Rattiner's Review FOR THE CFP® Certification Examination FAST TRACK STUDY GUIDE

Second Edition

- Covers the essentials needed to pass the CFP® Certification Examination
- Supplements financial planning classes, texts, and self-study materials
- A one-stop desk reference for all financial services professionals

Jeffrey H. Rattiner

RATTINER'S REVIEW FOR THE CFP® CERTIFICATION EXAMINATION, FAST TRACK, STUDY GUIDE

SECOND EDITION

Jeffery H. Rattiner

John Wiley & Sons, Inc.

Rattiner's Review for the CFP® Certification Examination, Fast Track, Study Guide

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Best of luck to all my students!

Jeffrey H. Rattiner, CPA, CFP®, MBA

CHAPTER 1

GENERAL PRINCIPLES OF FINANCIAL PLANNING

TOPIC 1: FINANCIAL PLANNING PROCESS

1. Purpose, benefits, and components

A. The purpose of financial planning is to provide sound, coordinated financial advice to individuals and their families.

2. Steps

A. Establishing client-planner relationships sets the expectations of the parties and lays the groundwork for developing the trust necessary for successful financial planning

(1) Identifying the service(s) to be provided
(2) Disclosing the financial planning practitioner's compensation arrangement(s)
(3) Determining the client's and the financial planning practitioner's responsibilities
(4) Establishing the duration of the engagement
(5) Providing any additional information necessary to define or limit the scope of the process

B. Gathering client data and determining goals and expectations. A financial plan is only as good as the data collected and the assumptions on which that data are based. Both quantitative and qualitative data are used to establish a client's goals and objectives.

(1) Quantitative data tells you where the client is and what it will take to get the client to a specific financial goal.
(2) Quantitative data is found using a fact-finding questionnaire. Qualitative data tells you why the client wants to reach the goal, what will make him or her work toward it, and what the client is not likely to do. Qualitative data is obtained by conducting a goals and objectives interview.
(3) Goals are broad-based projections of a client's aspirations. For example, a client's goal may be to retire rich.
(4) Objectives are quantifiable ways of achieving goals over a specified time period. For example, saving $5 million by age 65 is an objective, whereas retiring rich is the goal.

C. Determining the client's financial status by analyzing and evaluating his or her general financial status, special needs, insurance and risk management, investments, taxation, employee benefits, retirement, and/or estate planning
D. Developing and presenting the financial plan
E. Implementing the financial plan
F. Motivate the client. Draw on outside experts as needed.
G. Monitoring the financial plan

(1) Evaluate the performance. Review changes in client's circumstances and tax laws. Revisit other steps as necessary.

3. Responsibilities

(1) Financial planner. Evaluate client needs, explain financial planning concepts and clarify client goals, analyze client circumstances and prepare financial plans, and implement and monitor financial plans.
(2) Client. Express concerns, hopes, and goals; do not procrastinate; be honest with your answers to questions; live within your current income and do not live up to or beyond it; be open to formulating a financial plan and identifying strategies to reach goals and objectives.
(3) Other advisors. The planner may seek out the help of others when implementing the financial plan. Their responsibilities fall within the realm of their expertise.

TOPIC 2: CFP BOARD'S CODE OF ETHICS AND PROFESSIONAL RESPONSIBILITY AND DISCIPLINARY RULES AND PROCEDURES

The following contains wording from both the *Code of Ethics and Professional Responsibility and Disciplinary Rules and Procedures* (© 2006 by Certified Financial Planner Board of Standards, Inc.). It is strongly suggested by this author that all candidates for the CFP® examination read their own copies of the original *Code of Ethics and Professional Responsibility and Disciplinary Rules and Procedures*. These materials can be obtained from the CFP Board's Web site at www.CFP.net.

1. **Code of Ethics and Professional Responsibility**

   A. Preamble and applicability

      (1) The Code of Ethics and Professional Responsibility (Code of Ethics) has been adopted by the Certified Financial Planner Board of Standards, Inc. (CFP Board) to provide principles and rules to all persons whom it has recognized and certified to use the CFP certification mark and the marks CFP® and CERTIFIED FINANCIAL PLANNER™.

      (2) This Code of Ethics also applies to candidates for the CFP® certification who are registered as such with CFP Board.

   B. Composition and scope

      (1) The Code of Ethics consists of two parts: Part I, "Principles," and Part II, "Rules."

         (a) The Principles are statements expressing in general terms the ethical and professional ideals that CFP Board designees are expected to display in their professional activities. As such, the Principles are intended to provide a source of guidance for CFP Board designees.

         (b) The Rules describe the standards of ethical and professionally responsible conduct expected of CFP Board designees in particular situations.

      (2) Because of the nature of a CFP Board designee's particular field of endeavor, certain rules may not be applicable to that CFP Board designee's activities.

   C. Compliance—The CFP Board requires adherence to this Code of Ethics by all CFP Board designees.

   D. Terminology

      (1) *Client* denotes a person, persons, or entity who engages a practitioner and for whom professional services are rendered.

      (2) *CFP Board designee* denotes current certificate, candidates for certification, and individuals who have any entitlement, direct or indirect, to the CFP certification marks.

      (3) *Commission* denotes the compensation received by an agent or broker when the same is calculated as a percentage on the amount of his or her sales or purchase transactions.

      (4) *Compensation* is any economic benefit a CFP Board designee or related party receives from performing his or her professional duties.

      (5) *Conflicts of interest* exist when a CFP Board designee's financial, business, property, and/or personal interests, relationships, or circumstances reasonably may impair his or her ability to offer objective advice, recommendations, or services.

      (6) *Fee-only* denotes a method of compensation in which compensation is received solely from a client with neither the personal financial planning practitioner nor any related party receiving compensation that is contingent upon the purchase or sale of any financial product.

(7) *Financial planning engagement* exists when a client, based on the relevant facts and circumstances, reasonably relies upon information or services provided by a CFP Board designee using the financial planning process.
(8) *Personal financial planning* or *financial planning* denotes the process of determining whether and how an individual can meet his or her life goals through the proper management of financial resources.
(9) *Personal financial planning process* or *financial planning process* denotes a process that typically includes, but is not limited to, these six elements: establishing and defining the client-planner relationship; gathering client data, including goals; analyzing and evaluating the client's financial status; developing and presenting financial planning recommendations and/or alternatives; implementing the financial planning recommendations; and monitoring the financial planning recommendations.
(10) *Personal financial planning subject areas* or *financial planning subject areas* denotes the basic subject fields covered in the financial planning process, which typically include, but are not limited to, financial statement preparation and analysis (including cash flow analysis/planning and budgeting), investment planning (including portfolio design, i.e., asset allocation and portfolio management), income tax planning, education planning, risk management, retirement planning, and estate planning.
(11) *Personal financial planning professional* or *financial planning professional* denotes a person who is capable and qualified to offer objective, integrated, and comprehensive financial advice to or for the benefit of individuals to help them achieve their financial objectives.

E. Principles—Part I. The Code of Ethics Principles apply to all CFP Board designees and provide guidance to them in the performance of their professional services.

Principle 1: Integrity
Principle 2: Objectivity
Principle 3: Competence
Principle 4: Fairness
Principle 5: Confidentiality
Principle 6: Professionalism
Principle 7: Diligence

F. Rules—Part II. As stated in Part I, the Principles apply to all CFP Board designees. However, certain rules may not be applicable to a CFP Board designee's activities. The universe of activities engaged in by a CFP Board designee is indeed diverse. When considering the Rules, a CFP Board designee must first recognize the specific services he or she is rendering and then determine whether a specific Rule is applicable to those services. The Code of Ethics includes definitions to help a CFP Board designee determine which services he or she provides and which Rules are applicable to those services.

(1) Rules that relate to the Principle of Integrity:

(a) Rule 101. Do not solicit clients through false or misleading communications or advertisements.
(b) Rule 102. Do not engage in conduct involving dishonesty, fraud, deceit, or misrepresentation.
(c) Rule 103. This rule lists the specific responsibilities a Board designee has to his or her clients.

(i) Act in accordance with the authority set forth in the governing legal instrument (e.g., special power of attorney, trust, letters testamentary, etc.).
(ii) Identify and keep complete records of all funds or other property of a client.
(iii) Deliver any funds or other property that the client or third party is entitled to receive, and render a full accounting regarding such funds or other property.
(iv) Do not commingle client funds or other property with the CFP Board designee's personal funds or property. Two or more clients' funds or other property may be commingled, subject to compliance with applicable legal requirements and maintenance of accurate records.
(v) Show the care required of a fiduciary.

(2) Rules that relate to the Principle of Objectivity:

(a) Rule 201. Exercise reasonable and prudent professional judgment.
(b) Rule 202. Act in the interest of the client.

(3) Rules that relate to the Principle of Competence:

(a) Rule 301. Keep informed of developments in the field of financial planning and participate in continuing education.
(b) Rule 302. Offer advice only in those areas in which the CFP Board designee has competence. In areas where the CFP Board designee is not professionally competent, the CFP Board designee shall seek the counsel of qualified individuals and/or refer clients to such parties.

(4) Rules that relate to the Principle of Fairness:

(a) Rule 401. Disclose to the client all material information, such as conflict(s) of interest(s), changes in business affiliation, address, telephone number, credentials, qualifications, licenses, compensation structure, and any agency relationships. The information required by all laws applicable to the relationship in a manner complying with such laws
(b) Rule 402. A CFP Board designee shall make timely written disclosure of all material information relative to the professional relationship. In all circumstances such disclosure shall include conflict(s) of interest(s) and sources of compensation. Written disclosures that include the following information are considered to be in compliance with this rule: Rule 301. Keep informed of developments in the field of financial planning and participate in continuing education.
(c) Rule 403. Communicate CFP Board designee's compensation if client requests.
(d) Rule 404. Make disclosures annually for current clients, and provided if requested.
(e) Rule 405. Compensation must be fair and reasonable
(f) Rule 406. CFP Board designee shall perform professional services in accordance with the employer's objectives and in accordance with the Code of Ethics.
(g) Rule 407. ACFP Board designee shall: Advise an employer of outside affiliations that may reasonably compromise service to an employer. Provide timely notice to the employer and clients, unless precluded by contractual obligation, in the event of change of employment or CFP Board certification status.
(h) Rule 408. A CFP Board designee must disclose to an employer any compensation or other benefit arrangements in connection with his or her services to clients that are in addition to compensation from the employer.

(i) Rule 409. If a CFP Board designee enters into a business transaction with a client, the transaction shall be on terms that are fair and reasonable to the client.

(5) Rules that relate to the Principle of Confidentiality:

(a) Rule 501. Do not reveal, without the client's consent, any personally identifiable information relating to the client relationship, except when use is reasonably necessary: to establish an advisory or brokerage account, to effect a transaction for the client, or as otherwise impliedly authorized in order to carry out the client engagement. To comply with legal requirements or legal process to defend the CFP Board designee against charges of wrongdoing in connection with a civil dispute between the CFP Board designee and the client.
(b) Rule 502. Maintain the same standards of confidentiality to employers as to clients.
(c) Rule 503. Adhere to reasonable expectations of confidentiality while in business and thereafter.

(6) Rules that relate to the Principle of Professionalism:

(a) Rule 601. Use the marks in compliance with the rules and regulations of CFP Board (see Topic 2, Section 1.A.(1)).
(b) Rule 602. Show respect for other financial planning professionals and related occupational groups by engaging in fair and honorable competitive practices.
(c) Rule 603. Inform the CFP Board when another CFP Board designee has committed a violation of the Code of Ethics and there is no substantial doubt.
(d) Rule 604. Inform the appropriate regulatory and/or professional disciplinary body when there is unprofessional, fraudulent, or illegal conduct by another CFP Board designee or other financial professional and there is no substantial doubt.
(e) Rule 605. Disclose illegal conduct to the immediate supervisor and/or partners if illegal conduct is suspected. If appropriate measures are not taken to remedy the situation, alert the appropriate regulatory authorities, including the CFP Board, in a timely manner.
(f) Rule 606. In all professional activities, a CFP Board designee shall perform services in accordance with:

(7) Applicable laws, rules, and regulations of governmental agencies and other applicable authorities; applicable rules, regulations, and other established policies of the CFP Board

(a) Rule 607. Do not engage in any conduct that reflects adversely on the profession.
(b) Rule 608. Disclose to clients the firm's status as registered investment advisers. It is proper to use the term *registered investment adviser* if the CFP Board designee is registered individually. If the CFP Board designee is registered through his or her firm, then the firm is the registered investment adviser.
(c) Rule 609. A CFP Board designee must not practice any other profession or offer to provide such services unless the CFP Board designee is qualified to practice in those fields and is licensed as required by state law.
(d) Rule 610. Return the client's original records in a timely manner upon request of the client.
(e) Rule 611. Do not bring or threaten to bring a disciplinary proceeding under this Code of Ethics or report or threaten to report information to CFP Board pursuant to

Rules 603 and/or 604 for no substantial purpose other than to harass, embarrass, and/or unfairly burden another CFP Board designee.

(f) Rule 612. Comply with all applicable renewal requirements established by CFP Board.

(8) Rules that relate to the Principle of Diligence:

(a) Rule 701. Provide services diligently.
(b) Rule 702. Enter into an engagement only after securing sufficient information to satisfy the CFP Board designee that: The relationship is warranted by the individual's needs and objectives. The CFP Board designee has the ability to either provide requisite competent services or to involve other professionals who can provide such services.
(c) Rule 703. Implement only recommendations that are suitable for the client.
(d) Rule 704. Make a reasonable investigation regarding the financial products recommended to clients.
(e) Rule 705. Supervise subordinates with regard to their delivery of financial planning services.

2. Disciplinary Rules and Procedures

A. The Board of Professional Review is charged with the duty of investigating, reviewing, and taking appropriate action with respect to alleged violations of the Code of Ethics and alleged noncompliance with the Financial Planning Practice Standards.

TOPIC 3: CFP BOARD'S FINANCIAL PLANNING PRACTICE STANDARDS

Can divide the Board into two panels consisting of an Inquiry Panel and a Hearing Panel and designate a chair for each panel. No member of an Inquiry Panel shall act as a member of a Hearing Panel on the same matter.

1. Inquiry Panel

A. Investigates alleged grounds for discipline, with appropriate assistance from members of CFP Board staff; can dismiss allegations as being without merit, dismiss allegations with a letter of caution recommending remedial action and entering other appropriate orders, or refer the matter to CFP Board for preparation and processing of a complaint against the CFP Board designee. All answers to complaints shall be in writing. The answers shall be submitted within 20 calendar days from the date of service of the complaint upon the CFP Board designee. If the CFP Board designee fails to file an answer within the period provided, such CFP Board designee shall be deemed to be in default and the allegations set forth in the complaint shall be deemed admitted.

2. Hearing Panel

A. Conducts all hearings on complaints seeking disciplinary action against a CFP Board designee; reports its findings and recommendations to the Board for final decision; appeals must be made within 30 calendar days after notice of the order is sent to the CFP Board designee, or such order shall be final. Appeals must be made within 30 calendar days after notice of the order is sent to the CFP Board designee or such order shall be final.

3. Purpose and applicability

A. Staff counsel—maintains a central office for the filing of requests for the investigation of CFP Board designee conduct, for the coordination of such investigations, for the administration of all disciplinary enforcement proceedings carried out pursuant to these procedures, for the prosecution of charges of wrongdoing against CFP Board designees pursuant to these procedures, and for the performance of such other duties as are designated by the Board or the chief executive officer of CFP Board.

B. Content of each series (use most current Practice Standards, as posted on CFP Board's Web site at www.CFP.net)

4. Enforcement through Disciplinary Rules and Procedures

A. The following are grounds for discipline:

(1) Any act or omission that violates the provisions of the Code of Ethics
(2) Any act or omission that fails to comply with the Practice Standards
(3) Any act or omission that violates the criminal laws of any state or of the United States or of any province, territory, or jurisdiction of any other country
(4) Any act that is the proper basis for professional suspension
(5) Failure to respond to a request by the Board, without good cause shown
(6) Any false or misleading statement made to CFP Board

B. Forms of discipline

(1) No action. In cases where no grounds for discipline have been established, the Board may dismiss the matter either as being without merit or with a cautionary letter.
(2) Continuing education. The Board has the right to require CFP Board designees to complete additional continuing education or other remedial work.
(3) Private censure. The Board may order private censure of a CFP Board designee (i.e., an unpublished written reproach mailed by the Board to a censured CFP Board designee).
(4) Public Letter of Admonition. The Board may order that a Letter of Admonition be issued against a CFP Board designee (i.e., a publishable written reproach of the CFP Board designee's behavior).
(5) Suspension. The Board may order suspension for a specified period of time, not to exceed five years, for those individuals it deems can be rehabilitated. CFP Board designees receiving a suspension may qualify for reinstatement to use the marks.

TOPIC 4: FINANCIAL STATEMENTS

1. Personal

A. Statement of financial position

(1) A balance sheet is a statement of financial position. It is a financial snapshot of the individual's wealth at a moment in time. It contains three categories: (1) assets, (2) liabilities, and (3) net worth. Net worth measures the client's wealth or equity at a specified period of time (i.e., net worth equals total assets minus total liabilities).

(a) Net worth increases from the following:

(i) Appreciation in the value of assets
(ii) Increase in assets from retaining income
(iii) Increase in assets from gifts or inheritances

(iv) Decrease in liabilities through forgiveness

(b) Net worth is unchanged by the following:
(i) Paying off debt
(ii) Buying an asset with cash

(c) Assets and liabilities are indicated at fair market value (FMV), footnotes are used to describe details of assets and liabilities, and property is identified by type of ownership.

(d) Assets are categorized as (1) cash and cash equivalents (checking and savings account, money markets), (2) invested assets (stocks, bonds, mutual funds), and (3) use assets (home, furnishings, cars).

(e) Liabilities are categorized as (1) current liabilities (credit card balances) and (2) long-term liabilities (auto loans, real estate mortgages, life insurance loans).

(2) Statement of cash flow

(a) Must indicate the period of coverage, usually a calendar year

(i) Step 1. Estimate the family's annual income.
(ii) Step 2. Develop estimates for both fixed and discretionary expenses.
(iii) Step 3. Determine the excess of shortfall of income within the budget period. Net cash flow equals total income minus total expenses. If net income is positive, the client can increase discretionary expenses.
(iv) Step 4. Consider available methods of increasing income or decreasing expenses.
(v) Step 5. Calculate income and expenses as a percentage of the total to determine a better allocation of resources.

2. Business

A. Balance sheet
B. Income statement
C. Statement of cash flows
D. Pro forma statements

(1) Pro forma statements forecast future balance sheets and cash flow statements. It may make sense to include three different cash flow statements: (1) worst-case budget, based on lowest income and highest expenditures expected, (2) average-case budget, based on reasonable expectations of income and expenses, and (3) best-case budget, based on highest income and lowest expenditures.

TOPIC 5: CASH FLOW MANAGEMENT

1. Budgeting

A. There are two types of budgeting: discretionary and nondiscretionary. Discretionary expenses are flexible and can be prevented or timed. Nondiscretionary or fixed expenses can be changed, but must be paid. Various strategies are used to maximize income and minimize expenses:

2. Budgeting strategies

A. Debt restructuring: The process of paying off all outstanding credit cards by consolidating debt into one low personal line of credit

B. Asset reallocation: This process involves the change in assets from underperforming assets to more productive investment assets to improve return and income.
C. Expenditure control: The process of reducing consumption expenditures by emphasizing the savings element
D. Income tax planning: Process of benefiting from proper tax planning incorporating children's assets. The process of saving for a child in a custodial account or trust to benefit from the lower tax rate of the child
E. Qualified plan vehicles: The process of utilizing a qualified plan to benefit from saving programs and deductibility
F. Financing strategies: Consolidating credit card debt and student loan debt
G. Cash-out refinancing: A cash-out refinance will give a new first mortgage by paying off the current first mortgage and provide additional cash. If current mortgage rates are lower than that of the existing first mortgage, a new first mortgage will allow the borrower to save on the current debt. The combined loan to value of 80 percent is recommended to avoid mortgage insurance. Interest is tax deductible, as with all home mortgages.
H. Home equity loans or a home equity line of credit:
I. Loans on the cash value of a life insurance policy: Interest rate charges are generally less than for personal or credit card loans.
J. Tapping into a company savings plan
K. Using after-tax money from a Roth IRA: Tap into money that can be taken out without penalty or tax consequences.

3. Savings Strategies

A. Goal setting: Goals should be realistic and agreed upon by the family.
B. Self-rewarding plan: If a family exceeds the savings goal, they should spend the extra savings on themselves.
C. Savings-first approach: Save first and pay cash to avoid high interest charges on loans and to earn interest by investing the savings. Automatic savings plan. Deduct directly from a paycheck and invest the funds in savings. This includes dollar cost averaging into mutual funds and contributions to company retirement plans.

4. Emergency Fund Planning

A. Adequacy of reserves—Three to six months of monthly expenses is typically a reasonable range. For one-income families, a six-month level may be more appropriate. For two-income families, a three-month level may be adequate.

B. Liquidity versus marketability

(1) Marketability: The ease with which an asset may be bought or sold
(2) Liquidity: The ease with which assets can be converted into cash with little risk of loss of principal. Real estate is considered illiquid because it may take a while to sell and the asking price may be lowered. However, real estate is marketable because it is relatively easy to sell a house if priced below market value.
(3) Liquidity substitutes: Checking and savings accounts, money market accounts, U.S. Treasury bills, certificates of deposit (CDs), cash value of a life insurance policy, company savings plan, and home equity loans.

5. Debt Management Ratios

A. The client should have sufficient liquid assets for an emergency fund (generally three to six months of fixed and variable outflows).

B. Rule of thumb: Consumer debt, such as credit cards, auto loans, and the like, should not exceed 20 percent of net income (gross income – taxes).
C. Rule of thumb: Monthly payments on a home (including principal, interest, taxes, and insurance) should be no more than 28 percent of the owner's gross income. This is known as the housing payment ratio.
D. Rule of thumb: Total monthly payment on all debts should be no more than 36 to 38 percent of gross monthly income (principal interest taxes insurance [PITI], credit payments, alimony, child support, and maintenance). This is known as the total payment ratio. Renter's expenses divided by gross income = 30 percent.
E. Preferably more than one source of income. If there is only one source of income, greater planning is required. Having many sources of income creates greater financial stability. Savings and investments of at least 5 to 10 percent of gross income, not including reinvested dividends and income, are recommended.

(1) Consumer debt

(a) Types of consumer debt: (1) thirty-day or regular charge accounts; (2) revolving and optional charge accounts; (3) installment purchases or time-payment plans.
(b) Two methods: (1) buying on time from the seller or (2) borrowing money from credit institution, usually in the form of credit cards.
(c) Sources of consumer credit—commercial banks, consumer finance companies, credit unions, savings and loan associations, life insurance companies (cash value), brokerage companies (margin), and auto dealers (auto financing).

(2) Housing costs

(a) Home equity loan and home equity line of credit: A home equity loan is cash that is given up front (interest charged from start) at a fixed interest rate. In contrast, a home equity credit line allows the individual to use the money only when needed (no interest charged until used), but at a variable rate that is usually tied to the prime rate. Keep the current first mortgage and get a second loan for the necessary cash amount. If current mortgage rates are higher than that of the existing first mortgage, a home equity loan will allow the borrower to keep the current low first mortgage rate. Interest is fully tax deductible on home equity loans up to $100,000.

(3) Total debt

6. **Savings strategies**

TOPIC 6: FINANCING STRATEGIES

1. **Long-term vs. short-term debt**

A. Certain debts that cannot be discharged in Chapter 7 can be discharged in Chapter 13. Chapter 13 is often preferable to chapter 7 because it enables the debtor to keep a valuable asset, such as a house.

2. **Secured vs. unsecured debt**

A. Property of the estate: Property that is not exempt; property of the estate is usually sold by the trustee, and the claims of creditors are paid from the proceeds.
B. Qualified retirement plans: The Supreme Court held that retirement plans that have a legally enforceable anti-alienation clause (a provision preventing creditors from attacking the retirement funds of a debtor) are not property of the estate and thus are not subject to the

jurisdiction of the bankruptcy court and cannot be accessed to pay creditors. Nearly all pensions and 401(k) savings plans that are qualified under Employee Retirement Income Security Act (ERISA), the federal pension savings act, have an anti-alienation clause that excludes them from the bankruptcy estate. An exception to this rule is retirement plans that have only one participant, such as single employee corporate plans, and some other plans originating in self-employment.

C. Tax-advantaged saving plans: When retirement savings are property of the estate, because they are not ERISA qualified or because they are held in an IRA, they may be exempted from the estate under the available exemption statutes. Property that is exempt is removed from the estate and is not liable for the payment of creditor claims. The exact scope of the exemption and how much value can be exempted depends on the language of the exemption selected under state law.

D. Exemptions: Exemptions are the lists of the kinds and values of property that is legally beyond the reach of creditors or the bankruptcy trustee. Exemptions constitute the one area in which bankruptcy law varies from state to state. Congress created a set of exemptions in the Bankruptcy Code but allowed each state to opt out of those exemptions in favor of the state exemptions. Sixteen states allow debtors to elect the Bankruptcy Code exemptions. In those states, debtors have a choice between the federal exemptions and those in the law of their state. For the rest of the states, only the state exemptions can be selected.

E. Dischargeable versus nondischargeable: A discharge releases the debtor from personal liability for discharged debts and prevents the creditors owed those debts from taking any action against the debtor or his or her property to collect the debts. Most unsecured debt is dischargeable. Most secured debt (liens and mortgages) survives bankruptcy as a charge on the property to which it attaches unless a court order modifies the lien. The following debts cannot be discharged in either Chapter 7 or Chapter 13. If you file for Chapter 7, you will still be responsible for repaying these debts after your discharge. If you file for Chapter 13, these debts will have to be paid in full in your plan. If they are not, the balance will remain at the end of your case: debts you forget to list in your bankruptcy papers, unless the creditor learns of your bankruptcy case; child support; alimony; debts for personal injury or death caused by driving while intoxicated; student loans, unless it would be an undue hardship for you to repay fines and penalties for violating the law, including traffic tickets and criminal restitution; recent income tax debts (past three years) and all other tax debts; certain long-term obligations (such as a home mortgage). The following debts may be declared nondischargeable by a bankruptcy judge in Chapter 7 if the creditor challenges your request to discharge them: debts you incurred on the basis of fraud; credit purchases of $1,150 or more for luxury goods or services made within 60 days of filing; loans or cash advances of $1,150 or more taken within 60 days of filing; debts resulting from willful or malicious injury to another person or another person's property; debts arising from embezzlement, larceny, or breach of trust; debts you owe under a divorce decree or settlement, unless after bankruptcy you would still not be able to afford to pay them or the benefit you would receive by the discharge outweighs any detriment to your ex-spouse (who would have to pay them if you discharge them in bankruptcy). Alternatives—debt consolidation, debt negotiation, and home equity loans or line of credit.

3. Consumer protection laws

A. Federal Trade Commission (FTC): The Commission has enforcement and administrative responsibilities under 46 laws. Statutes relate to competition and consumer protection missions.

B. Consumer protection mission of the FTC

(1) Truth in Lending Act: Title I of the Consumer Credit Protection Act requires all creditors who deal with consumers to make certain written disclosures concerning all finance charges and related aspects of credit transactions (including disclosing finance charges expressed as an annual percentage rate).

(2) Fair Credit Billing Act: This amendment to the Truth in Lending Act protects the borrower in the event a credit card is lost or stolen to a maximum loss of $50 per card or until the card has been reported as missing if less; prohibits creditors from taking actions that adversely affect the consumer's credit standing until an investigation is completed.

(3) Equal Credit Opportunity Act: Title VII of the Consumer Credit Protection Act prohibits discrimination on the basis of race, color, religion, national origin, sex, marital status, age, receipt of public assistance, or good faith exercise of any rights under the Consumer Credit Protection Act. The Act also requires creditors to provide applicants, upon request, with the reasons underlying decisions to deny credit.

4. Buy vs. lease/rent

A. Buying or leasing an automobile

(1) To buy: For business use, taxpayers who own an auto can choose the standard mileage rate in the first year and switch to actual expense method in a later year if it becomes more favorable. Taxpayers who lease an auto can choose the standard mileage rate in the first year, but must use it for the life of the auto. Consumer intends to keep the auto for more than four years. Auto is driven for more than 15,000 miles per year. Lease contracts generally have a 15,000 limit and charge for excess miles. Consumer has cash for the purchase or down payment.

(2) To lease: Lower monthly payments with little or no down payment. This leaves more cash to invest elsewhere, such as business or investments. Leasing is suited for individuals who desire a new car every two or three years and who would borrow to pay for a new car. The trade-in value would be less than the loan value, resulting in a loss.

(3) Service, convenience, and flexibility: Taxpayer needs or desires a high-priced vehicle for business use. Tax advantages of leasing over buying increase with a car's value and percentage of business use.

(4) Off-balance-sheet financing for business: For business use, taxpayers who trade in autos every three years or less usually end up with a realized loss that cannot be deducted. The taxpayer's basis (after limited depreciation deductions) exceeds the trade-in value, but the loss is not recognized, because of Section 1031 like-kind exchange rules. For business use, the cost of interest is included in the lease payments (the entire payment is 100 percent deductible). Interest is not deductible for employees who purchase their vehicles.

B. Buying a house or leasing (renting)

(1) The most common reason for renting instead of buying is the lack of funds for a down payment; buying a home offers many advantages: There are tax advantages with home ownership; creditors look more favorably on homeowners; a residence's monthly housing costs tend to be more stable than the cost of renting; renting may make sense if the stay is short term.

(2) Adjustable and fixed rate loans: Fixed rate loans have a stated interest rate that lasts for the term of the loan and are more appropriate for clients with a low tolerance for risk.

Adjustable rate loans have provisions that permit the lender to change the interest rate periodically. If the time expected to be in a house is short term, an adjustable rate mortgage (ARM) may be preferred to a fixed rate mortgage because of lower initial interest rates resulting in the lowest current payment. This assumes the client has a higher risk tolerance for a variable rate. An ARM with a 2/6 cap indicates a 2 percent maximum interest rate increase per year, 6 percent life of loan. In a low or increasing interest rate environment, a client is best served using a fixed rate loan. In contrast, in a high or decreasing interest rate environment, the client may be best served with a variable rate loan.

C. Effect on financial statements

(1) Balance sheet effect: Leased or rented assets have no entry except to the extent that a lump sum may have been taken from one of the listed assets as an initial payment to secure the leased asset. An initial payment results in a cash decrease and a decrease in net worth. There is no debt, so there is no asset. Purchased assets with 100 percent cash—reduce cash but add in the asset by the same amount—result in no change to net worth. Purchased assets with loan—result in a reduction of cash or other liquid asset that was used for the purchase or down payment. If there is a loan that was secured in order to purchase the asset, it will show up as a liability. This results in no change to net worth. For example, assume $5,000 cash is used as a down payment to purchase a car valued at $10,000, and the remaining $5,000 is financed through an auto loan. The effect is a $5,000 increase in assets ($10,000 market value of car minus $5,000 decrease in cash) and a $5,000 increase in liabilities (loan amount).

5. Mortgage financing

A. Conventional vs. adjustable-rate mortgage (ARM)
B. Home equity loan and line of credit
C. Refinancing cost-benefit analysis
D. Reverse mortgage

TOPIC 7: FUNCTION, PURPOSE, AND REGULATION OF FINANCIAL INSTITUTIONS

1. Banks

A. Primary depository for checking accounts and short-term financing for corporations; insured by the Federal Deposit Insurance Corporation (FDIC)

2. Credit unions

A. Primary depository for checking accounts and short-term financing for corporations; nonprofit, cooperative financial institutions owned and run by members; members pool their funds to make loans to one another. The members elect the volunteer board that runs each credit union. Depositors benefit from earnings—in the form of dividends—after operating expenses are paid and reserve requirements are satisfied. Credit unions are organized to serve people in a particular community, group or groups of employees, military, or members of an organization or association. They are insured by the National Credit Union Administration (NCUA), an agency of the United States government, for losses up to $100,000.

3. **Brokerage companies**

   A. Primary depositories for investment accounts that trade stocks. The distinction between brokerage firms and banks has become blurred; however, the Glass-Steagall Act of 1933 forbids banks from underwriting corporate securities. Insured by the Securities Investor Protection Corporation (SIPC).

4. **Insurance companies**

   A. Primary places for obtaining life, health, property, and disability insurance. In the McCarran-Ferguson Act, Congress reaffirmed the right of the federal government to regulate insurance, but agreed it would not exercise this right as long as the industry was adequately regulated by the states. In effect, the law explicitly grants the states the power to regulate the insurance business. The National Association of Insurance Commissioners (NAIC) is composed of the commissioners of insurance from all states. It has no legal power over insurance regulation, but the Commissioner of Insurance in each state is charged with the administration of the state's insurance laws and operations and recommends legislation.

5. **Mutual fund companies**

   A. Primarily start open-end and closed-end mutual funds and sell these to the investing public, but some offer other services like the sale of stocks and bonds; insured by the SIPC.

6. **Trust companies**

   A. Savings and loans: Primarily a source for mortgage loans; insured by the FDIC. FDIC reimburses the depositor for any losses up to $100,000; a depositor does not have to be a U.S. citizen or even a resident of the United States. Protects deposits that are payable in the United States. Deposits payable only overseas are not protected. All types of deposits received by a financial institution in its usual course of business are insured. FDIC does not insure Treasury securities. Deposits in different institutions are insured separately. If an individual deposits at the main office and at one or more branch offices of the same institution, the deposits are added together in calculating deposit insurance coverage. Deposits maintained in different categories of legal ownership are separately insured. A depositor can have more than $100,000 insurance coverage in a single institution. Joint accounts are insured separately from single-ownership accounts. IRA and Keogh funds are separately insured from any nonretirement funds the depositor may have at an institution. If a depositor has both a Roth IRA and a traditional IRA at an insured depository institution, the funds in those accounts would be added together. The new limit for IRA FDIC insurance is $250,000. SIPC protects customers of broker-dealers as long as the broker-dealer is an SIPC member. If an SIPC member's registration with the U.S. Securities and Exchange Commission is terminated, the broker-dealer's SIPC membership is also automatically terminated. Brokerage firms that are members of the SIPC pay the cost of insurance. Customers of a failed brokerage firm get back all securities (such as stocks and bonds) that already are registered in their names or are in the process of being registered. If sufficient funds are not available in the firm's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of $500,000 per customer, including a maximum of $100,000 for cash claims. Among the investments that are ineligible for SIPC protection are commodity futures contracts and currency, as well as investment contracts (such as limited partnerships) that are not registered with the U.S. Securities and Exchange Commission under the Securities Act of 1933.

TOPIC 8: EDUCATION PLANNING

1. Funding

A. Hope Credit: Available only for first two years of undergraduate work; qualified expenses include tuition (books and supplies are included as qualified tuition only if the fees must be paid to the institution as a condition of enrollment). Expenses that do not qualify include room and board and, generally, books and supplies. The amount of credit is 100 percent of the first $1,100 of qualified tuition you paid for each eligible student and 50 percent of the next $1,100. The maximum amount is $1,650 times the number of eligible students.

B. Lifetime Learning Credit: Available for all years of undergraduate and graduate work; qualified expenses include tuition (books and supplies are included as qualified tuition only if the fees must be paid to the institution as a condition of enrollment). Expenses that do not qualify include room and board and, generally, books and supplies. The amount of the credit is 20 percent of the first $10,000 of qualified tuition paid for all eligible students. The maximum amount per family is $2,000 and is calculated as 20 percent × $10,000.

2. Needs analysis

A. The goal is to establish a saving schedule for the client; it requires the following: the age at which the child will attend college, the after-tax earnings rate of the parents, the inflation-adjusted interest rate, the current cost of tuition, and the rate of increase—the rate of increase is generally the rate of inflation but can differ.

B. For example, consider the following hypothetical: John Harris wants to plan for his son's education. His son was born today and will attend a private university for four years beginning at age 18. Tuition is currently $20,000 a year and increases annually at 7 percent, whereas inflation increases only at 3 percent per year. John expects to earn an after-tax return of 10 percent from investments. How much must John save at the end of each year if he would like to make his last payment at the beginning of his son's first year of college? Solving this problem requires three steps: (1) Inflate the current cost of tuition by the tuition inflation rate for the number of years until the child begins college. Calculator: 20,000 [PV]; 18 [N]; 7 [I]; 0 [PMT] = −67,598 [FV]. (2) Calculate the present value of an annuity due for the number of years the child will attend college. Use the inflation-adjusted discount rate for this step. Calculator: begin mode; 67,598 [PMT]; 0 [FV]; 4 [N]; 1.10 [ENTER] 1.07 [÷] 1 [−] 100 [×][I] = −259,530[PV]. Determine the periodic payment that must be made to reach the account balance in step 2. Calculator: end mode; 259,530 [FV]; 18 [N]; 10 [I]; 0 [PV] = 5,691[PMT].

3. Tax credits/adjustments/deductions

A. Student loan interest: Taxpayers can deduct up to $2,500 of interest on qualified education loans for college expenses as an adjustment to income. The deduction phases out when modified adjusted gross income (AGI) exceeds certain limits. Voluntary payments of interest are also deductible. Deductible amounts must be reduced by any nontaxable education benefits received, such as employer-provided assistance and nontaxable distributions from a Coverdell education savings account (ESA). Deduction for higher education expenses; for tax years 2002 through 2005, taxpayers will be allowed to claim a deduction for qualified higher education expenses as an adjustment to income. The deduction expires for tax years after 2005. The allowable deduction was based on the tax year and the taxpayer's modified AGI. In 2005, if AGI does not exceed $65,000 if single or $130,000 if married filing jointly

(MFJ), then the deduction limit is $3,000. There is no phase-out range—a married taxpayer with $3,000 in qualified educational expenses and modified AGI of $130,000 would be entitled to deduct the full $3,000. The same taxpayer with just $1 more in modified AGI would not be entitled to a deduction. Cannot be claimed in a year in which a Hope or Lifetime Learning Credit has been claimed for the same student.

4. Funding strategies

A. Section 2503(c) Minor's Trust: Allows the transferred trust property to be treated as a gift of a present interest to the child and so qualifies for the annual gift tax exclusion; the trust is used when (1) the grantor's income tax bracket is high and the recipient's tax bracket is low and (2) the grantor does not want an appreciating asset included in the gross estate. If income of the trust is distributed each year, it is taxable to the recipient (who is usually at a lower tax bracket); if income is accumulated, it is taxed to the trust. All of the trust property and accumulated income must be payable to the child when he or she reaches age 21.

5. Ownership of assets

A. Affects financial aid: When determining how much a family can afford to pay, the processing firm uses the federal methodology formula known as the expected family contribution. To pay for college, parents can use as much as 47 percent of after-tax income, but no more than 5.6 percent of assets—capital gains are treated as income. The amount of total contribution expected from a family is reduced by saving money in the parent's name and not the child's name—the formula calls on students to contribute 35 percent of their assets to college costs. Investing in a 401(k) or other tax-sheltered retirement plans is excluded in calculating total value of assets owned by parents.

6. Vehicles

A. Qualified tuition programs (§529 plans)

(1) Qualified tuition plans (QTPs or 529 plans); every state's program must meet the regulations of Section 529 of the Internal Revenue Code defining QTPs. It is a state-sponsored, taxed advantage plan used for undergraduate- and graduate-level expenses; extends tax-exempt status to qualified tuition programs funded by private institutions. Account owner selects beneficiary.

(2) If beneficiary does not attend college, the contributor is allowed to replace the current designated beneficiary with a new beneficiary who is a member of the family. The plan can be established by anyone to pay for qualified education expenses. Tax-free growth of earnings if withdrawn for qualified educational expenses. Penalty-free withdrawals include tuition, room and board, and books and supplies. The funding is treated as a gift of a present interest qualifying for the annual $12,000/$24,000 tax exclusion. Contributor may elect to treat the gift as occurring ratably over a five-year period, so that the $12,000/$24,000 exclusion can be leveraged to as much as $60,000/$120,000 in one year. Contributions are treated as a completed gift for estate and gift tax purposes. This rule applies despite the fact that the owner retains ownership rights, which would normally be treated as his or her estate.

(3) While it varies by state, there is generally no age restriction for the beneficiary. Contributions can be made to a Coverdell (education) IRA and a 529 College Savings Plan in the same year for the same beneficiary without penalty. Contributions may be deductible for state income tax (depending on state plan). Contribution limits vary by state, but some plans allow an annual contribution of up to $300,000.

(4) Investment choices—vary by type of plan:

(a) Prepaid tuition plan: Guarantees money saved today matches the growth in tuition inflation at state-run colleges; college savings plan. Managed by state treasurer or outside investment adviser— invests in stocks, bonds, and cash. Impact of financial aid—varies by type of plan: Prepaid tuition plan. Every dollar used for tuition takes a dollar away from the student's eligibility for aid.
(b) College savings plan: If plan is in parent's name, the college will count no more than 5.6 percent of the money each year. If the plan is in the child's name, each year the school may want 25 or 30 percent of the money.
(c) Coordination with Hope and Lifetime Learning Credits: Can claim the Hope and Lifetime Learning Credit in the same year of receiving a tax-free distribution provided the distribution is not used for the same expenses for which the credit is claimed.

(5) Major drawbacks:

(a) This is a long-term plan that should be started when the child is 10 years old or younger. Withdrawals are treated as income to the child and could hurt financial aid. Typically they provide very few investment choices; they are difficult to transfer to another program earnings taxed as ordinary income and a 10 percent penalty tax on nonqualified distributions. The 2001 tax law sunsets on January 1, 2011—on that day Congress could make withdrawals from these accounts taxable. However, as of this printing, the Congress has voted to repeal the sunset provision. It is awaiting the president's signature.
(b) They may impact financial aid: Consider coordination of Hope and Lifetime Learning Credits.
(c) Can claim the Hope and Lifetime Learning Credit in the same year of receiving a tax-free distribution from a Coverdell ESA or 529 Plan provided the distribution is not used for the same expenses for which the credit is claimed; the contribution is phased out if AGI exceeds limits (unlike a 529 Plan).

(6) Savings bonds or CDs: savings bonds sold at a discount and pay no annual interest; interest earned is not taxable at the state and local levels, but is taxable at the federal level. Interest is excluded from federal income tax if used for higher-education expenses in the same calendar year the bonds are redeemed.

(a) The following criteria must also be satisfied: A person has to be at least 24 years old at time of issuance; registered in name of purchaser or child if intended for child's education; only savings bonds issued after December 21, 1989; qualified educational expenses include tuition and fees; the cost of books and room and board are not qualified expenses; the exclusion is phased out with high AGI. The exclusion is not available for married taxpayers filing separately.

(7) CollegeSure CD: Sold in whole units and fractional units and is purchased from College Savings Bank; do not have to buy CollegeSure CDs in one lump sum; calculates the annual interest on a CD on the basis of the Independent College 500 Index; there is no limit on how much a CD can earn—the CD is guaranteed to keep up with college costs. The CD is guaranteed to earn a minimum of 4 percent even if college costs do not increase in a given year. Insured by FDIC for up to $100,000, and investors pay no fees or commissions. If student earns a scholarship, the parents get back all the money they have invested plus the accumulated interest.

B. Coverdell Education Savings Accounts

(1) Education IRAs (also called Coverdell ESAs): An education savings plan used for undergraduate- and graduate-level expenses

(a) Account owner selects beneficiary: Parent or guardian establishes the account and can elect to maintain control over the account for educational purposes (the institution where you establish the Coverdell ESA will have policies determining the decision-making authority for the account). Any withdrawals from the Coverdell ESA are paid to the beneficiary and are not refunded to the parent or other person who establishes the account. If beneficiary does not attend college, the beneficiary can be changed to a member of the beneficiary's family if under the age of 30. To establish the account, beneficiary must be under age 18 unless the individual is designated as a special needs beneficiary. Tax-free growth of earnings occurs if withdrawn for qualified educational expenses before the child is age 30. Withdrawals are tax free if they are not more than the beneficiary's qualified education expenses for the tax year.

(b) Contributions can be made only after the beneficiary reaches age 18 if the beneficiary is a special needs beneficiary; can be made to one or several Coverdell ESAs for the same designated beneficiary, provided that the total contributions are not more than the contribution limit; can be made to a Coverdell ESA and a 529 College Savings Plan in the same year for the same beneficiary without penalty; nondeductible from taxes; penalty-free withdrawals are tuition, room and board, and books and supplies. Earnings are taxed as ordinary income and subject to 10 percent penalty for nonqualified use. Parent or guardian manages the investment choices, and there is a broad choice of investment vehicles, including stocks and bonds.

(2) Uniform Transfers to Minors Act (UTMA) and Uniform Gifts to Minors Act (UGMA) accounts

(a) Two vehicles are designed to set up custodial accounts in a child's name for the benefit of the child; simple and inexpensive method of making a gift to a child without the expense of a trust; parents often transfer assets to children to reduce the income taxes on the earnings (taxed to the child's bracket). Money transferred to a custodial account is considered an irrevocable gift. Once the child reaches the age stipulated by law—usually 18 or 21—the money is the child's to use as he or she pleases. No guarantee is required that the child will use the money for college. Ownership of assets has implications for college financial aid. In calculating estimated family contributions toward college costs, the standard federal aid formula requires children to pay 35 percent of savings held in their names. In contrast, parents contribute only 5.6 percent of their assets.

(3) Savings bonds

(4) Zero coupon bonds: Promise no interest during the life of the bonds but only the payment of the principal at maturity—the bonds are sold at a discount. A tax feature reduces the attractiveness of zero coupon bonds. The IRS taxes the accrued interest even though the investor does not receive the funds until a bond matures.

7. Financial aid

A. Government grants and loans; grants and scholarships; Pell Grants; distributed on the basis of financial need—maximum amount is up to $3,750 per year. These are available only to undergraduate students, both part-time and full-time (reduced grants for part-time students).

Federal Supplemental Education Opportunity Grants (FSEOGs): Distributed on the basis of financial need—maximum amount is up to $4,000 per year; available to undergraduate students only, both part-time and full-time (reduced grants for part-time students). Students receiving Pell Grants are given highest priority.

B. Student loans

C. Perkins Loan: Funded by the federal government, but administered by the individual schools. Distributed on the basis of financial need—maximum amount is $4,000 per year for undergraduate students and $6,000 per year for graduate students. Available to graduate and undergraduate students, both part-time and full-time. Five percent interest, and allows for a grace period of nine months after graduation before loan payments are due. Repayment is usually over 10 years.

D. Stafford Loans: Available to graduates and undergraduates, both part time and full time. Based on financial need, with limits applying as to the amount of funds that may be received, both in any one year and cumulatively. Interest rate fluctuates with the 91-day T-bill plus 3.1 percent, capped at 9 percent for the first four years of repayment.

E. Subsidized loans (needs based): Students will not be charged any interest before they begin repayment or during authorized periods of deferment.

F. Unsubsidized loans: Repayment begins at loan inception. Eligible students are provided employment to earn maximum amounts stated by the federal government while attending school.

TOPIC 9: FINANCIAL PLANNING FOR SPECIAL CIRCUMSTANCES

1. Divorce

A. Property valuation and settlement

(1) It is important to understand that *equitable* does not mean “equal”; it only means “fair.”
(2) Property settlements—Section 1041—no gain or loss on divorce transactions

B. Career assets

(1) Sometimes one spouse has significant assets tied to his or her career. For example: A wife quits her job so her husband can move and advance his career.
(2) Career assets include life, health, disability, and long-term care insurance; vacation and sick pay; Social Security; stock options; and pension and retirement plans.
(3) Career assets are assumed to be jointly owned by both spouses.

C. Family business and house

(1) Three options for when deciding how to divide a business and/or house:

(a) One spouse keeps the business/home by buying out the other’s interest.
(b) Both spouses continue to own business/home.
(c) The business/home is sold and proceeds are divided.

D. Retirement plans. Two methods for dividing:

(1) Buy-out or cash-out method: Nonemployee spouse gets a lump sum settlement—or marital asset of equal value—at the time of divorce in return for the employee’s right to keep the retirement plan.
(2) Deferred division or future value method: No present value is determined—each spouse gets an equal share of the benefits when they are paid.

E. Alimony

(1) A series of payments from one spouse to another, or to a third party on behalf of the receiving spouse
(2) Taxable income to the recipient and, generally, tax-deductible expense to the payer

F. Child support

(1) Established by the courts and based on the ratio of each parent's income, the percentage of time the child spends with each parent, and the amount of alimony payments made to the custodial parent
(2) Is not deductible by the payor and not includible in the income of the recipient
(3) The child can be counted as an exemption by only one parent, but the exemption can be traded back and forth each year.
(4) Only the custodial parent is entitled to claim both the child and the dependent care credit.

2. Disability

A. The chance of becoming disabled prior to retirement is greater than the chance of death. Purchasing a disability income policy satisfies full protection.
B. Workers' compensation handles work-related injuries.
C. Company sickness and accident plans have waiting periods and are limited to years of coverage.

3. Terminal illness

A. Long-term care insurance: Insurance policy used to provide funding for long-term care, such as stays in nursing homes, not covered under Medicare or other medical expense policies. Viatical agreements. Terminally ill individuals may be able to sell their life insurance policies to a viatical company.

4. Nontraditional families

A. Proper estate planning through wills and trust is essential—there is no unlimited marital deduction for unmarried couples. Planning is necessary for single parents, as well as ensuring necessary amounts of insurance inasmuch as there is only one wage earner.

5. Job change and job loss

A. Emergency fund covering three to six months of expenses. State unemployment insurance programs exist in all states and are designed to provide protection against involuntary unemployment when the individual is available for work but is temporarily unemployed. Protection is limited in amount and duration. Payable through state unemployment offices. Unemployment compensation is taxable and reported by a taxpayer on Form 1099-G.

6. Dependents with special needs

A. The special needs are typically those that help support and educate a child with serious physical, emotional, and/or cognitive problems. Special needs trusts can preserve state-provided benefits that would be prohibitively expensive otherwise.

7. Monetary windfalls

A. A client who receives an immediate lump sum of money. Great care should be displayed when approaching clients who never have had such a large sum of money and whose desire is to spend it immediately.
B. An analysis of receiving the lump sum vs. taking a periodic annuity should be conducted.

TOPIC 10: ECONOMIC CONCEPTS

1. **Supply and demand**

   A. Demand curve:

   (1) The law of demand states that higher prices reduce the demand for an item and lower prices increase the demand for an item.
   (2) Consumers buy less of a product as prices increase primarily because of the availability of substitutes.

   (a) A substitute is an item that performs functions similar to those of an item it has replaced.
   (b) Consumers are more responsive to price when more viable substitutes are available.

   (3) The demand curve slopes down to the right, indicating that as price drops, the quantity demanded will increase—indirect relationship.
   (4) Price elasticity is manifested when a small price change causes a rather large change in the amount purchased.

   (a) This is common with goods that have many substitutes. For example, if the price of Pepsi rises, consumers will purchase Coke.
   (b) Perfect elasticity results in a horizontal demand curve.
   (c) Time has the greatest effect on elasticity; when the price of a product increases, consumers will reduce their consumption more in the long run than in the short run—called the second law of demand.

   (5) Price inelasticity is manifested when a large price change does not cause much change in the quantity demanded.

   (a) Inelastic goods have few substitutes. An example of an inelastic good is gasoline. Even as the price rises, people still need to buy gasoline.
   (b) Perfect inelasticity is represented by a demand curve that is vertical.

   (6) Movement along the demand curve represents a change in quantity demanded resulting from a price change. However, some factors will cause a shift in demand. A shift in demand is caused by:

   (a) Changes in consumer income
   (b) Changes in the price of related goods (substitutes and complements). If two goods go together, they are complements—for example, ice cream and hot fudge. A price rise in one good will cause a drop in demand for its complement.
   (c) Changes in consumer expectations
   (d) Changes in the number of consumers in the market
   (e) Demographic changes
   (f) Changes in consumer tastes and preferences

   B. Supply curve

   (1) The law of supply indicates that a higher price will increase the supply of a good.
   (2) There is a direct relationship between the price of a good and the amount supplied in the marketplace.
   (3) The supply curve is elastic when a price change leads to a large change in quantity supplied. This happens when resources are added inexpensively. The supply curve is inelastic when a price change leads to a small change in supply.

(4) Change in quantity supplied is identified as movement along the supply curve. It is the willingness of producers to offer a good at different prices. A shift in the entire supply curve is referred to as a change in supply.
(5) Factors that increase the opportunity cost of producing a good will discourage production and shift the supply curve inward to the left; the reverse is also true. Such factors include the following:

(A) Changes in resource prices. Higher resource prices (and opportunity costs) will reduce the supply of a good, causing a shift to the left in the supply curve.
(B) Changes in technology. Lower-cost techniques will increase production and decrease the opportunity cost of a good, causing the supply curve to shift outward to the right.
(C) Natural disasters and political disruptions.

C. Income elasticity is the sensitivity of demand to change in consumer income.

(1) An inferior good has negative income elasticity. This means that when income increases, the quantity demanded decreases; when income decreases, the quantity demanded increases. An example of an inferior good is margarine.
(2) A normal good has positive income elasticity. When income increases (decreases), the quantity demanded also increases (decreases). An example of a normal good is butter.

2. Fiscal policy

A. Fiscal policy refers to the government's ability to influence the economy by raising or lowering government spending and taxes.
B. If the government wants to stimulate the economy, it can implement expansionary fiscal policy by increasing spending or reducing taxes. This generally results in increased gross domestic product (GDP) and higher price levels.
C. The government can use restrictive fiscal policy to slow the economy by decreasing spending and increasing taxes.

(A) Fiscal Policy Summary	
(B) Expansionary	Contractionary
(C) Taxes go down	Taxes go up
(D) Public spending goes up	Public spending goes down
(E) Government borrowing goes up	Gov't borrowing goes down

3. Monetary policy

A. Monetary policy is used by the Federal Reserve System (Fed) to influence the money supply.

B. The Federal Reserve controls the money supply with three policy tools:

(1) The required reserve ratio. Required reserves are the minimum reserves banks must hold as required by law. These funds do not earn interest and cannot be lent to customers. When the required reserve ratio falls, the money stock rises. However, the money supply increases only if member banks are willing to lend and their customers are willing to borrow. This is an uncommon choice by the Fed.
(2) Open market operations: This is the Fed's most powerful tool for controlling the money supply. If the Fed sells government securities, it receives money in return, which reduces the money supply. If the Fed buys government securities, it adds reserves into the banking system and the money supply grows.

(3) Discount rate: The discount rate is the rate charged to member banks when they borrow from the Fed. If the discount rate drops, member banks can borrow at a lower cost to meet reserve requirements. Therefore, banks are more willing to provide loans to consumers because they can borrow from the Fed at a lower rate in case of emergency. The result is an increase in the money supply when the discount rate drops. However, this is overestimated in the public's eyes because most of the borrowing and lending of reserves takes place in the federal funds market, rather than through direct borrowing from the Fed. The federal funds market is where banks borrow reserves from other banks. The rate of interest charged is called the federal funds rate. As a result, the discount rate has little impact on the money supply.

C. The Fed can participate in expansionary or restrictive policy.

(1) Expansionary policy is manifested when the Fed increases the money supply by lowering the required reserve ratio, buying government securities, or lowering the discount rate.
(2) Restrictive policy is manifested in a reduction in the growth rate of the money supply caused by raising the required reserve ratio, selling government securities, or raising the discount rate.

D. In the short run, an unanticipated increase in the supply of money will increase aggregate demand.
E. If the increase in money supply is anticipated, there will be little or no impact on aggregate demand or real interest rates. In addition, an anticipated change in the money supply has the same effects as long-run implications of monetary policy.
F. Supply of money

(1) M-1, the simplest definition of the supply of money, includes currency in circulation (coins and paper), checkable deposits, and traveler's checks.
(2) M-2, a broader definition, equals M-1 plus savings deposits and time deposits less than $100,000 plus money market mutual fund shares.
(3) If individuals shift from savings accounts to checking accounts, the money supply is increased under the narrow definition (M-1) but is unaffected under the broader definition (M-2).

G. The impact of monetary policy of stock prices

(1) The effects of monetary policy are shown via the dividend-discount model:

(a) $V = D_0(1 + g)/k - g$
(b) Where V is the value of the stock, D_0 is the dividend that is currently being paid, k is the investor's required rate of return, and g is the growth rate in the firm's dividend.
(c) Any factor that affects any variable of the model then must have an impact on the valuation of the stock.

(2) When the Federal Reserve tightens credit and drains the money out of the system, interest rates rise.

(a) Higher interest rates increase the required rate of return (k) and suggest that the value of the stock should decline.
(b) Higher interest rates may also reduce the firm's earnings, hurting its ability to grow and pay dividends; the D_0 or g is reduced, causing the value of the stock to decline.

(3) The easing of credit has the opposite effect.

(a) Lower interest rates may increase the value of a stock by increasing earnings.
(b) This leads to higher dividends or increased growth, and a lower required rate of return (k).

(4) The anticipation of higher interest rates suggests that investors should avoid fixed income investments, firms whose cost of funds is sensitive to changes in interest rates and unable to pass on the increased cost, and firms in cyclical industries whose product demand is affected by changes in interest rates.

Monetary Policy Summary
- **Legal reserve** increase contracts the money supply.
- **Discount rate** increase discourages banks from lending money because it makes it more expensive to borrow.

Open market operations
- Fed buys securities (i.e, Treasuries), which stimulates growth by putting more money into the marketplace.

4. Economic indicators

A. Investors who invest on the basis of relationships between security prices and economic activity want to know the direction of economic change before it happens. An emphasis is placed on leading economic indicators of economic activity.
B. The National Bureau of Economic Research (NBER) tabulates a series of economic indicators. The ten leading indicators are:

(1) Stock prices (S&P 500 index)
(2) Average weekly work hours
(3) Average unemployment claims
(4) Manufacturers' new consumer goods orders
(5) Manufacturers' new orders for nondefense capital goods
(6) Vendor performance (companies receiving slower deliveries)
(7) New building permits
(8) Interest rate spread (difference between 10-year Treasury bond and federal funds rate)
(9) Inflation-adjusted M-2
(10) Consumer expectations from the University of Michigan Research Center

C. Measures of inflation can have an important impact on investor behavior.

(1) Inflation is a general rise in prices and is measured by an index.
(2) Two commonly used indexes are the Consumer Price Index (CPI) and the Producer Price Index (PPI).

(a) CPI is calculated by the Bureau of Labor Statistics and measures the cost of a basket of goods and services over time.
(b) PPI is calculated by the U.S. Department of Labor and measures wholesale cost of goods over a period of time.

5. **Business cycles**

   A. The term *business cycle* refers to a pattern of changing economic output and growth. The business cycle starts at an initial period of growth and rises as the economy expands until it reaches a peak. The economy then declines, reaching a trough, and subsequently starts to rebound to repeat the process.
   B. The peak is generally accompanied by an increased rate of inflation. This results in a period of rising unemployment and declining national output, called a recession.
   C. A recession is a period when real GDP declines for two or more successive quarters; a depression is a prolonged and very severe recession.
   D. Gross domestic product (GDP) is the most common means of measuring economic activity.

      (1) GDP is the total value of all final goods and services newly produced within a country by domestic factors of production.
      (2) Trucks made in the United States by Honda are included in GDP, whereas IBM computers made in Europe are not.

   E. The key variables used for determining the phase of the business cycle are real GDP and the unemployment rate. Real GDP is nominal GDP that has been adjusted to remove the impact of inflation. The average expansion lasts 3.5 years, while the average contraction lasts 1 year.

Business Cycle Summary

For the exam, you need to understand the cause-and-effect relationship. Remember, businesses adapt more quickly to changes in the economy than consumers do.

Midcontraction–Midtrough
Interest rates go down.
Inflation goes down.
Stocks go up.
Bonds go up.
Real estate goes down.
Gold goes down.
Physical assets go down.

Midtrough–Midexpansion
Interest rates go down.
Inflation goes down.
Unemployment goes down.
Capacity utilization goes up.
Capital spending goes up.
Bond purchases goes up.
Corporate earnings goes up.
Stocks go up.

Midexpansion–Midpeak
Interest rates go up.
Inflation goes up.
Labor productivity goes up.

Capacity utilization goes up.
Fed tightens up-money supply goes down.
Hard asset go up.
Real estate goes up.
Gold goes up.

Midpeak–Midcontraction
Interest rates go up.
Inflation goes up.
Profits go down.
Capital spending goes down.
Unemployment goes up.
Stocks go down.

6. Inflation, deflation, and stagflation

A. Definitions

(1) *Inflation* is manifested when prices are rising, when it costs more one year to buy the same goods and services as it did the year before.
(2) *Deflation* is manifested when prices are falling.
(3) *Disinflation* is manifested when the rate of inflation decreases; prices are still rising, but at a slower pace.
(4) *Recession* is a period of rising unemployment (which may or may not be accompanied by deflation)—real GDP declines for two or more successive quarters.

B. Inflation

(1) In a period of inflation, investors should avoid interest-sensitive securities and long-term debt instruments that pay fixed amounts of interest.
(2) They should acquire short-term instruments (U.S. Treasury bills) whose yields will increase with the rate of inflation.
(3) The expectations of an inflationary environment suggest that investors should stress common stocks of firms whose asset bases will be enhanced by increased asset values (oil, metal, and land companies). Investors should avoid stocks of firms lacking assets that would rise with inflation.

C. Deflation

(1) In periods of deflation, prices of tangible assets (real estate, collectibles, and precious metals) will decline.
(2) The anticipation of deflation strongly suggests that investors should acquire those financial assets whose values will not fall.
(3) The safest strategy is to acquire short-term liquid assets, such as bank deposits, because deflation will increase the purchasing power of money.
(4) Deflation makes long-term debt obligations good investments, but an investor should purchase only bonds of excellent quality, because deflation may be accompanied by bankruptcies as firms are unable to meet their financial obligations.
(5) The same stress on quality applies to common stocks. Because many firms will experience falling demand and declining profit margins, quality should be stressed in purchasing stocks.

D. Recession and economic stagnation

(1) During a recession, the Federal Reserve will put money into circulation and expand the supply of credit. This expansion will at least initially decrease interest rates until the stimulus increases the level of economic activity.
(2) The federal government will adopt an expansionary fiscal policy. Lower taxes and increased government expenditures will increase aggregate demand for goods and services. This increased demand is designed to stimulate economic activity, which reduces the level of unemployment.
(3) To take advantage of the economic stimulus, the investor will seek to move out of short-term money market instruments into common stocks of firms that will benefit from the expansionary monetary and fiscal policy.
(4) Once the investor identifies the firms most likely to benefit from the expansionary monetary and fiscal policy, he or she may adopt any of a number of individual strategies:

(a) A conservative strategy may include the purchase of convertible securities (i.e., convertible bonds and preferred stock) and common stocks of firms with low beta coefficients. Fixed-income securities may be purchased in anticipation of lower interest rates. But the investor must be willing to move rapidly out of fixed-income securities, because they do not benefit from economic expansion and may be hurt if the expansion leads to higher interest rates.
(b) An aggressive strategy designed to take advantage of expansionary fiscal policy will stress less current income (i.e., no fixed-income securities) and more potential for capital gains. The investor will then primarily purchase common stocks of firms with low payout ratios that retain earnings to finance expansion.

7. Yield curve

A. A graph showing the relationship between term to maturity and yield to maturity is known as a yield curve.
B. The yield curve shows the relationship between interest rates and time, typically relating to government Treasury securities.
C. The yield curve is important to investors because as rates change, they usually do not change by the same amount of basis points across maturities.
D. Yield curve risk is the risk that yields for different maturities may not change by the same amount in the presence of an interest rate change.

(1) The risk is measured with the help of duration—a measure of bond price sensitivity to interest rates.

TOPIC 11: TIME VALUE OF MONEY CONCEPTS AND CALCULATIONS

1. Present value

A. Present value is determined by taking the future value of a sum of money and calculating what it is worth today, using a discount rate. The formula is $PV = FV/(1 + I)^N$.

(1) Example: Calculate the present value of $10,000 to be received in five years, using an annual interest rate of 10 percent.
(2) Solution: 10,000 FV, 10 I, 5 N, calculate PV → $6,209.21 (ignore the sign).

B. The more frequent the compounding, the smaller the present value.

2. **Future value (FV) is the future amount of a sum invested today that will grow over time when it is compounding interest. The formula for finding the future value of a single cash flow is FV = PV(1 + I)N.**

   A. *Example*: Calculate the future value of $10,000 invested for five years, using an annual interest rate of 10 percent.
   B. *Solution*: −10,000 PV, 10 I, 5 N, calculate FV. $16,105.10

3. **Ordinary annuity and annuity due**

   A. An annuity is a series of equal cash flows that occur at equal intervals over a period of time. For example, the receipt of $1,000 at the end of each year for the next 10 years is an annuity.

      (1) An ordinary annuity is one in which cash flows begin at the end of each year.
      (2) An annuity due is one in which cash flows begin on the same day as the initial investment.

   B. *Example* 1: Finding the future value of an ordinary annuity.

      (1) Calculate the future value of an ordinary annuity that will pay $1,000 per year for each of the next 10 years while earning a 12 percent rate of return.
      (2) *Solution*: 10 N, 12 I, 1,000 PMT, compute (CPT) FV. $17,548.73.

   C. *Example* 2: Finding the present value of an annuity due.

      (1) Calculate the present value of an annuity of $2,000 received annually, beginning today and continuing for 15 years, earning a 10 percent rate of return.
      (2) First, put your calculator in the begin mode.
      (3) *Solution*: 15 N, 10 I, 2,000 payment (PMT), CPT PV. $16,733.38.

   D. *Example* 3: Finding the annual payment in an ordinary annuity.

      (1) Calculate the annual payments required to fund your retirement plan in order to have $25,000 at the end of 10 years while earning a 12 percent rate of return.
      (2) *Solution*: 10 N, 12 I, FV 25,000, CPT PMT. $1,424.61.

   E. *Example* 4: Finding the monthly payment in an annuity due.

      (1) Calculate the annual payments received at the beginning of each month for 10 years from an investment of $50,000 earning an annual return of 7 percent, compounded monthly.
      (2) First, put your calculator in the begin mode.
      (3) *Solution*: 120 N (10 × 12), .5833 (7/12) I, −50,000 PV, CPT PMT. $577.17.

4. **Net present value (NPV)**

   A. Net present value is the amount of cash flow (in present value terms) that a project generates after repaying the invested capital and required rate of return on that capital.
   B. If the project generates a positive NPV, then shareholder wealth increases. In contrast, a negative NPV will decrease shareholder wealth.
   C. NPV is considered better than internal rate of return (IRR) because it measures profitability in dollars added to shareholder value. In contrast, IRR measures profitability as a rate of return.
   D. NPV assumes that the reinvestment rate of cash flows is the cost of capital, whereas IRR assumes that the reinvestment rate is the IRR.

E. When the IRR is equal to the cost of capital, the NPV will be zero. If the IRR is less than the cost of capital, the result is a negative NPV.

F. *Example*: Calculate the NPV of a project with an initial cost of $2,000 that produces the following cash flows (CF): year (1) +1,000; year (2) +500; year (3) +700; year (4) −500; year (5) +300. The cost of capital is 5 percent.

(*Solution:* −2,000[CF0]; 1,000 CFj; 500 CFj; 700 [CFj]; 2500 [CFj]; 300 [CFj]; 5 [I]; [NPV] −$165.71.)

5. Internal rate of return (IRR)

A. The IRR calculates the rate of return at which the present value of a series of cash inflows will equal the present value of the project's cost.

B. It is also defined as the rate of return in which the net present value of a project is zero. It assumes that all cash flows are reinvested at the IRR.

C. The IRR is equivalent to the yield to maturity (YTM), the geometric average return, and the compounded average rate of return.

D. If IRR is less than the cost of capital, reject the project. If IRR is greater than the cost of capital, accept the project.

E. *Example*: Calculate the IRR of a project that has an initial outflow of 5,000 and will generate the following cash flows: year (1) 3,000; year (2) −500; year (3) 2,500; year (4) 500; year (5) 1,500.

