Case #14: Doug and Sara Williams Case

Doug Williams
Doug is age 65. He has been retired for five years. A few years ago, he turned his plumbing business over to his younger brother. Doug has a prior marriage and various children from the prior marriage. Sara is his second wife. Due to his divorce experiences, he entered into a prenuptial agreement with Sara prior to their marriage.

Sara Williams
Sara is age 62. Sara has had one prior marriage. She has three children by that marriage. Since Doug requested a prenuptial agreement, she requested one also. She only has limited assets due to taking care of her son Tom's needs. Tom's needs have exhausted her nonqualified assets. Because of Tom's situation, Sara has made out a simple will with 50% of her assets to Tom (in a testamentary trust) and 50% Bill (her other son).

Doug and Sara
Doug and Sara currently live in a community property state. They both did prenuptials before they got married five years ago. After they got married, Doug added QTIP trust provisions to his existing revocable trust. He wants Sara to be able to use certain assets (especially the house) if she survives him. He wants all his assets to ultimately go to his children by a prior marriage.

Prenuptial - Doug
All assets owned by Doug go to his children. These assets were owned prior to his marriage to Sara. Assets shown in joint name (new) will go by joint tenancy to Sara. If Sara survives Doug, some assets may go into the QTIP trust.

Doug's planning
Doug did a revocable trust for stock he inherited and his residence. The business ownership and warehouse pass through his will to his revocable trust.

If Doug dies first, the following happens.
1. $1,000,000 will be divided between his children at his death.
2. $2,500,000 will go into a applicable credit shelter (exemption) trust. Income only will be paid to Sara. After 10 years, the remaining trust principal will be paid out to his children equally.
3. Any remaining assets will be placed in a QTIP trust for Sara's benefit for as long as she may live. At her death, the trust principal will be paid out to his children equally.

Doug's brother
Eric is age 60. Since Doug retired five years ago, Eric has run down the business. Five years ago, the business generated $200,000 of income for both Doug and Eric. Now Eric is barely taking $100,000 from the business, and Doug takes nothing. Eric just can't handle the business alone. Doug has a third party who is interested in buying the business from the partnership and the warehouse from Doug. Doug would like to get what he can from these assets while he can. The business and property are in another state (common law). When Doug retired, he moved to California and got married.

Doug's children (first marriage)
Jack, age 40, married with 2 grown children and 4 grandchildren
Cynthia, age 38, divorced with 3 grown children and 3 grandchildren
Stacy, age 17, single Note: She lives with his ex-wife / no child support

Sara's children (first marriage)
Bill, age 35, divorced with 2 children ages 7 and 14 (has custody)
Tom, age 24, single Tom was born with various disabilities. He is unable to work. He lives with Doug and Sara. He has receive social security disability payments since age 18.
When Sara married the first time, her husband had children by a prior marriage. Sara is still very friendly with her stepchildren and their children. Sara's first husband (Harold) died recently.

Universal Life Policy - Doug

Death benefit	$200,000 Option A - level / Total cash value $50,000
Owner	Doug (purchased 20 years ago)
Beneficiary	Sara is the primary beneficiary; his children are the contingent beneficiaries.
Premium	$1,000 per year paid for by separately owned assets / income

Term Life Policy - Doug

Death benefit	$400,000 *
Owner / beneficiary	Eric
Premium	$500 per year.

*mandatory cross-purchase arrangement

Whole Life Policy - Sara

Death benefit	$100,000 / Guaranteed cash value $20,000
Owner	Sara
Beneficiary	Harold is the primary beneficiary; her children are the contingent beneficiaries.
Premium	Paid by dividends / all excess dividends paid in cash

Medicare Supplement Policy

Covered person	Doug
Type	Plan F
Deductible	$1,000
Premium	$1,000 per year

NOTE: Doug decided to take an optional high deductible plan to reduce his premium. His health has been excellent. He takes no medication.

Auto Policy (2 cars)

BI/PD	$250,000/$500,000/$100,000
Medical payments	$5,000/$15,000
UM	$250,000/$500,000
Collision	$500 deductible
Other than collision	$500 deductible
Premium	$1,500 per year

Homeowners Policy

Property	$240,000
Contents	$120,000
Liability	$250,000
Premium	$1,000 per year

Medical

Covered person	Sara
Physician services (preventive care)	No charge
Physician services - office	$15 co-pay
Physician services - surgical	$25 co-pay
Approved inpatient hospital services	$250 per day deductible/$1,000 inpatient deductible
Prescription drugs	$25 prescription drug card
Premium	$4,000 per year

NOTE: Sara has some medical problems that require her to take prescription drugs. In general, her health is good.

