1{,}500{,}000$ Sale Basis

   The profit is $1,000,000 ($2,500,000 minus basis of $1,500,000).

   $\frac{\text{Profit}}{\text{Total Contract Price}} = \text{Gross Profit Percentage}$

   $\frac{\$1{,}000{,}000}{\$2{,}500{,}000} = 40\%$

   40% of $250,000 is long-term capital gain ($100,000)

4. Answer: A

Net Worth	$14,850,000
Estate Exemptions ($5.0 million each)	10,000,000
	$ 4,850,000
Flat Tax	50%
	$ 2,425,000

5. Answer: C
   Answer A isn't totally correct. Yes, maybe he would have to pay extra premium to obtain a policy. Justin is still insurable. Answer D may be true for the future, but they do not appear to be charitable inclined, they have no asset to place in the FLP, and they are too young to do a GRAT. The current worst case estate tax is $2,425,000 and the ILITs have a combined $4.0 million of liquidity coverage.

6. Answer: D
   ERISA plans, like target benefit plans, are generally exempt from creditors. Their residence is owned in tenancy by the entirety. If only Justin is at fault, the creditors cannot get the residence. A professional UC has limited liability. Does that mean the firm has limited liability or does Justin have limited liability? Too difficult to answer. However, outright ownership of the Hodges Construction stock is subject to creditors. This is the best choice.

7. Answer: A
   Itemized deductions of charity, state income taxes and property taxes exceed the standard deduction. Answer C is false, AMT no longer exists.

8. Answer: B
   Voluntary termination (qualifying event) coverage under COBRA is 18 months for her and her children.

9. Answer: B
   If she rolls the 401(k) to her own IRA, then she can have her own money manager handle the Investment. If she rolls it into a Roth at least 50% will be lost to taxes. Answer D might be a good idea if they had an established business and cash flow.

10. Answer: A
    The money market fund is liquid. All the $250,000 (her portion) would not have to available at once but more as needed. Money market distributions are being taxed at over 50%. The bond fund has only $150,000 and would have slight income tax ramifications, if sold. The money manager is actually performing well. With mortgage loans at 15% this doesn't seem appropriate. Their excess cash flow is debatable, but a combination of A and E would be a good answer.

11. Answer: D
    The unlimited personal liability for acts of the partnership or a partner acting on behalf of the partnership (joint and several liability). This rules the entity out. The agency will not be profitable at this time. The need for a separate tax entity doesn't exist (answer B). The S Corporation isn't a bad answer, but the LLC can offer conduit of income and losses, plus losses, can be deducted up to basis like a partnership. LLC is the best choice.

12. Answer: C
    Regular corporations and S Corporations pay wages (W-2) subject to FICA. In an LLC, owners are members. Managing member income is subject to self-employment taxes like a partnership. The only possible answer was Answer C.

13. Answer: A
    Heather needs to protect her assets. All these policies are needed. The Workers' Compensation is necessary; they will have a "small staff."

14. Answer: B
    HIPAA/ACA states that there would be no pre-existing condition using the 63-day rule.

15. Answer: D
    With the life insurance trust their estate planning will cover any eventuality. A QTIP is normally used in a divorced spouse situation (remarriage of divorced spouses). They still do not indicate any charitable giving. In addition, the CRAT, the dynasty trust, and the QPRT appear to be overkill at age 48.

16. Answer: B
    TEY is defined as taxable equivalent yield, not tax-exempt yield. The fund is paying 11% annually.

17. Answer: C
    $1,000,000 PV, 12n, 18i = $7,287,592 FV
    Goals and Objectives indicate 12 years. This is the amount necessary at the first year of retirement. Hard to believe, but true.

18. Answer: A
    LLC's like partnerships can do buy-sell agreements. With a 200+ person law-firm cross-purchase agreement, one lawyer could have hundreds of policies on the other lawyers. This is not practical. Entity purchase or redemption is the only practical answer.

19. Answer: D
    Eligible expenses are: before-and after-school programs, nursery school, and pre-school. Education expenses (other than pre-school) are not eligible.

