Case #17: Richard and Tracy Croft Case

Richard
Richard is 50 years old. He and his brother, Robert, own R&R Electric, a partnership. Richard is married to Tracy (second marriage for both). Richard is still paying alimony payments to his first wife of $36,000 per year. Richard's health has been poor since before his marriage to Tracy. His poor health is from the stress of business and financial problems and from not taking care of himself.

Richard's children
Richard has two children. William, age 20, in college now, plans to go on to medical school. Diane, age 18, in college now, plans to be an attorney.

Tracy
Tracy is 38 years old. Tracy works part-time ($25,000/yr.) in the office at R&R Electric. Tracy receives child support of $20,000/year (eight more years) but no alimony. Tracy is in good health. She exercises regularly and generally takes very good care of herself.

Tracy's children
Elizabeth, age 15, and James, age 13, are both in high school. At this point, both Elizabeth and James plan to go to college.

Richard and Tracy
Richard and Tracy were married eight years ago after both went through messy divorces. Before they married, both did prenuptials and set up various trusts.

Prenuptial agreements
--All assets by prior marriage are separately owned property.
--All separately owned property will pass directly to their children by prior marriages.

Richard's planning
Richard has established a revocable trust with a pour-over will. At his death, his trust will provide income for educational and support needs until his children are age 30. At that time, the remaining assets will be turned over to his two children (equal shares).

Tracy's planning
Tracy only has a simple will leaving all her assets to her children, equally. She knows she should do some additional planning but hasn't gotten around to it. If she dies, her ex-husband will take care of the two children until they are on their own.

R&R Electric
Richard and Robert each put up $25,000 to start the business some years ago. The business currently has a fair market value of $200,000. The company does electrical contracting. The business was worth a lot more a few years ago for two reasons. First, the downturn in the economy has reduced their business volume. Secondly, Robert (the brother) has become disinterested in the business and is letting his work slide. As a result, R&R continues to lose money each year.

Richard and Robert draw $100,000 per year each out of R&R Electric. Richard feels that he can run the company alone more effectively. Without Robert's $100,000 salary, the company will make a profit.

Richard has approached Robert on a buy-out, but Robert feels R&R is worth more than $200,000. Robert feels half of his salary is due to being 50% owner of R&R. He feels his ownership is equivalent to a 10% return on his investment.

The company has various fringe benefits (see R&R Electric benefits), but Richard would like to add additional benefits to retain key employees.

R&R Electric business property
Prior to Richard and Robert starting R&R Electric, Richard had owned outright a commercial building. After they started their partnership, Robert agreed to use the commercial building as R&R Electric's business location.

The land and building was originally purchased by Richard for $250,000. The building ($175,000) is mostly depreciated (adjusted basis $60,000). The original mortgage was $200,000 at 10% for 30 years and has been paid off.

The lease payment more than pays for the property expenses, and improvements. Due to a good location and improvements, the commercial building is now worth $750,000.

Richard would like to share the income the commercial property is making with his children.

The commercial property has been a thorn in Robert's side. He does not feel the lease payments are excessive, but he sees the property values increasing and he has nothing to show for it.

Richard and Tracy Statement of Financial Position			
Cash/cash equivalents		**Liabilities**	
Checking account (JT)	$12,000	Credit card (JT)[8]	
Money market account (JT)	30,000	Home[9] (Tracy)	70,000
	$42,000		$70,000
Investments			
IRA (Tracy)[1]	$200.000		
Growth mutual fund (Tracy)[2]	150,000		
401(k) (Richard)[3]	175,000		
401(k) (Tracy)[3]	50,000		
R&R Electric (Richard)[4]	100,000		
Commercial property (Richard)[5]	750,000		
Growth stocks (Richard)[6]	125,000		
Muni bonds (Richard)	75,000		
	$1,625,000		
Use assets			
Home (Tracy)[7]	$400,000		
Personal property (Tracy)	50,000	**Net worth**	$2,147,000
Personal property (JT)	100,000		
	$550,000		
Total assets	$2,217,000	**Liability and Net Worth**	$2,217,000

