

**CFP<sup>®</sup> CERTIFICATION EXAMINATION ANSWERS**

**Released as of November 1994**

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Explanations have been added to the answers, all prepared by

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and are not part of the CFP Board of Standards' materials.

1. E	11. E	21. D	31. B	41. B	51. C
2. B	12. C	22. B	32. E	42. B	52. A
3. E	13. C	23. A	33. C	43. A	53. D
4. C	14. C	24. C	34. B	44. A	54. A
5. C	15. B	25. E	35. D	45. C	55. B
6. D	16. A	26. D	36. D	46. A	56. A
7. C	17. B	27. C	37. B	47. E	57. E
8. A	18. A	28. D	38. B	48. A	58. A
9. D	19. E	29. D	39. D	49. D	59. C
10. B	20. A	30. E	40. B	50. E	

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**Tax - Penalties (easy)**

1. E

Sara owes a penalty and interest on the \$400 that she owed on April 15<sup>th</sup>.

**Tax - Information Sources (moderate)**

2. B

The question asks about very recent changes to tax law, and the best source is Congressional Committee reports for bills passed and signed into law. Recent changes would not be reflected in the other sources of information.

**Retirement - Qualified Plan Requirements (moderate)**

3. E

This is a top-heavy plan as evidenced by the salary of Jack in comparison to other employees. The choices for vesting schedules in a top-heavy plan are (a) immediate, (b) 3-year cliff, and (c) 2 - 6 graded. Due to the average length of employment, the most suitable vesting schedule from Jack's point of view (cash flow if termination occurs and forfeiture) is the graded vesting. B and C would be unavailable to Jack.

**Investments - Options (moderate)**

4. C

The client will benefit if the market increases. Her portfolio, because it is diversified, should be highly correlated and move with the market. An index option also moves with the market and, therefore, would be a good hedge vehicle. A put should be used, because it will increase in value if the market should decline, thereby offsetting any losses on the portfolio.

**Investments - Performance Measures (easy)**

5. C

$$\text{Sharp Index} = \frac{\text{Realized Return} - \text{Risk Free Return}}{\text{Standard Deviation of Portfolio}}$$

$$0.47826 = \frac{(0.19 - 0.08)}{0.23}$$

**Fundamentals - Financial Planning Process (easy)**

6. D

This is simply a matter of which function as a planner comes in what order. Interview, collect, prepare, implement, and monitor.

**Retirement - Profit-Sharing Plans (easy)**

7. C

Profit sharing plans do not require annual contributions (however, contributions must be “substantial and reoccurring”). Additionally, profit sharing plans do not require a company to have made a profit during the year in order to make a contribution for the given year. D is incorrect today because profit-sharing plans allow the employer to contribute up to 25% of covered compensation.

**Estates - Estate Tax (moderate)**

8. A

Since she made no provisions to the contrary, the 50% tax will come out of the bequest to the son. The bequest to the husband qualifies for the unlimited marital deduction, and thus did not create any tax liability.

**Investments - Standard Deviation of Portfolio (moderate)**

9. D

Unless the correlation coefficient between the stocks is equal to one, the standard deviation for the portfolio will be lower than the weighted average standard deviation for the portfolio.

**Insurance - Retirement Needs Analysis (moderate)**

10. B

The question asks what is not needed to calculate the value of a life. The human life value is determined by finding the present value of the future cash flows (the client’s annual salary). A, C, D, and E are all needed in this calculation. Social Security benefits are not earned; they are an entitlement. Therefore, benefits from Social Security are not needed in this calculation.

**Investments - Stock Valuation (moderate)**

11. E

The intrinsic value of a share of common stock is equal to the discounted present value of its cash flows.

**Insurance - Terminology (easy)**

12. C

This is the definition of a hazard (a condition which increases the likelihood (prohibiting) or severity of a loss) usually distinguished from peril (cause of loss) and risk (expected variability of outcomes).

**Fundamentals/ Retirement - Time Value of Money (difficult)**

13. C

Year 1 - 5	PV	=	\$40,000
	i	=	5.5
	N	=	5
	FV	=	(\$52,278.40)
Year 6 - 10	PV	=	\$52,278.40
	i	=	4.0
	N	=	5
	FV	=	(\$63,604.67)
Year 10 - 13	PV	=	\$63,604.67
	i	=	3.5
	N	=	3
	FV	=	(\$70,519.63)

**Investments - Taxation of Securities (moderate)**

14. C

Below is the CFP Board of Examiner's response to a candidate's question regarding this exam item:

*70% of the preferred dividends received by a corporation are exempt from Federal income taxes. (Actually, if 20% or more of the corporation paying the dividend is owned by the company receiving the dividends, then up to 100% of the dividend is tax-free.) E. Non-profit institutional – Typically pay no Federal taxes; therefore, the corporate dividend received deduction of 70% is of no value.*

**Retirement - Defined Benefit Plans (easy)**

15. B

Defined benefit plans require mandatory contributions; therefore, B is not true. A, C, D, and E are all true statements regarding defined benefit plans.

**Insurance - Homeowners Insurance (easy)**

16. A

B through E are open perils covered by HO-3. Flood is excluded as a general exclusion under Section 1 of all Homeowner forms.

**Investments - Municipal Bonds (easy)**

17. B

General obligation bonds are backed by the full taxing authority of the municipality, whereas revenue bonds are only repaid from revenues of a particular project.

**Investments - Options (easy)**

18. A

The option is out of the money; therefore the intrinsic value is zero. The premium of an option does not affect the intrinsic value of the option.

Below is the CFP Board of Examiner's response to a candidate's question regarding this exam item:

*This is a good question because it is commonly misunderstood. Intrinsic value reflects the amount, if any, by which an option is "in the money". It cannot be less than "0". "In the money" = market price -- exercise price. Do you find yourself reversing formula components (which, by the way, is exactly why distractor C was offered)?*

**Fundamentals - Forms of Business (moderate)**

19. E

The question asks about legal forms. Partnerships (A and B) are excluded due to disruption if a partner were to leave. Corporation (C) is excluded due to implicit double taxation and no need for capital accumulation. Professional Corporation (D) is not available for a franchise operation. Therefore, the S Corporation is the best choice - a flow through entity, offering limited liability and ease of continuation and exchange of ownership. A Limited Liability Corporation would accomplish the same goals, but it was not a choice.

**Investments – Arbitrage Pricing Theory (easy)**

20. A

Arbitrage Pricing Theory uses multiple regression (many factors) to determine a model or formula that has numerous factors. This model is then used to determine the value of a security. The CAPM is based on the single factor of Beta, which measures the level of systematic risk within a portfolio.

**Fundamentals - Financial Statements (easy)**

21. D

The question is what value should be used in preparation of a personal financial statement. The answer is fair market value (FMV). D is the definition of FMV.

**Investments - Options (moderate)**

22. B

A call option has unlimited price potential which means that writing a call without the stock as a hedge will provide the greatest loss potential.

**Tax - Depreciation (moderate)**

23. A

This is a depreciation question. MACRS is 20% declining balance depreciation and will accomplish the maximum allowable depreciation expense.

**Tax - Kiddie Tax (moderate)**

24. C

The question relates to the Kiddie tax, which applies to unearned income in excess of \$1,200 (for 1994) by a child under the age of 14. E is incorrect, because Mark, while under the age of 14, has only earned income. B and C are incorrect, because Jennifer is 14, and Steven, age 10, had unearned income less than \$1,200. Therefore, the answer is C, because Nancy, age 12, had unearned income of \$1,900.

**Tax/Retirement - IRA (moderate)**

25. E

The question asks about deductible IRA contributions. The client is single, and not covered by a pension plan. Therefore, he can contribute earned income up to \$2,000 (for 1994) to a deductible IRA. There is no phase out based on AGI.

Below is the CFP Board of Examiner's response to a candidate's question regarding this exam item:

*The AGI limits do not apply here. The question states that the company does not cover him under a qualified pension plan. The AGI limits only apply where an individual is covered under a qualified plan.*

**Retirement - Choosing a Retirement Plan (difficult)**

26. D

Objective #5 basically answers the question. Only a defined benefit plan will provide benefits to employees without risk to the employees. Rewarding long-term employees eliminates C - defined benefit plan plus 401(k). Implementing a 401(k) plan will not benefit long-term employees.

**Insurance - Homeowners Insurance (moderate)**

27. C

A predetermined value is placed on such objects. If the loss is total, the insurance company pays the face value of the policy (predetermined). D and E incorrectly characterize endorsements.

**Insurance - Taxation of Life Insurance and Annuities (difficult)**

28. D

A is incorrect. Modified endowment policies provide tax-free death benefits like other life insurance policies. C is incorrect because beneficiaries of permanent life insurance in a pension plan are liable for tax on the cash value. E is incorrect because the applicable year is 1982. B is incorrect because there is no tax deferral if the annuity is owned by a corporation.

Below is the CFP Board of Examiner's response to a candidate's question regarding this exam item:

*D is indeed the correct answer because immediate annuities are not subject to a premature distribution penalty tax. This only applies to deferred annuities.*

**Investments - Stock Valuation (difficult)**

29. D

The market risk premium is the additional return for accepting the risk of the market. If the market premium increases with all else remaining the same, then the price of the stock would have to decrease. An increase in the market premium would also increase the discount rate used to value the stock. This higher discount rate will cause the present value of the cash flows to be smaller.

**Investments - Stock Valuation (difficult)**

30. E

PV = \$1.36

FV = (\$2.00)

N = 5

i = 8.02

$$\text{Value of common stock} = \frac{d_1}{\text{RRR} - g} = \frac{1.082 (2.00)}{0.12 - 0.08} = \frac{2.16}{0.04} = \$54.00$$

RRR = Required Rate of Return

g = growth rate

**Fundamentals - Consumer Protection (moderate)**

31. B

Each credit card carries a maximum \$50 potential liability, which is mitigated with notice prior to fraudulent use.

