

## **Case Study: The Donovan Family**

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Here's the story of a Maine family in the 21st century, describing their "wealth" and philanthropy within the context of the tax climate and family dynamics. The scenario is realistic, from the perspective of the charity, as an advisor/attorney, or as the trust officer involved in trust administration. Vehicles discussed include a conservation easement, charitable remainder trust, retirement plan charitable beneficiary designations, 529 Plan funding, plus considerations involving both state and federal estate and gift taxes, capital gains exposure and income tax considerations.



The best way to begin a conversation about planning is to focus on the goals of the people involved, so our initial planning question is always about goals. That's the focus, too, from beginning to end.

In this case, we learn right from the start the fairly straightforward (and not uncommon) goals of these clients:

**Maintain diversified portfolio of assets & dependable income stream for life**  
**Pass wealth to heirs with minimal transfer tax cost, help assure daughter's situation, perhaps grandchildren's education expenses**  
**Create Charitable Legacy, provide example of responsible wealth stewardship to heirs**

### **Let's take a look at who's involved:**

Donors – David and Donna Donovan

Heirs – their children and grandchildren

Professional Advisor (a trusts & estates attorney, financial planner, appraiser)

Charities of Donors choice, specified below



### **What are their circumstances?**

The Donovan's have a combined estate of \$4M consisting of:

\$ 500,000	His 403(b) and 401(k) plans, now IRA plan assets (He's 71, RMD started)
\$ 400,000	Her 401(k), now IRA plan assets (She's 70, RMD about to start)
\$1,000,000	Marital Home on 2 acre lot, including 5 acres of oceanfront, adjacent to nature preserve
\$ 600,000	Vacation cottage, also on coast
\$1,000,000	Life Insurance, payable to heirs upon "second to die"
\$ 500,000	Stock Portfolio

David went to University of Wisconsin, Madison, received degrees in biology, founded a biological laboratory on that has made significant advancements in medical research areas, had a for-profit subsidiary that had pharmaceutical contracts, helped him build his retirement. Donna went to University of Maine, they met when his family was on vacation on the coast



of Maine, they married when he finished his graduate work, lived and raised their family in Maine where he founded the lab, she worked for BIW for 20 years after kids were in school, as a systems engineer, retired at 65.

The Donovan's have two children, Donald, age 48, and Dodi, age 45. Donald has no children, Dodi has two (Donnie, age 18 and Dot, 15. Donald and Dodi are professionals (Donald is a software engineer, Dodi is a lawyer) but Dodi, because she was not in the work force for very long, has no retirement savings. Her ex-husband (also her former law partner) left her for his secretary, and while she receives alimony and child support, she has not returned to the work force, and knows her earning potential in the legal field is lower than her peers due to her few years of experience before leaving practice to stay home to raise her two children.

Donald is in 28% tax bracket while Dodi is in a 15% tax bracket.

Back to our donors: David and Donna bought their home, an 1850's cape, with the 7 acres, when they were first married, paid \$50,000 for it, have added on but kept the 5 acre lot



as a buffer between the house and a local preserve that has public access. They spent most summers at a cottage "downeast" that they built over the years, their basis in that property is also \$50,000. It is surrounded by both vacation homes and year-round homes.

Their children don't live in Maine. Their son Donald lives in New York, visits at Christmas and for two weeks each summer. Their daughter, Dodi, her husband and their two children live in Boston. Their oldest grandchild, Donnie, is about to start college, the younger grandchild, Dot, is just starting high school. Dodi and the Donovans grandchildren alternate visits to David and Donna and their other grandparents, who live on the west coast.

David and Donna's concerns are having "enough to live on", especially as they get older. Their goal is to remain in the house for as long as possible. They had thought for many years that their children would probably want to have the camp, but they can see that it's so far away, with the cost of gasoline, and the fact that it is only a two bedroom house, their children probably would not be able to use it very often, and it requires annual winterization, etc.

The house is very accessible and is situated in an area that has become expensive and more densely developed; their 5 acre adjacent oceanfront parcel makes their property value extremely high, and consequently results in a substantial property tax bill annually. They have talked over with Donald and Dodi whether they would like to have the house as a vacation home or other purpose: they do want to keep the home, and understand that they'll need to agree on its use, maintenance and all expenses.

They are concerned about their daughter Dodi's financial security. They also want to do what they can to help assure that their grandchildren get through college, and are somewhat disillusioned about their former son-in-law's commitment to their education.

Both are extremely loyal to their alma maters, and also support local charities including the hospital where their children were born, the local land trust that oversees the preserve near

their house, and the social service agency where they have begun to volunteer their time in retirement. They are extremely committed to the idea of community service, and always have been. They have taught this to their children, and when possible, to their grandchildren.