JT is JTWROS

[1] QDRO settlement from prior marriage (originally $100,000), beneficiary is her estate.
[2] Property settlement from prior marriage (basis $50,000).
[3] Company matches at 50% up to 6% deferral, beneficiary is spouse if living; if not, estate of owner.
[4] Based on FMV of $200,000.
[5] Based on FMV.
[6] Property settlement from prior marriage. Purchased stock with his prior wife for $50,000.
[7] Property settlement from prior marriage, basis $100,000, FMV at time of divorce $200,000.
[8] Paid off monthly upon receipt
[9] 30-year, 6% mortgage, 20 years remaining.

Cash Flow Statement		
Income		
Richard[1]	94,000	
Tracy[1]	23,500	
Commercial building[2]	60,000	
Dividends and capital gains[3]	10.000	
		187,500
Alimony		-36,000
Taxes		
Federal income tax[4]	22,000	
FICA	8,000	
Real estate tax	7,000	
		-37,000
Expenses		
Mortgage payments (Tracy)	15,000	
Home maintenance/furnishings	5,000	
Food / beverage / entertainment	10,000	
Clothing/personal care	10,000	
Education (Richard)	30,000	
Education (Tracy)[5]	-0-	
Vacations	10,000	
Insurance	2,000	
Charitable contributions	1,500	
Miscellaneous	3,000	
		-86,500
Savings		$28,000

[1] Net of 6% contribution to the 401(k)

[2] Net of all expenses

[3] Includes municipal bond interest

[4] 25% marginal tax bracket

[5] Tracy's children's education expenses are paid for with child-support payments

INSURANCE - PERSONAL	
Homeowners insurance - Tracy	
Type	HO3/15
Coverage	$200,000
Personal property	$100,000
Liability	$100,000
Deductible	$500
Premium	$1,000 per year

LIFE INSURANCE- Richard	
Death benefit	$250,000
Cash value	$10,000 (not shown on the financial statement - kept for death benefit only)
Owner	Richard
Beneficiary	Revocable trust (Richard's)
Premium	$1,000 per year (paying minimum)

COMMERCIAL BUILDING INSURANCE - Richard	
Building coverage	$450,000
Coinsurance required	90%
Liability	$1,000,000
Deductible	$1,000
Premium	$5,000 per year (paid out of lease payments)

R&R Electric - commercial insurance policies

1. Auto policy
   R&R Electric provides Richard and Tracy with company cars and pays all insurance costs.
2. Businessowners policy
   R&R Electric has adequate contents coverage and $3,000,000 of liability coverage.
3. Workers' compensation policy
   In addition to all R&R Electric employees being covered, Richard and Robert have elected to be covered.
4. Umbrella policy
   R&R Electric purchased a $5,000,000 umbrella policy.

R&R Electric - employee benefits		
Medical insurance		
Plan:	PPO Plan	All R&R Electric employees are eligible after 6 months.
Premium:	Company covers and pays premium for Richard, Tracy and four children.	

401(k) plan	
Richard's current deferral	$6,000 per year
Tracy's current deferral	$1,500 per year
R&R Electric match	Match at 50% up to 6% deferral

GOALS AND OBJECTIVES

1. Education costs are a continuing burden to Richard and Tracy. Because of their income levels, they don't qualify for grants, scholarships or credit programs. They would like you to suggest how they could pay for college costs with pre-tax or low-tax dollars.
2. Estate planning, asset division, and future income needs by a surviving spouse are a source of conflict between Richard and Tracy due to prior marriages. They would like you to suggest how they could better structure their estate plans to meet this goal.
3. Richards knows he needs to settle with his brother, Robert. Richard's poor health is somewhat due to Richard working harder to make up for Robert's ineptness. Richard is open to any solution that makes sense for him and Robert.
4. Richard would like to fully retire in 12 years. He feels he needs $125,000 in today's dollars to retire comfortably. He and Tracy feel they can get $24,000 in Social Security benefits, but they don't want that to offset the $125,000.
5. Tracy has her eye on a mountain cabin in California. She feels that this would be a good place to get away to for Richard's health and for retirement use. She plans to purchase it with her assets.

