

CFP Certification Examination

1999 RELEASED CASE SCENARIO AND MULTIPLE-CHOICE QUESTIONS

The Clarke case, its related multiple-choice questions, and 90 additional multiple-choice and matching questions released in February 1999 have all been used on CFP® Certification Examinations. The correct answer to each question is indicated with an asterisk, however, changes for current law and practice subsequent to December 1998 are not considered as of the date of release. The questions that are no longer correct due to law changes were left unedited. These questions were used previously on the CFP Certification Examination when the law correctly applied.

The CFP Board of Examiners approved the Clarke case and the multiple-choice questions for publication. The CFP Board of Examiners, a voluntary board comprised of seven members, oversees the content of the CFP Certification Examination and is the sole governing body qualified to answer technical questions regarding the content of the examination. Therefore, technical questions regarding the enclosed examination questions must be addressed, in writing, to the Board of Examiners at the CFP Board's address. The Examiners will make every reasonable attempt to provide a response to specific issues raised about a given question prior to the next scheduled CFP Certification Examination, though the CFP Board cannot guarantee the timeliness of the Examiners' response.

1.

Directions: This part consists of one case problem followed by a set of questions or incomplete statements. Four or five suggested answers or completions follow each question or incomplete statement. Select one best answer or completion for each question. Each question should be answered independently.

JAMES AND PAT CLARKE

Personal Data

Husband: James Clarke, age 44, college professor
Wife: Pat Clarke, age 43, college professor
Child: Kim Clarke, age 14
James' parents: In good health, in mid to late 70s
Pat's parents: Deceased

Financial Data

James and Pat Clarke have the following assets at fair market value (FMV):

- Single premium deferred annuity (Pat) \$ 50,000
- Cash (JTWROS*) 250,000
- Stock in the XYZ Corporation** (JTWROS) 50,000
- IRAs
 - Pat 20,000
 - James 30,000
- Home (JTWROS) 100,000

Their simplified income statement is presented as follows:

- Salary (combined) \$ 82,500
- Interest income 12,500
- Living expenses & taxes 90,000

They have no liabilities and no company-sponsored retirement plans.

They have no wills and they live in a non-community property state.

James' parents can meet all current expenses from current cash flow but have very limited reserve funds and still live in their own paid-for mobile home.

*Joint tenancy with right of survivorship

**XYZ Corporation is an S-corporation for which James worked before he started teaching.

JAMES AND PAT CLARKEOther Pertinent Data

- The tax basis of the home is \$90,000; the tax basis of the stock is \$55,000.
- The Clarkes are in a 30% marginal combined state and federal tax bracket.
- They are inexperienced investors, but they are willing to take reasonable and normal investment risk if appropriate, but they do not wish to invest aggressively.
- Both James and Pat have purchased term life insurance policies with \$250,000 death benefit on each; they own their own policies, and Kim is the contingent beneficiary on both policies.
- James is the primary beneficiary of Pat's single premium deferred annuity; Kim is the contingent beneficiary.
- You have found their disability insurance inadequate. The Clarkes have indicated they could fit your proposed \$1,600 annual premium for an adequate policy into their living expenses.
- You have reviewed their auto, homeowner's, liability, and life insurance and found their policies adequate. James and Pat are responsible for their medical expenses.
- Kim is a trustworthy high school honor student who earns \$2,000 annually and has a \$500 savings account.
- The "cash" is invested in a variety of money market funds and insured savings accounts.
- Their IRAs are invested in money market funds. James and Pat are the primary beneficiaries on each other's IRA account; Kim is the contingent beneficiary.
- They do not plan additional children and they have no other dependents.
- The Clarkes currently can save \$5,000 per year out of current salary and can continue to do so (in inflation-adjusted dollars) until they retire in 20 years. This savings rate assumes that all planned asset acquisition and replacements are paid out of income before savings (except the three goals shown on the following page).

JAMES AND PAT CLARKEGoals (in order of priority)

1. College education for Kim. They expect to spend a total of \$50,000 (present value) for her entire education.
2. Retirement in 20 years which maximizes their standard of living at retirement. Their IRAs, Social Security, and personal retirement savings form a basis for retirement.
3. Pat and James plan to take 6 months off from work (“sabbatical”) in 4 years for travel and research and to spend \$50,000 (after-tax and in current dollars).

Economic Environment

The economy has been in a period of modest economic growth for about 2 years. Inflation, as measured by the CPI, was at a 4.9% annual rate over the last year. Ninety-day T-bill rates are currently 6%, while the yield to maturity on 20-year government bonds is 7.5%. During the last quarter, unemployment was at 4.8% and real economic growth was about 0.75%. Most forecasts call for little change in these conditions over the short and long term.

Planner’s Assumptions

<u>Investment</u>	<u>Pre-Tax Expected Return</u>	<u>Beta with S & P 500</u>
Biotech mutual fund	20.0%	1.75
Leveraged commercial real estate	8.5%	1.40
Small cap stock mutual fund	10.0%	1.10
S&P 500	9.0%	1.00
Taxable zero-coupon bonds	9.0%	1.00
Zero-coupon municipal bond fund	7.5%	.80
Treasury bonds (30-year)	7.5%	.70
Long-term municipal bond fund	5.0%	.70
International stocks	11.0%	.40
Treasury notes (7-year)	7.0%	.25
Treasury bills	6.0%	.10
Precious metals	5.0%	-.25
R&D partnership	14.0%	N/A
Certificate of deposit	7.0%	N/A

You are doubtful anyone can “beat the market” through asset selection or timing.

4.