20. Answer: B
    Beth may not be able to use the 529 plan. A children's trust 2503(c) isn't a bad idea. At age 21 it would become a revocable trust for Beth's benefit. The Irrevocable trust would achieve similar benefits to the 2503(c). A Special Needs Trust might be more appropriate depending on Beth's mental condition.

    Special Needs Trust (SNT) (Simple Trust)
    Because expenditures need to be approved by a trustee, the trusts can protect a physically or mentally disabled person from being exploited by others looking for money. Perhaps more importantly, the trust allows the beneficiary to continue receiving public benefits, such as Medicaid, Section 8 housing assistance, and Supplemental Security Income (SSI). However, the trust can pay only for supplemental needs not covered by those programs. Those extras might Include private-duty nursing care, furniture and supplemental housing expenses, and even a few luxuries, such as swimming lessons or vacations. But the key word is "consider" from the question.

21. Answer: C
    If her mother earns more than the exemption amount (which would be about $4,300 - 2022). Heather can no longer claim her as a dependent and she loses the exemption. The number might be $6,000 per year 19 years from now. She should make more than $6,000. Then Answer C is false.

22. Answer: E
    The cost at the first year of college $100,000 PV, 2n, 20i = $144,000*
    During the four years at school $144,000 PMT (begin), 4n, 1.10 + 1.20i = $659,4143 PV
    *-8.3333%

23. Answer: B
    Increases in compensation will change the contribution. The other answers are correct. The original actuarial assumption was based on his salary 23 years ago (19 plus 4 years).

Justin and Heather Hodges – Trilogy Case 3 of 3

NOTE*: There are three cases that will take a client through a full life cycle. All the data and events will move through the years from first employment to mid-life to retirement. Data from Case #1 will be updated in Cases #2 and #3. The questions for each case will pertain only to that case, not prior case data. Justin and Heather have aged 12 additional years since case #2.*

Justin (age 60)

Justin has been downsizing his practice for the past 2 years. He has only taken on selective interesting litigation cases. After years of adding names to the company name, the firm simply changed its name to Litigation Solutions, LLC. He has told senior management he plans to semi-retire (consulting only). He plans to only take on an occasional case on a consulting basis.

Justin's health is his main concern. He already has had a triple bypass operation. The doctors want him to reduce his stress and control his diet and weight.

Justin is interested in continuing to find and restore antique guns. The collection required its own building and shop.

After his mother died, he inherited more Hodges Construction, Inc. stock. After selling $2.5 million of stock to his brother years ago, the business almost failed. His brother tried to save the business, but it consumed all of his brother's assets. Justin bought all of his brother's stock, left his brother as the president. Unfortunately, his brother's health deteriorated, and he had to semi-retire. Justin talked his son John into learning the business and now runs the company successfully, thanks to a well-trained staff plus his brother's input. The company is now a regular C Corporation.

Heather (age 60)

Heather and Jane established a very successful agency over time. They have a total staff of 40 people. The agency, Author's Unlimited, Inc., is a regular C Corporation. It has been profitable for years. Heather doesn't plan to retire, but Jane, age 64+, is considering retiring due to health problems. Heather and Jane have a buy-sell agreement funded with life insurance.

Heather's mother is now retired. She never saved any money except through Author's Unlimited's 401(k) profit sharing plan but did qualify for Social Security and Medicare. She lives with Justin and Heather. They added a wing to the house with its own kitchen facilities for her mother. Her 401(k) RMD from the 401(k), now IRA, is $16,000 per year.

Heather's book collection gets notoriety. She is known to buy rare books for pennies on a dollar from down and out authors. But her ability to get authors on the best seller lists is her strength. She is a bit ruthless.

Children
Meredith never made it to medical school. In her senior year at college, she met the man of her dreams. After working a few years after college, she decided she wanted children. She has four children, ages 8, 6, 4, and 1 years old. Her husband also works at Hodges Construction, Inc. He is the V.P. of Sales. Some of the success of the turnaround at Hodges is due to Meredith's husband, Joe Delano.

John is the president of Hodges Construction, Inc. John is married with one child, a boy age 4.

Beth lives at home with her parents. Beth can do simple work and Heather made sure Jane understood that Beth would have a job of some kind at Author's Unlimited. Fortunately, by the time Beth graduated from the private high school, there were plenty of tasks Beth was quite capable of doing.