Solution: −5,000[CF0]; 3,000 CFj; −500 CFj; 2,500 [CFj]; 500 [CFj]; 1,500 [CFj]; [IRR]14.09 percent.

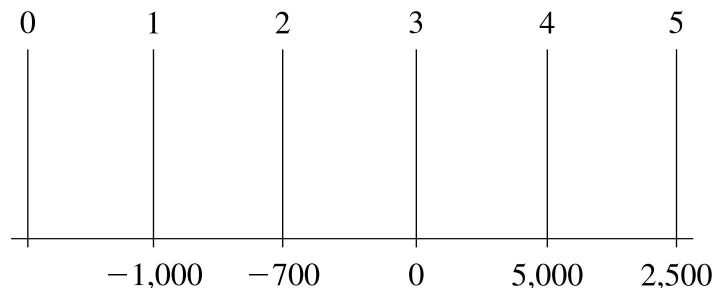
6. Uneven cash flow

A. It is common for the stream of cash flows to change from year to year for projects or investments, so it is not an annuity. The uneven cash flow is simply just a stream of (annual) single cash flows.

B. To determine the FV/PV of irregular cash flows, you need to find the FV/PV of each cash flow and then add them up. The PV of an uneven cash flow stream is also calculated using the NPV function on your calculator.

C. *Example* 1: Calculate the present value of an uneven cash flow series using a 10 percent discount rate and PV1 though PV5. Assume cash flows are:

Exhibit 1.1 Cash Flow Diagram



PV_1: enter FV = −1,000; I/Y = 10; N = 1; CPT → PV_1 = −909.09
PV_2: enter FV = −700; I/Y = 10; N = 2; CPT → PV_2 = −578.51
PV_3: enter FV = 0; I/Y = 10; N = 3; CPT → PV_3 = 0.00
PV_4: enter FV = 5,000; I/Y = 10; N = 4; CPT → PV_4 = 3,415.07
PV_5: enter FV = 2,500; I/Y = 10; N = 5; CPT → PV_5 = 1,552.30
Add up the PVs 3,479.77

7. Serial payments

A. A serial payment is a payment that increases at some constant rate on an annual basis; the constant rate is usually inflation.
B. The last serial payment will have the same purchasing power as the initial serial payment.
C. Serial payments are not fixed payments like annuities; the first serial payment will be less than an annuity payment, but the last serial payment will be more than an annuity payment.
D. *Example* 1: Assume Jeff wants to start a business in five years. He needs to have $250,000 (today's dollars) in five years to finance his business. Inflation is expected to average 3 percent, and Jeff can earn an 8 percent annual compounded rate on his investments. What serial payment should Jeff invest at the end of the first year?

Solution: 250,000 FV; 5 N; 0 PV; [(1.08/1.03 − 1)] × 100[I]; [PMT] 1.03 [×]$46,736.78

TOPIC 12: FINANCIAL SERVICES REGULATIONS AND REQUIREMENTS

1. Registration and licensing

A. National Association of Security Dealers, Inc. (NASD)

(1) Anyone who sells stocks, bonds, tax-sheltered investments, options, mutual funds, or other securities must register with the NASD in addition to the Securities and Exchange Commission (SEC).
(2) The NASD is an independent group overseen by the SEC and is a self-governing organization that polices its own members.
(3) Registration with the NASD is accomplished by completing a Uniform Application for Securities Industry Registration, a Form U-4, and receiving a passing grade on one or more exams, depending on the products the adviser wishes to sell. Passing the exam(s) and being given the right to sell makes the individual a registered representative (Registered Representative).
(4) Qualification and registration requirements for security licenses:

(a) Series 3—Futures and Commodities. For individuals who wish to sell commodities or futures contracts
(b) Series 4—Registered Options Principal. For managers supervising options sales personnel or supervising compliance
(c) Series 6—Investment Companies. For individuals who wish to sell only mutual funds and variable annuities
(d) Series 7—General Securities Representative. For individuals who wish to trade securities
(e) Series 9 and 10 (also known as Series 8)—General Sales Supervisor. For New York Stock Exchange (NYSE) managers to supervise branch activities
(f) Series 11—Assistant Representative. For sales assistants who wish to accept unsolicited customer orders
(g) Series 24—General Securities Principal. For licensing NYSE managers to supervise branch activities
(h) Series 27—General Financial/Operations Principal. Required for the chief financial officer of NASD member firms
(i) Series 55—Registered Equity Trader. Required for persons participating in equity trading

(j) Series 63—Uniform State Law. Required for most individuals who solicit orders for any type of security in a particular state
(k) Series 65—Registered Investment Adviser. Required by many states for individuals who act as investment advisers
(l) Series 66—Combined Registered Investment Adviser/Uniform State Law. Combines the Series 65 and Series 63 licenses

B. The insurance buyer makes contact with the insurer in any of three ways and must be registered as such.

(1) Agent: Representative of the insurance company (also called principal). An agent has authority to act on behalf of the principal in business transactions and has the power to bind a company to a risk by acceptance.
(2) Broker: A marketing intermediary between the insurer and the policy owner, who represents the policy owner instead of the insurer. This generally permits sales representatives to sell products from a number of companies, primarily as the representative of the insurance buyer. In regard to insurance consultants and financial planners, many states require anyone who presents him- or herself as providing advice regarding insurance, including financial planners, to have a license.
(3) Service representatives: These are salaried individuals hired by insurers to assist agents in selling and servicing insurance. A license is usually not required by the state to act as a service representative.

C. SEC Release No. IA-770: The SEC has taken the position that the Investment Advisors Act of 1940 is the statutory body of law that should control the area of regulation of financial planners.

(1) SEC Release No. IA-770 sets forth three separate tests for determining whether a financial planner's activities fall under the Investment Advisors Act of 1940. All three tests must be answered in the affirmative for the Investment Advisors Act of 1940 to apply to the financial planner.
(2) Investment advice is clearly a part of the person's primary business. The advice is specific and action oriented. The adviser receives compensation for the advice.
(3) If a financial adviser passes all of these tests, the SEC assumes that he or she is in the business of investment advice and requires that person to register unless otherwise exempted.

D. The Investment Advisors Act of 1940 specifies six areas set forth in Section 202(a)(11) that eliminate the need for financial service professionals to be subject to the mandates of the statute. The Investment Advisors Act of 1940 does not apply to any of their activities if they fall within the following categories:

(1) Any bank or holding company that is not an investment company
(2) Any lawyer, accountant, engineer, or teacher, when the advisory services are "solely incidental" to the practice of his or her profession
(3) Any broker, dealer, or registered representative whose performance of advisory services is solely incidental to his or her performance as a broker or dealer and who receives no specific compensation for these services
(4) The publishers of newspapers, newsmagazines, or business or financial publications of general or regular circulation

(5) Any person whose advice, analysis, or reports relate only to securities that are direct obligations of or publications guaranteed as to principal or interest by the United States of America
(6) Any other persons not within the intent of law as specified by the SEC

E. There are five other groups of individuals who fall within the definition of investment adviser but are exempt from registration with the SEC under Section 203(b) of the Investment Advisors Act of 1940:

(1) Any investment adviser whose clients are all residents of the state in which the adviser maintains his or her principal office and place of business and who does not provide advice or analysis in regard to listed securities or on any securities admitted to unlisted trading privileges on any national securities exchange
(2) Any investment adviser whose primary clients are insurance companies
(3) Any investment adviser who has fewer than 15 clients in a year and does not present him- or herself as an investment adviser to the public
(4) Any investment adviser that is a charitable organization or employed by a charitable organization and provides advice and analysis only to charitable organizations
(5) Any investment adviser who provides investment advice exclusively to church employee pension plans

F. Investment Advisors Supervision Coordination Act of 1996—enacted in 1997, the Investment Advisors Supervision Coordination Act of 1996 changed the landscape in regard to the Investment Advisors Act of 1940. The primary outcome is that financial planners need to be registered with the SEC or state authorities, but not both.

(1) Any adviser with $30 million or more of assets under control will still have to register with the SEC, but will be exempt from state registration.
(2) Those with less than $30 million in managed assets will have to register with the state. Any adviser with between $25 million and $30 million of managed assets can register with either the state or the SEC.
(3) All other areas of the Investment Advisors Act of 1940, with the exclusion of registration, will still apply to Registered Investment Advisers (RIAs).
(4) States retain jurisdiction in regard to fraud and illegal activity as it applies to RIAs.
(5) A national de minimis standard rule was introduced, stating that investment advisers may not be required to register in a state unless the adviser has a place of business in that state or, during the preceding 12 months, has had more than five clients who are residents of the state.
(6) Record-keeping rules put forth that no state may require more stringent requirements than the resident state of the adviser.
(7) The Act allows the denial of registration to felons if within 10 years of the conviction.
(8) The Act mandated a new consumer information hotline allowing for inquiry regarding disciplinary actions and proceedings against any RIA or associates.

2. Reporting

A. Form ADV

(1) When an investment adviser is required to register with the SEC, he or she must also file SEC Form ADV and pay the required filing fees. Form ADV contains two sections:

(a) Part I contains general and background information regarding the applicant and questions regarding the applicant’s expected clients.

(b) Part II is more detailed, requiring information about the adviser's fee structure, specific types of services offered, and the method of business operation, as well as questions in regard to the direct involvement of the adviser in securities transactions for his or her clients.

(2) Once registration is complete, the investment adviser may use the official title of Registered Investment Adviser, but not the initials "RIA," which may suggest that an exam or class work was completed and a professional designation obtained.

(3) Form ADV generally restricts advisers from "performance-based" fees in regard to the performance of assets under management; however, there is no restriction placed on the adviser in basing fees as a percentage of the total assets under management with a client. Rule 205-3 says performance-based fees are permitted when (1) the client is a registered investment company, (2) the adviser manages more than $750,000 of the client's assets, or (3) the adviser believes that the client's net worth exceeds $1.5 million.

B. Brochure rule

(1) Since January 1979, RIAs are required to deliver a written disclosure, a requirement commonly called the "brochure rule." The disclosure is to be delivered to the client within 48 hours of entering into an investment advisory agreement or when the contract is signed if the client has the right to terminate the contract within five days of signing.

(2) Form ADV, Part II, can be used to meet the requirement of the brochure rule.

3. Compliance

A. The SEC requires a detailed file of record keeping.

B. Section 206 of the Investment Advisors Act of 1940 has also come to be known as the "antifraud provision," making any illegal actions by the adviser equivalent to fraud. The Act puts the adviser in a fiduciary position.

C. Should an adviser fail to meet any of the requirements of the Investment Advisors Act of 1940, the registration process, or the continued registration requirements, the SEC may investigate and confiscate all books and records as well as levy fines for noncompliance.

D. The Insider Trading and Securities Fraud Enforcement Act of 1988 mandates that investment advisers maintain a clearly written set of rules and policies in order to prevent the likelihood of insider trading on nonpublic information.

4. State securities and insurance laws

A. State securities

(1) Advisers should be knowledgeable of the "blue sky laws" mandated by states requiring the registration of advisers.

(2) Currently, 49 states require the registration of investment advisers.

(3) Many states require a minimum capitalization amount as a prerequisite for granting investment adviser registration.

B. Insurance laws

(1) In contrast to securities, the insurance industry is regulated at the state level. Advisers wishing to sell insurance products must be licensed for all products they wish to sell within the state in which they work. This means that advisers wishing to sell all types of insurance must pass exams for each type as specified by each state.

(2) Keep in mind that variable life and variable annuities contain investments and, therefore, require the adviser to also have a Series 6 securities license.

TOPIC 13: BUSINESS LAW

1. Contracts

A. Definitions important to contract law include:

(1) Offeree: Person to whom an offer is made
(2) Offeror: Person who makes an offer

B. Legal requirements for contracts—for a valid contract to exist, five elements must exist: offer and acceptance, genuine assent, adequate consideration, capacity, and legality.

(1) Offer and acceptance: One party must make a definite, unqualified offer, and the other party must accept this offer in total. Three conditions must exist for exist to be a valid offer: intent, communication, and definiteness. Three conditions must exist for exist to be a valid acceptance: bilateral contract or a unilateral contract, content, and communication.
(2) Genuineness of assent: It is important that both parties are bound by their promises. There are certain conditions that would cause a lack of assent so that no valid contract exists:
(a) Misrepresentation
(b) Duress, indicating a condition of coercion
(c) Undue influence, indicating a lack of assent by the offeree
(d) A unilateral mistake, whereby one party knows or should realize that the other party is relying on a mistaken belief or incorrect information
(e) A mutual mistake, indicating a contract that contains latent ambiguities and can be avoided by either the offeror or the offeree
(f) A lack of mutuality exists in a situation in which a statement has been made that sounds like a promise but does not, in reality, bind the person making the statement to do anything.

(3) Adequate consideration: Consideration is something that is bargained for and exchanged in a contract.
(4) Legal capacity: The parties to an enforceable contract must be capable of entering into the contract in the eyes of the law. There are certain parties who lack legal capacity: A minor lacks legal capacity; an insane person lacks legal capacity; an intoxicated person may lack legal capacity.
(5) Legality: The terms of a contract cannot require any laws to be broken.

C. Types of contracts

(1) Nature of the promise

(a) Bilateral contract: The promise of one party is exchanged for the promise of the other party. Both parties make promises that are legally enforceable.
(b) Unilateral contract: The promise of one party is exchanged for the other party's performing some act or refraining from some act. Only one party can be forced to comply with the contract. For example, insurance contracts are unilateral. Only the insurer is legally bound to do something. The insured makes no promise to do anything. Of course, if the insured does not pay the renewal premium, the policy is canceled.

(2) Legal validity and enforceability

(a) Enforceable contract: All conditions and elements are present and clear.

(b) Void contract: A void contract has no legal standing because it lacks one or more of the requirements specified by law for a valid contract.
(c) Voidable contract: A voidable contract is a legally enforceable contract, but one from which at least one of the parties can escape liability because of lack of capacity, lack of mutuality, duress, misrepresentation, undue influence, or mistake.
(d) Quasi-contract: Not actually a contract, but can act like one. It serves as a remedy where someone has unjustly received a benefit but where there was no contract.
(e) Unenforceable contract: A contract can exist because it has all of the elements of a valid contract. However, at least one of the parties may have a defense that can be used to render it unenforceable, such as the Statute of Frauds or a material breach of contract.

D. Two topics in contract law, which are unrelated to each other, concern written agreements:

(1) The Statute of Frauds states in general that a contract does not have to be in writing in order to be enforceable. However, there are exceptions to this general rule. The following contracts must be in writing to be enforceable:

(a) A promise to answer for debts of another. For example, one person promises to pay a debt and another person guarantees that promise. The guarantee must be in writing to be enforceable.
(b) A contract to transfer an interest in real estate must be in writing.
(c) A contract that cannot, by its terms, be performed within one year from the date of agreement must be in writing.
(d) The Uniform Commercial Code (UCC) on the sale of goods of $500 or more must be in writing.

(2) The parol evidence rule also impacts written contracts. When a contract is in writing, this rule limits the evidence that can be introduced at trial to prove what the terms of the contract are. The contract as written will be binding on both parties.

E. Any nonperformance of a contract is a breach of the contract. However, there are times when nonperformance of the terms of a contract is excused:

(1) If one party has committed a material breach, the other party is excused from performance.
(2) Death excuses a party from the duty to perform services, but not from the contractual duty to deliver goods or convey real estate.
(3) If a breach of contract has occurred, there are various remedies available to the nonbreaching party. The nonbreaching party can be awarded monetary damages.

(a) The general measure of monetary damages is the amount of money that will put the nonbreaching party in the position that he or she would have occupied had there been no breach. Such damages are known as compensatory damages.
(b) Punitive damages are damages aimed at punishing the breaching party rather than merely compensating the nonbreaching party. Punitive damages are not usually allowed in breach-of-contract cases.
(c) Liquidated damages are damages for breach of contract where the monetary amount was agreed to at the time the contract was made. Courts allow such damages only if the amount is reasonable.
(d) Under certain circumstances, the nonbreaching party can be awarded equity.

2. Torts

A. A person can commit two classes of wrongs: public and private.

(1) A public wrong is a violation of one of the laws that govern the relationships of the individual with the rest of society. It is called a crime and is subject to criminal law.
(2) A private wrong is an infringement of the rights of another individual. A private wrong is called a tort, and the person who commits such a wrong is called a tortfeasor. A tort may give the person whose rights were violated a right of action for damages against the tortfeasor. This action is called a civil action.

B. Torts are divided into two types: intentional and unintentional.

(1) Intentional torts include infringements on the rights of others such as assault and battery, libel, slander, false arrest or imprisonment, trespass, and invasion of privacy. Individuals who suffer injury as a result of these intentional torts have the right to sue for damages.
(2) Unintentional torts are those that result from negligence or carelessness, and in these cases, the injured party may also be entitled to damages in a civil action even though the tortfeasor had no malicious intent as in an intentional tort.

C. An individual's exposure to financial loss associated with liability may arise from three sources: (1) criminal acts, (2) torts, and (3) legal liability arising out of breach of contract.

D. Liability insurance is rarely concerned with the legal penalties resulting from criminal behavior or intentional torts. In liability insurance, we are concerned primarily with unintentional torts or losses arising from negligence.

3. Agency

A. The term *agency* refers to a two-party relationship in which one party (an agent) is authorized to act on behalf of the other (a principal).
B. Certain general characteristics are found in this type of relationship:

(1) In acting for a principal, the agent has a fiduciary duty to act for the benefit of the principal and not in the agent's own self-interest.
(2) The agent may be subject to the control of the principal.

(a) If the agent is an independent contractor, the principal has no control.
(b) If the agent is an employee of the principal, the agent is subject to the control of the principal.

C. The principal will be bound by an agent's contracts made with third parties as long as the agent has one of the following kinds of authority:

(1) Implied authority: The authority that an agent has as necessary to carry out acts needed to exercise his or her express authority.
(2) Apparent authority: Authority that, in the absence of contrary action by the principal, appears to a reasonable person to be possessed by the principal's agent.

D. A principal is liable for all torts committed by its agents in the scope of employment.
E. An agent will have liability to a third party for the agent's own torts and contracts.

(1) An agent is liable along with the principal for the agent's own torts.
(2) For contracts, the general rule is that the principal is liable and the agent is not, as long as the agent acted within the scope of the agent's authority and the identity of the principal was fully disclosed. This rule holds regardless of how authority arose.

F. The relationship between a principal and an agent can be terminated. The relationship can be terminated by operation of law. The following automatically terminate an agency:
   (1) Death of either the principal or the agent
   (2) Insanity of either the principal or the agent
   (3) Bankruptcy of the principal
   (4) Illegality of agency purpose

4. Negotiable instruments

A. A negotiable instrument is a written contract that can be used as a substitute for money. In negotiable instruments: Generally, there are two types of negotiable instruments:
   (1) A promissory note is a written promise to make payment.
   (2) A draft is a written order to make payment, but three parties are involved. Even if a single party occupies two of these positions, it is still a three-party instrument.

B. A holder in due course of a negotiable instrument is entitled to payment despite most defenses that the maker or drawer may have. There are several exceptions to the rule that a holder in due course takes the negotiable instrument free of personal defenses:
   (1) Infancy is a defense against a holder in due course. Thus, a minor who signs a promissory note cannot be held liable.
   (2) An exception arises if the instrument was created under extreme duress.
   (3) An exception arises in case of bankruptcy of the party designated to make payment.
   (4) An exception arises if a fraud occurred that the signer of the instrument had no opportunity to detect.

C. Several steps are necessary for a party to become a holder in due course of a negotiable instrument:
   (1) A document is considered a negotiable instrument only if it has a particular form.
      (a) It must be in writing and signed by the maker or drawer.
      (b) It must contain an unconditional promise or order to pay.
      (c) It must be for a sum certain in money.
      (d) It must be payable at a definite time or on demand.
      (e) It must be payable to order of a party or payable to the bearer of the instrument (except for checks).
      (f) It must contain no other obligation, promise, or requirements.
   (2) The person trying to assert status as a holder in due course of the instrument must be a holder. The person is a holder if the instrument was properly negotiated to him or her.

D. The relationship that exists between a bank and its customers is also important. The bank (the drawee on a check) has an obligation to a customer (the drawer of a check). A bank must also follow a customer's order not to pay:
   (1) An oral stop order is valid for 14 days.
   (2) A written stop order is valid for six months.

E. A person who presents an instrument for payment and a person who transfers an instrument to another party make, by operation of law, certain warranties regarding the instrument. The warranties in these two cases differ slightly, but, in general, they are as follows:
   (1) The person has good title to the instrument that is being presented or transferred.
   (2) All signatures are genuine or authorized.
   (3) There are no known defenses to the instrument.

5. **Fiduciary liability**

   A. Because of the nature of a practitioner-client relationship, services and recommendations provided by financial planning practitioners carry a certain level of liability exposure; it is inherent to the profession. The Practice Standards, however, should assist the practitioner in managing that risk. The potential of common-law liability to clients includes liability based on (1) breach of contract, (2) tort or negligence, and (3) fraud.

TOPIC 14: CONSUMER PROTECTION LAWS

1. **Bankruptcy**

   A. Chapter 7 of the United States Bankruptcy Code is the Bankruptcy Code's "liquidation" chapter. To qualify for relief under Chapter 7 of the Bankruptcy Code, the debtor must be an individual, a partnership, or a corporation. As of October 2005, debtors have to satisfy a "means test," which determined whether they have an appropriate income level for the repayment of the debt. The individual debtor is permitted to retain certain "exempt" property. A trustee liquidates the debtor's remaining assets. Accordingly, potential debtors should realize that the filing of a petition under Chapter 7 may result in the loss of property. The discharge has the effect of extinguishing the debtor's personal liability on dischargeable debts. A discharge is available to individual debtors only, not to partnerships or corporations.

   B. Chapter 11 bankruptcy

      (1) Reorganizations of persons, firms, and corporations, especially those whose debts exceed the limits of Chapter 13. The court ultimately approves (confirms) or disapproves the plan of reorganization. The debtor usually remains in possession of his or her assets and continues to operate any business, subject to the oversight of the court and the creditors' committee.

   C. Chapter 13 bankruptcy

      (1) For debtors who are in financial difficulty and who voluntarily petition the bankruptcy court. The debtor received a briefing 180 days before that individual can proceed with Chapter 13 bankruptcy. Furthermore, after the bankruptcy filing, the debtor must complete a financial management instructional course before being discharged. The debtor keeps his or her property and makes regular payments to the Chapter 13 trustees out of future income to pay creditors over time (three to five years). An individual debtor faced with a threatened foreclosure of the mortgage on his or her principal residence can prevent an immediate foreclosure by filing a Chapter 13 petition. Certain debts that cannot be discharged in Chapter 7 may be discharged in Chapter 13. Chapter 13 is often preferable to Chapter 7 because it enables the debtor to keep a valuable asset, such as a house.

2. **Property of the estate**

   A. Property that is not exempt; property of the estate is usually sold by the trustee, and the claims of creditors are paid from the proceeds.

3. **Qualified retirement plans**

   A. The Supreme Court held that retirement plans that have a legally enforceable anti-alienation clause (a provision preventing creditors from attacking the retirement funds of a debtor) are not property of the estate and thus are not subject to the jurisdiction of the bankruptcy court and cannot be accessed to pay creditors.

B. Nearly all pensions and 401(k) savings plans that are qualified under Employee Retirement Income Security Act (ERISA), the federal pension savings act, have an anti-alienation clause that excludes them from the bankruptcy estate. An exception to this rule is retirement plans that have only one participant, such as single employee corporate plans, and some other plans originating in self-employment.

4. Tax-advantaged saving plans

A. When retirement savings are property of the estate, because they are not ERISA qualified or because they are held in an IRA, they may be exempted from the estate under the available exemption statutes.
B. Property that is exempt is removed from the estate and is not liable for the payment of creditor claims. The exact scope of the exemption and how much value can be exempted depends on the language of the exemption selected under state law.

5. Exemptions

A. Exemptions are the lists of the kinds and values of property that is legally beyond the reach of creditors or the bankruptcy trustee. Exemptions constitute the one area in which bankruptcy law varies from state to state.
B. Congress created a set of exemptions in the Bankruptcy Code but allowed each state to opt out of those exemptions in favor of the state exemptions. Sixteen states allow debtors to elect the Bankruptcy Code exemptions. In those states, debtors have a choice between the federal exemptions and those in the law of their state. For the rest of the states, only the state exemptions can be selected. Dischargeable versus nondischargeable: A discharge releases the debtor from personal liability for discharged debts and prevents the creditors owed those debts from taking any action against the debtor or his or her property to collect the debts.
C. Most unsecured debt is dischargeable. Most secured debt (liens and mortgages) survives bankruptcy as a charge on the property to which it attaches unless a court order modifies the lien.
D. The following debts cannot be discharged in either Chapter 7 or Chapter 13. If you file for Chapter 7, you will still be responsible for repaying these debts after your discharge. If you file for Chapter 13, these debts will have to be paid in full in your plan. If they are not, the balance will remain at the end of your case:

(1) Debts you forget to list in your bankruptcy papers, unless the creditor learns of your bankruptcy case
(2) Child support
(3) Alimony
(4) Debts for personal injury or death caused by driving while intoxicated
(5) Student loans, unless it would be an undue hardship for you to repay fines and penalties for violating the law, including traffic tickets and criminal restitution
(6) Recent income tax debts (past three years) and all other tax debts
(7) Certain long-term obligations (such as a home mortgage)

E. The following debts may be declared nondischargeable by a bankruptcy judge in Chapter 7 if the creditor challenges your request to discharge them:

(1) Debts you incurred on the basis of fraud
(2) Credit purchases of $1,150 or more for luxury goods or services made within 60 days of filing
(3) Loans or cash advances of $1,150 or more taken within 60 days of filing

(4) Debts resulting from willful or malicious injury to another person or another person's property; debts arising from embezzlement, larceny, or breach of trust; debts you owe under a divorce decree or settlement, unless after bankruptcy you would still not be able to afford to pay them or the benefit you would receive by the discharge outweighs any detriment to your ex-spouse (who would have to pay them if you discharge them in bankruptcy)
(5) Alternatives—debt consolidation, debt negotiation, and home equity loans or line-of-credit consumer protection laws

F. Federal Trade Commission (FTC): The Commission has enforcement and administrative responsibilities under 46 laws. Statutes relate to competition and consumer protection missions.
G. Consumer protection mission of the FTC:
  (1) Truth in Lending Act
  (2) Title I of the Consumer Credit Protection Act requires all creditors who deal with consumers to make certain written disclosures concerning all finance charges and related aspects of credit transactions (including disclosing finance charges expressed as an annual percentage rate).
H. Fair credit reporting law
  (1) Amendment to the Truth in Lending Act
    (a) Protects the borrower in the event a credit card is lost or stolen to a maximum loss of $50 per card or until the card has been reported as missing if less; prohibits creditors from taking actions that adversely affect the consumer's credit standing until an investigation is completed. The maximum amount that may be garnished from wages is 25% of take-home pay.
  (2) Equal Credit Opportunity Act
  (3) Title VII of the Consumer Credit Protection Act
    (a) The Act prohibits discrimination on the basis of race, color, religion, national origin, sex, marital status, age, receipt of public assistance, or good faith exercise of any rights under the Consumer Credit Protection Act. The Act also requires creditors to provide applicants, upon request, with the reasons underlying decisions to deny credit.
I. Privacy policies
  (1) Identity theft protection
    (a) The Identity Theft and Assumption Deterrence Act of 1998 outlawed identity theft and made it a crime subject to a maximum penalty of $250,000.

MULTIPLE CHOICE QUESTIONS

1. *Practice—financial planning process* (CFP® Exam, released 1/99). 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 larger gains in the coming year. The caller wishes to purchase shares of the fund through you. Keeping in mind stages of the overall personal 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 2 only
(B) 2 and 4 only
(C) 1, 2, and 3 only
(D) 1, 2, and 4 only

Ans. C

2. ***Practice—financial planning process.*** **Which one of the following statements regarding the second step of the process, Gathering client data and determining goals and expectations, is correct?**

A. General goals, such as "adequate retirement income" provide appropriate guidance in developing the plan.
B. Quantitative information and qualitative information are equally important.
C. This step provides the greatest time-saving potential since most of the information required can be estimated and reasonable accuracy is not affected.
D. Most clients will be able to completely implement their financial plans in a relatively short period of time, so prioritization is merely a formality and not particularly important.

Ans. B

3. ***Practice—financial planning process.*** **What is the first step in the financial planning process?**

A. Recommending a plan
B. Establishing the client planner relationship
C. Analyzing information
D. Gathering data

Ans. B

4. ***Practice—ethics*. A client of a CFP is seeking advice regarding the tax consequences of an investment. The CFP meets with the client and gets the information about the investment, but has his assistant calculate the tax consequences and write a letter to the client. Which of the following is true?**

A. The letter should have been signed by the CFP.
B. It would be okay if the assistant were a CPA.
C. The CFP should not consult on tax consequences of investments.
D. The CFP is ultimately responsible.

Ans. D

5. ***Practice— ethics.*** **The following are Code of Ethics' Principles EXCEPT:**

A. Integrity
B. Competence
C. Professionalism
D. Consistency

Ans. D

6. ***Practice—ethics*. Your client's old CPA put him into an oil and gas partnership that lost him money. Although he doesn't feel the CPA necessarily misled him, he wants to know what he can do to seek reimbursement.**

A. Tell him there is no recourse.

B. Tell him he can consult an attorney.
C. Call the CPA.
D. Notify the CPA Board.
E. Do nothing.

Ans. B

7. ***Practice—ethics*. Under what circumstances can a CFP reveal client confidential information?**

(1) To defend oneself against an action of wrongdoing
(2) To demonstrate the type of work performed
(3) To complete a new account form
(4) To convey data to an estate planning attorney with the implied consent of the client

(A) 1 only
(B) 1 and 2
(C) 3 and 4
(D) 1, 2, and 4

Ans. D

8. ***Practice—ethics*. After working with your client, he advises you that he didn't disclose all assets as part of a prenuptial agreement. You have worked for him, not his new wife. Under the circumstances, what should you do?**

A. Disclose the hidden assets to his wife.
B. Continue the relationship.
C. Fire the client and return his fees paid.
D. Fire the client and keep the fees.

Ans. D

9. ***Practice—practice standards.* The following apply to the *Financial Planning Practice Standards* EXCEPT:**

A. Help practitioners focus on what to provide as part of the six-step financial planning process and base services on what clients need.
B. The Board of Practice Standards drafted ten standards.
C. The Practice Standards can be modified to reflect what practitioners actually do, as identified in future studies.
D. The Practice Standards require practitioners to provide comprehensive planning for clients.

Ans. D

10. ***Practice—practice standards*. Which of the following statements about the CFP Board's *Financial Planning Practice Standards* is correct?**

A. Practice standards are based on the daily activities of a personal financial planner.
B. Practice standards apply to all CFP designees regardless of the work they are doing.
C. The Practice Standards provide a basis for determining legal liability of financial planners.
D. The practice standards describe the expected level of professional practice to be followed by CFP designees.

Ans. D

11. ***Practice—balance sheet* (CFP® Exam, released 1/99). A client provides a current personal balance sheet to the financial planner during the initial data-gathering phase of the finan-**

cial planning process. This financial statement will enable the financial planner to gain an understanding of all the following EXCEPT:

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

Ans. B

12. ***Practice—cash flow*. Which of the following would not be included in cash flow?**

A. Taxes
B. Salaries
C. Auto note balance
D. Mortgage note payments
E. Interest income

Ans. C This would not be included in cash flow (included in net worth).

13. ***Practice—fundamentals*. Your client has a current net worth of $200,000. Last year, his net worth was $175,000. He had net cash outflows of $34,000, which included mortgage costs. His total cash inflows were $36,000. His investments appreciated $12,500 during the year. The value of all other assets remained the same. How much principal did he pay off?**

A. $2,000
B. $10,500
C. $12,500
D. $25,000

Ans. B His net worth increased by $25,000 last year ($200,000 − $175,000). The increase can be partially explained by his positive cash flows of $2,000 ($36,000 − $34,000) and the $12,5000 appreciation of his investments. The remaining $10,500 ($25,000 increase less $2,000 net cash flow less $12,500 appreciation) must be the reduction of the mortgage liability.

14. ***Practice— budgeting*. Which one of the following is not a discretionary expense?**

A. Mortgage
B. Gifts
C. Vacation
D. Savings

Ans. A

15. ***Practice—budgeting*. Which of the following is the logical first step in the budgeting process?**

A. Determine how much is to be saved or invested.
B. List all the categories and amounts of fixed expenditures.
C. Estimate all income and income sources.
D. Eliminate all discretionary expenditures.

Ans. C

16. ***Practice—emergency.* John and Jane Jones are in the 15% income tax bracket. What is the best option for their $20,000 emergency fund?**

A. GNMA fund

B. Money market fund
C. Exchange traded fund
D. Hedge fund

Ans. B

17. *Practice—liquidity*. All of the following are liquidity substitutes EXCEPT:

A. Checking and savings accounts
B. Certificates of deposit (CDs)
C. Cash value of a life insurance policy
D. Fixed income mutual fund

Ans. D

18. *Practice—bankruptcy*. Bob filed for chapter 7 bankruptcy. What debts cannot be discharged?

(1) Credit card debt
(2) Child support
(3) Alimony
(4) Personal debt
(5) Government loans

(A) 1, 2, and 4
(B) 1 and 4
(C) 2, 3, and 5
(D) 3, 4, and 5
(E) All of the above can be discharged.

Ans. C

19. *Practice—bankruptcy*. The following debts cannot be discharged in chapter 7 EXCEPT:

A. Child support
B. Alimony
C. Student loans
D. Unsecured debt

Ans. D

20. *Practice—mortgages.* If a mortgage lender charges three "points" to the purchaser of a home with a $100,000 mortgage, the cost of these "points" is:

A. $30
B. $300
C. $3,000
D. $30,000

Ans. C

21. *Practice—lease vs. buy.* Which of the following is the best reason to rent an apartment as opposed to purchasing a home?

A. Do not want to pay property tax
B. Expect to relocate within one to three years
C. Do not want to tie yourself into doing yard work
D. Do not want to purchase any homeowner's insurance

Ans. B

22. ***Practice—FDIC.*** **Which one of the following is true regarding FDIC insurance?**

A. Reimburses the depositor for any losses up to $300,000
B. A depositor has to be a United States citizen.
C. T-bills purchased by an insured depository institution on a customer's behalf are not insured by the FDIC.
D. Deposits maintained in different categories of legal ownership are not separately insured.

Ans. C

23. ***Practice—SIPC.*** **Which one of the following is true regarding SIPC insurance?**

A. SIPC protects customers of broker-dealers even if the broker-dealer is not an SIPC member.
B. The cost of insurance is paid by all brokerage firms.
C. Broker-dealers that are registered with the SEC and members of the national security exchange must be members of the SIPC.
D. All types of deposits received by a financial institution in its usual course of business are insured.

Ans. C

24. ***Practice—client attitudes.*** **Which of the following is a trait found among risk-averters?**

A. They seldom change jobs.
B. They frequently change jobs.
C. They prefer change.
D. They are gamblers.

Ans. A

25. ***Practice—education.*** **Which of the following are needs-based programs?**

(1) Pell Grants
(2) Parent Loans for Undergraduate Students (PLUS)
(3) State prepaid programs
(4) Subsidized Stafford Student Loans

(A) 1 and 2
(B) 1 and 4
(C) 2 and 4
(D) 2 and 3
(E) 1, 2, and 3

Ans. B

26. ***Practice—education.*** **Which of the following are needs-based programs?**

(1) Coverdell Education Savings Accounts
(2) Supplemental Education Opportunity Grants
(3) Perkins Loans
(4) Subsidized Stafford Student Loans

(A) 1 and 3
(B) 2 and 3
(C) 2 and 4
(D) 2, 3, and 4
(E) 1, 2, and 4

Ans. D

27. ***Practice—education.*** **A client with adjusted gross income (AGI) of $55,000 wants to establish an education IRA. Which one of the following statements is true?**

A. With her AGI, she could contribute $3,000.
B. After five years, she could take distributions from the account tax free.
C. Any contributions she makes to the education IRA will reduce the allowable contributions she could make to a traditional IRA.
D. She could transfer the account to another beneficiary, such as a niece or nephew.

Ans. D

28. ***Practice—special circumstances*****. Which of the following statements regarding same-sex couples is correct?**

A. If they register as a nontraditional family, the state laws of intestacy will treat them the same as if they were married.
B. Social Security survivor benefits can be directed to the same-sex partner.
C. For estate tax purposes, the unlimited marital deduction is not available.
D. When same-sex couples separate, the courts generally divide property in the same manner as if the couple had been married.

Ans. C

29. ***Practice 13—fiscal policy*****. What can the federal government do to help get the economy out of a recession?**

(1) Decrease the national debt.
(2) Lower income taxes.
(3) Reduce any budget deficit.
(4) Increase government spending.

(A) 1 and 2
(B) 2 and 4
(C) 3 and 4
(D) 1, 2, and 4

Ans. B

30. ***Practice—monetary policy*****. What mechanism can the Federal Reserve use to help stimulate the economy?**

(1) Lower the discount rate.
(2) Lower the federal funds rate.
(3) Lower the prime rate.
(4) Sell treasuries.
(5) Lower reserve requirements.

(A) 1 and 2
(B) 2 and 4
(C) 1 and 5
(D) 1, 4, and 5

Ans. C

31. ***Practice—monetary policy*****. Which of the following entities controls monetary policy?**

A. Congress
B. Federal Reserve Bank of New York

C. Federal Open Market Committee (FOMC)
D. Federal Reserve Board
E. Executive branch

Ans. D

32. ***Practice—net present value*. An investor is considering purchasing an investment. His required rate of return is 12 percent. If he calculates the net present value of the investment and determines it to be 9.5, what do you know about the internal rate of return (IRR) of this investment?**

A. Nothing
B. The IRR is less than 12%.
C. The IRR is equal to 12%.
D. The IRR is greater than 12%.

Ans. D

33. ***Practice – future value.* Fifty years ago, you bought a share of stock for $10. The stock has paid no dividends during this period. It has yielded 20 percent over the past 50 years, compounded annually. What is your investment worth now?**

A. $10,000
B. $27,230
C. $45,502
D. $91,004

Ans. D N = 50; I/Y = 20; PV = −10; PMT = 0; CPTFV = 91,004.38

34. ***Practice—rate of return*. What rate of return will cause a $100 investment to turn into $300 over five years?**

A. 8%
B. 13%
C. 17%
D. 25%

Ans. D N = 5; PV = −100; FV = 300; PMT 0; CPTI/Y = 24.57%

35. ***Practice—Rule of 72*. If you invest $5,000 in a fund offering a rate of return of 12 percent per year, how many years will it take for your investment to reach $10,000 using the rule of 72?**

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

Ans. B If you use the rule of 72, you get 72/12 = 6 years.

36. ***Practice—uneven cash flows*. An investment is expected to produce the following end-of-year cash flows:**

Year 1	$500
Year 2	$200
Year 3	$800

If the required rate of return is 12 percent, what is the present value of this investment?
A. $925

B. $1,125
C. $1,175
D. $1,345

Ans. C Using your cash flow keys, $CF_0 = 0$; $CF_1 = 500$; $CF_2 = 200$; $CF_3 = 800$. NPV = $1,175.29. Or you can add up the present values of each single cash flow. PV_1 = N = 1, FV = 500, I/Y = 12; CPT PV = 446.43. PV_2 = N = 2; FV = 200; I/Y 12; CPT PV = 159.44. PV_3 = N = 3; FV = 800; I/Y = 12; CPT PV = 569.42. Hence, 446.43 + 159.44 + 569.42 = 1,175.29.

37. ***Practice—mortgages*. Smith's wife has been hassling him about buying a house. She can have her dream home if they take out a $50,000 mortgage. How much interest will they pay over the life of the mortgage if they secure a 15-year note with 7 percent interest and make all their payments on time?**

A. $25,633
B. $27,294
C. $30,894
D. $35,275

Ans. C N = 180; I = .5833; PV = $50,000; FV = 0; Solve for PMT = 449.41; 449.41 × 12 months × 15 years = $80,894; $80,894 − $50,000 = $30,894

38. A rep is a Series 6 licensed registered representative. Assuming she also has the appropriate state insurance licenses, what products can she sell?

(1) Variable life insurance
(2) Mutual funds
(3) Variable annuities
(4) Exchange-traded funds

(A) 1 and 2
(B) 1, 2, and 3
(C) 1 and 3
(D) 1, 2, 3, and 4

Ans. B

39. ***Practice—RIA*. If Jones is a registered investment advisor, which of the following is permitted?**

A. Jones, CLU, ChFC, CFP®, RIA
B. Jones, CLU, ChFC, CFP®, R.I.A.
C. Jones, CLU, ChFC, CFP®, RIA™
D. None of the above

Ans. D

40. ***Practice—RIA*. If you are a registered investment advisor, what must you provide to clients?**

A. Nothing
B. SEC form ADV, part I
C. SEC form ADV, part II
D. SEC form ADV, parts I & II

Ans. C SEC form ADV, part II, must be provided to the client 48 hours before entering into the investment advisory contract or may be presented at the time of entering into the contract provided the client is given five business days to terminate the contract with no penalty.

41. *Practice—RIA*. Registration of an investment adviser is accomplished by:

A. Paying a filing fee and filing FORM U-4 with the NASD
B. Filing FORM ADV-S
C. Filing FORM ADV
D. Filing FORM ADV-W

Ans. C

42. *Practice—industry regulation*. Which of the following statements concerning the Investment Advisers Act's definition of a security is correct?

A. The Act defines the term *security* in the broadest possible fashion.
B. The Act doesn't define the term *security*.
C. The Act uses a limited definition of the term *security* so that the term *security* includes only stocks, bonds, and certificates of deposit.
D. SEC hearings are periodically held to arrive at a definition of the term *security*.

Ans. A

43. *Practice—industry regulation*. In order to be classified as an investment adviser, a person's activities must satisfy a three-pronged test. All the following are "prongs" in the three-pronged test EXCEPT:

A. The person provides general or specific advice about securities.
B. The person provides general advice that is incidental to a nonadvisory investment business and receives no compensation for services provided.
C. The person provides investment advisory services for compensation that is not incidental.
D. The person charges either a separate fee or receives compensation in the form of commissions.

Ans. B

Chapter 2

INSURANCE PLANNING AND RISK MANAGEMENT

TOPIC 15: PRINCIPLES OF RISK AND INSURANCE

1. Definitions

A. *Risk* is defined as the possibility of loss. The definition of risk refers to the possibility, not the probability, of loss. It does not suggest an element of measurability. *There are different classifications of risk:*

(1) *Financial and nonfinancial risk:* Risk may involve financial loss in some cases; in other cases, there is no financial loss. Insurance is concerned with those risks that involve a financial loss.

(2) *Static and dynamic risk:* Dynamic risks are those resulting from changes in the economy. Changes in price level, consumer tastes, income and output, and technology may cause financial loss to members of the economy. Static risks involve those losses that would occur even if there were no changes in the economy, such as the perils of nature and the dishonesty of other individuals. Static risks are more suited to treatment of insurance than are dynamic risks.

(3) *Fundamental and particular risks:* Fundamental risks involve group risks, caused by conditions more or less beyond the control of the individuals who suffer the losses. These risks are the responsibility of society rather than the individual, such as unemployment and occupational disability. Particular risks involve losses that arise out of individual events and are felt by individuals rather than by an entire group. Particular risks are more appropriate for insurance than fundamental risks.

(4) *Pure and speculative risks:* Pure risk is used to designate those situations that involve only the chance of loss or no loss. Speculative risk describes situations in which there is a possibility of loss, but also a possibility of gain. Gambling is an example of a speculative risk. Only pure risks are generally insurable.

B. There are different elements for determining an insurable risk:

(1) The risk of loss must be definable and measurable.

(2) There must be a large enough number of similar exposure units to make potential losses somewhat predictable.

(3) A potential loss must be fortuitous or accidental.

(4) The loss must not be catastrophic.

2. Concepts

A. Peril

(1) Peril is a cause of a loss. Examples of perils are fire, windstorm, hail, and theft. Each of these is a cause of a loss that occurs.

B. Hazard

(1) Hazard is a condition that may create or increase the chance of a loss arising from a given peril. It is possible for something to be both a peril and a hazard. Hazards are normally classified in three categories:

(a) *Physical hazards* consist of those physical properties that increase the chance of loss from the various perils. Examples of physical hazards that increase the possibility of loss from a peril of fire are the type of construction and the location of a property.

(b) *Moral hazard* refers to the increase in the probability of loss that results from the dishonest tendencies of an insured in an attempt to defraud an insurance company.
(c) *Morale hazard* results from the careless attitude of an insured person toward the occurrence of losses. The purchase of insurance may create a morale hazard, inasmuch as the realization that the insurance company will bear a loss may lead the insured to exercise less care than if forced to bear the loss alone.

C. Law of large numbers

(1) As the number of independent trials is increased, the actual results will come ever closer to the results that would be expected to occur based on the underlying probability.
(2) For example, the law of large numbers can be explained by flipping a penny; half the time it will come up heads, and half the time it will come up tails.
(3) If there are enough observations of an event, its outcome can be predicted with some accuracy. Insurance companies do such predicting. Based on years of historical information, insurance companies can predict, with reasonable accuracy, how many claims will be made and the amount of the claims for an entire group. They cannot predict the claims for an individual.

D. Adverse selection

(1) The tendency for those who know that they are highly vulnerable to specific pure risks to be most likely to acquire and to retain insurance to cover that loss

E. Insurable risks

(1) Insurable risks have the following four components: significant number of exposure units to make the losses reasonably predictable; losses must be definite and measure; losses must be accidental or fortuitous, and they must not be catastrophic.

F. Self-insurance

(1) This is a method for companies to set aside funds to cover any losses that may arise. This is an example of risk retention.

3. Risk management process

A. The risk management process follows the financial planning process in six steps.

(1) Establish the risk management objectives.
(2) Gather information to identify the loss exposures.
(3) Analyze and evaluate the loss exposures.
(4) Develop the insurance plan.
(5) Implement the plan.
(6) Monitor the plan.

4. Response to risk

A. Risk control

B. Ways to minimize losses—includes risk avoidance and risk reduction. In contrast, risk financing—ways to pay for those losses that happen—includes risk transfer and risk retention.

(1) Risk avoidance
(2) Occurs when an individual refuses to accept a risk even for an instant. This is accomplished by merely not engaging in the action that gives rise to risk. The avoidance

of risk is one method of dealing with risk, but it is a negative rather than a positive technique. Both personal advancement of the individual and progress in the economy require risk taking. If avoidance were utilized extensively, both the individual and society would suffer. Risk avoidance is characterized by high frequency and high severity.

(3) Risk diversification

(a) An example of risk sharing, whereby the risk taker is shifting it to someone other than the insurance company

(4) Risk reduction

(a) Achieved through loss prevention and control. Safety programs and means of loss prevention include medical care, fire departments, night security guards, sprinkler systems, and burglar alarms. Risk reduction is characterized by high frequency and low severity.

C. Risk financing

(1) Risk retention

(a) Perhaps the most common method of handling risk. The retention may be voluntary or involuntary. As a general rule, risks that should be retained are those that lead to relatively small certain losses. Risk retention is characterized by low frequency and low severity.

(2) Risk transfer

(a) The transfer of risk from one individual to another who is more willing to bear the risk. Insurance is the most widely used means for reducing risk by transfer. Risk transfer is characterized by low frequency and high severity.

5. Legal aspects of insurance

A. Principle of indemnity

(1) Insurance contracts are contracts of indemnity. This means that the insurer promises to reimburse the insured up to the extent of the insured's covered financial loss, or the amount of coverage, whichever is less.

(2) This arrangement ensures enforcement of the principle of indemnity because the insured is generally not reimbursed by being provided with new property as a replacement for old property.

B. Insurable interest

(1) Insurance is issued only if the applicant has an insurable interest in the subject matter being insured. For example, homeowners have an insurable interest in their home because they would suffer a financial loss if the home were damaged or destroyed.

C. Contract requirements

(1) For a valid contract to exist, five elements must exist: offer and acceptance, genuine assent, adequate consideration, capacity, and legality. (See Topic 18 for a complete discussion on contracts.)

D. Contract characteristics

(1) An insurance contract is a personal contract. This means that the policy is personal to the insured. With the exception of life insurance, it may not be assigned to anyone else

without the approval of the insurer. Insurance contracts are unilateral. Under the terms of a unilateral contract, only one party can be forced to comply with the contract. Under the terms of a bilateral contract, both parties make promises that are legally enforceable. Insurance contracts are unilateral. An insurance contract is a contract of adhesion. The insured can accept or reject the contract only as written. Thus, the policy is not drawn up through negotiations.

(2) Insurance contracts are aleatory contracts. An *aleatory contract* is one in which one party may receive benefits greatly in excess of the benefits to be received by the other party. An insurance contract is aleatory because the insured may receive benefits far in excess of the premium paid.

(3) Insurance contracts are also contracts of utmost good faith. If the information provided by the applicant is false or incomplete, the insurer may be able to void the contract on grounds of breach of warranty, misrepresentation, or concealment.

(4) Other characteristics within the legal framework of insurance contracts:

(a) *Misrepresentation* is a false statement. If a misrepresentation is intentional and material, it is usually basis for voiding the contract. For life insurance policies, the misrepresentation must be discovered within the one- or two-year contestable period.

(b) *Warranty* is a statement made by one party to a contract, which, if untrue, renders the policy voidable by the other party.

(c) *Representation* is information given that is true to the best of the individual's knowledge. Courts generally hold that insurance contracts may not be voided because of a breach of warranty or misrepresentation unless the violation was material and/or increased the risk that contributed to the loss. Such decisions are obviously more favorable for the insured.

(d) *Concealment* is the failure to disclose known material information. Information is material if it would have led the insurer to make a different underwriting decision had the withheld information been known. Intentional concealment (intent to defraud the insurer) is grounds for voiding the contract.

(e) *Estoppel* prevents one from denying a fact if the fact was admitted to be true by previous actions. If one party to a contract waives its right to enforce a part of the contract, and the other party relies on that waiver, the first party is prevented (estopped) from enforcing it later.

(f) *Rescission:* An insurance policy may be rescinded if one party can prove that the other party misrepresented material information in the preparation or negotiation of the insurance contract.

(g) *Reformation* is the changing of an existing contract, not the creation of a new one. It is done when both parties agree to change the new contract from what was originally intended.

(h) *Conditional:* The insurance company is obligated to pay a claim on the condition that a covered loss is sustained.

E. Categories for analyzing insurance contracts

(1) Declarations are factual statements identifying the specific person, property, or activity being insured and the parties to the insurance transaction.

(2) The definitions section of the policy is an explanation of the key policy terms. The insuring agreement is the heart of the insurance policy. This agreement(s) spells out the basic premise of the insurance company. An example is an agreement to pay the face

amount of the policy in the event of the insured's death. Exclusions are items that the insurer does not intend to cover. A practical result of exclusions is to hold down the premium cost of coverage for policy owners.

(3) *Conditions:* The insuring agreement is a qualified promise that is enforceable only if the policy owner fulfills the conditions that are spelled out in the policy. An example of these conditions is timely payment of premiums.

(4) *Policy continuation:* One of the most important miscellaneous provisions of a policy relates to the right of the owner to continue coverage. These policy renewal provisions fall into seven categories:

(a) *Noncancelable:* This gives the policy owner the right to renew the coverage at each policy anniversary date, and future rates in the coverage are guaranteed in the contract itself.

(b) *Guaranteed renewable:* Like a noncancelable policy, a guaranteed renewable policy gives the policy owner the right to renew the coverage at each policy anniversary date, but the insurer does not guarantee future rates for the coverage.

(c) *Nonrenewable for stated reasons only:* These policies often qualify as guaranteed renewable, but allow the insurer to refuse to renew the policy for conditions specifically listed in the policy.

(d) *Optional renewable:* This gives the insurer the unilateral right to refuse to renew a policy at the end of any period for which premiums have been paid.

(e) *Cancelable:* A few property and liability policies are cancelable during the period for which premiums have been paid.

(f) *Valuation of losses:* Another type of miscellaneous provision concerns a required sharing in the amount of the loss by the insured. For example, deductibles are common in homeowners insurance, auto insurance, and medical expense insurance.

(g) *Endorsements and riders:* An endorsement—or, in life insurance, a rider—is a provision added to the policy, generally for an extra premium charge. As a general legal principle, whenever the wording in an endorsement or rider conflicts with the terms of the policy to which it is attached, the endorsement or rider takes precedence.

F. Policy ownership

(1) Policy ownership means the owner possesses "incidents of ownership" regarding what can be done with the policy. This means the owner can:

(a) Assign the policy
(b) Change the beneficiary
(c) Receive cash surrender value
(d) Receive dividends
(e) Pledge the policy
(f) Take a loan out on the policy
(g) Surrender the policy

G. Designation of beneficiary

(1) The owner of the policy can choose the beneficiary. This is a very important decision, which should not be taken lightly.

TOPIC 16: ANALYSIS AND EVALUATION OF RISK EXPOSURES

1. **Personal**

A. Death

(1) The primary purpose of life insurance is to permit a person's dependents to live in a similar manner that was enjoyed before the person's death.

(2) Two approaches evaluate the risk of premature death:

(a) Human life value: This is the present value of that portion of estimated future earnings that is necessary to support dependents. For example, assume future income is estimated at $90,000 per year, but the economic value to dependents is only $65,000. The life value at age 35 is measured by an amount, invested at a reasonable rate, yielding an income of $65,000 per year for 30 years (up until retirement age of 65). If the discount rate used is 6 percent, the present value is $894,714. The present value of an individual reduces over time until finally disappearing at retirement age.

(b) Needs analysis: Needs analysis requires determining needs that arise or continue to exist after a person's death and comparing them to sources that already exist, such as employer-provided life insurance and retirement accounts. For example, there may be a need to provide a source of funds to support the living expenses of the family or to pay for the college education of children.

B. Disability

(1) This is the inability to work because of sickness or accident, resulting in loss of income to the individual or family. There is a tendency by individuals to underestimate the frequency and severity of long-term disability.

C. Poor health

(1) Individuals often find themselves in need of protection against financial consequences of poor health.

D. Unemployment

(1) In a volatile economy, unemployment is always a possibility. Unemployment can be a significant cash drain to a family. Emergency funds should be well funded in order to deal with temporary lapses in income.

E. Superannuation

(2) Outliving one's capital. The risk of living too long is called superannuation. The risk is caused by individuals not saving enough by the time retirement arrives, and the assets that have been accumulated do not last for the rest of the individual's life. One product offered by insurance companies to protect against retirement risk is a life-income annuity.

2. **Property**

A. Real

(1) Land and anything attached and affixed to it, and all rights inherent in ownership. Real property is subject to loss from many different perils, and insurance policies provide protection.

B. Personal

(1) Tangible (other than real estate) and intangible assets that are subject to ownership. These include such things as clothes, furniture, china, artwork, vehicles, patents, and copyrights. Personal property coverage is also categorized under named perils or open perils.

C. Auto

(1) Auto insurance is considered a necessity for individuals who drive. There are severe financial consequences that arise from auto accidents on a daily basis.

3. Liability

A. Torts are divided into two types: intentional or unintentional.

(1) Intentional torts include such infringements on the rights of others as assault and battery, libel, slander, false arrest or imprisonment, trespass, and invasion of privacy.
(3) Unintentional torts are those that result from negligence or carelessness.

B. Negligence

(1) Negligence is conduct that is below the standard of care established by law for the protection of others against unreasonable risk of harm within the scope of reasonable expectation. Those things that must be proven to establish tort liability for negligence are as follows:

(a) A duty owed by the wrongdoer to the plaintiff.
(b) The wrongdoer failed to conduct him- or herself in accordance with the duty owed (breach of duty).
(c) Measurable damage to property or injury to the plaintiff has occurred.
(d) The breach of the duty is the proximate cause of the damage or injury.
(e) For obvious reasons, mentally incompetent persons are generally exempted from the definition of behaving as a reasonable and prudent individual. In addition, infants cannot be held negligent if they have not reached the age of reason. The age of reason varies among states.
(f) Normally, the burden of proof for negligence lies with the injured party. However, there are also three doctrines that impose liability by statute or shift the burden of proof from the injured party to the defendant. Negligence per se, or negligence "as a matter of law," may exist when a person violates a statute. Consider, for example, the speed limits established by law around schools, put in place to protect children. These speed limits amount to the establishment of rules that no reasonable person should violate. If the rules are violated, the injured party is relieved of the obligation of proving that the speed was unreasonable.

C. Intentional torts

(1) Libel is an intentional tort. Libel is writing untrue information about someone that defames him or her. Slander is also an intentional tort. Slander is verbal or spoken information about someone that defames him or her.

D. Strict liability

(1) Absolute liability (strict liability) arises when a person who commits certain types of torts will be liable for any injury inflicted on another, regardless of willful wrongdoing or negligence on his or her part. This is sometimes referred to as "liability without fault." Workers' compensation laws impose absolute liability on employers for injuries to employees. Res ipsa loquitur is translated as "the thing speaks for itself." Under this

uncommon provision in the law, a defendant is presumed guilty unless he or she can prove innocence. In the eyes of the law, the fact that the accident occurred is evidence that the defendant was negligent. For example, if a man walks down the street and a safe being lowered by a rope falls on him, he is not required to prove that the person lowering the safe failed to exercise due care. When someone is accused of negligence, there are four defenses available that may reduce or eliminate the liability:

(a) Assumption of the risk occurs when the injured party reasonably should have recognized and understood the danger involved in an activity and voluntarily chose to pursue the activity anyway. For example, a plaintiff who took boxing lessons would have learned about all of the dangers of boxing.

(b) Contributory negligence is the lack of ordinary care on the part of an injured person, which combined with the defendant's negligence and contributed to the injury as a proximate cause. Contributory negligence on the part of an injured party will defeat his or her claim, no matter how slight the negligence.

(c) Comparative negligence means that damages will be diminished in proportion to the amount of negligence attributable to the person injured or to the owner or person in control of the damaged property.

(d) Last clear chance means that the contributory negligence of an injured party will not bar his or her recovery if the defendant immediately prior to the accident had a "last clear chance" to prevent the accident but did not act on that opportunity. The collateral source rule is further protection against a negligent act. Under the collateral source rule, an injured person may receive the full compensation awarded by the court in a negligence suit and still obtain the benefits of any personal insurance available to him or her. The collateral source rule prevents the defendant from escaping the penalty merely because the injured party provided his or her own insurance coverage. Vicarious liability can result from negligence. This type of liability is ascribed to one person or entity because of the acts of another. It is based on the common law principle of repondeat superior, "Let the master answer." A principal has vicarious liability because of the tortuous conduct or negligence of his or her agent. Parents are generally liable for the acts of their children. Survival of tort actions extends beyond the death of the plaintiff and defendant. The estate or heirs have a right to sue for loss.

(2) Malpractice is alleged professional misconduct or lack of ordinary skills in the performance of a professional act. A practitioner is liable for damages or injuries caused by malpractice.

4. Business-related

A. Workers' compensation laws impose absolute liability on employers for injuries to employees. Death or disability of a partner or proprietor may cause serious problems for the existence of a business.

TOPIC 17: PROPERTY, CASUALTY AND LIABILITY INSURANCE

1. Individual

A. Homeowner's insurance

(1) Real and personal property

(a) Land and anything attached and affixed to it, and all the rights inherent in ownership. It includes such things as mineral rights, air rights, dwellings, and those things

permanently attached to buildings. Real property is subject to loss from many different perils. Insurance policies help provide protection for some of these perils:

(i) Named perils. The named-perils policy contains a list of covered perils. If the peril is not listed, then any loss associated with that peril will not be covered;
(ii) All-risk (open perils). This policy covers all losses to property unless peril is specifically excluded from coverage.

B. There are eight standard homeowners forms:

(1) HO-1—Basic Form: Designed for owner-occupants of one- to four-family dwelling units. Provides named perils coverage for 12 perils, insuring the dwelling, other structures, and personal property.

Exhibit 2.1 Homeowners' Forms

Coverage	**Form HO-2**	**Form HO-3**	**Form HO-4**	**Form HO-6**	**Form HO-8**
A: Dwelling	Amount based on replacement cost, $15,000 minimum	Amount based on replacement cost, $20,000 minimum	Not covered	$1,000 on owner's additions and alterations to the unit	Amount based on actual cash value of the home, $15,000 minimum
B: Other Structures	10% of Part A	10% of Part A	Not covered	Included in Part A coverage	10% of Part A
C: Personal Property	50% of Part A	50% of Part A	$6,000 minimum	$6,000 minimum	50% of Part A
D: Loss of Use	30% of Part A	30% of Part A	30% of Part C	40% of Part C	10% of Part A
Perils Covered	Perils 1–18	All perils except those specifically excluded from building; perils 1–18 on personal property	Perils 1–18	Perils 1–18	Perils 1–12

Perils 1–12 are fire, lightning, windstorm, hail, riot or civil commotion, aircraft, vehicles, smoke, vandalism or malicious mischief, explosion, theft, and volcanic eruption.
Perils 1–18 are Perils 1–12 plus (13) falling objects, (14) weight of ice, snow, or sleet, (15) accidental discharge or overflow of water or steam, (16) sudden and accidental tearing apart, cracking, burning, or bulging, (17) freezing of plumbing, heating, air-conditioning system, or appliances, and (18) damage from artificially generated electricity.

(2) HO-2—Broad Form: Designed for owner-occupants of one- to four-family dwelling units. Provides named perils coverage for 18 perils (broad form), insuring the dwelling, other structures, and personal property.
(3) HO-3—Special Form: Designed for owner-occupants of one- to four-family dwelling units. Provides open perils coverage for insuring the dwelling and other structures.

(a) Personal property is subject to the named perils covered in HO-2.

(4) HO-4—Contents Broad Form: HO-4 is designed for renters. It has no dwelling coverage. Provides named perils coverage (18 perils—broad form) for personal property.
(5) HO-5—Comprehensive Form: Designed for owner-occupants of one- to four-family dwelling units. Provides open perils coverage for dwelling, other structures, and personal property.
(6) HO-6—Unit-Owners Form: HO-6 is designed for the owners of condominiums. Provides named perils coverage (18 perils—broad form) for personal property.
(7) HO-8—Modified Coverage Form: Designed for owner-occupants of one- to four-family dwelling units. Provides protection for dwellings that have a fair market value (FMV) less than the replacement value of the dwelling. Reduced named perils coverage for 12 perils, insuring dwelling, other structures, and personal property. The HO-8 policy was created to provide coverage where housing prices are so low that the cost to rebuild a structure exceeds the cost of the identical house next door and the land it is on.
(8) HO-15—Homeowners Special Personal Property Coverage Form: Provides open perils coverage of personal property and is used in combination with an HO-3 policy.

C. Each homeowner form has two major sections:

(1) Section I provides property coverage, which contains five categories of property coverage:

(a) Coverage A for the dwelling
(b) Coverage B for the other structures
(c) Coverage C for personal property
(d) Coverage D for loss of use
(e) Additional coverage that provides protection for assorted situations

(2) Section II provides liability and medical payment coverage.
(3) The coverage under Section II is identical for all forms, and it is only in respect to Section I that the forms differ.

D. Coverage A—Dwelling

(1) This is the part of the policy that insures the house and anything attached to it.
(2) Land is specifically excluded.
(3) It is important to remember that the insurance coverage is based on the cost to rebuild or repair, not the market value of a house. House prices are affected more by market conditions than construction costs.

E. Coverage B—Other Structures

(1) This insures other structures such as a shed, detached garage, or fence.
(2) Three exclusions under Coverage B.
(3) Structures used for a business are not covered.

(4) Structures that are rented to nonresidents of the house are not covered unless it is the garage that is rented, which may be rented to anyone if used exclusively for garage purposes.
(5) Coverage does not extend to land.

F. Coverage C—Personal Property

(1) This insures the personal property of the homeowner at its actual cash value;
(2) It is broad form unless open perils coverage is added.
(3) This coverage applies to personal property owned or used by any insured while anywhere in the world. The coverage is provided on both owned and borrowed property. For example, if the insured or a family member borrows property from a friend, and the property is damaged as a result of a peril, the homeowners policy will cover the property as if it had been owned by the insured.
(4) Some personal property is excluded under contents:

(a) Articles that are separately described and specifically insured under the homeowners policy or any other insurance policy—those covered under floaters or inland marine coverage
(b) Animals, birds, and fish
(c) Motorized land vehicles
(d) Aircraft and their parts
(e) Property contained in an apartment regularly rented or held for rental to others by the insured
(f) Property of roomers, boarders, and other tenants not related to the insured
(g) Property rented or held for rental to others away from the premises
(h) Business property
(i) Credit cards or fund transfer cards

(5) Personal property coverage contains limits in the blanket policy:

(a) $200 limit includes cash.
(b) $250 limit includes property away from the building used for business purposes.
(c) $1,000 limit includes personal records, collectibles, electronic equipment, and securities.
(d) $2,000 limit includes firearms.
(e) $2,500 limit includes property at the dwelling used for business and the theft of silver- and goldware.
(f) If these items are insured for a larger amount, they must be scheduled.

G. Coverage D—Loss of Use: Pays for time in a hotel when the owner must stay away from the house while it is being repaired.
H. Additional coverage

(1) This covers such things as debris removal; reasonable repair; damage to trees, plants, and shrubs; fire department service charge; damage to property removed; and losses from credit cards.
(2) $500 per tree; $500 limit for credit cards.

I. Coverage E—Personal Liability

(1) This coverage provides insurance in case someone is injured on the property or through the negligence of the owner, and that injured person sues.
(2) The minimum amount of coverage is $100,000 per occurrence.

J. Coverage F—Medical Payments to Others

(1) The insurer agrees to pay all reasonable medical expenses (defined to include funeral expenses) incurred by persons who are injured while on the insured premises with the permission of any insured, or who are injured away from the premises if the injury results from an activity of the insured or a member of the insured's family, even if insured is not liable.
(2) The coverage does not apply to the insured and members of the insured's household.
(3) Medical payment coverage is not liability coverage and is not based on fault. If the insured was liable, Coverage E is used.
(4) Coverage will generally be up to $1,000 for medical payments to others.

K. Conditions under Section I:

(1) The insured has specific duties following a loss:

(a) Give notice to the company.
(b) Protect the property from further damage.
(c) Prepare an inventory of the damages, indicating items and amount of loss.

(i) Property: For the building, the conditions apply the replacement cost provision and limitations of replacement cost. In effect, the dwelling must be insured up to 80 percent of its replacement value for the insurer to pay the face amount of the claim, less the deductible.
(ii) A pair and sets clause prevents the insured from collecting for a total loss when part of a pair is lost.
(iii) An appraisal provision is used when the insured and insurer cannot agree on the amount of loss. In effect, each party selects an appraiser and the appraisers then select an umpire. This does not dispute whether a loss is actually covered or not. Such disputes are settled in courts.
(iv) The loss payment clause requires the insurance company to pay for the loss within 30 days after an agreement has been reached as to the amount of loss.

L. General conditions applicable to Sections I and II

(1) The policy will be void if the insured willfully misrepresented or concealed any material fact concerning the insurance.
(2) The liberalization clause allows for any new form or endorsement made by the insurer during the term of the policy to broaden the policy without additional premium.
(3) No waiver is valid unless in writing.
(4) The insured can cancel the policy immediately, and the insurer can cancel only under certain conditions and must give the insured advanced written notice.
(5) If the insurance company decides not to renew, then 30 days' written notice is required prior to expiration.
(6) Assignment of a policy is not valid unless the insurance company gives written consent.
(7) There is a subrogation clause in the policy.