Discover Card	\$50
Master Card	\$50
VISA	\$50
Sears	\$25
Marshall Fields	<u>\$50</u>
	<u>\$225</u>

**Retirement - Tax – Sheltered Annuities (moderate)**

**32. E**

The question asks for the statement that is incorrect. E states that all employees of 501(c)(3) organizations are eligible for the catch-up provision. This statement is incorrect. Only employees of 501(c)(3) organizations that are educational institutions, hospitals, home health services, and health and welfare service agencies are catch-up provisions (e.g., not Boy Scouts).

**Retirement - Target Benefit Plan (moderate)**

**33. C**

The maximum contribution to a target benefit plan is limited to 25% of covered compensation (this would include only income below the \$150,000 salary maximum).

Below is the CFP Board of Examiner's response to a candidate's question regarding this exam item.

*#3 option is incorrect because the maximum contribution is the lesser of 25% of compensation or the applicable dollar figure for the year in which the annual addition is made. Thus, if an employee's compensation were \$200,000, the addition would be the lesser of 25% x \$200,000 - \$50,000 or \$30,000. Note that the \$30,000 would be the maximum and would be less than the 25%.*

**Insurance - Contracts (moderate)**

**34. B**

Statements #1 and #3 provide the correct definitions of absolute and collateral assignment.

**Retirement - Qualified Plans (moderate)**

**35. D**

Statement #1 is incorrect because forfeitures will be used to reduce contributions. Annual earnings and rollover contributions do not impact contributions to a defined contribution plan. Employee and employer contributions are included in the annual additions limit calculation.

**Investments – Performance Measures (easy)**

36. D

Sharpe uses standard deviation and Treynor uses beta.

**Investments – Unit Investment Trusts (easy)**

37. B

Once capitalized, unit trusts do not accept additional funds. Unit trusts are self-liquidating. Units are generally traded directly with the fund at net asset value.

**Tax – Self-Employment Tax (moderate)**

38. B

Income from rental property is not subject to Social Security tax nor are dividends paid to S Corporation shareholders/employees as long as the employees' compensation is considered reasonable.

**Insurance – Life Insurance (easy)**

39. D

Life insurance policies can be issued to anyone with an insurable interest. The policy may be assigned to anyone and anyone may be named as beneficiary. The insured need not be insurable at the time of assignment.

**Estates – Gift Tax (moderate)**

40. B

#1 and #3 are taxable gifts since the amount transferred is in excess of the annual exclusion. #2 is not taxable because it does not exceed the annual exclusion. #4 is a qualified transfer which is not taxable.

**Estates – Gross Estate (moderate)**

41. B

The power to revoke, amend or continue to enjoy a gift will cause the gift property to be included in the donor's gross estate. Although taxable gifts will be added to the tax basis, they are not generally included in the gross estate.

**Retirement – Profit – Sharing Plan (moderate)**

**42. B**

Under a 401(k) plan (CODA), deferrals are not subject to Federal income tax, but are subject to payroll taxes (FICA). In addition, these deferrals are not subject to forfeiture since they are the contributions of the employee.

**Investments – Bond Valuation (moderate)**

**43. A**

		<u>YTM</u>	<u>YTC</u>
PV	=	(\$1,147.20)	(\$1,147.20)
PMT	=	80	80
N	=	10	5
FV	=	\$1,000	\$1,050
i	=	6	5.45

The price of a bond is inversely related to changes in interest rates. Therefore, #1, #2, and #3 are all correct.

**Investments/ Retirement/Insurance – Regulatory Requirements (easy)**

**44. A**

Organized exchanges are regulated by the SEC, which is a Federal agency. All other statements are true.

**Insurance – Medical Insurance (moderate)**

**45. C**

Medicare covers all costs for the first 20 days for nursing home care; so statement #1 is incorrect. This leaves options C and D. Statement #4 must be true. Statement #2 is true; therefore, C is the correct answer.

Below is the CFP Board of Examiner's response to a candidate's question regarding this exam item:

*The clarification on why (3) above is incorrect is that a comprehensive major medical policy would pay for treatments for the arthritis but not for the custodial care which is required because he cannot perform the functions of daily living; i.e., dressing, feeding, bathing, etc.*

**Retirement – Defined Benefit Plans (easy)**

**46. A**

Actuarial assumptions used in a defined benefit plan do not include ratio of single to married participants because it is irrelevant (statement #4). Statements #1, #2, and #3 are correct; therefore, A is the correct answer.

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**Retirement - Profit-Sharing Plans (easy)**

47. E

The employer that offers a profit-sharing plan may make contributions regardless of profitability and is not held to minimum funding standards. Profit-sharing plan sponsors must make “substantial and recurring” contributions. Forfeitures may be distributed to participants’ accounts or returned to the employer.

**Investments – Risk (easy)**

48. A

Non-diversifiable risks or systematic risks are those that affect the entire market, including market risk, interest rate risk, and purchasing power risk.

**Investments – American Depository Receipts (easy)**

49. D

ADRs are used to trade foreign securities in the U.S. ADRs are foreign shares denominated in U.S. dollars and do not eliminate currency risk.

**Fundamentals - S Corporation (moderate)**

50. E

Statements #1, #2, #3, and #4 describe an S Corporation non-employee shareholder; therefore, E is the correct answer. Statement #1 uses the term “compensation” to describe the flow of funds, not to describe the concept of taxable income.

**Fundamentals – Home Mortgages (moderate)**

**51. C**

Gross income (statement #1) is not a relevant factor since we are told to assume that the couple qualifies for both mortgages. Estimated length of ownership (statement #2) is important, because the longer the period of ownership, the more attractive prepaid interest (points) become. Real estate tax liability (statement #3) is not affected by the type of mortgage. Cash currently available (statement #4) is certainly important, because of the need for cash to pay points.

PV	=	\$100,000 (assumed)	PV	=	\$100,000
N	=	360 (12 x 30)	N	=	360 (12 x 30)
i	=	0.875 (10.5 ÷ 12)	i	=	0.9583 (11.5 ÷ 12)
PMT	=	(\$914.74)	PMT	=	(\$990.29)

<u>Points</u>	<u>Breakeven Point to Recover Points</u>
Five Points      \$5,000	
Two Points <u>\$2,000</u>	<u>\$3,000</u>
Difference <u>\$3,000</u>	= 39.7 months
	(\$990.29 – \$914.74)

**Note:** Buyer must own house for 39.7 months for #1 to be better.

Below is the CFP Board of Examiner's response to a candidate's question regarding this exam item:

*The question tries to eliminate the need to include (1) gross income as part of the answer by stating in the fact pattern the couple could qualify for both mortgages.*

**Fundamentals – Economics (moderate)**

**52. A**

Shifts in aggregate demand are stimulated by an increase in demand for capital goods (statement #1) and increases in personal disposable income (statement #3). Increases in interest rates (statement #2) and savings (statement #4) dampen aggregate demand.

**Estates – Life Insurance (moderate)**

**53. D**

Life insurance policies transferred within 3 years of death are included in the gross estate.

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**Investments – Bond Swaps (easy)**

54. A

Statements #1, #2 and #3 are true. Statement #4 is false because tax swaps generally take advantage of capital losses by selling bonds, which have been devalued by increasing interest rates.

**Fundamentals – Financial Statements (easy)**

55. B

Furniture is a personal use asset and a variable outflow.

**Tax – Taxation of Mutual Fund Shares (moderate)**

56. A

The client has three choices for determining the cost basis of mutual fund shares; FIFO, specific identification and average cost.

**Insurance – Contracts (easy)**

57. E

Any contract for life insurance has each of the four characteristics.

**Fundamentals – Regulatory Requirements (easy)**

58. A

Nothing assures the safety of funds while investing and trading in securities (statement #4). Statements #1, #2, and #3 are correct.

**Investments – Modern Portfolio Theory (moderate)**

59. C

Statement #1 is true. It is not necessary to have negatively correlated assets; it is only necessary to have assets that have a correlation less than positive one (+1); thus, statement #2 is false. Statement #3 is false, because diversifying across asset types is more, not less, effective than within an asset type. Statement #4 is false, because all the input variables in statement #1 help to create the efficient frontier.

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3. A	18. B	33. D	48. C	63. D	78. C
4. E	19. C	34. C	49. E	64. E	79. C
5. B	20. D	35. C	50. C	65. A	80. B
6. A	21. C	36. B	51. B	66. E	81. C
7. D	22. B	37. B	52. E	67. E	82. D
8. D	23. B	38. E	53. A	68. B	83. E
9. C	24. D	39. E	54. A	69. C	84. C
10. E	25. A	40. B	55. A	70. B	85. B
11. A	26. C	41. E	56. D	71. B	86. A
12. C	27. B	42. B	57. C	72. B	
13. D	28. E	43. E	58. D	73. C	
14. D	29. D	44. A	59. C	74. D	
15. A	30. B	45. E	60. D	75. D	

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**Tax - Adjusted Gross Income (moderate)**

1. C

\$600	Dividend Income
<u>32,000</u>	Salary
\$32,600	
<u>(2,400)</u>	S Corp Loss
<u>\$30,200</u>	AGI

The \$1,500 loss (Laminate) is passive, and the \$500 loss (Venture) is passive. Both are suspended under the passive activity rules.

**Tax - Sale of Personal Residence (moderate)**

2. B

Sales Price	\$176,000	
Selling Expenses	<u>(10,000)</u>	
	\$166,000	Net Selling Price (Need to reinvest)
	<u>(155,000)</u>	Reinvestment within 2 years of sale
	<u>\$11,000</u>	Maximum Capital Gain

**Tax – At-Risk Rules (moderate)**

3. A

The maximum tax deduction is the lesser of the passive income provided by the limited partnership (\$15,000) or the amount at risk (\$50,000).

**Investments - Municipal Bond Insurance (easy)**

4. E

Municipal Bond Insurance Association (MBIA) is the only choice that insures municipal bonds.

**Insurance - Insurance Binders (easy)**

5. B

“Conditional receipt” is provided to the insured by the insurer.