They are also fond of the animal shelter near their summer cottage, and have taken time during their vacations to help out as volunteers there, even taking their kids, and later their grandkids, to teach them about community service.

### **Let's take a look at their asset situation again, and analyze each component:**

David and Donna's Retirement Plan Assets:

\$500,000 His 403(b) and 401(k) plans, now IRA plan assets (He's 71, RMD started) fully taxable (estate and income)

\$400,000 Her 401(k), now IRA plan assets (She's 70, RMD about to start) fully taxable (estate and income)



Both of these assets have imbedded income tax. Their son would pay 28% in income taxes on any portion he receives through their estates, and daughter would pay 15% or higher, if her income situation improves and she's in a higher bracket.

### **Real Estate:**

\$1,000,000 Marital Home on 2 acre lot, including 5 acres of oceanfront, adjacent to nature preserve (basis: \$50,000)

They are entitled to \$500,000 of gain without tax, so there's \$450,000 of taxable gain here on sale of the asset.

\$600,000 Vacation cottage, also on coast (basis \$50,000)  
There's \$550,000 of gain on sale of the asset

Capital gain rates on assets held over 1 year is currently no higher than 15%, but will return to 20% in 2011 under current law.

\$1,000,000 Life Insurance, payable to heirs upon "second to die"

The Donovans took out this policy when they were younger in both of them were gone, to provide for their children. That purpose is no longer compelling, but the policy is "paid up"

\$ 500,000 Stock Portfolio, basis in assets is approx. \$200,000. There's \$300,000 of gain built into this portfolio

### **Tax Climate:**

\$1,000,000 Threshold for Maine Estate Tax

\$1,000,000 Threshold for US Estate Tax beginning 2011

\$2,000,000 Threshold for US Estate and Generation Skipping Tax in 2008

\$3,500,000 Threshold for US Estate and Generation Skipping Tax in 2009  
\$ unlimited No estate or Generation Skipping tax in 2010 (but no "step-up in basis"  
so capital gains tax payable by heirs on sale of inherited assets)

\$1,000,000 Threshold for US Gift Tax in all years

Assuming that neither of the Donovan's will die before 2011, which is likely given their good health and ages, under current tax law their combined estates will pay Maine and federal estate tax on \$2,000,000 that could total as much as about 65% or more, or \$1,300,000. They have the ability to pass \$2,000,000 of their assets free of tax, which they both feel is more than adequate. They want to pass as much to charity as possible to result in no estate tax to either the State of Maine or the Federal Government, and are averse to paying any Gift or Generation Skipping taxes, if possible.

The Donovan's have been approached by the land trust about the lot adjacent to their house. The land trust would like to see them either deed it outright to the land trust, or place a conservation easement on the property to prohibit any further development of the property. While wanting to support the trust, the Executive Director of the trust encouraged



them to talk with their attorney and financial planner first. They realized that they needed to consider their entire estate plan before committing to such a gift, and when they called their attorney, she agreed, and had them complete a questionnaire that laid out much of the information above.

After reviewing that information and conferring with the financial planner and local real estate appraiser, their attorney recommended the following estate plan:

The Donovan's could grant a conservation easement on the 5 acre parcel adjacent to their house and simultaneously reduce the value of their residence. With a preliminary opinion from a "qualified appraiser" who regularly does appraisals of conservation property that are used for IRS purposes, it appears that the property would have a value of \$550,000 if a conservation easement prohibiting further development were placed on the 5 acre parcel. This would give the Donovan's an income tax deduction that for six consecutive years would reduce their income tax liability, and would also give them a significantly reduced annual property tax bill. The result; The value of the property in their estates is a total of \$450,00, and no capital gain would be recognized if the asset were sold from the estate.

**Recap:**

- Conservation easement gives Donovan's 6 years of income tax deduction
- Property value reduced to \$550,000 for estate tax purposes
- Property value reduced for annual local property tax purposes
- Donovan's retain permanently undeveloped buffer on 5 acre adjacent lot to house

## **Life Insurance & Retirement Plan Assets**

The largest amount of taxation would occur if the Retirement Plan assets were left to the Donovan heirs. As much as 85% of the \$900,000 would be exposed to income and estate taxes on the state and federal levels. This asset should be used for a charitable gift, but the Donovan's should have full access to it during their lifetimes.

The Life Insurance is not longer as compelling an asset for heirs as it was, but it could be very helpful as a retirement cushion for their daughter. At the same time, they do want to treat their children equally, although they realize they may need to accelerate what they provide for their daughter, and their son may have to wait.

