Case 6 -- Dr. and Mrs. Everett M. Catalpa, III – Maximized Planning

Dr. and Mrs. Catalpa have a significant estate consisting of appreciated real estate and cash accumulations from Dr. Catalpa's medical practice and subsequent investments. Their real property consists of a five hundred acre farm in Howard County about ten miles from Columbia, acquired as an inheritance from Mrs. Catalpa's father, and several smaller parcels in Highland and Ashton. The real property is valued at some four million dollars. They also have nearly four million dollars of cash and cash equivalents, both in and out of retirement plans, conservatively invested in money-market funds and mutual funds.

Dr. Catalpa refers to the property as his "retirement plan," and he and Mrs. Catalpa intend to sell the farm and live on the proceeds. Dr. Catalpa intends to retire next year, and sell off the properties one by one, with the cash as a “buffer.”

The farm property was inherited with a basis of one hundred thousand dollars, but has a market value of two-and-a-half million dollars as development property in the current market. Dr. Catalpa has received offers of that amount from developers. The other properties have various amounts of built-in gain. Dr. Catalpa is interested in avoiding capital gains tax on the sale of the property.

Dr. and Mrs. Catalpa visit their accountant to discuss retirement planning and sale of the properties. Their accountant suggests that they transfer their property to a trust called a "Charitable Remainder Trust." This trust is sanctioned by the Internal Revenue Code, and is an entirely legal form of tax avoidance. Their accountant explains that the trust holds property, sells it, invests the proceeds, and pays a life income to the Catalpas, or the survivor of them. At the death of the survivor, the trust will pay the principal to the charity of the Catalpas' choice.

Mr. Catalpa objects that he has never been charitably minded, and does not want to “give away” his most valuable asset. His accountant suggests that they review the consequences of “keeping” the farm. If it is sold during the lifetime of either of the Catalpas, the federal and state capital gains tax will take nearly a third of the value. If it remains in the estate of either of the Catalpas, federal estate taxation will require payment of about half of the value to the government. Mr. Catalpa, while still not particularly charitably minded, knows that there is one organization which he does not want to fund, and will undertake even a charitable gift to avoid unnecessary payments to the taxing authority. Their accountant continues to set forth the advantages of the trust:

The trust will sell the properties, valued together at just over four million dollars, and avoid capital gains tax, for an approximate increase in available funds of one million dollars. The trust will exclude the properties and proceeds from estate taxation, for a savings of one-third of the value. Because the trust makes eventual distribution to a charity, the present value of that future gift creates a current income tax deduction to the Catalpas, which will partially offset the income stream from the trust. The Catalpas should receive regular income of two hundred thousand dollars if the trust nets a five percent return.

The Catalpas immediately grasp the advantages of the arrangement. Mrs. Catalpa points out, however, that this plan effectively leaves out the children. Their accountant suggests that they use a "Wealth Replacement Trust," a form of irrevocable trust, to hold a “second-to-die” life insurance policy for three million dollars on the Catalpas’ lives for the benefit of the children, to replace the anticipated after-tax value to the children of the properties placed in the Charitable Remainder Trust. The “second-to-die” policy pays only on the death of the second spouse to die, thus decreasing the premium cost, which can be paid out of the income stream from the Charitable Trust for a period of ten years or so. The surviving spouse will be adequately provided for by the remaining income from the Charitable Trust and the securities and cash in the family portfolio. By causing the Wealth Replacement Trust to purchase the policy and own it, the policy value is excluded from the Catalpas' estate, thus not increasing their estate tax.

The Catalpas take the plan to their attorney, who drafts the required legal documents, and suggests that they use a Revocable Living Trust as the foundation of their planning, to take advantage of the one million dollar exclusion against Maryland estate tax for both spouses and to avoid probate costs. Their attorney also counsels them to execute powers of attorney for asset management and medical care, to provide for incapacity. The total cost of the document drafting was less than one percent of the probable taxes and costs on the estate without the planning.

The Catalpas' attorney is willing to act as trustee of both trusts, arranging for the sale of the properties and the investment of the proceeds, and suggesting a financial professional for investing the charitable trust proceeds and the investment to select the insurance policy for use with the Wealth Replacement Trust. Although the Catalpas cannot technically have any influence on the administration of their trusts, their trustee is open to their input and will probably take their suggestions to heart.

Additionally, their financial planner suggests restructuring their investment holdings to account for the income from the Charitable Trust. Since their living expenses will be paid by the Charitable Trust, they can afford to put their cash accumulations into a growth form to increase the value without generating additional taxable income to the Catalpas, thus maximizing distribution to their children.

The net benefit to their estate will exceed one million dollars, and will provide a benefit to charity of over three million dollars. After providing for their own retirement, the needs of a surviving spouse, their children, and their favorite charity, the Catalpas can face the future with confidence.