Below is the CFP Board of Examiners' response to a candidate's question regarding this exam item:

*Note that while the conditional receipt sets forth certain terms of temporary life insurance coverage, it will not be issued without a completed application and payment of an initial premium.*

**Estates - Adjusted Gross Estate (moderate)**

6. A

The adjusted gross estate (AGE) consists of the gross estate less funeral expenses, administrative costs, and liabilities. The marital deduction and the charitable gifts deduction are taken after AGE is calculated. Costs associated with maintaining the estate assets are deductible when arriving at AGE.

**Tax/Retirement - IRA Deductibility (moderate)**

7. D

A Section 457 plan is not a qualified plan or SEP. A Section 457 plan is a deferred compensation plan and, thus, would not preclude a participant making \$100,000 from having a deductible IRA. Participants in a SEP and the three other plans (401(k), 403(b), and defined benefit plan) are considered to be “active participants” and would be precluded from making a deductible IRA contribution at the \$100,000 income level.

**Investments – Security Types (easy)**

8. D

Convertible bonds generate current income from coupon payments and allow for growth through the stock conversion feature. Options “A” and “B” provide income only and Option “C” is designed for growth.

**Investments - Options (easy)**

9. C

The exercise price for a put is the price at which you can sell the stock. Thus, a price of \$55 will be assured if she buys a \$55 put.

**Fundamentals – Home Mortgages (easy)**

10. E

$$\begin{aligned} N &= 264 (22 \times 12) \\ i &= .66667 (8 \div 12) \\ PV &= \$122,056 (\$120,056 + \$2,000) \\ PMT_{OA} &= \$983.99 \end{aligned}$$

**Investments – Stock Valuation (moderate)**

11. A

$$V = \frac{d_0 (1 + g)}{k - g} = \frac{\$2.30 (1.04)}{0.09 - 0.04} = \$47.84 \text{ (value using dividend growth model)}$$

Since the value of \$47.84 is greater than the current market price, the stock is underpriced in the market. Tom should purchase the stock.

**Investments – Security Types (easy)**

12. C

Ginnie Maes are the only securities listed that are backed by the full faith and credit of the U.S. Government.

**Investments – Investment Planning Process (moderate)**

13. D

One of the first steps that must be taken in planning for wealth accumulation is to determine the risk tolerance of the investor.

**Retirement – Types of Retirement Plans (moderate)**

14. D

He currently has a 15% profit sharing plan (maximum contributory profit sharing plan in 1994). He can add a 10% money purchase plan, and he will be able to contribute a maximum of 25% of his compensation. Of course, since he is self-employed he will be able to contribute only 20% ( $0.25 \div 1.25$ ) after deducting one-half of his Social Security taxes.

**Tax – Tax-Free Exchange (difficult)**

**15. A**

**A**

New Parcel	\$80,000
Cash Received	\$20,000
Adjusted Basis of Old Parcel	(50,000)
Gain Realized	\$50,000

The client must recognize gain up to the boot received (cash) of \$20,000.

**B**

New Parcel	\$75,000
Cash Received	\$10,000
Adjusted Basis at Old Parcel	(100,000)
Loss Realized	(\$15,000)

The client will not recognize loss in a like-kind exchange. The client will have a new asset worth \$75,000 with a basis of \$90,000 (\$100,000 - 10,000).

**Estates - Pourover Provision (easy)**

**16. A**

A “pourover” provision allows transfer of assets into a trust created prior to creation of the “pourover” provision. Assets affected by a “pourover” provision are subject to estate taxation, pass through probate and will not be permitted to be transferred to another person’s estate.

**Insurance - Taxation of Group Disability Benefits (easy)**

**17. B**

When the premiums for disability are paid by the employer, the benefits are received “in lieu of wages.” Thus, they are considered taxable income.

**Retirement - Defined Benefit Plans (moderate)**

**18. B**

The company sponsoring the plan would be impacted and may have to increase contributions as a result of investment results being less than actuarially expected. Investment risk for a defined benefit plan resides with the employer, not the employee.

**Tax - Alimony (easy)**

19. C

Payments for child support are not alimony and are not deductible.

**Fundamentals - Education Funding (moderate)**

20. D

Under PLUS, parents may borrow an unlimited amount (not to exceed the cost of schooling) of funds for their children's undergraduate schooling. This loan is not need-based, unlike the other three choices.

**Estates - Uniform Simultaneous Death Act (moderate)**

21. C

A survival clause does not make a presumption about the order of deaths. It simply states that to take under the device (insurance, trust, or will), the beneficiary, legatee, or heir must survive beyond a term certain. It is important to note that a survivorship clause for a spouse not exceeding 6 months is an exception to the terminable interest rule and, therefore, will qualify for the unlimited marital deduction assuming such surviving spouse lives beyond the survivorship term.

**Estates - Estate Planning Techniques (difficult)**

22. B

	<b>Current</b>		
	<u>1<sup>st</sup> death</u>	<u>2<sup>nd</sup> death</u>	
Gross Estate	\$1,000,000	\$2,000,000	
Administrative	0	(150,000)	
Marital Deduction	<u>(1,000,000)</u>	<u>0</u>	
Taxable Estate	<u>\$0</u>	<u>\$1,850,000</u>	
Tentative Tax	\$0	\$713,300	
Unified Credit (1994)	<u>0</u>	<u>(192,800)</u>	
Tax Liability	<u>\$0</u>	<u>\$520,500</u>	
			D \$265,000
	<b>Proposed</b>		
	<u>1<sup>st</sup> death</u>	<u>2<sup>nd</sup> death</u>	
Gross Estate	\$1,000,000	\$1,400,000	
Administrative	0	150,000	
Marital Deduction	<u>400,000</u>	<u>0</u>	
Taxable Estate	<u>\$600,000</u>	<u>\$1,250,000</u>	
Tentative Tax	\$192,800	\$448,300	
Unified Credit	<u>(192,800)</u>	<u>(192,800)</u>	
Tax Liability	<u>\$0</u>	<u>\$255,500</u>	

**Insurance - Regulation (easy)**

23. B

One must obtain a license in each individual state to sell life insurance.

**Insurance – Types of Life Insurance (difficult)**

24. D

Analysis indicates that policy 4 will likely have the largest increase due to its projection being the greatest over the T-bond yield. The interest sensitive policy is funded at the full target premium, making it the least risky for premium increases. Universal life has a flexible premium; thus, if premiums are not paid, there is great risk of premium increases.

**Estates - Premarital Agreements (easy)**

25. A

Premarital agreements require full disclosure by both parties as to their financial matters prior to marriage.

**Investments – Security Valuation (moderate)**

26. C

Of all the choices, only unexpected corporate earning growth would have a significant positive impact on the value of a stock. Under the Efficient Market Hypothesis, any expected changes would already be reflected in the price of the common stock. Unexpected increases in inflation would increase the discount rate and reduce the value of the fund.

**Investments - Capital Market Line (moderate)**

27. B

Above the line would indicate a higher than expected return for the given risk level. On the line would indicate an expected return for the given risk level. Below the line would indicate lower than expected return for the given risk level.

**Investments – Fixed-Income Securities (easy)**

28. E

A debenture is an unsecured corporate debt.

**Retirement – Vesting Requirements (easy)**

29. D

The penalty (requirement) for extending the service requirement to 2 years is full (100%) and immediate vesting.

**Estates - GRATs (easy)**

30. B

A GRAT is only effective if the grantor survives the GRAT term. If the grantor does not outlive the GRAT term, then the assets in the GRAT are brought back into the gross estate.

**Retirement – Defined-Benefit Plan (easy)**

31. C

The benefit received cannot exceed the average of the 3 highest consecutive earnings years within the limit of maximum compensation  $(\$90,000 + \$100,000 + \$110,000) \div 3 = \$100,000$ .

**Estates - Taxation of Life Insurance (difficult)**

32. B

If the insured does not own the life insurance policy, then a gift of policy's face value will be deemed made from the owner to the beneficiary upon the death of the insured.

**Tax - Unreasonable Compensation (difficult)**

33. D

The contribution of low dividends and high compensation are likely to cause an IRS challenge. Statement #2 fits this description. Statement #5 could trigger IRS investigation since capital-intensive businesses usually pay out higher dividends.

**Retirement - Qualified Plan Distributions (moderate)**

34. C

Only statements #2 and #4 are available to someone who is age 59 in 1996. To utilize 10-year averaging, a person must be born before January 1, 1936.

**Retirement - 401(k) Plans (easy)**

35. C

Statement #1 is correct. The 1996 cap on compensation is \$150,000; statement #4 is correct.

**Retirement - Fiduciary/Party in Interest (easy)**

36. B

A fiduciary must manage plan assets solely in the best interest of participants and beneficiaries and has a duty to diversify. The transaction described was a prohibited transaction in 1996, because self-employed individuals were not permitted to have loans from a qualified plan.

**Fundamentals - Economics (difficult)**

37. B

Durable goods and capital goods are more greatly affected by recession than non-durable goods or services, because they are larger items, last a longer period of time, and are generally discretionary.

**Estates - Estate Planning (easy)**

38. E

All of the factors listed are important to reduce the risk of overpayment of taxes at the settlement of the 1<sup>st</sup> estate or the 2<sup>nd</sup> estate if it closely follows the first.

**Tax – Tax-Exempt OIDs (difficult)**

39. E

All of the statements are true.

**Investments - Immunization (difficult)**

40. B

The goal of immunization is to match the investment time horizon with the duration of the portfolio. Since the duration of a coupon bond is less than its maturity, only the 9-year bond might immunize the portfolio. The other two choices will not immunize the portfolio. The best choice would be a 7-year zero-coupon bond; however, this choice is not available.

**Retirement - Qualified Pension Plans (easy)**

41. E

Only two pension plans (defined benefit and cash balance) have PBGC insurance. The defined benefit plan is the only one listed here.

**Investments - Risk (moderate)**

42. B

Systematic risk cannot be eliminated, thus statement #2 is false. Beta only measures systematic risk; statement #5 is false. All other statements are true.