1. Which one of the following statements most accurately describes the risk exposure of the Clarkes' portfolio?
 - A. The portfolio has excessive market risk.
 - B. The portfolio should be unaffected by changes in interest rates.
 - C. The portfolio contains an excessive level of business risk.
 - D. The portfolio contains excessive liquidity risk.
 - * E. The portfolio contains excessive purchasing power risk.
2. With respect to the Clarkes' risk tolerance, which of the following statements is true?
 - A. Because of their lack of investment experience, equity investments are inappropriate.
 - * B. Because of their stated risk preferences, investment in an R&D partnership is inappropriate.
 - C. Regardless of their specific goals, a portfolio with a weighted average beta close to 1 is appropriate.
 - D. Because of their stated risk preferences, a biotech mutual fund is appropriate.
 - E. Regardless of their risk tolerance, leveraged commercial real estate is appropriate.
3. To diversify the Clarkes' investment portfolio, which of the following investments would be most appropriate?
 - (1) S&P 500 Index Fund
 - (2) zero-coupon municipal bond fund
 - (3) international stocks
 - (4) leveraged commercial real estate
 - * A. (1) and (3) only
 - B. (1) and (4) only
 - C. (2) and (3) only
 - D. (2) and (4) only
4. What would you advise James and Pat regarding James' parents' estate planning documents?
 - A. Transfer the parents' assets to a pooled income fund.
 - B. Establish a charitable remainder annuity trust.
 - C. Transfer the parents' assets to a revocable trust.
 - * D. Set up durable power of attorney for healthcare.
5. With regard to funds earmarked for the education goal, which type of investment makes the most sense and why?
 - * A. a series of taxable zero-coupon bonds owned by Kim because they can provide appropriate funds at the correct times and are taxed at the child's rate
 - B. a variable life insurance policy owned by Kim because it saves taxes and it contains life insurance
 - C. a certificate of deposit owned by James and Pat because CDs are very safe
 - D. a small cap stock mutual fund owned by Kim because it provides the best return at a modest level of risk consistent with the time horizon
 - E. Treasury notes with a 7-year maturity owned by James and Pat because the 7-year maturity Treasury notes have little interest rate risk
6. Which type(s) of investment(s), to be held in their IRA accounts, would be consistent with their retirement goal and why?
 - (1) a small cap mutual fund, because it provides growth with reasonable risk
 - (2) a municipal bond fund, because it provides tax advantages and relative safety
 - (3) an international stock fund, because it provides an element of diversification and growth
 - (4) precious metals, because they provide diversification and tax advantages
 - A. (1) only
 - * B. (1) and (3) only
 - C. (2) and (4) only
 - D. (1), (2), and (3) only
 - E. (1), (3), and (4) only

5.

7. With regard to the funds earmarked for the Clarkes' "sabbatical" goal, which type of investment is most appropriate?
- A. S&P 500 index fund
 - * B. zero-coupon municipal bond
 - C. 7-year Treasury notes
 - D. biotech mutual fund
 - E. small cap stock mutual fund
8. Assume the following additional facts:
- The Clarkes have purchased a homeowner's policy (HO3-comprehensive) covering 100% of the replacement cost of their residence. This policy has a \$500 deductible. Also, they have purchased a disability income policy with a 30-day elimination period and an any-occupation definition of disability.
- What actions should the Clarkes consider in order to improve the quality of the insurance program described above?
- (1) Purchase an endorsement to the homeowner's policy providing all risk/replacement cost (all perils) coverage for personal property.
 - (2) Decrease the homeowner's policy deductible to \$250.
 - (3) Reduce the homeowner's policy coverage to 75%.
 - (4) Purchase an own-occupation disability policy.
- * A. (1) and (4) only
 - B. (2) and (4) only
 - C. (1), (2), and (4) only
 - D. (1), (3), and (4) only
9. One commonly used method of calculating the total retirement fund necessary on the first day of retirement is to use the present value of an annuity due. The Clarkes anticipate that their annual retirement income will need to increase each year at the rate of inflation. Based on the following assumptions, calculate the total amount needed to be in place when James and Pat retire. (Round to the nearest \$1,000.)
- | | |
|---|----------|
| First-year annual income | \$90,000 |
| Social Security annual income, assumed to increase at the rate of inflation | \$45,000 |
| Annual after-tax rate of return on invested assets | 7% |
| Joint life expectancy during retirement | 25 years |
- A. \$878,000
 - B. \$887,000
 - * C. \$896,000
 - D. \$1,773,000
 - E. \$1,792,000
10. Assume that James has predeceased Pat by 1 year. If Pat died yesterday, which combination of the following financial assets would be included in her probate estate?
- (1) James' life insurance policy
 - (2) Pat's SPDA
 - (3) XYZ stock
 - (4) home
 - (5) Pat's life insurance policy
- A. (4) only
 - B. (1) and (5) only
 - * C. (3) and (4) only
 - D. (1), (2), and (5) only
 - E. (2), (3), (4), and (5) only
11. Which of the following tax forms or schedules will XYZ Corporation provide to James and Pat on an annual basis?
- A. Schedule E
 - B. Form 1099-S
 - C. Form 1099
 - D. Form W-2
 - * E. Schedule K-1

Certification Examination Questions Released as of January, 1999

Directions: This part consists of problem sets. Each problem set consists of a brief fact pattern followed by two or more questions or incomplete statements. Four or five suggested answers or completions follow each question or incomplete statement. Select one best answer or completion for each question.

- I. Bond A has a 6% annual coupon and is due in 2 years. Its value in today's market is \$900.
 Bond B has a 10% annual coupon and is due in 4 years. It is priced to yield 12%.
 Bond C is a 9% zero-coupon bond priced to yield 11% in 8 years.
1. The yield to maturity of Bond A is closest to
 - A. 9.90%.
 - B. 10.40%.
 - C. 10.90%.
 - D. 11.40%.
 - * E. 11.90%.
 2. Assuming that the duration of Bond A is 1.94 years, which of the following statements about the effect of a 1% decline in interest rates is true?
 - * A. Bond C, having a longer duration than Bond A, would have a larger percent increase in price than Bond A.
 - B. The percent change in price of a bond is independent of the duration of a bond.
 - C. It is not possible to determine the percent change in price of Bond A versus Bond C because the duration of Bond C is not given.
 - D. Bond A would have a greater percent change in price than Bond C because it has a shorter duration.
 - E. The percent change in the price of Bonds A and C is equal since it is not affected by duration.

II. A young couple (both age 30) comes to the financial planner with the desire for assistance in improving their family's financial position. They have two healthy children, ages 3 and 6. The husband is a foreman for a manufacturer of auto parts. His current salary is \$30,000 per year. The wife is a marketing professor for a state university. Her current salary is \$40,000 per year. The couple recently purchased a riverfront home for \$100,000 using their entire savings of \$20,000 as a down payment. In addition to an \$80,000 mortgage, the couple's only debt is an automobile loan having a balance of \$12,000. Both husband and wife have very good family health insurance from their employers. The wife has employer-paid life insurance equal to two times her annual salary.