Beth has requested that another wing be added to the house so she can have her own little apartment.

Justin and Heather's Estate Planning
Justin realizes he really just interested in estate tax issues and hasn't changed the basic planning of 12 years ago except to add another joint life policy of $2 million.

- Revocable trusts with credit shelter provisions (updated 5 years ago)
- Durable powers of attorney and living wills (updated 5 years ago)
- Pour-over wills (updated 5 years ago)
- Life insurance trust for his life policy ($2.0 million) benefiting Heather
- Life insurance trust for their two last-to-die (survivorship) life policies, to provide liquidity for estate taxes. A second policy $2.0 million was taken out 10 years ago.

Economic Environment
The current environment exhibits medium short-term rates (7%), and medium real long-term rates (8%), medium to low economic growth, high unemployment and low-to-medium inflation (6%). College costs are inflating at 9%.
NOTE: *The high inflation of 12 years ago continued for 3 years. The result was a severe depression. Value of investments of all asset classes fell by 50%.*

Changes in the last 12 years:

- 60% is the top marginal bracket for income taxes
- 10% is the state income tax
- There is no AMT
- Flat tax of 60% applies above $10.0 million for both estate and GST tax. Step up in basis applies for income tax
- Applicable exclusion amount for gift tax is $2.5 million
- Annual exclusion for gifts is $30,000 per done

NOTE: *All other rules regarding Insurance, investments, Income tax, retirement plans, and estate planning remain unchanged (present day rules).*

Justin and Heather Hodges
Statement of Financial Condition

Assets		**Liabilities**	
Checking (JT)	$ 100,000	Credit Cards[12]	$ -0-
Money Market (Justin's Trust)[1]	300,000		
Money Market (Heather's Trust)[1]	300,000		
	$ 700,000		
Invested Assets			
Bond Mutual Fund (JT)[2]	600,000		
Money Manager #1 (Justin's Trust)[3]	7,000,000		
Money Manager #2 (Heather's Trust)[3]	8,000,000		
Target Benefit Plan (Justin)[4]	4,000,000		
Roth IRA (Heather)[5]	1,000,000		
Profit-sharing 401(k) (Heather)[6]	1,000,000		
Hodges Construction, Inc. (Justin)[7]	10,000,000		
Litigation Solutions, LLC (Justin)[8]	5,000,000		
Author's Unlimited, Inc. (Heather)	4,000,000		
	$40,600,000		
Use Assets			
Residence (JT)[9]	3,000,000		
Personal Property (JT)	500,000		
Antique Guns (Justin)[9]	5,000,000		
Rare Books (Heather)[10]	3,000,000		
Transportation (JT)[11]	500,000		
	$ 12,000,000		
TOTAL ASSETS	$53,300,000	**TOTAL LIABILITIES AND NET WORTH**	$53,300,000

NOTE*: JT is tenancy by the entirely*

[1]The money market mutual funds are paying 7%. They are not insured.
[2]Heather has kept the bond fund through up and down markets; the basis of the fund is $500,000. Currently the return is 8% taxable.
[3]Some years ago they decided to change money managers and use separate managers. Money managers #1 prior year return was 12%. Money manager #2 prior year return was 13%. These returns were 2-3% above the S&P 500 for the past few years.
[4]Justin expects to take some distributions from the target benefit when he semi-retires. The beneficiary is Heather if living, if not Justin's revocable trust.
[5]Heather rolled her 401(k) that she had with Riverside into a Roth IRA some years ago. The beneficiary is Justin if living, if not Heather's revocable trust.
[6]Heather defers the maximum of her salary into the company 401(k). The company matches at 50% up to 6%. The beneficiary is Justin if living, if not Heather's revocable trust. Occasionally the company adds profit sharing contributions up to the maximum allowed under Section 415.
[7]Through the years by inheritance and purchase, Justin owns 100% of the Hodges Construction, Inc. stock. His basis is $4.0 million. ***NOTE****: Now a regular C Corporation*.
[8]Justin plans to enter into an agreement with Litigation Solutions, LLC to buy back his interest. Justin is considering an installment sale over 10 years plus 10% interest. He only plans to work for them as a consultant for 5 years maximum. His basis is $3.0 million.
[9]The residence has had one wing added to the home for Heather's mother. In addition, Justin added a separate stand-alone building to store his antique gun collection plus an assortment of equipment to repair guns. The collection has a basis of $1.5 million. The land has a basis of $500,000.
[10]Heather's rare book collection is in her library at her office. She is proud of her bargain basement purchases. The cost basis of the books is $1.0 million.
[11]Almost all transportation runs on electricity. Solar panels are on the top of the house, garage and Justin's building. The solar panels are very efficient. They produce enough energy for household needs and charge the batteries in the transportation vehicles. The transportation vehicles have solar panels on top. Only after days of bad weather do they have to rely on power plant electricity.
[12]Credit cards no longer exist. Everyone has a personal ID based on fingerprints, voice, and eye identification. Identification, credit card, and other debt sources were destroyed by thieves.