**Tax - QDRO (moderate)**

43. E

A QDRO cannot force Jack to take a lump-sum distribution. The other statements are true.

**Fundamentals - Economics (difficult)**

44. A

Statements #1, #2, and #3 are true. Statement #4 is false (the price would decrease). Using the supply/demand graph simplifies this question.

**Estates - Irrevocable Life Insurance Trust (easy)**

45. E

All statements are reasons to establish an irrevocable life insurance trust that provides income to the spouse and the remainder to children.

**Estates - Marital Deduction (easy)**

46. D

Property that qualified for the marital deduction is included in the surviving spouse's estate. A QDOT is used to establish the marital deduction for an alien surviving spouse. Statements #1 and #3 are true.

**Retirement/Estates - Rabbi Trust (moderate)**

47. C

A rabbi trust is generally used with a nonqualified deferred compensation plan. Statement #1 is false, the trust is not revocable. Statement #3 is true for employer contributions. Assets in the trust can be used to discharge the indebtedness of the corporation. This creates "substantial risk of forfeiture" and allows the deferred compensation to not be treated as taxable income.

**Retirement - ERISA (easy)**

48. C

The plan's summary annual report (statement #2) must be distributed, and a benefit statement for terminated employees (statement #4) must be distributed. Statements #1 and #3 are false.

**Estates - Gifts in Gross Estate (moderate)**

49. E

Only gifts of life insurance (within 3 years of death), and incomplete gifts (retained interests) are included in the gross estate. Statements #2, #3, and #5 are true. Other taxable gifts are added to the taxable estate at the date of gift value. (Statements #1 and #4)

**Estates - Property Titling (easy)**

50. C

Property passing by operation of law avoids probate, may qualify for the marital deduction and is transferred to the survivor(s) listed in the title.

**Investments - Dollar Cost Averaging (moderate)**

51. B

Dollar cost averaging is when an equal dollar amount is invested periodically. This does not prevent capital losses but can lower the average cost per share due to periods of decline in the stock price.

**Estates - Basis of a Gift to Donee (moderate)**

52. E

Statement #1 is false; the double basis rule would not permit this favorable treatment. Statement #2 is false; at the date of death, the property basis would be adjusted to fair market value. Statement #3 is true. Statement #4 is false; the property would be depreciated based upon its adjusted basis, not its fair market value.

**Retirement - Deferred Compensation Agreements (easy)**

53. A

Statement #1 is true. Statement #2 is false; the participant generally has a substantial risk of forfeiture. Statement #3 is false; the employer cannot receive a tax deduction until the employee receives the income as taxable.

**Insurance - Group Term Life Insurance(moderate)**

54. A

Group term may be converted to permanent insurance; however, the premium will then be paid by the owner/insured.

**Investments - Bonds (Difficult)**

55. A

\$800 per year (annual coupon).

\$400 per coupon payment (semi-annual coupon).

\$200 represents accrued interest, because the bond was purchased at a date in the middle of the coupon payment period (not on an interest date).

Therefore, the \$9,800 is comprised of the following:

\$9,500	Bonds
100	Commission
<u>200</u>	Accrued interest
<u>\$9,800</u>	

Since he received a coupon payment of \$400, he will receive a Form 1099 for the same amount. However, only \$200 of the \$400 will be taxable since only \$200 has been earned. \$200 was accrued and prepaid.

**Fundamentals – Business Organizations (moderate)**

56. D

Only the C Corporation will solve investor #1's concern about showing business income on his personal return.

**Insurance - Characteristics (easy)**

57. C

The first three characteristics are fundamental to insurance. Speculation is not a characteristic of insurance.

**Fundamentals - Related Party Loans (easy)**

58. D

Statements #1 through #3 help to establish the nature of the transaction as a loan and not a gift.

**Insurance – Regulatory Requirements (moderate)**

59. C

The National Association of Insurance Commissioners is involved in the regulation of insurance indirectly and accredits state insurance regulatory offices. The NAIC does not regulate states nor is state insurance regulation uniform.

**Estates - QTIPs (easy)**

60. D

Statements #1, #2, and #4 are not necessary for a QTIP. Statement #3 is the general rule at death.

**Investments - Taxation of Securities (moderate)**

61. E

Of the choices, only EE bonds can generate Federal tax-exempt income. T-Bills and T-Bonds generate state tax-exempt income but not Federal tax-exempt income. GNMA funds are taxable at the state and Federal level.

**Estates – Estate Planning Techniques (moderate)**

62. E

Statement #1 advocate an illegal act – planning for Medicaid. Statement #2 is appropriate due to her declining health. Statement #3 is inappropriate due to the irrevocability. Statement #4 is inappropriate, because it is unnecessary. The value of her estate is less than the unified credit.

**Retirement - Taxation of IRA Distribution (moderate)**

63. D

Statement #1 is false; she could avoid the 10% penalty through substantially equal payments. Statement #2 is true (the withdrawal is income). Statement #3 is true (minimum of 5 years). Statement #4 is false; she will not exceed the \$150,000 limit on annual distributions applicable in 1996.

**Insurance - COBRA Coverage (moderate)**

64. E

All of the selections are covered under COBRA.

**Estates - GSTT (easy)**

65. A

Statements #1, #2 and #4 are true. The GSTT has not been repealed.

**Insurance – Life Insurance Settlement Options (easy)**

66. E

There is no tax liability on the proceeds of \$200,000; therefore, statement #5 is false. Statements #1, #2, #3, and #4 are all relevant to selecting a settlement option.

**Retirement/Insurance - Social Security (difficult)**

67. E

Bill is not disability insured.

**Retirement/Insurance - Social Security (moderate)**

68. B

Bill is currently insured. His family will receive benefits as described in statements #1, #2, and #4.

**Retirement - 401(k) Plans (moderate)**

69. C

Statement #1 is false; the limit on salary deferrals under a 401(k) plan is much less than the annual additions limit. Statement #2 is true. Statement #3 is false; this technique is used to increase amounts to non-highly compensated employees to meet the ACP test. Statement #4 is true.

**Retirement – Retirement Planning (easy)**

70. B

His compensation is too high to qualify for a pre-tax (deductible) IRA. Statements #1 and #3 are feasible.

**Estates - Property Transfer (moderate)**

71. **B**

The titling of property as joint tenants on the farmland implicitly means with right of survivorship, thus making **B** the only correct answer.

**Estates - Property Transfer (easy)**

72. **B**

The farm (real property) goes to his brother, James; the CD, etc. goes to the children.

**Fundamentals - IRR (moderate)**

73. **C**

CF <sub>0</sub>	=	(\$9,200)
CF <sub>1</sub>	=	\$600
CF <sub>2</sub>	=	\$2,300
CF <sub>3</sub>	=	\$2,200
CF <sub>4</sub>	=	\$6,800
CF <sub>5</sub>	=	\$9,500
IRR	=	24.18%

**Fundamentals - IRR (moderate)**

74. **D**

Statement #4 is false, because if the cost of capital is less than the IRR, then the project should be accepted (NPV > 0).

**Investments – Security Returns (moderate)**

75. **D**

$$\frac{\text{Total annual income}}{\text{FMV @ June 30 last year}} = \frac{\$26,500}{\$400,000} = 6.63\% \text{ annual yield}$$

$$\frac{\text{Change in value}}{\text{FMV @ June 30 last year}} = \frac{\$85,000}{\$400,000} = 21.25\% \text{ appreciation (Before tax)}$$

76. **The question was deleted by the Board due to ambiguity.**

**Insurance - Taxation of Disability Benefits (easy)**

77. A

\$40,000	W-2 wages
<u>x 60%</u>	Disability replacement
\$24,000	Gross disability benefits
<u>x 65%</u>	Post tax %
<u>\$15,600</u>	per year post tax disability benefits
<u>\$1,300</u>	per month post tax disability benefits

**Insurance - Taxation of Disability Benefits (easy)**

78. C

\$40,000	
<u>x 60%</u>	
<u>\$24,000</u>	per year
<u>\$2,000</u>	per month

**Note:** The benefits are not taxable since Jo Anna pays the premium.

**Insurance - Term Insurance (easy)**

79. C

He will not have a taxable gain with the cancellation of term insurance since there is no investment component.

**Insurance - Whole Life Insurance (moderate)**

80. B

\$40,000	Cash value
<u>(30,000)</u>	Payments (\$2,000 x 15 years)
<u>\$10,000</u>	Gain (treated as ordinary)

**Insurance - Whole Life Insurance (moderate)**

81. C

The dividends are considered a return of capital from the policy and are not taxable.

**Retirement - Retirement Planning (moderate)**

82. D

Statement #1: This is an appropriate reason, because it satisfies one of her objectives.

Statement #2: Lowering the tax of the principal/participant is generally beneficial and appropriate.

Statement #3: The use of a retirement plan for the purpose of appearance is not appropriate.

**Retirement - Plan Selection (difficult)**

83. E

Of the choices, the SARSEP is the cheapest to install while allowing benefits on a contributory basis. (**Note:** SARSEPs cannot be created after 12/31/96.)

**Estates - Gross Estate (moderate)**

84. C

\$300,000 Life insurance

15,000 Gift tax paid on gifts made within 3 years of death

\$315,000 Increase in gross estate

**Estate - Taxable Gift (easy)**

85. B

\$40,000 Stock to Mickey

(10,000) Annual exclusion (in 1996)

\$30,000 Taxable gift

Since the life insurance policy will be included in the gross estate it is not added to the adjusted taxable gift.

**Estates - Gross Estate (moderate)**

86. A

The correct answer is zero because neither the life insurance proceeds nor the gift tax paid would be included in the gross estate.

**CFP<sup>®</sup> CERTIFICATION EXAMINATION ANSWERS**

**Released as of January 1999**

The alphabetical answer was provided by the CFP Board of Standards and used with permission.

Explanations have been added to the answers, all prepared by

BISYS Education Services,

and are not part of the CFP Board of Standards' materials.