3. The couple wants to start an investment program as soon as possible. To correct the weakness in their financial planning before beginning the investment program, they should
- (1) establish an emergency fund with stock mutual funds.
 - (2) start a college savings fund for the children.
 - (3) purchase disability insurance for the wife and the husband.
 - (4) prepare wills for the wife and the husband.
 - (5) secure credit life insurance for the auto loan.
- A. (5) only
 B. (1) and (2) only
 C. (1) and (3) only
 * D. (3) and (4) only
4. When the couple is able to begin an investment program, they want to begin making investments for their retirement and their children's education. All of the following actions will help accomplish their goals in a tax-efficient manner except
- A. investing in individual Roth IRAs.
 - B. investing through a 403(b) program for the wife.
 - * C. investing in a growth and income mutual fund.
 - D. investing in education IRAs for each child.

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?"*

III. Grantor has established a trust, naming a bank as trustee. Pursuant to the terms of the trust document, Grantor is to receive all of the income generated by the trust assets during his life. Grantor may withdraw assets from the trust or place additional assets into it. The assets placed into the trust consist of Grantor's mutual fund portfolio, personal residence, a rental property located in another state, and two installment notes held by Grantor. Upon Grantor's death, all of the assets remaining in the trust are to be distributed to Grantor's two children.

5. Which of the following statements is/are correct?
- (1) Upon the transfer of the installment notes to the trust, any deferred gain will be recognized as taxable income.
 - (2) After the transfer, the income from the mutual funds will be reported on Grantor's tax return.
 - (3) Upon the transfer of the rental property to the trust, all excess prior years' depreciation will be recaptured.
 - (4) After the transfer, the \$125,000 exclusion from capital gain remains available for the principal residence.
- A. (4) only
 B. (1) and (3) only
 * C. (2) and (4) only
 D. (1), (2), and (3) only
 E. (1), (2), (3), and (4)
6. Upon Grantor's death, the assets remaining in the trust will
- (1) be included in Grantor's taxable estate.
 - (2) be subjected to the probate process.
 - (3) receive a new basis except for the installment notes.
 - (4) be distributed as directed by Grantor's will.
- A. (4) only
 * B. (1) and (3) only
 C. (1), (2), and (3) only
 D. (1), (2), (3), and (4)

CFP Board of Examiner's 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.)*

IV. A client sold an apartment building last year for \$100,000, paying a sales commission of \$5,000 plus \$2,500 closing costs. The building originally cost \$80,000 20 years ago. Total straight line depreciation of \$40,000 had been taken. The building had a mortgage of \$60,000 that was assumed by the buyer.

7. What is the seller's adjusted cost basis?
- A. \$32,500
 - B. \$37,500
 - * C. \$40,000
 - D. \$52,500
8. What is the purchaser's cost basis?
- A. \$70,000
 - B. \$92,500
 - * C. \$100,000
 - D. \$107,500

Multiple-Choice Questions

Directions: Four or five suggested answers or completions follow each question or incomplete statement. Select one best answer or completion for each question.

9. John Hedrick wants to pay one-half of the college costs for his daughter, Ruth. She will be attending a private college with annual costs of \$20,000 today. Ruth is 10 years old and will be starting college in 8 years. If these costs are expected to increase annually by 8%, how much will Mr. Hedrick need to provide for her first year of college?
- * A. \$18,509
 - B. \$23,409
 - C. \$27,371
 - D. \$37,019
 - E. \$74,037
10. One of your clients wants to know the maximum amount that might be allocated to her 401(k) account in 1998. She expects to earn \$40,000. You explain the possible sources of an annual addition to her account, including allocation of forfeitures from departing non-vested employees, and the limitation on that addition. The largest annual addition that could be made to her 401(k) account in 1998 is
- A. \$6,000.
 - B. \$8,000.
 - C. \$9,600.
 - * D. \$10,000.
 - E. \$30,000.
11. The following set of newly issued debt instruments was purchased for a portfolio:
- Treasury bond
 - zero-coupon bond
 - corporate bond
 - municipal bond
- The respective maturities of these investments are approximately equivalent.
- Which one of the investments in the preceding set would be subject to the greatest relative amount of price volatility if interest rates were to change quickly?
- A. Treasury bond
 - * B. zero-coupon bond
 - C. corporate bond
 - D. municipal bond
12. Which of the following statements about S corporations is true?
- A. S corporation status is automatic if there are fewer than 75 shareholders.
 - * B. S corporations are prohibited from having more than one class of stock.
 - C. S corporations are prohibited from earning passive income.
 - D. S corporations may have non-resident aliens as shareholders.

13. The best life insurance policy for the payment of federal estate taxes for a 50-year-old couple with illiquid assets is
- A. an individual whole-life policy on each spouse on a cross-ownership basis.
 - B. a joint first-to-die life insurance policy owned jointly.
 - C. a joint last-to-die life insurance policy owned by the spouse with the larger estate.
 - D. a joint and last-to-die life insurance policy owned by the spouse with the smaller estate.
 - * E. a joint and last-to-die life insurance policy owned by an irrevocable trust.
14. Which one of the following factors would be the strongest indication that interest rates might rise?
- * A. selling of dollar-denominated assets by foreign investors
 - B. decreasing United States government deficits
 - C. decreasing rates of inflation
 - D. weak credit demand by the private sector of the United States economy
15. What is the main responsibility of the underwriting department of a life insurance company?
- * A. to guard against adverse selection
 - B. to set a limit on the amount of insurance issued
 - C. to set adequate insurance rates
 - D. to avoid exposures that could result in loss
16. Which of the following best describes the investment characteristics of a high-quality long-term municipal bond?
- * A. high inflation risk; low default risk
 - B. low inflation risk; high market risk
 - C. low inflation risk; low default risk
 - D. high inflation risk; high market risk
17. Robert Smith asks for your help in preparing his cash flow statement. He tells you that his salary before taxes is \$250,000 and that he has no mortgage on his home. Which of the following statements is true about Robert's cash flow statement?
- A. The value of the home would be an income source since there is no mortgage.
 - B. The value of the home would be an asset.
 - C. The taxes on his salary would be a liability.
 - * D. The taxes on his salary would be an expense.
18. Billy Smith, age 55, has been a member of the union for 30 years, and as a result, has been excluded from his employer's retirement plan. Billy has been offered a management position with his firm, which will make him eligible to participate in the company's 401(k) plan.
- Billy's objective is to retire at age 65 with \$2,000 in monthly retirement income, exclusive of Social Security benefits. He assumes a life expectancy of age 95. The union retirement plan will provide him with \$1,000 monthly. (There are no matching contributions from Billy's employer to the 401(k) plan and, his income is adequate to have the required level of contributions fall within the deferral limits of the 401(k) plan. Contributions and payments, as appropriate, are made at the beginning of each month.)
- If the return in the company's 401(k) plan is 10%, what monthly amount will Billy have to contribute to that plan for 10 years to meet his objective?
- * A. \$556
 - B. \$566
 - C. \$576
 - D. \$747
 - E. \$1,113