Justin and Heather Hodges
Projected Cash Flow Statement

Inflows	
Justin's Consulting (estimated)[1]	$1,000,000
Heather's Salary (estimated)[2]	1,200,000
Litigation Solutions Installment Sale (estimated)	600,000
TB withdrawals (as needed)[3]	?
Investment Income[4]	$ 100,000
Hodge Construction, Inc.[5]	?
Outflows	
Federal Income Tax[6]	?
State Income Tax[6]	?
FICA/Medicare Taxes[6]	?
Self-Employment Tax	?
Residence Maintenance[7]	30,000
Food	60,000
Utilities	60,000
Transportation	100,000
Clothing	50,000
Entertainment/Travel	200,000
Heather's Mother	50,000
Medical Costs[8]	?
Collectibles[9]	500,000
Miscellaneous	400,000
NET[10]	?

[1]Consulting only. He will be considered self-employed.
[2]Depends on when Jane retires. If Jane retires, Heather will take more salary, but the extra cash flow will be used to buy Jane's stock. However, this will increase taxable income.
[3]Withdrawals will be taken as needed to meet cash flow needs after retirement.
[4]Income from various investments, no withdrawals.
[5]Unknown, Justin isn't taking any distributions. All profits are being reinvested.
[6]All unknown.
[7]Residence has no mortgage.
[8]Justin's medical needs
[9/10]Justin and Heather have agreed to limit new collectible purchases until their cash flow stabilizes. They do not want to spend too much of their capital.

Justin and Heather Hodges
Insurance Information

Personal Insurance

Homeowner's Policy - Primary Residence

Type of Policy	H0-3 with H0-15 rider (H0-5)
Dwelling Coverage	$2,500,000
Personal Property	$1,500,000
Personal Liability	$2,000,000
Deductible	$5,000
Premium	$12,500

Antique Gun Collection

Type of Policy	Inland Marine Fine Arts Floater
Personal Property	$5,000,000
Deductible	$100,000
Premium	$10,000

Transportation Policy

Type of Policy	Transportation (4 vehicles)
Bodily Injury/Property Damage	$1,000,000 combined single limit
Uninsured Motorist	$1,000,000 single limit
Collision	$1,000 deductible
Other than Collision (comprehensive)	$10,000 deductible*
Premium	$30,000 per year

**The biggest problem with the transportation remains theft. The transportation unit uses a biometric scan to operate. It is possible to duplicate the biometric scan and steal the unit. Justin and Heather had to provide transportation units for her mother and Beth (to and from town).*

Umbrella

Bodily Injury/Property Damage	$10,000,000
Uninsured Motorist	$10,000,000*
Premium	$20,000 per year

*The required underlying coverage is $2,000,000 homeowners' policy and $1,000,000 on the transportation policy. ***NOTE****: The dividends are currently paying the premium.*

ILIT - Justin

Type of Policy	Variable Universal Life
Face Amount	$2,000,000
Cash Value	$800,000
Owner	Irrevocable Life Insurance Trust
Beneficiary	ILIT benefiting Heather
Premium	$20,000 per year (paid 19 years total)

ILIT - Joint Lives

Type of Policy	Universal Life
Face Amount	$2,000,000
Cash Value	$750,000
Owner	Irrevocable Life Insurance Trust