1. E	16. A	31. D	46. D	61. D	76. D
2. A	17. D	32. A	47. C	62. C	77. C
3. D	18. A	33. A	48. A	63. D	78. A
4. C	19. D	34. D	49. D	64. D	79. B
5. C	20. B	35. D	50. C	65. C	80. B
6. B	21. C	36. E	51. D	66. C	81. C
7. C	22. B	37. D	52. D	67. B	82. B
8. C	23. D	38. A	53. E	68. E	83. A
9. A	24. A	39. B	54. C	69. C	84. D
10. D	25. D	40. B	55. C	70. D	85. D
11. B	26. C	41. E	56. E	71. B	86. B
12. B	27. C	42. B	57. D	72. A	87. A
13. E	28. D	43. D	58. C	73. C	88. B
14. A	29. C	44. B	59. A	74. C	89. D
15. A	30. D	45. B	60. A	75. E	90. A

**Fundamentals – Yield to Maturity (moderate)**

**1. E**

Yield to maturity for bond A:

$$N = 2$$

$$PV = (\$900)$$

$$PMT_{OA} = \$60$$

$$FV = \$1,000$$

$$i = 11.90998$$

**Investments – Duration (moderate)**

**2. A**

The bond with the longest duration has the greatest interest rate risk. The greater the duration, the more effect a change in interest rates has on the bond's value. A zero coupon bond's duration equals its time to maturity.

**Fundamentals – Financial Planning (easy)**

**3. D**

An emergency fund should be funded with liquid securities, not equities. College savings funds are a form of investment. Lack of disability insurance and wills are weaknesses that need to be addressed. The couple has sufficient home equity to cover the auto loan in the event of death, so statement #5 is incorrect.

**Retirement – Investing (easy)**

**4. C**

Statement #1, #2 and #4 describe tax-deferred investing. A growth and income mutual fund does not provide tax-deferred earnings.

Below is the CFP Board of Examiners' clarification of the intent of the question:

*For instructional purposes, the stem might be changed to read: "Which of the following actions will be the least tax-efficient manner of helping to accomplish the stated goals?"*

**Estates – Trusts (moderate)**

5. C

The trust is revocable, because the grantor will receive a life income and is permitted to withdraw assets from the trust. Statements #1 and #3 are not true, because the trust is revocable. Statements #2 and #4 are true, because the trust is a grantor trust.

CFP Board of Examiners' comment:

*For instructional purposes, change the stem to read that Grantor is single and change option (4) to read \$250,000 rather than \$125,000. (Note that (4) is no longer correct under current tax law.)*

**Estates - Trusts (easy)**

6. B

Since the grantor has control over the assets in the trust, the value of the assets in the trust will be included in the gross estate. All assets within the trust will receive an adjustment to FMV at the date of death except those items which are considered "income in respect of a decedent," such as the installment notes. Statement #1 is true. Statement #2 is false, because trusts become irrevocable at death and avoid probate. Statement #4 is incorrect, because assets in a trust will transfer as dictated by the trust instrument. Statement #3 is correct, because assets at death will receive an adjustment in basis to the value as of the date of death (or alternate valuation date).

**Fundamentals – Adjusted Tax Basis (easy)**

7. C

The seller's cost basis is equal to the purchase price less depreciation ( $\$80,000 - \$40,000 = \$40,000$ ).

**Fundamentals – Adjusted Tax Basis (easy)**

8. C

The buyer's cost basis is \$100,000 - the purchase price of the building.

**Fundamentals – Time Value of Money (easy)**

9.

**A**

$$N = 8$$

$$i = 8$$

$$PV = \$10,000$$

$$PMT = \$0$$

$$FV = \$18,509$$

**Retirement - 401(k) (easy)**

10.

**D**

IRC section 415(c) limits contribution (both employee and employer contributions, as well as forfeitures) to defined contribution plans to the lesser of 25% of compensation or \$30,000. 25% of \$40,000 is \$10,000. Thus, no more than \$10,000 could be allocated to her account.

**Investments – Bonds (easy – application)**

11.

**B**

A zero-coupon bond's duration equals its maturity. Coupon bonds (the remaining options) have durations less than their maturities. Higher duration bonds are subject to more price volatility than lower duration bonds.

**Tax – S Corporations (easy)**

12.

**B**

S Corporation status is never automatic. More than one class of stock is not permitted with an S Corporation with one exception. There can be more than one class of stock as long as the only difference is that one class has voting rights and the other class does not. S Corporations are permitted to earn passive income. Non-resident aliens are not permitted to be shareholders of S Corporation stock.

**Estates – Life Insurance (easy)**

13.

**E**

Using insurance proceeds for the payment of Federal estate taxes is most efficient when the insured(s) has no ownership interest in the policy, avoiding inclusion of the proceeds in the gross estate of the decedent(s). The best answer is ownership outright by an heir or ownership in an irrevocable trust. E is the best answer.

**Fundamentals – Economics (moderate)**

14. A

When investors are selling dollar denominated assets, interest rates may rise due to a decrease in the money supply. The other three choices (B, C, and D) would cause interest rates to fall.

**Insurance – Underwriting (easy)**

15. A

The underwriter tries to manage the risk of adverse selection. C is incorrect, because the rate is usually set after establishing underwriting standards. D is incorrect, because the purpose is not to avoid exposure but to manage risks. B is a responsibility of underwriters but is not their main responsibility.

**Investments – Bonds (easy – application)**

16. A

A longer-term bond will be subject to more inflation risk. Since the quality of the bond is high, the level of default risk is low.

**Fundamentals – Financial Statements (easy)**

17. D

A is incorrect because the value of the home is an asset, not a source of income. Although B is an accurate statement, it refers to the statement of net worth, not the cash flow statement. Taxes on salary are not a liability but are an expense on the cash flow statement.

**Retirement – Capital Needs Analysis (moderate)**

**18. A**

	<u>Step 1</u>		<u>Step 2</u>
N	= 360 (30 x 12)	N	= 120 (10 x 12)
i	= 0.8333(10 ÷ 12)	i	= 0.8333 (10 ÷ 12)
PMT <sub>AD</sub>	= (\$1,000)	PV	= \$0
FV	= \$0	FV <sub>65</sub>	= \$114,900.41
PV <sub>65</sub>	= \$114,900.41	PMT <sub>OA</sub>	= (\$556.28)

Below is the CFP Board of Examiners' clarification of the intent of this question:

*This question is intended to test several time-value-of-money calculations, and is not intended to imply a level retirement income or savings approach.*

**Retirement – Minimum Distribution Rules (moderate)**

**19. D**

The client needs to take a \$2,000 minimum distribution ( $\$48,000 \div 24 = \$2,000$ ). By taking only a \$1,000 distribution, the client is subject to a 50% penalty on the underdistribution of \$1,000 ( $\$1,000 \times 50\% = \$500$ ).

**Investments –Options (moderate)**

**20. B**

Selling a call option will allow her to generate income from the option premium with little risk since she does not expect the stock to continue to increase. If the stock does exceed \$50, she would be paid what she wants for the stock.

**Investments –Security Pricing Theories (easy)**

**21. C**

The statement in the question is referring to the definition of the semi-strong form of the efficient market hypothesis.

**Estates – Taxable Gifts (moderate)**

**22. B**

The \$12,000 paid to the school is a qualified transfer and is not a taxable gift. The gifts of \$12,000 each to Sarah and Nicole are gross gifts subject to the annual exclusion of \$10,000 each, making adjusted taxable gifts equal to \$4,000 ( $\$2,000 \times 2$ ).

**Estates – Post-mortem Devices (moderate)**

23. D

The objective is to reduce the overall estate tax liability of both estates. His life expectancy is so short he should consider estate equalization, disclaiming one-half of the \$3 million estate using the alternate valuation date.

**Retirement/Insurance - Medicare (moderate)**

24. A

Hospice benefits are provided for the terminally ill under Medicare Part A.

**Retirement – SIMPLE (moderate)**

25. D

SIMPLE plans subject a participant to a penalty of 25% for withdrawals within the first 2 years.

**Investments – Bond Valuation (moderate)**

26. C

$$N = 35 (17.5 \times 2)$$

$$i = 4 (8 \div 2)$$

$$PMT_{OA} = \$37.50 (\$75 \div 2)$$

$$FV = \$1,000$$

$$PV = (\$953.34)$$

**Retirement –Qualified Plan Contribution Limits (moderate)**

27. C

The maximum 1998 contribution will consist of the employer's contribution to the money purchase pension plan (MPPP) and the employee's deferral in the 401(k) plan. The employer will contribute \$16,800 (12% x \$140,000) and the maximum deferral is \$10,000. Therefore, the maximum that could be contributed in 1998 is \$26,800 (\$16,800 + \$10,000). Remember that the limit for all defined contribution plans of an employer is the lesser of 25% or \$30,000.

**Investments – Performance Measurements (moderate)**

28. D

Generally, investors evaluate performance of investments based on risk-adjusted returns. Therefore, A and B must be wrong since they only address one aspect of the risk-return relationship. Treynor and Sharpe ratios are performance measures in which the higher the ratio, the better the risk adjusted return. No calculation is needed for this question. D is the only reasonable answer. It is the only one that indicates that a fund should be chosen, because the performance measure is high (not low).

**Fundamentals – Ethics (moderate)**

29. C

The actions of Mary Clark are a violation of the CFP<sup>®</sup> Code of Ethics and raise substantial question as to her honesty, trustworthiness, and fitness as a CFP<sup>®</sup> designee. The CFP<sup>®</sup> Code of Ethics requires a CFP<sup>®</sup> licensee to report these types of situations to the Board under the principal of professionalism.

**Investments – Immunization (moderate)**

30. D

To immunize a bond portfolio, an investor should match the duration of the bond portfolio to the investment time horizon.

**Tax – Fringe Benefits (easy)**

31. D

In order for an athletic facility to be non-taxable, it must be on the premises of the employer. The other choices, A, B, C, and E, if non-discriminatory, are all non-taxable to employees.

**Retirement – Flexible Spending Accounts (easy)**

32. A

B, C, and D are correct. Contributions to an FSA that are not used during that year will expire at the end of the year.