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.*

19. A client becomes age 70½ on October 1 of this year and must receive a minimum distribution from his IRA account, which had a value at the beginning of the current year of \$48,000. His spouse, age 63, is the beneficiary of the IRA account. Their combined life expectancy according to IRS tables is 24 years. If the client takes a \$1,000 distribution by next April 1, what will be the tax penalty?
- A. \$0
 - B. \$100
 - C. \$150
 - * D. \$500
 - E. \$1,000
20. Jasmine has a large paper profit in her Amalgamated Corporation shares, currently at 46. She is happy with the stock but realizes that a good thing cannot go on forever. If she is willing to sell at 50, what strategy could you recommend to her?
- A. Buy \$50 call options.
 - * B. Sell \$50 call options.
 - C. Buy \$50 put options.
 - D. Sell \$50 put options.
21. "Stock prices adjust rapidly to the release of all new public information." This statement is an expression of which one of the following ideas?
- A. random walk hypothesis
 - B. arbitrage pricing theory
 - * C. semi-strong form of the efficient market hypothesis
 - D. technical analysis
22. Before her death, LaDonna Kiniston, age 74, gave her three grandchildren some money for their private school education. She paid \$12,000 to the school for Jake's tuition and gave a like amount to Sarah and Nicole. What would be the adjusted taxable gifts calculated in her estate taxes?
- A. \$0
 - * B. \$4,000
 - C. \$6,000
 - D. \$16,000
 - E. \$36,000
23. Mrs. Bailey dies leaving her entire \$3.2 million estate to her penniless husband, Mr. Bailey. Their estate goes to their children at his death. He has terminal cancer with a life expectancy of 1-2 years. The alternative valuation date computes Mrs. Bailey's entire estate equal to \$3.0 million. Select the postmortem technique he should utilize to reduce the overall estate tax liability of both estates.
- A. elect to use date-of-death valuation
 - B. elect to use the alternate valuation method
 - C. disclaim \$625,000 and elect to use the alternate valuation method
 - * D. disclaim \$1,500,000 and elect to use the alternate valuation method
 - E. disclaim \$3,000,000 and elect to use the alternate valuation method
24. Which of the following is a benefit provided by Medicare?
- * A. hospice benefits for terminally ill persons
 - B. a stop-loss limit for annual medical expenses in excess of \$2,500
 - C. coverage for custodial care
 - D. coverage for prescription drugs that can be self-administered
25. What is the early withdrawal penalty for a SIMPLE plan during the 2-year period beginning on the date the employee first participated in the SIMPLE plan?
- A. 10%
 - B. 15%
 - C. 20%
 - * D. 25%

26. Assuming that the current market yield for similar risk bonds is 8%, determine the discounted present value of a \$1,000 bond with a 7.5% coupon rate which pays interest semiannually and matures in 17.5 years.

A. \$504.68
 B. \$539.78
 * C. \$953.34
 D. \$968.96
 E. \$1,653.26

27. Calculate the maximum 1998 contribution for an employee earning \$140,000 annually, working in a company with the following retirement plans: a 401(k) with no employer match and a money-purchase pension plan with an employer contribution equal to 12% of salary.

A. \$16,800
 B. \$26,300
 * C. \$26,800
 D. \$30,000
 E. \$35,000

28. Given the following diversified mutual fund performance data, which fund had the best risk-adjusted performance if the risk-free rate of return is 5.7%?

FUND	AVERAGE ANNUAL RETURN	STANDARD DEVIATION OF ANNUAL RETURN	BETA
A	.0782	.0760	0.950
B	.1287	.1575	1.250
C	.1034	.1874	0.857
D	.0750	.0810	0.300

A. Fund B because the annual return is highest
 B. Fund A because the standard deviation is lowest
 C. Fund C because the Sharpe ratio is lowest
 * D. Fund D because the Treynor ratio is highest
 E. Fund A because the Treynor ratio is lowest

29. Judy Green, a CFP licensee, has proof that Mary Clark, another CFP licensee in her office, has utilized clients' funds under management to cover gambling debts. Mary returned the funds to the clients' accounts and made them whole, including the earnings that would have accrued during the time that the funds were withdrawn. Under the *Code of Ethics and Professional Responsibility and Disciplinary Rules and Procedures*, Judy is obligated to

A. report Mary's action to the local CFP organization for proper processing.
 B. report Mary's action to the CFP Board of Examiners because Mary has violated the Professionalism Principle.
 * C. report Mary's action to the CFP Board because Judy is bound by the CFP Code of Ethics and Professional Responsibility to do so.
 D. not report Mary's action to the CFP Board because Judy would violate the Confidentiality Principle.
 E. not report Mary's action to the CFP Board because Mary made full restitution and the clients involved were not harmed by Mary's action.

30. To immunize a bond portfolio over a specific investment horizon, an investor would do which of the following?

A. Match the maturity of each bond to the investment horizon.
 B. Match the duration of each bond to the investment horizon.
 C. Match the average weighted maturity of the portfolio to the investment horizon.
 * D. Match the average weighted duration of the bond portfolio to the investment horizon.