Budget

Income

401(k) distribution	$ 40,000
IRA distribution	23,000
Doug's social security	18,000
Sara's social security	7,000
Stock dividends[1]	24,000
Warehouse [2]	-0-
	$ 112,000

Expenses

Income taxes [3]	$ 15,000
Property taxes	5,000
Home maintenance	3,000
Food	6,000
Clothing	2,000
Insurance[4]	9,000
Transportation [5]	6,000
Entertainment / Vacation	10,000
Medical	2,000
Gifting to family / Tom's needs	20,000
Miscellaneous	5,000
	$83,000

[1] In order to meet their cash flow needs, they take the dividends in cash.
[2] The warehouse cash flow just meets the expenses of upkeep. The building is fully depreciated.
[3] Their marginal income tax bracket is 25%.
[4] Their insurance costs consist of the follow
$1,000 for homeowners
$1,000 for Medicare supplement (Doug)
$4,000 for Sara's medical policy
$1,500 for auto insurance
$1,500 for life insurance
[5] Doug and Sara buy a new car every three years, keeping the newer car.

Doug and Sara Williams
Statement of Financial Condition

Assets		Liabilities
Checking (JT)	$ 20,000	None
IRA [1] (Sara)	500,000	
401(k) [2] (Doug)	1,000,000	
Stock [3] (Doug's trust)	2,000,000	
Warehouse [4] (Doug)	600,000	
Business[5] (Doug)	400,000	
Residence[6] (Doug's trust)	400,000	
Personal Property (JT)	100,000	
	$5,020,000	

JT is joint with right of survivorship.
[1] The IRA is a rollover from a QDRO from a prior marriage.
[2] The primary beneficiary is Sara, with no contingent beneficiary.
[3] The stock was inherited from Doug's father many years ago. The inherited value was $1,000,000.
[4] The warehouse is owned by Doug. The building is fully depreciated. The land has a value of $400,000 and a basis of $300,000. The building has seen better days.
[5] The business is owned in a partnership formed with Doug's brother, Eric. The book value of the business is $200,000. The buy-sell agreement is based on the life insurance death benefit.
[6] The residence was purchased prior to Doug's marriage to Sara for $350,000.

GOALS AND OBJECTIVES

Doug and Sara have various concerns. Retirement has left Doug at loose ends with himself. He has felt lost since he retired. In addition, he expected his business (the partnership with Eric) to produce some income. It has not. As a result, both he and Sara have had to take distributions from their retirement accounts.

Their various children (and stepchildren) by prior marriages have been eating away at any spare cash Doug and Sara have. They would like to help their children and grandchildren more. They would also like to set up a trust for Tom. Their children think they are going to get large inheritances because Doug and Sara have always lived well. Because of messy and expensive divorces, much of their respective net worth has gone to their prior spouses and divorce proceedings.

Doug's estate planning and community property issues have left Sara concerned. All she has are the IRA rollover money and her social security. Doug has been talking to various financial planners who have

been suggesting family limited partnerships, charitable giving, and other gifting arrangements. Sara feels left out in the planning and asset distributions.

Doug and Sara are both in good health. Their marriage appears to be working out. Financial arrangements and finances seem to be the biggest problem between them.

STANDARD DEDUCTION - 2015

Single	$6,300
Married filing jointly	$12,600
Married filing separately	$6,300
Head of household	$9,250
Over 65 / blind	$1,250

NOTE: Before reviewing the answer, you must keep this in mind - this is really a common law case with a community property adder. Both his property and hers was obtained prior to their marriage; therefore, it is separate property, not community property This is very important. The CFP Board exam will not give you this hint.

1. If Doug dies first, how much is included in his probate estate?

   A. $800,000
   B. $1,000,000
   C. $1,020,000
   D. $1,060,000
   E. $1,120,000

2. If Doug dies first, how much is include in his gross estate?
   A. $2,510,000
   B. $2,610,000
   C. $4,460,000
   D. $4,550,000
   E. $4,660,000

3. If Doug dies first, how much property will pass to the QTIP trust this year based on the case data?

   A. -0-
   B. $100,000
   C. $200,000
   D. $400,000

E. $1,000,000

4. If Doug and his brother sell the business, who should own Doug's term life insurance policy currently owned by Eric?

   A. Eric
   B. Doug
   C. Sara
   D. Doug's children

5. Doug and Sara file their taxes jointly. What is their 2015 standard deduction? HINT: Please refer to bottom of Page 4.

   A. $6,300
   B. $12,600
   C. $13,850
   D. $15,100
   E. $10,450

6. Doug has reviewed your analysis of his estate plan. He is considering placing the warehouse and $600,000 of the stock in a family limited partnership. If he gifts the whole family limited partnership to his children, what would be the basis of the gift?