**Insurance – Disability Insurance (easy)**

33. A

The architect is concerned about total disability and the risk reduction in income due to partial disability. Residual disability benefits, which focus on income lost, is the only option that meets the objectives of the architect.

**Estates – Life Insurance (easy)**

34. D

There is a split interest between the wife (income) and the children (remainder interest), suggesting and justifying the use of a trust. There is no charitable intent indicated in the stem. A charitable trust would cause the proceeds to go to charity instead of the children.

**Fundamentals – Financial Statement Analysis (easy)**

35. D

B is generally false. C cannot follow from the stem. A is not responsive to the credit policy. D is the best answer.

**Tax – Municipal Bonds (moderate)**

36. E

$5\% \div (1 - .43) = 8.7719\%$ .

**Fundamentals – Regulatory Requirements (moderate)**

37. D

Form ADV Part II must be given promptly to a client, not 2 weeks after the signing of a contract. It should have been provided prior to the signing of the contract.

CFP Board of Examiners' clarification of the intent of the above question:

*The question is challenging because of option C. However, future planning (holistic and lifecycle planning) is acceptable. It does not imply that her projections were inappropriate.*

**Fundamentals – Arbitration (difficult)**

38. A

A is true, the SEC and NASD both require arbitration if voluntary negotiations fail.

**Fundamentals – Financial Statements (easy)**

39. B

A balance sheet does not include cash flow information.

**Tax –Taxation of Securities (moderate)**

40. B

The client can use specific identification as a method to determine the basis of stock for purposes of calculating gains and losses. This method will generally produce the least amount of gain, because the highest basis shares can be sold first.

Sale price (500 shares)		\$12,500
Sell 200 shares @ \$20/share	\$4,000	
Sell 200 shares @ \$18/share	\$3,600	
Sell 100 shares @ \$12/share	\$1,200	<u>\$8,800</u>
		<u>\$3,700</u> gain

Presuming that the sale date is sometime after June 2, 1993, the client could sell and determine long-term capital gain by selling the shares that were purchased at the highest prices.

**Estates – Unified Credit (easy)**

41. E

The maximum amount a married couple can give in 1998 to a single donee will be by making use of the annual exclusion and the unified credit.

\$625,000 x 2 = \$1,250,000 lifetime exemption.

\$10,000 x 2 = \$20,000 annual exclusion. Therefore, the maximum amount that could be given to a single, third-party donee will be \$1,270,000.00 (\$1,250,000 + \$20,000).

**Estates – Gift Tax (easy)**

42. B

The best assets to transfer when trying to lower estate taxes at death are those most likely to appreciate significantly. This strategy removes future appreciation from the estate.

**Retirement – Target Benefit Plans (easy)**

43. D

The maximum retirement benefit from all defined contribution plans depends on the value of the participant's account at retirement.

**Insurance - Property (easy)**

44. B

\$150,000

(40,000) Value of the lot

\$110,000 Value of the dwelling and, therefore, the amount of insurance needed

Although the minimum level of coverage to avoid a co-insurance situation is \$88,000, you would recommend that they have \$110,000 of coverage.

**Retirement – Defined Contribution Plans (easy)**

45. B

The compensation limit for all qualified plans is \$160,000 for 1998 and 1999. Therefore, income exceeding \$160,000 is not considered when determining qualified plan contributions.

**Fundamentals - Agency (easy)**

46. D

Jones' use of the funds constitutes ratification of Jill's act, even though she was outside the scope of her agency.

**Estates – Estate Planning (easy)**

47. C

A and B will cause the entire estate to be included in the second estate. C will make use of the credit equivalency in the first estate. D may create an estate tax liability in the first estate.

**Tax – Business Gifts (easy)**

48. A

\$25 is the limit for business gifts per donee per year.

**Tax – Depreciation Recapture (difficult)**

49. D

A represents a transaction that entails a carryover basis. B represents a transaction that entails a carryover basis, unless boot is received. C represents the adjustment in basis to FMV at death. D represents a sale for cash that causes recapture of gain to the extent of gain in excess of basis.

**Tax - Adjusted Taxable Basis (easy)**

50. C

The basis of an asset is equal to the purchase price plus the cost to place the property into service.

$$\$25,000 + \$1,250 = \$26,250$$

The personal property tax is an annual executory cost and is expensed annually, rather than capitalized.

**Tax - Cash Basis Taxpayer (easy)**

51. D

A cash basis taxpayer includes income upon receipt. An accrual basis taxpayer includes income when the service is rendered.

**Tax - Divorce (easy)**

52. D

The basis of property transferred between spouses, incident to a divorce, is not adjusted. The basis will be a carryover basis, similar to basis of property transferred to related persons through gifts.

Below is the CFP Board of Examiners' clarification of the intent of the question:

*For instructional purposes, (D) might be changed to read, "Property transfer will result in the transferor's basis in the property being carried over to the transferee."*

**Tax - AMT (easy)**

53. E

E is correct since no taxes are deductible for AMT purposes.

**Estates – Gross Estate (moderate)**

54. C

Sam has an incidence of ownership in the trust at the time of his death. Therefore, the date of death value of \$650,000 should be included in his estate.

**Insurance – Group Universal Life Insurance (moderate)**

55. C

Group universal life insurance is a shared premium arrangement; therefore, C is incorrect.

**Tax – Community Property (moderate)**

56. E

Both halves of community property receive an adjustment to fair market value at the death of the first spouse. This adjustment to both halves of property does not apply to property included in the estate of a decedent living in a non-community property state.

**Fundamentals - Ethics (easy)**

57. D

The initial duty is to inform the client.

**Fundamentals - FDIC (moderate)**

58. C

The FDIC generally insures separate legal categories of accounts of a single institution up to \$100,000. Therefore, the IRA rollover account will be insured for \$100,000 and the two accounts that are owned individually by Mrs. Smith will be insured for a total of \$100,000 (not \$125,000). Joint accounts are more difficult than individual accounts to analyze and make use of the following three rules: 1) no joint account can be insured for more than \$100,000, 2) all joint accounts with the same ownership must be combined, and 3) no one person's interest in all joint accounts can exceed \$100,000. Both the joint accounts will be insured for \$25,000 each. The total amount that is insured will be \$250,000.

**Fundamentals – Basics (easy)**

59. A

The first step Bob should take is to file for unemployment benefits.

**Insurance – Business of Life Insurance (moderate)**

60. A

Neither an entity agreement nor a cross-purchase agreement would cause a transfer-for-value problem.

**Estates – Property Titling (moderate)**

61. D

Termination of tenancy by the entirety can occur by death, divorce or consent of the spouses. Therefore, statements #1 through #3 are correct. Statement #4 is not permitted.

**Fundamentals – Emergency Fund (easy)**

62. C

Since the investment vehicle is for an emergency fund, the investment must be liquid, eliminating A. Statements #3 and #4 meet the objective of a liquid investment. A line of credit is not an investment vehicle.

**Investments – Mortgage Backed Securities (easy)**

63. D

Mortgage-backed securities are subject to the same risk as bonds plus the risk of prepayment.

**Tax – Deductions (easy)**

64. D

Tax planning for the business is deductible on Schedule C, as is business investment planning. However, usually the CFP<sup>®</sup> is performing services for the individual, which would be deductible on Schedule A. Since the question is not definitive as to the services and the word “may” is used, D is the best answer. At no time would these expenses be included on Schedule D, which is used to reflect capital gains and losses.

**Retirement – TSAs (moderate)**

**65. C**

TSAs are for non-profit, non-taxed entities (501(c)(3) organizations). Statement #1 is wrong because reductions in income are subject to Social Security tax. Statement #2 is correct for 1999. Statement #3 is incorrect since 501(c)(3) organizations are non-taxable entities and, therefore, do not have deductions. Statement #4 is correct.

**Retirement – Distributions (moderate)**

**66. C**

Statement #1 is correct since this scenario is generally imposed by a judge. Statement #2 is correct because participants may begin to receive substantially equal payments at any age as long as the payments continue until the greater of 5 years or the attainment of age 59 ½ by the participant. Statement #3 is incorrect.

**Retirement - IRAs (moderate)**

**67. B**

The client has already made a non-direct withdrawal (60-day rollover) this year. Statement #1 is incorrect, because he is not permitted to have another 60-day rollover during the same year. Statement #2 is a permitted alternative. Statement #3 is not permitted without the proceeds being included in taxable income, and this is essentially the same as statement #1.

**Retirement – Qualified Plan Forfeitures (moderate)**

**68. E**

Statement #1 is incorrect. Vesting is critical to entitlement. Statement #2 is a permitted method of allocating forfeitures. Statement #4 is also correct. Statement #3 is a typical outcome of these types of plans.

**Investments – Investment Planning Process (moderate)**

69. C

Question #1 should always be asked. Question #2 is a reasonable question, since it provides the planner with a concept of the client's investment experience leading to suitability. This type of analysis is a part of data gathering. Question #3 goes to suitability and should be asked, or the age should be determined relative to risk and time horizon. The question relates to the first two stages of data collection and goals. Reinvestment of dividends does not go to suitability and will be addressed after the investment decision is made.

Below is the CFP Board of Examiners' clarification of the question:

*(1), (2), and (3) all relate to the second step of the financial planning process, namely, "Gathering client data and determining goals and expectations". The first step is "Establishing the client-planner relationship".*

**Fundamentals – Regulatory Requirements (easy)**

70. D

All are exempt under the definition of "investment advisor".

**Fundamentals – Ethics (easy)**

71. B

Statement #1 is correct – non-lawyers should not practice law. Statement #2 is wrong for the same reason. Statement #3 is correct when a legal issue arises. Statement #4 is incorrect; you would contact the tax preparer only if the client requested it.

**Insurance – Automobile Insurance (easy)**

72. A

Everybody needs liability insurance; therefore, D is incorrect. The car is old, so damage to the insured's auto may not be needed. The answer must be A since it is the only answer without statement #4.