31. Which of the following employee fringe benefits would be taxable to the employee?
- A. business use of an employer-provided automobile
 - B. employee of an airline flying standby from Los Angeles to San Francisco
 - C. benefits of de minimis value
 - * D. monthly dues to the local health club paid by the employer
 - E. a 10% employee discount on department store merchandise
32. Many employers are now making flexible spending accounts (FSAs) available to employees. Which of the following statements concerning the nature of these accounts is incorrect?
- * A. The balance in an employee's FSA can be carried forward or exchanged for cash if unused for expenses incurred.
 - B. An FSA is technically a cafeteria plan that can be used by itself or as part of a broader cafeteria plan.
 - C. A separate FSA salary reduction must be made for each type of eligible benefit.
 - D. A salary reduction for an FSA will lower an employee's income for social security tax purposes if the employee earns less than the social security wage base.
33. A successful architect wants to purchase disability income insurance. She is concerned about becoming totally disabled, but also about a reduction in income if she is obliged to reduce her workload because of a less-than-total disability. To satisfy these concerns, which of the following should be included in her disability income coverage?
- * A. residual disability benefits
 - B. a change-of-occupation provision
 - C. dismemberment benefits
 - D. a relation of earnings-to-insurance provision
34. John and Mary Meyers have a combined estate of \$900,000 including a \$250,000 life insurance policy on John's life. The Meyers have two children. John prefers Mary receive the income from the policy if he dies but wants the proceeds to go to his children after her subsequent death. John and Mary have recently executed wills that contain unified credit trusts. What is the best beneficiary designation for John's life insurance policy?
- A. his wife Mary
 - B. his two children
 - C. a charitable remainder trust
 - * D. his testamentary trust
35. In analyzing the financial statements of a client's business, you notice that the collection period for accounts receivable has been increasing. What does this increase suggest about the firm's credit policy?
- A. The firm's current ratio is also increasing.
 - B. The collection period has no relationship to a firm's credit policy.
 - C. The firm is losing qualified customers.
 - * D. The credit policy is too lenient.
36. Your client's federal marginal tax rate is 36%, and the state marginal rate is 7%. The client does not itemize deductions on his federal return and is considering investing in a municipal bond issued in his state of residence which yields 5%. What is the taxable equivalent yield?
- A. 3.20%
 - B. 4.65%
 - C. 5.38%
 - D. 7.81%
 - * E. 8.77%

37. Johanna Olsen, CFP, is duly registered under the Investment Advisers Act of 1940. For which one of the following activities would this planner be in violation of the act?
- A. She received, with the client's knowledge, both a fee for advice given to the client and a commission from client transactions.
 - B. She included the cost of preparing the client's income tax returns as part of the annual fee charged the client.
 - C. She gave clients planning advice that was not achievable, given the current economic conditions.
 - * D. She distributed to clients the written disclosure brochure 2 weeks after an investment advising contract was duly signed.
39. A client provides a current personal balance sheet to the financial planner during the initial data gathering phase of the financial planning process. This financial statement will enable the financial planner to gain an understanding of all of the following except the
- A. diversification of the client's assets.
 - * B. size of the client's net cash flow.
 - C. client's liquidity position.
 - D. client's use of debt.

CFP Board of Examiner's 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.*

38. Which of the following statements is correct with regard to the use of an arbitration clause in an investment advisory agreement?
- * A. The SEC and NASD require arbitration if voluntary negotiation fails.
 - B. The SEC requires that such a clause be contained in any investment advisory agreement.
 - C. The NASD requires that such a clause stipulate that arbitration must be conducted by non-industry organizations.
 - D. The clause must allow state regulation to take precedence over federal regulation.

40. Your client is contemplating the sale of some of her holdings in her employer's stock. The stock was acquired in four separate purchases as follows:

Date	Shares	Cost Per Share	Cost
June 1, 1986	200	\$10	\$2,000
June 1, 1988	200	\$18	\$3,600
June 1, 1990	200	\$12	\$2,400
June 1, 1992	200	\$20	\$4,000
Total	800		\$12,000

She wants to know the least amount of gain she would be required to report if she sold 500 shares for \$12,500. Compute this gain.

- A. \$500
 * B. \$3,700
 C. \$4,300
 D. \$5,000
 E. \$5,700
-
41. Assuming neither person has used any of his/her unified credit, what is the maximum amount a married couple can give to a single, third-party donee in 1998 without paying federal gift tax?
- A. \$625,000
 B. \$635,000
 C. \$1,250,000
 D. \$1,260,000
 * E. \$1,270,000
42. If a client's primary goal in making lifetime gifts to his children is to lower his estate taxes, he should make gifts of property that
- A. are expected to depreciate significantly in the future.
 * B. are expected to appreciate significantly in the future.
 C. have already depreciated significantly.
 D. have already appreciated significantly.
43. The maximum retirement benefit a participant in a target-benefit plan can actually receive depends on the
- A. initial actuarial computation according to the plan's formula.
 B. amount of contributions determined in reference to the targeted benefit.
 C. maximum annual additional amounts.
 * D. value of the participant's account at retirement.
 E. present value of the actuarially determined target benefit.
44. A client recently purchased a new home from a builder for \$150,000 including the lot valued at \$40,000. How much insurance would you recommend that your client purchase to cover full replacement of the house in the event of a loss?
- A. \$ 88,000
 * B. \$110,000
 C. \$120,000
 D. \$150,000