The recommendation is to leave the \$900,000 in retirement plan assets, or whatever is left, to charity. They want it divided equally between the social service agency to support their programs addressing hunger, the animal shelter 'downeast', and the hospital's birthing unit. The financial planner estimates that the fund, if drawn down over the next 20 years or so sufficient to satisfy their RMD's and give them about \$6,000 a month or \$72,000 a year, will actually increase in value to almost \$1,000,000. This will require them to change the beneficiary designation on their plans to reflect these charities in equal shares. Their attorney has already contact the charities to be sure they have the ability to receive these types of gifts, and are satisfied with the purposes that the gifts have, although she did not disclose the identity of her clients.

The Life Insurance, payable when the second of them dies, is an attractive option for two purposes: to fund a means of looking after their daughter, and fund another gift for their alma maters. The life insurance would be payable to a charitable remainder trust that would pay 7% per year, or \$70,000 to their daughter for her lifetime, then pass the remainder on to the Universities in equal shares. The projections for the remainder's value, based on their daughters age and with conservative market projections, is in excess of \$1,000,000, or in excess of \$500,000 for each school. This removes most of the value of the asset from their estate, with the exception of the gift they are making to their daughter, which would likely not result in any estate or gift tax.



**Recap:** Donovan's retain retirement plans to support them, but change the beneficiary designations on their death to support three (3) charities; the plans provide them sufficient income for their needs, and will provide substantial income and estate tax savings funding significant, meaningful charitable gifts.

## Real Estate

The house with a reduced value of \$550,000 and cottage valued at \$600,000 can both be left to be divided equally between their children. This would allow them to liquidate the cottage and either use that money to fund the maintenance of the house or otherwise, and leave them the marital home. This then passes \$1,150,000 of value to their heirs.

## Stock portfolio

This is an asset with embedded capital gain, and on which they do not rely for income. It could, however, be a resource for their grandchildren's education. Because the conservation easement would give them substantial offsets for income taxes, including capital gains, the recommendation is that for 2008, they sell \$60,000 worth to put into a 529 plan for the first grandchild, then add \$12,000 from the portfolio per year for each of the next 5 years to fund the plan a total of \$120,000 for college and graduate school. For the other grandchild, they would gift \$60,000 of the portfolio in 4 years – again, using their charitable deduction carry-forward to shelter the capital gain, and fund another 529 plan for the younger grand-

child and again, gifting \$12,000 per year to the plan for 5 years for a total of \$120,000. In both cases, there would be no gift tax payable. Once both of those gifts are fully funded, there could remain at least 260,000 assuming no growth in the portfolio, but more likely at least \$400,000 that could be left to the two children in equal shares. If possible, they would have reduced the capital gains-laden portion of the portfolio. This strategy alleviates their concerns about funds available for their grandchildren's education, and still potentially leaves about \$400,000 to their two children.

**At this point, let's review goals achieved in the proposed plan:**

*Determined that their \$900,000 retirement plan assets are sufficient for their income needs*

*Reduced the expense of their home, in which they intend to remain, and provided a generous gift to the land trust*

*Provided a retirement income for their daughter, and generous charitable gifts to their respective alma maters*

*Provided for the grandchildren's education*

*Provided generous gifts to the hospital, social service agency and the animal shelter*



Passed approximately \$1,550,000 to the two children, free of tax. If they sell either the cottage or the house, they will likely be able to use the value of the property as of the date of death of the second parent to die, as their tax basis in the property, so that some of the capital gain that would otherwise have been payable by their parents will not be payable by them at what would likely be a higher rate.

It is also recommended that they bring their children and grandchildren together to review their plans, and thereby explain all of their goals and strategies of attaining those goals, to their children. They want to diffuse any hostility between Donald and Dodi, given that Dodi will receive the benefit of the charitable remainder trust and Donald will not, and that the grandchildren will receive funds for their education out of their estate plans. They feel that Donald is sympathetic with his sister's situation, and is extremely devoted to her children (one of whom was named after him), such that it will not be a difficult conversation. They also want to have the chance to explain to their children and grandchildren how much it means to them to be able to continue their charitable support through the gifts their plans include, and celebrate all the goals they are able to accomplish through their plans.

With careful and thoughtful consideration of their goals, these advisors have created gifts and used vehicles with tax efficiencies that support all of the Donovan's goals, and a strategy for communicating their plans to educate their heirs about wealth stewardship and preserve goodwill amongst family members.

*All of the names and facts recited in the above case study are fictitious and bear no relation to actual individuals. The accuracy of calculations herein is not guaranteed and any individuals should not rely upon this material as advice but should seek the independent professional advice of a qualified professional.*