**Insurance – Rating Services (easy)**

73. C

Dun and Bradstreet does not rate insurer strengths; the others do.

**Tax – Practice (easy)**

74. C

Enrolled agents, CPAs, and attorneys may all appear before the IRS to represent a client. Generally, CFP<sup>®</sup>s do not represent clients before the IRS.

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**Investments – Duration (easy)**

75. E

Duration is a present value, time weighted measure of payback. All of the factors listed are important components in determining duration.

**Estate/Tax – Gifts and Investment Income (moderate)**

76. D

Statements #1 and #4 are correct because of the Kiddie tax. Statement #2 is incorrect, because the Kiddie Tax. Statement #3 is false because the gain will be reported by Tom's daughter.

**Estates/Insurance/Tax – Life Insurance (moderate)**

77. C

Proceeds from life insurance policies are included in the gross estate if the decedent had incidents of ownership or if the estate was designated as the beneficiary. Statement #1 is correct. Sale of the policy may cause the policy to be subject to income taxes; statement #2 is also correct. Statement #3 is false. The best answer is C.

**Investments – Bonds (easy)**

78. A

Reinvestment rate risk is the risk that cash flows that occur during the holding period of the investment will not be able to be reinvested at a rate of return at least as great as the internal rate of return (or yield to maturity) of the investment. Since Bond A has the highest coupon payment (and, therefore, the highest cash flow during the holding period), it has the greatest amount of reinvestment rate risk.

**Investments – Bonds (easy)**

79. B

Both coupon rate and maturity should be examined to determine interest rate risk for a bond or series of bonds. Since all three bonds have the same maturity date, the distinguishing factor is the coupon payment. The lower the coupon payment, the more volatile the bond will be. Since Bond B is a zero-coupon bond, it is the bond that is most sensitive to changes in interest rates.

**Investments – Bonds (easy)**

**80. B**

The bond with the highest duration is the bond that has the most interest rate risk. Since duration is tied to maturity and cash flow and all three bonds have the same maturity, the distinguishing factor is the coupon payment of the bonds. Since Bond B has the lowest coupon payment, it will have the longest duration.

**Estates – Charitable Trusts (easy)**

**81. C**

Both CRATs and CRUTs provide income for life or a term  $\leq 20$  years and provide a current tax deduction.

**Estates – Charitable Trusts (easy)**

**82. B**

Both CRATs and CRUTs provide estate tax advantages; however, only a CRUT may have a payment that varies from one year to the next. This variation is attributed to the variation in the value of the underlying assets within the trust.

**Estates – Charitable Trusts (easy)**

**83. A**

Both CRATs and CRUTs provide for a current income tax deduction (charitable deduction). However, the CRAT will have a fixed annuity every year.

**Estates – Charitable Trusts (easy)**

**84. D**

Neither a CRAT nor a CRUT will provide immediate income to charity. A Charitable Lead Trust would accomplish this objective.

**Fundamentals – Time Value of Money (easy)**

**85. D**

Net Present Value (NPV) is defined as the difference between the discounted inflows and the initial outflow. For example, if the discounted cash inflows were \$10 and the initial outflow was \$8, then the NPV would be \$2.

<u>Net Present Value</u>			
		<u>Investment A</u>	<u>Investment B</u>
FV	=	\$13,000,000.00	\$2,000,000.00
N	=	1	1
i (discount rate)	=	10%	10%
PV	=	\$11,818,181.82	\$1,818,181.82
Less Initial Outflow	=	<u>(10,000,000.00)</u>	<u>(1,000,000.00)</u>
NPV	=	\$1,818,181.82	\$818,181.82

<u>Internal Rate of Return</u>			
		<u>Investment A</u>	<u>Investment B</u>
FV	=	\$13,000,000.00	\$2,000,000.00
N	=	1	1
PMT	=	\$0	\$0
PV	=	(\$10,000,000.00)	(\$1,000,000.00)
i	=	30%	100%

**Fundamentals – Time Value of Money (easy)**

**86. B**

See chart above.

**Fundamentals – Time Value of Money (easy)**

**87. A**

See chart above.

**Investments - Investment Companies (easy)**

**88. B**

Shares of closed-end funds trade on exchanges just like shares of stock.

**Investments - Investment Companies (easy)**

**89. D**

Generally, open-end investment companies are actively managed. Shares of open funds are not traded in the secondary market or exchanges. Shares are either traded through a broker or directly with the fund family.

**Investments - Investment Companies (easy)**

**90. A**

Unit investment trusts are passively managed portfolios consisting of self-liquidating securities. They trade in units and do not trade on exchanges.

**CFP<sup>®</sup> CERTIFICATION EXAMINATION ANSWERS**

**Released as of August 2004**

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Explanations have been added to the answers, all prepared by

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and are not part of CFP Board's materials.

1. B	6. D	11. B	16. A	21. D	26. C
2. A	7. B	12. C	17. D	22. B	27. A
3. D	8. C	13. A	18. C	23. D	28. C
4. C	9. A	14. A	19. D	24. D	
5. C	10. C	15. A	20. B	25. A	

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**Insurance – Life Insurance (moderate)**

1. B

Variable life policies contain sub-accounts that can be invested in equities or fixed-income securities, typically mutual funds. These sub-accounts are not guaranteed.

**Fundamentals –Time Value of Money (easy)**

2. A

They will accumulate \$10,368 more than needed. First, the actual cash need must be determined in future dollars:

$$PV = -\$300,000$$

$$i = 4\%$$

$$n = 18$$

$$FV = \$607,745$$

Second, the amount saved must be determined:

$$PMT = -\$20,000$$

$$i = 6\%$$

$$n = 18$$

$$FV = \$618,113$$

Finally, the surplus/shortfall must be determined:

Amount saved	\$618,113
Less: amount needed	<u>(607,745)</u>
Surplus	\$ 10,368

**Fundamentals – Economics (moderate)**

3. D

The federal funds rate and discount rate are both short-term interest rates. The discount rate is the rate the Federal Reserve charges its member banks for the overnight lending of reserves. The federal funds target rate is also set by the Federal Reserve and is the rate banks charge one another for the overnight lending of reserves. If most banks have reserve deficiencies (they need money), and only a few have excess reserves (high supply of money), market conditions (supply and demand) will cause the federal funds rate to rise. There is a low supply of money and a large demand for money.

A is incorrect. The Federal Reserve is putting cash into the market, increasing the supply of money. Market conditions would cause a decline in the federal funds rate.

B is incorrect. The federal funds rate is an open market rate that fluctuates based on market conditions. It is highly correlated with the discount rate. Therefore, if the Federal Reserve lowers the discount rate, the federal funds rate will likely move lower as well.

C is incorrect. If only a few banks have reserve deficiencies (they need money), and the rest have excess reserves (high supply of money), market conditions (supply and demand) will cause the federal funds rate to decline.

#### Investments – Securities (moderate)

4. C

Blue chip common stocks provide a good hedge against inflation, because they typically provide a return that significantly outpaces inflation.

A is incorrect. The government does not back FNMA securities.

B is incorrect. Call options purchased by a client will not help protect a client from a downturn in the market.

D is incorrect. Aggressive growth stocks generally perform worse during economic contractions than less aggressive investments.

#### Investments – Security Valuation (easy)

5. C

This is a question regarding the constant dividend growth model for determining the value of a stock. The following formula is used for the constant dividend growth model:

$$P_0 = \frac{D_1}{k - g} \text{ where:}$$

$P_0$  = Price for the security.

$D_1$  = The dividend paid at period 1.

$k$  = The investor's required rate of return.

$G$  = The growth rate of the dividends.

Therefore, the value of the stock is \$40.04, calculated as follows:

$$P_0 = \frac{(\$3.85)(1.04)}{.14 - .04} = \$40.04$$

**Retirement – Choosing a Retirement Plan (moderate)**

6. D

An age-weighted profit-sharing plan is a qualified plan that would offer maximum benefits for the principals, who are older. An age-weighted profit-sharing plan would also offer contribution flexibility and low administrative costs.

A is incorrect. A defined-benefit plan would not have contribution flexibility, nor does it have low administrative costs.

B is incorrect. Although a profit-sharing plan would offer contribution flexibility and low administrative costs, it would not allow maximum benefits for the principals.

C is incorrect. A SEP is not a qualified plan.

**Insurance – Life Insurance (moderate)**

7. B

Michelle's gain upon the surrender of the policy would be \$5,000. Michelle has a basis in the policy of \$10,000, calculated as follows:

Total premiums paid	\$50,000
Less: outstanding loan	(30,000)
Less: dividends received	<u>(10,000)</u>
Basis in policy	\$10,000

Dividends received represent a return of premiums, and therefore, reduce the policy owner's basis in the policy.

Michelle has a gain upon surrender of \$5,000, calculated as follows:

Net cash value	\$15,000
Less: basis in policy	<u>(10,000)</u>
Gain upon surrender	\$ 5,000

**Fundamentals - Education Funding (easy)**

**8. C**

A parent who claims a child as a dependent is entitled to take the HOPE credit for the educational expenses of the child.

A is incorrect. The Lifetime Learning Credit is equal to 20% of qualified educational expenses up to a certain limit.

B is incorrect. The HOPE credit is available for the first 2 years of postsecondary education

D is incorrect. The contribution limit for Coverdell Education Savings Accounts is applied per year per student (not donor).

**Investments - Bonds (moderate)**

**9. A**

Treasury zero-coupon bonds do not pay interest to the investor. However, the accrued interest is taxable each year. Therefore, this type of investment is best suited for a tax-advantaged account.

**Insurance - Basics (easy)**

**10. C**

With respect to the COLLISION exposure, the client should probably not insure, thus retaining the risk exposure. The car itself is only worth \$1,500.

**Tax – Taxation of Investments (difficult)**

**11. B**

The CD, blue chip stock, and savings bonds (in that order) would result in the lowest tax liability upon liquidation.

CD – since the interest on the CD was taxable each year, the basis in the CD would be equal to the value. Therefore, no federal or state income taxes would result upon liquidation.