Premium	$15,000 per year (paid 19 years)
ILIT - Joint Lives (2nd Policy)	
Type of Policy	Whole Life
Face Amount	$2,000,000
Cash Value	$200,000
Owner	Irrevocable Life Insurance Trust
Beneficiary	ILIT for estate planning
Premium	$20,000 per year (paid in 10 years)

Author's Unlimited Insurance Policies

Life Policy - Cross-Purchase Policy on Jane	
Type of Policy	Variable Universal Life*
Face Amount	$2,000,000
Cash Value	$500,000
Owner	Heather
Beneficiary	Heather
Premium	$20,000 per year (paid 10 years)

**Although the recommendation was to do a whole life policy, Heather preferred a variable universal life policy. By changing the asset allocation, she has consistently outperformed the market. In fact, she was in a money market position when the market crashed a few years ago.*

Business Insurance - Author's Unlimited, Inc.

Group Medical Policy	
Type of Policy	Self-Funded Comprehensive Major Medical
Deductible	$1,000 per person per calendar year
Coinsurance	50% of the next $5,000 paid by the employee 50% paid by Author's (coinsurance) per person per calendar year
100% Clause	Claims per person per year in excess of $3,500 will be paid 100% by Author's
Premium	Company is paying for employee cost only

***NOTE**: Heather and Beth are covered as employees.*

Flexible Spending Account (FSA)	
Benefits Available	Medical Expenses Dental Expenses Dependent Care Expenses
Contribution	Paid by employee

Comprehensive General Liability (BOP)

Contents	Covered in Full
Liability	$10 million

Business Umbrella Liability $10 million*

Worker's Compensation
All Employees are covered, including officers.
*Works with comprehensive general liability policy

Justin and Heather's Goals and Objectives

- Reduce federal and state income taxes
- Maintain or improve their current lifestyle
- Retirement for Justin
- Fund for college level education for their grandchildren
- Planning for Beth and Heather's mother should Justin and Heather both die

Case 3 of Justin and Heather Hodges Trilogy Exam Questions

1. If Justin is in fact not an employee of Litigation Solutions, LLC and he is taking distributions from the target benefit plan, can he establish a SEP for himself for his consulting income?

   A. No, his consulting practice will be considered a related employer
   B. No, he will still be an active participant in the Litigation Solutions plan
   C. No, SEP plans are only available for corporate entities
   D. Yes, but not the distributions from his target benefit plan
   E. Yes, and he could roll the target benefit plan distributions into the SEP tax-free

2. If Justin elects COBRA, how long could he stay under the Litigation Solutions HSA plan?

   A. 18 months
   B. 29 months
   C. 36 months
   D. 0 months, he is voluntarily resigning

3. Justin has medical problems. How should he handle his medical insurance?

   A. Do not quit as an employee of Litigation Solutions until age 65 to get Medicare
   B. Elect COBRA, then HIPAA/Affordable Health Care Act to get to Medicare
   C. Have Heather add him to her major medical plan
   D. Purchase coverage as a self-employed individual

4. If Justin does a 10-year installment sale for his Litigation Solutions interest, how much will he receive and how will the payments be treated tax wise?

A. $200,000 per year is taxable at LTCG rates and interest is taxable at ordinary income tax rates. He will receive $500,000 per year.
B. $200,000 per year is taxable at LTCG rates and interest is taxable at ordinary income tax rates plus a 10% penalty. He will receive $500,000 per year.
C. $300,000 per year is taxable at LTCG rates and interest is taxable at ordinary income tax rates. He will receive $500,000 per year.
D. $300,000 per year is taxable at ordinary tax rates and interest is taxable at ordinary income tax rates plus a 10% penalty. He will receive $500,000 per year.

5. If Justin's stand-alone building (other property structure) is worth $500,000, does he have enough coverage under a standard HO-5 policy for that building?