M. Perils covered under Section I

(1) Section I—general exclusions: ordinance or law, earth movement, flood and/or water, power failure, neglect, intentional losses, nuclear waste, accident, war
(2) There are 12 basic named perils covered under an HO-1 (no longer commonly sold) and HO-8 policy: fire, lightning, windstorm, hail, riot or civil commotion, aircraft, vehicles, smoke, vandalism or malicious mischief, explosion, theft, and volcanic eruption

(3) There are 18 total perils covered under broad named perils—the 12 basic named perils plus the following 6 perils:

(a) Falling objects
(b) Weight of ice, snow, and sleet
(c) Accidental discharge or overflow of water or steam
(d) Sudden and accidental tearing apart, cracking, burning, or bulging of a steam, hot water, air-conditioning, or automatic fire protective sprinkler system, or from within a household appliance
(e) Freezing of a plumbing, heating, air-conditioning, or automatic fire sprinkler system, or of a household appliance
(f) Sudden and accidental damage from artificially generated electrical currents

N. The majority of perils are self-explanatory, but further explanation of some perils is necessary for a full understanding of the coverage permitted for that peril:

(1) Not all fires are covered under the fire peril. A friendly fire is one that burns within the confines in which it was intended. A hostile fire is one that has escaped its intended confines. Only hostile fires are covered under the fire peril.
(2) Windstorm and hail peril excludes any damage to the interior of a building unless the roof or exterior walls are first damaged by the wind or hail. For example, if damage is caused to the walls and carpet because the insured left the window open, there is no coverage. In contrast, if the wind broke the window, there would be coverage.
(3) Explosions are covered, regardless of whether they are internal or external.
(4) Damages to the interior of a building caused by falling objects, such as a tree, are covered to the extent that the loss due to the falling object first damages the exterior of the building.
(5) If snow melts and leaks into a residence, causing damage, it is not covered. It is only the damage caused by the weight of snow, ice, or sleet that is covered.
(6) Sudden and accidental damage from artificially generated electrical currents excludes damage to tubes, transistors, and electronic components (television sets and stereos are not covered).
(7) The policy requires the insured to give immediate notice to the police if an article is stolen. There are three general exclusions for theft:

(a) Theft committed by any insured

Exhibit 2.2 Covered Perils in HO Policies

	Form HO-2	Form HO-3	Form HO-4	Form HO-6	Form HO-8
A: Dwelling	Broad	Open peril	N/A	Broad	Basic
B: Other Structures	Broad	Open peril	N/A	N/A	Basic
C: Personal Property	Broad	Broad	Broad	Broad	Basic
D: Loss of Use	Broad	Open peril/broad	Broad	Broad	Basic

(b) Theft in or from a dwelling under construction or of materials or supplies for use in the construction until the dwelling is completed and occupied

(c) Theft from any part of a residence rented by an insured to anyone except another insured

(8) In addition to the three general exclusions for theft, there are three more exclusions for *off-premises theft:*

(a) Property at any other residence owned, rented to, or occupied by any insured is not covered for loss by theft except while the insured is residing at the location. For example, theft coverage does not apply at an individual's summer cottage unless the individual is actually residing at the cottage. This also applies to students, unless the student has been at the residence anytime during 45 days immediately preceding the loss.

(b) Theft from watercrafts or their furnishings, equipment, and outboard motors.

(c) Campers and trailers stolen while away from the premises.

O. Inland marine coverage

(1) Inland marine coverage is insurance on specific items of personal property either as an endorsement to the homeowners (HO) policy (scheduled floater) or as a separate policy, because coverage may be limited or excluded under the general HO policy.

(2) This coverage is sometimes called scheduled personal property endorsement or personal articles floater.

P. Comprehensive personal liability coverage for the individual

(1) Purchasing liability insurance

(a) It may be purchased as a separate comprehensive personal liability policy, generally referred to as a CPL.

(b) It is included as Section II of the homeowners policy, which provides essentially the same coverage as the separate CPL.

(c) It is included in other contracts. For example, an individual's automobile policy provides the coverage.

(2) Comprehensive personal liability coverage

(a) Liability insurance is comprehensive because it is designed to protect against all types of hazards.

(b) The insured under the liability coverage of CPL:

(i) The named insured and the individual's spouse if a resident of the same household

(ii) Relatives of either spouse who are residents of the household and anyone else under age 21 in the care of any of the foregoing (i.e., children and other minors living with the insured)

(iii) A child while away at college

(iv) Anyone legally responsible for animals or watercraft to which the insurance applies (This provides coverage for individuals to whom the insured may have loaned such animals or watercraft, or who have custody for other reasons.)

(v) Any vehicle to which the policy applies for anyone while working for the insured or any person named previously; also any other individuals using the insured vehicle with the insured's consent

(c) Section II general exclusions for liability and medical payments: the CPL policy does not apply to auto/boat/plane, intentional damage, business pursuits, uninsured

locations, war/nuclear waste, criminal activities, or damages covered by workers' compensation.

(3) Optional personal injury liability endorsements expand homeowner's liability protection for tort action, such as libel, slander, and defamation of character, false arrest, or invasion of right of privacy.

2. Automobile and recreational vehicle

A. Personal Auto Policy (PAP) is a package policy, similar to a homeowners policy, that provides both property and liability insurance for family members. PAP provides four types of insurance:

(1) Part A. Liability coverage
(2) Part B. Medical payments coverage
(3) Part C. Uninsured motorists coverage
(4) Part D. Coverage for damage to the policyholder's auto
(5) The policy also contains two sections—Part E and Part F—that explain the duties of the insured following an incident or loss, and includes other policy provisions.

B. Part A—Liability coverage

(1) The PAP defines an insured as:

(a) The insured or any family member for the ownership, maintenance, or use of any auto or trailer
(b) Any person using the insured's covered auto with permission

(2) PAP defines the covered auto as:

(a) Any vehicle shown in the declarations
(b) Any newly acquired auto—always covered automatically for 14 days
(c) Any trailer the insured owns, or any auto or trailer the insured does not own while used as a temporary substitute for any other vehicle

(3) Coverage

(a) For the named insured and family members, coverage applies to any auto, including borrowed or rented autos.
(b) Persons other than the named insured and family members are covered while using the auto if there is a reasonable belief that the person has the right to do so.
(c) The coverage is not extended to automobiles used in any business or occupation.

(4) There may be situations in which two policies will apply to the same loss:

(a) *Example*: If Steve borrows Megan's car, Megan's policy will provide coverage for both Steve and Megan in the event of a loss. Megan is covered as the named insured, and Steve is covered as a permissive user. Steve also has coverage under his own policy as the named insured while using a borrowed auto with permission.
(b) When two policies apply to the same loss, the policy of the auto being driven is primary and the policy of the permissive user is excess.

(5) PAP is written with split limits, such as $25,000/$50,000/$10,000. These limits apply to each accident.

(a) The first limit is the maximum amount that will be paid to any one person for bodily injury claims.
(b) The second limit represents the aggregate that will be paid for all bodily injury claims.
(c) The third limit applies to aggregate property damage claims.
(d) *Example:* Harry's PAP provides for $250,000/$500,000/$50,000. Harry gets into an auto accident and injures two people in the other car. The courts award one of the injured people damages of $300,000, and the other is awarded damages of $200,000. Their car was totally demolished and cost $65,000.
(e) Solution: The insurer will pay only $250,000 of the $300,000 award because the per person policy limit is $250,000. The policy will pay the full $200,000 to the other individual. The policy will pay only $50,000 for the damage to the car because the property damage limit is $50,000.

C. Part B—Medical coverage

(1) Medical payments in the auto policy cover the cost of medical services for the insured, relatives, and anyone else in the insured's car. Coverage is provided to the named insured while occupying an owned or nonowned automobile. Coverage also applies to the named insured and family members if, while any of them is a pedestrian, he or she is struck by any motor vehicle designated for use of public roads. Payment is made under the pedestrian provision.
(2) This coverage does not apply to pedestrians or to occupants of the other vehicle. In contrast, we learned that homeowners insurance provides coverage for medical payments to others.
(3) The advantage of medical payment coverage in addition to liability insurance is that the payment is prompt because there is no time wasted in determining liability.

D. Part C—Uninsured motorists

(1) This part of the PAP protects the driver against those who have no coverage or are underinsured. It also covers hit-and-run situations.
(2) It is necessary to show that the other driver was at fault in order to collect on a claim.
(3) This type of policy applies only to bodily injury.

E. Part D—Coverage for damage to insured's auto

(1) Comprehensive physical damage

(a) Comprehensive insurance protects the car against breakage of glass, theft, vandalism, falling objects, fire, hail, water, flood, riot, earthquake, and contact with a bird or animal.
(b) This coverage does not apply to cars damaged in a collision with another car or object, or to normal wear and tear on a car.
(c) The extent and deductible of the coverage varies from policy to policy.

(2) *Collision* is defined as the upset of a covered auto or its impact with another vehicle or object; collision coverage applies to the covered auto regardless of fault; collision insurance includes a deductible amount.

F. Part E—Duties after accident or loss: In the case of a claim, the policyholder must do the following:

(1) Send the insurance company accident-related paperwork.
(2) Authorize the insurance company to obtain medical and other pertinent records.

(3) Submit proof of loss.
(4) Cooperate with the insurance company in every way.

G. Part F—General provisions: The key provisions are:

(1) The term of the policy may be changed or waived only by an endorsement signed by the company.
(2) The policy provides that the insurer will not provide coverage for any insured that has made fraudulent statements with any accident or loss.
(3) The policyholder may cancel the policy by notifying the company in writing.
(4) There is a subrogation clause that applies to all coverage.

H. Many companies give discounts for at least some of the following: higher deductibles; elimination of collision coverage for older cars; no accident for some period of time, generally three years; smoking avoidance; students with good grades; driver's education course for young drivers; a defensive driving course; airbags and automatic seat belts in vehicle; other policies with the same company; travel short distances to work; individuals over age 25; women (versus men); and married people (versus single).

I. There are three primary areas in auto insurance that may not be covered:

(1) When someone is living in the same house as the owner but is not listed on the insurance policy. It is vital to include all appropriate family members on the insurance policy. It is generally recommended to insure children under the owner's policy, even if the children are away at school.
(2) When the accident occurs during business use
(3) When travelers reject insurance coverage through a rental company; their insurance policy may not fully cover rental cars, especially if accidents happen outside of the United States.

3. Business

A. Commercial property insurance: Protecting real and personal property used in business. The *coverage* applies to losses from most perils other than those that relate to crime, transportation, and boiler explosion.
B. Business income insurance: Protects against loss of income after the occurrence of direct physical damage to business property
C. Boiler and machinery insurance: Covers a wide range of damage to personal and real property and can be written to provide business income and extra expense coverage. Generally used to cover items not covered by commercial property and business income insurance
D. Inland marine insurance: Specialized transportation insurance characterized by coverage of specific goods in transit
E. Crime insurance: Protects the business against losses that arise from illegal activities such as burglary, robbery, extortion, forgery, employee dishonesty, and theft
F. Commercial general liability (CGL) insurance: Protects business owner against claims by members of the public who are injured or suffer a loss in, or as a result of, the business. The policy provides little or no coverage for (1) liability to employees, (2) liability arising from rendering or failure to render professional services, and (3) liability arising from automobile, aircraft, or watercraft. A client who suffers a financial loss because a financial planner implemented an incorrect investment transaction is not covered by CGL insurance.
G. Commercial auto insurance: When an auto is not eligible for PAP, it is generally provided similar coverage under a commercial auto policy.

4. Umbrella liability insurance

A. Broadens coverage over and above the underlying personal liability coverage. A deductible must be satisfied in all umbrella policies, which is usually equal to the liability limits of the automobile or homeowners policy. Most insurance companies require one or both of automobile and/or homeowners policy to be with the company that is providing the umbrellas coverage. Lastly, the insurance company will require specified minimum levels of automobile or homeowners coverage to be kept by the insured as a prerequisite for providing umbrella insurance to the insured.

5. Commercial liability insurance

A. Professional liability insurance provides coverage for legal liability arising from the failure of a person to use the care and the degree of skill expected of a practitioner in his or her profession. The liability coverage available to professionals is two forms:

(1) Errors and omissions insurance covers exposures to financial and property damage liability (including intangible property). This coverage is designed primarily for insurance agents, lawyers, accountants, architects, and real estate agents. This is the form used by financial planners.
(2) Malpractice insurance is used to cover exposures to bodily injury liability. This coverage is designed for doctors, dentists, and hospitals.

B. Product liability insurance protects against claims resulting from a product that is produced or manufactured by a business.

6. Umbrella liability

A. An umbrella liability policy provides liability coverage in excess of the limits or exposures in basic liability policies. Coverage is typically $1 million or more. The two functions of the umbrella policy are:

(1) To provide increased coverage when the limits of the basic coverage are inadequate to cover future judgments
(2) To provide broader coverage than that provided by the basic policy or policies (the homeowners and auto policies would both be basic policies)

B. The umbrella insurer requires the insured to have adequate underlying basic liability policies before an umbrella liability policy will be issued. For example, a typical insurer may insist that the insured have auto liability limits of $100,000/$300,000/$50,000 and minimum CPL coverage of $300,000.
C. If the policy owner fails to maintain adequate underlying coverage, the insurer will pay only the amount it would be required to pay had the underlying policy been in force.

(1) *Example:* assume a $1 million umbrella policy with the required underlying limit of $250,000 per person under an auto liability policy, but the insured's liability limits are only $50,000. If an injured party obtains a legal judgment of $750,000 against the insured, the underlying auto policy will pay $50,000 and the umbrella policy will pay $500,000. The insured would have an uninsured loss of $200,000.

D. Exclusions to umbrella liability insurance include: (1) owned or leased aircraft and watercraft; (2) business pursuits (unless these exposures are covered by a basic policy or policies); (3) rendering or failure to render professional services; (4) claims normally covered by workers' compensation; (5) intentional injury; (6) damage to

property owned by the insured, or damage to nonowned property in the insured's care, custody, and control.

7. Professional liability

A. Business and business activity

(1) Commercial property insurance: Protecting real and personal property used in business. The coverage applies to losses from most perils other than those that relate to crime, transportation, and boiler explosion.
(2) Business income insurance: Protects against loss of income after the occurrence of direct physical damage to business property
(3) Commercial general liability (CGL) insurance: Protects business owner against claims by members of the public who are injured or suffer a loss in, or as a result of, the business. The policy provides little or no coverage for:

(a) Liability to employees
(b) Liability arising from rendering or failure to render professional services
(c) Liability arising from automobile, aircraft, or watercraft

(4) A client who suffers a financial loss because a financial planner implemented an incorrect investment transaction is not covered by CGL insurance.

8. Directors and officers liability

A. A corporation purchases this insurance, and the corporation is the policyholder but not the insured. The officers and directors are the insured. It protects officers and directors against lawsuits brought by stockholders, creditors, competitors, and governments.
B. Exclusions include bodily injury and damage to tangible property, fraudulent acts, violations of securities laws, and acts that result in personal gain to which the director or officer is not entitled.

9. Workers' compensation and employers liability (WC&EL)

A. If an employee is hurt on the job, even because of his or her own negligence, the injury is covered.

TOPIC 18: HEALTH INSURANCE AND HEALTH CARE COST MANAGEMENT (INDIVIDUAL)

1. Hospital, surgical, and physicians' expense insurance

A. These plans provide benefits only for individuals who are hospitalized or need surgery. There are no benefits for visits to the physician's office.
B. The policy is inadequate for prolonged sickness and serious accidents, as well as medical expenses outside the hospital setting.
C. Hospital coverage is provided for a limited number of days, and surgical coverage is paid on a fee-schedule basis. A fee-schedule basis repays the patient an amount stated in the contract for each day of hospitalization and for listed surgical procedures, regardless of the actual cost.
D. These plans tend to have the lowest premiums because they pay the least benefits.

2. Major medical insurance and calculation of benefits

A. These plans usually provide $1 million or more in coverage and cover almost everything related to illness or injury. They typically have a deductible, coinsurance, and a stop-loss that apply to a wide range of covered expenses.

B. Major medical plans share several characteristics:

(1) In most cases, the insured has complete freedom to choose any medical provider without reduced benefits. In some cases, the insured receives reduced benefits if a medical provider is chosen outside the network.
(2) These plans do not make use of a gatekeeper (i.e., primary care physician).
(3) Major medical plans do not provide benefits for preventative care.
(4) Major medical plans differ in their coverage of prescription drugs. Some plans require a policy rider for drug coverage, and others carry limitations, such as a maximum benefit.

3. Traditional indemnity

A. Indemnity plans—comprehensive medical expense plan

(1) Coverage includes diagnostic, medical, hospital, and surgical services.
(2) Reimbursement amounts are capped; the plan pays up to policy or lifetime limit.
(3) Patients are allowed to visit any doctor for any number of visits.
(4) Escalating costs have resulted in managed care plans: preferred provider organizations (PPO), health maintenance organizations (HMOs), and point-of-service (POS) plans.

B. Managed care plans share the following characteristics:

(1) Controlled access to providers: Managed care programs control costs by limiting which physicians or hospitals can be used. They also use primary care physicians to determine the necessity of specialized care in order to control costs.
(2) Comprehensive case management: This includes treatment, ongoing care, and reviews.
(3) Preventative care: To keep costs down, managed care plans encourage a healthy lifestyle to prevent illness in later years.
(4) Risk sharing: If physicians share in the financial consequences of their decisions, managed care programs can possibly eliminate unnecessary tests and expenses.
(5) High-quality care: The quality of care must be high to encourage individuals to participate.

4. Preferred provider organization (PPO)

A. Benefit plans that contract with preferred providers to offer medical services to plan participants at a reduced rate
B. There are several characteristics of a PPO:

(1) Medical providers are paid on a fee-for-service basis.
(2) The insured has the choice to use network or out-of-network providers. There are incentives to use network providers, including such benefits as lower deductibles and copayments and broader type of covered care.
(3) Most PPOs do not use a primary care physician as a gatekeeper. Therefore, participants do not need referrals to see specialists.
(4) PPOs are slightly more costly than HMOs.

5. Health maintenance organization (HMO)

A. An organized system of health care that provides a broad range of medical services on a prepaid basis to subscribers within a particular geographic region. There are several characteristics of an HMO:

(1) Highest degree of review, including financial incentives and disincentives for providers
(2) Offers a comprehensive package of health care with an emphasis on preventative care

(3) Subscribers pay an annual premium to receive medical services.
(4) Subscribers are required to see providers who are affiliated with the HMO. Out-of-area or out-of-network coverage is possible, but only in the case of medical emergencies.
(5) Emphasizes treatment by primary care physicians; therefore, access to specialists is controlled.

6. Continuance and portability

A. When a worker loses eligibility from employer-provided group health insurance, the worker may opt for COBRA coverage (see topic 29.D) or elect to convert to an individual policy.
B. The portability feature is that the worker can convert the employer policy to an individual one and take it with him or her after leaving employment. This conversion privilege only provides the worker with the right to buy an individual policy at individual rates offered by the insurer. Lastly, an insurer may refuse to issue a conversion policy if the individual can receive coverage elsewhere, such as through Medicare.

7. Medicare

(1) Medicare Part A
(a) Anyone over 65 who is eligible for retirement benefits is eligible for Medicare Part A.
(b) Disabled persons are covered after two years of disability benefits.

(2) Medicare Part B
(a) Anyone eligible for Part A is automatically eligible for Part B.
(b) Voluntary enrollment—a person can opt out of Part B.
(c) A monthly premium payment is required.

(3) Medicare Part C
This is a prescription drug plan offered since 2006 through stand alone plans or HMO plans with an average monthly premium of $35. Initial enrollment is between Nov. 15 and Dec. 31. A premium penalty is imposed for applying past May 15. Anyone enrolled in Medicare Part A or Part B, or both, is eligible for coverage, including those on Medicare because of disability. For 2007, the plan will pay the following percentages of prescription drug costs.

- 0% of the first $265 (the insured's deductible)
- 75% on amounts between $265 and $2,400
- 0% on amounts between $2,400 and $5,451.25
- 95% on amounts above $5,451.25 (once out of pocket costs exceed $3,850)

8. Coverage provided by Parts A and B

A. Benefits covered by Medicare Part A
(1) Hospital coverage
(a) Hospital expenses are paid in full for 60 days during the benefit period. This is followed by 30 additional days with copayment and a 60-day lifetime reserve.
(b) A benefit period begins when a Medicare recipient is hospitalized and ends only when the recipient has been out of the hospital or skilled-nursing facility for 60 consecutive days.
(c) There is no limit on the amount of benefit periods a person can have in a lifetime.
(d) The 60-day lifetime reserve may be used if the 90-day period has been exhausted.

(2) Skilled nursing facility
(a) Benefits in a skilled-nursing facility are provided only if a physician certifies that skilled-nursing care or rehabilitative services are needed for a condition

that was treated in the hospital resulting in a stay of at least 3 days within the last 30 days.

(b) Benefits are paid in full for 20 days, and an additional 80 days are covered with a copayment. After 100 days of coverage, the patient must pay the full cost of skilled-nursing facility care.

(c) Every patient must be under the supervision of a full-time nurse and a physician, and the physician must be available at all time for emergencies.

(d) It is important to note that sole custodial care is not provided under any part of Medicare. However, there is a degree of custodial care provided when skilled-nursing or rehabilitative services are needed and covered under the plan.

(3) Home health care

(a) Medicare pays home health care benefits in full.

(b) To receive these benefits, a person must be confined to his or her home and be treated under a home health plan established by a physician.

(4) Hospice

(a) Hospice benefits are available under Medicare for individuals who are certified as being terminally ill with a life expectancy of less than six months.

(b) Benefits are provided primarily in the patient's home by a Medicare-approved hospice.

B. Benefits covered by Medicare Part B: Physicians' and surgeons' fees, diagnostic tests, physical therapy, drugs that cannot be self-administered, medical supplies such as splints and casts, rental of medical equipment such as wheelchairs, mammograms and Pap smears, prosthetic devices, ambulance services, diabetes glucose monitoring, colorectal and prostrate cancer screening, and bone mass measurements

C. Benefits not covered under Medicare: The original Medicare plan does not cover health care for a person traveling outside the United States (there are exceptions for emergencies in Mexico and Canada); it does not cover custodial care, dental work, cosmetic surgery (except after an accident), routine foot care, eye and hearing exams, prescription glasses and hearing aids, most prescription drugs, private room in hospital or nursing home, services covered under workers' compensation, most chiropractic care, acupuncture, or most immunizations.

D. Benefits covered by Medicare + Choice (Part C): Covers all the services covered under Part A and Part B and additional services such as prescription drugs

9. Cost of coverage

A. Medicare Part B costs are $93.50 per month (in 2007).

B. Medicare + Choice Plans and Medigap premiums vary among companies.

10. Taxation of premiums and benefits

A. Medical premiums can be deductible on Form 1040 in one of two places. If the individual is self-employed, the entire premium can be written off as an above the line deduction (for AGI). If the individual is an employee, then it must be written off below the line (from AGI) on Schedule A of Form 1040.

B. Benefits for all taxpayers must be written off on Schedule A of Form 1040. They are generally tax free to the taxpayer unless insurance reimbursements exceed actual expenses.

C. Health Savings Accounts (H S A) provide another benefit and are discussed under topic 29.F.1.

TOPIC 19: DISABILITY INCOME INSURANCE (INDIVIDUAL)

1. **Definitions of disability**

   A. No benefit is payable if the injury or illness is not disabling. There are four basic types of definitions of total disability found in current policies:

      (1) Own occupation: The inability to engage in one's own occupation
      (2) Modified any occupation: The inability to engage in an occupation for which fitted by education, training, or experience
      (3) Any occupation: The inability to engage in any occupation. It is the most restrictive and is used by only a few companies.
      (4) Loss of income: This provision pays when the insured has a reduction of income due to an illness or injury that is at least at a specified level. It measures only income.

   B. A number of companies use a so-called split definition of disability. A split definition is own occupation for some period of time, such as two years, then a modified own occupation definition. This is found in group policies more often than individual policies.
   C. Many short-term disability income policies do not provide disability income benefits for illnesses or accidents resulting from occupational exposures. In most cases, workers' compensation laws mandating coverage cover occupational disabilities. Policies excluding occupational disabilities are known as nonoccupational policies. Long-term policies often provide benefits for both occupational and nonoccupational disabilities.
   D. Beyond the basic definition, many policies provide different benefit levels for disabilities that are total, partial, and/or residual disabilities:

      (1) Total disability benefits provide for the full policy benefit.
      (2) Partial benefits promise to pay a reduced benefit if the insured can perform some but not all of the important daily duties of his or her occupation. The partial disability benefit is usually 50 percent of the total disability benefit. The benefit is usually paid for only a short time. Six months is the most common benefit period.
      (3) Residual benefits are usually paid after a total disability and are designed to allow the insured to return to work without losing all benefits. Benefits are usually paid based on the percentage of lost income. These are better than partial disability benefits in that there is typically no limit for the length of time that reduced benefits are available.

2. **Benefit period**

   A. Benefits are usually paid based on the percentage of lost income. These are better than partial disability benefits in that there is typically no limit for the length of time that reduced benefits are available.
   B. Short-term disability provides benefits for a limited period of time, usually up to six months, subject to a one- to seven-day waiting period for sickness and no waiting period for accidents. Some plans have the same waiting period for sickness and accidents, and other plans have no waiting period. Benefits rarely exceed beyond one year.
   C. Long-term disability provides extended benefits—up to two years or life—subject to a three-month or six-month waiting period. Six-month waiting periods are the most common.
   D. The waiting periods for sickness and accident are the same.

3. **Elimination period**

   A. Elimination period (waiting period) is the deductible for a disability income insurance policy. The purpose of the waiting period is to eliminate coverage for short-term disabilities

and to help control the moral hazard. By denying replacement of income for a period, the insurer can deter the insured from faking a disability to enjoy a paid vacation. The longer the elimination period, the lower the premium.

4. Benefit amount

A. Disability income plans are designed to provide a benefit level that replaces a percentage of regular earnings (excluding bonuses and overtime):

(1) Short-term disability plans range from 50 to 100 percent, but 70 percent is usually the upper limit. Some short-term plans use different percentages—for example, paying 100 percent of earnings for four weeks and then 70 percent of earnings for the rest of the time.

(2) Long-term disability plans typically provide benefits in the range of 50 to 70 percent of an employee's gross income; 60 and 66 2/3 are the most common percentages. These plans often place a maximum dollar amount on the benefit that is provided.

5. Provisions

A. Riders

(1) Cost-of-living allowance (COLA) riders provide for periodic increases in the disability income benefit after the insured becomes disabled.

(2) The presumptive disability provision states that the loss of the use of two bodily members or the loss of sight or hearing will be presumed to be total disability, whether or not the insured is able to do any work for compensation.

(3) The guaranteed insurability provision permits the insured to purchase additional amounts of coverage if his or her income has increased.

(4) The automatic benefit increase provision increases the benefit each month to reflect the increased cost; a waiver of premium provision exists if the insured becomes totally disabled and the disability lasts for a period of time.

(5) The Social Security substitute rider permits the coordination of disability insurance with the Social Security insurance program.

(6) The probation period is the period of time after issuance of a policy in which specified illnesses or injuries will be excluded from coverage.

(7) The preexisting conditions clause covers a physical condition that the insured had before the disability income policy was issued. Preexisting conditions are typically excluded from coverage under individual disability income policies.

(8) The change of occupation provision allows the insurer to reduce the benefit payable if the insured changes to a more hazardous occupation.

(9) The relation of earnings to insurance clause (also called average earnings clause) states that if the total disability income provided by all policies exceeds the insured's earned income, or average earned income for the preceding two years (whichever is greater), the income benefits under the policy will be reduced proportionately. The clause is designed to protect the insurer from the moral hazard associated with a situation in which the disability benefits payable may exceed the normal income of the insured.

B. Policy continuation provisions

(1) Noncancelable policy: The insurer may not cancel or increase premiums.

(2) Guaranteed renewable policy: The insurer may not cancel, but may increase premiums for an entire class of policy owners.

(3) Conditionally renewable policy: The insurer has the right to terminate the contract by not renewing it.

(4) Policy renewable at the company's option (optionally renewable): Usually tied to association-type plans. The insurance company has the right to cancel the insured's policy at the end of the policy year.
(5) Policy with no provision: The insurer has complete flexibility to renew or refuse to renew the policy. The insured must apply for new coverage rather than a renewal.
(6) Cancelable policy: This is an even more common clause used in association with group plans. The insurer can terminate this policy anytime during its term.

6. Taxation of premiums and benefits

A. If disability benefits are received from an employer-provided disability policy, such benefits are totally included in taxable income.
B. If disability benefits are received from an employee-paid disability policy, such benefits are excluded from taxable income.
C. If disability benefits are received from a policy paid by both an employer and an employee, then benefits are included in income to the extent of the employer pro rata share of premiums. *Example:* Steve is covered under a long-term disability income insurance plan of his employer. Steve pays 75 percent of the premium cost, and the employer pays 25 percent of the premium cost. The income tax treatment is as follows:

(1) The employer's contributions are deductible and are not taxable as income to Steve.
(2) Steve's contributions are not tax deductible.
(3) 25 percent of any disability income payments are tax free to Steve, and 75 percent are taxable as income.

TOPIC 20: LONG-TERM CARE INSURANCE (INDIVIDUAL)

1. Eligibility

A. The Health Insurance Portability and Accountability Act (HIPAA) created a definition for qualified long-term care (LTC) plans. HIPAA provides favorable tax treatment only for qualified long-term care insurance contracts:

(1) Only qualified long-term care insurance can be provided.
(2) The policy cannot pay for expenses reimbursed under Medicare.
(3) The policy cannot have a cash surrender value or loan provision.
(4) Refunds of premiums and policy dividends must be used to reduce future premiums or increase future benefits.
(5) The policy must comply with consumer protection provisions, such as those adopted in the National Association of Insurance Commissioners (NAIC) model Act.

B. HIPAA defines qualified long-term care services as necessary diagnostic, preventive, therapeutic, curing, treating, and rehabilitative services and maintenance or personal care services that are required by a chronically ill person and are provided by a plan of care prescribed by a licensed health care practitioner.

C. A chronically ill person is one who meets the following requirements:

(1) The inability to perform at least two activities of daily living (ADLs) for a period of at least 90 days. The Act identifies ADLs as eating, bathing, dressing, transferring from bed to chair, using the toilet, and maintaining continence. A qualified long-term care policy must contain at least five of the six.

(2) Substantial services are required to protect the individual from threats of health and safety due to cognitive impairment.

2. Services covered

A. Nursing home and in-home care

(1) Skilled-nursing care: Requires a registered nurse who is under a licensed physician's supervision. The nurse is available 24 hours a day.
(2) Intermediate care: Requires fewer nurses per 100 persons for whom nursing care is being provided and must be based on doctor's orders.
(3) Custodial care: Care for which medical services are not needed. Custodial care requires a low nurse-to-patient ratio. The main services and functions provided are food preparation, food service, bathing, and moving patient from bed to chair and subsequently from chair to bed.
(4) Home health care: Allowed when a person is capable of providing limited service for him- or herself. Daily or weekly nurse visits are common.
(5) Assisted-living care: This is provided by facilities that care for the elderly who do not need the same level of care as provided in nursing homes.
(6) Respite care: This is occasional full-time care at home for a person receiving home health care. It gives family members a break from providing care.

3. Medicare limitations

A. Medicare only pays for the first 100 days of stay at a skilled nursing facility. Medicare generally will also not pay for custodial care.
B. Benefit period

(1) The duration of an LTC policy benefit is impacted by the elimination period and a maximum benefit period; the longer the elimination period, the lower the premium. In contrast, the longer the maximum benefit period, the higher the premium.

C. Elimination period

(1) Elimination protection: Benefits do not begin until a specified period of time passes after the individual starts receiving LTC. This period can be as short as 0 days and as long as 365 days.

D. Benefit amount

(1) Benefits are primarily a specified amount per day. They are sold in increments of $10 per day up to $500 per day; benefits can be provided on an indemnity basis that covers 80 to 100 percent of charges up to a maximum amount.

E. Provisions

(1) The NAIC model legislation emphasizes two areas, policy provisions and marketing provisions.

(a) Policy provisions:

(i) Certain terms can be used in the policy only if defined. These include adult day care, skilled-nursing care, and the like.
(ii) The renewal provisions are only guaranteed renewable and noncancelable:
- Guaranteed renewable: Premiums can be adjusted.
- Noncancelable: Premiums cannot be changed.
(iii) Exclusions are prohibited except for some conditions:

- (iv) A maximum look-back period of six months relating to preexisting conditions
- (v) Mental and nervous disorder (but not including Alzheimer's disease)
- (vi) Alcoholism and drug addiction
- (vii) Suicide and war
- (viii) Services available under Medicare and other social insurance programs.
- (ix) A policy must offer the ability to purchase more coverage.
- (x) It must offer the right to purchase a nonforfeiture option.
- (xi) An inflation protection benefit must be offered.
- (xii) The policy must have a provision that waives premiums if the insured has been receiving benefits for a specified period of time, such as 60 or 90 days.
- (xiii) After two years, the policy must be incontestable based on misrepresentation. It can still be contested if the applicant intentionally misrepresented facts pertaining to his or her health.
- (xiv) There is a prohibition of a prior hospitalization requirement in order to qualify for nursing home care, and a prohibition on requiring prior nursing home care in order to qualify for home health care benefits.
- (xv) Group coverage must provide for continuation or conversion.

(b) Marketing provisions

- (i) The prospective applicant must receive an outline of coverage, a shopper's guide, and a free 30-day look at the policy. Therefore, a full refund of premiums must be paid up to 30 days after the policy is purchased if the applicant chooses not to keep the contract.
- (ii) The insurer must ensure fair and accurate comparisons with other competitors.
- (iii) The insurer must provide unambiguous and clear wording in the application to ascertain the applicant's health.
- (iv) The policy cannot be issued until the applicant is given the option to identify a third party to be notified of any pending lapses because of failure to pay premiums.
- (v) If a policy replaces another policy, the new policy must waive any time period pertaining to preexisting conditions and probationary periods for comparable benefits.
- (vi) Insurers must report lapse rates, replacement sales, and denied claims each year.
- (vii) Advertising materials used by insurance companies must be filed with the state regulatory authority.
- (viii) The contracts must have a defined incontestability period and require that the insurance company define conditions for rescission of the policy.
- (ix) Inflation protection: The cost is built into the initial premium. Therefore, premiums do not increase at the time of the annual increase.

(2) Taxation of premiums and benefits

F. Tax implications and qualifications: Qualified long-term care contracts have favorable tax benefits if the contracts are guaranteed renewable, do not provide a cash surrender value and must not pay for expenses that are reimburseable by Medicare. If so, then individuals can deduct premiums paid for LTC in excess of 7.5 percent of adjusted gross income within certain limits established by a covered individual's age. Employer contributions are deductible to the employer and result in no taxable income to the employee; benefits are received tax free with one exception. For contracts written on a per diem basis, proceeds are excludible from income up to a certain daily amount, which is indexed annually.

TOPIC 21: LIFE INSURANCE (INDIVIDUAL)

1. Concepts and personal uses

A. Certain basic characteristics are common among all life insurance policies:

(1) It is not the possibility of death that is insured, but rather an untimely death.
(2) Life insurance is not a contract of indemnity. It does not attempt to put the individual in the same financial position as before the loss.
(3) An insurable interest must exist at the onset of the contract.

2. Policy types

A. Life insurance is divided into two types:

(1) Term insurance

(a) Term insurance is sometimes called pure insurance.
(b) It pays a death benefit if a person dies during a specified time period.
(c) There is no cash value or loan element.
(d) There are increasing premiums in later years when the policy is renewed.
(e) Key points common with term policies are renewability and convertibility.

(i) Renewability: The right to renew the contract without a medical examination or other evidence of insurability
(ii) Convertibility: Allows the policyholder to exchange the term policy for a permanent policy without evidence of insurability

(2) Permanent insurance

(a) The protection afforded by permanent insurance never expires, and the policy never has to be renewed or converted.
(b) The protection is guaranteed as long as policyholders continue to pay premiums or pay up their policies, regardless of health.
(c) Permanent policies have a cash value and a loan element.
(d) There is an advantage of tax-deferred investment income with the cash value.
(e) Permanent insurance includes whole life insurance, endowment insurance, universal life insurance, adjustable life insurance, and variable life insurance.

B. The cash value of a permanent insurance policy acts as a savings fund for the policyholder:

(1) The level premium concept helps explain how a cash value reserve accumulates over time for the insured. This means that the insurance company will receive the same premium amount regardless of the age of the insured. In the early years of the policy, the insured pays more than the cost of pure life insurance protection. In later years, the insured is actually paying less than the cost of pure life insurance.
(2) The policy can be viewed as having two parts: the portion of the cash value and the pure insurance. The effective amount of insurance is the difference between the face amount and the reserve. This amount is called the net amount at risk. Life insurance is seen as a decreasing term (net amount of risk) and an increasing amount of investment (the growing reserve). These two elements always equal the face amount of the policy.
(3) The cash value reserve is not solely the property of the insured. It is the insured's only if and when the policy is surrendered.

(4) There are three distinct advantages in the use of a cash reserve:

(a) By paying an amount in excess of the cost of pure insurance during the early years of the contract, the insured avoids a rising premium in the later years.
(b) If the insured survives, he or she has accumulated a savings fund that can be used for income in old age.
(c) Cash value policies permit borrowing on the policy up to a specified percentage of cash value, usually at a guaranteed interest rate.

C. Term insurance

(1) A yearly renewable term (YRT) policy is a one-year term contract renewable for successive periods of one year each. It is a policy that typically has a low first-year premium that increases every year while the face amount is fixed.
(2) Level-term insurance guarantees level premiums and face value for up to 10 years, and there are some policies that project level premiums for 20 years or more.
(3) Decreasing term insurance provides systematic decreases in the amount of benefit from year to year. Decreasing term insurance is often used to provide funds for paying off a mortgage. Such policies typically have a level premium.

D. Whole life insurance

(1) Whole life insurance was devised as an alternative to the increasing premium payment associated with term insurance. The level premium is the result of spreading out the increasing annual insurance costs over the life of the insured (see Topic 29 1.C.).
(2) Whole life policies involve the fixed payment of premiums over a very long period of time. Premiums must be paid when due or when the policy lapses.
(3) These policies provide a guaranteed but fixed death benefit.
(4) Whole life policies offer a balance between protection and cash accumulation.
(5) The insured does not control the investment vehicle in a whole life policy. Instead, the insurance company invests the premiums in investment-grade bonds and high-quality mortgages. The result is a modest return on invested funds. Thus, whole life policies do not provide a hedge against inflation. The cash values lose purchasing power during inflationary periods.
(6) The policyholder can discontinue making premium payments and choose among the different nonforfeiture options.
(7) There are four primary types of whole life insurance:

(a) Ordinary whole life assumes that the premium rate will be payable throughout the insured's life. It has the lowest premium rate for any whole life policy and a lower cash value than other whole life policies.
(b) Limited-pay whole life is for someone who wants protection for life without paying premiums in retirement. This type of whole life policy differs from a traditional whole life policy in three ways: (1) Premium payments do not continue for life even though it provides lifetime protection; (2) the premium rate is higher than that of whole life because the period of time is limited; (3) the policy builds up cash value faster than whole life.
(c) Single-premium whole life (SPWL): Whole life policy in which a single premium is paid up front as a lump sum for life protection. The compelling reason for buying an SPWL is to use a life insurance policy as a tax-deferred investment.

(d) Graded premium whole life: Has a relatively low initial premium that increases each year for five to seven years. When it levels out, it is usually higher than the whole life premium that would have been charged at the beginning of the policy's life, but lower than if the policy were taken out at the end of the increasing premium period. It is designed to allow individuals who want income to catch up with permanent insurance premiums.

E. Universal life insurance

(1) Universal life (UL) permits a policyholder to increase or decrease the death benefit coverage with satisfactory evidence of insurability.
(2) It provides extreme flexibility by allowing the policyholder to increase or decrease the amount and frequency of premium payments as long as the cash value is sufficient to cover the cost of continuing the policy.
(3) Interest credited to the policy's cash value is geared to current interest rates, but is subject to a minimum amount, such as 4 percent. This provides a hedge against inflation.
(4) As interest rates increase, the policy's cash value increases more than that of whole life, and this results in more tax-deferred investment income.
(5) Changes in interest rate can also be viewed as a disadvantage inasmuch as future yield potential may be uncertain.
(6) Universal life is often called unbundled insurance—it is possible to see the entire operation (operating expenses, mortality charges, and cash value buildup) of the policy in the annual statement.
(7) A UL policy differs from a whole life policy in specific ways:

(a) The premium payment is flexible.
(b) The death benefit is adjustable.
(c) The investment and mortality risks are shifted from the insurance company to the policyholder.

(8) There are two choices of death benefit designs:

(a) Universal life, Option A (or 1)—level death benefit:

(i) The death benefit is the face amount of the policy. Hence, the death benefit includes the cash accumulation fund.
(ii) The mortality charges are based on the net amount at risk or protection element, the face amount of the policy minus the accumulation fund.
(iii) One exception: If the cash value gets high enough and represents a large proportion of the death benefit, the policy will increase the death benefit even though it is called a level death benefit contract. This is a rare occurrence, and tax law defines the specified proportion of the death benefit derived from the net amount at risk.

(b) Universal life, Option B (or 2):

(i) This form of universal life pays the stated face amount plus its cash value at the insured's death.
(ii) There is always a constant net amount at risk over the policy's cash value.
(iii) The death benefit increases when the cash value increases, whereas a reduction in cash value will reduce the death benefit.
(iv) The monthly mortality charges are based on the face amount of the policy every year.
(v) This option is more expensive than Option A (or 1).

F. Variable life insurance

(1) The policy owner selects the investments to which the savings element will be directed.
(2) There is no guaranteed cash value or crediting rate.
(3) Investments are in separate accounts that look much like mutual funds, but technically are different. Policies generally have between 5 and 15 separate accounts from which to choose, one of which is always a conservative interest-bearing account.
(4) In a down market, a policyholder runs the risk of being surprised with a premium notice that a substantial payment must be made just to keep the policy in force.
(5) A variable life insurance policy shifts the investment risk to the insured and lets the insured direct some or all of the policy's cash value into the securities market. This permits the insured to participate in the returns of the equity market.
(6) Must be sold with a prospectus and can be sold only by licensed insurance and securities agents
(7) Guaranteed minimum death benefit only equal to the initial face amount of the policy
(8) Above the minimum, the death benefit depends on the performance of the policy owner's selected investments.
(9) Allows policy loans, but at a smaller percentage than traditional whole and universal life insurance
(10) Contains the usual range of nonforfeiture options

G. Variable whole life insurance

(1) Fixed premiums of whole life
(2) Guaranteed death benefit of whole life
(3) Investment flexibility of variable life
(4) The big difference from other types of whole life insurance is that it has no guaranteed cash values.

H. Variable universal life insurance:

(1) Premium flexibility of universal life
(2) Death benefit design flexibility of universal life
(3) Investment flexibility of variable life
(4) The big difference from ordinary universal life insurance is that it has no guaranteed cash values.

I. Endowment policies

(1) Death benefit equals cash value at maturity.
(2) Purchaser can specify the policy's maturity date (10-, 15-, 20-, 25-, 30-year endowments, and longer).
(3) Whole life insurance is identical in design to an endowment at age 100, when cash value equals the death benefit.
(4) The 1984 change in the federal income tax law eliminated the tax-advantaged buildup of an endowment's cash value. The current sale of endowment contracts is very limited in the United States.

J. Joint-life insurance

(1) A first-to-die policy is specifically for business continuation agreements. All of the owners are insured under the same policy. When the first owner dies, the insurance company makes a payment that is used to buy the deceased owner's share of the business.

(2) A second-to-die policy is popular for estate tax payment:

(a) It is usually purchased as a policy on the lives of both spouses.

(i) Upon the death of a married person, the entire estate passes to the surviving spouse free of federal estate taxes. However, upon the death of the second spouse, estates of more than $2 million (in 2007) are taxable. The taxes can be paid with the proceeds from a second-to-die policy.

(b) This policy eliminates any liquidity problems.

(c) If the deceased owned the policy, it is included in the estate of the deceased, even if the deceased is not the beneficiary.

(3) A family income policy is a combination of decreasing term insurance and some form of whole life insurance. The whole life insurance pays a lump sum, and the term rider provides income designed to end at a specified date in the future.

(4) A family life insurance policy has a base policy on one adult in the household. This is typically whole life. The policy also covers other members of the family. The policies are usually sold in "units." A typical unit may be $25,000 on the primary insured, $15,000 on the spouse, and $5,000 on each child.

3. Contractual provisions

A. Participating versus nonparticipating policies

(1) Nonparticipating policies do not pay any policy owner dividends. In contrast, participating policies charge a small extra margin in the premium with intent to return a part of the premium in the form of dividends.

(2) Participating policies have the ability to respond to changes in the economy. When interest rates soared in the late 1970s and early 1980s, it was participating policies that kept up with the changes and did not lock policy owners into very low interest earnings in their policies.

B. Entire contract: The policy, including the attached application, is the whole contract. There are no other documents that control it.

C. Ownership: Someone owns life insurance with an insurable interest in the insured. The contract can be transferred in whole or in part by the owner, but the transfer is effective only if the insurance company is notified in writing.

D. Beneficiary: The beneficiary or beneficiaries are named in the application. The owner may change the beneficiary unless that designation has been made irrevocable. Any change must be in writing to the insurance company to be effective:

(1) Primary beneficiary: The individual first designated to receive the proceeds of an insurance policy

(2) Contingent beneficiary: A beneficiary who is entitled to receive proceeds if the primary beneficiary has died

E. Collateral assignment: Allows the owner to use the policy as collateral. This is often done in a business setting.

F. Incontestable clause: This clause gives the insurance company two years during the life of the insured to discover any information about the insured that would have affected issuance of the policy. If material adverse information is found, the company has the right to void the contract. If the information is found after the two years, the policy stays in force (fraud is an exception).

G. Misstatement of age: If, at death, the death certificate shows the insured was older or younger than stated in the application, the death benefit will be adjusted to what the premium would have purchased.

H. Grace period: This is the automatic extension for premium payment, usually to 31 days after due date. Without this provision, if a premium is received after the due date, the policy lapses.

I. Reinstatement: If the premium arrives after the grace period, the policy lapses. The reinstatement provision permits the owner, if insurable interest still exists and if the insured is still insurable, to reinstate a policy that has lapsed for nonpayment of premium. If a policy was surrendered for its cash value, it may not be reinstated. Generally, reinstatement is automatic if requested within 30 days of the end of the grace period.

J. Automatic premium loan: If the premium has not been paid at the end of the grace period, the company will automatically lend the owner the premium, using the cash value of the policy as collateral. This prevents the policy from lapsing. It is used only in cash value policies.

K. Suicide clause: Adverse selection would occur if insurance companies had to honor death claims for suicides that occurred shortly after a life insurance policy is taken out. In most states, if the insured commits suicide within the first two years after the policy was issued, the insurance company will pay only the cumulative premiums plus interest.

L. Aviation and war clauses: These eliminate coverage for any death that is aviation related or due to war. Few if any policies currently have these provisions.

M. Policy loans: Permanent policies permit owners to borrow from the insurance company at a specified interest rate, using the policy as collateral. The policy loan clause describes that right and contains specific provisions.

N. Simultaneous death clause: If the insured and the beneficiary die simultaneously, it will be presumed that the beneficiary died first. The proceeds will be distributed as if the insured survived the beneficiary and will be paid to the secondary beneficiary or to the insured's estate.

O. Common disaster clause: Settlement of the policy proceeds is withheld for a designated number of days after the death of the insured (usually 30), and any beneficiary surviving the insured but dying within the specified period is considered to have predeceased the insured. Therefore, the proceeds are distributed as if the insured survived the beneficiary.

P. Guaranteed purchase option: This option protects the policy owner against the chance of becoming uninsurable by allowing the insured to purchase additional amounts of insurance at specified times or ages without showing evidence of insurability.

Q. Waiver of premium: If the insured becomes disabled, the insurance company will waive premiums on the life insurance policy during the continuance of the insured's disability.

R. Accelerated benefits provision (accelerated death benefit): This allows a terminally ill insured to withdraw a portion of the policy's death benefit before death. The amount received is income tax free.

S. Prohibited provisions found in life insurance:

   (1) Nonpayment of a loan is not a cause for forfeiture.
   (2) An insurance company cannot promise something in the declarations and take it away in the fine print.

T. Dividend options—Participating life insurance policies offer several dividend options:

   (1) Cash: Dividend is paid to the owner in cash. Such payments are considered a return of premium and are income tax free.
   (2) Reduction of premiums: The dividend is used to reduce the current premium.

(3) Accumulation at interest: The insurance company holds on to the funds and pays interest on the accumulated funds. The interest is taxed as ordinary income. This is similar to a savings account.

U. Purchase of paid-up additions: The annual dividend is used to purchase small amounts of paid-up permanent insurance (no future premiums due).

V. Purchase of term insurance: Used in combination with one of the other options. Part of the dividend is used to purchase one-year term insurance in the amount of the guaranteed cash value of the policy.

W. Many companies also permit the owner to apply the dividend to any interest or principal of a policy loan.

4. Nonforfeiture option: A number of choices are available regarding how a life insurance policy owner can use the policy's cash value:

A. Surrender for cash: The policy owner can withdraw the cash value (called cash surrender value) of the policy. All surrenders must be made in cash.

B. Purchase an annuity: The policy owner can purchase an annuity to provide income for life or a specified time period.

C. Buy a reduced amount of paid-up permanent insurance: This option permits the owner to have a zero premium policy of a reduced amount.

D. Buy the same amount of extended term insurance: The amount of the term insurance is the same as the face amount of the original policy, but the period of coverage will be only for the time frame identified in the policy.

5. Settlement options

A. An interest-only option can be used to "buy time" before a final settlement is chosen. When interest only is chosen, the insurance company typically sends a quarterly check representing interest earned during the quarter.

B. A lump sum payment is income tax free. This is the most popular choice of life insurance settlement. A cash settlement allows the beneficiary to retire outstanding debt, pay funeral costs, provide for an emergency fund, and allow for investing in the market.

C. There are several fixed annuity options that provide partial taxability:

(1) Fixed income option: The recipient tells the insurance company how much income is needed each month. The insurance company tells the recipient how long the payments will continue.

(2) Fixed period option: The recipient tells the insurance company how long the money must last. The company then calculates the amount of each payment.

(3) There are four life income options:

(a) Straight life income: The beneficiary receives a specified amount for as long as he or she lives, but nothing is paid after his or her death. This option provides the largest monthly benefit per $1,000 of proceeds.

(b) Life income with period certain: The beneficiary is paid a life income for as long as he or she lives, with a guaranteed minimum number of payments to be made, regardless of how long he or she lives.

(c) Life income with refund: The beneficiary is paid a life income for as long as he or she lives, and if the amount of the original lump sum has not been paid out by the time the beneficiary dies, the remainder of the proceeds will be paid to the secondary beneficiary in a lump sum or continued installments.

(d) Joint-and-survivor income: After the death of one payee, the benefit payments continue until the death of the second payee. The monthly income is reduced when benefits are payable based on two lives.

D. A variable annuity option can also be chosen as a settlement choice. The limitation of the fixed annuity option is that it is, in effect, a savings account that earns a fixed rate of interest. As such, it does not serve as a hedge against inflation. In contrast, a variable annuity offers a return that is consistent with the market by investing the proceeds in a family of mutual funds. The risk of return transfers from the insurance company to the policyholder.

E. Endowment policies:

(1) Death benefit equals cash value at maturity.
(2) Purchaser can specify the policy's maturity date (10-, 15-, 20-, 25-, 30-year endowments, and longer).
(3) Whole life insurance is identical in design to an endowment at age 100, when cash value equals the death benefit.
(4) The 1984 change in the federal income tax law eliminated the tax-advantaged buildup of an endowment's cash value. The current sale of endowment contracts is very limited in the United States.

6. Illustrations

A. Illustrations are sales tools used to help sell life insurance policies, which emphasize projections of financial results that may be achieved from the insurance policy. Because they rely on assumptions over a long period of time, such as for interest rates, dividends, premium payments, and investment earnings, the chances of illustrations proving true over the long term are virtually none.

(1) Policy replacement

B. Sometimes an agent or planner will suggest that an existing life insurance policy be allowed to lapse and that a new and improved policy be purchased to replace the old one.

C. These are some reasons that may justify replacement of a policy:

(1) The insurance company that issued the policy is in financial trouble, and the policy is performing very poorly.
(2) The policy was issued as a "smoker's" policy, the insured quit smoking three years ago, and the insurance company will not consider changing it to a "nonsmoker's" policy.
(3) It is a relatively small term insurance policy, and by replacing it with a very large policy, the cost per thousand of insurance will drop substantially.
(4) All needed life insurance is being purchased by an irrevocable life insurance trust.
(5) Certain provisions and/or riders available with the replacement policy may not be available with the original policy.

D. There are some reasons that replacement may not be appropriate for a client:

(1) The client will have to pay policy acquisition costs again. New underwriting and commission costs must be covered, and any dividends and cash values on the new policy will be small or nonexistent for several years.
(2) The new policy will have a new contestable period and a new suicide clause.
(3) Some provisions and/or riders in the new policy may be less favorable to the client than those in the old policy.

(4) The new premium will be based on the insured's attained age at the time of the replacement.

(5) Although most policies have a policy fee, the savings by eliminating the fee from an old policy generally do not offset the financial losses associated with replacement.

7. Tax issues and strategies

A. Income taxation of death proceeds

(1) The Internal Revenue Code (IRC), under Section 101(a), defines life insurance. If a policy does not qualify under the law as life insurance, the earnings each year (above the premiums paid) are considered ordinary income for tax purposes. If it does qualify as life insurance, all earnings are tax deferred and the death benefit is income tax free.

(2) There are two tests the IRS uses to determine whether a policy meets the definition of life insurance:

(a) The first is called the cash value accumulation test. The most that can be paid into a policy is an amount that would be the "net single premium" to pay up the policy. This rule applies to traditional life insurance policies.

(b) The second test is the guideline premium and corridor test. This test first defines the maximum premium that can go into the policy at any given point in time. It then compares the cash value with the death benefit. There are limits as to what percentage of the death benefit the cash value can be. As this test is generally applied to universal life–type policies, the death benefit of the policies generally increases automatically if the cash value vastly increases, so the policy will continue to qualify as life insurance.

(3) The transfer for value rule states: When a life insurance policy is transferred from one owner to another for "valuable consideration," then a transfer for value has occurred and the income tax exclusion is lost. Only the amount paid for the policy and any subsequent premiums are recovered income tax free by the transferee-owner. There are exceptions to this exception: A transfer for value does not cause this loss of tax-free benefit if it can be categorized as one of the following transfers:

(a) A transfer to the insured

(b) A transfer to a partner of the insured or a partnership in which the insured is a partner

(c) A transfer to a corporation in which the insured is a shareholder or officer;

(d) A transfer in which the basis for the new owner is the same as the basis of the original owner. (This is typically a gift of a policy from an insured to his or her spouse or children.)

(4) Death proceeds distributed from a series of payments have a return of principal portion that is not taxable and an interest earned element that is taxable.

B. Income taxation of living proceeds

(1) Inside cash buildup. A cash buildup in a life insurance policy is not subject to taxation as long as it stays in the policy. If cash is taken out or loaned, it is not taxable unless the life insurance policy is a modified endowment contract (MEC).

(2) An MEC is a policy that failed the seven-pay test:

(a) The policy is an MEC if the total premium actually paid into the policy at any time during the seven-year testing period is more than the sum of the net level premiums that would be needed to result in a paid-up policy after seven years.

(b) If this happens, the death benefit remains income tax free, but there are other changes affecting the loan value:

(i) If the policy cash value exceeds the premiums paid and the policy owner borrows against the policy, then the amount of the loan that is part of the gain in the policy is taxed as ordinary income.
(ii) If the owner is under age 59 1/2, there is a 10 percent penalty tax for taking out the loan.
(iii) If the loan is repaid, it is considered an addition to the basis in the policy.

(c) An MEC is subject to a last-in, first-out (LIFO) tax treatment with respect to loans and distributions from the policy. In contrast, if the policy qualifies as life insurance and is not an MEC, it is taxed as first-in, first-out (FIFO).

(3) Taxation of dividends: The IRS has taken the position that dividends paid on life insurance policies are a return of excess premium. When a policy owner receives dividends from a life insurance company, those dividends are income tax free. If the cumulative dividends paid exceed the cumulative premiums paid for the policy, the excess dividends are reportable as ordinary income for tax purposes.
(4) Taxation of cash surrender: The taxable amount is the total surrendered value minus the policy owner's current basis in the policy:

(a) Surrender value = policy loan + net cash value
(b) Tax basis = premiums paid – dividends
(c) Taxable gain = surrender value – tax basis

(5) IRC Section 1035 Exchange: Under IRC Section 1035, a life insurance policy or an annuity may be exchanged for a similar contract with no adverse income tax consequences.

(a) The funds must be transferred company to company, not through the hands of the policy owner.
(b) The basis in the original policy becomes the basis in the new policy.
(c) The new policy cannot have a later maturity date than the original policy. This means that an endowment at age 65 may not be exchanged for a whole life policy that endows at age 100.
(d) A life insurance policy may be exchanged for an annuity, but an annuity may not be exchanged for a life insurance policy.
(e) The new policy must cover the same insured(s) or annuitant(s).

C. Gift taxation of life insurance:

(1) If a life insurance policy is transferred from one individual to another, or to a trust, there is a potential gift tax. The value of the policy is the interpolated terminal reserve. For the most part, this is close to the cash value of the policy.
(2) Gift tax can apply if a policy owned by one individual on another's life matures by reason of the insured's death and a person other than the policy owner is named beneficiary. For example, if a wife owns a policy on her husband's life and the children are beneficiaries, the proceeds are payable to the children instead of to her. In this case, the policy owner (wife) has made a gift to the beneficiaries (children).

D. Estate taxation of life insurance is influenced by ownership:

(1) If an insured owns a policy on his or her life, then at death the death benefit will be included in his or her estate in determining whether any estate taxes are due.

(2) If the insured had an incident of ownership within three years of death, the proceeds of the policy will be included in his or her estate.

8. Policy ownership issues and strategies, including split-dollar

A. The following are the three popular ownership choices available to purchasers in order to avoid having the proceeds included in the estate of the deceased:

(1) If an irrevocable trust is the owner of the policy, the insured makes payments to the trust to cover the premiums on the life insurance policy. The trust is the beneficiary and designates how the benefits are to be distributed. However, the proceeds are added back into the estate if death occurs within three years after the transfer of the insurance policy to the trust.
(2) A charity chosen by the client can be the owner and beneficiary of an insurance policy. A yearly tax-deductible gift to the charity pays the policy's premium.
(3) The insured can make children the beneficiaries and owners of a policy. Parents can pay premiums without paying gift taxes, if under limits. The child receives the face amount free from federal income and estate tax when the parent dies.

B. Split-dollar life insurance: The owner can be either the insured's employer or the insured.

(1) Endorsement method: The employer owns the policy and has the primary responsibility for paying premiums.
(2) Collateral assignment method: The insured employee owns the policy and has primary responsibility for paying premiums.
(3) Viatical and life settlements

C. Viatical and life settlements: Legal principles:

(1) In a viatical agreement, a policy owner (the viator) who is terminally ill or chronically ill sells a life insurance policy to a third party (the viatical settlement provider) in return for a lump sum cash settlement; The lump sum is a percentage of the death benefit (generally 40 to 80 percent).

D. Requirements: The insured must be terminally ill—expected to live less than two years—or chronically ill—permanently and severely disabled or unable to perform at least two activities of daily living for at least 90 days. The viatical settlement provider generally must be licensed with the state. If the state does not require this, then the provider must meet the requirements of the NAIC Model Act.

E. Tax implications: Viatical agreements are income tax free if the requirements are met. If transferred for value, capital gains may result on the difference between the settlement received and the total premium paid. If the insured lives beyond 24 months, the insured does not have to pay tax.

F. Planning:

(1) Alternatives to consider before using a viatical agreement include an accelerated death benefit provision, accessing cash value in the form of a loan, and using cash value as collateral for a loan from a bank or family member.
(2) The proceeds may make the viator ineligible for assistance that he or she would otherwise receive, such as Medicaid and Supplemental Security Income.
(3) The proceeds may be subject to creditor's claims.
(4) When choosing a viatical settlement provider, financial planners should help clients to consider the provider's reputation, financial strength, privacy provision, state licenses, and overall return.

G. Ethical concepts and planning:

(1) A contractual agreement regarding privacy should be considered to ensure that the viator's personal information (i.e., life expectancy) is not shared with outside sources.
(2) The viator may not receive an adequate payment, and investing in such a contract may be difficult for some investors. The earlier an insured dies, the larger the return provided to the investor.
(3) The new policy owner has no insurable interest in the life of the insured, which can provide an incentive for foul play.

TOPIC 22: INCOME TAXATION OF LIFE INSURANCE

1. **Dividends**

A. Taxation of dividends. The IRS has taken the position that dividends paid on life insurance policies are a return of excess premium. When a policy owner receives dividends from a life insurance company, those dividends are income tax free. If the cumulative dividends paid exceed the cumulative premiums paid for the policy, the excess dividends are reportable as ordinary income for tax purposes.

2. **Withdrawals and loans**

A. Withdrawals are generally treated as a nontaxable return of capital unless the amount exceeds the basis of the policy. At that point, tax would be owed.
B. If the policy is considered a modified endowment contract (MEC—see topic 22.D. below), or if there is a reduction in death benefit during the first 15 years of the policy, then amounts withdrawn are treated as income to the extent of earnings under the policy. Once the policy is considered a MEC, it is always considered a MEC.
C. If withdrawals are taxed, they are always taxed as ordinary income (not capital gains).
D. Loans are borrowings from the policy that are supposed to be paid back. Loans do not create a taxable event unless the policy terminates, lapses, or is considered a MEC. In these cases, the loan may give way to a taxable event.

(1) Death benefits

E. Income taxation of death proceeds:

(1) The Internal Revenue Code (IRC), under Section 101(a), defines life insurance. If a policy does not qualify under the law as life insurance, the earnings each year (above the premiums paid) are considered ordinary income for tax purposes. If it does qualify as life insurance, all earnings are tax deferred and the death benefit is income tax free.
(2) There are two tests the IRS uses to determine whether a policy meets the definition of life insurance:

(a) The first is called the cash value accumulation test. The most that can be paid into a policy is an amount that would be the "net single premium" to pay up the policy. This rule applies to traditional life insurance policies.
(b) The second test is the guideline premium and corridor test. This test first defines the maximum premium that can go into the policy at any given point in time. It then compares the cash value with the death benefit. There are limits as to what

percentage of the death benefit the cash value can be. As this test is generally applied to universal life–type policies, the death benefit of the policies generally increases automatically if the cash value vastly increases, so the policy will continue to qualify as life insurance.

3. **Modified endowment contracts (MECs)**

A. Modified endowment contracts rules were issued by Congress to curb tax shelter abuses in the sale of single premium, universal life and limited pay life insurance policies. The main difference between MECs versus other types of life insurance policies is the federal income tax treatment of amounts received during the insured's life. Distributions from a MEC may be subject to income tax (under the LIFO method—last-in, first-out) and possibly a 10 percent penalty.

B. The basic test to determine whether a policy is classified as a MEC is the seven-pay test. Under this test, if at any time during the first seven years of a life insurance policy's existence, the cumulative premiums exceed the seven-pay premiums times the number of years since the issue of the contract, the policy becomes a MEC.

C. As stated above, amounts withdrawn (whether surrendered or borrowed) from a policy considered a MEC are treated as income to the extent of earnings under the policy. Once the policy is considered a MEC, it is always considered a MEC.

4. **Transfer-for-value**

A. The transfer for value rule states that when a life insurance policy is transferred from one owner to another for "valuable consideration," then a transfer for value has occurred and the income tax exclusion is lost. Only the amount paid for the policy and any subsequent premiums are recovered income tax free by the transferee-owner. There are exceptions to this exception.

B. A transfer for value does not cause this loss of tax-free benefit if it can be categorized as one of the following transfers:

(1) A transfer to the insured
(2) A transfer to a partner of the insured or a partnership, in which the insured is a partner
(3) A transfer to a corporation in which the insured is a shareholder or officer
(4) A transfer in which the basis for the new owner is the same as the basis of the original owner. (This is typically a gift of a policy from an insured to his or her spouse or children.)

C. Death proceeds distributed from a series of payments have a return of principal portion that is not taxable and an interest earned element that is taxable.

5. **§1035 exchanges**

A. IRS Code Section 1035 allows an individual to trade life insurance and/or annuity policies in certain situations in order to defer the gain (as opposed to a tax-free exchange).

B. Here are the transactions that can qualify under this Code Section.

(1) Life insurance policy—life insurance policy
(2) Life insurance policy—annuity
(3) Annuity—annuity (as long as the annuity does not have a later maturity date)

C. Notice that an annuity cannot be traded for a life insurance policy.

TOPIC 23: BUSINESS USES OF INSURANCE

1. **Buy-sell agreements**

   A. Business continuation (buy-sell) plans
   B. Buy-sell agreements make sure an estate can sell a business interest for a reasonable price. The contract contains wording that binds the owner of a business to sell his or her share of the business at a specified price to a designated buyer, usually partners in the business.
   C. There are numerous benefits for constructing a buy-sell agreement:

      (1) Guarantees a market for a closely held business
      (2) Provides a source of liquidity for estate taxes owed
      (3) Allows for the continuation of the business with the other owners
      (4) Improved credit risk

2. **Types**

   A. Cross-purchase agreement

      (1) Each owner purchases an insurance policy on other owners.
      (2) Policy owner is also the beneficiary.
      (3) Upon the death of an owner, the owner's estate will sell and the other owners will buy the business interest of the deceased.
      (4) Insurance proceeds are used to fund the agreement.
      (5) For example, assume three equal partners and one of them dies. The two surviving partners will each purchase one-half interest of the deceased partner.
      (6) Advantages/disadvantages

         (a) The surviving stockholders pay for the stock with after-tax dollars.
         (b) Premiums are paid with money that might have been taxed both to the corporation and to stockholders.
         (c) It is easy to form when there are a small number of stockholders.
         (d) The obligation to purchase the shares falls on younger shareholders who are often not in a position to buy the shares.
         (e) This agreement results in fewer legal problems and tax consequences.

   B. Entity agreement (also called stock-redemption agreement)

      (1) The business buys the insurance on the owners.
      (2) The firm is the beneficiary and carries life insurance on each partner.
      (3) Upon the death of an owner, the business will buy the business interest from the deceased owner's estate.
      (4) Advantages/disadvantages

         (a) The corporation, not the stockholders, pays the life insurance premiums under the agreement—premiums are paid with money that has been taxed only once to the corporation.
         (b) It is easy to form when there are a large number of stockholders.
         (c) It results in no dividend treatment.
         (d) The corporation may not have enough cash to redeem shares if life insurance is not used.
         (e) The corporation can use installment payments of the purchase price to redeem shares.

3. Business overhead expense insurance

A. Proceeds are used to cover ongoing operating costs of a business while the business owner is disabled, such as paying rent, salaries, taxes, and utilities.
B. The elimination period is short; generally provides a benefit for up to two years.
C. The purpose of the insurance is to continue to keep staff and premises available until business can resume when the owner returns.
D. Premiums are deductible and benefits are taxable.

4. Executive/owner benefits (Section 162)—executive-bonus life insurance

A. This allows an employer to provide life insurance protection for a selected employee on a tax-deductible basis.
B. Upon the death of the employee, the insurance company pays the death benefit directly to the beneficiary; proceeds are income tax free.

5. Split-dollar life insurance

A. This allows an employer to provide life insurance protection for a selected employee.
B. The death benefit is split as follows:

(1) The corporation receives a return of its contributions, which is the cash surrender value.
(2) The beneficiary receives the net amount at risk.

6. Employer and employee split (share) the premium

A. Employee pays the portion of premium that is attributed to the "economic benefit" (= lesser of P.S. 58 cost or "standard risk," one-year individual term rates) of the insurance protection in that year.
B. Employer pays the remaining portion of the premium attributed to the cost of insurance (the amount equal to the annual increase in the cash surrender value).