Blue chip stock – the appreciation of the blue chip stock would be taxed, but at favorable capital gains rates.

U.S. Savings Bonds – the appreciation would be taxed at ordinary income tax rates for Federal income tax purposes. However, savings bonds are not subject to state income taxes.

Traditional IRA – The appreciation only (client has basis for the contributions because they were non-deductible) would be taxed at both federal and state ordinary income tax rates.

401(k) Plan – The entire amount would be taxed at both federal and state ordinary income tax rates.

**Retirement – Retirement Plans (moderate)**

12. C

1 is incorrect. Both the 401(k) plan and the IRA could offer a life annuity option.

2 is correct. A qualified plan, such as a 401(k) plan, can offer loans. IRAs are not permitted to offer loans.

3 is correct. A participant in a qualified plan, such as a 401(k), can separate from service after attaining age 55, and receive a distribution without paying an early withdrawal penalty. This exception to the early withdrawal penalty does not apply to IRAs.

4 is incorrect. 5-year forward averaging was repealed several years ago.

**Tax – Gain on Sale of Inherited Property (moderate)**

13. A

The XYZ stock received a step-up in basis upon the relative's death. All inherited property is long-term.

Value on date of sale	\$6,250
Less: selling expenses	<u>( 250)</u>
Amount realized	\$6,000
Less: basis	<u>(5,750)</u>
Capital Gain	250

**Estates – Trust Taxation (easy)**

14. A

Since the trust is revocable, the trust is considered a grantor trust for income tax purposes. The grantor, Ronald, will pay taxes on all income earned by the trust.

**Tax – Charitable Deduction (moderate)**

15. A

When an individual donates long-term stock to charity, the individual is entitled to claim a charitable contribution based on the full fair market value of the stock. However, this deduction is limited to 30% of the taxpayer's adjusted gross income. The fair market value of Jorge's stock is \$30,000, but his current deduction will be limited to \$12,000 (\$40,000 AGI x 30%). He will have a carry forward of \$18,000. Note: An election is available to deduct only the basis of the stock, thus allowing an AGI limit of 50%. However, since the basis of the stock is only \$7,000, this election would not be appropriate.

**Insurance – Business Use of Life Insurance (moderate)**

16. A

In a stock redemption buy-sell agreement, the corporation purchases a separate life insurance policy on the life of each shareholder. The corporation is the purchaser, owner, and premium payer. The amount of insurance on each shareholder is equal to the respective shareholder's interest in the business. Therefore, the company should own and pay for two \$250,000 contracts, one on Terry and one on Pat.

**Tax - AMT (moderate)**

17. D

1 is correct. Certain deductions that are allowable for regular tax purposes (e.g., real estate taxes) are not allowed for alternative minimum tax purposes.

2 is incorrect. The Alternative Depreciation System (ADS) is allowed for alternative minimum tax purposes. If a client ELECTS to use ADS for regular tax purposes, the depreciation deduction for both regular tax purposes and AMT purposes will be the same.

3 and 4 are correct. If AMT is due, it may be a good idea to accelerate ordinary income for regular tax purposes, and defer real estate taxes (which are disallowed for AMT) to future years.

**Fundamentals – Business Organizations (moderate)**

18. C

1 is correct. The first \$50,000 of corporate taxable income is only taxed at 15%, and the next \$25,000 of corporate taxable income is only taxed at 25%. These rates are much lower than the maximum individual tax rate of 35%.

2 is incorrect. When accumulated profits are distributed to shareholders as a dividend, they are double taxed. The dividend is first taxed at the corporate level, then to the individual. Note: recent legislation reduced the dividend rate to equal the capital gain rate, however, dividends are not actually considered capital gains. This favorable tax treatment of dividends is scheduled to expire.

3 is correct. Corporations can provide many tax-favored fringe benefits to shareholders, such as group term life insurance. Several of these fringe benefits are not available to other types of entities, such as partnerships.

4 is incorrect. Once a corporation has been established, it is not easy to change the form of business. When a corporation is liquidated, both the corporation and the shareholder must pay tax, resulting in double tax treatment.

**Tax – Sources of Authority (easy)**

19. D

Treasury regulations have the highest precedential value of all the options listed. Only the Internal Revenue Code has a higher precedential value.

**Retirement – Choosing a Retirement Plan (moderate)**

20. B

A SEP would allow the client to contribute up to 20% (self-employed maximum) of the consulting income to the plan, and receive an immediate income tax deduction. The SEP will also provide tax-deferred growth of the investments.

A is incorrect. Since the client is making the maximum salary reduction permissible to the 403(b) plan, he/she will be precluded from making salary reduction contributions to a SIMPLE IRA.

C is incorrect. If the client purchased tax-free municipal bonds, the income from the bonds would be tax-free, but the client would not receive an income tax deduction when the bonds are purchased. A SEP would provide an immediate income tax deduction.

D is incorrect. A 457 plan is a deferred compensation plan, sponsored by a tax-exempt organization (usually a government organization). The client's consulting business would not be eligible to establish a 457 plan.

**Retirement – Choosing a Retirement Plan (easy)**

21. D

1 is correct. He could invest in an annuity, which would provide tax-deferred growth.

2 is incorrect. He could contribute to an IRA, but the contributions would not be deductible.

Marcus is an active participant in the 401(k), and his AGI is high enough to cause a complete phase-out of the allowable deduction.

3 is correct. He could make non-deductible contributions to the IRA.

**Tax – ISOs and NQSOs (moderate)**

**22. B**

When a nonqualified stock option is exercised, the bargain element is treated as ordinary income, and is subject to payroll taxes. When an incentive stock option is exercised, the bargain element is not subject to ordinary income taxes or payroll taxes, but is subject to alternative minimum tax.

Exercise of incentive stock option:

Fair market value of stock per share	\$80
Less: Exercise price per share	<u>(30)</u>
Bargain element per share	\$50
Multiplied by: Number of shares exercised	<u>x 500</u>
Equals: Bargain element	25,000

The bargain element of \$25,000 will be subject to an alternative minimum tax adjustment.

Exercise of non-qualified stock option:

Fair market value of stock per share	\$80
Less: Exercise price per share	<u>(45)</u>
Bargain element per share	\$35
Multiplied by: Number of shares exercised	<u>x1,000</u>
Equals: Bargain element	35,000

The bargain element of \$35,000 will be subject to ordinary income taxes and payroll taxes.

**Investments - Securities (moderate)**

**23. D**

A stock index fund is a mutual fund that mirrors a stock index. Typically, the fund pays little or no dividends, and is therefore tax efficient.

A is incorrect. Nonleveraged equipment leasing investments have more of an income objective than a growth objective and are not tax efficient because the income is taxed each year.

B is incorrect. A balanced mutual fund usually invests a large percentage of the fund assets in fixed-income securities.

C is incorrect. Preferred stocks often pay a large dividend and usually have an income objective.

**Problem Set**

**Estates – Transfer Taxes (moderate)**

24. D

A bypass trust would be appropriate to utilize the applicable credit of the first spouse to die. Since all assets are currently being left to the surviving spouse, the first spouse to die would waste his/her applicable credit. A bypass trust would solve this problem.

A is incorrect. Susan is already listed as the beneficiary of the policy. James would therefore be eligible for a marital deduction if the proceeds are paid to Susan. Transferring ownership of the policy will not result in any estate tax savings.

B is incorrect. Their current estate plan leaves all assets to the surviving spouse upon the first spouse's death. As a result, the first spouse to die will waste their applicable credit because of a full marital deduction. The best solution is to establish a bypass trust at the first spouse's death.

C is incorrect. Because of the applicable credit, James and Susan can avoid estate taxes at both of their deaths with proper planning. Giving gifts is not necessary. Of course, they may desire to give gifts, but the question asks for the best strategy for reducing transfer taxes.

**Estates – Probate Estate (easy)**

25. A

The stocks, valued at \$300,000, would be the only asset included in James' probate estate.

The assets titled JTWROS would pass by operation of law, thus avoiding probate. The 401(k) and life insurance policies have named beneficiaries, thus avoiding probate.

**Estates - Gross Estate (easy)**

**26. C**

James' gross estate is \$1,590,500 calculated as follows:

<u>Asset</u>	<u>Value</u>
Checking (1/2 value)	\$ 2,500
Savings (1/2 value)	3,000
Certificates of Deposit (owned by Susan)	0
Home (1/2 value)	140,000
Vehicles, furniture, etc. (1/2 value)	45,000
Stocks (owned by James)	300,000
Apartments (1/2 value)	130,000
401(k) (owned by James)	600,000
Group Term life insurance (owned by James)	120,000
Life insurance (owned by James)	<u>250,000</u>
Gross estate	\$1,590,500

**Estates – Life Insurance (easy)**

**27. A**

Since Susan does not need the income from the policy upon James' death, the children should be named as the beneficiaries. By transferring the policy to a trust, the policy would be excluded from James' gross estate, provided James survives three years after the transfer.

B is incorrect. There is no need to surrender the policy, and if the policy was surrendered, the \$10,000 gain would be taxable income.

C is incorrect. If Susan was the owner of the policy and the children were named beneficiaries, Susan will have made a \$250,000 gift to the children upon James' death.

D is incorrect. If James' estate is named beneficiary of the policy, the proceeds will be included in his gross estate when he dies. This could be avoided using a trust.

**Estates – Marital Deduction (moderate)**

**28. C**

If Susan were to die, her marital deduction would be \$680,500, calculated as follows:

<u>Assets left to James</u>	<u>Value</u>
Checking (1/2 value)	\$ 2,500
Savings (1/2 value)	3,000
Certificates of Deposit (left to James in Will)	380,000
Home (1/2 value)	140,000
Vehicles, furniture, etc. (1/2 value)	45,000
Apartments (1/2 value)	130,000
Life insurance (owned by Susan)	50,000
Liability on Home (1/2 value)	(25,000)
Liability on Apartments (1/2 value)	<u>(45,000)</u>
Marital Deduction	\$680,500