   A. $240,000
   B. $300,000
   C. $540,000
   D. $600,000
   E. $1,000,000

7. If Doug and Sara die in a simultaneous death (USDA), who would get Sara's assets including the joint tenancy property? NOTE: The Uniform Simultaneous Death Act (USDA) provides that any persons who die within 120 hours of each other, by law, predecease each other. This rule keeps the property of one deceased person from passing through the estate of another deceased person before passing to those who survive both.

   A. Sara's ex-husband
   B. Doug
   C. Sara's children
   D. Sara's children and ex-husband's children

8. Sara wants to help her son Bill. Bill makes $40,000 per year in a sales-type position. Sara wants to provide for future education funding for his children. Which investments in an UTMA account would make the most sense?

   A. 7 yr old child: convertible bond fund; 14 yr old child: GNMA fund
   B. 7 yr old child: GNMA fund; 14 yr old child: Growth fund
   C. 7 yr old child: Growth fund; 14 yr old child: International fund
   D. 7 yr old child: global fund; 14 yr old child: gold fund
   E. 7 yr old child: small cap fund; 14 yr old child: Growth fund

9. How much of Doug and Sara's social security will be subject to taxation?

   A. $25,000
   B. None because he is over age 65
   C. 50%
   D. 85%
   E. 100%

10. Doug is also considering gifting the warehouse to his favorite public charity. What is their AGI?

    A. $84,000
    B. $84,250
    C. $87,000
    D. $108,250
    E. $112,000

11. Doug is bored with retirement. He is considering starting another business. If he does, he plans to roll his 401(k) into the new company's 401(k). What is the latest he can take RMDs if he continues to contribute to the plan?

    A. When he actually retires
    B. Age 70 1/2
    C. By April 1st following the year in which Doug attains age 70 1/2
    D. He is already taking RMDs because he is retired.

12. If Sara dies first, how much is included in her gross estate?

    A. $500,000
    B. $560,000
    C. $620,00
    D. $660,000
    E. $2,510,000

13. When will Tom be eligible for Medicare?

    A. At age 65
    B. Never
    C. He has been eligible.
    D. When he is no longer claimed as a dependent by Doug and Sara

14. If Doug dies first, which assets will get a full step-up in basis?

    I. 401(k)

    II. Stock

    III. Warehouse

    IV. Business

    V. Residence

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

15. If Doug and Sara decide to gift out of their joint account, will one or both of them have to file a 709?

    A. They both need to file because they live in a community property state.
    B. Neither needs to file because they live in a community property state.
    C. If yes then it is less than $28,000 to single individual.
    D. Neither needs to file if it is less than $28,000 to a single individual.
    E. Doug must file and Sara needs to sign the 709 (consent).

16. If Doug and Sara return to a common law state, which assets will keep their community property characteristics?

    I. Checking

    II. Stock

    III. Warehouse

    IV. Business

    V. Her IRA

    A. I
    B. I, II, V
    C. II, III
    D. II, III, IV
    E. None of the assets

17. Sara was getting social security benefit before age 62. How was this possible?

    A. Her prior husband died.
    B. Her son was disabled.
    C. She could receive benefits as early as age 60.
    D. She lied about her age.

Case 14 Answers

1. **Answer: B**

   Only the warehouse ($600,000 and the business $400,000 - shown as a half interest) are subject to probate because they are personally owned. They are not in the trust. Even though personal property, and checking account are community property the assets are held in joint tenancy. There is no probabte even in community property states when the property is held in JT (JTWROS). Other assets pass by trust document or beneficiary. The life insurance is not included in the probate estate because there is a named beneficiary. NOTE: JTWROS can be used in community property states.

2. **Answer: E**

1/2 checking*	$ 10,000
401(k)	1,000,000
Stock	2,000,000
Warehouse/business	1,000,000
Residence	400,000
1/2 personal property*	50,000
	$4,460,000
Plus personal life insurance**	200,000
	$4,660,000

The joint property would be considered community property. The other property was separately owned before marriage and is not community property. This includes his insurance policy which is paid for with income from his separately owned assets. Property acquired before marriage is separately owned. Please review Live Review page E-1. This is a very important concept for community property cases.

**The personal owner UL indicates it is Option A. The cash value does not affect the death benefit. If it said Option B (increasing), then the cash value would be added to the death benefit. In addition, Eric owns a policy on Doug. It is not included. Doug owns a policy on Eric. The unearned premium would be included in his gross estate. It is shown as no unearned premium to keep the question simple.

3. **Answer: A**

Stock	$2,000,000	
Warehouse/business	1,000,000	
Residence	400,000	
	3,400,000	
To children	-1,000,000	
To applicable credit shelter trust	-2,400,000	(has a $5,340,000 exemption)
QTIP	$ -0-	

The house is titled in his name not JTWROS. He bought it with his separately owned money. The other property passes by joint tenancy or beneficiary arrangement. This is a **difficult** question/answer. The house will be in the bypass trust, which is for her benefit. This solves the issue of her being able to live in the house. Technically, with the exemption at $5,340,000 you probably would not want to fund a QTIP unless your portion of your estate going into the applicable credit trust exceeds $5,340,000 million. The credit shelter trust must be funded first. This was handled in the Live Review class. NOTE: Sara is the beneficiary of his 401(k). She will get $1 million of his assets.