7. Key employee life insurance

A. Insurance on a key employee and owned by the business who is also the beneficiary
B. Premiums are not deductible to the business.
C. Death benefits are tax free.
D. The purpose of key employee insurance is to:

(1) Protect the business against loss of business income.
(2) Provide funds for locating and training a replacement.

TOPIC 24: INSURANCE NEEDS ANALYSIS

1. Life insurance

A. Life insurance amount required: Liquidity and survivor income needs:

(1) A financial needs analysis approach is used to determine how much life insurance a family needs if the principal sum is to be liquidated in the process of meeting the client's financial objectives for his or her survivors.

(2) The risk associated with the liquidation approach—use of investment earnings and capital—is running out of funds while the beneficiary still needs them. The nonliquidation approach—use of investment earnings only—provides a smaller monthly

income for the beneficiary, but the income will continue indefinitely because the principal is not used.

(3) Life insurance should fund the unfunded portions of lump sum and ongoing income needs:

(a) Determine the financial objectives after death.
(b) Determine the extent to which these objectives are satisfied by current cash, investments, and insurance.
(c) Determine the amount of life insurance necessary to meet the gap between current sources of funds and needs.

B. Find the present value of future additional income needs—usually broken into component segments—in which the total income need is the sum of the present values of each of the separate, individually calculated segments.

C. Capital needs analysis (capital retention)

(1) Does not liquidate the lump sum principal received after death, and uses a high capitalization rate to provide income benefits from the investment income only.
(2) Additional capital needs used to meet the desired objective are calculated by dividing the amount of additional income need by the after-tax interest rate anticipated on the capital sum. For example, if $75,000 per year of additional income is needed, the capital sum generating this income payment (assume a 5 percent after-tax return) is $1,500,000 ($75,000 ÷ .05).

D. Human life value

(1) This concept is credited to Solomon Huebner. It is not possible to place a value on a human life. It is only possible to place a relative value on a human life. It must be related to what will be lost if a person dies.
(2) This is the present value of that portion of a person's estimated future earnings that will be used to support dependents.
(3) For example, assume an individual takes home $50,000 per year, and $10,000 of that can be directly attributed to his or her expenses. As a result, the family loses $40,000 if that person dies. Assuming the individual is 40 years old today, and normal retirement for Social Security is age 67 for that person, the dependents will lose the present value of $40,000 per year, adjusted for expected increases over 27 years. The present value of an annuity due for 27 years, using a $40,000 shortfall as the payment and a conservative discount rate of 5 percent, is $585,721. This may seem like a lot, but calculate how much this individual would be earning 27 years from now by inflating $40,000 at 5 percent (annual salary increase) for 27 years. The result is an annual income of approximately $149,000.

E. If an individual has no dependents, this approach to determining his or her value would result in a value of zero.

2. Disability income insurance

A. The difference between income needs (i.e., expenses) and income sources is the financial risk in the event of an illness or accident that results in disability. Having no dependents may eliminate the need for life insurance, but an individual with no dependents still has a need for disability insurance. Disability payments generally do not go on for life and commonly end at age 65. As such, protection should be provided for the worst possible

outcome—disability for life. It is important that the disability protection program help the individual save for retirement just as it would if he or she were without disability.

3. **Long-term care insurance**

   A. The United Seniors Health Council (a nonprofit organization) recommends that individuals buying LTC insurance meet a minimum threshold before purchasing it in order to afford premiums to continue coverage: $75,000 in assets in addition to a home, plus a yearly income of $25,000 for singles and $35,000 for couples; It is generally advisable to purchase LTC insurance when an individual is around age 60. At an earlier age, it is difficult to determine how much coverage an individual needs and what facilities are needed; The amount of coverage is determined in a similar way to life insurance: Take the present value of the estimated future expense that is necessary to support an LTC facility.

4. **Health insurance**

   A. The primary consideration for health insurance is protection against catastrophic loss. There is generally a five-step process for determining the ideal health plan:

      (1) Select the plan that best meets the family's needs.
      (2) Analyze the coverage of the plan in regard to the medical needs of the family.
      (3) Choose a reasonably priced plan offering the most desirable services.
      (4) Check the quality of care—this information can be obtained from the National Committee for Quality Assurance (a nonprofit organization).
      (5) Check the location and accessibility of the medical facility.

5. **Property insurance**

   A. Insure against significant risk, and bear the small risks that can be financially covered. Reduce risk through preventative measures (such as antitheft devices for homes and cars).

6. **Liability insurance**

   A. It is imperative that the liability limits of the homeowners and auto policies are coordinated with the deductible under an umbrella policy. For example, assume an insured has a $100,000 limit under the homeowners and auto policies but has a $300,000 deductible under an umbrella policy. If a claim is $500,000, the first $100,000 is covered under either the homeowners or auto policy, and the amount of $300,000 is covered by the umbrella policy, but the gap of $200,000 is not covered.
   B. It is often recommended that the homeowners, auto, and umbrella policies be purchased from the same insurance company to avoid any gaps in coverage.
   C. The amount of liability insurance should be based on the risk exposure of the individual—this is commonly based on the risk of a profession and the amount of personal assets and income that is exposed to claims and lawsuits.

TOPIC 25: INSURANCE POLICY AND COMPANY SELECTION

1. **Purpose of coverage**

   A. Protecting existing assets: It is vital to have the right proportion of homeowners insurance to replacement value of a house. An adequate level of auto insurance is necessary to protect against major property loss through an accident or theft.

B. Protecting income: Life insurance will allow for an uninterrupted replacement of income caused by death. Disability insurance will provide income when the ability to earn income is not possible because of an accident or illness. Protecting both income and assets. An adequate level of liability insurance and health insurance prevents a deterioration of existing assets and the potential use of income for unexpected lawsuits and emergencies.
C. Risk tolerance: Investment choice. A variable form of insurance introduces a certain degree of risk. Generally, anyone who is risk averse is better off with a traditional form of insurance than with a variable form.

2. Duration of coverage

A. Length of time required—life insurance:

(1) Term insurance is used for short-term needs:

(a) Term insurance can be used to hedge a mortgage or loan. An entrepreneur can use term insurance to protect his or her family from any speculative business dealings.
(b) A parent with young children is likely to need more insurance while the children are dependent than when they are self-sufficient.

(2) Permanent insurance is used for long-term needs:

(a) Is used to augment or maximize retirement income many years later. A client has safety of principal and death protection, while benefiting from a cash value savings.
(b) The most appealing factor of permanent life insurance as an investment is its role in simultaneously meeting the opposing risks of premature death and outliving savings.

(3) Life insurance is not a pure savings vehicle. An individual who has no need for death protection but purchases life insurance as an investment incurs costs for death benefits and commissions that are avoided with other investments.

3. Participating or nonparticipating

A. Participating whole life policies pay dividends and non-participating policies do not. Policies are not required to pay dividends even if the illustration shows that it will. Dividends may be paid if the insurance company has had favorable experiences concerning interest rate returns, decreased operating expenses, or lower mortality costs.

4. Cost-benefit analysis

A. Families should buy adequate disability and health insurance even if it means a sacrifice in the amount of life insurance coverage; a higher deductible will lower the premium of an insurance policy; risk reduction can reduce the cost of insurance policies; risk retention will eliminate the cost of insurance.

5. Company selection

A. The primary measure used in evaluating an insurance company is its financial strength. The selection of an insurance company by consumers generally involves six factors:

(1) Financial strength
(2) Willingness and ability to pay claims
(3) Lines of coverage offered
(4) Service before and after a claim
(5) Cost of the coverage
(6) Age of the company

B. Only after adequately identifying sound companies should a planner compare products. A company's primary line of business and policy size provide important information. The following are generalities to consider:

   (1) Companies selling only life insurance, with a substantial portion of permanent insurance, will have better financial stability than those companies dabbling in many product lines.
   (2) Companies dealing mostly with term insurance are less stable because the price of term insurance is so competitive, and poor underwriting can create substantial financial stress.

C. *Ratios:* Another reference for insurance company analysis is the NAIC Watch-list. This Insurance Regulatory Information System (IRIS) is a series of 12 financial ratios designed to measure the financial strength of insurers. A company that has a number of bad ratios can be put on the NAIC Watch-list. The insurance commissioners then tend to keep a close eye on the company to see how it is doing relative to improving those ratios.

D. Risk-based capital (RBC) ratio is a method developed by the NAIC to measure the minimum amount of capital that an insurance company needs to maintain to support its overall operations. The RBC ratio is used as a warning sign for insurance commissioners to keep track of companies having financial problems. Currently there are four major categories of risk that must be measured to arrive at an overall risk-based capital amount: asset risk, credit risk, underwriting risk, and off-balance-sheet risk.

6. Industry ratings

A. The lapse ratio is based on the percentage of policies that are canceled. A high lapse ratio can make profitability difficult.

B. Ratings: Ratings of financial strength are best obtained from the five primary established rating organizations:

   (1) A. M. Best
   (2) Fitch (formed by merger of Duff & Phelps and Fitch IBCA)
   (3) Moody's
   (4) Standard & Poor's
   (5) Weiss

C. Ratings are generally based on the analysis of five factors:

   (1) Underwriting results
   (2) Economy of management
   (3) Adequacy of reserves for undischarged liabilities
   (4) Adequacy of policyholders' surplus to absorb shocks
   (5) Soundness of investments

D. The following list identifies the lowest rating system used by each rating agency in identifying a good insurance company—a higher rating indicates a stronger company, and a lower rating indicates a weaker company: (1) A. M. Best FPR 5 Good; (2) Fitch BBB Good; (3)Moody's Baa 3 Adequate; (4) Standard & Poor's BBB Adequate; (5) Weiss B Good.

E. It is often suggested that before any insurance company is recommended, it should have one of the top three ratings from at least three of the previously listed organizations.

7. Mutual versus stock

A. Stock insurance companies

(1) Capital stock insurance companies are profit-making ventures in which stockholders assume the risk from individual insured.
(2) Stockholders own the company and elect a board of directors.
(3) The premium charged by the company is final.
(4) Earnings are distributed to shareholders in the form of dividends.
(5) Capital invested by stockholders provides a surplus to protect against adverse contingencies.

B. Mutual insurance companies

(1) Policyholders own the company. Ownership is acquired when they purchase a policy from the mutual insurer. There is no vested right of ownership except in the case of liquidation.
(2) The premium charged by the company is not fixed.
(3) There is a lack of capital stock and distribution of earnings.
(4) The company must accumulate a surplus to protect against adverse contingencies.

8. Reinsurance: Reinsurance is insurance for insurers.

A. The purpose is the diversification of losses when catastrophic events occur. In this way, it enhances the financial strength of the insurance company. Reinsurance also enhances the growth of small companies by having a reinsurer take over part of the requirement for maintaining adequate reserve; the policy owner looks to the primary insurer for paying a claim. The reinsurer then reimburses the primary insurer.

B. Investments: Insurers as a way of lowering the cost of insurance invest. Premiums received and as a source of profit; the way insurers can invest funds is highly regulated by state laws—the strictest regulation applies to life insurers. Life insurers invest most funds in long-term securities. Liquidity of investments is not a major consideration in investing funds. In 2000, the general makeup for life insurance companies was 11 percent invested in government bonds, 40 percent in corporate bonds, and 30 percent in stocks. The remaining amount was in the form of cash equivalents, real estate mortgage loans, policy loans, and other investments; Non–life insurers invest a larger holding in government bonds than life insurers because property and liability contracts are of a short duration and have no savings element. In 2000, the general invested makeup was 36 percent government bonds, 21 percent corporate bonds, and 21 percent stocks.

9. Underwriting

A. Underwriting is the selection and classification of insurance applications. The selection process involves accepting some applicants while rejecting other applicants; the primary purpose of underwriting is to identify adverse selection, inasmuch as it can be disastrous to an insurer; the agent and the home office conduct underwriting at the time of original application and at each renewal. The home office serves as the primary underwriter of an insurance contract; underwriting information is obtained from the applicant, the agent, the claims department, insurer bureaus and associations, and outside agencies.

TOPIC 26: ANNUITIES

1. Types

A. Annuities are really thought of as "upside down life insurance." With life insurance generally you pay premiums to receive a lump sum death benefit down the road, whereas annuities you may begin with a lump sum amount and then receive periodic payments from that amount.

B. Annuities operate as systematic contracts that provide for payments of interest and principal over time. Annuities can be worthwhile in order to ensure that the annuitant does not outlive his or her income. Annuities receive favorable tax treatment under the Code in that its buildup in cash grows tax-deferred.

C. Payments begin: immediate vs. deferred

(1) Annuities that pay out monies one periodic interval after they are purchased are called "immediate annuities."

(2) Annuities that begin making payments more than one interval after they are purchased are called deferred annuities. The purchase price can be paid in a single lump sum premium or they can be made over a period of months or years.

D. Policies sold: individual vs. group

(1) Individual annuities are bought by owners to provide for a monthly income or a lump sum. Group annuities generally serve as a funding vehicle for retirement plans.

E. Policy infrastructure: fixed-dollar vs. variable

(1) Fixed-dollar annuities pay a specified benefit which is known in advance and based on guaranteed cost elements concerning interest credits, mortality and expenses. After annuitants outlive their benefits, the balance is paid in the way of an insurance benefit.

(2) Variable annuities operate similarly to variable life insurance policies in that these premiums are generally invested at the policyholder's discretion in either a portfolio of stocks, a bind fund, money market accounts or a combination of any of these. Unlike fixed annuities, the interest credits here are not guaranteed. Instead, they are based on the performance of the investments chosen by the annuitant.

F. Benefits paid: single life vs. joint life

(1) Annuities may provide payment based on a single life or upon two or more lives (joint). If a joint annuity, the payments could change after the death of the first annuitant.

G. Benefits paid: pure life annuity vs. annuity certain

(1) Pure life annuities make payments only until the annuitant dies. Annuity certain pays out until the end of a specified term. If the annuitant were to die before the term ends, then the annuitant's beneficiary receives the balance. If that person were to also die, then it would continue to be paid out to the next in line until the initial term expires.

(2) Equity indexed annuity

(a) Equity indexed annuities are fixed annuities that earn interest or provide benefits that are linked to the performance of an equity index, such as the S&P 500. The crediting rate is a function of the relative change in the index, the participation rate (which is always under 100% and any caps imposed on the crediting rate. Gains that are achieved are taken into account after a specified time period, such as five years. Equity indexed annuities have minimum interest rate guarantees to comply with minimum nonforfeiture laws.

(3) Uses

(a) Annuities can be used as accumulation devices to save substantial amounts of money on a tax-deferred basis, or to provide a systematic design of payments to the annuitant for life or for a certain period of time whereby those clients have already accumulated a large sum of money.

H. Structured settlements

(1) Structured settlements allow an individual to accept periodic sums of money (annuity) instead of a lump sum. They are found in situations where compensation is a factor by compensating an individual who has been wronged by another such as from an automobile accident.

I. Taxation

(1) The investor is not taxed on the yearly buildup in the value of the investment. Tax is deferred, but the gain in an annuity will eventually be taxed as ordinary income when distributed.
(2) The portion representing a return of basis is not taxed; the portion representing a distribution of accumulated earnings is taxed as ordinary income.
(3) Interest earnings are always assumed to be withdrawn first and then principal, unless an annuity option is selected, and then only a portion of each annuity payment is taxable as ordinary income. Exception: Annuity contracts executed before August 13, 1982, retain the right to receive tax-free early withdrawals of investment in contract first (FIFO method).

J. Annuities are fully taxable if:

(1) The taxpayer did not contribute to the cost.
(2) The taxpayer's entire cost has been recovered.

K. Partially taxable distributions

(1) Three-year rule: Repealed for annuities starting after July 1, 1986. This allows the taxpayer to recover the tax-free basis in the first three years of receiving distributions.
(2) General rule: The percentage of each annuity payment excluded from gross income is total after-tax contribution of employee divided by annual payment times life expectancy.
(3) Simplified method: The nontaxable portion of each annuity payment received is:

    (a) Total after-tax contribution of employee divided by number of expected payments.
    (b) The number of expected payments is set forth in a government table and is based on the annuity start date and age of the participant at annuity start date.

(4) *Note:* The general rule must be used unless the distribution qualifies for treatment under the simplified method. The simplified rule cannot be used for any of the following:

    (a) Nonqualified plans
    (b) Qualified plan if annuitant is age 75 or older and the annuity payments are guaranteed for at least five years
    (c) Individual retirement accounts (IRAs)

(5) Annuities starting after December 31, 1997. If the annuity is payable to a primary annuitant and to more than one survivor annuitant, the combined age is the age of the primary annuitant plus the youngest survivor annuitant. If the annuity is payable to more than one survivor annuitant and there is no primary annuitant, the combined age is the age of the oldest survivor annuitant plus the youngest survivor annuitant.

L. A 10 percent excise tax applies for withdrawals taken before the applicant turns age 59 1/2.

(1) The penalty tax applies only to the portion that is subject to income tax. The penalty does not apply if the contract holder becomes disabled or if the distribution is over the life of an annuitant.

M. If the annuitant dies before recovering his or her investment, the unrecovered portion is allowed as an itemized deduction on his or her final Form 1040.

(1) Corporation annuities: A corporation must report any earnings or accruals in an annuity as ordinary income in the year in which it is credited to the contract.
(2) Commercial annuities: Gains are eventually taxed as ordinary income resulting in no step up in basis.

(a) 1035 exchanges: An annuity may be exchanged for another annuity policy in certain situations in order to defer the gain (as opposed to a tax-free exchange).
(b) An annuity cannot be traded for a life insurance policy.

MULTIPLE CHOICE QUESTIONS

Insurance Planning

1. ***Practice—risk management*****. Which of the following would have the least risk exposure?**

A. Leaving the HO policy liability at $100,000 (no umbrella)
B. Leaving long-term disability with two-year benefit period
C. Not having a long-term care policy
D. Having $60,000 Part A coverage on a home with a replacement cost of $100,000

Ans. A

2. ***Practice—risk*****. All of the following are principles behind the theory of insurance EXCEPT:**

A. Transfers of risk from an individual to a group
B. Law of large numbers
C. Pooling of risk
D. Speculation

Ans. D

3. ***Practice—risk*****. Which of the following correctly defines a "hazard"?**

A. The same thing as the term *peril*
B. A condition that increases the chance of loss
C. The same thing as risk
D. Uncertainty arising from loss
E. The same thing as probability of loss

Ans. B

4. ***Practice—risk*****. From the viewpoint of society and the economy, the most preferred way of dealing with risk is:**

A. Tranfer
B. Retention
C. Loss prevention
D. Sharing
E. Hedging

Ans. C

5. ***Practice—risk*. What are the three categories for hazards?**

   A. Personal, property, and liability
   B. Perils, risks, and uncertainties
   C. Moral, morale, and physical
   D. Peril, property, morale
   E. Slight, moderate, and extreme

   Ans. C

6. ***Practice—risk*. The most common method used by individuals to deal with most risks is:**

   A. Reduction
   B. Transfer
   C. Retention
   D. Sharing
   E. Avoidance

   Ans. C

7. ***Practice—risk*. What accurately describes adverse selection?**

   A. Is generally considered to be unavoidable
   B. Affects the accuracy of insurer's predictions
   C. Creates a random pattern of insured exposures
   D. Has little effect on the operation of the insurance mechanism
   E. More than one of the above

   Ans. B

8. ***Practice—risk management*. Which of the following are true of a risk management policy statement?**

   A. Provides a framework within which the risk manager may make decisions
   B. Is desirable from the perspective of both the risk manager and the organization
   C. Should permit the risk manager some latitude
   D. Should be a product of the board of directors with advice from the risk manager.
   E. All of the above

   Ans. E

9. ***Practice—risk management*. Steven just bought his 16-year-old son a $1,500 car with 120,000 miles on it. With respect to collision coverage, what is the most appropriate risk management technique?**

   A. Insure
   B. Subrogate
   C. Share
   D. Retain

   Ans. D Steven should not purchase collision insurance due to the low amount at risk and the high cost of the insurance.

10. ***Practice—liability*. Liability insurance is concerned primarily with which of the following financial consequences?**

    A. Intentional torts
    B. Unintentional torts

C. Intentional and unintentional torts
D. Crimes

Ans. B

11. ***Practice—liability*. Betty's vacant lot has several hills. When it snows, the local kids use the hills for sledding. If a child were hurt, under which principle could she be liable?**

A. Assumption of risk
B. Absolute liability
C. Strict liability
D. Attractive nuisance
E. Res ipsa loquitur

Ans. D

12. ***Practice—liability.* John and Mary bought the last lakefront lot in a valuable development in Florida. Until they sell their current home, they cannot afford to build. What kind of liability policies do they need?**

(1) Comprehensive personal liability
(2) Builder's risk
(3) Umbrella
(4) General liability
(5) HO-3

A. 1 only
B. 1 and 2
C. 2 and 4
D. 3 and 4

Ans. B

13. ***Practice—contract*. Which of the following is not a requirement of a legally binding contract?**

A. Offer and acceptance
B. Written
C. Consideration
D. Competent parties
E. Legal object

Ans. B

14. ***Practice—contract*. How is the principle of indemnity enforced?**

A. Through policy laws
B. Through the principle of subrogation
C. To the same extent in all fields of insurance
D. To a greater extent in life insurance than in the field of property insurance
E. None of the above

Ans. B

15. ***Practice—life insurance.* All of the following pertaining to a whole life policy are correct EXCEPT:**

A. The policy offers insurance protection to age 100.
B. It provides both insurance protection and "living values."

C. It is designed to endow at the insured's age 100.
D. The face amount may be paid as a lump sum at the policy owner's selected retirement age.

Ans. D

16. ***Practice—life insurance.* Policy benefits of a variable life insurance policy will vary according to the:**

A. Value of equities supporting the contract
B. Flexibility of premiums
C. Mortality factor
D. Underwriting requirements

Ans. A

17. ***Practice—life insurance.* In what respects do limited pay life policies differ from whole life policies?**

A. Limited pay life policies do not give insurance protection to age 100.
B. Limited pay life policies are payable to age 100.
C. Limited pay life policies have a shorter premium-paying period.
D. Limited pay life policies invest in money market funds.

Ans. C

18. ***Practice—life insurance.* All the following statements concerning universal life are correct EXCEPT:**

A. The policy's cash value is increased by the amount of the gross premium minus only operating expenses.
B. An increased cash value would increase interest earnings for the month with no change in the mortality charge.
C. Interest earnings depend on investment results.
D. It is not possible to predict actual future cash values.

Ans. A

19. ***Practice—life insurance.* A modified endowment contract is a life insurance contract that:**

(1) Meets the requirement of a life insurance contract under state law
(2) Was entered into on or after 6/21/88
(3) Fails to meet the "seven-pay test"
(4) Meets the guideline premium and corridor test or cash value accumulation test, which determine whether the policy is a life insurance policy

A. 1 and 4 only
B. 2 and 3 only
C. 1, 2, and 3
D. 1, 2, 3, and 4

Ans. D

20. ***Practice—life insurance.* The proceeds of a life insurance policy are included in the estate of the insured for federal tax purposes EXCEPT:**

A. Where the proceeds from the policy were payable to or for the benefit of the estate of the insured
B. Where the policy is transferred within three years prior to death
C. Where the insured held any incident of ownership at the time of death

D. Where the proceeds are paid to an irrevocable life insurance trust

Ans. D

21. ***Practice—income tax and life insurance.*** **Which of the following statements pertaining to the income tax treatment of life insurance policies is NOT correct?**

A. There is no deduction permitted for premium payments on individual life insurance policies.
B. Dividends received by the policyholder are not subject to federal income taxation.
C. The cash value increases in a life insurance policy resulting from investment income are not taxable as income as long as the policy remains in force.
D. Modified endowment contracts are not taxable for life insurance policies issued 7/15/92 and thereafter.

Ans. D

22. ***Practice—life insurance.*** **What is the purpose of the incontestable clause of a life insurance policy?**

A. During a specified period, the policy owner may reinstate a lapsed policy upon payment of past-due premiums and proof of insurability.
B. During a specified period, the policy owner may pay a premium in default without causing the policy to lapse.
C. After a specified period, the insurer may challenge the policy on grounds of misstatement of fact.
D. After a specified period, the insurer is prohibited from challenging the policy EXCEPT on the basis of fraud.

Ans. D

23. ***Practice—life insurance.*** **George W. Bush purchased a whole life policy ten years ago. He would like to stop paying the premiums on his policy. If he did so, which one of the following is a nonforfeiture option he could use?**

A. Installments for a fixed period
B. Interest only
C. Paid-up reduced amount
D. Installments for a fixed amount

Ans. C

24. ***Practice—life insurance.*** **Which of the following are dividend options, which are available to the policyholder of a participating whole life insurance policy?**

(1) Paid-up additions
(2) Accumulate at interest
(3) Extended term
(4) Premium reduction

A. 3 and 4 only
B. 2, 3, and 4 only
C. 1 and 2 only
D. 1, 2, and 4

Ans. D

25. ***Practice—life insurance.*** **Which one of the following describes the conversion provision in a life insurance policy?**

A. The insured is guaranteed the right to renew the policy for a limited number of additional periods.
B. The insured may exchange term insurance for permanent insurance without having to show evidence of insurability.
C. The insured may purchase additional amounts of insurance without having to show evidence of insurability.
D. The insured is guaranteed the right to exchange term insurance for permanent insurance if he or she becomes disabled.

Ans. B

26. ***Practice—life insurance.*** **Which of the following are features of group term life insurance?**

(1) It provides protection for a number of persons under a master or single life insurance policy.
(2) The insurance is individually underwritten.
(3) The employee may deduct the premiums paid by the employer.
(4) There are no income tax consequences to the employee on the first $50,000 of death benefit.

A. 2 and 4 only
B. 1 and 3 only
C. 1 and 4 only
D. 2 and 3 only

Ans. C

27. ***Practice—life insurance.*** **Which of the following statements are uses of universal life insurance?**

(1) To provide flexibility of both premium and death benefits
(2) To provide adjustable types of coverage throughout the lifetime of the insured
(3) To provide the insured with a high risk/high return investment vehicle
(4) To provide a cash-value fund that accumulates tax deferred

A. 3 and 4 only
B. 1 and 2 only
C. 1 and 4 only
D. 2 and 3 only

Ans. C

28. ***Practice—life insurance.*** **Which is true concerning a variable life insurance policy?**

A. It provides a guaranteed minimum death benefit.
B. Benefits are linked only to the Dow-Jones stock averages.
C. It is made up of endowment and decreasing term insurance.
D. Premiums and benefits are both variable.

Ans. A

29. ***Practice—life insurance.*** **Which is true concerning a variable-universal life insurance policy?**

A. The cash value is never invested in equity-based products.

B. The policyholder must pay only fixed premiums.
C. Death benefits may be adjusted by the policyholder.
D. The policy contains a guaranteed minimum death benefit.

Ans. C

30. ***Practice—life insurance.*** **How is a policy loan repaid if the policy becomes a death claim?**

A. Because the policyholder, not the beneficiary, made the loan, it does not have to be repaid at the insured's death.
B. The loan, plus any interest due, is deducted from the death benefit.
C. The beneficiary takes over the loan, plus any interest due.
D. The loan, plus any interest due, is paid through the insured's estate, just as with any other loan.

Ans. B

31. ***Practice—life insurance.*** **If a policy owner names an irrevocable beneficiary, how does this affect the policy owner's rights in the contract?**

A. The policy owner temporarily relinquishes all rights to the insurance company.
B. The policy owner has only those rights provided with the consent of the insured.
C. The policy owner cannot exercise rights unless written consent of the beneficiary is obtained.
D. The policy owner retains all rights under the policy.

Ans. C

32. ***Practice—life insurance.*** **From a tax standpoint, when a policy owner surrenders a life insurance policy and receives a lump sum payment of the cash value, which of the following applies?**

A. A lump-sum payment is tax exempt.
B. The full sum, less the policy owner's cost basis, is taxable as capital gains.
C. The lump-sum payment is taxable under the annuity rule.
D. The lump sum, less the policy owner's cost basis, is taxable as ordinary income.

Ans. D

33. ***Practice—life insurance*****. All of the following statements about a universal life policy are true EXCEPT:**

A. It is a single contract containing renewable term insurance and a cash value account.
B. Premiums and/or amount of coverage may be increased or decreased at the policy owner's option.
C. Its cash values generally are invested in highly rated corporate bonds.
D. The interest rate used in crediting interest to the cash value account varies, although it usually is guaranteed for an initial period.

Ans. C

34. ***Practice—life insurance.*** **Which of the following is true with respect to "participating" life insurance policies?**

A. Dividends left with an insurance company generally earn more interest than savings in a bank.
B. A participating policy is the cheapest from of buying life insurance.
C. Dividends are guaranteed.
D. It is possible that an insured may receive less than the amount expected since dividends are not guaranteed.

Ans. D

35. ***Practice—life insurance.* A whole life insurance policy has an accumulated cash value of $35,000 and a face value of $80,000. Upon death of the insured, the beneficiary would receive $35,000 representing cash value plus:**

A. $35,000
B. $45,000
C. $80,000
D. $115,000

Ans. B

36. ***Practice—life insurance.* At death, your beneficiary receives $100,000. The federal income tax portion is:**

A. $100,000
B. Cash value in the policy
C. Determined by her total income
D. 0

Ans. D

CHAPTER 3

EMPLOYEE BENEFITS PLANNING

TOPIC 27: GROUP LIFE INSURANCE

1. Types and basic provisions

A. Group term insurance

(1) Must satisfy four requirements:

(a) Plan must provide a general death benefit, which is excludible from income.
(b) Plan must be provided to a group of employees as compensation for personal services as employees.
(c) Insurance must be provided under a policy carried directly or indirectly by the employer.
(d) Amount of insurance provided to each employee must be computed by a formula that precludes individual selection; the formula can be based on age, years of service, compensation, or position.

(2) Most inexpensive form of group insurance
(3) Easiest and least expensive to administer
(4) Master contract between employer and insurance company; individual employees receive a certificate as evidence of coverage.
(5) Evidence of insurability is not required = guaranteed issue; coverage is between $5,000 and $100,000.
(6) Premium waiver
(7) Payout is usually a lump sum distribution to the beneficiary (spouse and/or children of the insured), although an installation method may be permitted in the master contract.
(8) A terminated employee may convert the group term policy to an individual cash value policy without evidence of insurability; the premium would be based on the age of the participant on the conversion date. Cost can be prohibitive at older ages.
(9) For retired participants, the employer may set up a "retired lives reserve."

B. Group permanent

(1) The employee receives a permanent benefit because the policy provides an "economic value" that extends over more than one year.
(2) Evidence of insurability is not required = guaranteed issue.
(3) There are generally three different types of group insurance: group paid up, group ordinary, and group universal life (UL).

C. Dependent coverage—supplemental coverage

(1) Dependents' group life

(a) Group life coverage for an employee's spouse and unmarried children (age 14 days to age 19, age 24 if full-time student)
(b) Limit for children of employee is $500 for age 14 days to 6 months, thereafter up to 2,000. Limit for spouse is usually up to $10,000.
(c) May be convertible to individual policies

(2) Supplemental group term

(a) Additional group term coverage for specific class of employees, but not for individuals
(b) must be provided on a nondiscriminatory basis
(c) Evidence of insurability required because there is potential for adverse selection

(3) Group carve-out
   (a) Individual, discriminatory benefits provided to selective employees (i.e., executives)
   (b) Cost of the coverage must be included in the executive's gross income and is deductible to the employer.
      (i) Sometimes referred to as a premium bonus plan
   (c) May be used to bring group term coverage into compliance
   (d) Policy owned by the employee—fully portable when employee leaves employer

2. Income tax implications

A. Plans can be established as
   (1) Contributory plan. Employee pays some of the cost (i.e., premium).
      (a) Employee contributions are usually made with after-tax dollars.
      (b) Employee can use pretax dollars for contributions if plan is part of a cafeteria plan (IRC Section 125).
   (2) Noncontributory plan. Employer pays the entire cost.

B. Nondiscrimination rules: Any plan that qualifies as group term insurance (under IRC Section 79) must satisfy one of the following four conditions:
   (1) It must benefit at least 70 percent of the employees.
   (2) No more than 15 percent of the participants can be "key employees."
   (3) Benefits are either a flat amount or a uniform percentage of salary.
   (4) Plan is part of a cafeteria plan (IRC Section 125) and is covered under IRC Section 125 nondiscrimination provisions.

C. Income tax considerations
   (1) Group term insurance less than $50,000 coverage
      (a) Premiums are deductible by the employer.
      (b) Premiums are not taxable to the employee.
      (c) Key employee in a discriminatory plan—premiums are taxable based on a rate schedule, referred to as Table 1, provided by IRS regulations.
   (2) Group term insurance greater than $50,000 coverage
      (a) Premiums are deductible by the employer.
      (b) Premiums are taxable to the employee—based on Table 1 costs less employee contributions.
      (c) Key employee in a discriminatory plan—premiums are taxable based on a rate schedule, referred to as Table 1, provided by IRS regulations.
   (3) Group term or permanent life in a qualified plan—any face amount of coverage
      (a) Premiums are deductible by the employer.
      (b) Premiums are taxable to the employee.
         (i) Permanent equals lesser of one-year term rate of P.S. 58 (provided by the federal government to measure the taxable economic benefit received by employees from the pure insurance protection provided by split-dollar plans and qualified retirement plans).
         (ii) Term equals lesser of premium of P.S. 58.

(c) Key employee in a discriminatory plan—premiums are taxable and handled in same way as for employee.

(4) Group permanent life insurance—any face amount of coverage

(a) Premiums are deductible by the employer, only if the employee has vested rights to the insurance.
(b) Premiums are taxable to the employee.

(i) Permanent equals premium costs.
(ii) Permanent and term equals allocation formula less employee contributions.

(c) Key employee in a discriminatory plan—premiums are taxable.

(5) Employee contributions toward coverage are subtracted from the cost of employer-provided coverage greater than $50,000. Exceptions: Cost of excess coverage is not taxed to the employee if:

(a) The beneficiary is a charity.
(b) The employee is disabled.
(c) The employee is one of certain retirees (i.e., retired before 1984, or age 55 before 1984).

(6) The cost of employer-provided insurance coverage up to $2,000 on dependents is excludible from income as a de minimis fringe benefit. Cost of coverage over $2,000 is fully taxable to the employee.
(7) Dividends from permanent insurance may be taxable to the employee. Amount taxable to the employee for dividends received (either actually or constructively) is offset by employee contributions.

D. Death benefit is income tax free.

TOPIC 28: GROUP DISABILITY INSURANCE

1. **Basic provisions and limitations**

A. Own occupation limits (See Topic 19)
B. Definition of disability (See Topic 19)
C. Income tax implications (See Topic 19)

(1) Employer-paid premiums are deductible to the employer (if benefits are paid to employee).
(2) Benefits attributable to employer-paid premiums are taxable to the employee.
(3) Premiums paid by employer are nontaxable to the employee.

2. **Integrated with Social Security, workers' compensation, or other income.** There is a reduction of disability benefits payable under a disability contract to the extent that other benefits are available.

TOPIC 29: GROUP MEDICAL INSURANCE

1. **Types and basic provisions**

A. Indemnity: comprehensive medical expense plan (See Topic 18)
B. Preferred provider organization (PPO) (See Topic 18)

C. Health maintenance organization (HMO) (See Topic 26)
D. Dental and vision plans

(1) Dental exclusions

(a) Cosmetic services (orthodontics are usually covered)
(b) Replacement of dentures
(c) Services that have no professional endorsement
(d) Occupational injuries that are covered under workers' compensation laws

(2) Dental limitations

(a) Limit benefits to the least expensive type of accepted dental treatment for a given condition
(b) Usually have overall benefit limits
(c) Limit frequency with which benefits are paid (e.g., allowing only two cleanings per year)

(3) Vision plans do not pay for necessary eye surgery or treatment of eye disease because such services are covered under medical health insurance. Benefits are available to improve vision, such as LASIK surgery.

2. Income tax implications

A. Employer pays premium. Deductible to the employer and not taxable to the employee.
B. Employee receives benefit. Reimbursement for medical expenses is not taxable to the employee.
C. Cafeteria plans that comply with Section 125 (i.e., do not discriminate) are not subject to the doctrine of constructive receipt and generate no taxable income to the extent an employee chooses the types of benefits that are normally nontaxable.

(1) The choice of cash is a taxable benefit.
(2) Life insurance in excess of $50,000 is taxable.

D. Flexible spending accounts (FSAs) allow for the funding of benefits with pretax dollars.

3. Employee benefit analysis and application—nondiscrimination rules

A. Insured group health plans (i.e., HMO, PPO) are not required to meet discriminatory tests.
B. Self-funded plans are required to meet at least one of the following:

(1) Benefits at least 70 percent of all employees
(2) Benefits at least 80 percent of eligible employees if 70 percent or more of all employees are eligible
(3) Benefits a class of employees that is considered nondiscriminatory

C. Nondiscrimination requirements for benefits: The same type and amount of benefit is available to all employees regardless of compensation level; that is, benefits available to a highly compensated employee (HCE) must be equally available to other participants.

4. COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985)

A. COBRA requires some employers to offer the right to continued health coverage to employees and their families who have had a qualifying event.
B. Continuation coverage requirements

(1) Employees. Qualifying events include voluntary or involuntary termination (for reasons other than gross misconduct) and change from full-time to part-time status.

(2) Spouses and other dependents of covered employee. Qualifying events include employee's death, divorce, legal separation, and eligibility for Medicare.
(3) Children of covered employee. Qualifying events include loss of dependent status due to plan age limitations or marriage.

C. Qualified beneficiary has 60-day window after the qualifying event to elect to continue coverage and 45 days to pay the premium for the period prior to the election.
D. Continuation coverage for the qualified beneficiary continues until the earliest of:

(1) 18 months
(2) 29 months if beneficiary is totally disabled (Social Security definition) during the first 60 days of COBRA coverage
(3) 36 months if a second qualifying event (death or divorce of terminated employee) occurs during continuing coverage period
(4) The date the plan terminates for all employees
(5) The date the premium for coverage is not paid on time
(6) The qualified beneficiary becomes covered under another employer-sponsored health plan.
(7) The qualified beneficiary becomes eligible for Medicare.
(8) The widowed or divorced spouse remarries and becomes covered under the new spouse's employer-sponsored health plan.

E. Coverage must be identical to coverage provided to employees.
F. Coverage cannot be conditioned on evidence of insurability.
G. At the end of continuation coverage, a qualified beneficiary must be offered the right to convert to an individual plan.
H. Long-term care is not subject to COBRA rules.
I. COBRA charges may not exceed 102 percent of the cost of the plan.
J. Notification of the right to COBRA coverage

(1) Must be made at two distinct times:

(a) When the plan becomes subject to COBRA rules or employee becomes covered under a plan subject to COBRA
(b) When a qualifying event occurs

(2) Penalty of $100/day/qualified beneficiary for failure to notify; may not apply to minor or good-faith violations.

K. Exemptions from COBRA rules

(1) Employers who have fewer than 20 employees for at least half of the prior year (i.e., applies to = 20 employees)
(2) Government and church employers

L. Full coverage of preexisting conditions

5. Savings accounts

A. Health savings accounts (HSA) are high deductible health insurance coverage that allow for tax deductible contributions of 1/12 of the lesser annual deductible or $2,850 (2007) for individual or $5,650 (2007) for family coverage. Age 55 or older individuals can receive an increase in the annual limit of $700.

B. Archer Medical Savings Accounts (MSA) have been grandfathered since the arrival of HSAs. No new ones are permitted, but existing ones have been grandfathered.

C. Health Reimbursement Arrangement (HRA) is a supplement to medical expense insurance. HRAs reimburse employees for medical expense incurred as submitted. It could reimburse employees for medical expenses not covered through regular medical insurance. HRA payments are tax deductible to the employee and tax free to the employee (as long as the plan is not discriminatory).

TOPIC 30: OTHER EMPLOYEE BENEFITS

1. Cafeteria plans and flexible spending accounts

A. Basic provisions and eligible benefits

(1) Cafeteria plan (IRC Section 125)

(a) Written plan under which employees may choose between two or more benefits consisting of two mandatory components:

(i) Cash—taxable to the employee as compensation

(ii) One or more qualified benefits

- Medical expense benefit via individual or group—nontaxable
- Cost of group term insurance in excess of $50,000—taxable

(b) Core benefits include life insurance, health insurance, and disability insurance.

(c) Credits for selection of additional benefits:

(i) Credits may be allocated according to age, salary, and service.

(ii) Credits may purchase enhanced core benefits or additional benefits: flexible spending account, dental insurance, dependent child care, additional vacation days (cannot carry over), and 401(k) plans (salary reduction) or 401(m) plans (after-tax contributions) with or without employer matching.

(iii) May not select

- Retirement plan or deferred compensation
- Scholarships and fellowships
- Transportation/commuter benefits
- Educational assistance
- Employee discounts
- Noncash (de minimis) fringe benefits
- Long-term care insurance (added by the Health Insurance Portability and Accountability Act [HIPAA])

(d) Plan may offer a choice of prepackaged benefit plan combinations.

(e) If a plan is discriminatory in favor of the HCE, the HCE will be taxed on employer contributions to the plan to the extent of the cost of all taxable benefits that are available to the HCE.

(2) Flexible spending account (FSA)

(a) A type of cafeteria plan funded through salary reductions, stand-alone plan, or included as part of an IRC Section 125 plan

(b) Allows an employee to fund certain benefits with pretax dollars

(c) Employee commits a specific salary reduction dollar amount for the coming year for benefits.
(d) Key phrase: Use it or lose it! Employer gets the forfeiture.
(e) Benefits provided include medical and dental expenses not otherwise covered, such as vision, dependent care expenses for children or parents, health insurance premiums, disability insurance premiums, extra vacation, and contributions to 401(k) plan.

2. Fringe benefits

A. Employees are taxed on the fair market value of certain noncash fringe benefits provided by the employer because these benefits are treated as compensation and will be included in gross income.

(1) Personal use of company car, airplane, or lodging
(2) No-additional-cost services and qualified employee discounts to HCE if not available to rank-and-file employees
(3) Country club dues paid on behalf of an employee
(4) Season tickets to theatrical or sporting events furnished by the employer
(5) Employer-sponsored van pools

B. There are some fringe benefits that are not taxable:

(1) No-additional-cost services normally provided to the public, such as hotel rooms or airline, bus, or cruise seats, which would remain unused if employee did not use them
(2) Qualified employee discounts on goods and services offered for sale to the customers, not to exceed employer's gross profit percentage or for services, cannot exceed 20 percent.
(3) Working condition fringe benefits such as property or services that the employee could deduct as business expenses if not employer provided
(4) De minimis fringe benefits so small as to make accounting impractical or unreasonable
(5) Use of employer-operated or on-premises athletic facilities
(6) Meals furnished to the employee for the employer's convenience and on the employer's premises, and lodging furnished for the employer's convenience and the employee is required to accept as a condition of employment
(7) Dependent care assistance program benefits
(8) Business use of employer-provided automobile
(9) Transportation benefits, such as free parking, at the employer's place of business
(10) Moving expense reimbursement

C. If the benefit is not considered to be exempt as a qualified non-cash fringe benefit, then it will be included in Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes.

3. Voluntary employee beneficiary association (VEBA)

A. A type of multiple-employer trust that can be used to prefund employee benefits
B. Employer receives tax-favored treatment—employer deposits into the trust are immediately tax deductible.

(1) Must have at least 10 participating employers, generally members of a professional organization
(2) The plan is structured to be a welfare benefit plan that cannot be considered a deferred compensation plan.

C. VEBAs that comply with IRC Section 501(c)(9) (nondiscrimination) and Section 505 (maximum $200,000 limit on compensation for benefit formulas) are exempt from income tax on

earnings. Note: Earnings in a welfare benefit trust, another type of multiple-employer trust, are fully taxable to the employer.

D. Expensive to set up and administer, and the IRS has more specific rules regarding VEBAs.

E. Purpose of a VEBA as stated in Section 501(c)(9)

  (1) To provide "life, sick, accident, and other" benefits designed to "safeguard or improve the health of member . . . against a contingency that . . . impairs a member's earning power."
  (2) Other benefits include vacation, child care, legal services, severance pay, education and job training benefits, supplemental unemployment benefits, and pre-retirement death benefits.
  (3) Prohibited benefits

    (a) Retirement benefits
    (b) Commuting benefits

F. Benefit payments

  (1) Dollar value of benefit provided and employer's contribution to the VEBA are not included in the employee's gross income.
  (2) Only plan benefits may be paid from the VEBA; trust earnings cannot be paid directly to any individual.
  (3) Benefits paid to employees are subject to the same tax treatment as benefits paid through similar individual plans; employee is not taxed on the contributions to the VEBA.

G. Membership in VEBA

  (1) Voluntary for the employee
  (2) The employee's designated beneficiaries may also join.
  (3) Noncurrent employees may become members, but the number of such "nonemployees" cannot be greater than 10 percent of the total membership.

H. Prepaid legal services

  (1) The purpose is for an employer to provide an employee with legal services, such as in a divorce, drafting a will or trust, home purchases closings, and others.
  (2) Tax implications should be carefully considered.

I. Group long-term care insurance

  (1) Group programs generally provide benefits for three to five years.
  (2) Individually owned long-term care (LTC) insurance is more flexible with waiting periods, benefit payment periods, types of facilities, and premium waiver.

TOPIC 31: EMPLOYEE STOCK OPTIONS

1. Basic provisions

A. Company restrictions: Insiders are subject to insider trading rules that limit the sale of stocks by the employee to within six months of the time he or she has been issued the option.

B. Transferability

  (1) Incentive stock option (ISO): Only the employee may exercise the option during his or her lifetime. The employee can transfer only upon death.
  (2) Nonqualified stock option (NSO): Option is transferable to family members.

C. Retirement

(1) Systematic repositioning of the portfolio is a consideration if the stock represents a large percentage of the employee's holdings.
(2) A method must be devised to raise cash for exercising the options if the employee wants potential future appreciation.

D. Vesting schedule

(1) Straight vesting: Same percentage of options becomes exercisable each year (e.g., 500 options each year).
(2) Cliff vesting: All options become exercisable at one time.
(3) Step vesting: The percentage of exercisable options varies year to year.
(4) Performance vesting: Options become vested in the year the company achieves a particular goal (e.g., revenue or price/share goal).
(5) Early vesting (accelerated exercise): In this type of arrangement, employees are allowed to immediately exercise options when they are granted. For each option exercise, they receive a share of "restricted" stock, which is subject to a holding period that is based on the stock option plan's original vesting schedule.

E. Expiration

(1) Generally, employees have 10 years (or less) to exercise the option.
(2) Terminated employees may have 30 to 90 days after termination to exercise vested options; the period may extend to six months to one year in the event of death or disability.

F. Availability to nonemployees (directors, board members, etc.): An individual must be an employee to benefit from an ISO.
G. Cashless exercise/same day sale: No money is exchanged. A broker lends money to the employee to purchase shares and then sells them immediately for a fee.
H. Potential problems include expiration of the option, termination from employment, and over allocation.

2. Incentive stock options (ISOs)

A. Income tax implications (regular, alternative minimum tax [AMT], basis)

(1) Upon grant. Income not reported; no income tax due
(2) Upon exercise. No income for calculating regular tax. Difference between the fair market value (FMV) at exercise and exercise price (the bargain element or "spread") is an adjustment item for calculating the AMT.
(3) Upon (qualifying) sale. For AMT, long-term capital gain is difference between FMV at time of sale and FMV at time of exercise. For regular tax, long-term capital gain is difference between FMV at time of sale and exercise price.
(4) Employer receives no tax deduction, unless holding requirement is not satisfied.

B. Holding period requirements for a qualifying sale: Shares must be held for at least one year after the option is exercised and for at least two years after the option is granted.

(1) If the holding period requirement is not met, a disqualifying disposition occurs and the appreciation on the sale (untaxed bargain element plus other appreciation) will be taxed as ordinary income.
(2) An employee receiving the ISO is required to continue as an employee from the time of the grant of the options until at least three months before the exercise. If not, options are converted to NSOs.

C. Disqualifying dispositions: If the holding requirements are not satisfied, then a portion of the employee's profit is taxed as compensation and the employer is allowed a deduction for that compensation. The other portion is taxed to the optionee as a short-term capital gain.
D. Employee benefit analysis and application: Options may be granted to executives, key employees, or other groups of employees on a discriminatory basis.

3. Nonqualified stock options (NSOs)

A. Income tax implications (regular, AMT, basis)

(1) Upon grant: No income tax is due.
(2) Upon exercise: The employee realizes income equal to the difference between grant (exercise) price and FMV at time of exercise. This difference is called the bargain element. The FMV at time of exercise becomes the new cost basis. The company must withhold federal and state taxes (using the supplemental wage tax) as well as Social Security taxes. Depending on the individual's tax situation, too much or too little tax may have been withheld.
(3) Upon sale: If the employee holds the stock and sells later, the employee recognizes capital gain or loss; may be short or long term, depending on whether it is held for more than one year. The sale will not trigger additional tax unless the selling price exceeds the share basis.

B. Gifting opportunities: May gift to family members, family trusts, charities

(1) IRS safe harbor allows the gifting of vested options where valuation is based only on Black-Scholes valuation model.
(2) Gift tax valuation: Options must be valued for gift tax purposes at the time of the gift. If the employer uses straight vesting (e.g., 20 percent yearly for five years), the employee can make a completed gift of the vested portions at an earlier date when the options have a low value.

C. Employee benefit analysis and application: Option may be granted to an employee, a member of the board, an independent contractor, a family member, or any other beneficiary of the employee on a discriminatory basis.

4. Planning strategies for employees with both incentive stock options and nonqualified stock options

A. There should be consideration given to exercising options and selling stock over a period of time to take advantage of price averages and risk reduction.
B. Individuals in high tax brackets should consider early exercise for appreciating stocks to benefit from lower taxes, because the bargaining element is taxed as income for NSOs and possible AMT consequences for ISOs.
C. It makes sense to hold on to the stock for more than one year after exercise to change tax treatment to long-term capital gain.
D. Diversification and meeting financial goals may be good reasons for selling options sooner than the end of the exercise period.

5. Election to include in gross income in the year of transfer (Section 83(b) election)

A. Employee makes an election to include in income the FMV of the stock, less any amount paid for the stock, at the time the stock is issued.
B. The election can be made only if the stock is subject to substantial risk of forfeiture and is not transferable.

C. After the forfeiture restrictions have lapsed, any subsequent appreciation or depreciation after the election date is taxed as capital gain or loss when the employee sells the stock.

TOPIC 32: STOCK PLANS

1. **Types and basic provisions**

   A. Restricted stock: Shares of stock are granted to the employee at no cost or at a bargain price with restrictions: stock cannot be sold or disposed of before a specified period of time, and employee cannot work for a competitor and /or must stay with the employer for a specified time period and meet performance criteria.

   B. Basic provisions

      (1) May be issued to employees on a discriminatory basis
      (2) Used as a form of incentive compensation to key employees

2. **Income tax implications**

   A. Stocks are subject to risk of substantial forfeiture so income (value of the shares) is not recognized.

   B. When no longer subject to forfeiture (i.e., stock is substantially vested), the value of the stock is recognized as ordinary income to the employee, and the employer can take a deduction.

   C. If the employee is confident that the restricted stock will not be forfeited, within 30 days of the date of the grant, the employee can pay income tax and file an 83(b) election on the value of the shares as of the grant date. When the restrictions lapse and the employee sells the stock, the appreciation is taxed as capital gain.

   D. Any appreciation or depreciation after the stock is vested is capital gain or loss when the employee sells the stock.

   E. Dividends that are paid on unvested shares are treated as income to the employee and deductible compensation for the employer.

3. **Junior stock: Restricted stock that can be converted into common stock of the company but only if performance goals are reached. Its voting, liquidation, and dividend rights are subordinate (i.e., junior) to the regular class of common stock.**

   A. Basic provisions

      (1) Convertible to common stock upon certain events, such as attainment of performance goals
      (2) Conversion at option of employee or may be automatic
      (3) Similar to NSO

   B. Income tax implications

      (1) When purchased at FMV, there is no tax to employee when the junior stock is issued.
      (2) There is no tax when the junior stock is converted to common stock.
      (3) Employee recognizes gain on the date he or she sells the common stock that was exchanged for junior stock. Basis is the amount paid for the junior stock.

   C. Performance share/unit plans

      (1) Basic provisions

         (a) Awards are “granted” at the start of a specific time period (usually measured in years, e.g., three to five years) and earned through attaining performance goals.

(b) Value of shares/units determined by performance results for each performance cycle
(c) Payments made in cash and/or stock

4. Phantom stock and other employee stock plans

A. Basic provisions

(1) Employee is awarded units analogous to shares using a formula (e.g., based on compensation).
(2) After a time specified in the plan, the employee is entitled to receive deferred compensation in cash and/or stock.
(3) Phantom stock is not real stock but a method of tracking the performance of the employer's stock. There is no dilution of company stock.
(4) The plan is an unfunded and unsecured promise of the employer to pay cash, stock, or other property. There is no recognized income by the employee.
(5) The employee cannot specify the date on which to exercise the stock.

B. Income tax implications

(1) No income is recognized on the date the phantom stock is awarded.
(2) Upon exercise, the company generally pays in cash the difference between the current stock value and the value of the phantom stock units. The entire amount received is subject to ordinary income tax rates and the usual withholding tax rules.

C. Stock appreciation right (SAR): The right of an employee to receive cash and/or stock equal to the increase in the value of the company's stock after the date the SAR is granted.
D. The employee receives payment for the appreciation in stock price without exercising the options.

(1) Basic provisions: Similar to a phantom stock plan, except:

(i) The SAR is generally offered together with a stock option.
(ii) It gives the employee the right to appreciation in the stock after the grant date.
(iii) The employee has the right to decide when to exercise the SAR.

(2) Income tax implications. The amount is taxed as ordinary income in the year of exercise—similar to phantom stock.

5. Employee stock purchase plans (ESPPs). A form of stock option plan under IRC Section 423; allows a company to sell stock to employees at a discount from the market price

A. Basic provisions

(1) The option must be offered to employees on a nondiscriminatory basis.
(2) Transferability. Only the employee may purchase the shares during his or her lifetime.
(3) Purchase price of the stock can be as low as 85 percent of FMV on the offer/grant date or sale date, whichever is less. The offer typically permits employees to purchase stock every six months via payroll withholding.
(4) Maximum FMV of the stock that an employee may accrue the right to purchase in any calendar year cannot exceed $25,000.

B. Income tax implications

(1) Upon grant. Income is not recognized = no income tax.
(2) Upon purchase. Income is not recognized.

(3) Upon sale. Whether treated as compensation income or long-term capital gain depends on whether the holding period requirements (as for ISOs) are met and whether the stock is sold for more or less than the purchase price.

C. Qualifying sale (disposition)

(1) Amount of ordinary income recognized equals the lesser of (1) the actual gain (amount by which the sale price exceeds the actual purchase price) or (2) the purchase price discount (when the purchase price is based on the lower of the value of the stock on the first or last day of the offering period, even if it is the higher price). All additional gain on the sale of stock is treated and taxed as long-term capital gain.

(2) Example: Assume company uses a 15 percent discount on the lower of the value of the stock on the first or last day of the offering period and that the stock price is $10 per share on the first day of the offering period (which is the purchase date) and $30 when sold. When the stock is sold after satisfying the holding period requirements, recognize ordinary income of $1.50 per share (15% of $10) and long-term capital gain of $20 per share ($30 minus ordinary income of $1.50, minus the purchase price of $8.50). The $1.50 will be reported on a W-2.

D. Disqualifying sale (disposition)

(1) Amount of ordinary income is equal to the difference between the FMV of stock at date of purchase and purchase price. Ordinary income is measured as the "spread" on the purchase date, regardless of whether the purchase price is calculated on the first day of the offering period. In addition, any difference between the sale price and the basis will be a capital gain or loss, which will be long-term if the stock has been held for more than one year.

(2) Example: Assume a sale is one year after grant but less than two years from purchase. Further assume that the company uses a 15 percent discount and that the stock price is $10 per share on the first day of the offering period, $15 on the last day of the offering period, and $20 when the stock is sold. The individual will recognize ordinary income of $6.50 per share ($15 minus purchase price of $8.50) and long-term capital gain of $5.00 per share ($20 minus $15 basis, which is the sum of the purchase price and the amount of ordinary income recognized) when the stock is sold.

E. Employee benefit analysis and application—ESPP must be offered to all employees who qualify on a nondiscriminatory basis; ISO and NSO may discriminate.

6. Election to include in gross income in the year of transfer (Section 83(b) election)

A. Employee makes an election to include in income the FMV of the stock, less any amount paid for the stock, at the time the stock is issued.

B. The election can be made only if the stock is subject to substantial risk of forfeiture and is not transferable.

(1) After the forfeiture restrictions have lapsed, any subsequent appreciation or depreciation after the election date is taxed as capital gain or loss when the employee sells the stock.

TOPIC 33: NONQUALIFIED DEFERRED COMPENSATION

1. Basic provisions and differences from qualified plans

A. Nonqualified plans are different from qualified plans in the following ways:

(1) Tax deferred for employees unless considered funded. Tax is always deferred for employees with qualified plans.
(2) Tax deduction deferred for employers until the benefit has been paid (unless considered funded). Qualified plans always provide immediate deduction for employers.
(3) Earnings do not accumulate tax free (unless tax shelter is used). Earnings always accumulate tax free for qualified plans.
(4) No special tax treatment at retirement for employees. Qualified plans offer special tax treatment for rollovers and forward averaging.
(5) Minimal and inexpensive legal and administrative requirements. Qualified plans are burdensome and expensive.
(6) Minimal and inexpensive reporting and disclosure requirements. Qualified plans are burdensome and expensive.
(7) More effective ability to attract, retain, and motivate employees
(8) Provide retirement benefits in excess of qualified plan limits

B. Nonqualified plans circumvent qualified plan nondiscrimination rules.

2. Types of plans and applications

Note: Must have a signed written agreement for deferring compensation prior to any services being performed (i.e., prior to earning it) to avoid adverse tax consequences. Plans may discriminate. No ERISA requirements need to be satisfied.

A. Salary reduction plans

(1) Employer can supplement current existing salary of an employee/executive with a salary continuation agreement to take place at death or retirement of the selected executive.
(2) Employer can negotiate with executive to defer some of his or her current salary and provide additional compensation at death to a beneficiary or at the retirement of the executive.

B. Pure deferred compensation (i.e., a salary reduction plan)

(1) Employee agrees to give up a specified portion of compensation (e.g., salary, raise, bonus, commissions).
(2) Employer promises to pay a benefit sometime in the future, equal to the amount deferred plus a predetermined rate of interest.
(3) Often referred to as an in lieu of plan; employee is accepting a promise in lieu of current income.
(4) A rabbi trust is commonly used to fund this type of plan.
(5) Main consideration for the executive should be the strength of the company making the promise.

C. Salary continuation plans

(1) Employee/executive does not give up current compensation for the benefit. Rather, an additional amount is supplemented by the employer.

(2) Employer makes a commitment to provide the benefit.
(3) Can also be designed to provide additional retirement plan benefits above a company's qualified retirement plan calculations, thus providing an incentive for hiring midcareer executives
(4) Generally available only to executives and selected top management
(5) It can also be integrated with Social Security.

D. Rabbi trusts

(1) A rabbi trust is an irrevocable trust set up by the employer for a nonqualified deferred compensation (NQDC) plan.
(2) Funds are set aside prior to retirement and secured against unwillingness to pay.
(3) Funds contributed into the trust:

(a) The funds must be available to pay benefits to the employees, and assets cannot revert back to the employer even with a hostile takeover.
(b) The funds are subject to the claims of all general creditors of the company in the event of a bankruptcy.
(c) Notice must be given to the trustee by the firm immediately if the firm becomes bankrupt or insolvent.

(4) The trust cannot contain insolvency triggers that hasten payments to executives when the employer's net worth falls below a certain point.
(5) Used as a method to "fund" unfunded deferred compensation plans

(a) Gives the employee the security of a funded plan (except in a bankruptcy)
(b) Tax-deferred benefits of an unfunded plan—not taxable to employee (i.e., income deferred) or deductible by employer

(6) Executives can take a hardship withdrawal without triggering constructive receipt.
(7) Such a fund can be useful for an executive in the event of a hostile takeover or merger, but provides no benefit if a firm goes bankrupt.

E. Secular trusts

(1) A secular trust is an irrevocable trust set up to provide nonqualified benefits to an employee.
(2) Funds are set aside prior to retirement and secured against unwillingness to pay.
(3) Employer contributions into the trust are not subject to claims of general creditors.
(4) Deferred compensation plans funded by a secular trust result in the employee's being in constructive receipt of the contribution. Contributions are taxable to the employee at the later of the date that contributions are made or the date when benefits become nonforfeitable. The employer gets an immediate deduction for the contribution into the trust.
(5) Provides protection for the employee in the event of the employer's bankruptcy, insolvency, merger, takeover, or outright refusal to pay. The price of this protection is immediate taxation on the contribution.
(6) Potential for double taxation, once at the trust level and again when actually paid out to the employee. Because of tax consequences, secular trusts are not common.

3. Tax implications

A. Constructive receipt

(1) An employee is taxed on compensation he or she has a right to receive on demand without any risk of forfeiture. In a NQDC plan, if the employee had a choice to receive the

compensation but declined for whatever reason, the IRS will treat the compensation as taxable income to the recipient.

(2) The tax issue is whether or not a taxpayer can control the timing of the actual receipt of the income.

(3) Treasury Revenue Ruling 60-31: An employee is not taxed on compensation if all three of the following are satisfied:

(a) The election to defer compensation is made under a written agreement before services are rendered.

(b) The agreement represents an unsecured promise to pay.

(c) The plan is unfunded, or if funded, there is a substantial risk of forfeiture.

B. Substantial risk of forfeiture

(1) Exists if the participant's right to the compensation is conditioned on the future performance of substantial services. The risk of forfeiture must be real and substantial.

(2) Examples that indicate a substantial risk of forfeiture include:

(a) Continued employment for a specified time period (e.g., until retirement) or else employee losses benefit

(b) A noncompete clause after employee leaves employer for a specified time period or in a certain geographic area

(c) Availability of the employee for consulting services after retirement

(3) Note: Death and disability are not considered reasons for substantial risk of forfeiture.

4. Funding methods

A. Unfunded versus informally funded

(1) Unfunded: There is only the employer's promise to pay an amount sometime in the future.

(2) Informally funded

(a) Assets are set aside in a general reserve fund to meet the benefit obligations of the plan.

(i) Employee has no rights or security interest in the assets or fund.

(ii) Funds are always subject to the claims of the company's creditors.

(iii) Funds may be invested in life insurance, mutual funds, or other securities.

(iv) Promise to pay is the employee's only security for future benefits.

(b) There is no taxation to the employee as long as funds are subject to the company's creditors, inasmuch as there is no constructive receipt.

(c) If the employee has vested benefits, there is no constructive receipt, because the funds are not secured.

B. Funded

(1) The deferred compensation is secured by property in which the employee has a beneficial interest and is beyond the reach of creditors.

(2) To avoid taxation, constructive receipt must be avoided.

(3) Most plans are designed to be unfunded for ERISA and tax purposes.

5. Strategies: The strategies are apparent in the use of different nonqualified plans.

MULTIPLE CHOICE QUESTIONS

Group Life Insurance

1. **Which of the following are features of group term life insurance?**
   (1) It provides protection for a number of persons under a master or single life insurance policy.
   (2) The insurance is individually underwritten.
   (3) The employee may deduct the premiums paid by the employer.
   (4) There are no income tax consequences to the employee on the first $50,000 of death benefit.
   A. 2 and 4 only
   B. 1 and 3 only
   C. 1 and 4 only
   D. 2 and 3 only

   Ans. C

2. **Which one of the following describes the conversion provision in a life insurance policy?**
   A. The insured is guaranteed the right to renew the policy for a limited number of additional periods.
   B. The insured may exchange term insurance for permanent insurance without having to show evidence of insurability.
   C. The insured may purchase additional amounts of insurance without having to show evidence of insurability.
   D. The insured is guaranteed the right to exchange term insurance for permanent insurance if he or she becomes disabled.

   Ans. B

3. **Regarding employer-provided group term life insurance plans:**
   (1) An employer generally may deduct its contribution to a group life insurance plan.
   (2) The cost for up to $50,000 of coverage is excludable from an employee's income.
   A. 1 only
   B. 2 only
   C. Both 1 and 2
   D. Neither 1 nor 2

   Ans. C

4. **If an employer-provided group term life insurance plan discriminates in favor of any key employee:**
   A. All key employees lose the favorable tax treatment.
   B. The key employees who were favored lose the favorable tax treatment.
   C. There is no effect on tax treatment.
   D. All employees lose favorable tax treatment.

   Ans. A

Use the following excerpts from the Section 79, Uniform Premium Table I, to answer question 5.

Five-Year Age Bracket for One-Month Period	Cost per $1,000 of Protection
35 to 39	$.09
40 to 44	$.10
45 to 49	$.15
50 to 54	$.23

5. **Bob Smith is age 43 and has $60,000 of group life insurance. What amount, if anything will show up on his W-2 statement?**

   A. $0
   B. $12
   C. $72
   D. $108

   Ans. B

6. **Group universal life insurance has the following features:**

   (1) Flexibility in amount and timing of premium payments
   (2) Choice of two death benefit options
   (3) Cash value accumulations

   A. 1 only
   B. 1 and 3
   C. 2 and 3
   D. 1, 2, and 3

   Ans. D

7. **Don Ingalls injured his back last year and claims he is not able to work. Some of his colleagues observed that he was playing tennis yesterday. This scenario suggests that the group disability benefits might have created a(n):**

   A. Aversion to work
   B. Moral hazard
   C. Morale hazard
   D. Physical hazard

   Ans. B

8. **The definition of what constitutes a disability is the determinant of whether a claim will be paid. The following are possible definitions:**

   (1) Inability to perform own occupation
   (2) Inability to perform occupation for which trained or educated
   (3) Inability to perform any substantial gainful work

   A. 1 only
   B. 1 and 2
   C. 1 and 3
   D. 1, 2, and 3

   Ans. D

Use the following information to answer question 9. Ziggy has a major medical policy through his employer that has a $500 deductible, an 80%–20% coinsurance clause and a $5,000 annual out-of-pocket maximum. His total medical expenses (which included a surgery fee of $4,000) were $20,000 for the year.

9. **What will Ziggy's obligation be for these charges?**

   A. $500
   B. $3,900
   C. $4,400
   D. $5,000

   Ans. C

10. PPOs differ from HMOs in these respects:

(1) Patients choose salaried doctors within the PPO.
(2) Fees usually subject to a schedule that is similar for all PPO participants.
(3) A choice of practitioners or facilities is made each time medical care is needed.

A. 2 only
B. 3 only
C. 1 and 2
D. 2 and 3
E. 1, 2, and 3

Ans. D

11. Jessie was terminated by his company. Because he is married and has one child, he is in a state of panic about medical insurance. As his financial advisor, you point out that he has COBRA coverage and the following will apply EXCEPT:

A. He will receive continuation of coverage of his coverage for 18 months.
B. At the next enrollment period, he can change his managed care plan to an indemnity policy offered by the company.
C. Charges for the COBRA coverage may not exceed 102% of the cost of the plan.
D. After his date of termination, he has a 60-day window to elect coverage.

Ans. B

12. Jasmin has obtained a new job and determined that her group medical coverage with her new employer begins after the 90-day probationary period. She's concerned about the continuity of medical coverage. As her financial advisor, you suggest that she:

A. Take the COBRA coverage until such time that her new policy goes into effect.
B. Take out the conversion policy offered by her former employer.
C. Take the risk that nothing is going to happen during the next 90 days.
D. Obtain an individual short-term medical policy.