   A. Yes, the residence is insured at 100% of value
   B. Yes, an HO-3 with an HO-15 rider has coverage B insurance valued at 20% of coverage A
   C. No, an HO-3 with an HO-15 rider only has coverage B insurance valued at 10% of coverage A.
   D. Yes, he has an all-risk policy (open perils)

6. Is the antique gun collection adequately insured?

   A. Yes, under the HO-3 with HO-15 rider
   B. Yes, under the inland marine fine arts floater
   C. No, the HO-3 with HO-15 rider has limitations for collectibles
   D. No, he should get an appraisal.

Questions 7 - 9 relate to the Hodges Construction, Inc. stock.
NOTE*: For all questions which follow Justin and Heather have used up $250,000 each of their gift tax exemption because of gifting to Heather's mother through the years.*

7. Justin owns Hodges outright. His son, John, is age 28. Justin would like to transfer the future appreciation of the business to his son. However, he doesn't want to lump-sum gift the stock away and incur a sizable gift tax. He also wants to maintain control of the business until his son has more experience. Finally, if possible, he would like to receive income from the business in his retirement years. Which transfer technique do you suggest he consider?

   A. Gift-Lease Back
   B. Recapitalization
   C. Installment Sale
   D. Private Annuity
   E. Self-Canceling Installment Note (SCIN)

8. Heather, after listening to question 7, voiced her concern that Meredith's husband, Joe Delano, is also working for Hodges. She proposed that Justin do a family limited partnership and they split gift stock to Meredith and her husband and John and his wife. If the IRS allowed for a 50% discount to value the FLP gift, how long would it take them to gift away $4.8 million of the stock?

   A. 8 years
   B. 10 years
   C. 16 years
   D. 20 years

9. If Justin and Heather gifted $4.8 million of Hodges to their children using the annual split gift exclusion, what would their tax basis be (*total of all 4 not individually*)?

   A. $1,780,000
   B. $1,920,000
   C. $2,080,000
   D. $2,220,000

10. Based on the current annual exclusion, how much could Justin and Heather split gift into a 529 plan for each of their grandchildren?

    A. $120,000
    B. $150,000
    C. $300,000
    D. $750,000

11. How many exemptions do Justin and Heather get this year?

    A. 0
    B. 2
    C. 4
    D. 5

12. If Heather does a 10-year installment sale buy-out of Jane's stock, what should she do with the life insurance policy she owns on Jane?

    A. Surrender it for the cash value and use of the proceeds to pay a few years of the installment
    B. Keep the policy for the 10-year period in case Jane dies
    C. Keep the policy and borrow some of the cash value out to pay a few of the installments
    D. Sell the policy to Jane
    E. Do a 1035 exchange into an annuity and take distributions over the 10-year period

13. Jane plans to work to age 65, can she elect COBRA?

    A. No, she will be eligible for Medicare
    B. No, group health plans only last to age 65
    C. Yes, for up to 18 months
    D. Yes, but only until she qualifies for Medicare

14. Is the rare book collection covered properly under Heather's company policy?

    A. Yes, the comprehensive general liability policy says contents are covered in full
    B. Yes, the book collection is in the office
    C. No, the rare book collection is personally owned
    D. No, the contents coverage isn't enough to cover $3,000,000 in rare books

15. Based on Justin and Heather being in the maximum federal and state income tax brackets, what type of tax-exempt yield should out-of-state municipal bonds be paying to be comparable to the bond mutual fund?

    A. 3.2%
    B. 4.0%
    C. 16%
    D. 20%

16. Since there are a lot of uncertainties with their projected cash flow statement, approximately how much do they need in inflows to maintain their style of living if:
    - 12 years ago, their lifestyle was $2,085,000
    - Inflation over the past few years averaged 6%

    A. $1,036,181
    B. $3,952,389
    C. $4,195,430
    D. $4,729,513

17. If Heather continues to work, when is the latest she can take RMDs from her 401(k) plan at Author's Unlimited?

    A. 73
    B. By April 1st of the year after she turns 73
    C. When she retires
    D. By April 1st of the year alter she retires

18. If Jane dies before or after retirement, will her life insurance policy cause Author's Unlimited, Inc. to pay a corporate AMT?