4. **Answer: B**
The term policy will ultimately get very expensive. Eric would have no business reason to keep the policy, and Doug is in good health. A sale to Sara or Doug's children would be a "transfer of value." This is definitely a "transfer-for-value question. A sale is not a gift. A gift would not violate "transfer for value." This would make the policy income taxable. Doug could use it in his estate planning.

5. **Answer: C**

Married filing jointly	$12,400
Doug (age 65)	1,200
	$13,600

Tom could be claimed as a dependent, but that does not affect the standard deduction. Doug, age 65, gets the additional $1,200. The cash flow statement indicates $5,000 of property taxes were paid, but they do not count in 2014 standard deduction.

6. **Answer: D**

Warehouse (land)	$300,000
Stock (inherited)	300,000
	$600,000

The information indicates the warehouse is fully depreciated. Only the land has basis ($300,000). $600,000 of the $2,000,000 (6/20) of the stock will be gifted ($1,000,000 basis x 6/20 = $300,000 stock basis) FLPs allow for discounts for gifting, but not a discount for basis. **Very Difficult**

7. **Answer: C**

Her half of the joint tenancy would pass to her children by simple will (like a disclaimer). In regards to her life insurance policy, Sara's children will be able to show that their father is dead. Then the policy would pay to the contingent beneficiaries (her children), or the probate court would decide the outcome. Unless the will includes step-children, any reference to them should be ignored. Answer C is the best choice.

8. **Answer: A**

The kiddie tax would apply to both children. (Somewhat subjective) However her son Bill (head of household) will only be in a 15% tax bracket. [40,000 - (9,100* + 11,850*)] = 19,050 (2014). Taxation should not affect the convertible bond fund. The 14-yr old only has 4 years or less before college. Growth funds are not appropriate due to the short time period before the 14-year old will need the education fund. One answer must work for both children. Answer A is the best choice.

* The $9,100 is the standard deduction for head of household and the $11,850 is 3 exemptions at $3,950. The numbers are used to justify the answer but do **not** appear as part of the question. However, it is important you have some idea of Bill's marginal tax bracket.

9. **Answer: D**

Their joint AGI is over $44,000; 85% of their Social Security income will be subject to tax. 85% of $25,000 is $21,950.

10. **Answer: D**

$108,250 That is 85% of their social security income ($25,000) plus 401(k) and IRA distributions and stock dividends.
$21,250 (85% of $25,000) + $40,000 + $23,000 + $24,000 = $108,250

11. **Answer: C**

    Answer C defines the RBD (required beginning date). He will be more than a 5% owner and will have to take RMDs. He can contribute to the new plan, but he must also take distributions from both plans. At this point, he is not taking RMDs, he is taking distributions. The distributions are necessary to support his lifestyle, but are not required. If he was over 70 1/2, he has to take RMDs.

12. **Answer: D**

    Sara's gross estate would consist of the IRA ($500,000), one-half of the jointly held ($60,000) property, and her life insurance ($100,000). She is the insured-owner of the policy. it is paid for using dividends. A total of $660,000

13. **Answer: C**

    He is eligible for social security, and he has been receiving benefits for more than two years. That will qualify him for medicare.

14. **Answer: C**

    All separately owned (LTCG) property subject to appreciation will get a full step-up in basis. The property is separately owned, not held jointly (1/2 step-up). 401(k) is ordinary income property. It does not get a step-up in basis.

15. **Answer: D**

    Jointly owned property is always one-half owned. Only when they gift more than $14,000 each, or $28,000 total, will they both have to file a 709. They entered into marriage late in life. Prior to their marriage the property was separately owned.

16. **Answer: E**

    The stock, warehouse, and business were never community property. The jointly held property will be diluted by separate asset income after they move to a common law state. His distribution from the 401(k), her distribution from her IRA, Social Security, etc. is all separate property income. That is what is feeding the checking account. Once they move out of a community property state, this separate income will avoid the joint property - community property status. It would become common law joint property because separately owned money will be feeding the account. Think of it this way. There is $20,000 in the checking account and they are spending $7,500 per month. In three months they will have used up the $20,000. The new money giving into the account is separately owned, not community property money. It loses its community property status due to separate asset contributions coming from various separately held assets. NOTE: This case makes you think that it is a community property case but a very important fact is in the data. Almost all the assets were separately owned prior to marriage. Remember separately owned is not community property.

17. **Answer: B**
    Sara had a child "in care". Tom became disabled before age 22.