Ans. A

13. Section 125 Cafeteria Plans allow employee participants to choose among two or more benefits consisting of qualified benefits and cash. Cafeteria plans can include all of the following benefits EXCEPT:

A. Medical expense benefits
B. Disability benefits
C. Long-term care benefits
D. Life insurance benefits

Ans. C

14. Flexible spending accounts are attractive as they enable employees to pay for some expenses on a pretax basis. The risk involved in using such accounts is that:

(1) Employees must estimate the expenses correctly or they chance to lose what was not used.
(2) Employees must make decisions in the year prior to the effective date of the plan.

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

Ans. C

15. What is the single most distinctive feature of all nonqualified deferred compensation plans?

A. Contributions deductible by the corporation and not includible as income for the employee
B. Insurance required as the funding instrument
C. Discrimination permitted with respect to coverage and benefits
D. Investment income earned on the employer's contributions used to acquire listed securities is tax deferred for both the employer and the employee
E. The employee is required to accept a reduction in current compensation.

Ans. C

16. Which of the following statements concerning specific types of nonqualified deferred compensation plans is correct?

A. A "pure" deferred compensation plan provides for a reduction in the employee's current compensation.
B. Under the typical salary continuation plan, the employee promises to remain with the employer for a specific time period.
C. Death benefit only plans mean the death benefit is includible in the deceased employee's gross estate.
D. SERPs can be used only if the extra retirement benefits are available for all employees.
E. An excess benefit plan will typically provide a larger benefit than a SERP.

Ans. A

17. Which of the following statements concerning the rabbi trust is (are) correct?

(1) It is an irrevocable trust but assets are still available to creditors.
(2) The employee is taxed immediately on assets placed in the trust because the trust is irrevocable.

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

Ans. A

18. Which of the following statements concerning the federal income tax treatment of benefit payments to an employee under the terms of an unfunded deferred compensation agreement is (are) correct?

(1) Such payments are taxed as ordinary income when received.
(2) Such payments are subject to income tax withholding when the payments are directly or constructively received.
(3) Such payments are currently subject to Social Security taxes the same as any other earned income.

A. 1 only
B. 1 and 2 only
C. 1 and 3 only
D. 2 and 3 only
E. 1, 2, and 3

Ans. E

19. Because incentive stock options (ISOs) are qualified or statutory options, a number of requirements apply EXCEPT:

A. Must be exercised in the order granted
B. May be issued only to employees
C. Are not transferable
D. Maximum option term is 10 years

Ans. A

20. Companies may issue either nonqualified stock options (NSOs/NQSOs) or ISOs. The primary differences between the two types of options is/are:

(1) Tax treatment at time of grant
(2) Tax treatment at time of exercise
(3) Tax treatment at time of sale

A. 2 only
B. 3 only
C. 2 and 3
D. 1, 2, and 3

Ans. C

21. ISOs are subject to the following withholding taxes at time of exercise:

(1) FICA
(2) AMT

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

Ans. D

22. To qualify for favorable tax treatment, incentive stock options (ISOs) must meet certain holding requirements; that is, they cannot be sold:

(1) Before one year from the date of grant
(2) Before two years from the date of exercise

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

Ans. D

23. Upon the exercise of nonqualified stock options:

(1) Withholding rules apply only if the stock is sold.
(2) Bargain element is taxed as ordinary income.
(3) Basis in the stock is the fair market value on date of exercise.

A. 2 only
B. 1 and 2
C. 2 and 3
D. 1, 2, and 3

Ans. C

24. All of the following apply to an 83(b) election EXCEPT:

A. Elect to have taxation occur at the time the stock is issued.
B. Subsequent appreciation is taxed as capital gain or loss.
C. Stock must be subject to substantial risk of forfeiture.
D. A tax refund may be applied for if employment is terminated before restrictions lapse.

Ans. D

25. An 83(b) election is typically only available for:

A. Nonqualified stock options
B. Restricted stock
C. Employee stock purchase plans
D. Phantom stock

Ans. B

26. When a company establishes a *rabbi trust* with its nonqualified plans, the participant obtains protection from the following:

(1) Change of corporate control
(2) Bankruptcy of the company

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

Ans. A

27. The difference between a *rabbi trust* and a *secular trust* is:

A. Rabbi trusts are available only to religious orders.
B. Secular trust offers protection against bankruptcy.
C. With a rabbi trust executive is subject to income taxes.
D. Secular trusts use revocable trust instruments.

Ans. B

28. The difference between the fair-market value of stock at the time of exercise and the option price is referred to as the:

(1) Bargain element
(2) Spread
(3) Equity from options

A. 1 only
B. 2 only
C. 1 and 2
D. 1, 2, and 3

Ans. A

Use the following information to answer questions 29 and 30. Jose Marquez was granted 2,000 stock options in his first year at a $10 option price; 2007 in his second year at a $12 option price. The options fully vest in four years. The current fair market value is $20 a share.

29. What is the bargain element now for each of the options in the first year?

A. $8
B. $10
C. $12
D. $20

Ans. D

30. What is Jose's current total equity in his stock options?

A. $10,000
B. $20,000
C. $36,000
D. $64,000

Ans. B

CHAPTER 4

INVESTMENT PLANNING

TOPIC 34: CHARACTERISTICS, USES, AND TAXATION OF INVESTMENT VEHICLES

1. **Security risk diagram**

   A. Risk (and return potential) increases from bottom to top.
   B. Risk (and return potential) increases from left to right.
   C. Federal Deposit Insurance Corporation (FDIC)-insured certificates of deposit (CDs) are less risky.
   D. Futures and commodities are most risky.

2. **Futures and commodities**
3. **Speculative common stocks and bonds**
4. **Gold, silver, and collectibles**
5. **Limited partnerships**
6. **Real estate options**
7. **High-grade common stock**
8. **Growth mutual funds**
9. **Balanced mutual funds**
10. **High-grade preferred stock**
11. **High-grade convertible securities**
12. **High-grade municipal bonds**
13. **Money market accounts**
14. **High-grade corporate bonds**
15. **FDIC-insured CDs**
16. **U.S. series EE and HH bonds**
17. **Insurance-based investments**
18. **Treasury bills, notes, and bonds**
19. **FDIC-insured checking and savings accounts**

1. **Cash and equivalents**

   A. Certificates of deposit

   (1) A certificate of deposit (CD) is a time deposit with a specified maturity.
   (2) It is nonnegotiable or negotiable.

   (a) A nonnegotiable CD is one in which the initial depositor must wait until maturity to receive the funds. If funds are withdrawn prior to the maturity date, there is an early withdrawal penalty.
   (b) A negotiable CD allows the depositor to sell the CD in the open market anytime before maturity.

(3) Depository institutions can sell negotiable CDs or jumbo CDs if an investor has $100,000 or more to invest. Maturities tend to be up to one year. CDs of less than $100,000 are generally nonnegotiable.

B. Money market mutual funds

(1) Money market mutual funds specialize in short-term securities. This is an alternative to other money market instruments.
(2) They are made up of many short-term instruments available in the open market (Treasury bills, commercial paper, banker's acceptances, certificates of deposit, repurchase agreements, etc.).

C. Treasury bills

(1) Treasury bills are issued by the federal government.
(2) These securities are in denominations of $1,000 to $100,000 and mature in 3 to 12 months.
(3) They are sold at a discount.
(4) Interest is subject to federal income tax but exempt from state and local tax.

D. Commercial paper

(1) Commercial paper is unsecured short-term promissory notes issued by corporations.
(2) Only firms with excellent credit ratings are able to sell commercial paper, so the risk of default is small.
(3) The maturity of commercial paper is usually less than 270 days.
(4) Commercial paper is sold at a discount.

E. Banker's acceptances

(1) Banker's acceptances are short-term promissory notes guaranteed by a bank. The bank takes ultimate responsibility for repaying these loans to the holder.
(2) These acceptances are sold on a discounted basis and are common with international trade.

F. Eurodollars

(1) Dollar-denominated deposits in banks in foreign countries using dollars to make loans rather than the local currency

G. Individual bonds

2. U. S. Government bonds and agency securities

A. Treasury notes have maturities in 2 to 10 years in denominations of $1,000 to more than $100,000.

(1) Treasury bonds are the government's long-term debt and have maturities greater than 10 years.
(2) Notes and bonds are issued as coupon securities.
(3) Treasury notes and bonds are the safest intermediate- and long-term investments available for purchase because they are backed by the government. This increased safety results in yields that are lower than those of high-quality corporate debt.
(4) Interest is subject to federal income tax but exempt from state and local tax.

B. Treasury STRIPS

(1) In 1985, the Treasury introduced zero coupon bonds called STRIPS, standing for separate trading of registered interest and principal securities.

(2) STRIPS are direct obligations of the federal government.
(3) STRIPS do not pay a coupon, but interest is taxed as it accrues. Therefore, it is appealing to purchase STRIPS in retirement accounts because tax in retirement accounts is deferred until funds are withdrawn.
(4) STRIPS are more volatile than other government bonds during periods of changing interest rates.
(5) To take advantage of the greater price volatility found in STRIPS, it is better to buy them when interest rates are expected to fall.

C. Municipal bonds—general obligation bonds and revenue bonds

(1) General obligation bonds are backed by the full faith and credit of the taxing power of the issuing government.
(2) Revenue bonds are supported by the revenue of a project.
(3) General obligation bonds have less risk than revenue bonds because they are supported by taxes, whereas revenue bonds are supported only by the funds generated by a project.
(4) Municipal bonds tend to lack marketability and liquidity. These issues are traded over the counter and the market is thin, causing a large spread between bid and ask. They trade in denominations of $5,000 face value.
(5) Most debt issued by state and local governments is a long-term serial issue. Serial bonds offer the benefit to the buyer of knowing when the bonds are going to mature. The bonds are purchased based on the investor's time horizon.
(6) The federal government does not tax interest earned from municipal bonds. Municipal bond interest may also be tax exempt for various states. For example, Colorado does not tax Colorado municipal bond interest, but taxes municipal interest from other states.

D. Treasury inflation protected securities (TIPS)

(1) TIPS are securities issued by the federal government that have coupon payments that periodically adjust to changes in the inflation rate.
(2) Changes in inflation are represented in the principal and not the coupon.
(3) The inflation-adjusted principal is multiplied by the real rate to get the appropriate coupon payment. The real rate represents the fixed coupon rate net of inflation. For example, suppose a par value of $10,000 and a coupon rate of 4 percent. Annualized inflation for the next six months is 5 percent. The coupon payment is calculated as follows:

    (a) First, compute the inflation-adjusted principal. If the annual inflation rate is 5 percent, then the semiannual rate is 2.5 percent (5% × 1/2). Apply this to the principal of $10,000 to get an inflation-adjusted principal of $10,250 ($10,000 × 1.025).
    (b) Next, compute the semiannual coupon payment. This is found by multiplying the inflation-adjusted principal amount with the semiannual real rate. The semiannual coupon rate equals $205 ($10,250 × 2%).

E. Series EE, HH, and I bonds

(1) The Series E bond was designed to encourage more people to save money. It was sold in denominations of $25, $100, $500, and up to $10,000. Series E bonds were sold at a discount and paid no interest, similar to zero coupon bonds.
(2) Treasury issued the new Series EE bond to replace the Series E bond. The rate of interest is a variable rate that allows investors to benefit from increasing interest rates.
(3) Interest earned for both E and EE bonds is not taxable until the bonds are redeemed or reach maturity. However, they do permit recognition of the income in earlier years with

a valid election. Recognizing the income from E and EE bonds may be a tax planning strategy for young children who have no other taxable income and will thereby create basis in the bonds.

(4) Interest deferred on Series EE bonds can be further deferred by exchanging the EE bonds for HH bonds. The deferral continues until HH bonds are sold or mature.

(5) Interest from Series EE U.S. government savings bonds may be completely excluded from gross income if the bond proceeds are used to pay qualified higher education expenses.

(6) H and HH bonds are sold at par in larger denominations (minimum of $500). The bonds have a maturity of 20 years, and interest is paid and is fully taxable in the year of payment. There is not an option to accumulate the interest or defer the taxes. Series HH bonds are a new issue that is designed to replace the older series H bonds.

(7) It should be noted that the interest earned form E, EE, H, and HH bonds is U.S. government interest and is not taxable by municipalities.

F. Mortgage-backed securities

(1) Bonds issued by federal agencies are not debt of the federal government. Therefore, their yields are higher than those yields available on U.S. Treasury debt. However, they are extremely safe because they have the backing of the federal government.

(a) This backing in most cases is only moral backing, which, in the case of default, the federal government is not obligated to support the debt.

(b) Other agency debt has a legal backing. In this case, the Treasury is legally bound to assume any obligation contained in the debt's indenture.

(2) Federally related institutions include the Government National Mortgage Association (Ginnie Mae) that is backed by the full faith and credit of the U.S. government. These bonds have no credit risk because there is no chance of default.

(3) The other type of agency debt, government-sponsored entities, includes the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Bank Corporation (Freddie Mac), and the Student Loan Marketing Association (Sallie Mae). These are privately owned, publicly chartered institutions that were created by the U.S. gov't.

3. Asset-backed securities

A. An asset-backed security represents a pool of asset-linked debts.

B. Investors receive payments on a monthly basis, consisting of scheduled principal and interest, and any unscheduled payments consisting of prepayments.

C. Unlike prepayments for mortgage-backed securities, prepayments for asset-backed securities are almost unaffected by changes in market interest rates, resulting in relatively predictable cash flows.

D. All asset-backed securities have one or more credit enhancements that result in a higher credit rating. They offer investors higher yield than corporate bonds of similar quality and maturity.

E. The market for asset-backed securities is very liquid.

4. Mortgage pass-through securities

A. A mortgage pass-through security represents a self-amortizing pool of mortgages.

B. Payments are made on a monthly basis and consist of scheduled principal and interest, as well as any unscheduled payments consisting of prepayments and defaults. The timing and

amount of cash flows are largely dependent on prepayments. Payments vary from month to month, and the amount received by the investor also varies each month.

C. If no prepayments are made, the monthly cash flows will remain constant. It is only the composition of the cash flows between interest, principal, and servicing fees that changes when a loan amortizes.

D. Mortgage pass-through securities should be evaluated by fixed-income investors because they provide many benefits.

   (1) Their yields can be as much as 200 basis points higher than comparable government and corporate fixed-income debt.
   (2) They are considered to be of higher credit quality than AAA corporate bonds, because mortgage pass-through securities are issued by federal agencies.
   (3) These securities prove to be very liquid in the marketplace. They are more liquid than corporate bonds and as liquid as Treasuries.
   (4) They are a very good source for an investor interested in receiving a monthly income.

E. Mortgage pass-through securities also carry a degree of risk.

   (1) Interest rate risk
   (2) Reinvestment rate risk

F. The uncertainty in the monthly payments affects the valuation of a mortgage pass-through security. If mortgages are paid off sooner than expected, the realized return will be higher than the expected return. The opposite is also true: If mortgages are paid off later than expected, the realized return will be smaller than the expected return.

5. Collateralized mortgage obligations (CMOs)

A. A collateralized mortgage obligation is a derivative of a pass-through security held by a trust in which prepayment and reinvestment risk is reduced.

B. The CMO is subdivided into different classes (called tranches), which receive different cash flow payments. The principal repayment is directed to the first tranche until it is retired and then paid to the next tranche. Principal repayments are not made to the next tranche until the prior tranche is retired. Interest is paid off annually on the amount of the loan in each tranche.

C. By accepting a later repayment of principal, investors in the longer tranches accept a higher interest rate than investors in the early tranches.

D. With a mortgage pass-through security, prepayments are spread over the entire life of the security. In the case of a CMO, prepayments are spread over each tranche. The timing of principal repayment becomes slightly more known than that of a mortgage pass-through security. For example, an investor in need of cash is better served by purchasing the first tranche, whereas an investor in little need of cash is better off acquiring a later tranche.

6. Zero coupon bonds

A. Bonds sold with no coupon at a discount and redeemed for face value at maturity. Interest is accrued over the life of the bond.

B. There is no tax avoidance in buying zero coupon bonds.

C. The tax disadvantage of accrued interest can be circumvented in retirement accounts because tax is deferred until funds are withdrawn.

D. Zero coupon bonds are extremely volatile in periods of changing interest rates.
E. Zero coupon bonds should be bought when interest rates are expected to fall, to take advantage of the increased bond price.

7. Municipal bonds

A. These are debt obligations issued by state and local governments.
B. General obligation bonds. These are backed by the full faith and credit of the government unit.
C. Revenue. These are backed by the specific project financed by the bond issue.

8. Corporate bonds

A. Mortgage bond. These bonds are issued to purchase specific fixed assets which are then pledged to secure the debt. These bonds are mainly issued through utility companies which use the proceeds to build power plants. As the asset generates revenue, the revenue generated goes towards retiring the debt and servicing the interest.

9. Debentures

A. Debentures are promissory notes that are not backed by collateral (they are unsecured), but are supported by the creditworthiness of a firm or government agency.
B. During bankruptcy, debentures are redeemed only after all secured debt has been paid off. Therefore, debentures pay a higher yield than secured debt because of the added risk.
C. Some debentures are subordinated, and these are even more risky than other debt. Subordinated debentures are paid off after all other unsecured debt is paid off during bankruptcy. Investors are often attracted to subordinated debt because of higher yields and other embedded options, such as convertible provisions.

D. Investment grade

(1) Investment grade bond does not indicate a particular type of bond; the term refers to any debt of high quality—rated triple B or higher.
(2) There are several types of corporate bonds that can be investment grade (but these can also be high-yield grade, discussed under topic 40.4.B).

E. Secured versus unsecured bonds

(1) Secured bonds have a claim to assets of a corporation in the event of default, insolvency, or liquidation. For example, a mortgage bond is secured by real property or buildings.
(2) Unsecured bonds are not backed by collateral.

F. High yield

(1) High-yield securities are often referred to as “junk” bonds. These are bonds that are low quality, speculative grade, usually rated below triple B. The features are the same as investment grade debt. However, the poor quality means they offer higher yields than investment grade debt. Triple B or better is generally considered investment grade.
(2) High-yield securities often have a call feature and sinking fund. They are usually debentures and may be subordinated to a firm’s other debt. However, some high-yield securities have collateral (i.e., mortgage bonds).
(3) These bonds are often issued to finance a takeover and merger or to help a start-up firm raise capital.

G. Convertible

(1) Conversion rights allow a bondholder to convert the bond into shares of common stock. The conversion feature acts as a benefit to induce investors to buy the bonds. It allows a corporation to have a debt instrument in its capital structure, although the conversion feature usually comes at a cost.

(a) These bonds tend to trade at a lower coupon rate than is available with other bonds.
(b) They are subordinate to other debt issued by the corporation.

(2) They often have a sinking fund provision and are often called by corporations to force bondholders to convert to common stock.
(3) The true benefit to holding these bonds is the safety of debt with the potential for capital gains. Convertible bonds will increase (decrease) in value as the underlying stock increases (decreases).
(4) Both the underlying stock and interest rates cause variations in the price of convertibles. Convertibles are in double jeopardy during periods of high interest rates and low stock prices.
(5) Conversion ratio. The number of shares into which a bond is converted is found by taking the face value of the bond and dividing it by the conversion price. Example: If a bond is priced at $1,000 and the conversion price is $25, the conversion ratio equals 40 shares ($1,000/$25).
(6) Conversion value. The number of shares into which a bond is converted times the market price of the stock gives the value of the bond in terms of stock. Example: If a bond is convertible into 40 shares and the market price of the stock is $23, then the bond's value is worth $920 relative to stock ($23 × $40).
(7) The market price of a convertible bond cannot be less than the conversion value, or an opportunity for arbitrage would exist.

H. Callable

(1) A call provision allows a firm to buy back bonds at a specified price before maturity.
(2) It is often used after a period of high interest rates. If bonds were issued during a period of high interest rates, it may make sense for a firm to refinance new debt at a lower interest rate.
(3) The call price is usually less than the market price. If the call price is higher than the market price, it is not beneficial for the issuer to call the bonds.
(4) There is risk to purchasing a callable bond:

(a) Increased interest rate risk
(b) Increased reinvestment risk
(c) Reduced potential for capital appreciation

(5) The call price acts like a ceiling in periods of falling interest rates. The price of a bond without a call provision will continue to rise as interest rates fall. There is an advantage to callable bonds when interest rates rise; the price of a callable bond does not fall as much as the price of a straight bond because of the call provision.

10. Foreign bonds

A. These bonds offer a mode of diversification and could offer higher returns at a given point of time than alternative domestic bonds. They may be more difficult to invest in than domestic bonds and carry higher transaction costs.

11. Promissory notes

A. These are unsecured documents signed by the borrower promising to repay a loan under specified conditions and are not backed by the specific asset as security.

12. Individual stocks

A. Common

(1) Investors often try to match their financial objectives with the particular characteristics of stocks.

(2) There are six categories of common stock:

(a) *Blue chip stocks:* Highly regarded investment quality companies. They are well established and older and have the ability to pay dividends in both good and bad years.

(b) *Income stocks:* Pay regular and steady dividends and provide consistent current income for investors. These stocks should also appreciate enough to keep up with inflation.

(c) *Growth stocks:* Sales, earnings, and market share grow at rates that are higher than those of an average company or the general economy. Blue chip stocks can also be classified as growth stocks. Little to no dividends are paid.

(d) *Cyclical stocks:* Cyclical stocks tend to prosper in growing and expanding economies and tend to do poorly during down business cycles. Examples include autos, paper, and airlines.

(e) *Interest-sensitive stocks:* The performance of some companies is largely affected by changes in interest rates. For example, the housing industry has more demand when interest rates are low because it is cheaper for consumers to purchase homes. Examples include insurance companies, telephones, utilities, and banks.

(f) *Defensive stocks:* Stocks that are relatively unaffected by general fluctuations in the economy are considered to be defensive stocks. Examples are soft drinks, groceries, alcohol, and tobacco.

(3) Control or voting rights

(a) *Noncumulative:* One share of common stock permits one vote for each member of the board of directors. This noncumulative voting would allow a shareholder of 100 shares of common stock to cast 100 votes for each of the director's positions.

(b) *Cumulative:* Permits a shareholder to cast votes equal to the number of positions on the board of directors times the number of shares owned, allocated in any way the shareholder wishes. Example: Three positions on the board of directors would allow a shareholder with 100 shares to cast 300 votes for one position, 150 votes for two positions, 100 votes for three positions, or any combination that does not exceed the 300 allotted votes. Cumulative voting helps to protect minority shareholders' right to management.

(4) Cash dividends are payments to the owners of a corporation.

(a) Stock price adjustment: The price of the stock declines by the amount of the dividend per share on the ex-dividend date. For example, assume a $100-priced stock that pays a $1 dividend. On the ex-date, the stock's price will drop to $99, but the stockholder will receive $1 in dividends, so there is no change in overall value to the stockholder. A firm's balance sheet will adjust, too—both cash and retained earnings decline by the amount of dividends paid.

(b) Dividend process

(i) Declaration date: The declaration date is the date when the board of directors passes a resolution to pay a dividend.

(ii) Ex-dividend date: In return, brokerage firms and stock exchanges establish the ex-dividend date to make sure the right people get the dividend. The exdividend date is two business days before the date of record. If you buy the stock before the ex-dividend date, you are entitled to receive the dividend. If you buy the stock after this date, you will not receive the dividend. Before the date, the stock trades "cum dividend."

(iii) Date of record. The corporation prepares a list of all individuals believed to be stockholders. The date of record is then the date on which holders of record are designated to receive the dividend.

(iv) Date of payment. The date of payment is when dividends are mailed to stockholders.

(5) A stock split is an increase in a firm's number of shares outstanding and is expressed as a ratio. For example, a two-for-one stock split means that a stockholder who owns 100 shares will now own 200 shares. A three-for-two stock split means that 100 shares increase to 150 shares ($3 \div 2 \times 100$).

(6) A stock dividend is a payment made by the firm in the form of additional shares instead of cash and is expressed as a percentage. For example, a 20 percent stock dividend means that shareholders receive one new share for every five shares owned. An investor who owns 100 shares will now have 120 shares. The result is a 20 percent increase in the total number of outstanding shares.

(7) Shareholders do not gain value after a stock dividend or split, because the price of the stock declines by the same percentage as the stock dividend or split.

(8) Effect of noncash dividends on the balance sheet

(a) Cash and stock dividends produce different results on the balance sheet, and stock splits have no effect on the capital structure of a firm.

(b) Cash dividends result in a reduction in cash and a corresponding reduction in retained earnings.

(c) Stock dividends increase the total number of outstanding shares, thus increasing the total value of common stock par and paid-in-capital surplus, but there is a reduction in retained earnings to offset. The net effect is no change in total stockholders' equity.

(d) Stock splits reduce par value but do not change the common equity part of the balance sheet. The shares are increased, but there is a counterbalancing decline in par value. The net effect is no change in total stockholders' equity.

B. Rights

(1) Preemptive rights are the rights of current stockholders to maintain their proportionate ownership in the firm.

(2) Firms that have given preemptive rights present a rights offering when they issue new stock. This offering allows existing shareholders to purchase new shares before they are offered to the general public. This right prevents dilution of an investor's ownership percentage when new shares are issued.

(3) The right is defined as an option given to stockholders to buy additional shares at a specified price during a specified time period.

(4) The distribution affects the shareholder's proportionate interest in the corporation.
(5) There are distributions of certain preferred stock.
(6) Taxable distributions. They are reported as income. The taxable dividend equals the FMV of the stock on the date of distribution. The holding period begins on the date of the stock dividend distribution.
(7) Nontaxable distributions. Affect the basis in the old shares. The cost basis of the old stock is divided by the total number of shares held after the distribution. The holding period of new shares starts on the same date as the holding period of the old shares.

C. Warrants

(1) The exercise of a warrant is not a taxable event.
(2) The cost basis of the common stock is the purchase price of the warrant plus the cost to exercise.
(3) The holding period of the stock begins at the time of exercise.

D. Preferred stock

(1) Preferred stock usually pays a fixed dividend that is not guaranteed. It is expressed as a percentage to par or dollar amount. For example, a $5 preferred represents a $5 annual dividend per share. The dividends are paid from earnings and given preference over common stock dividends.
(2) Cumulative preferred is preferred stock in which dividends are not paid but accumulate. The dividends are said to be in arrearage. This means they have not been paid but will be at some time in the future before dividends are paid to holders of common stock.
(3) Noncumulative preferred is preferred stock in which dividends do not accumulate. In this case, any missed dividend payments are not paid in the future.
(4) Preferred stock is usually purchased by investors seeking a fixed stream of income, as are bonds.
(5) There are some significant differences between preferred stock and bonds.

(a) Preferred stock is perpetual. This means that a firm does not have to generate sufficient money to retire it.
(b) Preferred stock is less risky than common stock but is more risky than debt. A firm has a legal obligation to make interest payments to bondholders, but does not have to make dividend payments to preferred stockholders.

13. American depository receipts (ADRs)

A. Foreign firms can have their shares traded on U.S. exchanges.

(1) One way is to have their shares directly available for trading by listing them on exchanges. These shares are traded exactly like those of a U.S. company.
(2) The other way is by issuing ADRs.

B. ADRs represent indirect ownership in shares of a foreign company. ADRs are tradable receipts issued by U.S. banks that have possession of physical shares held on deposit by correspondent banks in the home country of the company whose shares are issued. The correspondent bank holding the shares receives the dividends and converts them into U.S. dollars after paying all foreign withholding taxes.

C. ADRs are an effective means of investing in foreign companies without having to worry about currency risk.

14. Pooled and managed investments

A. Exchange-traded funds (ETFs)

(1) Characteristics of ETFs

(a) Exchange traded funds offer purchasers the ability to invest in a basket of stocks that closely mirror an underlying benchmark index. They trade daily on exchanges and are priced continuously by the marketplace throughout the day.
(b) Can be sold short and bought on margin—anything you might do with a stock, you can do with an ETF.
(c) Most charge lower annual expenses than index mutual funds, but you must pay a commission to buy and sell ETF shares.
(d) The funds rely on an arbitrage mechanism to keep the prices at which they trade roughly in line with the net asset values of their underlying portfolios.
(e) Forces of supply and demand determine the market price of an ETF.

(2) ETFs are different from traditional mutual funds in three ways:

(a) Trading flexibility: ETFs trade throughout the day, which allows an investor to buy and sell them at any time.
(b) Cost: In terms of the annual expenses charged to investors, ETFs are considerably less expensive than the vast majority of mutual funds, but this does not include the commissions charged for trading these funds.
(c) Taxes: Most trading in ETFs takes place between shareholders, shielding the fund from any need to sell stocks to meet redemptions. However, ETFs do make capital gains distributions, as they buy and sell stocks to adjust for changes to their underlying benchmark.

15. Unit investment trusts

(1) Unit investment trusts represent a fixed portfolio of assets and are sold to investors in units of $1,000.
(2) The assets of a unit investment trust are frozen. That means no new securities are purchased. In addition, the securities already purchased are seldom sold.
(3) The trust is self-liquidating. After a period of time, the portfolio is sold and the funds are distributed to the stockholders. When funds are received, they are not reinvested in the trust.
(4) Unit investment trusts are designed to meet specific objectives, such as interest income. Expenses are lower than closed-end and open-end funds because of a fixed portfolio. This generally means that there is no management fee.

16. Open-end mutual funds

(1) Open-end investment companies are also called mutual funds and do not trade on the secondary markets. These shares are purchased directly from the fund at the net asset value (NAV) plus any applicable sales charge.

(a) A no-load fund charges no sales fee when an investor is buying and selling shares.
(b) A load fund charges a sales fee to the investor. The investor pays the offering price. It is determined as

(i) $\text{Offering price} = \dfrac{\text{NAV}}{(1 - \text{load})}$

(ii) Assume an investor is looking to purchase an open-end fund with a load of 5.5 percent and net asset value of $10. The offer price is

$$\frac{\$10}{(1 - 0.055)} = \$10.58 \text{ share}$$

(2) When the mutual fund receives money from an investor, it issues new shares and purchases additional assets. If an investor sells the shares, they are redeemed and the fund pays the investor from its cash holdings. In some instances, a fund may have to sell shares within the fund to pay the investor.
(3) The possibility of buying an open-end fund at a discount and selling it at a premium does not exist.

B. Closed-end investment companies

(1) Closed-end investment companies issue a specified number of shares composed of stock or a combination of stock and debt. The shares cannot be redeemed and new shares are not issued after the initial offering. These shares trade on the open market.
(2) A closed-end investment company can trade at a price that is greater or less than NAV. If it is less than NAV, it is selling at a discount. If it is greater than NAV, it is selling at a premium. The reason for the market price to be different from the NAV is supply and demand.
(3) The NAV is the asset value of all shares owned by the investment company. It is total assets (stock, bonds, cash) minus total liabilities (accrued fees) divided by the number of shares outstanding.

17. Index securities

A. Index securities are a portfolio of underlying equities or bonds seeking to mirror the performance of a like type index.
B. Advantages include:

(1) Low costs: Index fund costs may be 0.15 to 0.25 percent per year, as compared with the internal cost of 0.75 to 1.25 of actively managed funds.
(2) Lower taxes: Managers do not actively buy and sell stocks. Actively managed funds may result in massive capital gain distributions even while losing money, but index funds rarely experience this problem.
(3) Keeping pace with the index: This is a great benefit, inasmuch as the majority of actively managed stock funds underperform the Standard & Poor's (S&P) 500 index.

C. Disadvantages include:

(1) Downside risk: Index funds cannot hold cash, which often cushions the fall in a declining market.

(a) Tax ramification in a down market. When nervous investors start to redeem shares, index funds are compelled to sell shares because there is no cash position to act as a buffer. This may hurt after-tax returns.

(2) Value added by money managers: There are some active money managers who have established long-term track records that outperformed the market.

18. Guaranteed investment contracts (GICs)

A. These contracts, issued primarily by insurance companies, typically pay a guaranteed contractual interest rate. Since the risk factor is low, the rate of return is also low.

19. Real estate

A. Investor managed

(1) The investor typically owns outright or directly controls real estate and can profit through price appreciation and attain significant tax benefits through depreciation.

20. Real estate investment trust (REIT)

A. An REIT is a publicly traded closed-end investment company that invests in a managed, diversified portfolio of real estate or real estate mortgages and construction loans—think of it as a real estate mutual fund.
B. REITs are traded on exchanges and can sell for premiums or discounts to the NAV.
C. Investors must pay the tax on an REIT's earnings as they are distributed. Distributed income is taxed as ordinary income. Capital gains and losses from the sale of assets in the REIT portfolio retain their character and are taxed as gains and losses when distributed.
D. Three types of REITs

(1) *Equity REITs*: Acquire ownership interests in commercial, industrial, and residential properties. Income is primarily received from the rental of these properties.
(2) *Mortgage REITs:* Lending funds for construction loans, mortgages; these types of REITs can invest in mortgage-backed securities.
(3) *Hybrid REITs*: Combinations of equity and mortgage REITs

E. Advantages of REITs include (1) limited liability, (2) no corporate-level tax; REIT shareholders avoid double taxation, (3) ability to leverage, (4) usable as collateral, (5) liquidity, (6) diversification in real estate portfolio, and (7) inflation hedge.

F. Disadvantages of REITs include (1) loss of control, (2) lower potential returns, (3) management fees and administrative charges, and (4) no flow-through of tax benefits—losses cannot be passed through.

21. Real estate (investor managed)

A. Real estate properties are classified as:

(1) Income properties—residential and commercial properties
(2) Speculative properties—raw land and investment properties

B. Framework for determining value in real estate investment analysis:

(1) Investor objectives include investment characteristics and constraints and goals.
(2) Analysis of important features includes physical property, property rights, time horizon, and geographic area.
(3) Data collection and determinants of value include demand, supply, benefits of property, and property transfer process.
(4) Valuation of property includes estimating market value and the investment analysis.

C. Estimating market value

(1) Cost approach: Evaluates property based on the current cost to rebuild it. It works best for newer properties.
(2) Comparative sales approach: Evaluates property relative to comparable properties that have recently sold in the same area.
(3) Income approach: Evaluates a property at the present value of all future cash flows. The capitalization approach treats net operating income as if it were a perpetuity.

(a) Market value (V) = annual net operating income (NOI) ÷ market capitalization rate (R).
(b) Where NOI is gross potential income less vacancy and collection losses, and less operating expenses including insurance and property taxes. R is the required rate of return for investors.
(c) Example: A building would earn $250,000 if fully occupied. The building has a 5 percent vacancy rate and operating expenses of $50,000. An investor wants a 12 percent return on this investment. The market value is Step 1. NOI = $250,000 − (0.05)($250,000) − $50,000 = $187,500. Step 2. V = $187,500 ÷ 0.12 = $1,562,500.

D. Investment analysis

(1) Net present value analysis using after-tax cash flows
(2) Internal rate of return analysis

22. Private placement

A. Private placements sell securities directly to sophisticated or accredited investors. They do not require a Securities and Exchange (SEC) registration filing and are established for a predetermined amount of time.
B. Rule 504 of Regulation D exempts issuance of securities of up to $1 million in a 12-month period to an unlimited number and type of investors.
C. Rule 505 of Regulation D exempts issuance of up to $5 million in a 12-month period. Sales can be made to no more than 35 nonaccredited investors and to an unlimited number of accredited investors. Accredited investors include banks, savings and loan associations, insurance companies, individuals having a net worth of at least $1 million or annual income of $200,000, and so forth.
D. Rule 506 of Regulation D exempts the issuance of an unlimited amount of securities in a private placement. Requirements are similar to those established under Rule 505. However, any nonaccredited investors must be sophisticated investors or represented by a sophisticated investor. A sophisticated investor is one with knowledge and experience in financial matters.
E. Sales under Rule 505 or 506 of Regulation D are restricted as to resale. These securities (as well as securities sold by a controlling person) may not be resold unless either registered with the SEC (unless exempted by securities laws) or sold per the safe harbor provisions of Rule 144.

23. Hedge funds

A. Pools of investment products set up as limited partnerships to increase an investor's investment options

24. Limited partnerships

A. Businesses owned by general and limited partners

(1) General partners manage the business. As a result, they can be held accountable and liable for all the actions of the business.
(2) Limited partners are investors and are liable only up to the amount of their investments. Limited partners who take an active management role in the business can lose their limited liability protection and then be considered general partners.

25. Privately managed accounts

A. These are an alternative for investors who wish to diversify using stocks but do not want to use mutual funds in accordance with specific objectives.

26. Separately managed accounts

A. These allow the investment manager to select stocks to meet the client's objectives.

27. Alternative investments

A. Derivatives—securities with a value that is tied to the value of underlying securities

(1) Options

(a) An option is a contract that gives the owner the right (but not a legal obligation) to trade an underlying asset at a predetermined future date and price. The value of an option depends on the value of an underlying asset. The price paid for the option contract is called the premium.

(b) Options are classified as calls and puts.

(i) A call gives the holder the right to buy an asset at a predetermined price.
(ii) A put gives the holder the right to sell the asset at a predetermined price.

(c) The seller of an option contract is called an option writer.

(i) The writer of a call must deliver the asset at a predetermined price.
(ii) The writer of a put must purchase the asset at a predetermined price.

(d) Strike price and expiration date

(i) The strike price is the predetermined price for an option. If a call is exercised, the holder buys the asset at the strike price. If a put is exercised, the holder sells the asset at the strike price. If a call writer is assigned, the writer must deliver the asset at the strike price. If a put writer is assigned, the writer must purchase the asset at the strike price.
(ii) The predetermined time when the option contract expires is called the expiration date.
(iii) For example, one stock option contract generally represents 100 shares of the underlying stock. An XYZ Dec 75 call priced at $2.50 represents an actual cost of $250 dollars (100 shares times $2.50 per share). The contract will expire in December and the stock price is $75.

(e) Definition of in-the-money, out-of-the-money, and at-the-money

(i) In-the-money: The option has value.

- Call option: The underlying stock price is greater than the strike price.
- Put option: The underlying stock price is less than the strike price.

(ii) Out-of-the-money: The option has little to no value.

- Call option: The underlying stock price is less than the strike price.
- Put option: The underlying stock price is greater than the strike price.

(iii) At-the-money: The option has minimal value.

- Call option: The underlying stock price is equal to the strike price.
- Put option: The underlying stock price is equal to the strike price.

(f) Option expiration: Listed stock options expire on the Saturday following the third Friday of the expiration month. The only exceptions are when legal holidays fall on this Friday or Saturday.

(g) Difference between American and European options

  (i) American options allow the holder the right to exercise the option contract at some predetermined price anytime before or at expiration.
  (ii) European options allow the holder to exercise the option only at expiration.
  (iii) The majority of options that are traded are American options. It is important to understand that the name of the option has nothing to do with the geography.
  (iv) American options have more theoretical value than European options because of the early exercise privilege.

(h) Intrinsic value and time value

  (i) The intrinsic value is the minimum price an option can command. For call options, it is the stock price minus the strike price for an in-the-money option. Conversely, for put options, it is the strike price minus the stock price for an in-the-money put.
  (ii) The time value is the premium minus the intrinsic value. For example, a $50 XYZ call is priced at $5. The underlying stock is trading at $53. The intrinsic value is $3 and the time value is $2. An out-of-the-money option consists entirely of time value because there is no intrinsic value.

28. **Tangible assets: Tangible assets include collectibles, such as Beanie Babies, baseball cards, coins, stamps, and the like. A strong secondary marketplace and government regulation do not exist for these assets. Liquidity risk and fraud can run high.**

29. **Natural resources: Investments in timber, oil, and the like. They have an elastic demand, which means they are price sensitive to demand. Increases in demand cause their value to rise, and vice versa.**

30. **Futures**

  (1) A futures contract is a formal agreement between a buyer and seller and a commodity exchange.
  (2) When purchasing a contract (long position), the buyer agrees to accept a specific commodity at a specified date. When selling a contract (short position), the seller agrees to deliver the specific commodity at a specified date. The long position increases in value if the underlying commodity increases in value; the short position increases in value if the underlying commodity decreases in value.
  (3) Future price. The price in a contract for the future delivery of a commodity
  (4) Spot price. The current price of a commodity
  (5) Purchasing futures contracts requires a margin account with an initial deposit and a required minimum balance. Futures contracts are settled daily (called marking-to market). Traders are required to realize losses in cash on a daily basis. If the futures contract increases, the investor is permitted to withdraw the increase in the margin account. If the contract decreases in value below the maintenance margin, the investor must deposit cash or securities to restore the initial margin level.
  (6) As the delivery date gets closer, the future price will converge with the spot price for that commodity.
  (7) Daily limit: The maximum daily change permitted in a commodity future's price.

TOPIC 35: TYPES OF INVESTMENT RISK

1. **Systematic/market/nondiversifiable risk**

   A. Systematic risk includes risks that affect the entire market. An acronym to remember this by is PRIME which stands for the following: purchasing power risk, reinvestment risk, interest rate risk, market risk, and exchange rate risk (foreign currency risk). Systematic risk cannot be eliminated through diversification because it affects the entire market. Beta is a measure by which systematic risk is determined. Beta is an accurate measure of systematic risk only when calculated for a diversified portfolio.

2. **Inflation risk**

   A. Inflation risk, or purchasing power risk, arises from variations in cash flows from a security because of inflation, which reduces the purchasing power of money.
   B. *Example*: If the purchaser buys a bond paying a coupon rate of 5 percent, but inflation later increases to 5.5 percent, then the purchasing power of the cash flow (i.e., money) has declined.

3. **Interest rate risk**

   A. The prices of bonds and stocks are inversely related to interest rates. When market interest rates increase, the prices of bonds and stocks go down. When market interest rates drop, the prices go up.
   B. The inverse relationship between market yields and bond prices is extended to a bond's coupon. If market yields fall below a bond's coupon, the price of the bond will always exceed its par value. The bond is said to trade at a premium. In contrast, when market yield rises above coupons, the price of a bond is always less than its par value. It is said to be trading at a discount.

      Premium bond: Coupon rate $>$ market yield; THEN bond price $>$ par value
      Discount bond: Coupon rate $<$ market yield; THEN bond price $<$ par value
      Par bond: Coupon rate $=$ market yield; THEN bond price $=$ par value

   C. If investors anticipate that interest rates will rise, then they are predicting that bond prices will fall. If they predict that interest rates will drop, they are anticipating that bond prices will rise.
   D. The magnitude of change in a bond's price is subject to the bond's maturity and coupon. Bonds with longer maturities and lower coupons are subject to more price volatility than bonds with shorter maturities and higher coupons.
   E. There is a deeper relationship between price and yield for bonds.

      (1) As the yield increases, the price curve gets flatter. Changes in yields have a smaller effect on the bond's price when yields increase.
      (2) As yields drop, the price curve gets steeper. Changes in yields have a large impact on the bond's price.
      (3) This relationship shows that yields affect price volatility. When yields are high, bond price volatility is low (flatter price curve). When yields are low, bond price volatility is high (steeper price curve).

4. **Unsystematic/nonmarket/diversifiable risk**

   A. Unsystematic risk is the risk associated with individual events that affect a particular security. It implies the ease with which a security can be bought or sold. These risks include

business risk and financial risk. Unlike systematic risk, unsystematic risk can be eliminated through diversification. Several studies have found that unsystematic risk has been significantly reduced with portfolios of 10 to 15 stocks.

B. Total risk to an investor consists of systematic risk and unsystematic risk.

5. **Business risk**

A. Business risks are unique to a single business or industry, such as operations and methods of financing.

B. Investment risk equals total risk equals standard deviation equals systematic risk (nondiversifiable risk) plus unsystematic risk (diversifiable risk).

6. **Financial risk**

A. Financial risk is the uncertainty introduced through how a firm finances its investments. If a firm uses common stock only to finance investments, it incurs only business risk. If a firm borrows money to finance investments, it must pay fixed financing charges in the form of interest to creditors prior to providing income to the common stockholders. This causes the uncertainty of returns to equity investors to increase. This increase in uncertainty because of fixed-cost financing is called financial risk and causes an increase in the stock's risk premium.

7. **Liquidity risk**

A. Liquidity risk represents the ease with which the security can be sold at a fair price without risk of loss. Securities can be marketable but not necessarily liquid.

B. The primary measure of liquidity is the size of the spread between the bid and ask. A larger spread signals an illiquid market. Investors want liquid markets so as to sell their securities quickly at a fair price. In general, liquidity improves when more participants are engaged in trading the security.

8. **Reinvestment risk: Occurs when amortizing securities repay principal and expose investors to the risk of investing these funds at a lower interest rate**

9. **Political risk: Also called regulatory or country risk, political risk consists of changes in government, restrictions imposed on foreign exchange flows, and environmental and other regulations that impose compliance costs on the firm.**

10. **Exchange risk**

A. Exchange rate risk, or currency risk, occurs when interest and dividend payments are denominated in a foreign currency and the value of the currency fluctuates relative to the value of the home currency.

B. If the foreign currency increases against the home currency, each unit (i.e., dollar) will be worth more; if a foreign currency decreases against the home currency, each unit will be worth less.

11. **Tax**

A. Tax risk is the risk that an investor's situation may change due to the nature of the tax code laws changes. If the tax code increases the capital gains tax (currently set to expire after December 31, 2010), a tax risk would occur.

12. **Investment manager**

A. Invesment manager risk is the risk that either an investment manager leaves the fund or that the manager does not act in the best interests of the fund.

TOPIC 36: QUANTITATIVE INVESTMENT CONCEPTS

1. **Distribution of returns**

   A. Distribution of returns is measured by the standard deviation (see 36-5 below).
   B. Normal distribution measures the results of a bell curve.
   C. Lognormal distribution occurs when a variable has normal distributions with the mean and standard deviation.
   D. Skewness measures the symmetry of the bell curve. The "skewness" occurs whereever the tail is larger. Skewness to the right represents positive and to the left represents negative.
   E. Kurtosis measures the tallness or flatness of the bell curve. If high peaks are present, that shows a high kurtosis, where small peaks occur shows a low kurtosis.

2. **Correlation coefficient (r)**

   A. The correlation coefficient combines standard deviations of two variables and the covariance.
   B. It is a measure of the relationship of returns between two stocks.

      (1) A correlation coefficient of +1 means that returns always move together in the same direction. They are perfectly positively correlated.
      (2) A correlation coefficient of −1 means that returns always move in exactly the opposite directions. They are perfectly negatively correlated.
      (3) A correlation coefficient of zero means that there is no relationship between two stocks' returns. They are uncorrelated.
      (4) All other possibilities lie between a positive and negative one.

   C. There is an inverse relationship between correlation and diversification. The lower the correlation, the greater the diversification. Risk is erased when returns are perfectly negatively correlated.
   D. If the correlation coefficient between securities is less than 1, then the risk of a portfolio will always be less than the simple weighted average of the individual risks of the stocks in the portfolio.
   E. The correlation coefficient between securities 1 and 2 is

$$r1,2 = (cov1,2)/s1s2$$

3. **Coefficient of determination (R2)**

   A. The correlation coefficient is often converted into the coefficient of determination.
   B. The coefficient of determination is often referred to as R2. It gives the variation in one variable explained by another and is an important statistic in investments.
   C. R2 is systematic risk; 1 − R2 is unsystematic risk.
   D. R2 is calculated by squaring the correlation coefficient (r).
   E. The beta coefficient reports the volatility of some return relative to the market. The strength of the relationship is indicated by R2. If R2 equals 0.15, an investor can assume that beta has little meaning because the variation in the return is caused by something other than the movement in the market (unsystematic risk). If R2 equals 0.95, the variation in the market explains 95% of the variation in the return (systematic risk—where beta is a good measure of risk).

4. Coefficient of variation (CV)

A. This is a relative measure of dispersion and is defined as the ratio of the standard deviation divided by the mean.
B. Where standard deviation is a measure of absolute dispersions, the coefficient of variation is a measure of relative dispersions.
C. The CV measures an investment's risk/return trade-off. It is calculated as follows: Standard deviation ÷ mean.
D. The larger value indicates greater dispersion relative to the arithmetic mean of the return.

(1) *Example*: Assume stock A has a standard deviation of 7.5 and an average rate of return of 4 percent. Stock B has a standard deviation of 9.5 and an average rate of return of 10 percent.
(2) The standard deviation indicates that stock B has greater risk than stock A because of a higher standard deviation. However, the relative dispersion is less for stock B than for A.
(3) Investment A has a 1.87 (7.5 ÷ 4) coefficient of variation, whereas investment B has only a 0.95 (9.5 ÷ 10) coefficient of variation. Considering the relative dispersion, investors seeking less risk would consider purchasing stock B instead of stock A.
(4) The lower the CV, the better the risk/return trade-off.

5. Standard deviation (s)

A. Standard deviation is a measure of variability of returns of an asset as compared with its mean or expected value. It measures total risk.
B. There is a direct relationship between standard deviation (s, sigma) and risk. The larger the dispersion around a mean value, the greater the risk and the larger the standard deviation for a security.
C. Observations will tend to cluster around the expected mean, and the bell-shaped curve is often used to represent the dispersion. The standard deviation is a measure of this dispersion or variability.

(1) Approximately 68 percent of outcomes fall within ±1 s of the mean.
(2) Approximately 95 percent of outcomes fall within ±2 s of the mean.
(3) Approximately 99 percent of outcomes fall within ±3 s of the mean.

D. *Example*: Assume the standard deviation for stock A is 1.03. If stock A has an average return of 15 percent, then 68 percent of all returns fall within 13.97 and 16.03 percent.
E. Standard deviation is an absolute measure of dispersion. That is, it can be influenced by the magnitude of the original numbers. If stock A and stock B had different returns, a comparison of standard deviations may not indicate that B is more diverse. Other measures of risk are useful complements to standard deviation.
F. Steps to calculating historical standard deviation

(1) For each observation, take the difference between the individual observation and the average return.
(2) Square the difference.
(3) Sum the squared differences.
(4) For sample s, divide this sum by one less than the number of observations. For populations, divide this sum by the total number of observations (for the CFP® Examination, assume sample unless stated differently).
(5) Take the square root.

G. Calculation example: Great Properties, Inc., has an average return of 12 percent and the following individual returns for the corresponding time periods listed in the following table. What is the standard deviation for Great Properties, Inc.?

Year	Actual Return	Average Return	Difference	Difference Squared
1	12%	6.8%	5.2	27.04
2	10	6.8	3.2	10.24
3	−5	6.8	−11.8	139.24
4	7	6.8	0.2	0.04
5	10	6.8	3.2	10.24

Sum of squared differences = 186.80
The standard deviation is [186.80 ÷ (5 −1)]1/2 = 6.83%

H. The expected rate of return (ER) for a single stock or portfolio of stocks is calculated as follows:

ER stock = S(R)(probability)
ER portfolio = S(ER stock) (W% of funds invested in each stock)
ER for a two-stock portfolio = W1ER2 + W2ER2

I. The standard deviation of returns for an individual investment is calculated as asset = [S(R actual − ER) 2 (probability)] 1/2

J. Calculation example:

Step 1

Expected Return	Probability Return (R)	Expected Return
0.25	5%	1.25%
0.35	15%	5.25%
0.40	25%	10.00%

Sum of expected returns = 16.25%

Step 2
Standard Deviation of Return (standard deviation is square root of variance)
Probability Return (R) ER (R − ER)2

[(R − ER)2]
(probability)

0.25	5%	16.25%	0.0127	0.0032
0.35	15%	16.25%	0.0002	0.0001
0.40	25%	16.25%	0.0077	0.0031

Variance = 0.0064
Standard deviation = 0.08

K. The standard deviation of a portfolio is not the average of the standard deviations of the individual stocks. It is not a linear combination of the standard deviations of the individual assets. The standard deviation of a portfolio is usually less than the average standard deviation of the stocks in the portfolio.

6. Beta

A. The beta coefficient is a measure of systematic risk and should be used for a diversified portfolio.
B. Beta measures the volatility of the individual asset relative to the volatility of the market.
C. In the construction of a well-diversified portfolio, all unsystematic risk is removed. A diversified portfolio is a portfolio of systematic risk, and the beta coefficient is a measure of volatility for a diversified portfolio.
D. If the stock has a beta of 1.0, the implication is that the stock moves exactly with the market. A beta of 1.2 is 20 percent riskier than the market, and 0.8 is 20 percent less risky than the market.

7. Covariance

A. Covariance is a measure of the degree to which two variables move together over time. A positive covariance indicates that variables move in the same direction, and a negative covariance indicates that they move in opposite directions. Larger numbers indicate a stronger relationship, and smaller numbers indicate a weaker relationship.
B. Covariance is an absolute number and can be difficult to interpret. It is often converted into the correlation coefficient, which is easier than covariance to interpret.
C. The covariance between securities 1 and 2 is

$$cov1,2 = (r1,2)(s1)(s2)$$

8. Variance

A. Variance is the standard measure of total risk.
B. It measures the dispersion of returns around the expected return. The larger the dispersion, the more risk involved with an individual security.
C. Variance is an absolute number and can be difficult to interpret. It is often converted into standard deviation, which is easier than variance to interpret. The square root of variance is standard deviation.
D. Semivariance measures downside risk, which is the dispersion of returns occurring below a specified target return such as zero or the T-bill rate.

TOPIC 37: MEASURES OF INVESTMENT RETURNS

1. Simple versus compound return

A. The realized compound rate on an asset is the actual return based on the present value of future cash flows. The realized compound rate is commonly known as the time value of money. The equation is

$$P0(1 + r)n = Pn$$

where P0 is the purchase price of the security, r is the rate of return for the period, n is the number of periods, and Pn is the price at which the security is sold.
B. To find the rate of return, assume a stock was purchased at \$50 and later sold at the end of the fifth year at \$90. The rate of return is easily solved using a calculator:

$$PV = -\$50, FV = \$90\ N = 5 \text{ solve for } I = 12.47\%$$

2. Geometric versus average return

A. Another way to determine the rate of return over a period of years is to use the geometric average. The standard formula for the geometric average is

$$G = [(1 + x1)(1 + x2) \ldots (1 + X8)]1/x - 1$$

B. Calculate the geometric average using the annual rate of returns:

Year	Return
1	15%
2	20%
3	−10%
4	−5%
5	15%

C. In this example, the returns are redefined to make them positive. This is done by adding 1.0 to the returns. The term (1 + Rt) represents the year ending value relative to the initial investment at the beginning of the year. The calculation is

$$[(1.15)(1.20)(0.90)(0.95)(1.15)]1/5 - 1 = 6.29\%$$

D. Understand that the beta coefficient for an individual security may be unstable over time. It is not an accurate predictor of future movements in stock prices. The beta coefficient for a portfolio of securities is fairly stable over time. For a portfolio of securities, as one stock's beta increases, another tends to decrease, thus averaging each other out over time.

3. Time-weighted versus dollar-weighted return

A. Time-weighted rate of return. This method does not weigh the amount of all dollar flows during each time period. It computes the return for each period and takes the average of the results. It finds the holding period for each period and averages them. If the investment is for more than one year, take the geometric mean of the annual returns to find the time-weighted rate of return for the measurement period. Looking back at the previous example:

Holding period 1 (\$55 − \$50 + \$1) ÷ \$50 = 12%
Holding period 2 (\$130 − \$110 + \$2) ÷ \$110 = 20%
The geometric return [(1.12)(1.20)]1/2 − 1 = 15.9%

B. In the investment management industry, the time-weighted return is the preferred method of performance measurement because it is not affected by the timing of cash flows. If a client adds funds to an investment portfolio at an unfavorable time, the dollar-weighted return will tend to be depressed. If funds are added at a favorable time, the dollar-weighted return will tend to be elevated.

C. As indicated in the previous example, the time-weighted rate of return is less than the dollar-weighted rate of return because the stock performed better in the second year when the investor owned more shares. If the stock performed better in the first year rather than the second year when the investor had fewer shares, the time-weighted return would have been more than the dollar-weighted return.

D. Dollar-weighted rate of return. It applies the concept of internal rate of return (IRR) to investment portfolios. The dollar-weighted rate of return is defined as the internal rate of return of a portfolio, taking into account all cash inflows and outflows.

(1) *Example*: Assume an investor buys one share of stock for \$50 at the beginning of the first year, and buys another share for \$55 at the end of the first year. The investor earns

$1 in dividends in the first year and $2 in the second year. What is the dollar weighted rate of return if the shares are sold at the end of the second year for $65 each?

(2) Step 1. There are two cash outflows: $50 at time period t = 0 and $55 at time period t = 1. There are also two cash inflows: $1 at time period t = 1 and $132 ($2 dividends plus $130 proceeds) at time period t = 2.

(3) Step 2. Group net cash flow by time. The t = 0 net cash flow is −50, the t = 1 net cash flow is −54 (−$55 + 1), and the t = 2 net cash flow is $132 ($130 + $2). The net cash flows can be entered on the calculator to solve the IRR.

(4) − 50[CF0]; −54[CFj]; 132 [CFj] f[IRR] = 17.21%

E. The annual rate of return is used for comparison purposes among companies. It is referred to as the APR, or annual percentage rate. The annualized return is calculated by multiplying a given rate by the number of compounding periods that annualizes it. For example, if the quarterly rate of return is 4 percent for an investment, the annual rate of return is 16 percent.

F. Time value of analysis tells us that a 4 percent quarterly return is actually more than a 16 percent annual return. It is actually 16.99 percent [(1.04)4].

4. Real (inflation-adjusted) return

A. The real return is the earnings from an investment that are above inflation. The real return is determined by the following formula:

(1) $\dfrac{1 + \text{nominal rate}}{1 + \text{inflation rate}} - 1 \times 100$

(2) Where the nominal rate is the absolute return, and the inflation rate is the rate of inflation for the period.

B. *Example*: Assume an individual invests $1,000 at the beginning of the year and earns 10 percent. The inflation over the period is 3 percent. The real return equals 1.10

$$\frac{1.10}{1.03} - 1 \times 100 = 6.79\%$$

5. Total return

A. Total return represents the capital appreciation plus income generated from the investment.
B. Capital appreciation is the price an investor receives from the sale of the investment versus the cost the investor pays for the investment. The reverse would be capital depreciation.
C. For stocks, dividends represent the income of the investment.
D. For bonds, interest payments represent the income of the investment.

6. Risk-adjusted return

A. In determining the various returns earned by a portfolio, a higher return by itself is not necessarily indicative of superior performance. Alternately, a lower return is not indicative of inferior performance.
B. There are three major composite equity portfolio measures that combine risk and return to give quantifiable risk-adjusted numbers. These composite performance measures are the Treynor index, the Sharpe index, and the Jensen index (see topic 40). Investors can use these measures together to determine whether a portfolio or fund manager actually beat the market.
C. In the simplest way, the risk-adjusted return is calculated by taking the rate of return of a stock or portfolio and dividing it by some risk measure, such as standard deviation or beta.

7. **Required rate of return.** The capital asset pricing model (CAPM) determines the required rate of return for any risky asset. It specifies that the return on an investment (r) depends on the return the individual earns on a risk-free asset and a risk premium. The return of a U.S. Treasury bill is used as the risk-free asset. The risk-adjusted return is expressed as r 5 rf 1 (rm – rf) beta where rf is the risk-free asset and rm is the return of the market. The risk premium, which is the additional return of the market over the risk-free rate of return (rm – rf) is adjusted by the systematic risk associated with that asset, the beta coefficient.

8. **Expected rate of return**

   A. The expected return is the anticipated growth from an investment. It is the return that is expected to occur for the amount of risk undertaken. The expected return is calculated as

$$E(r) = \frac{E(D)}{P} + E(g)$$

   where E(r) is the expected return (as a percentage); E(D) is the expected dividend [current dividend × (1 + expected growth rate)]; P is the price of the asset; and E(g) is the expected growth.

   B. *Example*: If the stock is selling at $50 and is expected to pay a $3 dividend, which is expected to grow 5 percent per year, then the expected return is

$$\frac{\$3}{\$50} + 0.05 = 11\%$$

9. **Holding period return**

   A. The holding period return (HPR) is the total return and is determined by taking the total return divided by the initial cost of the investment:

   (i) $\text{HPR} = \frac{P1 - P_0 + D}{P_0}$

   Where, P1 is the sale price, P0 is the purchase price, and D is the dividend paid.
   For example, if an individual buys a stock for $10 and collects a $1 dividend and later sells it for $15, the holding period is

$$\text{HPR} = \frac{\$15 - \$10 + \$1}{\$10} = 60\%$$

   B. There is a major weakness in using the holding period. It does not consider how long it took to earn the return. This problem is evident if the stock paid annual dividends of $0.25, and the stock was sold at the end of the fourth year for $15. The return of 60 percent is higher than the true return.

10. **Internal rate of return**

   A. The internal rate of return is the discounted rate that makes the present value of the cash outflows equal to initial cash inflows such that the net present value is equal to zero.

   B. *Example*: Assume an investor bought a stock for $50 and sold the stock two years later at $65. The internal rate of return can be found using a calculator:

$$PV = -\$50, FV = \$65, PMT = 0, N = 2. \text{ Solve for } I = 14.02\%$$

11. Yield to maturity

A. The yield to maturity is the internal rate of return of a bond if held to maturity. It considers the current interest return and all price appreciation or depreciation. It is also a measure of risk and is the discount rate that equals the present value of all cash flows.

B. From a firm perspective, it is the cost of borrowing by issuing new bonds. From an investor perspective, it is the internal rate of return that is received if the bond is held to maturity.

C. The yield to maturity can easily be solved using a financial calculator, in the same way as finding the internal rate of return. For example, assume a $1,000 par bond is priced at $950 with a 10 percent semiannual coupon payment. The bond matures in three years. The yield to maturity is found as follows:

$$N = 6;\ PV = -\$950;\ FV = \$1{,}000;\ PMT = \$50.\ \text{Solve for } I = 6.01 \times 2 = 12.03\%$$

D. Yield to maturity (and internal rate of return) has a shortcoming: It assumes all cash flows are discounted at the same rate and are reinvested at the yield to maturity rate (IRR). If cash flows are not reinvested at the IRR, the realized return does not equal the IRR. This is defined as *reinvestment risk*.

12. Yield to call

A. The yield to call is used to determine the internal rate of return earned by the bond until it is called or retired by the firm. The yield to call is calculated in a similar way as is the yield to maturity, except:

(1) The expected call date is used in place of the known maturity date.
(2) The principal plus call penalty is used in place of principal only.

B. Suppose a bond matures after 10 years and pays a 10 percent semiannual coupon rate and is selling for $925. The yield to maturity is 11.26 percent. An investor believes the bond will be called in five years at a penalty of $75 per $1,000 bond. The yield to call is calculated, using a financial calculator, as

$$N = 10,\ PV = -\$925,\ FV = \$1{,}075,\ PMT = \$50.\ \text{CPT YTC} = 6.60 \times 2 = 13.2\%$$

where N is the five-year call period multiplied by 2 (semiannual payments).

The yield to call is 13.2 percent, which is greater than the yield to maturity (11.26 percent) because the bond is selling at a discount, and it takes a greater return to erase the discount sooner; if the bond is selling at a premium, the yield to call is less than the yield to maturity because the premium is spread out over a smaller time horizon.

C. For example, assume a $1,000 par value bond priced at $950 with a 10 percent semiannual coupon rate. The current yield is

$$\frac{\$100}{\$950} = 10.5\%$$

13. Current yield

A. The current yield considers only the coupon component of bonds. It does not include any reinvestment income or price appreciation or depreciation. The current yield is annual coupon payment divided by the price of bond.

B. The current yield is important to investors interested in income. Those investors who want high yearly income want bonds with a high current yield.

14. After-tax yield

A. The after-tax yield on a bond issue after paying taxes is computed as pretax yield on an equivalent but fully taxable bond × (1 – marginal tax rate).
B. The taxable equivalent yield (TEY) is calculated to determine the yield that must be earned on a taxable bond to equal the same yield for a tax-exempt municipal bond. It is calculated as

$$\text{Taxable equivalent yield (TEY)} = \frac{\text{Tax-exempt yield}}{1 - \text{marginal tax rate}}$$

C. *Example*: Assume a municipal bond yields 4.3 percent. Assume a Treasury security is yielding 6.7 percent. The investor is in the 37 percent tax bracket. Which investment should be purchased?

(1) The tax equivalent yield is

(a) $4.3 \div (1 - 0.37) = 6.82\%$
(b) Because 6.82 percent is greater than 6.7 percent, the investor should choose purchasing the municipal bond because it earns a higher taxable equivalent yield.

(2) The after-tax yield is

(a) $6.7\% \times (1 - 0.37) = 4.22\%$
(b) 4.22 percent is less than 4.3 percent, so the choice again is to purchase the municipal bond. The two equations yield the same result.

15. The after-tax return is calculated by multiplying the pretax rate by the quantity one minus the marginal tax bracket of the investor. For example, if an asset has a taxable return of 15 percent and the investor is in a 36 percent tax bracket, the after-tax return is 15(1 − 0.36) = 9.6 percent.

TOPIC 38: BOND AND STOCK VALUATION METHODS

Note: For present value, future value, and internal rate of return (IRR), see topic 11.

1. Bond duration and convexity

A. Duration is the average time it takes to capture interest and principal repayments. It seeks to compare bonds with different coupons and maturities by determining how sensitive the price of each bond is to interest rate changes.
B. Bonds exhibit more price volatility the longer the term to maturity. If two bonds have the same coupon, the bond with the greater maturity will have the longer duration. Low coupon bonds are generally more volatile than high coupon bonds. If two bonds have the same maturity, the bond with the lower coupon will have the longer duration.
C. The process gets a little more complex for a bond with a shorter (longer) maturity and smaller (larger) coupon. For bonds with different maturities and coupon rates, using duration is an excellent technique for determining which bond is more volatile to changes in interest rates.
D. The bond with the longer duration will decline more in price with an increase in interest rates; the bond with the longer duration will increase more in price with a decrease in interest rates.

E. To illustrate how duration is determined, consider a 10 percent semiannual three-year bond. The current interest rate on similar bonds is 12 percent. The bond is currently selling for $950.82. The cash flows are as follows:

Year	Payment
0.5	$50
	$50
1.5	$50
	$50
2.5	$50
	$1,050

F. The duration of a bond is the sum of the present value of cash flows weighted by a time period (t) in which the payment is received. All individual present values are summed and then divided by the current price of the bond. The following demonstrates this relationship:

Period (t)	Interest	Cash Flow	Solve Present Value (PV)	PV × t
1	6%	$50	$47.17	$47.17
2	6%	$50	$44.50	$90.00
3	6%	$50	$41.98	$125.94
4	6%	$50	$39.60	$158.40
5	6%	$50	$37.36	$186.81
6	6%	$1,050	$740.21	$4,441.25
				Sum = $5,048.57

$$\text{Duration} = \frac{\$5{,}048.57}{\$950.82} = 5.30 \div 2 = 2.65 \text{ years}$$

G. Because of semiannual compounding: Annual payment and interest rate are divided by 2, the number of payments is multiplied by 2, and duration of 5.30 is divided by 2.

H. The duration of 2.65 years means that the investor collects on average all interest and principal repayment within 2.65 years. Keep in mind that not all payments are received at 2.65 years. Duration represents the weighted average of all payments. Therefore, duration is not the sum of all present values (which is the price of the bond). The longer the term to maturity, the more weight put on the calculation.

I. Duration can be precisely defined as the approximate percentage change in the price of a bond to a small change in interest rates. More specifically, duration is the approximate percentage change in price with a 100 basis point change in interest rates. Therefore, duration of 2.65 means that the price of a bond will change approximately 2.65 percent with a 100 basis point change in interest rates.

J. For large changes in yield (50 or more basis points), duration tends to underestimate the increase in price that occurs with a decrease in yield, and overestimate the decrease in price that comes with an increase in yield.

2. Bond convexity

A. The price-yield relationship can be represented by a tangent line. The tangent line shows the rate of change in price to changes in yield. The slope of the tangent line is one basis point. The tangent line is strongly related to duration. In fact, duration is used interchangeably

with a tangent line because both estimate the rate of change in price. There is more duration the steeper the tangent line and less duration the flatter the tangent line.

B. There is an interesting relationship between duration (tangent line) and the approximate change in price. The actual price change is greater than the estimated price change when yields decrease; the actual price change is less than the estimated price change when yields increase.

C. Duration becomes less exact with greater changes in yields because the price-yield relationship is not linear, but curved. How curved the path actually is depends on the degree of convexity. The distance between the tangent line (estimated price) and the curvature of the actual path (actual price) is the error in estimating price based on duration. If the degree of convexity is measured, the price of a bond can be estimated with more accuracy.