    A. Yes, life insurance death benefits can cause corporations to pay AMT
    B. Yes, because it is a regular C Corporation. If it was an S corporation this wouldn't be true
    C. No, corporate AMT had been eliminated.
    D. No, the corporation is paying substantial amounts of corporate taxes
    E. No, because Author's gross receipts are less than $7.5 million

19. Author's Unlimited has a value of $4,000,000. It is a regular C Corporation. Besides the regular corporate tax, what other taxes could it be subject to?

    A. None
    B. Corporate AMT
    C. Corporate Accumulated Earnings Tax (AET)
    D. Personal Holding Company Tax
    E. NOL

20. Many years ago, Heather and Justin considered a special needs trust for Beth, but never created the trust. Considering the current situation, what type of trust should they set up for Beth?

    A. Special Needs Trust
    B. 2503(c) Trust
    C. 2503(b) Trust
    D. Irrevocable trust with Crummey, HEMS and "5 or 5" provisions
    E. No trust

21. If Justin and Heather created a dynasty trust (split gift) for $10 million, how much will it be subject to gift and GST tax?
__NOTE__: Ignore the annual exclusion but use prior taxable gifts from earlier question.

A. $4.5 million would be subject to gift taxes and $5 million subject to GST taxes.
B. $5 million would be subject to gift taxes and there would be no GST taxes due
C. $5.5 million would be subject to gift taxes and there would be no GST taxes due
D. $9.6 million would be subject to gift taxes and $10 million to GST taxes due

22. To reduce the amount of estate taxes at their death, what planning suggestion would you make?

I. Buy more life insurance on Heather in an ILIT
II. Gift antique gun collection to an appropriate museum
III. Gift rare book collections to a library
IV. Set up an FLP to gift stock to family members using the annual exclusion
V. Establish a dynasty trust for family members.

A. All of the Above
B. II, III, IV, V
C. II, III
D. IV, V

23. What could Heather do to simply provide enough money to her mother should she die before Justin?

A. Gift her lump sum of money
B. Let her mother own a term life insurance policy on Heather's life
C. Set up a 2503(b) trust
D. Provide for her under her Bypass Trust

24. Based on the case information and data, how would you prioritize Justin and Heather's goals?

I. Reduce federal and state income taxes
II. Maintain or improve their current lifestyle
III. Retire
IV. Fund for college level education for their grandchildren
V. Planning for Beth and Heather's mother should they both die

A. I, III, V, II, IV
B. II, V, Ill, I, IV
C. III, II, I, V, IV
D. IV, III, II, V, I
E. V, II, III, I, IV

Case 3 of Justin and Heather Hodges Trilogy Answer Key

1. Answer: D
   If he does an installment sale of his interest, he will no longer be an owner. If he doesn't do an installment sale, he will not fall under the related employer rules because his ownership in Litigation Solutions would be a small percentage (*Case #2: 200+ person law firm*). He is no longer an employee (Answer B). SEPs are available to self-employed. He could lump-sum rollover the target benefit plan into the SEP, but not the distributions.

2. Answer: A
   A voluntary termination qualifies for continuation coverage for up to 18 months.

3. Answer: C
   He doesn't want to work full-time. Group health coverage is only available to employees who work 30 hours or more per week. Answer B is an option, but Answer C makes more sense. At age 60 and in poor health, no insurance carrier will offer him an individual plan. HIPAA will allow him to transfer from Litigation Solutions to Heather's plan with no pre-existing conditions. Answer B is a possibility, but answer C is a better solution and would allow Heather's firm to pay the premium.

4. Answer: A

   $$\frac{\text{Profit}}{\text{Contract Price}} = \frac{\$2{,}000{,}000}{\$5{,}000{,}000} = 40\%$$

   Interest is taxable as ordinary income. There is no 10% penalty on interest.

   <u>10-year installment on $5,000,000</u>
   $500,000 is 40% taxable as LTCG

5. Answer: C
   Other structures (coverage B) are only 10% of coverage A.

6. Answer: B
   Floaters offer broader coverage for valued coverage for antiques. The coverage is open perils. It also provides coverage for property away from the premises. It can be purchased as a floater on a homeowner's policy to a limited extent, but he has $5.0 million of antique guns. Although answer C is true, it doesn't apply.