1. Richard would like to transfer some of his before-tax income to his children to pay for current and future college costs. However, he wants to control the cash flow from the estate for retirement needs. What would you suggest?

   A. Transfer $56,000 outright of his municipal bonds to his children per year (split gift).
   B. Transfer $56,000 outright of his growth stock to his children per year (split gift).
   C. Form a family limited partnership (using commercial property) and transfer $56,000 of limited partnership units to his children per year.
   D. Form an LLC (using R&R Electric) and transfer $56,000 of shares to his children per year.

2. If Richard transfers assets (Question 1) to his children, what vehicle should he use?

   A. Outright gift
   B. UTMA account
   C. 2503(c) account
   D. 529 plan

3. If Richard gifted the $56,000 of growth stock (owned solely), to his children using an annual split gift exclusion (Tracy consents), what would be his children's basis if they sold it?

   A. $20,800
   B. $22,400
   C. $24,000
   D. $25,200
   E. $28,800

4. If the IRS allowed for a 50% discount using an annual split gift exclusion of FLP units to Richard's children, how long would it take to gift away $448,000 of the commercial property to his children?

   A. 4 years
   B. 5 years
   C. 6 years
   D. 7 years
   E. 8 years

5. If Richard gifted $448,000 of the commercial property to his children, what would be their basis in the FLP using current values?

   A. Where do you get questions like this?
   B. $74,880
   C. $80,640
   D. $90,780
   E. $135,000

6. Richard would like to make Robert a buy-out offer he can't refuse. Which of the following would be most attractive to Robert?

   A. $360,000 cash
   B. $60,000 at the beginning of each of the next 10 years using an installment sale
   C. $100,000 at the beginning of each of the next 5 years using an installment sale
   D. $120,000 at the end of each of the next 5 years using an installment sale

7. If Tracy died, to whom would her IRA pass?

   A. Richard
   B. Her estate
   C. Her ex-husband
   D. Her children

8. If Tracy wished to rollover her IRA into the R&R Electric 401(k), should she and why or why not?

   A. Yes, it is a IRA and then she could avoid the 10% penalty by using separation from service after age 55.
   B. Yes, it is a IRA and it would simplify her assets and planning.
   C. No, she wants her separate assets to go to her children.
   D. No, 401(k)s never have any provisions for a rollover from a IRA.

9. Tracy is considering taking out a second mortgage of $100,000 to fund her two children's 529 plans ($50,000 each). Would the mortgage interest be deductible?

   A. No, it is being used to fund 529 plans.
   B. No, consumer interest is no longer deductible.
   C. Yes, as long as it is limited to $100,000 and is less than the taxpayer's net equity.
   D. Yes, as long as Richard co-signs the loan application.

10. If Richard dies, how much is in his probate estate?

    A. $200,000
    B. $850,000
    C. $950,000
    D. $1,050,000
    E. $1,100,000

11. If Richard dies, how much is in his gross estate?

    A. $1,296,000
    B. $1,367,000
    C. $1,446,000
    D. $1,546,000
    E. $1,617,000

12. If Tracy purchases a mountain cabin in California, will the property be community property?

    A. It is in California; therefore it is community property.
    B. It is quasi-community property.
    C. It is not community property.
    D. It will be community property when Tracy and Richard retire and move to California.

13. What type of planning does Tracy need to do?

    I. Guardianships for her children
    II. A QTIP to benefit Richard at her death
    III. A revocabale living trust for all her assets
    IV. A unified credit trust to benefit Richard at her death
    V. A 'marital A" trust

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

14. If Tracy established a UTMA account ($20,000 per split gift) for Jame's education, what would be the appropriate investment to put in the account?