D. Duration is used to approximate the first percentage change in price. Convexity is used to approximate the second and is added to duration.

3. Capitalized earnings

A. Capitalization treats earnings and dividends as a perpetuity. Preferred stock is a perpetual debt instrument. Its dividends continue indefinitely because there is no maturity on preferred stock. The value of preferred stock is the present value of its dividends discounted at the appropriate interest rate over an infinite period of time. The value of a preferred stock is

(1) $Vp = \frac{D}{k}$

(2) *Example*: Assume a preferred stock pays an annual dividend of $2 per share. The discount rate for comparable preferred stock is 8 percent. The present value of a share is

(a) $Vp = \frac{\$2}{0.08} = \$25$

(b) An investor is paying too much if the preferred stock is purchased for more than $25 per share; the stock is relatively cheap if it is trading under $25 per share.

B. The value of a bond is also found through capitalization. The price of a bond is the present value of future cash flows discounted at the appropriate interest rate.

(1) The price of a bond is found with a calculator. Example: Firm A has issued a five-year bond with a 10 percent coupon and a face value of $1,000. The interest rate for competitive bonds with a similar length of time to maturity and credit risk is 7 percent. Interest is paid annually. The value of the bonds is determined by

(a) FV = $1,000, PMT = $100, N = 5, I = 7. Solve for PV

(b) The present value of the bond is $1,123, so it is selling at a premium (higher price than the face value) because the bond is paying a 10 percent interest rate, whereas the current market interest rate is only 7 percent.

(2) If other competitive bonds are paying a current interest rate of 12 percent, the 10 percent coupon is less attractive to bondholders. They are not willing to pay $1,000 for a bond paying a 10 percent interest rate when they can pay the same price for other competitive bonds yielding 12 percent. The price of the bond must drop to yield 12 percent. The calculation is

(a) FV = $1,000, PMT = $100, N = 5, I = 12. Solve for PV

(b) The price of the bond is $927.90. The bond is said to be selling at a discount (lower price than face value). In this situation, an investor will be competitive with similar bonds and yield 12 percent on the investment.

(3) Bonds generally pay interest twice a year (semiannually) instead of once a year. The equation previously presented is modified slightly by adjusting the total number of periods and the amount of each payment. The total number of periods becomes 10 (2×5 years), the amount of payment is \$50 (\$100 coupon ÷ 2), and the yield become 6 percent (12% ÷ 2). The calculation is as follows: FV = \$1,000, PMT = \$50, N = 10, I = 6. Solve for PV = −\$926.39.

4. Dividend growth models

A. Valuing stock with no dividend growth

(1) This model uses the same equation as that used to value a preferred stock. The only difference is the required rate of return on the common stock, which tends to account for more risk than that of a preferred stock.

(2) $V = \frac{Do}{k}$

B. Stock value, assuming a one-year holding period

(1) The value of a stock is the present value of any dividend received during the year, plus the present value of the price of stock at the end of the year. The valuation equation is

$$V = \frac{\text{Dividend to be received}}{(1 = ke)1} + \frac{\text{Year-end sale price}}{(1 + ke)^1}$$

(2) *Example*: What is the value of a stock that last year paid a \$1 dividend that is expected to grow 10 percent next year? The stock will be selling at \$25 at year end. The risk-free rate of interest is 4 percent, the market return is 10 percent, and the stock's beta is 1.2.

(a) Step 1. Solve for the discount rate. Kstock = 4% + (10% − 4%)1.1 = 10.6%.
(b) Step 2. Add the future dividend to future stock price. D1 = \$1(1.1) = \$1.10, so add future value of stock and dividend to get \$26.10 (\$1.10 + \$25).
(c) Step 3. Find the present value. $\frac{\$26.10}{(1 + 0.106)1} = \$23.59$

C. Valuing stock with constant dividend growth

(1) The constant growth dividend discount model assumes that dividends may increase at a fixed rate on an annual basis in the future. Example: If the latest dividend is \$1 and dividends grow at an annual rate of 5 percent, the dividend next year is

(a) \$1(1 + 0.05)1 = \$1.05
(b) The dividend in the second year is \$1(1 + 0.05)2 = \$1.10.
(c) The pattern of 5 percent growth is expected to continue into the future.

(2) The value of a common stock with a constant rate of growth can be determined by

$$V = \frac{Dp(1 + g)}{k - g} \text{ or } \frac{D}{k - g}$$

where D0 is the latest dividend paid per share, D1 is the expected dividend per share for year 1, k is the required rate of return on the stock, and g is the expected growth rate of dividends.

(3) *Example*: What is the value of a stock that paid a \$2 dividend last year, which is expected to grow annually at 5 percent? The risk-free rate is 4 percent and the expected return on the market is 10 percent. The stock's beta is 1.7.

(a) Step 1. Determine k by using CAPM.
kstock = Rrisk free + betastock (Rmarket – Rrisk free)
kstock = 4% + 1.7(10% − 4%) = 14.2%

(b) Step 2. Use the constant dividend discount model.

$$Vo = \frac{\$2(1 = 0.05)}{0.142 - 0.05} = \$22.82$$

(c) If the stock is bought at a lower price than $22.82, its expected return will exceed 14.2 percent. If the stock is bought at a higher price than $22.82, its expected return will not exceed 14.2 percent. For example, if the stock price is currently $25, the

$$\text{Expected return is (E(r))} = \frac{\$2}{\$25} + 0.05 = 13\%$$

(4) The constant growth dividend discount model (DDM) has the following assumptions:

(a) The stock pays dividends, and they grow constantly forever.
(b) The constant growth rate continues for an infinite period.
(c) k must be greater than g.

D. Temporary supernormal growth

(1) Some companies have supergrowth in the early years that levels out in later years. For these companies, k is less than g. Therefore, the constant growth DDM does not work.

$$\text{Value supernormal growth} = \frac{D1}{(1 = k)} + \frac{D2}{(1 + k)2} \cdots + \frac{\frac{D(n + 1)}{(k - g)}}{(1 = ke)n}$$

(2) *Example*: For years 1 through 4, g = 25 percent; for years 5 on, g = 5 percent; D1 = $1, and k = 10 percent. Solve for the stock's value.

(a) Step 1. Project dividends into the future:
D1 = $1, D2 = $1.25, D3 = 1.56, D4 = 1.95, D5 = $2.04
(b) Step 2. Find the value of the stock at the end of year 4, using D5:
V4 = D5/(k − g) = $2.04/(0.10 − 0.05) = $40.80
(c) Find the present value using the supernormal growth model:

$$\frac{1.00}{(1 + 0.10)} + \frac{1.25}{(1 + 01.10)2} + \frac{1.56}{(1 = 0.10)3} + \frac{1.95}{(1 + 01.10)4} + \frac{40.80}{(1 + 0.10)4} = \$32.31$$

Note: The present value of $40.80 is found by discounting four periods, not five periods, because the stock price was found at the end of year 4.

5. Ratio analysis

A. Price/earnings

(1) The price/earnings (P/E) ratio (earnings multiplier) is used to determine the value of a stock. The earnings multiplier tells an investor the price being paid for each $1 of earnings. For example, a stock earning $5 per share with a 15 P/E means an investor is willing to pay $75 a share for the stock.

(2) The expected earnings multiplier is used to value a stock by estimating earnings for the next 12 months. The equation becomes:

$$Po = \text{Current market} \frac{E1 \times P0}{E1}$$

(3) The P/E ratio is really just a reinstatement of the dividend discount model. The firm's dividend is related to earnings and the proportion distributed. In dividing both sides of the formula by expected earnings for the next 12 months, E1, the result is

(a) $\frac{Po}{E1} = \frac{\frac{D1}{E1}}{k - g}$

(b) The previous formula shows that a P/E ratio depends on the same factors to value a stock as those achieved through the use of the dividend discount model. The factors include (1) the dividend payout ratio (dividend divided by earnings, D/E), (2) the required rate of return (k), and (3) the expected growth rate of dividends (g).

(4) Advantage: P/E ratio can be applied to stocks that are not paying cash dividends. The dividend discount model assumes the firm is paying or is going to pay a cash dividend.

(5) Disadvantage: P/E ratio does not tell whether a stock is overvalued or undervalued to its market price. Investors are required to draw inferences to historical P/E ratios in determining if the P/E ratio is high or low. The dividend discount model allows for comparison to determine whether a stock is overvalued or undervalued to its actual price.

(6) The estimated value of a stock can be determined by using the P/E ratio and applying it to estimated earnings for the next year (E1).

(7) Example: A firm has an expected payout ratio of 50 percent, a required rate of return of 11 percent, and an expected dividend growth rate of 6 percent. Earnings for the current year (E0) are $2.00. The future earnings multiplier is computed as

(a) $\text{P/E future ratio} = \frac{0.50}{0.11 - 0.06} = 10 \times$

(b) Current earnings are $2.00 and g is 6 percent, so earnings per share estimate = 2.00(1.06) = $2.12.

(c) The future value of the stock is estimated as V1 = (EPSestimate) × (P/Efuture) = $2.12 × 10 = $21.20.

(8) Compare this estimated value (end of year 1) of the stock to its market price to determine whether the stock should be bought or sold—the price and ending dividend must be discounted by the required rate of return of 11 percent. If the present value of the future stock price and dividend payment are greater than the current market price, the stock is undervalued and should be bought. If the present value of the future stock value and dividend payments are less than the current market price, the stock is overpriced and should be avoided.

(9) There is a relationship between the P/E ratio and all components of the dividend discount model. First, the higher the payout ratio, the higher the P/E. Second, the higher the expected growth rate, g, the higher the P/E. Finally, the higher the required rate of return, k, the lower the P/E. The spread between k and g is the main determinant of the

P/E ratio, but the dividend payout ratio does have an impact. The expected (P0/E1) earnings multiplier is what should be used when valuing stocks, not the historical (P0/E0) ratio.

B. Price/free cash flows

(1) The price to cash flow ratio is defined as the market value divided by per-share cash flow.
(2) This ratio is often used in conjunction with the P/E ratio, because emphasis is placed on growth in cash flows versus earnings; earnings are often subject to accounting manipulation, whereas cash flows are often more stable. Cash flows are often used to predict financial strength and potential problems.

C. Price/sales

(1) This ratio is defined as the firm's stock price divided by its per-share sales.
(2) Advantages: The ratio is meaningful for distressed firms; sales figures are not as easily manipulated as earnings; less volatile than P/E multiples. Disadvantage: It can distort valuation when earnings drop.
(3) A low P/S ratio indicates low valuation, whereas a high P/S ratio indicates high valuation.

6. Price/earnings/growth (PEG)

(1) PEG is calculated by dividing the P/E ratio by the estimated earnings growth rate. If dividends are significant, add the dividend yield to the growth rate when calculating the PEG ratio.
(2) It indicates the price the market placed on earning expectations.

7. Intrinsic value

A. Intrinsic value is the underlying value that a careful evaluation would produce.
B. An efficient market would always price stocks at their intrinsic value; an inefficient market would not necessarily do so.
C. Under the dividend discount model, the intrinsic value of stock is the present value of the stock's expected future dividends, discounted at the stock's required rate of return.
D. If a stock trades above its intrinsic value, the stock should be sold. If a stock trades below its intrinsic value, the stock should be bought.

8. Book value

A. Book value is stockholder's equity divided by outstanding shares. Stockholder's equity includes the sum of stock, additional paid-in capital, and retained earnings on a firm's balance sheet.
B. Value investors pick stocks that trade below book value.
C. The price/book value is defined as the firm's stock price divided by its per-share book value.

(1) A low ratio suggests that a stock is undervalued; a high ratio suggests that it is overvalued.
(2) What is considered high or low is up to the discretion of the analyst, but should be used in comparison with other stocks. It has become an important measure of relative value among stocks.

TOPIC 39: INVESTMENT THEORY

1. **Modern portfolio theory (MPT)**

   A. Understanding the relationship between portfolio risk and correlation is the key to modern portfolio theory.

   B. Markowitz portfolio theory is based on several important assumptions. Under these assumptions, a portfolio is considered to be efficient if no other portfolio offers a higher expected return with the same (or lower) risk or if no other portfolio offers lower risk with the same (or higher) return.

      (1) Investors view investment alternatives as being represented by a probability distribution of expected returns over the same holding period.
      (2) Investors maximize their one-period expected utility.
      (3) Investors estimate risk of a portfolio on the basis of variability of expected returns.
      (4) Investors base all decisions on expected return and risk.
      (5) For a given level of risk, investors prefer higher returns to lower returns, or for a given return level, investors prefer less risk to more risk.

   C. The standard deviation of a portfolio is less than the weighted average standard deviation of the individual stocks in the portfolio. An exception exists if the correlation coefficient of the stocks in the portfolio is 11; then the standard deviation of the portfolio is equal to the simple weighted standard deviations of the individual stocks in the portfolio.

   D. The covariance of returns between stocks must be found in order to determine the standard deviation of a portfolio. Recall that the covariance of two stocks is (cov1,2) = (r1,2)(s1)(s2). This can be rearranged to find the correlation coefficient, which is r1,2 = (cov1,2)/s1s2.

   E. The standard deviation of a two-stock portfolio is s portfolio = (W12s12 + W22s22 + 2W1W2s1s2r1,2)1/2.

   F. Note that the correlation impacts only the risk of a portfolio. The equation for expected return for a two-stock portfolio is unchanged. W1ER2 + W2ER2.

   G. When you combine stocks of equal returns and equal risk, but change the correlation coefficient to less than +1, the return is constant but the risk is less. Portfolio risk declines when the r1,2 goes from +1 to −1. In fact, at −1 there would be no risk. As correlation decreases, diversification increases.

   H. What we learn from modern portfolio theory is that the correlation coefficient is the engine that drives the whole theory of portfolio diversification. The lower the correlation coefficient, the greater the diversification.

   I. Markowitz (father of the portfolio theory) constructed the efficient frontier. The efficient frontier represents a set of portfolios that will give an investor the highest return at each level of risk (or the lowest risk for each level of return).

   J. Combining the efficient frontier and an investor's indifference curve (U2,U1) map indicates which efficient portfolio satisfies the investor's risk/return trade-off. The optimal portfolio (point X) for an investor is the highest indifference curve that is tangent to the efficient frontier. The optimal portfolio gives the investor the greatest possible utility. Steep indifference curves represent a conservative investor, and flat indifference curves indicate a less risk-averse investor.

2. **Capital market theory**

   A. Capital market theory starts where Markowitz left off.

B. Assumptions to capital market theory

(1) All investors are Markowitz efficient investors who want to target points on the efficient frontier.
(2) Investors can borrow and lend any amount of money at the risk-free rate of return.
(3) All investors have the same homogeneous expectations—they see the same risk/return distribution and cannot buy below the capital market line.
(4) All investors have the same one-period time horizon.
(5) All investments are infinitely divisible—meaning that it is possible to buy and sell fractional shares of any asset or portfolio.
(6) There are no taxes or transaction costs.
(7) There is no inflation and no interest rates changes.
(8) Capital markets are in equilibrium.

C. The combination of a risk-free asset and a risky asset produces a linear risk/return line.
D. The linear (straight) efficient frontier line is called the capital market line (CML). Any two assets falling on this line will be perfectly positively correlated with each other.
E. You can get better portfolios by moving up the efficient frontier until you reach point M, which is the best combination (see following graph). Investors hold the risk-free asset and portfolio M between Rf and M. This means that investors are lending some of their funds at the risk-free rate (buying the risk-free asset). To the right of M, investors hold more than 100% of portfolio M. This means that they are borrowing funds to buy more assets (buying on margin).
F. The CML tells us that all investors will hold some combination of the risk-free asset and portfolio M. Portfolio M, called the market portfolio, is held by all investors and contains all stocks, bonds, and risky assets in existence. The market portfolio represents the ultimate or completely diversified portfolio.
G. All securities below the CML are inefficient, and according to capital market theory, no one will buy them (all investors have homogeneous expectations), but casual observation tells us that someone will own a security below the CML. The problem is that we have not correctly specified our measure of risk by using standard deviation (unsystematic risk is not rewarded).
H. The proper risk/return relationship is not total risk and return but, rather, systematic risk and return. To quantify the risk/return relationship, we must measure systematic risk. Beta then becomes the measure of risk because it measures only systematic risk.
I. The security market line (SML) uses beta to plot risk. It is a linear line that replaces the CML. The equation of the SML is CAPM.

3. Efficient market theory (EMH)

A. Introduction: The EMH does not state that an individual cannot outperform the market. It states that an individual cannot outperform the market on a risk-adjusted basis over an extended period of time, because security prices fully reflect all available information and are consistent with the risk involved.
B. Strong form

(1) The strong-form EMH states that stock prices fully reflect all public and private information. The strong form includes all types of information: market, nonmarket public, and private information. Not even access to inside information can produce superior returns. It assumes that inside information cannot be kept inside.

(2) This does not assume an investor cannot be expected to achieve success, only that success should not be expected.
(3) An investor who accepts both the semistrong-form and strong-form EMH will generally avoid all active managers inasmuch as superior returns cannot be expected.

C. Semistrong form

(1) The semistrong-form EMH states that stock prices fully reflect all public information. Security prices include market and nonmarket public information. This includes a company's past history and information learned from studying financial statements, the industry, and the economic environment.
(2) An investor cannot expect to achieve superior returns using fundamental analysis. This does not assume that an individual cannot achieve superior returns, just that superior returns should not be expected.

D. Weak form

(1) The weak form assumes that stock prices fully reflect all available market information. The weak-form EMH believes that security returns are independent of each other and that correlation between stock prices over time is virtually nothing.
(2) The weak form can be explained by the random walk theory. Historical, price behavior, and technical indicators cannot produce superior returns. Information utilized by technical analysis has no predictive value.
(3) The weak-form EMH does state that using good research may produce superior returns; fundamental analysis may have value.

4. Anomalies

A. Tests of the EMH

(1) Testing the weak-form EMH

(a) Statistical tests of the independence of security returns
(b) Trading rule tests to examine whether mechanical trading rules can generate excess returns

(2) Testing the semistrong-form EMH

(a) Time-series tests and cross-sectional tests to predict future rates of return based on public information
(b) Event studies that examine the stock price reaction to significant economic events such as stock splits, initial public offerings, exchange listings, and announcements of dividend and accounting changes

(3) Testing the strong-form EMH: Academic tests are used to look at the legal use of private information and exclude illegal insider trading.

B. Anomalies from time-series tests

(1) Studies show that dividend yield, default spread, and term structure spread can be used to determine the returns on stocks and bonds.
(2) Quarterly earnings reports show that the market may not have adjusted stock prices as quickly as expected to reflect earning surprises.
(3) The January effect shows that stocks tend to perform well in January. To take advantage of the January effect, investors would buy securities in December and sell in

January. There is also a day of the week effect (or weekend effect). Research has suggested that the weekend generates a lower return. This implies that investors anticipating the purchase of a stock should not purchase the stock on Friday, but wait until Monday.

C. Anomalies from cross-sectional tests

(1) The P/E effect shows that low P/E stocks produce superior returns relative to the market, and high P/E stocks produce inferior returns.
(2) The small-firm effect (or small cap) indicates that small firms consistently produce superior returns relative to larger firms. The return of a firm diminishes as its market capitalization gets bigger.
(3) The neglected firm effect states that a firm that has a small number of analysts following it tends to produce higher returns than those firms covered by many analysts.
(4) Stocks with high book-to-price ratios have a higher risk-adjusted return, representing evidence against the EMH.

D. Anomalies from strong-form academic tests

(1) Stock exchange specialists have monopolistic access to information and derive above-average returns from the information.
(2) Corporate insiders also have monopolistic access to information, which produces excess returns.

E. Conclusions of the three forms of market efficiency

(1) Results support the weak-form EMH.
(2) Results are mixed for the semistrong form of the EMH. Event studies support the semistrong-form EMH, but time-series and cross-sectional tests give evidence that markets are not always semistrong-form efficient.
(3) Results support the strong-form EMH except for corporate insiders and specialists.

5. Behavioral finance

A. Behaviorial finance looks at how the investor's behavior impacts investment decisions. How investors react may not be prudent or rational and thus affect the outcome of the investment.

TOPIC 40: PORTFOLIO DEVELOPMENT AND ANALYSIS

1. Fundamental analysis

A. Fundamental analysis is the evaluation of a firm and its investment attractiveness based on the firm's financial strength, competitiveness, earnings outlook, managerial strength, and sensitivity to the macroeconomy and industry effects.
B. A top-down approach is used in fundamental analysis. It involves picking the best stocks within the most promising industries in the individual's economic forecast for inclusion in the portfolio. Steps include (1) determining general economic influences, (2) determining industry influences, and (3) company analysis.
C. Bottom-up works in reverse of a top-down approach. This begins with the company analysis and seeks to identify companies with appealing valuation and financial characteristics. The ultimate base comparison guide is the company's financial statements.

2. Technical analysis

A. Underlying assumptions of technical analysis

(1) Prices are determined by supply and demand.
(2) Supply and demand are driven by rational and irrational behavior.
(3) Security prices move in trends that persist for long periods of time.
(4) The actual shift in supply and demand can be observed in market price behavior.

B. The major challenge of technical analysis is the efficient frontier hypothesis. Efficient markets assume that new information will cause instantaneous price adjustments, past technical relationships cannot be repeated, technical analysis requires too much subjective interpretation, and decision variables change over time.

C. Technicians believe that the speed with which new information is impounded into prices is slow, whereas fundamentalists believe that prices adjust quickly, and efficient market hypothesis analysts believe it happens almost instantaneously.

D. There are two types of views:

(1) Contrarians follow the rule of doing the opposite to what the general investor does. Therefore, contrarians believe the majority of traders, investors, and institutional advisers are wrong most of the time.
(2) Smart money traders follow a different logic from contrary opinion technicians. They follow the money movement of what they consider to be sophisticated traders.

E. Contrarians use the following tools:

(1) Mutual fund cash positions
(2) Investor credit balances in brokerage accounts
(3) Investment advisory opinion
(4) Over the counter (OTC) versus New York Stock Exchange (NYSE) volume
(5) Chicago Board Options Exchange (CBOE) put/call ratio

F. Smart money traders use the following tools:

(1) The Confidence Index
(2) T-bill yields and Eurodollar rates
(3) Short sales by specialists
(4) Margin debit balances in brokerage accounts

G. The Confidence Index (CI) is found in Barron's and is the ratio of Barron's average yield on 10 top-grade corporate bonds to the yield on the Dow-Jones average of 40 bonds. This is given by Barron's average yield on 10 top-grade corporate bonds

(1) Dow-Jones average of 40 bonds
(2) The Confidence Index measures the difference between high-quality bonds and a large cross section of bonds. It is also stated as:

(a) Quality bond yield
(b) Average bond yield

(3) The Confidence Index rises during periods of confidence as the yield spread narrows and drops during periods of pessimism as the yield spread widens. Therefore, the Confidence Index moves in the opposite direction of yield spreads.

3. Market indicators used in technical analysis

A. Dow theory

(1) Recognizes three movements in security markets: major trends, intermediate trends, and short-term trends. Major trends are broad market movements lasting several years. Intermediate trends, occurring within a major trend, are influenced through current events and resemble waves lasting for several weeks or months. Short-term trends are daily ripples that have no significance.

(2) It is up to the technician to properly calculate the direction of a major trend. The term bull market is used for an upward major trend, and the term bear market is used for a downward major trend. Bull markets exist when upward rallies pass prior highs and declines stay above previous lows.

B. Importance of volume. Price movement alone does not tell how widespread the excess demand or supply is for a security. This is where volume comes into play. Low volume tells us nothing about market movement. High volume tells the extent of interest in and demand for a stock. A price increase on high volume is a very bullish indicator, whereas a price decrease on strong volume is a very bearish indicator.

C. Breadth of the market. This measures the number of advancing stocks in relation to the number of decreasing stocks.

D. Short interest ratio. This measures the cumulative number of shares sold short by investors divided by the daily volume of trading on an exchange.

E. Support and resistance levels. Stocks generally trade in ranges. The lower limit is a stock's support level, and the higher limit is its resistance level. The support level is the level at which technicians believe a stock should be purchased, whereas the resistance level is the level at which a stock should be sold. Technicians state that if a stock were to break its support level, rapid decline would occur before another support level would be defined. If a stock were to penetrate its resistance level, it would quickly move to the upside before reaching a new resistance level.

F. Relative strength ratio. Once a trend begins, it must continue until an event occurs to stop it. The relative strength indicator tells whether the trend is stock specific or caused by market movements. If the ratio increases over time, technicians would expect superior performance to continue. The ratio works in declining markets too. If the price of the stock does not decline as much as the rest of the market, the stock's relative strength ratio will increase. Technicians believe that if the ratio remains stable or rises in down markets, then the stock should do very well in rising markets.

G. Moving average lines. Moving averages allow technicians to find trends in stock prices. Stocks will trade above their moving average if the trend is up and will trade below the moving average if the trend is down. The most commonly used moving average line is a stock's 200-day moving average.

4. Investment policy statement

A. An investment policy statement (IPS) creates a structure for making investment decisions and managing the investor's portfolio.

(1) Establishes risk and return objectives

(2) Determines constraints: time horizon, tax consequences, liquidity needs, regulations, and unique client needs

(3) Establishes a standard of agreed-upon goals and other criteria against which investment performance can be measured

(4) Reduces professional liability exposure by documenting that prudent procedures were followed in making investment decisions

B. An IPS should be created for each individual client.

5. **Appropriate benchmarks:** Performance measurements of a portfolio are from the perspective of the entire portfolio's composition or from security classes and segments of the portfolio. It is appropriate to compare a large cap growth fund against the S&P 500 Index. It would not be appropriate to compare a small cap fund against the S&P 500 Index.

A. Planners should make a careful analysis to determine the appropriate benchmark(s) when tracking the return for a portfolio.

6. **Probability analysis, including Monte Carlo**

A. Monte Carlo simulation is a mathematical technique for numerically solving differential equations. The technique tends to be computer intensive.

B. To understand how the process works, consider an example of how a complex option might be priced. Suppose the option's value is dependent on two underliers, a stock index and an exchange rate. Monte Carlo simulation might be used to price such an option as follows:

(1) Randomly generate 10,000 scenarios for the value, on the option's expiration date, of the two underliers. Do so in a manner that is consistent with an assumed (risk-neutral) joint probability distribution of the two variables.
(2) Determine what the option's expiration value would be in each of the 10,000 scenarios.
(3) Form a histogram of those results. This represents a discrete approximation for the probability distribution of the option's expiration value. The discounted mean of the histogram is the estimated option price.

C. Note that this solution yields only an approximate price. By using more scenarios—say 20,000 instead of 10,000—the precision of the result can be improved.

D. A probability distribution is a mathematical function that describes the probabilities of possible events in a sample space. The sum probability of all the possible events in the sample space must equal 1.

7. **Tax-efficient investing**

A. Turnover

(1) Funds with a greater portfolio turnover ratio generate more tax consequences for their investors.
(2) The mutual fund turnover ratio identifies the amount of buying and selling happening in a specified mutual fund. Example: A turnover ratio of 50 percent means that a fund is expected to replace 50 percent of its investments over a year.

B. Short-term/long-term/unrealized capital gains

(1) The return of a mutual fund is stated before tax, but an investor gets to keep only the after-tax return. Tax efficiency is defined as the ability to generate returns without generating large amounts of tax obligations.
(2) There is no tax obligation if a fund does not receive income or realize capital gains (i.e., unrealized capital gains). If a fund sells securities within its portfolio, each sale results

in a taxable event. If these are short-term sales, then tax is paid at the stockholder's marginal federal income tax rate. If a fund rarely sells it investments, then the likelihood of long-term gains is greater.

(3) Many funds indicate a date when capital gains and income are distributed to shareholders. Investors should be alert to this date. The majority of funds make two distributions.

(a) Midyear distribution; consists of income
(b) Year-end distribution; consists of income and capital gains

(4) *Example*: Assume an investor purchases shares just prior to the distribution date. The investor is the holder of record and responsible for paying any tax of income and capital gains even though the rise in price occurred much earlier. It makes sense to delay the purchase and buy shares when the fund goes ex-dividend.

(5) Hidden capital gains result in unexpected taxes, but hidden capital losses offer tax-free gains. *Example*: If the fund per share price drops from $10 to $5, it has an unrealized loss of $5. Assume an investor purchases the shares at the net asset value of $5. If the shares rise to $10 and are redeemed by the fund, the investor does not incur any capital gains tax as long as the shares continue to be held. However, unrealized losses are not always an opportunity if the price decline is a result of poor management.

8. Stocks

A. Tax management states that the returns of a portfolio must ultimately be measured by the after-tax return.

B. Wash sale rule

(1) Selling shares at a loss and then buying them back within 30 days negates the ability to deduct such losses on your tax return. The disallowed loss amount can be added to the cost basis of the additional shares that were purchased. When these additional shares are sold, any taxable gain or loss includes the loss incurred on the original shares.

(2) The wash sale rule applies not only to stocks but also mutual funds and bonds.

9. Bonds

A. Taxable equivalent yield (see topic 37)
TEY = Tax-exempt municipal yield divided by (1 − marginal tax rate)

B. Premium/discount considerations

(1) If a bond was purchased at a premium, an investor may elect to amortize a part of the premium each year and reduce his or her basis by the amount deductible, which reduces current income from the bond. The taxpayer can also elect not to amortize the premium, and potentially take a capital loss deduction when the bonds are sold, called, or mature.

(2) When an investor sells a market discount bond, his or her gain is generally treated as interest income (ordinary income) to the extent of market discount accrued up to the date of disposition. Only gain in excess of the amount of accrued market discount may be treated as capital gain. However, if the investor elected to include market discount in income annually as it accrued, and to increase his or her basis, the gain would not include previously included market discount.

C. Securities and Exchange Commission (SEC) yield

(1) A standard yield calculation developed by the SEC that allows for fairer comparisons among bond funds. It is based on the most recent 30-day period covered by the fund's filings with the SEC. The yield figure reflects the dividends and interest earned during the period after deduction of the fund's expenses for the period.
(2) It captures the effective rate of interest that an investor can receive in the future.

10. Capital gain versus ordinary income

A. Every gain or loss is characterized as either ordinary or capital.
B. Capital gain or loss results from the sale of a capital asset, such as stocks and bonds. Any gain or loss that does not meet this definition is ordinary in nature, such as dividends and interest payments.

11. Tax advantages: Individuals pay no taxes on capital gains and income in tax-deferred accounts if the proceeds and payments are left in the account.

12. Net unrealized appreciation (NUA) is nontaxable. If a distribution is made from a tax-advantaged account, some or all of the distribution would be taxed as ordinary income and not capital gains.

13. Appropriate assets for tax-advantaged versus taxable accounts

A. Tax-advantaged accounts

(1) High-income–producing assets
(2) Stocks held for short-term appreciation
(3) Zero coupon bonds
(4) Treasury inflation protected securities (TIPS)

B. Taxable accounts

(1) Municipal bonds
(2) Treasury bills, notes, and bonds
(3) Growth stocks with long-term appreciation

14. Mutual funds

A. Basis determination

(1) The basis is the cash investments plus reinvested dividends and capital gains minus returns of capital received.
(2) Front-end and other sales charges adjust the share purchase price. This tends to increase the basis.
(3) Back-end loads and redemption charges reduce the proceeds received from the sale of the securities.
(4) Undistributed capital gains occur when the mutual fund retains the gain from a sale of securities. Taxpayers report their share of income but are allowed a credit for taxes paid by the mutual fund company. The taxpayer has an increase in basis of the difference between the total gain and the tax paid by the mutual fund company.

B. Taxation

(1) There are two methods for computing the basis of mutual funds.

(a) Cost basis. Actual cost of the mutual funds

(i) Specific identification (ID). To adequately identify shares, the taxpayer must

- Specify the specific shares that are sold
- Receive written confirmation of the identification and sale from the broker

(ii) First-in, first-out (FIFO). The oldest shares are sold first.

(b) Average basis. Total cost of shares owned divided by the total number of shares owned

(i) Single-category method: Average share is computed using all shares regardless of whether they are held short or long term.
(ii) Double-category method: The average basis per share is computed in two categories, short and long term.

(2) Specific ID and FIFO cannot be used if the average basis method is used for sale of any shares in the same mutual fund.
(3) Year-end distributions include any income paid during the year plus any distributions declared by December 31 and paid by January 31 of the following year.

15. Stocks

A. Dividends

(1) Dividends are reported on an annual Form 1099-DIV, and interest is reported on Form 1099-INT. The IRS receives copies of these forms and makes sure that they match the income reported by the investor on Schedule B, Form 1040.
(2) Dividend reinvestments are considered constructive receipt and taxed as ordinary income.

B. Basis determination

(1) Capital gains and losses are recognized on the trade date, not the settlement date.

C. Securities acquired by purchase have a cost basis that includes the security price plus any commission charges. Selling expenses are netted against the gross sales price in the computation of the amount realized on sale.

(1) Realized capital gain from the sale of a security is the amount realized over the cost basis in the security. Realized capital loss is the excess of basis over the amount realized.
(2) If an investor elects to have dividends reinvested in corporate stock or mutual funds to buy additional shares, the reinvested dividends become the cost basis of new shares.

D. Capital gains and losses (see topic 53) are reported on Form 1099-B; an individual investor fills out Schedule D, Form 1040.

E. Liquidations: Taxes are due in the year a sale has occurred in a taxable account. For a tax-deferred account, taxes do not occur until the liquidation of the account and are subject only to ordinary income.

F. Stock splits/dividends/rights

(1) The receipt of a stock split, stock dividend, and right is a nontaxable event, because it is simply dividing an existing investment into more parts.
(2) Exceptions: Distributions of stock are considered taxable events if

(a) The shareholder chooses to receive additional shares in lieu of cash.

16. Bonds

A. U.S. government

(1) Interest on U.S. government debt instruments is subject to federal income tax but totally exempt from state and local taxes.
(2) Treasury bills: The difference between the purchase price and the amount paid at maturity (or when sold) is the interest earned.
(3) Treasury notes and bonds: Interest is paid semiannually and reported in the year it is earned.

B. Agency

(1) Agency issues are taxed at both federal and state/local levels.
(2) Interest is taxed as ordinary income. Capital gain and loss treatment is applicable if bonds have appreciated or depreciated in value.

C. Municipal

(1) Interest income earned on state and local government debt instruments is excluded from federal taxes. State and local bond interest may be taxed by the state or locality in which the investor resides.
(2) Capital gains or loss treatment applies when the bonds are sold.
(3) Interest on tax-exempt private activity bonds issued by any state or local government after August 7, 1986, is a preference item for alternative minimum tax (AMT) purposes. As a result, individuals in high tax brackets cannot assume that they will benefit from tax-exempt status.
(4) Ordinary dividend distributions that constitute interest income from a mutual fund invested in state and local municipal bonds are tax exempt.
(5) No deduction is allowed for interest expense paid or accrued on a loan to buy or carry tax-exempt obligations.

D. Zero coupon

(1) The accrued interest is taxed as if it were received.
(2) Original issue discount (OID). When a long-term debt instrument is issued at a price lower than its par value, the difference is called OID. Investors cannot defer recognition of the interest income represented by the original issue discount. OID rules do not apply to short-term debt obligation (maturity dates of one year or less).
(3) Interest is reported on Form OID. The amount of interest shown is generally accurate for only the original bondholder, because the company that issued the bond does not track its activity in the secondary market.
(4) For bonds purchased on the secondary market, the amount of interest will have to be adjusted if a bond was purchased at a price that was different from the stated issue price plus accrued interest.

E. Treasury inflation protected securities (TIPS)

(1) The principal is adjusted up or down for inflation or deflation in addition to having a fixed interest rate.
(2) The interest is paid semiannually. Inflation-adjusted principal is not paid until the bond matures.
(3) Investors pay federal income taxes on the increasing principal amount as well as coupon interest. The entire gain is taxed as ordinary income, not just the coupon interest.

F. Convertible bonds

(1) The conversion to common stock is not a taxable event.
(2) The cost basis for the common stock is the original cost of the convertible bond.
(3) The holding period for the shares is from the time the convertible was originally purchased.

G. Accrued interest

(1) Seller. Reports the accrued interest in gross income. For example, a bond costing $10,000 is sold for $10,500. The sale price includes $400 of interest accrued. The seller reports interest income of $400 and capital gain income of $100.
(2) Purchaser. Deducts the accrued interest from the next interest payment as a return of capital. For example, if the purchaser of the $10,500 bond in the previous example receives total interest of $600 for the year, $200 is taxable interest income ($600 total − $400 accrued interest). The bond basis is $10,100 ($10,500 purchase price reduced by $400 accrued interest).

17. U.S. savings bonds: Interest is subject to federal taxation but exempt from state and local taxes. The taxpayer can report interest annually or upon redemption.

18. Performance measures

A. Sharpe ratio

(1) Relative measure of the risk-adjusted performance of a portfolio based on total risk (= systematic + nonsystematic risk)
(2) Standard deviation (s) is used as the measure for total risk.
(3) Because Sharpe uses standard deviation, it implies that the portfolio is not widely diversified. It is appropriate in working with a smaller portfolio.
(4) Because this is a relative measure, the Sharpe index must be used to compare alternative investments. *Note:* In comparing, bigger is better.
(5) If the portfolio is fully diversified (all nonsystematic risk has been eliminated), then the Sharpe index should yield similar results for a comparison of several investments as the Treynor index.
(6) The Sharpe ratio is calculated as

$$Si = \frac{rp - rf}{\sigma}$$

where rp is the portfolio rate of return, rf is the risk-free rate of return, and sis the standard deviation of the portfolio.

B. Treynor ratio

(1) Relative measure of the risk-adjusted performance of a portfolio based on the market risk (i.e., the systematic risk); therefore, use with diversified portfolios.
(2) Risk is measured by the beta coefficient (ß).
(3) If the portfolio is fully diversified (all nonsystematic risk has been eliminated), then both indices (Sharpe and Treynor) should yield the same results, because diversification will eliminate all unsystematic risk from the portfolio.
(4) Because this is a relative measure, the Treynor index must be used to compare alternative investments. In comparing, if the $Ti = 0$, that is good; if < 0, that is no good.
(5) The Treynor index should be computed for the market to determine whether a particular portfolio has outperformed the market. The results do not indicate by how much each portfolio outperformed the market.

(6) The Treynor ratio is calculated as

$$Ti = \frac{rp - rf}{Beta}$$

where rp is the realized return of the portfolio and rf is the risk-free rate of return.

C. Jensen ratio

(1) Alpha, a, is an absolute measure of performance and measures how well a managed portfolio performed relative to an unmanaged portfolio of equal risk.
(2) It determines how much the realized return differs from the required return. The following formula is used to find alpha:

$$a = rp - [rf + (rm - rf)\ beta]$$

(3) In the equation, the a (referred to as alpha) value indicates whether a portfolio manager is superior or inferior in market timing and stock selection. A positive alpha indicates a superior manager, and a negative alpha indicates an inferior manager.

(4) *Example*: Assume a return of 15 percent with a beta of 1.2 for manager X when the market return is 14.3 percent and the risk-free rate is 7 percent. The alpha is expressed as

(a) $a = 0.15 - [0.07 + (0.143 - 0.07)1.2] = -0.0076$
(b) This indicates inferior performance because it is negative. If portfolio manager Y earns a return of 12.5 percent with a beta of 0.7, then the alpha is expressed as

$$A = 0.125 - [0.07 + (0.143 - 0.07)0.7] = 0.0039$$

(c) This indicates superior performance because it is positive. The absolute return for manager X is higher, but the risk-adjusted return for manager Y is greater, denoting superior performance. Manager Y not only outperformed manager X but also outperformed the market return on a risk-adjusted basis. In the example, portfolio X performed 0.76 percent less than the market, whereas portfolio Y performed 0.39 percent better than the market.

D. Information ratio

(1) This ratio was developed by William Sharpe and incorporate a risk adjustment to alpha.
(2) It evaluates the return earned by a fund manager based on a given level of risk.

TOPIC 41: INVESTMENT STRATEGIES

1. Market timing (active investing)

A. Market timing is the active management of a portfolio. An investor anticipates the direction of economic conditions and stock prices and adjusts his or her portfolio to these changes.
B. Market timing is in direct conflict with the efficient market hypothesis.
C. The more an investor believes that markets are inefficient, the greater the argument for a market timing strategy.

2. Passive investing (indexing)

A. Investors are typically not attempting to outperform the market. Rather, investors are looking to immunize their portfolios in an effort to lock in specified rates of return (or terminal values) they deem acceptable, given the risks involved. These strategies do not generate significant transaction costs.

B. A passive asset allocation begins by setting specific percentages for each asset class. These percentages for a passive strategy should be maintained over time; the portfolio will require rebalancing every six months or so.
C. Passive versus active portfolio management. A passive strategy begins by setting specific percentages for each asset class. The portfolio will be rebalanced occasionally to maintain these percentages. A passive strategy should not be confused with a buy-and-hold strategy.
D. An active strategy is often referred to as market timing, whereas tactical asset allocation is driven by security selection as the reason for rebalancing.

3. Buy and hold

A. Investors hold on to their securities to minimize transaction costs because they do not believe that active management adds any additional returns to their portfolios. For bond investing, investors look for vehicles whose maturities (or duration) approximate their stipulated investment horizon in order to reduce price and reinvestment risk.
B. A buy-and-hold strategy should not be confused with a passive strategy. With a passive strategy, the asset allocation percentages are maintained over time by rebalancing the portfolio. A buy-and-hold strategy does not rebalance a portfolio.
C. The purchase of index funds is an example of a buy-and-hold strategy. These funds attempt to match the makeup of an index, such as the S&P 500.

4. Portfolio immunization

A. Immunization allows an investor to earn a specified rate of return on a bond portfolio regardless of the direction of interest rates. The investor becomes immunized to changes in interest rates over a time horizon.
B. Active rebalancing of bonds ensures that the duration of a portfolio always equals the investor's time horizon.
C. Two methods for immunizing a portfolio:

(1) Purchasing a series of zero coupon bonds whose maturities correspond with the planning horizon
(2) Assembling and managing a bond portfolio whose duration is kept equal to the planning horizon. The portfolio of bonds must be rebalanced whenever interest rates change.

D. Duration declines more slowly than the term to maturity; if interest rates do not change, a bond portfolio may still need to be rebalanced to correspond to the investor's time horizon. Only zero coupon bonds have a duration that decreases at the same rate as their term to maturity.

5. Swaps and collars

A. A swap is a technique for managing a bond portfolio by selling some bonds and buying others with the proceeds, in order to achieve benefits in the form of tax treatment, yields, maturity structure, or trading profits.

B. There are several types of swaps:

(1) *Substitution swap:* The swapping of bonds with virtually identical characteristics (i.e., same maturity, coupon, credit rating, and call and sinking funds) selling at different yields. The price difference is viewed as an arbitrage opportunity.
(2) *Intermarket spread (sector) swap:* This is a variation of a substitution swap. It is used when the difference in yield between two markets is excessive. An investor may swap a government bond for a triple-A–rated corporate bond if the yield is more favorable.

(3) *Pure-yield pickup swap:* The sale of a low-yield bond and purchase of a high-yield bond. The swap is usually for a bond with a longer maturity or lower quality in order to benefit from a higher yield.
(4) *Rate anticipation swap:* Seeks to take advantage or avoid the impact of an expected change in interest rates. If higher interest rates are anticipated, an investor will swap longer-term maturities for shorter-term maturities; if lower rates are anticipated, short-term maturities are swapped for long-term maturities.
(5) *Tax swap:* An investor attempts to take advantage of locking into a loss by selling a bond and buying a similar bond.

C. Collars

(1) Collars are created when an investor sells a call and buys a put.
(2) It is used when an investor believes that the stock has climbed rapidly and is not expected to get much higher.
(3) The investor locks in the gain with the purchase of a put and receives premium income by selling the call.

6. Formula Investing

A. Dollar cost averaging

(1) Dollar cost averaging is the process of purchasing securities over a period of time by periodically investing a predetermined amount at regular intervals.
(2) The goal of dollar cost averaging is to reduce the effects of price fluctuations. When the market is rising, additional shares will benefit from the price increases. When the market is declining, the additional shares purchased will be purchased at lower prices and will yield more shares per dollar invested.

B. Dividend reinvestment plans (DRIPs)

(1) Shareholders have cash dividends automatically reinvested in additional shares of the firm's common stock. The cost of doing this is low or none.
(2) Dividends that are reinvested are treated the same for tax purposes as a dividend received in the form of cash. These dividends, like other dividends, will be reported to the IRS on Form 1099-DIV.

C. Bond ladders, bullets, and barbells

(1) A bond ladder is the purchase of bonds with maturities distributed over a period of time. It is created to reduce interest rate risk. Example: A $100,000 bond portfolio would require $10,000 worth of bonds that mature each year for 10 years. If interest rates change, the price of bonds with shorter maturities (maturities of 1 to 5 years) will fluctuate less than the price of bonds with greater maturities (maturities of 6 to 10 years).
(2) Bond ladders provide three primary benefits:

(a) Interest rate risk is less than that of a portfolio of longer-term maturities.
(b) Interest earned on the portfolio is greater than that of a portfolio of shorter-term maturities.
(c) Cash is available each year when a short-term bond matures.

(3) Bond ladders also have a disadvantage: If an investor anticipates a change in interest rates and wants to alter the portfolio, then virtually all the bonds have to be sold.

D. Bond barbells

(1) Barbells constitute a strategy of acquiring a portfolio of very long term maturities and very short term maturities. For example, a $100,000 bond portfolio would require $50,000 in bonds that have short-term maturities (6 months to 1 year) and $50,000 in bonds with long-term maturities (20 to 30 years). In this way, an investor needs to sell only half a portfolio in order to adjust to any anticipation of interest rate moves.
(2) A barbell strategy will reduce the impact of fluctuating interest rates if an investor correctly anticipates the rate change. It will magnify the impact if the investor is incorrect.

(a) Time to maturity
(b) Interest rates
(c) Price of the underlying stock
(d) Volatility
(e) Call values decrease with an increase in one variable, the strike price.

E. Put-call parity

(1) This determines the value of a put option.
(2) Put-call parity means that there is a relationship between the prices of puts and calls and the underlying stock. It keeps the prices in check so that an opportunity for arbitrage does not happen. Arbitrage is the opportunity to make money without making an investment.
(3) Put-call parity makes certain that the prices of a call and put change with each other and the underlying stock. The put and call can be considered too expensive or cheap, but one cannot be more expensive or cheaper than the other.

7. Use of Leverage

A. Margin requirements

(1) When an investor purchases stock on margin, he or she makes an initial payment similar to a down payment on a house and borrows the remaining funds necessary to make the purchase. The investor is buying securities with borrowed money.
(2) The Federal Reserve sets the initial margin requirement, which is currently 50 percent. For example, if the initial margin requirement is 50 percent on a $20,000 transaction, the investor must deposit $10,000.
(3) The stock exchanges and brokerage houses set the maintenance margin requirement. The maintenance margin is the minimum equity an investor must have for a margin position. The maintenance margin protects the brokerage firm from being exposed to too much risk. For example, if the maintenance margin requirement is 35 percent, this means that the borrower must provide 35 percent of the funds and the brokerage firm lends the remaining 65 percent. The investor pays interest on the borrowed funds.
(4) Margin provides significant leverage to an investor. If the price of a stock goes up, the customer's profits accumulate much faster. The same can be said in regard to the downside. If the price of a stock drops, the percentage loss is greater. The leverage factor can be calculated as (1 ÷ margin %). Example: At a 35 percent margin requirement, the leverage rate is 2.85 (1 ÷ 0.35). If the rate of return on the stock is 10 percent, the rate of return using a 2.85 leverage rate is 28.5 percent, or 185 percent more.

B. Margin calls

(1) If a stock or portfolio declines sufficiently in price, a margin call will result. A margin call happens when the equity in the account has dropped below the margin requirement. The investor must increase his or her equity by depositing cash or securities or by selling assets.

(2) The following formulas are used to indicate what stock price will trigger a margin call.

(a) $\text{Long} = \dfrac{[\text{original price}(1 - \text{initial margin }\%)]}{1 - \text{maintenance margin }\%}$

(b) $\text{Short} = \dfrac{[\text{original price}(1 - \text{initial margin }\%)]}{1 + \text{maintenance margin }\%}$

(3) For example, an investor buys stock at $50. The initial margin requirement is 50 percent and the maintenance margin requirement is 35 percent. If the stock drops to $38 1/2, the investor will get a margin call. The calculation is

$$\text{Long} = \frac{\$50(1 - 0.50)]}{1 - 0.35} = \$38.50$$

(4) Consider a different way this problem can be posed. If stock drops to $40/share, how much cash will you be required to put up, assuming you bought 100 shares of XYZ stock for $60 per share with an initial margin of 50 percent and a 30 percent maintenance margin?

(a) Solve current equity .$4,000 (stock value) less $3,000 (loan amount) = $1,000 equity.
(b) Find required equity .$4,000 × 30% = $1,200
(c) Subtract (1) from (2) .$1,000 less $1,200 = $200

C. Calculating the rate of return on a margin transaction

(1) The rate of return is calculated by solving the net profit and total investment in a transaction.

Net profit ÷ investment = % gain or loss

(2) For example, assume Sarah short sells 100 shares of XYZ at $57 with a 50 percent initial margin. XYZ pays a dividend of $2 per share after she sells the stock. She then buys back the stock for $54. The rate of return is

(a) Investment is $100 × $57 × 0.5 = $2,850.
(b) Net profit is $5,700 (proceeds) less $5,400 (cost) less $200 (dividend payments) (short the position). The result is $100.
(c) $100 divided by $2,850 = 3.5%

D. Short sales

(1) A short sell is the sale of borrowed securities in anticipation of a price drop. The short seller profits by selling the securities first with the intention of purchasing them back at a lower price. Example: An investor sells 100 shares of XYZ stock short at $100 and later buys those shares back at $70, resulting in a $3,000 profit.

(2) Short selling occurs when an investor believes a stock is overpriced and expects the price to drop. The maximum loss can be unlimited if the price continues to rise.

(3) The investor does not own the securities that are being sold short. These securities are sold short with a contract for future delivery. In effect, the broker borrows shares held in a mar-

gin account and lends them to the short seller (shares held in a cash account cannot be lent to a short seller). The proceeds are not delivered to the seller but are held by the broker.

(a) These proceeds are used at a later date to buy back the shares (covering the short).

(4) Three technical points affect short sales.

(a) Investors can short sell only when the last trade for a stock is an uptick or zero uptick.

(i) If the price of a stock moves up from the previous trade, that is an uptick. If the price of a stock declines from the previous trade, that is a downtick. If the price of a stock does not change from a previous uptick, that is a zero uptick. The reason for this rule is to prevent traders from manipulating the market.

(b) Short sellers must pay all dividends that are owed to the lender of the security.
(c) The short seller must deposit margin money to guarantee the repurchase of the security.

(5) For example, assume the margin requirement is 50 percent. If an investor short sells 100 shares of XYZ stock at $70, the initial deposit must be $7,000 50 percent, or $3,500.
(6) This money is returned to the short seller with any gain or loss when the short position is covered.

8. Hedging and Option Strategies

A. Strategy of buying calls

(1) A call is an option to buy a specified amount of shares (usually 100) at a specified price (strike price) within a specified time period (expiration date).
(2) Investors should buy calls when they expect the underlying stock or index to rise.
(3) A long call position can be used in a speculative way through leverage, or conservatively as an insurance policy. The percentage increase in a call often exceeds that of the stock in a rising market. When the price of the underlying stock decreases, the percentage loss in the call is often greater than the stock. This is the effect of leverage. The absolute gain or loss on the call is less than it is when the stock is owned, because options are less expensive.
(4) The maximum gain is unlimited. The maximum loss is the premium paid for the options. The breakeven equals the strike price plus the premium.
(5) Time decay accelerates as the option approaches expiration.

B. Strategy of buying puts

(1) A put is an option to sell a specified number of shares (usually 100) at a specified price (strike price) within a specified time period.
(2) The objective in buying puts is for a trader to profit from or protect against a price decline in the underlying stock. Put buying is a speculative strategy using leverage or a conservative strategy of insurance.
(3) The maximum gain increases as the stock price decreases and is only limited by the stock going to $0. The maximum loss is the premium paid for the options. The breakeven equals the strike price minus the premium.
(4) Time decay accelerates as the option approaches expiration.
(5) For an investor wanting to protect against downside loss without selling his or her stock position, puts are insurance against falling stock prices. These are known as protective puts.
(6) Puts can be used as an alternative to short selling.
(7) An interesting point to note is that purchasing puts against a long position is the same as buying calls outright. Both strategies have limited loss (the premium paid) with unlim-

ited gain. Therefore, if puts are bought as insurance on a stock, it turns the position into a call option for the life of the option.

C. Strategy of selling naked calls

(1) The act of selling an option is known as writing. This strategy is also known as naked call writing.
(2) Selling naked calls exposes an investor to considerable risk. If the call is exercised because the price of the stock rises, the option writer is obligated to buy the stock back and deliver it to the buyer. The price of the stock can be significantly higher than when the call was originally sold. It is important to understand that the strategy for naked call writing does not involve ownership of the underlying stock (a strategy known as covered call writing).
(3) The maximum gain with this strategy is the premium received. The maximum loss is unlimited. The breakeven is the strike price plus the premium.
(4) The motivation for selling calls is to take advantage of volatility and time decay.

(a) If expected volatility is high, the premium for the call is larger, resulting in more money coming in for the seller.
(b) An investor can take advantage of time decay by selling an option in the final weeks before expiration. This is when time decay accelerates.

D. Strategy for selling naked puts

(1) The act of selling an option is known as writing. Therefore, investors may write naked puts.
(2) Naked put selling is a strategy in which the option trader assumes the risk of the underlying security in exchange for the premium. The writer puts an emphasis on the underlying stock's price not declining.
(3) The maximum gain is the premium received. The maximum loss is the cost of buying the stock at the strike price. The loss continues to grow as the underlying stock declines below the strike price. The breakeven is the strike price minus the premium.
(4) The motivation for selling puts is to take advantage of volatility and time decay.

E. Strategy of covered call writing

(1) Covered call selling (or writing) is taking a short call with a long stock position in the underlying stock. If the option is exercised, the seller supplies the stock at the strike price.
(2) The call seller limits the gain on the stock by the premium received plus the strike price minus the price paid for the underlying stock. For example, assume a seller receives $5 for selling a 50 XYZ call and pays $52 for 100 shares of XYZ stock. The maximum gain is $3.
(3) The maximum gain is made when the stock trades above the strike price at expiration. The maximum loss is the price paid for the security minus the premium received from selling the call. That means that by selling calls to receive a premium, an investor partially hedges against his or her stock position. The breakeven is also the price paid for the underlying security minus the premium received.
(4) This strategy is used if an investor expects a stable stock price.

F. Strategy of covered put writing

(1) The investor sells the stock short and sells the put in order to construct the covered put. If the put is exercised, the investor buys the shares and uses this to cover the short position. This is the opposite to covered calls in which the investor sells existing shares if the call is exercised.

(2) This strategy is used if an investor expects a stable stock price. The investor is neutral to slightly bearish. For example, assume a stock trades at $53 and the strike price of a put is $55 with a premium of $5. An investor short sells the stock and sells the put. If the stock stays below $58, the investor makes a profit. The maximum profit is $3 (the time premium). The maximum loss is unlimited if the stock price rises.

TOPIC 42: ASSET ALLOCATION AND PORTFOLIO DIVERSIFICATION

1. Strategic asset allocation

A. This is based on an investment policy that determines a suitable mix of assets for a client's portfolio.

B. Application of client life cycle analysis

(1) A client's risk tolerance can be deduced from an analysis of his or her life cycle. There are four life cycle phases: accumulation phase, consolidation phase, spending phase, and gifting phase.

(2) In the accumulation phase, individuals are accepting of high-risk investments for above-average returns. In the consolidation phase, individuals are accepting of moderate-risk investments. In the spending phase, individuals are accepting of low-risk investments. In this phase, the overall portfolio is less risky than during the consolidation years, but individuals still need to have some risky growth investments, such as common stock, for inflation protection. The gifting phase risk level is comparable to the spending phase.

C. Client risk tolerance measurement and application

(1) It is vital to find a portfolio that matches the investor's risk tolerance level while helping the investor achieve his or her return objectives.

(2) In certain cases, measuring risk tolerance can be objective, but it is generally a subjective measure of the emotional and financial ability of an investor to withstand financial loss. A careful analysis of the client's risk tolerance should precede any discussion of return objectives.

(3) Asset allocation portfolios are generally marketed as follows:

(a) Aggressive growth
(b) Growth
(c) Growth and income
(d) Balanced
(e) Fixed income

(4) Both the return and risk level decrease as we move from aggressive growth to growth, growth to growth and income, and so on.

D. Asset class definition and correlation

(1) Investments are distributed among three broad asset classes.

(a) Stocks
(b) Bonds
(c) Cash and money market instruments

(2) The correlation coefficient is the driving force of asset allocation. As mentioned earlier, as the correlation coefficient decreases from +1, there is an increase in

diversification. Diversification can increase the return of a portfolio while decreasing the risk.

(3) Keep in mind that the standard deviation of a portfolio is less than the weighted standard deviation of the individual stocks in the portfolio.

2. Rebalancing

A. Under strategic allocation, an investor systematically rebalances a portfolio to restore the different asset classes to their original weighted asset mix.

3. Tactical asset allocation uses security selection as its main approach to building a portfolio, whereas asset allocation uses an investment policy that determines a suitable mix of assets for a client's portfolio.

4. Control of volatility

A. Control of volatility refers to the investor assessing beta fluctuations surrounding the market average and then selling or purchasing risky or risk-free assets based on the value of the asset mix.

5. Strategies for dealing with concentrated positions

A. Rebalancing a portfolio to maintain asset allocation percentages is most appropriate for a tax-deferred retirement account, because gains on the sale of securities are not taxed. It is also appropriate for a regular account, but frequent rebalancing may cause complicated tax reporting headaches.

B. The basic rule of rebalancing is that it should be used at regular intervals, say every quarter or every six months.

TOPIC 43: ASSET PRICING MODELS

1. Capital asset pricing model (CAPM)

A. The CAPM determines the required rate of return for any risky asset. The required return is comprised of the risk-free rate an investor can earn by investing in a riskless security such as a U.S. Treasury bill and the risk premium. According to the CAPM, the risk premium is both the additional return an investor earns above the risk-free rate and the volatility of a particular security to that of the market. Therefore, the required rate (k) of return is

CAPM stock = Rrisk free + (Rmarket – Rrisk free) betastock

B. If the difference between the market rate and the risk-free rate widens, a stock's risk premium will grow. This is an important concept in stock valuation. The larger risk premium causes the stock's intrinsic value to decrease unless the stock can grow faster to keep up with the added risk. If growth cannot keep up with the high-risk premium, the stock's current value may come crashing down.

C. The CAPM can be used to identify undervalued and overvalued assets.

(1) Compare expected return to the required return (k).

(a) If the expected return is greater than the required return, the asset is undervalued.
(b) If the expected return is lower than the required return, the asset is overvalued.
(c) If the expected return equals the required return, the asset is properly valued.

(2) Any stock not plotting on the security market line (SML) is mispriced.

(a) If a stock's expected return falls below the SML, the stock is overpriced. The expected return is too low.

(b) If a stock's expected return rises above the SML, the stock is undervalued. It is offering a return that is greater than its systematic risk.

2. Arbitrage pricing theory (APT)

A. The CAPM is a one-factor model that considers only market risk. Because there are many factors that drive stock return, a multifactored model was developed.

B. The APT relies on few assumptions:

(1) Capital markets are competitive.
(2) Investors prefer more wealth to less wealth.
(3) The process generating asset returns is represented by the K-factor model.

C. The APT does not rely on the following CAPM assumptions:

(1) Investors have quadratic utility functions.
(2) Security returns are normally distributed.
(3) The market portfolio contains all securities and is mean variance efficient.

D. The model assumes K unspecified factors. For example, let Fi represent the risk premium for the ith risk factor and Bi represents the responsiveness of the asset's returns to that risk factor.

$$ER = Rf + BiFi + B2F2 + B3F3 + \ldots + BnFn$$

E. The major drawback of the APT is that it does not specify the risk factors.

F. If the APT had only one risk factor, that being market risk, it would equal the CAPM.

3. Black-Scholes option valuation model

A. Determines the value of a call option

B. The model assumes that the call option is European (exercisable only on expiration date) and not American (exercisable at any time) style.

C. There are five variables in Black-Scholes model.

(1) Call values increase with an increase in four variables.

4. Binomial option pricing

A. This complicated model is based upon the assumption that equity prices move to only two values over a small time period.

CHAPTER 5

INCOME TAX PLANNING

TOPIC 44: INCOME TAX LAW FUNDAMENTALS

1. **Sources of authority**

   A. Primary

   (1) Statutory laws

   (a) Internal Revenue Code of 1986. The primary source of tax law
   (b) Taxpayer Relief Act of 1997. Included more than 300 new provisions and 800 changes to the Internal Revenue Code of 1986
   (c) Tax legislative process begins with the House Ways and Means Committee and later goes to the House of Representatives. If the House approves the bill, it is submitted to the Senate Finance Committee and then to the entire Senate. If approved with no changes, it goes to the president for approval or veto. If there are changes, the Joint Conference Committee will address them and submit the bill back to the House and Senate.

   (2) Administrative pronouncements

   (a) Treasury regulations: The official interpretation of a statutory tax rule written and published by the U.S. Treasury; the highest source of authority next to the Internal Revenue Code. Treasury regulations have the full force and effect of the law.
   (b) Revenue rulings: Represent the official position of the Internal Revenue Service (IRS), but carry less authority than the Code and regulations. They provide interpretations of the tax law and give guidance to taxpayers.
   (c) Revenue procedures: These also represent the official position of the IRS. They are generally related to compliance matters such as tax tables, inflation-indexed amounts, asset class lives, and so forth.
   (d) Letter rulings: More specific interpretations by the national office of the IRS related to the tax consequences of a contemplated transaction at the request of the taxpayer. A letter ruling is applicable only to the taxpayer who requested it and cannot be used by another taxpayer in a dispute.

   (3) Judicial decision

   (a) Taxpayers can escalate any tax dispute to a regional appeals office of the IRS.
   (b) If a case is unresolved, the taxpayer can take it to federal court for judicial review, consisting of three trial courts.

   (i) U.S. Tax Court: Refuse to pay deficiency; no jury trial
   (ii) U.S. District Court: Pay the deficiency and sue for a refund; provides a jury trial
   (iii) U.S. Court of Federal Claims: Pay the deficiency and sue for a refund; no jury trial

   (c) If the case is still unresolved, the taxpayer can appeal to the U.S. Circuit Court of Appeals (appellate court); 13 courts, based on jurisdiction.

   (d) The final appeal is to the U.S. Supreme Court, which may agree to hear the case or refuse to hear it. Any ruling is equivalent to law.

   B. Secondary sources of tax information consist mainly of books, periodicals, articles, newsletters, and editorial judgments in tax services.

2. **Research sources: Research of a tax question involves the following steps:**

   A. Gather all the facts.
   B. Diagnose the problem.
   C. Locate the authority.
   D. Evaluate the authority.
   E. Derive the solution.
   F. Communicate the answer.

TOPIC 45: TAX COMPLIANCE

1. **Filing requirements**

   A. Every individual U.S. citizen and resident alien must file an income tax return when gross income exceeds the standard deduction amount plus the applicable personal exemption for the individual's filing status. Example: A single taxpayer in 2007 with $8,750 of income must file a tax return ($5,350 (2007) standard deduction + $3,400 personal exemption(2007)). The return must be filed whether or not any tax is due.
   B. The previous rules do not apply to an individual who is claimed as a dependent by another.

   The dependent must file a return if:

   (1) His or her unearned income is more than $850 (for 2007) plus any additional standard deduction claimed because of age or blindness.
   (2) His or her total gross income is more than the standard deduction.

   C. No return is necessary for a child if the parents elect to include the child's income in the parents' return under the "kiddie tax" rules (see topic 46).
   D. The following individuals have to file a tax return even if their gross income is below the required amount:

   (1) An individual who has $400 or more net earnings from self-employment
   (2) Individuals who have received tips from which Social Security tax was not withheld
   (3) Individuals owing alternative minimum tax
   (4) Employees of certain religious and other church-controlled organizations
   (5) Nonresident alien individuals
   (6) Individuals who have changed their country of residence or citizenship during the year
   (7) Individuals who must pay tax from an IRA or qualified retirement plan
   (8) Individuals who must pay tax from recapture of investment credit, low-income housing credit, or federal mortgage subsidy

   E. Most individuals are required to file Form 1040 by April 15 of the following year. Individuals who have adopted a fiscal year must file by the 15th day of the fourth month following the close of the taxable year. Corporations must file a tax return before the 15th day of the third month after the end of their tax year.
   F. The law permits individuals to file an automatic six-month extension (three-month extension for partnerships, trusts, and estates and six-month extension for corporations). The extension is only for filing the return, not for paying tax. From the government's perspective, taxpayers who are late in paying taxes are receiving a loan from the government. The IRS bills these taxpayers for interest owed from the required payment date to the date the delinquent tax is actually paid.

G. Corporations may deduct the interest paid on a tax deficiency as a business expense. For individual filers, the interest paid is nondeductible personal interest.

2. **Authority to represent the clients before the IRS (Circular 230): Certified public accountants (CPAs), attorneys, and enrolled agents have authority to represent a client before the IRS. Enrolled agents receive certification to practice before the IRS by passing a tax exam written and administered by the IRS.**

3. **Audits**

A. There are several ways in which the IRS chooses tax returns for audit.

(1) Discriminate Functions System (DIF) Score: Method of screening all returns based on a precomputed set of weighted norms used in selecting returns to audit. Based on the weighted score, the program ranks the returns from most auditworthy to least auditworthy. The higher the score, the greater the chance of audit. The DIF selection process is a closely guarded secret of the IRS. The following are ten items that practitioners consider topics of audit:

(a) 1040 business returns with total gross receipts (TGR) of $100,000 or more, or with substantial business losses
(b) 1040 nonbusiness returns with total positive income (TPI) of $50,000 or more
(c) Returns with tax shelter activity
(d) Returns prepared by an individual or firm on the Problem Preparer's List of the IRS
(e) Travel and entertainment expenses
(f) Business automobile expenses
(g) Casualty losses
(h) Barter income
(i) Deduction for office-in-the-home expenses
(j) "Hobby" losses

(2) Taxpayer Compliance Measurement Program (TCMP): Designed to compute the norms used by DIF, thereby determining where taxpayers are most likely to fail in complying with the law (55,000 returns every two years)
(3) Targeted programs: Target professions with income derived from tips and the like, or specific situations
(4) Document matching programs: Match specific documents such as W-2s, 1099s, and so forth, to determine discrepancies
(5) Random sample

B. Correspondence examinations: The most common and simplest form of audit is usually conducted by telephone or mail.
C. Office examination takes place at the IRS district office; field examination takes place at the taxpayer's business. Field audits are broader in scope than office examinations.

4. **Penalties**

A. Late-filing and late-payment penalty: A combined penalty that equals 5 percent of the balance of tax due for each month that the return is late, up to 5 months (until penalty equals 25 percent of balance due). After 5 months, the penalty is 0.5 percent for each month late, for an additional 45 months.
B. Statute of limitations

(1) The government's cashing a taxpayer's check or mailing a refund does not mean that the IRS has accepted the accuracy of the return as filed.
(2) The statute of limitations gives the IRS three years from the later of the statutory due date (usually April 15) or the date on which the return was actually filed to examine a return for mistakes.
(3) The statute of limitations is extended for six years if the taxpayer omits an amount of gross income exceeding 25 percent of the gross income reported.

5. Negligence

(1) The penalty equals 20 percent of any underpayment of tax attributable to the taxpayer's failure to make a reasonable attempt to comply with the law or intentional disregard of the law.
(2) The IRS has the burden of production to show that the taxpayer was negligent rather than he or she made an honest mistake. This means the IRS must show a preponderance of evidence that negligence occurred.