7. Answer: B
    - All of the Justin's stock should be re-issued as preferred, paying cumulative dividends.
    - The gift value of all the common stock is based on the value of the business less the value of the preferred. If the preferred is valued at $8 million, then the gift of the common is $2 million ($10 million FMV - $8 million preferred). The client can use his applicable credit plus the $30,000 exclusion. The remainder would be a taxable gift.
    - The preferred stock pays him dividends now and at retirement.
    - The preferred stock at his death will be valued at $8 million. (This is also an estate freezing technique).
    - The future appreciation of the business (common shares) is now in the son's name.

    He will lose control using Answers A, C, D and E.

8. Answer: B
    NOTE*: The annual gift tax exclusion is $30,000.*

    $30,000 ÷ 50% = $60,000/yr (using a 50% discount)
    $60,000 x 2 (split gift) x 4 = $480,000 per year
    $480,000 x 10 years = $4,800,000

9. Answer: B
    $$\frac{\$4{,}800{,}000 \text{ (gift)}}{\$10{,}000{,}000 \text{ (FMV)}} \times \$4{,}000{,}000 \text{ (basis)} = \$1{,}920{,}000$$

10. Answer: C
    $30,000 x 5 years = $150,000
    Split gift $150,000 x 2 = $300,000
    The question is asking each grandchild, not the total. Answer D is wrong. If it were asking total, the answer is $1.5 million.

11. Answer: A
    Personal exemptions have been eliminated starting in 2018.

12. Answer: C
    Heather should keep the policy. Jane is age 64 and wants to retire because of health reasons. The policy is not indicated to be an MEC. Heather could borrow some of the cash out of the policy. If Jane's health has deteriorated, the policy could not be purchased at standard rates, meaning Jane has a shortened life expectancy. The other answers are not bad. Answer C is the best choice.

13. Answer: C
    Eligibility for Medicare affects beneficiaries not terminated employees. Jane could elect COBRA for up to 18 months. Jane's spouse could elect COBRA for up to 36 months because she is eligible for Medicare. *Tough question and answer*.

14. Answer: C
    The books are owned by Heather not the business. The books should be covered under an inland marine floater policy owned by Heather. Unless there is an endorsement under the business policy, the books are not covered.

15. Answer: A
    Tax-exempt yield = taxable yield x (1 - marginal tax rate) Tax-exempt yield = 8% x (1 - 60%) = 3.2%

16. Answer: C
    $2,085,000 PV, 12n, 6i = $4,195,430 FV *Simple solution.*

17. Answer: B
    Since Heather will own all the stock of Author's Unlimited, she will be a more than 5% stockholder. The exception to wait until April 1st of the year after she retires doesn't apply. She has to take distributions as if she had an IRA (more than 5% owner).

18. Answer: C
    Corporate AMT has been eliminated starting in 2018.

19. Answer: C
    Every regular corporation can accumulate $250,000 without establishing a business need. If not, the corporation is subject to an accumulated taxable income. It is not subject to corporate AMT because the corporation doesn't own any life Insurance policies on the owners.

20. Answer: D
    The 2503(c) trust expires at age 21. The 2503(b) is a spend thrift (income only) trust. These don't make sense. A special needs trust doesn't seem applicable considering Beth's abilities. However, an irrevocable trust would allow Heather and Justin to gift each year using their annual exclusions. Beth can get the income plus the accumulations using the HEMS or "5 or 5" provisions.

21. Answer: C
    Just prior to question 7, it says that they each used up $250,000 of their $2.5 million gift tax exemption. They each have $2.25 million remaining of the gift tax exemption.
    $10 million minus $4.5 million = $5.5 million.
    There would be no GST tax; the exemption is $10 million.

22. Answer: B
    Nasty. Life insurance proceeds do not reduce estate taxes; they pay estate taxes. The others are good ideas. The dynasty trust is a freezing technique. It freezes the asset at the time of gift.

23. Answer: B
    Both Answer A and C require the use of Heather's remaining gift tax exclusion. Even at age 60, a 10- or 15-year level term policy would be reasonable and provide a lump sum to her mother. Then Justin wouldn't have to deal with her mother for money issues. Answer D isn't as practical as Answer B. The policy could be paid until her mother's death.

24. Answer: C
    This is the best order of events. You must choose from what is given.