45. In determining the allowable annual additions per participant to a defined-contribution pension plan account for 1998, the employer may not include
- A. compensation exceeding \$30,000 (indexed).
 - * B. compensation exceeding \$160,000.
 - C. compensation exceeding the defined-benefit limitation in effect for that year.
 - D. bonuses.
46. Jill Smith is an agent acting as a buyer for Tom Jones, d/b/a JKL Auto Repair, a sole proprietorship. Her authority is limited to purchasing supplies and equipment up to \$5,000 in cost. Jill signs a promissory note borrowing \$5,000 from a third party. Tom Jones uses the funds for business purposes. Which of the following statements describes Tom Jones' responsibility for Jill Smith's action?
- A. Jones is not bound by Smith's actions since she lacked the actual authority to sign for the loan.
 - B. Jones is not bound by Smith's actions since she lacked the necessary power of attorney to sign for the loan.
 - C. Jones is not bound by Smith's actions since she lacked the express authority to sign for the loan.
 - * D. Jones is bound by Smith's actions since he ratified her action by using the loan proceeds for his business.
 - E. Jones is bound by Smith's actions since she has the authority to purchase.
47. What is an appropriate standard estate planning strategy for married couples to minimize taxes over two deaths?
- A. Bequeath the entire estate to a trust, giving the surviving spouse a general power of appointment.
 - B. Bequeath the applicable exclusion amount to a qualified terminable interest property trust (QTIP) and the balance to the surviving spouse.
 - * C. Bequeath the applicable exclusion amount to a bypass trust to take advantage of the unified credit at the first death.
 - D. Bequeath the applicable exclusion amount to the surviving spouse and the balance to the children.
48. A client, who is a sole proprietor, is going to give her best customers gifts as a token of her appreciation. If the client wants to deduct the full cost of the gifts, what is the maximum amount that she may spend on each customer's gift?
- * A. \$25
 - B. \$50
 - C. \$100
 - D. \$250
49. Which of the following dispositions of IRC Section 1245 recapture property would result in the immediate recapture of some or all of previous depreciation deductions?
- A. a distribution by a partnership to its partners
 - B. a like-kind exchange
 - C. a disposition at death
 - * D. a sale for cash and an interest-bearing note
50. John is a contractor who has just purchased a tractor for use in his business. John paid \$25,000 plus \$1,250 in sales tax for the tractor. The local municipality also imposes an annual personal property tax of \$500. The tractor has an expected useful life of 5 years. What is John's basis in the tractor for depreciation purposes?
- A. \$25,000
 - B. \$25,500
 - * C. \$26,250
 - D. \$26,750

51. A cash basis taxpayer includes income from a service business when
- A. the services are performed.
 - B. the client is invoiced for the services.
 - C. the client's check is deposited in the bank.
 - * D. the client's check is received.
52. Which of the following is true about property transferred between spouses, or former spouses, incident to a divorce?
- A. Property transfer within 18 months of the divorce will have a basis equal to its fair market value at the date of transfer.
 - B. Property transfer will not be treated as if it were acquired by gift and will recognize gain or loss to the transferor.
 - C. Property transfer will be treated as if it were acquired by gift and the basis carried over to the transferee will be the lower of the fair market value or the transferor's basis.
 - * D. Property transfer will be treated as if it were acquired by gift and the transferor basis in the property will be carried over to the transferee.
- 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."*
53. Your client, who has a taxable income of \$200,000, is concerned about being subject to the alternative minimum tax (AMT). The following income and deductions were included in computing taxable income. Select the one item that may be added to (or subtracted from) regular taxable income in calculating the AMT.
- A. a long-term capital gain of \$100,000
 - B. a cash contribution to your client's church of \$25,000
 - C. dividend income of \$100,000
 - D. qualified housing interest of \$25,000
 - * E. a state income tax deduction of \$25,000
54. Sam, age 95, transferred \$600,000 of common stock to an irrevocable trust. Sam provides that the income from the trust is payable to himself for life, and upon his death, the trust corpus will pass to his sister. The trust prohibits Sam from changing the trust beneficiaries. If Sam dies 1 year from now when the value of the trust assets is \$650,000, how much of the trust will be included in Sam's gross estate?
- A. \$0; because Sam cannot change the beneficiaries
 - B. \$25,000; because of Sam's unified credit
 - * C. \$650,000; because Sam has the right to the trust's income for life
 - D. \$600,000; because Sam created an irrevocable trust
55. Your client's employer has recently adopted a group universal life insurance plan. The advantages of such a plan for your client typically include all of the following except that
- A. it allows employees to borrow or withdraw cash.
 - B. it provides an opportunity to continue coverage after retirement.
 - * C. the entire premium cost is borne by the employer.
 - D. it provides flexibility in designing coverage to best meet individual needs.
56. Sam and Sue paid \$100,000 for their home 5 years ago. Its fair market value was \$150,000 when Sam died. What was Sue's basis in the home after Sam's death if the home was held as community property?
- A. \$50,000
 - B. \$75,000
 - C. \$100,000
 - D. \$125,000
 - * E. \$150,000
57. A Certified Financial Planner licensee obtains a new client. During the fact-finding process, the CFP licensee discovers that the client's previous advisor, also a CFP licensee, had filed several tax forms incorrectly with computational errors. The CFP licensee's initial duty to the client should be which of the following?
- A. contacting the other financial planner
 - B. contacting the CFP Board
 - C. contacting the IRS
 - * D. informing the client of the situation

58. Mrs. Smith is an 80-year-old widow whose liquid assets are on deposit at a small FDIC-insured bank. She has the following on deposit:

<u>Asset</u>	<u>Ownership</u>	<u>Balance</u>
Various Certificates of Deposit	Mrs. Smith	\$75,000
Money Market Deposit Account	Mrs. Smith	\$50,000
IRA Rollover	Mrs. Smith	\$200,000
Passbook Savings	Joint with son	\$25,000
Checking Account	Joint with daughter	\$25,000

How much is currently insured by the FDIC?

- A. \$100,000
 B. \$150,000
 * C. \$250,000
 D. \$375,000
59. Bob, age 47, has worked for XYZ Company the past 12 years. XYZ Company has lost a major contract and must begin downsizing immediately. Bob was laid off yesterday. What should Bob do first?
- * A. file for unemployment benefits
 B. rollover his company 401(k) plan
 C. convert disability coverage under COBRA provisions
 D. notify the bank holding the mortgage on his house
60. Which of the following statements concerning the choice of an entity versus a cross-purchase partnership buy-sell agreement funded with insurance is false?
- * A. The use of existing insurance to fund the agreement causes a transfer-for-value problem if an entity agreement is selected, but does not cause this problem if a cross-purchase approach is used.
 B. A cross-purchase should be selected if the surviving partners expect to sell their interests during their lifetimes.
 C. An entity approach may solve the affordability problem if one partner is significantly older than the others.
 D. An entity agreement becomes more desirable as the number of partners included in the agreement increases.