6. Civil fraud

(1) The penalty is 15 percent for each month a return is late, up to a maximum of 75 percent. Fraud is defined as an intentional act of trying to cheat the government.
(2) The burden of proof for establishing fraud falls on the IRS. The IRS must show clear and convincing evidence that fraud actually occurred.

7. Criminal fraud

(1) Also known as tax evasion, this it is a felony offense, punishable by severe monetary fines (up to $100,000 for an individual and $500,000 for a corporation) and by imprisonment in a federal jail.
(2) There must be guilt beyond a reasonable doubt for a person to be convicted.

8. Tax return preparer penalties

(1) An income tax preparer is any person who prepares tax returns (or employs other people to prepare returns) for compensation.
(2) If the preparer understates the amount of tax, and he or she knows (or should know) that the position has no merit, the IRS can impose a $250 penalty. If there is a willful attempt to understate taxes, the fine increases to $1,000.

TOPIC 46: INCOME TAX FUNDAMENTALS AND CALCULATIONS

1. Filing status

A. Single: A taxpayer is single if, on December 31, he or she is unmarried or legally separated.
B. Married filing jointly (MFJ)

(1) Taxpayers may file jointly if, on December 31, they are:

(a) Married and living together
(b) Married and living apart, but not legally separated or divorced
(c) Living in common law marriage, if recognized in the state where they reside

(2) If a spouse dies, the survivor can file jointly if one of the preceding tests were met during the year, assuming the survivor did not remarry.

C. Married filing separately (MFS)

(1) Taxpayers who are married at the end of the year can elect to file separately.
(2) Reasons to file separately:

(a) No joint liability
(b) Lower taxes for some couples. The tax brackets for MFS are exactly half those for MFJ. Spouses generally pay the same amount of tax under MFS as they would under MFJ unless one spouse has medical expenses, casualty losses, or employee business expenses subject to the percentage limitation based on adjusted gross income (AGI).

(3) Potential disadvantages:

(a) If separate returns are filed and itemized deductions are elected by one spouse, the other spouse must also itemize deductions.
(b) Increase in taxable Social Security benefits
(c) Credit losses
(d) Loss of the special $25,000 allowance for rental real estate

D. Head of household (HOH)

(1) The taxpayer must meet all of the following tests to file as head of household:

(a) The taxpayer is not married at end of year.
(b) The taxpayer pays more than half the cost of the home.
(c) The home was the main home for more than half the year for:

(i) The taxpayer's child, stepchild, adopted child, or grandchild

- An unmarried child does not need to be a dependent.
- A married child generally must be a dependent.

(ii) Foster child who is a dependent
(iii) Another relative who is the taxpayer's dependent:

- Parent or grandparent
- Sibling, stepsibling, or half-sibling
- Mother-, father-, daughter-, son-, brother-, or sister-in-law
- Uncle, aunt, nephew, or niece

(iv) Relatives not listed and unrelated persons may be the taxpayer's dependents if they lived in the taxpayer's household for one full year.

(d) The taxpayer was a U.S. citizen or resident during the full year.

(2) Parents do not have to live with the taxpayer half of the year for the taxpayer to qualify as HOH. The taxpayer qualifies by paying more than half the cost of a parent's home. The home must be the main home of the parent for the entire year. The parent must be a dependent of the taxpayer. Paying half of a nursing home qualifies. The taxpayer must still meet tests (1) (a), the taxpayer is not married at end of year, and (1) (d), the taxpayer was a U.S. citizen or resident during the full year.
(3) A married taxpayer can file as HOH if all of the following are met:

(a) The taxpayer files a separate tax return.
(b) The taxpayer pays more than half the cost of the home.
(c) The spouse did not live in the home during the last six months of the tax year.

(d) The home was the main home for more than half the year for the taxpayer's child, stepchild, or adopted or foster child.
(e) The taxpayer was a U.S. citizen or resident during the full year.

E. Qualifying widow(er)

(1) If the taxpayer's spouse died within two years preceding the year for which the taxpayer's return is being filed, the surviving spouse can qualify to use the married filing jointly tax rate and standard deductions.
(2) The surviving spouse must meet all of the following:

(a) The taxpayer was entitled to file a joint return with decedent in year of death.
(b) The taxpayer did not remarry before the end of the current year.
(c) The taxpayer paid more than half the cost of the home.
(d) The home was the main home, for the entire year, of the taxpayer's child, stepchild, or adopted or foster child.

2. Gross income

A. Included income

(1) Wages, salaries, commissions, and fees
(2) Taxable noncash fringe benefits
(3) Allocated and unreported tips
(4) Gains from real estate, securities, and other property
(5) Rents
(6) Interest from bank accounts, CDs, securities, loans, etc.
(7) Accrued interest form zero coupon bonds
(8) Dividends
(9) Royalties
(10) Alimony and separate maintenance payments
(11) Annuities, pensions, IRA distributions
(12) Income from an estate or trust, but not a gift or bequest
(13) Prizes and awards
(14) For some taxpayers, up to 85 percent of their Social Security benefits
(15) All cash and property received, unless it is specifically excluded by federal tax laws

B. Income excluded from tax

(1) Gifts and inheritances
(2) Interest on certain municipal bonds and interest from mutual funds that hold such bonds
(3) Returns of capital (e.g., loan principal repayments)
(4) Reimbursements for business expenses
(5) Exclusions of up to $250,000 ($500,000 for married filing jointly) in gain from the sale of a home
(6) Some or all of Social Security benefits
(7) Compensation for injury or sickness, including workers' compensation and certain disability payments
(8) Employer-paid health coverage
(9) Employer-provided education assistance up to $5,250
(10) Qualified foster care payments
(11) Proceeds of life insurance paid because of death or chronic illness
(12) Payments received under accident, health, and long-term care insurance policies

(13) Amounts contributed to a medical savings account (MSA)
(14) Employer-provided child or dependent care services
(15) Scholarships and fellowships
(16) Employer-paid group life insurance up to $50,000

3. Imputed interest

A. Imputed interest rules were established to prevent individuals from shifting income from high tax brackets to low tax brackets and from shifting interest income to capital gain income by raising the purchase price and charging less interest.
B. If the interest rate is below the applicable federal rates (AFR), the seller may be required to add imputed interest to income.
C. If the AFR is above the interest rate charged at time of transfer, the seller reports the additional interest income, and the buyer is allowed an additional interest deduction.
D. Exceptions

(1) Loans up to $10,000 to purchase non–income-producing property
(2) Loans up to $100,000 if the borrower's net investment income is under $1,000
(3) Compensation-related loans up to $10,000 between an employer and employee or independent contractor
(4) Loans up to $10,000 between a corporation and a shareholder of a corporation

E. The AFR is set monthly by the federal government according to type and term of loan.
F. Original issue discount (OID)

(1) When a long-term debt instrument is issued at a price lower than its par value, the difference is called OID. Investors cannot defer recognition of the interest income represented by the original issue discount. OID rules do not apply to short-term debt obligations (maturity dates of one year or less).
(2) Interest is reported on Form OID. The amount of interest shown is generally accurate for only the original bondholder, because the company that issued the bond does not track its activity in the secondary market.

4. Adjusted gross income (AGI): The following deductions are subtracted from gross income to arrive at AGI:

A. Trade or business expense
B. Self-employed medical insurance premiums up to a limit
C. Moving expenses for work
D. Fifty percent of self-employment tax
E. Amounts forfeited to a bank or savings institution for premature withdrawal of funds from a deposit account
F. Alimony and separate maintenance payments
G. Employee expenses that are reimbursed by the employer
H. Contributions to tax-favored retirement plans for self-employed
I. Contributions to individual retirement accounts (IRAs)
J. The total taxable amount of a lump sum distribution from a retirement plan to participants who reached age 50 before 1986
K. Deductions in connection with property held for the production of rents or royalties
L. Deduction for interest on qualified education loans
M. Payments made in tax years beginning after 2001 for deductible higher education expenses

N. Contributions to MSA
O. Losses from the sale or exchange of property

5. Standard deduction (2007)

A. Married, filing jointly; and surviving spouse = $10,700
B. Married, filing separately = $5,350
C. Additional amount(s) for preceding two statuses if:

(1) 65 or older = $1,050
(2) Blind = $1,050

D. Single = $5,350
E. Head of household = $7,850
F. Additional amount(s) for preceding two statuses if:

(1) 65 or older = $1,300
(2) Blind = $1,300

G. Standard deduction for dependents

(1) A dependent is an individual for whom another taxpayer claims a dependency exemption.
(2) Dependents are not eligible to claim the regular standard deduction amounts on their own tax returns.
(3) The special standard deduction allowable on a dependent's tax return is the greater of:

(a) A sum equal to the amount of the dependent's earned income for the year plus $300, but not more than the regular standard deduction amount
(b) $850 (for 2007)
(c) *Example*: If a dependent has earned income of $1,000, he or she is entitled to a standard deduction of $1,300 ($1,000 + $300). If the dependent's earned income was $450, he or she is entitled to a standard deduction of $850.

6. Itemized deductions

A. These deductions are claimed on Schedule A. They are deductions taken from AGI in determining taxable income and are called "below-the-line" deductions. Deductions taken from gross income in determining AGI are called "above-the-line" deductions.
B. Types

(1) Medical expense

(a) Medical expenses are those paid for the taxpayer, his or her dependents, and anyone who would have been a dependent except for the income test.
(b) The actual deduction is the cost in excess of 7.5 percent of AGI.
(c) Medical expense deductions are allowed for

(i) All expenses made to maintain or improve health
(ii) Central air-conditioning when a family member suffers from respiratory ailments
(iii) New siding when the homeowner is allergic to old siding
(iv) Swimming pool for therapeutic purposes

(d) Unreimbursed expenses and insurance premiums paid for long-term care are deductible as medical expenses.
(e) Nondeductible medical expenses include

(i) Baby-sitting and child care
(ii) Costs covered by insurance
(iii) Cosmetic surgery
(iv) Funeral expenses
(v) Health club dues
(vi) Nonprescription drugs and medicines
(vii) Nutritional supplements
(viii) Weight loss program unless doctor recommends

(2) State and local income tax

(a) State and local income taxes are deductible, but not the amount paid for federal income taxes.
(b) If a deduction is taken in the year of payment but a refund is later received, the refund is taxable income in later years.

(3) Real estate and personal property tax

(a) Real estate taxes are deductible even if paid to a foreign country.
(b) Real estate taxes are deductible for all property owned by the taxpayer; mortgage interest deduction is limited to two homes.
(c) If property is owned for just part of the year, only that portion is included.
(d) Personal property taxes are deductible if based on the value of the property.

(4) Mortgage interest on primary and one secondary home—combined total of the debt

(a) Acquisition debt. Deduction is limited to the interest on the first $1,000,000 of qualified debt.
(b) Home equity debt. Deduction is limited to the lesser of the interest on:

(i) The fair market value (FMV) of the home minus the total acquisition indebtedness
(ii) $100,000 for the main and second homes combined

(c) *Example*: The FMV of a home is $100,000 and the current balance on the original mortgage (home acquisition cost) is $90,000. The bank offers a home equity loan of 125 percent of the FMV of the home less any outstanding mortgages or other liens. To consolidate some other debts, the homeowner takes out the full $35,000 home equity loan [(125% × 100,000) − 90,000] with the bank. The home equity debt deduction is limited to $10,000, which is the smaller of:

(i) $100,000 maximum limit
(ii) The amount that the FMV of $100,000 exceeds the home acquisition debt of $90,000

(d) Rules regarding a second home

(i) If a second home is rented, the taxpayer must use it more than 14 days or 10 percent of the number of days the home is rented at FMV, whichever is longer.
(ii) More than one second home

- Can treat only one as a qualified second home for the year
- Can choose a different one each year if neither of the second homes is rented out

(e) If a home is used for business and personal use, only the portion used for residential living counts as a qualified residence.

(f) IRS says that a taxpayer cannot deduct interest paid on behalf of another person; however, tax law has allowed deductions where the taxpayer is an "equitable owner" of the personal residence.
(g) Loan origination fees, maximum loan charge, loan discount, and discount points are tax deductible in the year paid if secured by the principal residence.
(h) If a seller pays points, they are deductible by the buyer in the year paid, but the buyer must reduce the basis in the home by the amount paid by the seller.

(5) Charitable contributions (see topic 58)

(a) Must be made to a qualified charitable organization. Payment must be made, not just pledged. Credit card payments are deductible.
(b) Services provided to a charity are not deductible, but out-of-pocket costs incurred for those services are deductible.

(6) Casualty and theft losses

(a) Include damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. The amount of casualty loss is the difference between the lesser of:

(i) FMV before event less the FMV after event (if stolen, the FMV after event is 0)
(ii) The adjusted basis

(b) Losses are reduced by any insurance recovery.
(c) Reduction for $100 and 10 percent AGI floors. A $100 floor applies to each incident, but a 10 percent AGI floor is applied to the aggregate casualty loss amount for the year.
(d) *Example*: Steve had his Babe Ruth autographed ball stolen. It was valued at $15,000, with a basis of $10,000. Steve's salary for the year was $40,000. The itemized deduction is calculated as $10,000 (lesser of basis or reduction in FMV) minus $4,000 (10 percent AGI) minus $100 floor. The itemized deduction for casualty loss equals $5,900.

(7) Employee business expenses

(a) This section is not applicable if all of the following are true:

(i) The employee fully accounted all work-related expenses to his or her employer.
(ii) The employee received full reimbursement for expenses.
(iii) The employer required the employee to return any excess reimbursement.
(iv) Box 12 of the employee's W-2 shows no amount.

(b) Employees can deduct unreimbursed business-related expenses for (1) travel, (2) entertainment, (3) gifts, and (4) transportation.
(c) Travel versus transportation expenses: Transportation expenses do not include expenses incurred while traveling away from home overnight. Those expenses are travel expenses.

(8) Investment interest

(a) Investment interest costs are limited to the amount of investment income.
(b) Capital gains may be included in investment income at the election of the taxpayer. The trade-off is that any capital gain included in investment income is not eligible for preferential long-term capital gain rates.

(9) Miscellaneous itemized deductions

(a) Deductions subject to a 2 percent limit

(i) Unreimbursed employee expenses
(ii) Tax preparation fees
(iii) Other expenses

(b) Deductions not subject to the 2 percent limit

(i) Amortizable premium on taxable bonds
(ii) Federal estate tax on income in respect to decedent
(iii) Gambling losses up to the extent of gambling winnings
(iv) Unrecovered investment in an annuity
(v) Expenses of officials paid on a fee basis
(vi) Repayments of more than $3,000 under claim or right
(vii) Impairment-related work expenses of persons with disabilities

(c) Nondeductible expenses

(i) Broker's commissions paid in connection with property or account
(ii) Burial or funeral expenses
(iii) Capital expenses
(iv) Fees and licenses, such as car license, marriage license, or dog tags
(v) Hobby losses
(vi) Home repairs, insurance, and rents
(vii) Losses from the sale of a home
(viii) Personal disability insurance premiums
(ix) Lobbying expenses

C. Limitations—itemized deduction phaseout (3 percent/80 percent rule)

(1) A taxpayer's allowable deductions are reduced by the lesser of (a) 3 percent of the excess of AGI over a specified amount or (b) 80 percent of the allowable itemized deductions for the year, but not including deductions for medical expenses, investment interest, nonbusiness casualty and theft losses, and gambling losses. That amount is then multiplied by ⅓ for the total disallowed amount. The specified amount for 2007 is $156,400 ($78,200, if married filing separately).
(2) *Example*: A husband and wife have AGI of $186,000 in 2007. Their itemized deductions total $30,000, including $3,500 in investment interest, but no medical or casualty losses. The amount by which their AGI exceeds $156,400 is $29,600. This amount is multiplied by 3 percent to get $888. Take the $888 and multiply that by 1/3 which equals $296. Next, take 80 percent of the allowable itemized deductions, which is (30,000 − 3,500) × 80% = $21,200. The lesser of the two calculations is $296. The total amount of itemized deductions that can be used to reduce taxable income is $30,000 − $296 = $29,704.

D. Deduction for personal exemptions

(1) Each taxpayer is allowed a personal exemption for him- or herself and spouse, and may qualify for additional exemptions for each dependent.
(2) In 2007, the amount is $3,400 for each exemption claimed.
(3) An individual who is claimed as a dependent by another cannot claim a personal exemption for him- or herself.

(4) A child cannot claim a personal exemption even if the parent does not take the dependency exemption.

E. Exemption for dependents: An individual qualifies as a dependent of the taxpayer if all of the following conditions are met:

(1) The person is related to the taxpayer or is a member of the taxpayer's household for the entire year. Certain relatives (child, grandchild, brother, sister, parent, etc.) do not have to live with the taxpayer to qualify.
(2) The person's gross income does not equal or exceed the exemption amount. This test does not apply to certain children:

(a) A child under age 19 at the end of the year
(b) A student under age 24 at the end of the year

(3) The taxpayer generally provides more than half the support to the person.
(4) The person does not file a joint return under certain conditions. Suppose, for example, you supported your daughter for the entire year while her husband was overseas on military duty. The couple files a joint return. You cannot take an exemption for your daughter.
(5) The person meets tests concerning citizenship or is a resident of the United States, Canada, or Mexico.

F. Phaseout of personal exemption (2007)

(1) The exemption amount will be reduced by 2 percent for each $2,500 ($1,250 for MFS), or fraction of that amount, by which the AGI of a taxpayer exceeds (2007):

(a) $234,600 MFJ
(b) $117,300 MFS
(c) $156,400 Single
(d) $195-500 HOH
(e) $234,600 Surviving Spouse

(2) *Example*: Taxpayers (MFJ) have an AGI of $273,500. The taxpayers have five personal and dependency exemptions. Calculate their actual personal and dependency exemption:

Step 1 Exemption amount = 5 × $3,400 = $17,000
Step 2 Difference = $300,000 (AGI) - $234,600 (threshold) = $65,400
Step 3 Divide by $2,500 = 26.16
Step 4 Round up to 27
Step 5 Multiply by 2% = 54%
Step 6 Multiply by 1/3 = 18%
Step 7 Loss disallowed due to threshold. 18% × $17,000 = $3,060
Step 8 Personal and dependency exemption after phaseout = $17,000 − $3,060 = $13,940

7. Taxable income is AGI reduced by the greater of allowable itemized deductions or the standard deduction and personal exemptions.

8. Tax liability

A. Rate schedule

(1) Under current law (2007), the tax rates are 10, 15, 25, 28, 33, and 35 percent.

B. Determine tax by using either tax tables if taxable income is under $100,000 or tax rate schedules if taxable income is $100,000 or more.
C. Tax credits such as child care, foreign tax credit, and credit for elderly must be taken into consideration in calculating total tax due. Moreover, other taxes such as self-employment tax and AMT may result in increasing total tax due.
D. Steps for calculating tax liability:

Step 1 Determine total gross income.
Step 2 Subtract deductions from gross income to find AGI.
Step 3 Determine itemized deductions to find out whether they exceed the standard deduction amount. Deduct the greater of total itemized deductions or the standard deduction.
Step 4 Subtract the total itemized deductions or the standard deduction amount.
Step 5 Determine how many personal exemptions can be claimed.
Step 6 To determine taxable income, subtract the personal exemptions from the total found in Step 4.
Step 7 Find the tax amount from either the tax tables or the tax schedules.
Step 8 Subtract tax credits, if any, from taxes determined in Step 7.

9. Kiddie tax

A. Kiddie tax rules were established to prevent the abuse of transferring income-earning property from high income tax brackets to low income tax brackets.

B. Kiddie tax rules apply to children if (in 2007)

(1) Unearned income (investment income) is above $1,700.
(2) Child is under age 18.
(3) Either parent was alive during the year.

C. For a child under age 18 by the close of the tax year, the first $850 of unearned income is not taxed, the next $850 of unearned income is taxed at the child's tax rate, and the excess of the child's unearned income is taxed at the parent's marginal rate.
D. For a child at or above age 18 by the close of the tax year, the first $850 of unearned income is not taxed, and any additional unearned income is taxed only at the child's rate. None will be taxed at the parent's rate.
E. Parents of children who are subject to the kiddie tax rule may elect to report the child's income on their own tax return (versus the child's filing a separate return). To make the election, the income must consist solely of dividends, interest, or capital gain distributions that amount to no more than $7,500.
F. Advantages of reporting the child's income on the parent's tax return:

(1) There is no need to file a separate return for the child.
(2) Parent's investment income is increased, which may allow for a greater investment interest deduction.
(3) The ceiling for charitable contributions is increased.

G. Disadvantages of reporting the child's income on the parent's tax return:

(1) Higher aggregate gross income

(a) Can accelerate phaseout of itemized deductions
(b) May reduce $25,000 rental loss allowance for active participants
(c) Deduction for IRA contributions may be phased out.
(d) May reduce or phase out several tax credits

(2) Lost deductions

(a) A child's itemized deductions are not allowed on a parent's return.
(b) The combined exemption for AMT may be reduced.

H. If the child is under 18, the kiddie tax can be avoided by transferring or investing in assets that appreciate and do not generate any taxable income until they are sold.

10. Tax credits (See topic 8 for Hope Credit and Lifetime Learning Credit)

A. Tax credits are dollar-for-dollar reductions in the actual tax paid; deductions limit only the amount of income subject to tax.

B. Child tax credit

(1) The amount of the child tax credit is $1,000 before 2010.
(2) The credit amount applies per qualifying child. A qualifying child is one who can be claimed for a dependency exemption.
(3) The credit is phased out by $50 for each $1,000, or fraction thereof, by which modified AGI exceeds the threshold amount. The phaseout begins at the following levels: MFJ = $110,000; MFS = $55,000; Single = $75,000. *Example*: MFJ taxpayers would have no child credit if their modified AGI exceeds $121,000.
(4) The credit is refundable (i.e., payable even if you have no tax liability) to the extent of 15 percent of earned income in excess of $11,300 (2006).

C. Child and dependent care credit

(1) The credit is 35 percent (2007) of expenses incurred by a taxpayer with AGI of $15,000 or less. The percentage decreases by 1 percent for each $2,000 (or fraction of that amount) of AGI over $15,000, but not below 20 percent. For taxpayers with AGI of more than $43,000, the applicable percentage is 20 percent.
(2) The maximum amount of related expenses that can be used to compute the credit is $3,000 for one qualifying child or $6,000 for two or more qualifying individuals.
(3) The maximum credit a taxpayer can obtain is $600 for one child and $1,200 for two children.
(4) To qualify for the credit, the taxpayer must furnish more than half the cost of maintaining the home and pay child and dependent care expenses in order to work or look for work.
(5) A qualifying child is someone under age 13 for whom the taxpayer is entitled a dependency deduction, or a dependent who is physically or mentally incapable of caring for him- or herself regardless of age.

D. Credit for elderly and disabled persons

(1) The credit is available to any individual who:

(a) Reaches 65 before the end of the tax year
(b) Is under 65 at the end of the tax year, but is retired with a permanent and total disability and receives disability income

(2) The credit is eliminated for joint filers with AGI of at least $25,000 (if both are over 65) or $20,000 (if one is over 65), and for a single person with AGI of $17,500 or more.

E. Earned income credit

(1) The credit is based on the percentage of earned income and is phased out if earned income exceeds a certain dollar amount.
(2) The percentage depends on whether the taxpayer has no children, one child, or more than one child.
(3) This credit is different from other credits in that it is refundable (other refundable credits are listed under “Other credits”).

F. Adoption credit

(1) There is a tax credit of up to $11,390 (in 2007) for qualifying expenses paid to adopt an eligible child, (which is indexed for inflation) in the year the adoption becomes final.
(2) If the child is not classified as a special needs child, the credit is for the amount actually spent not to exceed the limit for that year.
(3) If the child is classified as a special needs child, then regardless of what is actually spent on the adoption, the taxpayer can claim the maximum credit for that year.
(4) An eligible child is either under the age of 18 or is physically or mentally incapable of self-care.
(5) Any credit for adoption expenses disallowed can be carried forward to the next five years and used on a first-in, first-out (FIFO) basis.

G. Foreign tax credit

(1) U.S. citizens are subject to tax on their worldwide income. To avoid double taxation, a foreign credit is allowed when income is subject to both foreign and U.S. tax.
(2) Computing the credit

(a) The credit is generally the lesser of:

(i) The amount of foreign tax paid
(ii) The amount of U.S. tax that would be due on the foreign income

(b) To the extent that the credit is disallowed in the current year, it may be carried back two years and forward five years.
(c) The foreign tax credit is allowed against both regular tax and AMT, but must be re-computed for AMT purposes.

(3) Taxpayers are allowed to treat the amount of foreign taxes paid either as a deduction from income or as a refundable tax credit. The credit will generally be preferable, as it provides dollar-for-dollar tax savings.

H. Other credits

(1) Other nonrefundable credits (credits reduce tax to zero, but excess is not refunded): mortgage interest credit, credit for prior year minimum tax, and credit for electric vehicles
(2) Other refundable credits (any excess is refunded to taxpayer): credit for excess Social Security tax withheld, credit for tax on undistributed capital gain, and health insurance credit

11. Payment of tax

A. Most individuals are required to file Form 1040 by April 15 of the following year.
B. Individuals who have adopted a fiscal year must file by the 15th day of the fourth month following the close of the taxable year.

C. The law permits individuals to file an automatic six-month extension, but the individual will pay the IRS interest for the delinquent payment.
D. The required annual payment for most taxpayers is the lower of 90 percent of the tax shown on the current year's return or 100 percent of the tax shown on the prior year's return.
E. To avoid an underpayment penalty, an individual must pay 25 percent of a "required annual payment" by April 15, June 15, September 15, and January 15.
F. There is no underpayment penalty if the tax shown on the return is less than $1,000.

12. Withholding requirements

A. Withholding requirements are amounts withheld from employer paychecks throughout the year.
B. Employers must withhold income tax from wages paid to employees but not from amounts paid to independent contractors. Employees are entitled to additional withholding exemptions or allowances.

13. Estimated payment

A. Estimated payments are amounts paid throughout the year by self-employed taxpayers or those taxpayers owing taxes in the prior years. Tax law does not permit a taxpayer to wait until the date for filing returns to pay all taxes.
B. Estimated tax is due the middle of April, June, September, and January.
C. Corporations have estimated payments of 100 percent of the past year's tax or 100 percent of the current year's tax. If taxable income is above $1 million, the corporation cannot use last year's tax.
D. Estimated payments are made on a payment voucher Form 1040-ES or by phone using a credit card and calling 1-800-2PAY-TAX or 1-800-ALL-TAXX.

TOPIC 47: TAX ACCOUNTING METHODS

1. Accounting periods

A. The annual time period over which a taxpayer calculates tax liability
B. Taxpayers file on a calendar-year basis.
C. The tax year can be changed only with permission of the IRS.

2. Accounting methods

A. Cash receipts and disbursements method

(1) Recognize income when received; recognize expenses when paid.
(2) Include all items of income constructively received; deduct all bills paid.
(3) Expenses paid in advance are deducted when they apply.
(4) Use with service-oriented businesses and businesses with little or no inventory.

B. Accrual method

(1) Recognize income when earned; recognize expenses when incurred.
(2) Match income and expenses in the correct year.
(3) Items of income are included when they are earned, even though payment may be received in another tax year.
(4) All events that fix the individual's right to receive the income must have happened, and the individual must be able to figure the amount with reasonable accuracy.
(5) Only the accrual method may be used for purchase and sales of inventory.

C. Hybrid method
D. Any combination of the cash method and the accrual method may be used if the combination clearly shows income.
E. Applies to businesses with both service and inventory

3. Change in accounting method

A. Once a business entity or individual has adopted an accounting method or accounting period, a change in the method or period requires permission of the IRS even if the original method was incorrect. Such corrections cannot be made by filing an amended tax return.
B. Changes in method include going from cash basis to accrual basis or from one inventory valuation method to another (i.e., FIFO, LIFO [last-in, first-out]).

4. Long-term contracts: Building, installation, construction, or manufacturing contracts that are not completed in the tax year in which they are entered into (i.e., manufacturing contract, machinery contract)

5. Installment sales

A. Installment sale treatment occurs when payments are received in a year other than the year of sale.
B. Each payment usually consists of three parts: (1) interest, (2) gain on sale, and (3) recovery of basis.
C. Interest must be charged at a rate at least equal to the IRS minimum. The amount of interest is subtracted from the total of payments made, and the remainder is split between gain on sale and recovery of basis.
D. The following sales are not reported under the installment method:

(1) Sale resulting in loss
(2) Sale of inventory in the ordinary course of a trade or business
(3) Sale by a dealer of personal or real property, except for certain farm or time-share dispositions
(4) Publicly traded stocks or bonds
(5) Sale of a personal residence when the gain has been excluded under $250,000/$500,000 limits
(6) Portion of a sale resulting in ordinary income due to depreciation recapture
(7) Sale of depreciable property to a related person
(8) Sale when the gain has been deferred under the like-kind exchange rules
(9) Sale in which the taxpayer has elected not to use the installment method

E. A taxpayer would want to elect out of installment treatment for the following reasons:

(1) Taxpayer has a net operating loss (NOL) carryforward.
(2) Taxpayer has a long-term capital loss carryforward.
(3) Taxpayer has a large amount of suspended investment interest expense and can make an election to have the capital gain on the installment sale treated as investment income.
(4) Taxpayer has tax credits available.

F. Reasons for doing an installment sale:

(1) It defers tax.

(a) Higher principal earns more interest.
(b) Client may be in a lower tax bracket in the future.

(2) The note should carry higher interest rates than a bank.
(3) It makes the property easier to sell.
(4) Seller is willing to bear the risk of repossession in order to earn a higher profit.
(5) Reselling the note gives the seller greater liquidity.
(6) It may be the only way to sell closely held stock.
(7) It may prevent Social Security benefits from becoming taxable.

G. Get a large down payment to minimize potential foreclosure when selling on the installment basis.
H. A taxpayer may elect to report the entire gain in the year of sale even though the payments will be made in installments.
I. The seller must recognize a portion of the profit each year.

(1) The gross profit percentage is determined in the year the installment sale is made to determine how much of each payment is profit.
Gross profit percentage = Gross profit ÷ Contract price
(2) The contract price includes the total of all principal payments to be made by the buyer over the term of the installment sale.

J. Ordinary income recapture

(1) If property is subject to depreciation recapture, recaptured income must be fully reported by taxpayer in year of disposition as ordinary income.
(2) Recaptured income must be added back to adjusted basis before calculating gross profit percentage.

K. *Exception:* Related party rule: If sale occurs to family member who in turn sells the purchased property within two years, the original seller must recognize all gain deferred by installment sale.

6. Inventory Valuation and Flow Methods

A. Net operating losses (NOL)

(1) An NOL is the excess of business deductions over gross income in a particular tax year. An NOL deduction is allowed as a carryback or carryover to other tax years where gross income exceeded business deductions.
(2) NOL deduction is allowed for individuals, corporations, estates, and trusts; NOL deduction is not allowed for partnerships and S Corporations.
(3) NOL can be carried back two years and forward 20 years. A decedent's NOL can be carried back, but not forward. Farming losses can be carried back five years.
(4) Note: Do not confuse NOL with NCL (net capital losses), which a corporation can carry back three years and carry forward five years to offset capital gains. An individual can carry forward NCL indefinitely (see topic 53 for more details).

TOPIC 48: CHARACTERISTICS AND INCOME TAXATION OF BUSINESS ENTITIES

1. Entity types

A. Sole proprietorships
B. Partnerships
C. Limited liability company

D. Corporations
E. Trusts
F. Associations

2. Taxation at entity level

A. Formation

(1) Only corporations pay income tax at the entity level.

(a) Corporations report taxable income on Form 1120.
(b) Corporations are not subject to the passive activity loss rules.
(c) Taxable income paid and net income reported on financial statements are usually not the same.
(d) Corporations generally have tax rates that are more favorable than individual rates.

B. Dividends received deduction: If a corporation receives dividends from another corporation, it is entitled to a deduction.

(1) If recipient corporation owns less than 20 percent of the stock of the paying corporation, the deduction is 70 percent of dividends received.
(2) If recipient corporation owns 20 percent but less than 80 of the stock of the paying corporation, the deduction is 80 percent of dividends received.
(3) If recipient corporation owns 80 percent or more of the stock of the paying corporation, the deduction is 100 percent of dividends received.

C. The 2003 Tax Act reduced the double taxation of corporate earnings. It taxes dividends at the same rate as the maximum 15% capital gains tax for high income taxpayers and at 5% for taxpayers in the 10% and 15% tax brackets.
D. Net operating losses can be carried back only 2 years or forward 20 years to offset other corporate income. They are not passed through to shareholders.
E. Capital gains and losses recognized by corporations are taxed at the same rate as ordinary income and are not subject to the reduced capital gains rate. Deductions for capital losses can offset capital gains only, and no amount can be used to offset ordinary income. Net capital losses can be carried back three years and forward five years to offset capital gains.
F. Tax-advantaged employee benefits for corporations

(1) Nontaxable to employee and immediately deductible by corporation

(a) Premium for group term insurance less than $50,000
(b) Travel and entertainment
(c) Health and accident insurance
(d) Meals and lodging for convenience of employee

(2) Tax-deferred to employee and immediately deductible by corporation: qualified pension and profit-sharing plans
(3) Immediately taxable to employee and immediately deductible by corporation

(a) Group term insurance greater than $50,000
(b) Additional cash salary
(c) Group legal services

3. Flow through of income and losses to corporations

A. Getting cash out of the corporation

(1) Shareholders serve as corporate executives, therefore, receiving salary that is taxed only once at the individual level, while providing a tax deduction for the corporation.
(2) Shareholders serve as creditors.
   (a) By lending money to a corporation; the interest paid to the shareholder becomes a deductible expense for the corporation.
   (b) By leasing property to the corporation, the shareholders receive rent payments that are deductible expenses for the corporation.
(3) Dividends are paid with after-tax dollars (double taxation), but salaries, interest, and rent are paid with before-tax dollars.

B. Constructive dividend: a distribution by a corporation to a shareholder that the corporation classifies as salary, interest, rent, or some other type of payment but that the IRS classifies as a dividend

C. Using closely held corporations as a tax shelter

(1) Corporations generally offer lower tax rates than the high individual tax rates.
(2) Corporations avoid double taxation by accumulating earnings, thus increasing the value of the stock. The unrealized appreciation of stock is not taxable.
(3) When the stock is sold or liquidated at some future time, corporations recognize a taxable gain while indirectly paying a second tax on the accumulated earnings. This strategy reduces the present value of the second tax.
(4) Three factors create tax savings:
   (a) Spread between the corporate and individual tax rates
   (b) Deferral of tax payments
   (c) Conversion of ordinary income (dividend payments) to capital gain income

4. Flow through of income and losses to partnerships and S Corporations

A. Tax basis

(1) A partner's initial basis equals initial investment of cash or property plus the share of partnership debt for which the partner may ultimately be held responsible. Suppose, for example, three individuals each deposit $10,000 into a partnership in which they are equal general partners. The partnership borrows $15,000 from a bank to buy supplies and equipment. Each partner's basis is $15,000: the initial cash contributions plus a proportionate share of the partnership debt.
(2) A shareholder's initial basis in stock of an S Corporation equals the cash plus the adjusted basis of any property transferred in exchange for the stock. No debt is included in the shareholder's stock basis because there is no personal liability in S Corporations. However, a shareholder can have a separate basis in a debt obligation.

B. Reporting requirements: Partnerships and S Corporations are not taxable entities. Taxable income is measured and characterized at the entity level and taxed directly to the partners or shareholders.

C. Tax consequences to partners

(1) Each partner receives a Schedule K-1 that details information about the partner's distributive share of the partnership's income or loss from business items and separately stated items, such as dividend income, capital gains, and charitable donations.

(2) The cash flow from the business is irrelevant to the computation of the partner's tax liability. Thus, the partner is taxed on his or her distributive share of the partnership income whether or not the amount is actually distributed.
(3) General partners are required to pay self-employment (SE) tax on their distributive share of ordinary business income. Limited partners are not considered self-employed and are not required to pay SE tax on their distributive share of ordinary income.

D. Tax consequences to shareholders of an S Corporation

(1) Shareholders receive a Schedule K-1 (same as partnerships) to incorporate into their individual tax returns.
(2) The cash flow from the S Corporation is irrelevant to the computation of the shareholder's tax liability.
(3) Shareholders can also be employees of the corporation. The employee and corporation pay Federal Insurance Contributions Act (FICA) payroll taxes, and the corporation withholds federal income tax. The corporation issues a W-2 form to any shareholder/employee along with a K-1. Shareholders are not subject to SE tax.

E. Adjusting the basis in a partnership

(1) The basis in a partnership increases by ordinary business income, capital gains, and dividend income and decreases from ordinary business loss, capital loss, and cash distributions.
(2) If a partner is allocated income (taxable) but receives no cash distribution from that income, the partner is making an additional investment in the partnership. The cash distribution in future years is considered a nontaxable return on investment. Thus, cash distributions are generally nontaxable for pass-through entities.
(3) Partners may deduct their distributive share of partnership losses for the year. However, this results in a reduction of their cost basis in the partnership interest.
(4) The basis cannot be reduced below zero. If a partner's share of loss exceeds the basis, the excess cannot be deducted in the current year. It can be carried forward to future years, but the basis must be restored in order to deduct the carryforward.

F. Adjusting the basis of S Corporation stock

(1) Shareholders increase the basis of stock by their share of the corporation's income and gain; they decrease the basis of stock by their share of the corporation's losses.
(2) The cash distribution is considered a nontaxable return of investment that reduces their stock basis. Thus, cash distributions are generally nontaxable for pass-through entities.
(3) Losses are deductible to the extent of the owner's equity investment and debt obligation.
(4) In both cases, the basis cannot be reduced below zero. For example, Steve has a basis in stock of $90,000 and a basis in debt of $30,000. Therefore, Steve has an equity investment and an investment as a corporate creditor. If the corporation passes through a loss of $150,000 to Steve (reflected on his K-1), the most that can be deducted is $120,000 on his Form 1040. The $30,000 nondeductible loss is carried forward.

G. Maximizing tax benefits of start-up firms: Losses immediately pass through to partners or shareholders. For a C Corporation, losses may be trapped at the entity level as loss carry-forwards.
H. Partnerships offer the ability to shift income to family members.

(1) By dividing income among a number of family members, the total tax burden may shrink to the extent that the division causes income to be taxed at a lower tax bracket.
(2) Family partnerships are common for shifting income, but the IRS closely restricts their use as income-shifting devices.

5. Special taxes at entity level for flow-through entities

A. Built-in gains tax

(1) When one corporation is acquired by another, there are limits in the extent to which the built-in gains of one corporation (gain corporation) can be used to offset the preacquisition losses of the other corporation. If either corporation is a gain corporation, then any income attributable to built-in gains within five years of the acquisition date cannot be offset by the preacquisition loss of another corporation.
(2) This rule does not apply if there was a control relationship within a five-year period from the acquisition date.

B. LIFO recapture

(1) The LIFO recapture amount is excess FIFO inventory over that of LIFO.

C. A C Corporation must include the LIFO recapture amount in its income when it converts to an S Corporation.

(1) The tax calculated on the LIFO recapture is paid in four equal installments over four tax years.

D. Excess net passive income tax

(1) An S Corporation that was originally a C Corporation will owe excess net passive income tax if passive income is greater than 25 percent of all gross income. The tax is imposed at 35 percent of the excess net passive income.
(2) The tax makes an S Corporation with undistributed C Corporation earnings undesirable for holding rental properties or other income-generating assets.

E. Personal holding company

(1) This is a corporation in which 50 percent of more of the value of the outstanding stock is owned by five or fewer individuals and which creates most of its income from investment or passive activities, such as dividends, interest, rents, and royalties.
(2) The tax equals 35 percent (in 2007) of undistributed corporate earnings.

F. Personal service corporation

(1) Corporations performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, the performing arts, or consulting
(2) Subject to a flat tax rate of 35 percent and passive loss limitations

G. Accumulated earnings tax

(1) The tax advantage of corporate tax rates on earnings accumulated by the corporation is limited somewhat by the accumulated earnings tax.
(2) The accumulated earnings tax is a penalty tax designed to prevent tax avoidance through the accumulation of earnings within the corporation beyond expected needs of the business.

(3) A corporation can accumulate up to a minimum credit of $250,000 of earnings and profits without encountering any problem with the accumulated earnings tax; beyond this amount, it must demonstrate to the IRS that the accumulation is for reasonable needs of the business.
(4) If the corporation cannot demonstrate this need, the IRS imposes the accumulated earnings tax at a rate of 35 percent (in 2007) on all accumulated taxable income.

6. Use of losses

A. As mentioned earlier, a partner and a shareholder are allowed to deduct losses that are passed through against income from other sources.
B. The basis cannot be reduced below zero. If a partner's or shareholder's share of loss exceeds the basis, the excess cannot be deducted in the current year. It can be carried forward to future years, but the basis must be restored in order to deduct the carryforward.

TOPIC 49: INCOME TAXATION OF TRUSTS AND ESTATES

1. General issues

A. Filing requirements

(1) A trustee must file Form 1041 if the trust is not tax-exempt and if

(a) The trust has any taxable income for the year,
(b) The trust has gross income of $600 or more, or
(c) Any beneficiary is a nonresident alien

(2) The executor or administrator must file Form 1041 for a domestic estate that has

(a) Gross income of $600 or more, or
(b) Any beneficiary who is a nonresident alien

(3) Trusts and estates are required to file a tax return in each calendar year that it has taxable income. Trusts and estates use Form 1041 to report income and distributions.

B. Taxable income distributed to beneficiaries is passed through on a Schedule K-1. The trust pays tax on undistributed income.
C. Deadlines—For calendar-year estates and trusts, file Form 1041 and Schedule K-1 on or before April 15. For fiscal-year estates and trusts, file by the 15th day of the fourth month following the close of the tax year. An automatic extension of three months is available.
D. Choice of taxable year

(1) Trusts must use a calendar year unless they are tax-exempt, charitable, or grantor trusts.

E. Estates can use either a calendar or fiscal year.

(1) The time allowed for selection of a calendar year for an estate cannot extend beyond 12 months after the decedent's death.

F. Tax treatment of distributions to beneficiaries

(1) The beneficiary, not the trust or decedent's estate, pays income tax on his or her distributive share of income. Schedule K-1 (Form 1041) is used to notify beneficiaries of amounts to be included on their income tax returns. The distributed income maintains the same form it had in the trust or estate. Income is taxed to the trust or estate if it is retained.

(2) The composition of distributable net income (DNI) (discussed later) determines the type of income distributed and taxed to beneficiaries. If 75 percent of DNI is taxable income and 25 percent is tax-exempt interest, then 75 percent of DNI allocated to beneficiaries is taxable income and 25 percent is tax-exempt.

(3) Schedule K-1 reports the amounts taxable to beneficiaries.

2. Rate structure: Trusts and estates compute their tax under a separate, unfavorable tax rate schedule that has five brackets and quickly reaches the top marginal rate.

3. Grantor trusts: A trust grantor or another person with significant control over a trust and its property may be taxed on its income as the owner of the trust. A grantor trust is not treated as a separate trust for tax purposes, and income from the trust is taxed to the grantor.

4. Simple trusts

A. These trusts are required to distribute all of their trust accounting income to beneficiaries.

B. They have a standard deduction of zero and are allowed deductions similar to those of individuals, except that the personal exemption amount is only $300.

C. No distributions are allowed for charitable purposes.

5. Complex trust: A trust that does not meet the definition of a simple trust is a complex trust.

A. Such trusts can accumulate income, make charitable contributions, and distribute principal to beneficiaries. They have a standard deduction of zero and are allowed the same deductions as simple trusts, except that the personal exemption amount is only $100.

6. Revocable/irrevocable trusts

7. Trust income

A. Trust accounting income: This income includes interest, dividends, rents, royalties, and other items. Capital gains may also be included in the income of the trust if allowed by state law. Accounting income does not include DNI.

B. Trust taxable income

(1) The taxable income of a trust is calculated in the same manner as that of an individual unless indicated otherwise. A trust's taxable income equals accounting income less any deduction, which is limited to DNI.

(2) Interest that is tax-exempt to an individual is also tax-exempt to a trust. Capital gain and capital loss rules that apply to individuals also apply to estates and trusts. The rules that apply to reporting ordinary gains and losses for an individual also apply to trusts and estates.

(3) Trusts and estates are subject to the passive activity loss rules and the at-risk rules. If an owner of rental property actively participates in the management of the rental property, he or she can offset against other income up to $25,000 of net losses. The offset is phased out when modified AGI exceeds $100,000 and eliminated at $150,000. A trust is not allowed to use the offset. An estate is allowed to use the offset for taxable years ending within two years of the decedent's death.

(4) The rules for individual taxpayers claiming a deduction generally carry over to estates and trusts.

C. Distributable net income (DNI)

(1) The trust or estate receives a deduction based on the taxable income distributed to the beneficiaries during the year. The deductible amount is computed on Schedule B,

Form 1041. The income distribution deduction allowed by estates and trusts for funds distributed to beneficiaries is limited to DNI.

(2) Any type of income that includes DNI determines the taxability of the distribution, not the type of property received as distribution.

(3) Any amount distributed that is greater than the DNI is considered undistributed net income (UNI) or corpus. This excess amount receives no current deduction. If distributions are less than DNI, only the amount distributed can be deducted.

8. Estate income tax

A. Estate income tax is calculated as follows:

Step 1 Determine adjusted total income.
Step 2 Determine DNI.
Step 3 Subtract DNI from adjusted total income.
Step 4 The amount remaining is subject to tax at the estate or trust level.

B. In calculating taxable income, an estate may use a personal exemption of $600. If a trust (simple) must distribute all of its trust accounting income immediately, it is allowed a $300 exemption. All other trusts (complex) are allowed a $100 exemption.

TOPIC 50: BASIS

1. Original basis

A. The calculation of any assets depends on how the asset was acquired by the owner. Original basis can be summarized as follows:

(1) Gifts: FMV for losses or the donor's basis for gains (double basis rule)
(2) Inherited assets: Fair market value on date of death
(3) Assumption of debt: Buyer includes any debt assumed in the purchase price in his original basis.

B. Adjusted basis: The property's original basis adjusted to the date of disposition equals cost plus capital additions minus capital recoveries.

2. Amortization and accretion

A. Basis of property received by gift and in nontaxable transactions

(1) Adjusted basis of purchased property

(a) Purchase price plus acquisition costs (if any) plus improvements
(b) Factors that would reduce adjusted basis include depreciation (cost recovery deduction), Section 179 expense deduction, and return of capital.
(c) Acquisition cost includes freight, setup and installation, legal and professional fees associated with the purchase, settlement and recording fees, closing costs, and commissions.

(2) Adjusted basis if property acquired through an inheritance: Basis equals FMV on date of death or alternative valuation date (six months from date of death), if elected. Also referred to as "stepped-up basis."
(3) Adjusted basis of gifting: Basis cannot be determined until sale occurs.

(a) Sales price exceeds both donor's cost and FMV on date of gift; basis equals donor's cost.
(b) Sales price is less than both donor's cost and FMV on date of gift; basis equals the item that would result in smallest loss.
(c) Sales price is between donor's cost and FMV on date of gift; basis equals sales price (no gain or loss).

(4) Adjusting basis if gift taxes are paid: This applies only if the FMV of the property at the date of disposition exceeds the donor's adjusted basis. This allows the donee to calculate a new gain basis using:

$$\text{Donor's adjusted basis} + \frac{\text{Unrealized appreciation}}{\text{FMV}} \times \text{Gift tax paid}$$

Example: Mike gave Martha stock with an FMV of $50,000 and paid gift tax of $11,000.
Mike originally acquired the stock for $15,000. What is Martha's basis in the stock?

Answer: $\$15{,}000 + \frac{\$35{,}000}{\$50{,}000} \times \$11{,}000 = \$22{,}700$ basis

(5) Holding period for gifts

(a) For gain basis. The holding period starts on the date the donor acquired the property.
(b) For loss basis. The holding period starts on the date of the gift.

B. Basis of inherited property (community and noncommunity property)

(1) Assets included in a taxable estate of a decedent receive a stepped-up basis. The receivers of the bequests receive a basis in those assets equal to the fair market value at date of the decedent's death or, alternately, six months after the death. The step-up in basis is available only for those assets in the taxable estate. If assets are kept out of the estate, such as gifts, they will not enjoy the step-up in basis.
(2) Community property states provide a decided advantage over common law states in regard to basis adjustments at death.
(3) Couples residing in community property states should hold appreciated property as community property. On the other hand, if property has decreased in value, community property will receive a full step-down in basis at the first death and some other form of title may be preferred.
(4) Common law states have a step-up basis for half of the assets; a step-up in basis for the decedent's share of ownership but not for the survivor's share.
(5) Community property states have a full step-up in basis. For tax purposes at death, the new cost basis is the FMV at the date of death for both halves of the community property, even though only one-half is included in the decedent spouse's estate.
(6) Property owned solely by a decedent generally receives a full step-up basis for the person who acquires it.

Example: Bart owned stock in XYZ, which he purchased for $1,000 in 1935, until his death in 2007, when it passed on to his son John. At Bart's death, the stock was worth $250,000. John kept the stock for six months and sold it for $270,000. John has a realized long-term capital gain of $20,000 between the sale price and the date-of-death

value (because it was acquired from the decedent, the holding period for the property is automatically considered long term).

(7) For joint tenancy with right of survivorship, two rules are followed in deciding what is included in a decedent's estate and the surviving owner's new basis.

(a) Husband and wife rule: Where the only joint tenants are husband and wife, half of the FMV at the date of death is included in the decedent's estate and the surviving spouse's new basis will equal half the total predeath basis and half the FMV at the date of death.
(b) Consideration furnished rule: Where joint tenants include nonspouses, the decedent's gross estate includes that proportion of the property as the decedent's share of the consideration bears to the total consideration. The new basis for each surviving co-owner's interest is his or her old basis plus an increase by the amount included in the decedent's estate split equally among the surviving joint tenants.

(8) For tenancy in common, the surviving spouse's cost basis at death is the amount included in the deceased spouse's estate. If left to a co-owner, the new basis is his or her old basis plus an increase by the amount included in the decedent's estate.

Example: Lyle, Joel, and Dan purchased property as tenants in common. Of the $100,000 purchase price, Lyle paid $50,000 and took a 50 percent interest, Joel paid $30,000 and took a 30 percent interest, and Dan paid $20,000 and took a 20 percent interest. Years later when Joel died, the property was worth $250,000 and his estate included $75,000 because he owned a 30 percent interest. If Joel left his interest to his widow, Betty, her basis would be $75,000. If he instead left his interest to co-owner Dan, Dan's total basis in the 50 percent interest he would then own would be $95,000 ($75,000 plus his $20,000 contribution).

TOPIC 51: DEPRECIATION/COST RECOVERY CONCEPTS

1. **Definition of depreciable property**

   A. Property used in a trade or business or held to produce income
   B. Property must lose its value over time.
   C. Property must have a determinable life of greater than one year.

2. **What cannot be depreciated**

   A. Property placed in service and disposed of in the same year
   B. Land
   C. Inventory
   D. Equipment used to build capital improvements

3. **Modified accelerated cost recovery system (MACRS)**

   A. Depreciation rules that apply to assets placed in service between 1981 and 1986 are often referred to as the "accelerated cost recovery system" (ACRS). Assets that are placed in service after 1986 fall under a modified cost recovery system, which is called the "modified accelerated cost recovery system" (MACRS).
   B. ACRS generally provided faster recovery than MACRS, but only certain property placed in service under ACRS is still in service for tax purposes.

C. The term *accelerated* means any cost recovery method that provides a higher deduction in the earlier years of the asset's recovery period than would have been provided in a straight-line recovery method.
D. The estimated useful life of an asset is irrelevant in the computation of tax depreciation with MACRS. This often results in different numbers relative to what a firm reports as taxable income and what it reports as tax expense on its financial statements.
E. MACRS is used for most tangible assets in a business or in the production of income after 1986. Eight cost recovery periods are used for property: 3, 5, 7, 10, 15, 20, 27 ½, and 39 years. The most important recovery periods to know are those for computer software, at 3 years; cars and computer hardware, at 5 years; office furniture and fixtures, at 7 years; residential real estate, at 27 ½ years; and nonresidential rental property, at 39 years.
F. Assets with a 3-, 5-, 7-, or 10-year recovery period are depreciated using a 200 percent declining-balance method. Assets with a 15-year or 20-year recovery period are depreciated using a 150 percent declining-balance method. The depreciation method switches to straight-line when a straight-line computation over the remaining recovery period results in a greater reduction. There is no salvage value below 200 percent and 150 percent declining-balance. For property with a life of 27 ½ or 39 years, straight-line depreciation must be used. MACRS is an accelerated cost recovery system in name only for these assets.
G. Cost basis

(1) Depreciation allows for the recovery of the cost of assets purchased for use in a trade or business.

(a) Reduces the cost basis of an asset, thus increasing future gains
(b) Reduces current income by providing a deduction in calculating net income for a business

(2) *Example*: Rental property cost $50,000, sold for $90,000, and had $15,000 in depreciation. The amount of gain is

Step 1 Adjusted basis = Basis ($50,000) − Depreciation ($15,000)
Step 2 Gain = Proceeds ($90,000) − Adjusted basis ($35,000) = $55,000

(3) Allowed or allowable rule: Even if depreciation was not deducted on the taxpayer's return, the basis must be reduced by the depreciation that was allowable for that year.

H. Half-year convention

(1) The half-year convention means that in the first year of the recovery period, six months of depreciation is allowed regardless of when the asset was purchased. The firm later claims six months of depreciation in the year in which the asset is disposed of.
(2) This applies to all assets with a recovery period of 3 to 20 years.
(3) Exception: If more than 40 percent of the depreciable assets acquired during a taxable year are placed in service during the last three months of the year, the firm must use the midquarter convention.

I. Midquarter convention

(1) If the midquarter convention is used, then it must be used for all assets (recovery period of 3 to 20 years) placed in service during the year.
(2) Assets placed in service or disposed of in any quarter are assumed to be placed in service, or disposed of, at the midpoint of the quarter.

4. Repairs

A. When a cost incurred in regard to an asset will lengthen its useful life or increase its market value, the cost is considered a betterment and must be added to the cost of the asset and depreciated over the life of the associated asset.
B. If the cost is incurred only to bring the asset back to its normal use, then it will be considered a repair and can be expensed to reduce current income.

5. Special elections (Section 179 deduction)

A. A special election is an election to deduct all or part of the cost of certain qualifying property in the year it is placed in service, instead of taking depreciation deductions over a specified recovery period.
B. Taking the deduction on Form 4562 makes the election. Election can be revoked only with IRS consent.

C. Limitations

(1) The aggregate cost that may be taken into account for any taxable year cannot exceed the following applicable amount: $112,000 (2007) except for light trucks or trucks that weigh over 6,000 pounds. Those vehicles are capped at $25,000 in a given year.
(2) The applicable maximum deduction for any year is reduced (but not below zero) by the amount of qualifying property placed in service during the tax year that exceeds $450,000 (for 2007 and beyond).
(3) The total cost that can be deducted is limited to taxable income from the active conduct of any trade or business during the tax year. No loss can be created or increased by Section 179. The limit applies at both the business entity level and the individual level.
(4) If a deduction is fully used for the year, amounts above the limit can be considered for depreciation.

D. Property that qualifies

(1) Certain tangible property (except most buildings and their structural components), including "luxury" vehicles having a gross weight of more than 6,000 pounds.
(2) Leased property usually does not qualify, with exceptions for:

(a) Property manufactured or produced by the lessor
(b) Certain property that is subject to a short-term lease

E. Section 179 is not permitted if business use is 50 percent or less.
F. Section 179 recapture is required if business use drops to 50 percent or less.
G. For partnerships and S Corporations, the Section 179 deduction passes through to the owners but is limited by the Section 179 dollar limitation regardless of how many businesses the individual owns.

6. Amortization

A. Amortization is used for intangible assets that have a definite life—for example, a patent or copyright.
B. There is a 15-year amortization for intangibles beginning in the month of acquisition.
C. Certain intangibles are specifically excluded:

(1) Interests in corporations, partnerships, trusts, and estates
(2) Interests in land

(3) Computer software not acquired in connection with the purchase of a business or which is readily available to the general public
(4) Sports franchises
(5) Professional fees and transportation costs incurred in a corporate organization or reorganization

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TOPIC 52: TAX CONSEQUENCES OF LIKE-KIND EXCHANGES

1. **Reporting requirements**

A. Form 8824 is used for like-kind exchanges. It must be filed in the current year of exchange and for two years following the year of a related party exchange.
B. Property received must be identified within 45 days after the date on which the property is transferred, and received within 180 days after the date on which the old property is transferred, but not later than the due date of the tax return (including extensions) for the year that the old property is transferred.

2. **Qualifying transaction**

A. Only the disposition and receipt of qualifying property can result in a nontaxable exchange.
B. No gain or loss is recognized on the exchange of property

(1) Used in a trade or business
(2) Held for investment
(3) The following guidelines are also considered when (1) and (2) apply:

(a) Such property must be exchanged solely for property used in a trade or business or held for investment.
(b) The taxpayer's intent is important in determining if property is held for investment or trade or business.
(c) The length of time the new property is used for investment or trade or business is important.
(d) *Example*: Steve exchanges his apartment building in Denver for a condo in Vail that he rents out. Five months after the exchange, he moves into the condo with the intention to live there for two years. At that time, he plans to sell the condo for a nontaxable gain under tax laws for a residence ($250,000/$500,000 limitations). The IRS would argue that he never intended to use the condo as rental property.

C. Gain may be recognized when cash or unlike property is received in addition to like-kind property. The gain is the lesser of

(1) FMV of boot (nonqualifying property or cash) received
(2) The gain realized

D. Treatment of losses

(1) No loss is recognized when a taxpayer

(a) Receives unlike property in the exchange of property
(b) Receives cash in the exchange

(2) If the taxpayer conveys unlike property in an exchange transaction, loss is recognized to the extent that the adjusted basis of unlike property (other than cash) exceeds fair market value.

(3) Always increases cost basis for realized but not unrecognized losses.

E. The sale of property for cash followed by the purchase of another property does not qualify as a like-kind exchange. For example, if clients sell their property, put the money in a separate bank account, and later use it for a deposit on a new property, the transaction is not a like-kind exchange.
F. Like-kind exchanges are determined separately for buyer and seller. It is possible for only one of them to treat the property as a like-kind exchange.
G. If a property is used for both business and personal use, then an allocation of respective values must be made.
H. Property excluded from the definition of like-kind exchanges (if any of this property is received, it is treated as boot):

(1) Stocks, bonds, and notes
(2) Inventory property used for business
(3) Partnership interests (a limited partnership interest can be exchanged for a general partnership in the same partnership)
(4) Certificates of trust of beneficial interests
(5) Foreign real estate
(6) Contractual rights
(7) Livestock of different sexes (swap a bull for a breeding heifer)

I. Real estate treatment in like-kind exchanges

(1) Like-kind refers to the character of property, not to its quality. The following are considered like-kind exchanges:

(a) City real estate for a ranch or farm
(b) Improved real estate for unimproved real estate
(c) Office building for a hotel or for developed or underdeveloped land

(2) Intangible property qualifies for Section 1031 treatment if sold for like-kind property. If the nature of the rights are the same as the character of the underlying property, it is like-kind.

(a) A like-kind transaction is an exchange of a copyright on a book for a copyright on another book. It is not the exchange of a copyright on a book for copyright on a song.
(b) Goodwill does not qualify for a like-kind exchange.

(3) Depreciable tangible personal property must be in the same asset or product class. For example, the exchange does not qualify for Section 1031 if a half-ton truck is traded for a two-ton truck.

3. Multiple properties

A. The exchange is considered one of multiple properties if the transferred properties are separable into more than one exchange group. An exchange group consists of all properties transferred and received within an exchange that are of the same asset class or product class.
B. *Example*: An exchange of a boat for a boat and trailer creates two exchange groups. Each exchange group must transfer and receive at least one property.
C. Typical three-cornered exchange involves three parties and qualifies for Section 1031 treatment:

(1) Buyer: Wants to purchase property
(2) Trader: Wants to sell property, but only for other like-kind property, to avoid taxes

(3) Seller: Wants to sell property, but owns no new property
(4) Buyer wants Trader's property, and Trader wants Seller's property. Seller wants to sell.

(a) The property given up is not converted into cash.
(b) Intent of trade is established—wording must be included in the escrow instructions for Section 1031 exchange.

D. The purchase, sale, and exchange are usually simultaneous, but this is not required. When property is sold at different times, the exchange period begins on the date of the first exchange. In a delayed exchange, the replacement property must be designated within 45 days of closing escrow on the relinquished property and close within 180 days.
E. Exchange of one business for another generally does not qualify for Section 1031 treatment, because the assets of one business cannot be grouped together and treated as one asset.

4. **Liabilities:** When a taxpayer gives up property that is subject to a liability, and the transferee assumes the liability, then the taxpayer is treated as having received cash in the transaction equal to the amount of the liability being transferred. If the taxpayer has liability that is assumed, and in turn assumes a liability on the replacement property, the liabilities are netted together to calculate the cash received or paid.

5. **Boot**

A. Characteristics

(1) All property other than like-kind (nonqualifying property)
(2) Cash

B. Exchange of mortgage properties

(1) Relief of debt is boot received whether loan or mortgage (treated as cash received).
(2) Assumption of debt is boot given (treated as cash paid).

Example: ABC and XYZ exchange property A and property B as follows:
Property A—XYZ FMV = $670,000, debt = $175,000, basis = $200,000
Property B—ABC FMV = $495,000, debt = $0, basis = $415,000)

Exhibit 5.1 Tax Consequences of Exchange

	ABC	XYZ
Amount realized:		
Value of realty acquired	$495,000	$670,000
Boot received (debt relief)	175,000	0
	$670,000	$670,000
Basis of property surrendered:		
Realty	($200,000)	(415,000)
Boot paid (debt assumed)	0	(175,000)
Gain realized	$470,000	$80,000
Gain recognized*	$175,000	$0
Gain deferred	295,000	80,000
	$470,000	$80,000

*Lesser of FMV of boot received or gain realized

C. Basis of assets received

(1) Reduced by

(a) Cash (boot) received
(b) Loss recognized
(c) Liabilities conveyed

(2) Increased by

(a) Cash (boot) paid
(b) Gain recognized
(c) Liabilities assumed

Exhibit 5.2 Basis Computation

	ABC	XYZ
Basis of realty surrendered	$200,000	$415,000
Boot paid	0	175,000
Gain recognized	175,000	0
Boot received	(175,000)	0
Basis of realty acquired	$200,000	$590,000

D. If both parties are subject to a mortgage, only the net amount of debt is considered boot given and boot received.

Example: ABC and XYZ enter into a like-kind exchange. The property surrendered by ABC is subject to a $125,000 mortgage; property surrendered by XYZ is subject to a $100,000 mortgage. ABC has boot of $25,000 from the exchange (debt relief). XYZ paid $25,000 of boot in the exchange (debt assumption). ABC must recognize $25,000 of realized gains, whereas XYZ has a tax-free exchange.

E. There is net cash boot when cash is both given and received.

F. An offset is allowed where a taxpayer is relieved of debt (boot received) and pays cash or other boot. For example, ABC transfers property subject to a $50,000 debt and $30,000 of cash in exchange for property with no debt. The net boot received is $20,000 [$50,000 debt relief/boot received minus $30,000 cash paid (boot given)].

G. No offset is allowed where a taxpayer assumes debt (boot given) and receives cash or other boot. For example, ABC transfers property with no debt for property subject to a $50,000 mortgage (debt assumption) and $35,000 of cash. ABC has $35,000 in boot because netting is not allowed, even though ABC gave $50,000 in boot and received only $35,000 in cash. If this happens, the other party should take the $35,000 of cash and pay down the $50,000 of debt. As a result, the boot would be reduced by $35,000.

6. Related party transactions

A. A transaction between parties who share a common economic interest or objective and who may not be dealing at arm's length

B. A like-kind exchange of property between related parties qualifies for nonrecognition treatment.

C. If the property transferred is disposed of within two years after the date of transfer, the original property will not qualify for nonrecognition treatment. The gain or loss that was not recognized must now be recognized on the date of disposition.

D. The following dispositions will not invalidate the nonrecognition treatment of the original exchange:

(1) Dispositions or exchanges for which the avoidance of income tax was not the primary reason
(2) Dispositions due to death
(3) Dispositions due to the involuntary conversion of property
(4) Dispositions of property in nonrecognition transactions
(5) Transactions that do not involve shifting of basis

7. Involuntary conversion—Section 1033

A. An involuntary conversion is caused by the theft, destruction, seizure, sale or exchange under threat, or condemnation of taxpayer's property.
B. It is an exception to the two-year holding period under like-kind exchanges.
C. It allows a taxpayer who realizes a gain on the involuntary conversion of property to elect to defer the gain if two conditions are met.

(1) The taxpayer must reinvest the amount realized in property similar or related in service or use.
(2) Replacement of involuntarily converted property must occur within two taxable years following the year in which the conversion took place.

D. Rules for nonrecognition

(1) If the cost of qualifying replacement property equals or exceeds the amount realized on an involuntary conversion, none of the realized gain is recognized.
(2) If the amount reinvested in qualifying replacement property is less than the amount realized, realized gain is recognized to the amount that is deficient.
(3) The amount not reinvested is treated as boot and must be recognized as gain.
(4) Unrecognized gain is deferred until a later time in the future when the property is disposed of.

E. The basis of the replacement property is its cost less unrecognized gain.
F. Section 1033 applies only to gains, not to losses.

TOPIC 53: TAX CONSEQUENCES OF GAIN OR LOSS ON SALE OF ASSETS

1. Capital assets (Section 1221)

A. The IRC defines capital assets by exception. Every asset is a capital asset unless it falls in one of eight categories:

(1) Business inventories
(2) Business accounts or notes receivable
(3) Business supplies
(4) Real or depreciable business property and intangible business assets subject to amortization
(5) Creative assets (copyright, composition, or artwork if held by the creator)
(6) U.S. government publications
(7) Commodities derivatives
(8) Hedging transaction properties

B. Capital assets for businesses are any assets held for long-term investment rather than active business use. Equity and creditor interests in other firms are capital in nature. Self-created patents are capital assets. Goodwill is a capital asset.
C. Capital losses can be deducted only to the extent of capital gains.
D. Capital loss carrybacks and carryforwards vary among individuals and businesses.
   (1) Individuals can carry capital losses forward indefinitely.
   (2) Businesses can carry capital losses back three years and forward five years. Capital losses are used as a deduction only against capital gains recognized during the eight-year period.
E. Rules for netting capital gains and losses
   (1) Short-term losses are used to offset short-term gains, and long-term losses are used to offset long-term gains.
   (2) If there is a net short-term loss, it is used to offset long-term gains. If net short-term losses are less than long-term gains, the resulting amount is taxed as long-term capital gain.
   (3) If there is a net long-term loss, it is used to offset short-term gains. If net long-term losses are less than short-term gains, the resulting amount is taxed as short-term capital gain.
   (4) If there is a net short-term or long-term capital loss after deducting long-term and short-term capital gains, the capital loss is used to offset against other income, such as dividends and interest. Only $3,000 of the net capital loss can be allowed as a deduction against AGI. The nondeductible amount of the loss is carried forward indefinitely against future capital gains and losses. The long-term capital loss carryforward is netted against 28 percent rate gain before other long-term gain.
F. Preferential rates exist for individuals.
   (1) The 28 percent tax rate is a maximum rate of 28 percent. This category recognizes realized gains and losses from the sale of collectibles such as works of art, antiques, gems, stamps, and coins.
   (2) Other long-term gain is taxed at a 15 or a 5 percent rate.
G. In general, taxpayers prefer capital gains to ordinary gains; they prefer ordinary losses to capital losses.