    A. S&P Index fund
    B. Growth fund
    C. Global fund
    D. Laddered zero coupon bonds
    E. EE education bonds

15. If Richard buys out Robert, what type of business entity should Richard use after the buy-out?

    A. Sole proprietorship
    B. S corporation
    C. C corporation
    D. Family limited partnership
    E. Limited liability company

16. Tracy will need a downpayment to purchase the mountain home. What should she liquidate first?

    A. CDs
    B. Growth mutual fund
    C. Long-term bonds
    D. 401(k)
    E. IRA

17. When Richard retires, how much yearly income will he need, based on an inflation rate of 4%?
    A. $101,000
    B. $125,000
    C. $161,704
    D. $200,129
    E. $209,153

18. Based on Answer 17, Richard feels he and Tracy need $4,000,000 in investments. Using the current investment total ($1,600,000) and their current 401(k) contributions (end/annual), what type of before-tax return do they need to make to achieve this goal?

   A. 7.42%
   B. 7.46%
   C. 7.82%
   D. 8.28%
   E. 8.46%

19. In reviewing Richard's insurance, R&R Electric's commercial insurance and R&R Electric's employee benefits, what do you think Richard needs to do most?

   A. Purchase a second-to-die insurance policy in an irrevocable trust for estate liquidity.
   B. Purchase a term life policy on Robert for buy-out purposes.
   C. Purchase a term life policy on Tracy for family needs.
   D. Purchase disability insurance on himself.
   E. Review his liability exposures and purchase adequate protection.

20. Considering all the facts presented in this case, and the solutions to all the questions, in what order should Richard put the case goals and objectives?

   I. Education costs
   II. Estate planning and asset division
   III. Purchase Robert's business interest
   IV. Retirement
   V. Mountain cabin

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

Case 17 Answers

1. **Answer: C**
   If he gifts his municipal bonds or growth stock, they will not be available for his retirement needs. The LLC is a bad idea only because of the asset (R&R Electric). He needs to settle with his brother first.

2. Answer: A
   His children are 20 and 18. Custodianships, a trust, or a 529 plan don't make any sense at their current ages.

3. Answer: **B**

basis	x	gift	=	children's basis
current value				
$50,000	x	$56,000	=	$22,400
$125,000				

   There is no basis increase. The formula calculation is to get the prorata share of existing basis.

4. Answer: A
   His children only - split gift with Tracy's consent (William and Diane - $56,000 total)

$56,000/yr.	÷	50%	=	$112,000/yr.	(using 50% discount
$448,000	÷	$112,000/yr.	=	4 years	

   Split gift means she consented.

5. Answer: C

$135,000*	x	$448,000	=	$80,640
$750,000				

   * Original basis of land was $75,000 plus adjusted basis of building is $60,000 (total $135,000). Land never depreciates ($250,000 - 175,000 = $75,000) The current FMV of the property is shown ($750,000).

6. Answer: D

You had to dig in the data to find out how much Robert, **not** Richard, considers a reasonable before-tax return (10%) on his business ownership. The answers to B, C, and D are:

B.	$405,541 PV	
C.	$416,987 PV	
D.	$454,894 PV	($120,000 PMT, 5 N, 10 I in end mode

To compare Answer A, the answers to B, C, and D need to be converted to a present value.

7. Answer: B

On page 3 footnote #1, it says the IRA beneficiary is her estate.

8. Answer: C

It says she wants for her separate assets to pass to her children. If she rolls her IRA into the 401(k), the beneficiary will be Richard. She may not have a choice of beneficiary because it is a qualify plan. 401(k) **can** have provisions for rollovers. The best answer is C. It goes to her estate, then her will says to her children.

9. Answer: C

Unlike acquisition debt, a home equity loan may be used for any purpose. The home is owned by Tracy.

10. Answer: D

Although Richard set up a revocable trust, he never put his assets (except his life insurance) in his trust. Assets passing through a pour-over will are subject to probate.