Directions: This part consists of combination items. Each item contains a question or incomplete statement followed by a list of numbered responses. Select one best answer for each item that includes the correct combination of responses from the numbered list.

61. A tenancy by the entirety may be terminated in which of the following ways?
- (1) death, whereby the survivor takes the entire estate
 - (2) mutual agreement
 - (3) divorce, which converts the estate into a tenancy in common or a joint tenancy
 - (4) severance, whereby one spouse transfers his or her interest to a third party without the consent of the other spouse
- A. (4) only
 - B. (1) and (3) only
 - C. (2) and (4) only
 - * D. (1), (2), and (3) only
 - E. (1), (2), (3), and (4)
62. Which of the following investment vehicles are most appropriate for an emergency fund for a family with \$12,000 a year discretionary income?
- (1) balanced mutual fund
 - (2) line of credit
 - (3) money market mutual funds
 - (4) ladder CD's set to mature every 6 months
- A. (1) and (2) only
 - B. (2) and (4) only
 - * C. (3) and (4) only
 - D. (1), (2), and (3) only
63. Mortgage-backed securities may contain which of the following risks?
- (1) purchasing power risk
 - (2) interest rate risk
 - (3) prepayment risk
- A. (2) only
 - B. (1) and (2) only
 - C. (1) and (3) only
 - * D. (1), (2), and (3)
64. Alisha Sheridan, a CFP licensee and fee-only financial planner, has assisted Roger Regate, a self-employed physician, in tax and investment planning during the year. Identify the schedule(s) on which Alisha's fee may be deductible by Roger on his federal income tax return.
- (1) Schedule A--itemized deductions
 - (2) Schedule C--profit or loss from business
 - (3) Schedule D--capital gains and losses
- A. (1) only
 - B. (2) only
 - C. (3) only
 - * D. (1) and (2) only
 - E. (1), (2), and (3)
65. Which of the following statements is/are characteristics of tax-sheltered annuities (TSAs)?
- (1) Salary reduction contributions are not reported as W-2 income and are not subject to Social Security tax.
 - (2) Maximum salary deferral limit is \$10,000 for a newly hired employee.
 - (3) Employer contributions are deductible.
 - (4) Loans and "catch-up" contributions may be permitted.
- A. (4) only
 - B. (1) and (3) only
 - * C. (2) and (4) only
 - D. (1), (2), and (3) only
 - E. (1), (2), (3) and (4)

66. A premature distribution from a qualified retirement plan is allowed at age 52 without a 10% additional tax when a participant
- (1) becomes obligated for payment of plan benefits to an alternate payee under a qualified domestic relations order (QDRO).
 - (2) separates from service and takes an accepted form of systematic payment.
 - (3) remains with current employer but elects to take systematic payments over the life of the participant and spouse.
- A. (1) only
 B. (3) only
 * C. (1) and (2) only
 D. (1), (2), and (3)
67. A financial planner's client has an IRA with a balance of \$140,000 as of January 1. On April 15 of the same year, the client withdraws the entire amount from the IRA and places it in a non-IRA CD for 60 days, earning 9% interest. On the 60th day, the client promptly and timely reinvests the principal of the CD in an IRA containing an aggressive growth fund. On September 15 of the same year, the client becomes dissatisfied with the return and the variability of the investment. The client wants a less risky investment and wants assurance that any IRA distribution will not be taxed at the time of the change. Which of the following is/are acceptable alternatives for the client?
- (1) Withdraw the funds and reinvest them within 60 days in an IRA that invests exclusively in Treasury instruments.
 - (2) Direct the trustee of the IRA to transfer the funds to another IRA that invests exclusively in Treasury instruments.
 - (3) Withdraw the funds and reinvest within 60 days in an IRA that is an index mutual fund holding common stocks with portfolio risk equal to the S&P 500.
- A. (1) only
 * B. (2) only
 C. (2) and (3) only
 D. (1), (2), and (3)
68. Your client has the following beliefs about the allocation of forfeitures of contributions to employees who leave the company. Which of the following statements is/are correct?
- (1) Departing plan participants are entitled to their entire account balances regardless of the vesting schedule in effect.
 - (2) Forfeitures could be allocated to plan participants in exactly the same manner as the employer's contributions.
 - (3) Unless specific steps were taken to the contrary, the allocation of forfeitures in this company's plan over time would tend to discriminate in favor of the relatively few longer-hired and more highly-paid employees.
 - (4) The company could use forfeitures to offset amounts it would otherwise contribute to employees' accounts.
- A. (2) only
 B. (1) and (2) only
 C. (1) and (4) only
 D. (3) and (4) only
 * E. (2), (3), and (4) only
69. You receive a phone call from an individual you have not spoken with previously. The caller is excited, just having heard that a new mutual fund is positioned to deliver large gains in the coming year. The caller wishes to purchase shares of the fund through you. Keeping in mind stages of the overall personal financial planning process, which of the following questions that address the first two stages of the financial planning process should you ask the caller?
- (1) What are your goals for this investment?
 - (2) What other investments do you have?
 - (3) What is your date of birth?
 - (4) Do you want your dividends reinvested?
- A. (1) and (3) only
 B. (2) and (4) only
 * C. (1), (2), and (3) only
 D. (1), (2), and (4) only

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".