R&R Electric	$100,000
Commercial property	750,000
Growth stock	125,000
Municipal bonds	75,000
	$1,050,000

11. Answer: D

Probate property	$1,050,000	(from #10)
1/2 joint property	71,000	[($12,000 + 30,000 + 100,000) ÷ 2]
401(k)	175,000	
Life insurance	<u>250,000</u>	(page 2-4)
	$1,546,000	

12. Answer: C

In addition, Tracy is planning on purchasing it with her <u>assets</u>. Separate property is always separate property. There is no indication they live in a community property state.

13. Answer: E

Tracy's estate is only $851,000. She wants to leave all separately owned assets to her children. The QTIP, unified credit, and marital trusts will benefit Richard not her children.

1/2 jointly held ($142,000)	$71,000	
IRA	200,000	
401(k)	50,000	
Growth mutual fund	150,000	
Home less mortgage	330,000	
Personal property	<u>50,000</u>	(The 2nd $50,000 is **her** personal property.)
	$851,000	

There is no guardianship provisions, just a statement that her ex-husband will take care of them. Remember the court will decide maybe the kids do not want to live with their rigid father and attend another school. Guardianship is always an issue on the exam. None exists.

14. Answer: D

The kiddie tax should not be a factor ($20,000 x 6% = $1,200). After 4 years (age 17), the kiddie tax might be a factor, but they are only in a 25% marginal tax bracket. I think the time frame (4-5 years) to the first year in college is too short for the growth funds. Remember her son is 13. He could go to college at age 17. Besides, which growth fund? There is nothing in the case to indicate a preference for the S&P, Growth, or Global fund. They are all growth orientated. Their income is too high for the EE education bonds.

15. Answer: A

When Richard buys out Robert, the partnership is broken. There is not indication that the business is risky nor that Richard is interested in sharing the business with any family members. This must be a small electrical contractor if Richard and Robert draw $100,000 per year. I have covered that business risk with $8 million of liability insurance. In addition, there is no indication that this business is risky. That should be more than enough for any of their projects. In class I stress that when you see two answers that can apply, they are both usually wrong. A FLP and a LLC are similar answers. Answer A is subjective based on risky/not risk. This is called a financial planners evaluation of risk. Answer C is debatable. To use a C, Richard needs to be in a 39.6% tax bracket. Even eliminating, Robert might add another $100,000, but he is still no where near 39.6%. If answered B - are you wrong? No, I am just trying to use my business entity chart. S corporation is a good answer. This is the subjectiveness of the exam.

16. Answer: B

The growth stock will be subject to capital gains tax above basis. The IRA will be subject to ordinary income tax and a 10% penalty. If you spent a lot of time looking for the CDs, there were none. Can that be on the CFP Board exam? Yes!

17. Answer: D

$125,000 PV, 4 i, 12 n, = $200,129 FV

The $125,000 is a goal (#4).

18. Answer: B

$1,600,000 **CHS (±)** PV, **$11,250 CHS (±)** PMT, $4,000,000 FV, 12n =

7.46% (**end**) (Richard $6,000 + 3,000 and Tracy $1,500 + 750 = $11,250)

19. Answer: E

Remember what I said; if an umbrella is an answer, use it. The second-to-die is important, but first the estate must be planned. If Richard does an FLP, he may never have any estate taxes. Richard is planning to buy out Robert; the policy isn't necessary. A policy on Tracy is important. A disability policy for Richard is very importmant but unattainable. He is over age 50, has a poorly defined occupation and is in poor health. Very difficult to underwrite. Their personal liability protection is inadequate (no personal umbrella).

20. Answer: A

Tracy's mountain cabin is least important (last priority). That is Tracy's objective not Richard's objective. He does not even know about it. Doing the FLP to pay for education costs should be his first priority. But if the mountain cabin is last, then answer A is the best answer. **Key:** Look at the question in the following way - First, answer what is the most important. Last, answer - what is least important. Ignore the middle.