70. Which of the following are exemptions under the definition of "investment adviser"?
- (1) banks that are not investment companies
 - (2) accountants or lawyers whose investment advice is "solely incidental" to the practice of their profession
 - (3) persons whose advice relates only to securities issued or guaranteed by the U.S. government
 - (4) publishers of financial publications that have regular and general circulation
- A. (1) and (3) only
 - B. (2) and (4) only
 - C. (1), (2), and (4) only
 - * D. (1), (2), (3), and (4)
71. A local businessperson approaches a CFP licensee for assistance with an investment-related tax problem. The client's previous tax preparer had suggested the purchase of a variety of tax-advantaged investments to reduce the client's current and future tax burden. Time passed, the client's income dropped, and the tax laws changed. The client does not feel the tax preparer misrepresented the situation on the initial sale, but would still like to know what recourse is available with respect to the tax preparer. The CFP licensee should
- (1) explain to the client that this issue is beyond the scope of the CFP licensee's professional expertise.
 - (2) advise the client that no recourse is available.
 - (3) advise the client to contact an attorney.
 - (4) contact the tax preparer.
- A. (4) only
 - * B. (1) and (3) only
 - C. (2) and (4) only
 - D. (1), (2), and (3) only
72. Terry Underwood purchased a 15-year-old compact car with 100,000 miles for his teenage son who recently received his license. Which of the following auto insurance coverages should be included in the policy for this auto?
- (1) Part A - liability coverage
 - (2) Part B - medical payments coverage
 - (3) Part C - uninsured motorist coverage
 - (4) Part D - damage to insured's auto
- * A. (1), (2), and (3) only
 - B. (1), (2), and (4) only
 - C. (1), (3), and (4) only
 - D. (2), (3), and (4) only
73. In selecting insurance coverage for a client, the prudent planner should consult which of the following independent sources for determining company strength?
- (1) A.M. Best Reports
 - (2) Standard and Poor's
 - (3) Moody's Investors Services
 - (4) Dun and Bradstreet
- A. (1) and (3) only
 - B. (1) and (4) only
 - * C. (1), (2), and (3) only
 - D. (2), (3), and (4) only
74. Which of the following credentials permit an individual to appear before the IRS on behalf of a client?
- (1) enrolled agent
 - (2) Certified Public Accountant
 - (3) attorney
 - (4) Certified Financial Planner licensee
- A. (2) and (3) only
 - B. (2) and (4) only
 - * C. (1), (2), and (3) only
 - D. (1), (3), and (4) only

75. The duration of a bond is a function of its
- (1) current price.
 - (2) time to maturity.
 - (3) yield to maturity.
 - (4) coupon rate.
- A. (1) and (3) only
 - B. (2) and (3) only
 - C. (2) and (4) only
 - D. (1), (2), and (3) only
 - * E. (1), (2), (3), and (4)
76. Five years ago, Tom Mohy bought 10,000 shares of stock at \$10 per share in a pharmaceutical company. Today, the stock is worth \$200,000 and is paying a dividend of \$8,000 per year. Tom feels that the stock will continue to appreciate at a rate of 12% per year, including the dividend. Tom wants to establish a college education fund for his two daughters, ages 15 and 9. Which of the following statements is/are true?
- (1) If Tom gives 2,500 shares of stock to his 15-year-old daughter, all dividends from the 2,500 shares will be taxed in her income tax bracket.
 - (2) If Tom gives 2,500 shares of stock to his 9-year-old daughter, all dividends from the 2,500 shares will be taxed at her marginal rate.
 - (3) Two years from now, if Tom's older daughter sells her 2,500 shares of stock at \$30 per share, Tom will need to report the gain as a long-term capital gain on his personal income tax return.
 - (4) All dividend income earned by his 9-year-old daughter which exceeds \$1,400 in 1998 will be taxed at Tom's marginal tax rate.
- A. (2) only
 - B. (1) and (2) only
 - C. (1) and (3) only
 - * D. (1) and (4) only
 - E. (3) and (4) only
77. A client asks you to explain the statement, "Life insurance proceeds are tax-free." You answer that the general rule(s), subject to some exceptions, is/are that death benefits received from a life insurance policy due to the death of the insured are income-tax-free to the beneficiary, but
- (1) are subject to estate taxes in the estate of the insured if the insured owned the policy.
 - (2) may be subject to income taxes if the policy was sold to a third party.
 - (3) not if the contract was modified at purchase.
- A. (1) only
 - B. (2) only
 - * C. (1) and (2) only
 - D. (2) and (3) only
 - E. (1), (2), and (3)

Directions: This part consists of matching sets. Each matching set consists of a list of response options followed by a set of items. Follow the instructions that accompany each set to match the most appropriate response option to each item in the set. A response option may be used once, more than once, or not at all, unless otherwise specified.

- I. You are faced with the following alternative fixed income investments.
- A. a U.S. Treasury bond with an 11.625% coupon, due in 2004 with a price of \$142.50 and a yield to maturity of 6.3%
 - B. a U.S. Treasury strip bond (zero coupon) due in 2004 with a price of \$46.75 and a yield to maturity of 6.25%
 - C. a corporate B-rated bond with a 9.75% coupon, due in 2004 with a price of \$104.75 and a yield to maturity of 8.79%

 A 78. Which of these bonds has the greatest reinvestment rate risk?

 B 79. Which of these bonds has the greatest interest rate risk?

 B 80. Which of these bonds has the longest duration?

- II. Match the charitable trust listed below with the corresponding descriptions in each of the items that follow.

- A. charitable remainder annuity trust (CRAT)
- B. charitable remainder unitrust (CRUT)
- C. both A. and B.
- D. neither A. nor B.

 C 81. income tax advantage, life income

 B 82. estate tax advantage, income from the trust is variable

 A 83. income tax advantage, income from the trust is a sum certain

 D 84. estate tax advantage, immediate income to charity

- III. Investment A costs \$10,000,000 and offers a single cash inflow of \$13,000,000 after 1 year. Investment B costs \$1,000,000 and will be worth \$2,000,000 at the end of the year. The appropriate discount rate or required rate of return is 10% compounded annually. Match the investment(s) listed below with the corresponding financial information in the items that follow.

- A. Investment A
- B. Investment B
- C. Both A and B
- D. Neither A nor B

 D 85. The net present value (NPV) is \$818,182 and the internal rate of return is 30%.

 B 86. The NPV is \$818,182 and the internal rate of return is 100%.

 A 87. The NPV is \$1,818,182 and the internal rate of return is 30%.

IV. Match the investment characteristics listed below with the appropriate type of investment company in the items that follow.

- A. passive management of the portfolios
- B. shares of the fund are normally traded in major secondary markets
- C. both A. and B.
- D. neither A. nor B.

 B 88. closed-end investment companies

 D 89. open-end investment company

 A 90. unit investment trust

THI CONCLUDES THE 1999 RELEASED CASE AND QUESTIONS.