2. Holding period

A. Capital gains and losses are based on three holding periods.
   (1) Short-term capital gains or losses result from the sale of securities owned for one year or less. These are taxed as ordinary income.
   (2) Long-term capital gains or losses result from the sale of securities owned for more than one year. These receive a preferential tax rate.
B. The holding period generally starts the day after acquisition and runs through the date of disposition. If the asset is acquired through an exchange, and the basis in the acquired property is determined by the asset given up, then the holding period of the asset received includes the holding period of the property given up.
C. If the property is received by gift and later sold at a gain, then the donee's holding period includes the time the donor held the property. If the property is sold at a loss, then the donee's holding period does not include the time held by the donor.
D. Property acquired through a bequest is always considered to be held by the recipient for more than one year unless purchased by the estate for distribution to the recipient.

3. Sale of residence

A. $500,000 in gain for joint filers ($250,000 for single individuals)
B. Taxpayer must live at primary residence two out of last five years before sale
C. The exclusion is to be used only every two years.
D. Changes in employment, health problems, or unforeseen circumstances before reaching two-year exclusion requirement

(1) The numerator of the ratio is the shorter of

(a) The aggregate time period of ownership/use of the residence
(b) The time period between the earlier sale of a residence for which gain was excluded and the current sale

(2) The denominator is equal to two years.
(3) *Example*: A single taxpayer has lived in her first house for 18 months. She is forced to sell the house because of a new job accepted in a different state. The amount of gain excluded cannot exceed $187,500 ($250,000 × (18 ÷ 24)). If she realizes a gain of $75,000, the entire amount is excludible.

4. Depreciation recapture

A. Personal or real property used in trade or business (Section 1231)

(1) Section 1231 assets are certain assets used in trade or business that are held for more than one year. These assets include depreciable tangible and intangible personal property, as well as real property that is depreciable or not. Section 1231 assets do not include inventory.
(2) If a taxpayer has a Section 1231 net gain in the current year but had a Section 1231 net loss in any of the five previous years, the taxpayer must recapture the previous year's loss by treating an equivalent amount of current year gain as ordinary income.

(3) Section 1231 netting procedure

Step 1 Net all Section 1231 gains and losses.
Step 2 If combined result is a net loss, the loss is treated as ordinary; if the result is a gain, the gain is treated as a capital gain.

Exception
If a net gain applies to the current year but the taxpayer had Section 1231 net losses in any of the five previous years, the previous year's losses must be recaptured—an equivalent amount of current year gain is treated as ordinary income.

(4) The depreciation recapture rule requires that gains attributable to previous year depreciation or amortization deductions be characterized as ordinary income (Section 1245 or 1250), rather than Section 1231 gain.

(a) Full recapture rule. The amount of gain equal to accumulated depreciation or amortization through date of sale is recharacterized as ordinary income.

Example: ABC purchased an asset for $100,000. The asset has accumulated $60,000 MACRS depreciation over the last three years. This results in an adjusted cost basis of $40,000. If the asset is sold for $100,000, ABC recognizes a $60,000 gain. The entire gain is attributable to depreciation of the asset and, as such, is characterized as ordinary income. If the recapture requirement did not exist, the entire gain would be a Section 1231 capital gain.

(b) Partial recapture rule for realty. Applies to buildings, improvements, and other permanent attachments. Only accelerated depreciation in excess of straight-line depreciation is recaptured.

(5) Capital gains are always classified as Section 1231 and never as Section 1245 or 1250, whereas ordinary income is never Section 1231 but either Section 1245 or 1250.
(6) If the sales price is less than the adjusted basis, the loss will be classified as a Section 1231 loss.

B. Rules for personal property (Section 1245)

(1) Section 1245 applies to personal property.
(2) A gain on the distribution of Section 1245 property is treated as ordinary income to the extent of depreciation or amortization allowed. Any remaining gain is usually treated as Section 1231 gain.
(3) This section does not apply to losses—Section 1231 rules are used.
(4) A Section 179 expense election is treated as a depreciation deduction for Section 1245 recapture purposes.

C. Rules for real property (Section 1250)

(1) Section 1250 applies to real property (typically buildings and structural components).
(2) Where property was held more than one year, there is no depreciation recapture if it was depreciated straight-line.
(3) This section does not apply to losses—Section 1231 rules are used.

D. Exceptions—recapture under Sections 1245 and 1250 do not apply to:

(1) Gifts: Recapture potential carries over to the donee.
(2) Death: There is no recapture.
(3) Charitable transfers: Recapture potential reduces the amount of charitable contribution deductions.
(4) Certain nontaxable transactions: Recapture potential carries over to the transferee.
(5) Like-kind exchanges: Any remaining recapture potential carries over to the property received.
(6) Involuntary conversions: Any remaining recapture potential carries over to the property received.

5. Related parties

A. A gain on the sale of assets to a related party is treated the same as any other gain.
B. If a loss is realized on a sale to a related party, however, it is not recognized for tax purposes until the related party sells the asset to an unrelated third party.
C. Related parties include the immediate family members, closely held corporations (who owns more than 50 percent), sister corporations, and the like.

6. Wash sales

A. Selling shares at a loss and then buying them back within 30 days negates the ability to deduct such losses on a tax return. The disallowed loss amount can be added to the cost basis of the additional shares that were purchased. When these additional shares are sold, any taxable gain or loss includes the loss incurred on the original shares.
B. The wash sale rule applies not only to stocks but also mutual funds and bonds.

7. Bargain sales: When an asset is sold for an amount below fair market value, the difference is a bargain element.

A. Individual: The difference between the sale price and the FMV is treated as a gift.
B. Employee: The difference is taxed as ordinary income.
C. Shareholder: The difference is a constructive dividend and taxable as ordinary income.
D. Charitable organization. The difference is treated as part sale and part contribution.

8. Section 1244 stock (small business stock election)

A. Security losses generally are capital in nature. However, Section 1244 allows for ordinary losses if the loss is sustained by an individual who acquires the securities directly from the corporation.
B. Section 1244 losses are limited to $50,000 annually ($100,000 for joint filers).
C. The corporation must receive less than $1 million in capital stock at time of issue in order to qualify for Section 1244 treatment.
D. Section 1244 applies to losses only on the investment and not on the income.
E. Section 1244 must be elected in initial incorporation.

TOPIC 54: ALTERNATIVE MINIMUM TAX (AMT)

1. Individual and corporate AMT

A. Mechanics

(1) A parallel system of income taxation. It applies when the calculation of AMT results in a higher tax liability than the calculation of regular income taxation.
(2) The purpose is to ensure that an individual does not lower his or her tax liability below a reasonable level by using certain tax benefits targeted by AMT. Certain tax benefits available under regular income taxation are not available under AMT.
(3) It is mandatory tax paid only if it exceeds the regular tax liability. It is not an "alternative" or optional tax.
(4) A base exemption amount that is determined by the filing status for regular tax purposes is permitted to reduce the alternative minimum taxable income (AMTI). The base exemption deduction permitted to a taxpayer is diminished under the phaseout rules by 25 percent of AMTI that exceeds certain levels. AMTI amount resulting in no exemption (in 2006) is $346,000 for married filing jointly and $255,500 for single. In 2006, the base exemption is

Married filing jointly and surviving spouse	$62,550
Unmarried taxpayer	$42,500
Married filing separately	$31,275

(5) There are two tier levels relating to AMT:

(a) Tier 1 is a flat 26 percent rate that is applied to the first $175,000 of alternative minimum taxable income (AMTI).
(b) Tier 2 is a flat 28 percent rate that is applied to all of the AMTI in excess of $175,000.

(6) Capital gains distributions or reported long-term capital gains on Form 1040 are subject to tax at a maximum rate of 20 percent for both regular and AMT purposes.

(7) The following is an outline of how AMT for individuals is calculated:

Alternative Minimum Tax Structure

Regular taxable income before deduction for personal exemption

Plus	Regular tax net operating loss (NOL)
Minus	Itemized deduction limitations
Plus	Positive and negative adjustments
Plus	Tax preferences
Minus	AMT NOL
Equals	Alternative minimum taxable income (AMTI)
Minus	Exemption allowed
Equals	AMTI
Times	AMT rate: 26 percent on first $175,000 and 28 percent on excess over $175,000
Equals	Tentative alternative minimum tax (TMT) before credits
Minus	AMT foreign tax credits
Equals	TMT after credits
Minus	Regular tax liability
Equals	Alternative minimum tax (AMT)

B. Preferences and adjustments

(1) Preferences are tax benefits that are restricted under the AMT system. Preferences are always positive. Adjustments can be either positive or negative amounts.
(2) A child under age 18 has substantial adjustments or preferences subject to the AMT rules; the child may be subject to AMT.
(3) There are several common adjustments and preferences.

(a) Standard and itemized deductions: No standard deduction is allowed. Itemized deductions are not allowed for taxes, certain interest, and most miscellaneous expenses. Medical expense deduction is allowed but subject to a 10 percent floor. The overall limitation on itemized deductions does not apply in calculating AMTI.
(b) Passive activities: AMT passive rules are similar to regular rules, except that income and deductions are calculated using the AMT system rather than regular tax rules.
(c) Post-1998 depreciation. For property placed in service after 1998:

Section 1250 property	No adjustment
Other tangible property in which the straight-line	SL method using the same recovery period and convention used for regular tax (SL) method was used.
All other tangible property	150 percent declining balance, switching to straight-line depreciation for the first tax year in which using straight-line method yields a higher allowance, using the same recovery period and convention used for regular tax

(d) Post-1986 and pre-1999 depreciation. For property placed in service after 1986 and before 1999:

Section 1250 property	SL method over 40 years using the same midmonth convention used for regular tax purposes.
Other tangible property in which the SL method was used	SL method using the same recovery period and convention used for regular tax
All other tangible property	150 percent declining balance, switching to straight-line depreciation for the first tax year in which using straight-line method yields a higher allowance, using the same recovery period and convention used for regular tax

(e) Adjusted gain or loss: Gain or loss from the sale or exchange of property must be recomputed with regard to AMT adjustments.
(f) Loss limitations: Gains and losses from conduit activities for which the taxpayer has basis or at-risk limitations must be recomputed under AMT.
(g) Certain tax-exempt interest income: Interest on certain private activity bonds issued after August 7, 1986, is included in the AMT tax base. These bonds are issued by state and local governments to finance activities that are not associated with the issuing government.
(h) Incentive stock options: Excess of fair market value over option price at the earlier of the date the option rights become transferable or are no longer subject to a substantial risk of forfeiture must be included in the AMT tax base.
(i) Qualified small business stock: One-half of the gain is excluded from regular taxable income, but 42 percent of this gain must be included in AMT.
(j) Stock gain exclusion: Income from the sale or exchange of qualified small business stock must be included in the AMT tax base.

C. Exclusion items versus deferral items

(1) Certain itemized deductions are deductible in full under AMT. Allowable itemized deductions include

(a) Casualty losses
(b) Miscellaneous itemized deductions not subject to the 2 percent AGI requirement
(c) Returns of amounts included in income (claim right)
(d) Estate tax paid on income with respect to a decedent
(e) Charitable contributions
(f) Interest on indebtedness used to acquire or improve a qualified residence of the taxpayer
(g) Investment interest not in excess of qualified net investing income
(h) Medical expenses in which the floor is 10 percent

(2) Certain itemized deductions are completely disallowed under AMT.

(a) State and local taxes (This disallowance is the most common reason that AMT is applied.)

(b) Miscellaneous itemized deductions subject to the 2 percent AGI floor
(c) Home mortgage interest that was not used to buy, build, or substantially improve a primary residence or secondary home

(3) Recovery of a tax that is included in gross income for regular income tax is not included in AMT. For example, state income tax refunds are required to be included under gross income but not AMT.
(4) Net operating loss (NOL). If a taxpayer had an NOL from business activity, the NOL may be used to eliminate up to 90 percent of the taxpayer's AMTI. NOL can be different from that used for regular income tax because it is adjusted for any preference items.

D. Credit (creation, usage, and limitations)

(1) Any AMT paid in a given year because of the deferral (not the elimination) of deductions can be used to offset regular tax in future years when the deductions are used to reduce AMT below the regular tax.
(2) The minimum tax credit (MTC) can be used only against the regular tax liability. It cannot reduce the regular tax liability below the AMT liability for the year.
(3) The MTC is used only after all other nonrefundable credits have been utilized and there remains a regular tax liability in excess of the AMT.
(4) The MTC can be carried forward indefinitely; it cannot be carried back.

2. Small business exemption

A. AMT does not apply to S Corporations and partnerships.
B. C Corporations are generally subject to the AMT, but are exempt if they fit the definition of a "small corporation."
C. Corporations must meet an average annual gross receipt test to be excluded from AMT.

(1) For new corporations, average annual gross receipts must not exceed $5 million for the corporation's first three taxable years. After the initial test is passed, corporations cannot have three-year annual gross receipts in excess of $7.5 million.
(2) For corporations in existence before 1997, a $5 million average annual gross receipts test is applied to the three taxable years, beginning with the first taxable year ending after December 31, 1993. After the initial test is passed, corporations cannot have three-year annual gross receipts in excess of $7.5 million.

D. Corporations subject to AMT

(1) "Adjusted current earnings," or ACE adjustment, applies to corporations, not individuals, in calculating AMT. This adjustment includes items that are not treated as taxable income for regular tax purposes but are treated as "book" income for accounting purposes.
(2) An ACE adjustment item is book income attributable to life insurance owned by a corporation. Death benefits and increases in cash value raise the adjustment; premiums paid on a life insurance contract reduce the adjustment.

3. Planning strategies: Alternative minimum tax (AMT planning)

A. Incentive stock options

(1) Although no taxable income is recognized when an option is granted or exercised, the difference between the fair market value and the exercise price is an item of AMT tax preference and can trigger a significant AMT liability in the year of exercise if a large amount of appreciated stock is involved.

(2) When the stock is sold, most of the AMT liability will be recovered as an AMT credit against regular tax if the value of the stock has not decreased after the exercise of the option.

(3) The AMT gain is the difference between the fair market value of the stock at the time of the sale and the fair market value of the stock at the time of exercise.

(4) Regular tax gain is the difference between the fair market value at the time of the sale and the exercise price.

(5) Because regular tax liability will generally exceed the AMT tentative minimum, most or all of the credit for the previously paid AMT is typically claimed against regular tax in the year of sale.

Example: In 2006, an employee receives 10,000 shares of employer stock at $10 a share. There are no tax consequences in 2006. In 2007, the employee exercises the option. The fair market value at exercise is $50. The exercise results in no regular income tax in 2007. For AMT purposes, there is a tax preference of $400,000 (($50 − $10) × 10,000). For simplicity, assume the employee pays AMT liability of $112,000 on the $400,000 preference ($400,000 × 28%). In 2008 and 2009, the tentative minimum tax and the regular tax are exactly equal, so none of the credit is used against regular income.

B. If the employee sells all shares in 2010 at $60 a share, he will recognize a long-term capital gain of $500,000 (($60 FMV − $10 cost) × 10,000 shares). This results in a tax liability of $75,000 ($500,000 × 15% long-term capital gain rate). However, the long-term AMT capital gain is only $100,000 (($60 FMV − $50 AMT basis) × 10,000) and the tentative minimum tax on the gain is only $15,000 ($100,000 × 15%). *Note*: The 15 percent long-term capital gain rate applied is the same for regular tax and AMT. The AMT basis of each share of stock is increased from $10 to $50 by the $40 gain previously recognized in 2007 for AMT. Assume that the tentative minimum tax is exactly the same as the regular tax liability without regard to the regular tax long-term capital gain. If we consider the long-term capital gain, tentative minimum tax is $75,000 less than regular tax liability. Therefore, an $75,000 AMT tax credit against regular tax liability can be claimed. The remaining $37,000 ($112,000 − $75,000) unused AMT credit is carried forward to future years.

C. If the stock price drops significantly after exercise, it may be difficult to recover the AMT credit.

(1) An AMT tax preference is not created at exercise if the employee cannot sell the stock right away or it is subject to a substantial risk of forfeiture. With this type of stock, a "Section 83(b)" election can be taken to avoid AMT liability.

(2) No AMT adjustment is required if the incentive stock option (ISO) is exercised and sold in the same tax year.

TOPIC 55: TAX REDUCTION/MANAGEMENT TECHNIQUES

1. **Tax credits**

A. Deduction or exclusion versus tax credit

(1) Which is better? The answer depends on the tax bracket. A deduction or exclusion reduces the amount of taxable income that falls within a person's tax bracket. A credit reduces, dollar for dollar, the amount of tax computed on taxable income.

(2) *Example*: Suppose you are in the 28 percent tax bracket. The choice is between claiming a $1,000 deduction or a $250 credit. The deduction should be claimed because it saves you $280 ($1,000 × 28%) in taxes. The credit saves only $250 in taxes. On the other hand, if you were in the 15 percent tax bracket, the credit should be claimed.

B. Child and dependent care credit

(1) Any employer-provided dependent care assistance reduces the maximum amount on a dollar-for-dollar basis.
(2) If there is a choice between claiming the child and dependent care credit or participating in a dependent care flexible spending account (FSA), an individual will save more taxes by paying child care expenses with FSA money.
(3) If someone is hired to care for your children and provide the care in your home, the IRS generally considers you an employer. If you pay the worker more than $1,300 per year, you are liable for the employer's share of FICA tax.

C. Education tax credits

(1) Tuition paid in December 2006 for a course that begins in January 2007 is counted toward the 2006 credit, not the 2007 credit.
(2) A taxpayer may be able to reduce the amount of federal income tax withholding based on the estimated tax benefits of education credits and deductions.

2. Accelerated deductions

A. The acceleration of deductions (and deferral of income) reduces taxes in the current year. It is an effective strategy if the marginal tax rate for the client in future years will be the same or less. If the rate jumps up, then it makes little sense to defer income or accelerate deductions.

B. There are several strategies for accelerating deductions.

(1) Early payment of state income or property taxes: These are generally due on the 15th of the month after the tax year. If payments are made prior to the end of the tax year, a greater deduction can be taken.
(2) Early payment of mortgage and qualified education loan interest: The first mortgage payment in the next year can be paid in the current year to accelerate the mortgage interest deduction. The same is used for qualified education loan interest if the deductible limits have not been reached in the current year.
(3) Year-end charitable contributions: Make contributions before year end.
(4) Year-end expenses: Make repairs and perform maintenance of rental property before year end.
(5) Year-end purchase of assets: Take full use of a Section 179 depreciation for assets used in trade or business.
(6) Review of asset acquisitions: Ensure that assets are classified under the shortest period for depreciation.
(7) Year-end purchases: Tangible assets can depreciate a half-year if purchased in the last month of the year. This election is not possible if more than 40 percent of total tangible personal property is placed in service during the last 3 months of the year (the midquarter convention is used).
(8) Education payments. Next year's payments that qualify for credits should be paid in the current year, such as the Hope Credit or Lifetime Learning Credit.
(9) Purchase of supplies. Inventory and supplies can be expensed for businesses.

3. **Deferral of income: There are several strategies for deferring income.**
   A. Tax-advantaged retirement savings: Qualified retirement plans defer taxes on earnings and generally use pretax income for contributions.
   B. Deferred sales: Tax savings can be significant if sales of investments are deferred until death. The cost basis becomes the fair market value of such assets at death. Hedging strategies can be used to postpone the recognition of capital gains for stocks.
   C. Deferred collections: For a self-employed individual using the cash method, delay year-end billings until late enough in the year that payments will not be received before the end of the year.
   D. Delayed bonus payment: Employee year-end bonuses may be paid in the next year. The employer generally does not lose its deduction for the current year, as long as its obligation to pay the employee is fixed before the end of the tax year and paid within 2 1/2 months of the close of its tax year.
   E. Stock options. In order to obtain favorable long-term capital gain treatment, stock acquired under an Incentive stock option (ISO) may not be sold before the later of two years from the date of the grant of the option or one year from the date of exercise of the option.
   F. Deferred compensation. Nonqualified deferred compensation plans can defer receipt of income to selected employees for several years.
   G. Installment sales. The use of an installment sale does not affect the tax treatment of a gain as capital gain or ordinary income, but does affect its timing. Installment sales may allow an individual to reduce total tax on the sale by preventing taxable gain from pushing him or her into a higher tax bracket in the year of sale.
   H. Exchange of like-kind assets: A carefully structured and implemented exchange can defer tax liability.
   I. Annuities: Earnings on contributions accrue tax-deferred.
4. **Intrafamily transfers**
5. **Charitable gifts:** Gifts of appreciated property (such as stock) have a significant tax advantage by giving a charitable contribution deduction for the full appreciated value of the property, for both regular and AMT purposes (in addition to the avoidance of the capital gain tax).
6. **Stock redemption agreements**
   (1) The IRS defines a redemption of stock as an acquisition by a corporation of its own stock from a shareholder in exchange for property, whether or not stock so acquired is canceled, retired, or held as Treasury stock.
   (2) For tax planning purposes, the primary objective in arranging a stock redemption is to achieve capital gain treatment as opposed to dividend treatment on the exchange of stock for money or other property.
   (3) The redemption proceeds will be taxable as ordinary income if the transaction is treated as a dividend distribution.
   (4) A three-part tax treatment applies to a corporate distribution to a shareholder. The rules apply regardless of whether the distribution to the shareholder is made pursuant to a redemption of stock or paid with respect to the shareholder's ownership in stock (as shown in the following example).
      (a) The portion of the distribution not in excess of the corporation's current and accumulated earnings and profits is treated as a dividend and taxed as ordinary income.

(b) The portion of the distribution in excess of the corporation's current and accumulated earnings and profits is then treated as a nontaxable return of capital to the extent of the shareholder's basis in his or her stock.

(c) The portion of the distribution not treated as a dividend that exceeds the shareholder's basis in his or her stock is taxed as capital gain.

(d) *Example*: Steve is sole shareholder of a corporation that has $50,000 in current accumulated earnings and profits. His basis in the stock is $5,000. The corporation distributes $70,000, which is not compensation; $50,000 is treated as dividends and taxed as ordinary income, $5,000 is treated as a return of capital investment (basis is reduced to zero), and $15,000 is treated as capital gain.

(5) Constructive dividends are not intended by the corporation to be treated as dividends for tax purposes; however, if the economic effect of such a transaction is the same as that of a dividend distribution, the IRS may recharacterize the transaction as a taxable dividend. Dividends can be in the form of property other than money. The taxation is measured by the fair market value of the property distributed.

(6) Section 302 allows for capital gain treatment of four types of redemptions, in which the redemptions materially affect a shareholder's percentage of ownership.

(a) A redemption that is not essentially equivalent to a dividend
(b) A substantially disproportionate redemption
(c) A complete redemption
(d) A distribution to a noncorporate shareholder in a partial liquidation of the distributing corporation

(7) Section 303 redemptions apply to estates in which stock of a closely held corporation constitutes a substantial portion of total assets. For Section 303 redemptions, the beneficiary or estate receives a stepped-up basis in a decedent's assets that is generally equal to the value of the assets at the date of death of the decedent. If the stock increased in value from time of redemption and decedent's death, any amount in excess of the adjusted basis will be taxed as long-term gain.

TOPIC 56: PASSIVE ACTIVITY AND AT-RISK RULES

1. Definitions

A. At-risk rules limit a taxpayer's deductible loss to the amount that the taxpayer actually has at risk of loss.

B. At-risk rules apply to the following:

(1) Individuals
(2) Estates and trusts
(3) Partners
(4) Shareholders in S Corporations
(5) Most C Corporations

C. The amount at risk is equal to the sum of:

(1) The amount of cash and adjusted basis of other property contributed to the activity by the taxpayer
(2) Amounts borrowed for use in the activity for which the taxpayer is personally liable

(3) Amounts borrowed for use in the activity that are secured by property of the taxpayer that is not used in the activity (to the extent of FMV of the property)
(4) A taxpayer's share of qualified nonrecourse financing that is secured by the real property used in the activity. Nonrecourse financing generally means loans from banks, savings and loans, credit unions, and so on. Nonrecourse financing does not include borrowing from any person who has an interest in the activity other than a creditor, or from a related person.

D. Interplay of the amount at risk and the computation of the partner's outside basis (tax basis in his or her interest in the partnership):

(1) The partner's basis is increased by qualified nonrecourse debt.
(2) The deductible loss from the activity is limited to the amount at risk.

E. Passive activity rules. If a loss qualifies for recognition under at-risk rules, it may also be subject to passive activity rules. Passive activity losses may be used only to offset passive activity income (this does not include portfolio income). A passive activity loss for the year is the amount by which the aggregate losses from all passive activities exceed the aggregate income from all passive activities for that year. Passive activities are those activities that involve the conduct of a trade or business in which the taxpayer does not materially participate. Rental activities are always passive.

F. Taxpayers subject to passive activity rules:

(1) Individuals
(2) Estates
(3) Trusts
(4) Personal service corporations
(5) Closely held C Corporations (Five or fewer individuals own more than 50 percent of the stock.)
(6) Publicly traded partnerships (PTP)—partnership interests that are traded on an established securities market

(a) Net passive income from a PTP cannot be offset by losses from other passive activities.
(b) A net passive loss from a PTP cannot offset income from other passive activities.

(7) Owners of pass-through entity interests on their distributive shares of income or loss from those interests

G. Taxpayers not subject to passive activity rules:

(1) Corporations (other than those listed earlier)
(2) Partnerships (other than those listed earlier)
(3) S Corporations

H. Keep in mind that although partnerships and S Corporations are not subject to passive activity rules, the individual who receives the pass-through items is subject to such rules.

I. There are two kinds of passive activity losses:

(1) Rentals
(2) Businesses in which the taxpayer does not materially participate on a regular, continuous, and substantial basis

J. Income and losses from the following activities are generally passive:

(1) Equipment leasing
(2) Rental real estate
(3) Sole proprietorship in which the taxpayer does not materially participate
(4) Limited partnerships, with some exceptions
(5) Partnerships, S Corporations, and limited liability companies in which the taxpayer does not materially participate
(6) PTPs that are not treated as corporations

K. Income and losses from the following activities are generally nonpassive:

(1) Salaries, wages, and 1099 commission income
(2) Guaranteed payments
(3) Interest and dividends
(4) Stocks and bonds
(5) Sale of undeveloped land or other investment property
(6) Royalties from ordinary course of business
(7) Businesses in which the taxpayer materially participates
(8) Partnerships, S Corporations, and limited liability companies in which the taxpayer materially participates
(9) Trusts in which the fiduciary materially participates

L. Material participation rules are applied to any trade or business activity. If material participation rules are met, the income or loss from that activity is treated as nonpassive.

There are six different ways for an individual to meet this requirement:

(1) Participates more than 500 hours per year in day-to-day operations
(2) Participation essentially constitutes all significant participation in the work involved in the activity.
(3) Participates more than 100 hours, but not more than 500 hours, but more than anyone else
(4) Material participation in an activity for any 5 of the past 10 years
(5) Material participation in a personal service activity for any three prior years
(6) There are relevant facts and circumstances showing the taxpayer was a material participant.

2. **Computations: There are five steps for determining deductibility of losses on Form K-1:**

A. Determine whether the partner has sufficient basis.
B. Determine whether the partner has sufficient amount at risk.
C. Determine whether the passive activity rules apply.
D. If the partner passes all of the preceding tests, the loss still may not be deductible because of other limitations:

(1) Net operating loss limitation
(2) Capital loss limitation

E. If the deductibility of the partner's losses is limited because of insufficient basis or inadequate amount at risk, the suspended losses may be absorbed in subsequent years, depending on the amount of income in those years.

3. Treatment of disallowed losses

A. Net passive activity losses are suspended and carried forward to offset future passive activity income.
B. At-risk rules are applied before the passive loss rules. If a loss is not allowed because of the at-risk limitation, it is not a suspended loss under the passive loss rules. It is a suspended loss under the at-risk rules.

4. Disposition of passive activities

If the entire interest in a passive activity is disposed of, the suspended losses are fully deductible against other income.

5. Real estate exceptions

A. Rental real estate losses up to $25,000 may be deducted in full by anyone whose modified adjusted gross income is less than $100,000 (ignoring passive losses). The taxpayer must actively participate to qualify for the $25,000 offset. The $25,000 deduction is phased out at a rate of 50 cents for every dollar the modified adjusted gross income is over $100,000. It is completely phased out when modified adjusted gross income exceeds $150,000.

B. Active participation is participation by a natural person who

(1) Has at least a 10 percent interest in any rental real estate activity
(2) Participates in management decisions in a bona fide sense

C. Many vacation rentals have low periods of customer use. As a result, the activity falls outside the definition of a rental and the $25,000 offset does not apply. An activity is not rental under any of the following six conditions:

(1) Average customer use is seven days or less.
(2) Average customer use is 30 days or less, and the owner provides significant personal service.
(3) The owner provides extraordinary services.
(4) The rental activity is incidental to a nonrental activity of the taxpayer.
(5) The property is customarily made available during business hours for nonexclusive use by customers (golf courses).
(6) The property is used in a partnership, S Corporation, or joint venture in which the owner has an interest, and activity is not a rental activity.

TOPIC 57: TAX IMPLICATIONS OF SPECIAL CIRCUMSTANCES

1. Death (final income tax return)

A. An income tax return must be filed for a decedent for the year of death.
B. The decedent has a short tax year that ends at the date of death; however, deductions, exemptions, and credits can be taken in full.
C. Income in respect of decedent is income that comes after death and will become part of the decedent's estate.
D. The surviving spouse can file jointly in the year of death. If the surviving spouse has a minor child, he or she can file as surviving spouse for two additional years following death.

E. Medical expenses paid during the year following death may be filed either on the decedent's final return or estate tax return.
F. Any charitable contributions that cannot be used on the final return because of AGIlimitations are lost.

2. Marriage

A. Filing status

(1) If married on the last day of the year, taxpayers may choose to file either jointly or separately. In general, filing jointly is more beneficial to a couple.
(2) In some instances, spouses who file jointly pay more taxes than they would if they were able to file as two single taxpayers. This is often called the *marriage penalty.*

(a) In 2007, the standard deduction is $10,700 for married filing jointly, and $5,350 for two single taxpayers.
(b) Social Security benefits are taxable for a married couple when AGI plus half their benefits reaches $32,000 and as high as $25,000 for single taxpayers.

B. Children

(1) Tax treatment of dependent child's income

(a) Earned income only: Income up to the standard deduction is not taxable, regardless of age.
(b) Unearned income only

(i) For a child under age 18 by the close of the tax year (kiddie tax applies), the first $850 of unearned income is not taxed, the next $850 of unearned income is taxed at the child's tax rate, and the excess of the child's unearned income is taxed at the parent's marginal rate.
(ii) For a child at or above age 18 by the close of the tax year, the first $850 of unearned income is not taxed, and any additional unearned income is taxed only at the child's rate. No unearned income will be taxed at the parent's rate.

(c) Earned and unearned income

(i) For child under age 18

- Unearned: The first $850 of unearned income is not taxed, the next $850 of unearned income is taxed at the child's tax rate, and the excess of the child's unearned income is taxed at the parent's marginal rate.
- Earned: Earned income minus the remaining amount of the standard deduction is taxed at the child's rate.

(ii) For a child age 18 and over

Earned and unearned income: Income up to the standard deduction is not taxable; income over the standard deduction is at the child's tax rate.

(2) A child with income who qualified as a dependent on the parent's tax return cannot claim a personal exemption on his or her own tax return. Exemption can be claimed only by the parents, even if they choose not to claim the exemption.

C. Common law and community property

(1) Common law

(a) Common law is a body of law that is based on custom and general principles and is embodied in case law. It serves as precedent or is applied to situations not covered by statute. A husband and wife have equal ownership in all property under common law.
(b) Common law states have a stepped-up basis for half of the assets: a step-up in basis for the decedent's share of ownership, but not the survivor's share.

(2) Community property—recognized in nine states

(a) Community property is all property that has been acquired by the efforts of either spouse during their marriage while living in a community property state, except property acquired by only one of the spouses by gift, devise, bequest, or inheritance or acquired by either spouse prior to their marriage. The two spouses own community property equally.
(b) Community property states have a full step-up in basis. For tax purposes at death, the new cost basis is the FMV at the date of death for both halves of the community property even though only one-half is included in the decedent spouse's estate.
(c) Couples residing in community property states should hold appreciated property as community property. On the other hand, if property has decreased in value, community property will receive a full step-down in basis at the first death, and some other form of title may be preferred.

3. Divorce

A. Alimony

(1) A series of payments from one spouse to another or to a third party on behalf of the receiving spouse
(2) Taxable income to the recipient and tax deductible expense to the payor
(3) Payments are alimony only if all of the following conditions are met:

(a) Payments must be made in cash.
(b) Payments must end at death of payee.
(c) Payor and payee cannot live together.
(d) Agreement or decree does not specify that the payments are not alimony.
(e) Front loading is avoided.

(4) Front loading

(a) A measure to discourage property settlements as alimony
(b) There may be alimony recapture if there is more than a $15,000 decrease in alimony payments between any of the first three years.
(c) Another rule applies to the extent that the payments in the second year exceed the payments in the third year by more than $15,000.
(d) Alimony recapture affects the third year of alimony payments only. Recapture in the third year is claimed as income by the original payor and claimed as a deduction from income by the payee.

B. Child support

(1) Established by the courts and based on the ratio of each parent's income, the percentage of time the child spends with each parent, and the amount of alimony payments made to the custodial parent
(2) Is not deductible by the payor and not included in the income of the recipient

(3) The child can be counted as an exemption by only one parent, but the exemption can be traded back and forth each year.
(4) Only the custodial parent is entitled to claim both the child and the dependent care credit.

C. Qualified domestic relations order (QDRO)

(1) A QDRO is an order from the court that tells a trustee or administrator of a qualified retirement plan how much to pay out to the nonowner spouse pursuant to a divorce.
(2) A QDRO ensures that property from a qualified retirement plan can be divided up without negative tax consequences.
(3) Benefits begin when the participant reaches "earliest retirement age," defined as the earlier of

(a) The earliest date benefits are payable to the participant under the plan
(b) The later of the date when participant reaches age 50 or the date on which the participant could start benefits if separated from service

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TOPIC 58: CHARITABLE CONTRIBUTIONS AND DEDUCTIONS

1. Qualified entities

A. Public charities

(1) Churches
(2) Educational organizations
(3) Hospitals and medical research organizations
(4) Government entities
(5) Publicly supported organizations that receive a substantial amount of support from the general public or governmental units

(a) Red Cross and Salvation Army
(b) Boys & Girls Clubs of America

B. Private charities

(1) Veterans organizations
(2) Fraternal orders
(3) Certain private nonoperating foundations

2. Deduction limitations

A. Public versus private charities

(1) Contributions to public charities cannot exceed 50 percent of the taxpayer's AGI. A 30 percent ceiling generally applies to long-term capital gain (LTCG) property. Exception: The 30 percent limit does not apply if election is made to reduce the FMV of the property by the amount of the long-term capital gain if the property had been sold.
(2) Contributions to private charities cannot exceed 30 percent of the taxpayer's AGI. A 20 percent ceiling applies to all LTCG property.

B. Capital gain property, for purposes of charitable contributions, is property that has been held for more than 12 months. There are two types of capital gain property:

(1) Real and intangible personal property

(a) A gift of stock is considered intangible personal property, and appreciated land is an example of real property.

(b) For contributions made to public charities, the deduction cannot exceed 30 percent of AGI if the full market value of the gift is deducted. The 30 percent limit can be increased to 50 percent of AGI for public charities if the donor is willing to decrease the value of the gifts by 100 percent of the potential gain. This means reducing the fair market value to the property's cost basis.

(c) *Example*:

(i) Mark donates stock worth $45,000 to the Red Cross (public charity). The stock cost $25,000 when it was purchased five years ago. Mark has AGI of $50,000. Therefore, his maximum deduction for the year is $15,000 ($50,000 × 30%). The remaining $30,000 ($45,000 FMV − $15,000 current deduction) can be carried forward for five years and applied against future income.

(ii) Exception: If Mark excludes 100 percent of the potential gain, the deductible value is decreased to $25,000 (cost basis). Mark could deduct the entire $25,000, because 50 percent of his AGI is $25,000. The current year deduction is increased with this election.

(d) For contributions to private charities, the deduction cannot exceed 20 percent of AGI. There is a full deduction for fair market value only.

(2) Tangible personal property

(a) A car or jewelry is tangible personal property.

(b) A distinction is made between gifts that are used by the charity and gifts that are not used.

(i) Use related. Such property would include a painting given to a museum that is shown in public galleries.

- For contributions to public charities, the deduction cannot exceed 30 percent of AGI if the full market value of the gift is deducted. The 30 percent limit can be increased to 50 percent of AGI if the donor is willing to reduce the value of the gift by 100 percent of the potential gain.
- For contributions to private charities, the deduction is 20 percent of the donor's cost basis.

(ii) Use unrelated. The painting mentioned earlier would be use unrelated if it was sold by the museum or if it was given to the Boy Scouts.

- For contributions made to public and private charities, the fair market value of the gift must be reduced by 100 percent of the potential gain. This means that the amount of deduction is the donor's cost basis.
- For contributions to public charities, the deduction cannot exceed 50 percent of AGI. For donations to private charities, the deduction cannot exceed 20 percent of AGI.

C. Ordinary income property

(1) Ordinary income property is an asset that would have resulted in ordinary income (rather than capital gains) on the date of contribution if it were sold.

(2) Ordinary income property includes

(a) Capital assets held 12 months or less at time of contribution

(b) Art, books, and jewelry, but only if given by the person who created them

Exhibit 5.3 Charitable Contribution Deduction Limitation

Type of Property	Donee	Limitations of AGI	Amount Deductible
(A) Cash	Public Private	50% 30%	Full deduction Full deduction
(B) Capital gain property: (1) Real and intangible personal property	Public Private	30%, or 50% on election 20%	Full deduction for FMV Donor's cost basis Full deduction for FMV
(2) Tangible personal property:			
Use related	Public Private	30%, or 50% on election 20%	Full deduction for FMV Donor's cost basis Donor's cost basis
Use unrelated	Public Private	50% 20%	Donor's cost basis Donor's cost basis
(C) Ordinary income property	Public Private	50% 30%	Donor's cost basis Donor's cost basis

Chart revised from James Ivers III, *Fundamentals of Income Taxation*, 3rd ed., Huebner School Series (Bryn Mawr, PA: The American College, 2002).

(c) Businessperson's stock in trade and inventory

(3) The deduction is limited to the donor's cost basis.

3. **Carryover periods**

A. Contributions that exceed the AGI limit for the current tax year can be carried over to each of the next five years.
B. Carryover contributions are subject to the original percentage limits in the carryover years and are deducted after deducting allowable contributions for the current year.
C. Use the earlier year carryover if there are carryovers from two or more years.

4. **Partial interest gifts to charity**
Contributions that are less than the entire interest in a property are generally not deductible.
Exceptions:

A. A gift of a partial interest in property if that is the donor's entire interest
B. Property held in a charitable lead trust or a charitable remained trust

5. **Nondeductible contributions**

A. *Note:* Gifts to some organizations may not be deductible as charitable contributions, but may be deductible as ordinary and necessary business expenses.
B. There are certain nondeductible contributions.

(1) Money or property given to:

(a) Civic leagues, social and sports clubs, labor unions, and chambers of commerce
(b) Foreign organizations
(c) Groups that are run for personal profit

(d) Groups whose purpose is to lobby for law changes
(e) Homeowners associations
(f) Individuals
(g) Political groups or candidates for public office

(2) Cost of lotto and bingo tickets
(3) Dues and fees to country clubs
(4) Tuition
(5) Value of blood given to a blood bank
(6) Contributions consisting of the right to use property (such as a rent-free lease to the Boy Scouts)

C. Payments made to a college or university in exchange for the right to buy tickets to a sporting event qualify for a charitable deduction of 80 percent of the amount paid. Any amount actually paid for tickets is not deductible.

Example: Steve graduated from ABC University and donated $3,000 to the athletic department to guarantee priority to purchase two premium season tickets to home football games. Steve then purchased two season tickets at a regular price of $200 each. The charitable contribution for the current year is $2,400 (80 percent of $3,000). The $400 expenditure for the tickets cannot be claimed.

6. Appraisals

A. Appraisals are generally required if a contribution is more than $5,000. Fees paid for the appraisal are not deductible as contributions. They can be claimed as a miscellaneous itemized deduction on Schedule A, subject to the 2 percent of AGI limit.
B. A qualified appraisal is not required for publicly traded securities if quotations are published on a daily basis or readily available, even if the amount exceeds $5,000.

7. Substantiation requirements

A. Donations of less than $250

(1) Cash donations need receipts or other reliable written records with date, amount, and name of organization.
(2) Noncash donations do not require receipts where it is impractical to get them.

B. Donations of $250 or more

(1) Cash donations of $250 or more in any one day to any one organization must have written substantiation from the organization.
(2) Noncash donations require a written acknowledgement from the charitable organization. For contributions if more than $500, the taxpayer must show the means of acquisition of the property, the date acquired, and the adjusted basis. Most contributions of more than $5,000 require a written appraisal. Form 8283 must be filed for noncash contributions over $500.

C. Do not combine separate contributions. For example, donations of $25 each week to a church are considered separate payments that should not be combined.

8. Charitable contributions by business entities

A. Corporations can deduct up to 10 percent of taxable income after adding back any deduction for NOL or capital loss carrybacks or carryforwards and dividends received.
B. Excess contributions are carried forward five years.
C. Contributions from pass-through entities are reflected on the returns of the owners.

MULTIPLE CHOICE QUESTIONS

1. **A modified endowment contract (MEC) purchased after June 21, 1988, has many restrictions and characteristics EXCEPT:**

   A. An early withdrawal penalty of 10% will be imposed on the taxable portion of a distribution prior to 59½.
   B. A policy will be considered an MEC if it fails the seven-pay test.
   C. Distributions (withdrawals or loans) will be treated on a first-in, first-out (FIFO) basis.
   D. Distributions to disabled or annuitization over the life of a policyholder will not result in a 10% withdrawal penalty.
   E. MECs enjoy tax-deferred accumulation inside the contract just like any other insurance product.

   Ans. C

2. **Which of the following definitions relates to Treasury Regulations?**

   A. The administrative interpretation of the statutory tax law related to specific circumstances
   B. The administrative interpretation of the statutory tax law generally related to compliance matters
   C. Primary source of all tax law
   D. The general administrative interpretation of the statutory tax law
   E. Apply to a specific taxpayer and a particular situation

   Ans. D

3. **Seth received land as a gift from his great aunt. At the time of the gift, the land had a fair market value of $98,000 and an adjusted basis of $120,000 to Seth's grandmother. One year later, Seth sold the land for $145,000. What is the amount of Seth's gain on this transaction?**

   A. $0
   B. $22,000
   C. $25,000
   D. $50,000

   Ans. C

4. **The Greens purchased a home on August 1, 2007. They lived in the home for one year and then John received a job transfer to another state. As such, they unexpectedly sold the house at a profit of $550,000 on August 1, 2008. How much of the gain would be excluded from taxation assuming a new home is purchased by year-end?**

   A. $0
   B. $250,000
   C. $500,000
   D. $550,000

   Ans. B

5. **Which of the following is the tax penalty for negligence?**

   A. 20% of the underpayment
   B. ½% per month of the tax unpaid to maximum of 25%
   C. 75% of the underpayment

D. 5% of tax due per month up to 25% maximum
E. Greater of $5,000 or 10% of the correct tax

Ans. A

6. Which of the following is not considered one of the definitions for alimony to be deductible?

A. Payments must be made in cash.
B. Parties can file a joint return.
C. Payments must be received by or for the benefit of the payee spouse.
D. Legal documents cannot designate the payments as nonincludible in the payee spouse's income and nondeductible by the payor spouse.
E. Payments cannot extend beyond the death of the recipient spouse.

Ans. B

7. Which of the following are tax preference additions in calculating for the individual alternative minimum tax?

(1) Itemized deductions
(2) Bargain element on the exercise of incentive stock option (ISO)
(3) Percentage depletion
(4) Accelerated cost recovery system (ACRS) on real property in excess of straight-line

A. 1 and 3 only
B. 2 and 4 only
C. 1, 2, and 4 only
D. 2, 3, and 4 only
E. 4 only

Ans. B

8. Which of the following is not a requirement for a valid premarital agreement?

A. It must be in writing and signed by both parties.
B. There must be a full and complete disclosure of the parties' net worth.
C. It must not be intended to facilitate or promote the procurement of divorce.
D. It must be witnessed by two individuals.
E. Agreement must have been executed willingly by both parties and without duress.

Ans. D

9. Neil Harrington is a sole proprietor business owner. He is thinking of replacing outdated equipment with new equipment costing $205,000. He also anticipates profits to be $35,000 and W-2 wages from helping his wife amounting to $18,000. What is the maximum Section 179 deduction he can take in the current year?

A. $112,000
B. $53,000
C. $35,000
D. $25,000
E. $18,000

Ans. B

10. Alice Manley timely filed her prior income tax return that showed an adjusted gross income (AGI) of $120,000 and total tax of $30,000. She expects her total tax to be $180,000 this year. What is her required payment through withholding and estimated tax?

A. $63,000
B. $47,250
C. $33,000
D. $49,500

Ans. C

11. Income was actually or constructively received in 2007 in each of the following situations EXCEPT:

A. Earned income of a taxpayer was received by his agent on December 13, 2007, but not received by the taxpayer until January 6, 2008.
B. Taxpayer was informed his check for services rendered was available on December 30, 2007, but he waited until January 10, 2008, to pick up the check.
C. Taxpayer received a check on December 31, 2007, for services rendered, but was unable to make the deposit until January 3, 2008.
D. A payment on the sale of real property was made to an escrow account on December 1, 2007, but the taxpayer did not receive the payment until January 25, 2008, when the transaction was closed and the buyer authorized release of the money held in escrow.

Ans. D

12. In 2007, John Levine paid the following taxes:

State income taxes withheld from his pay	$12,000
Real estate taxes paid on his new primary residence	6,000
Sales taxes paid when he purchases a new car	1,500
Personal property taxes paid to his local government	1,000
Mortgage tax on the purchase of his home	2,000

What amount is allowable as an itemized deduction?

A. $18,000
B. $19,000
C. $20,500
D. $22,500

Ans. B

13. Sol Nelson owns and operated a manufacturing plan as a sole proprietor. He purchased a new machine qualifying as Section 1245 property at a cost of $15,000. He used the modified accelerated cost recovery system (MACRS) seven-year percentages to recover the cost of the machine. John sold the machine for $18,000 after claiming $2,143 of cost recovery deductions.

Calculate the amount of cost recovery deductions that will be recaptured as a result of this disposition.

A. Section 1250—ordinary income $1,071; Section 1231 gain $4,072
B. Section 1245—ordinary income $2,143; Section 1231 gain $3,000
C. Section 1231 gain $5,143

D. Section 1245—ordinary income $5,143
E. Section 1231 gain $3,000

Ans. B

14. Matt Wilson transferred an apartment building he held for investment to Eli Hart, an unrelated party, in exchange for an office building. At the time of the exchange, the apartment building had a fair market value of $150,000, and an adjusted basis to Matt of $70,000. The apartment building was subject to a liability of $60,000 that Eli assumed for legitimate business purposes. The office building had an adjusted basis to Eli of $70,000 and a fair market value of $100,000. In addition, Matt received $25,000 cash in exchange. What is Matt's recognized gain on this exchange?

A. $10,000
B. $35,000
C. $50,000
D. $85,000

Ans. D

15. Your client owns a condo in Arizona that he uses for one month of the year and then rents out during the prime time for three months. Gross rents are $7,800.

The following were his expenses for the tax year:

Real estate taxes	$ 985
Interest	6,472
Maintenance and utilities	2,662
Depreciation (total)	4,300

Calculate the deductions attributable to the vacation home.

A. $7,086 rental deductions and $5,593 itemized
B. $10,814 rental deductions and $1,864 itemized
C. $10,119 rental deductions and $1,864 itemized
D. $7,200 rental deductions and $5,400 itemized
E. $14,419 rental deductions and $0 itemized

Ans. B

16. Which of the following miscellaneous itemized deductions are not subject to the 2% floor?

A. Gambling losses to the extent of gambling gains
B. Union dues
C. Work uniforms (not suitable for street wear)
D. Home office expenses of an employee (the employer provides a regular office)

Ans. A

17. Taxpayer is a resident of a state that imposes income tax. Information regarding taxpayer's state income tax transactions is as follows:

Taxes withheld in 2007	$13,000
Federal refund received in 2007 from overpayment of 2006 tax liability	3,500
State tax deficiency assessed for 2005 (as a result of audit by the state)	6,000
Interest on the state tax deficiency	2,500

The 2005 state tax deficiency and interest thereon were paid by taxpayer in 2007. If taxpayer elects to itemize deductions for 2007, how much of the above transactions can be deducted?

A. $13,000
B. $19,000
C. $21,500
D. $25,000

Ans. B

18. Sally Reynolds, a widow, maintains a home for herself and her three dependent preschool children. In 2007, she earned income, and her adjusted gross income was $75,000. During 2007, she paid work-related expenses of $18,000 for a housekeeper to care for her children. How much can she claim for child care credit in 2007?

A. $0
B. $1,200
C. $1,800
D. $18,000
E. None of the above

Ans. B

19. Richard and Brenda Rosman are married and will file a joint return for the current tax year. They have provided you with the following information:

Richard W-2 income	$130,000
Brenda's W-2 income	65,000
Alimony payments to Richard's ex-wife	35,000
Property taxes	12,000
Mortgage interest	10,000
Charitable contributions	8,000

Based on the information given, what is the Rosman's's adjusted gross income for the current tax year?

A. $130,000
B. $150,000
C. $160,000
D. $195,000

Ans. C

20. Which of the following statements concerning the deductibility of bad debts is correct?

A. If a father guarantees his daughter's bank loan and she defaults, the father is entitled to a business bad-debt deduction.
B. Under certain circumstances, a bad-debt deduction may be available even if a legal debt does not exist.
C. No deduction for partial worthlessness of a debt is allowed.
D. A nonbusiness bad debt can be deductible only as a short-term capital loss.

Ans. D

21. Katie Long's husband died in the current year. Her married son and his wife do not qualify as her dependents because of their income. However, she provided over half the

cost of maintaining the household in which she, her married son, and his wife live. What is Katie's filing status for this year?

A. Married filing jointly as a surviving spouse
B. Unmarried individual
C. Married filing separate return
D. Head of household

Ans. A

22. **In which of the following courts may a taxpayer petition for redetermination of an assessed income tax deficiency and receive a jury trial?**

A. U.S. District Court
B. Court of Appeals for the Federal Circuit
C. U.S. Court of Federal Claims
D. U.S. Tax Court

Ans. A

23. **Matthew Mandone, who is covered by a qualified retirement plan and is age 30 and single, provided the following information for his 2007 income tax return:**

Salary	$30,000
Payment to an individual retirement account	4,000
Total itemized deductions	3,400
Number of exemptions claimed	1

Matthew Mandone should report taxable income for 2007 of:

A. $14,400
B. $17,250
C. $19,200
D. $22,600
E. None of the above

Ans. B

24. **Calculate the taxable income for a single taxpayer, age 65 and no dependents, provided the following information for his 2007 income tax return:**

Salary	$46,000
Capital loss	5,000
Total itemized deductions	4,500

A. $31,650
B. $32,950
C. $34,800
D. $36,500
E. None of the above

Ans. B

25. **Jeffrey and Karen Jones have given cash gifts to their children over the years. During the current year:**

Mark, age 15, earns $2,500 in salary.
Jennifer, age 18, earns $2,200 in dividends and capital gains.

Nancy, age 16, earns $1,900 in dividends and interest.
Steven, age 10, earns $900 in dividends and interest.

Whose income is subject to the tax at their parents' marginal rate? ***(CFP® Exam, released 3/95)***

A. Steven's
B. Jennifer's and Nancy's
C. Nancy's
D. Steven's, Jennifer's, and Nancy's
E. Nancy's and Mark's

Ans. C

26. Which of the following statements regarding the "kiddie tax" is/are correct?

(1) It applies to *all* unearned income from property transferred to a child from the child's parents.
(2) It applied to all children under the age of 19.
(3) A child's earned and unearned income may be subject to the tax.
(4) It is based on the additional tax the parents would have paid assuming the child's net unearned income had been included in the parents' taxable income.

A. 4 only
B. 1 and 4
C. 1, 2, and 3
D. 1, 2, and 4
E. 1, 2, 3, and 4

Ans. A

27. Howard, whose wife died in November of the current year, filed a joint tax return for the current year. He did not remarry and has continued to maintain his home for his two dependent children. In the preparation of his tax return for next year, what is Howard's filing status on his Form 1040?

A. Single
B. Surviving spouse
C. Head of household
D. Married filing separately
E. Qualifying widower

Ans. E

28. Ralph Gomez, age 23, a full-time student at Arizona State University, is claimed as a dependent by his parents. He earned $2,350 from a summer job in the current year. In addition, he earned $1,650 from a savings account established with funds inherited from his grandmother. He had total itemized deduction of $600 in the current year. What is Ralph's taxable income for the current year?

A. $0
B. $1350
C. $3,450
D. $4,000

Ans. B

29. On September 15, 2007, Ann Johnson, a cash-basis attorney, contracted to perform an audit during the month of December of the current year. At the time the contract was being negotiated, the client offered to pay for all the services in December of the current year. However, Ann wanted to defer as much income as possible until next year. The final agreement called for a $2,500 payment in December of the current year and a $5,000 payment in January of next year. As per the contract, the client wrote a check for the $2,500 charge on December 27, 2007. Ann refused to cash the payment until next year. What amount must Ann report on her current year tax return?

A. $0
B. $2,500
C. $5,000
D. $7,500

Ans. B

30. Jack and Diane were divorced in January of the current year. In accordance with the divorce decree, Jack transferred the title in their home as a result of the property settlement to Diane in the current year. The home, which had been owned by Jack for the past five years, has a fair market value of $375,000, and was subject to a $150,000 mortgage that had 300 more monthly payments. Monthly mortgage payments amount to $2,000. Under the terms of settlement, Jack is obligated to make the mortgage payments on the home for the full remaining 25-year term of the indebtedness, regardless of whether Diane lives the full 25 years. Jack made 12 mortgage payments in the current year totaling $24,000. What amount is taxable as alimony to Diane for her current year's tax return?

A. $0
B. $12,000
C. $80,000
D. $92,000

Ans. A

31. On January 1, 2007, Linus Post was awarded a postgraduate fellowship grant of $25,000 by a tax-exempt educational organization. Linus is *not* a candidate for a degree and was awarded the grant to continue his research. The grant was awarded for the period July 1, 2006 through June 30, 2007. On July 1, 2007, Linus elected to receive the full amount of the grant. What amount should be included in his gross income for 2007?

A. $0
B. $5,250
C. $10,000
D. $25,000

Ans. D

32. In the current year, Susan Smith, a single taxpayer, elected Section 179 for an asset acquired at a cost of $95,000. Susan's net income for the current year is $65,000. Determine Susan's Section 179 deduction for the current year (assume no other income).

A. $0
B. $25,000
C. $65,000
D. $95,000
E. $108,000

Ans. C

33. Bobby Jensen, a single-calendar-year, cash-basis taxpayer, has the following transactions during the current year:

Salary from job	$60,000
Alimony paid to ex-wife	5,000
Medical expenses	7,500

Based on this information, Bobby has:

A. AGI of $60,000
B. Medical expense deduction of $3,000
C. Medical expense deduction of $3,375
D. Medical expense deduction of $4,125
E. Medical expense deduction of $4,500

Ans. C

Chapter 6

RETIREMENT PLANNING

TOPIC 59: RETIREMENT NEEDS ANALYSIS

1. **Assumptions for retirement planning**

   A. Inflation: The costs of goods and services that retirees use most often increase faster than the general rate of inflation measured by the Consumer Price Index (CPI).
   B. Retirement period and life expectancy: Retirement period is contingent on various factors: years until retirement, years in retirement, and family history/longevity.
   C. Lifestyle: Before retiring, have your clients attempt to live on 80 percent of their current income. You can offer to invest the remainder. Most clients need more than 100 percent to maintain their current standard of living.
   D. Total return: Project investment return and project the tax rate.

2. **Income sources**

   A. Total return assumptions

   (1) Return assumptions include all sources of future income, such as qualified retirement plans, tax-deferred plans, and Social Security.
   (2) Retirement income-need analysis calculation—comprehensive example:

PV: Present value
I: Interest rate
N: Number of periods
FV: Future value
PMT: Payment

Jim Parker is currently age 37 and Sarah Parker is age 34. The Parkers would like to retire when Jim is age 65 (preretirement period of 28 years). The retirement income need is $70,000 in today's dollars. They will need to provide for retirement income until Sarah has reached age 95 (postretirement period of 33 years). They expect to earn an after-tax return of 8 percent, and inflation of 3 percent. The planner anticipates Social Security income to be $15,000 at retirement.

Step 1: Adjust income deficit for inflation over preretirement period. Solve future value of income deficit in first year of retirement. Subtract Social Security income to arrive at a net amount of $55,000.

PV = $55,000, I = 3%, N = 28, solve FV = $125,836

Determine retirement fund needed to meet income deficit. Solve lump sum needed at beginning of retirement (present value annuity due) to fund annual income deficit that increases annually with inflation (i.e., a growing annuity).

Find inflation-adjusted rate of return

$$[(1.08/1.03) - 1] \times 100 = 4.85\%$$

The inflation-adjusted rate of return is a serial payment. It increases each year by the assumed inflation rate.
Calculator should be set to "begin" mode, because payments are expected at the beginning of each year.

PMT = $125,836; I = 4.85; N = 33; FV = 0; solve PV = $2,150,395

Change calculator back to "end" mode.

Step 2: Analyze current assets and project growth from now to retirement. This amount is compared with the need projected in Step 1.

The Parkers have $150,000 in assets targeted for retirement purposes. Find the future value of these assets at retirement.

PV = $150,000; I = 8; N = 28; solve FV = $1,294,065

Shortfall is $2,150,395 − $1,294,065 = $856,329

Step 3: Determine additional savings needs by solving for yearly payments. Use level payment or serial payment.

Level payment accounts for inflation. Remember that an 8 percent after-tax return is the nominal rate. In basic terms, the nominal return = real rate + inflation rate. Solve for payment.

FV = $856,329; N = 28; I = 8%, PV = 0; solve PMT = $8,982

The Parkers will need to save $8,982 each year during the accumulation phase to reach the shortfall of $856,329 in assets.

Serial payments provide an inflation adjustment during the accumulation years because the payments increase each year by the inflation rate (this was automatically done during the level payment calculation). In order to calculate the first year serial payment, inflation must be removed from the future value of current assets because it will be accounted for in the serial payments and cannot be counted twice.

The shortfall value of $856,329 is deflated for inflation.

FV = $856,329; N = 28; I = 3%, PMT = 0; solve PV $374,281

The inflation-adjusted interest rate is used for serial payments. It was earlier calculated as [(1.08/1.03) − 1] × 100 = 4.85%. Calculate first year serial payments.

FV = $374,281; N = 28; I = 4.85; PV = 0; solve PMT = $6,562

This amount is increased by the inflation rate to provide the first year serial payments.

$6,562 × 1.03 = $6,759

If this amount is increased for inflation each year, the total future value at retirement will equal $856,329. Therefore, either using the level payment method or the serial payment method will yield the same result at retirement.

B. Probabilistic analysis assumptions

(1) The Monte Carlo system uses baseline information, such as age and the current value and composition of investments, along with certain assumptions about the unknown future, such as changing inflation rates, life expectancy and investment returns. Then the program runs through hundreds or thousands of random combinations to determine how much a client can safely spend at retirement.

(2) Monte Carlo can be misleading if a planner uses the wrong assumptions.

3. Alternatives to compensate for projected cash-flow shortfalls

A. Consider making the maximum contribution to qualified retirement plans.
B. Decrease current and future expenditures.
C. Participate in more aggressive investments.
D. Advance the retirement age or lower the desired amount of income.
E. Accept more risk by increasing the expected rate of return in forecasts.
F. Consider serial (increasing) annual payments versus level annual payments.

4. Financial needs

A. Living costs
B. Charitable and beneficiary gifting objectives: To stretch your client's retirement income, you may want to explore charitable estate planning strategies and reduce your client's current, ongoing contributions to charity.
C. Medical costs, including long-term care needs analysis
D. Other (trust and foundation funding, education funding, etc.): current residence, food costs, car loans, auto insurance costs, clothing cost, health insurance premiums, recreation costs, future savings, and income taxes

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TOPIC 60: SOCIAL SECURITY

1. Eligibility and Benefit

A. Terminology

(1) Fully insured = 40 quarters of coverage (total of 10 years in covered work).
(2) Currently insured = 6 quarters of coverage during the full 13-quarter period ending with the calendar quarter in which the person died, became entitled to disability benefits, or became entitled to retirement benefits.
(3) In 2007, workers receive one quarter of coverage for each $1000 of earnings up to a maximum of four quarters.

B. Retirement

(1) Entitled to retirement benefits if:

(a) Fully insured
(b) At least age 62

(2) The retirement benefit at normal retirement age (age 65, but gradually increasing to age 67 for those born after 1960) equals the worker's primary insurance amount (PIA).
(3) If benefits are received prior to normal retirement age, an individual will receive a monthly benefit equal to only a percentage of PIA. For a retired worker, PIA is reduced by $\frac{5}{9}$ of 1 percent for each of the first 36 months the worker is under normal retirement age when payments commence and by $\frac{5}{12}$ of 1 percent for each such month in excess of 36.
(4) Here is the important point: There are advantages and disadvantages to taking the benefit before full retirement age. The advantage is that the individual collects benefits for a longer period of time. The disadvantage is that the benefit is permanently reduced.
(5) An individual can obtain a higher retirement benefit by working past normal retirement age up to age 70.

C. Disability

(1) A person is entitled to disability benefits if he or she meets all of the following requirements.

(a) Is insured for disability benefits
(b) Is under the age of 65
(c) Has been disabled for 12 months, or is expected to be disabled for 12 months
(d) Has filed application for disability benefits
(e) Has completed a five-month waiting period or is exempted from this period

(2) A person must be so severely impaired, physically or mentally, that he or she cannot perform any other gainful work. The impairment must last 12 months or more. The determination is based on medical evidence.
(3) To qualify for disability, an individual must be fully insured and have at least 20 quarters of coverage during a 40-quarter period ending with the quarter in which the person is disabled. The quarterly period requirement is met if a person worked 5 years of the last 10 years before disability.
(4) Special insured status is required to qualify for disability benefits if an individual is disabled before age 31. Special insured status is established if a person:

   (a) Is disabled before the quarter in which age 31 is attained, and
   (b) Has credits in one-half of the quarters during the period beginning with the quarter after the quarter in which the person attained age 21 and ending with the quarter in which the person became disabled. If disabled before age 24, the person must have six quarters of coverage in the 12-quarter period.

D. Survivor: The following benefits are payable to the survivors of a deceased insured worker:

(1) Mother's and father's benefit: Monthly benefit for widow(er), regardless of age if caring for at least one child, under 16 or disabled before age 22, of a deceased worker
(2) Child's benefit: Monthly benefit for each child who is

   (a) Under age 18
   (b) Over age 18 and disabled before age 22
   (c) Under age 19 and a full-time student

(3) Widow(er)'s benefit: Monthly benefit for widow(er), or surviving divorced widow(er), age 60 or older
(4) Disabled widow(er)'s benefit: Monthly benefit for a disabled widow(er), age 50 to 60
(5) Parent's benefit: Monthly benefit for parent age 62 or older who was dependent on deceased worker for support
(6) Lump sum death payment of $255 (in 2007)

E. Family limitations

(1) A spouse is entitled to up to 50 percent of employee's full retirement benefit. The spouses' benefit ends when certain events happen:

   (a) The spouse dies.
   (b) The worker dies (in which case the spouse is entitled to widow(er)'s, mother's, or father's benefits).
   (c) The worker's entitlement to disability benefits ends and he or she is not entitled to retirement benefits.
   (d) The spouse is under age 62 and there is no longer a child of the worker under 16 or disabled who is entitled to child's benefits.
   (e) The spouse becomes entitled to retirement or disability benefits and his or her PIA is equal to or larger than one-half of the worker's PIA.
   (f) The spouse and worker are divorced before the spouse reaches age 62 and before the spouse and worker had been married for 10 years.
   (g) The divorced spouse marries someone other than the worker.

(2) Each qualified child may receive a monthly payment up to 50 percent of the employee's full retirement benefit amount, but there is a limit to the amount that can be paid to the

family as a whole. This total depends on the amount of the employee's benefit and the number of family members who also qualify on the employee's record. The total varies, but it is generally equal to about 150 to 188 percent of PIA for retirement and survivors. The child's benefit ends when certain events happen:

(a) The child dies.
(b) The child marries (but not if the child is a disabled child over age 18 and the child marries another Social Security beneficiary).
(c) The child's parent is no longer entitled to disability benefits, unless entitlement ended because the insured parent became entitled to retirement benefits or died.
(d) The child reaches age 18 and is neither under disability or a full-time student.

(3) A grandchild is considered the child of the worker if:

(a) The grandchild's natural parents are deceased or disabled at the time the worker becomes entitled to retirement or disability benefits or dies.
(b) The grandchild was legally adopted by the worker's surviving spouse.
(c) The grandchild is dependent on the insured.

(4) A person can lose benefits if he or she is under normal retirement age and earnings exceed $12,960 (in 2007).
(5) A widow or widower may receive employee's full benefit (100 percent PIA) at 65 or older, or reduced benefit as early as age 60 (or age 50 to 59 and disabled). Children under age 18 also receive 75 percent of the deceased employee's benefit.

Exhibit 6.1 Benefit Table

Benefits for workers and their families					Benefits for survivors of deceased workers					
		Benefits for family members			Spouse not Caring for child					
		Spouse not caring for child								
FRA retirement benefit or disability benefit	Age 62 retirement benefit	FRA	Age 62	Child or spouse caring for child	Age 65	Age 60 or age 50–59 and disabled	One child	Spouse and one child; or two children	Maximum family benefit for retirement and survivor	Maximum family benefit for disability
100% of PIA	77½% of PIA	50% of PIA	361¼% of PIA	50% of PIA	100% of PIA	71½% of PIA	75% of PIA	150% of PIA	150–188% of PIA	100–150% of PIA

Adapted from Mercer, *2003 Guide to Social Security and Medicare,* 31st ed., Louisville, KY: Mercer Human Resources Consulting, Inc., 2002.

2. How benefits are calculated

A. The primary insurance amount (PIA) is the basic unit used to determine the amount of each monthly benefit. A disabled or retired worker receives the full PIA if benefits start at normal retirement age.
B. It is necessary to know the average indexed monthly Earnings (AIME) to calculate PIA. AIME is based on an individual's lifetime earnings history.
C. Social Security benefits depend on an average of 35 years of worker's best earnings (after indexing) to figure AIME. If there are fewer than 35 years of earnings, zero is used for each

remaining year. The index factors given for each year make past earnings comparable to the level of earnings today.

D. AIME is computed by dividing the total earnings (sum of the highest 35 years of indexed earnings) by 420 (35 years × 12 months). This number is then used to find PIA.

E. The PIA formula for persons attaining age 62 in 2002, or becoming disabled or dying before age 62 in 2006, is:

(1) 90 percent of the first $656 of AIME, plus
(2) 32 percent of the next $3,299 of AIME, plus
(3) 15 percent of AIME in excess of $3,955
(4) The dollar amount in the PIA formula after 2006 is adjusted annually by changes in the national indexing average wage. The PIA resulting from the formula is increased annually to reflect changes in the cost of living.

F. The PIA formula for persons who attained age 62 before 2006 (born before 1940) uses a different index factor multiplier and PIA benefit formula, but the steps are similar for those attaining age 62 in 2006.

3. Working after retirement

A. No benefits are lost for those older than normal retirement age.

B. If a person is under the normal retirement age, the following apply:

(1) If no more than $34,440 is earned in 2007 by a worker who reaches normal retirement age in 2007, no benefits are lost for that year.
(2) If more than $34,440 is earned in 2007 before the month the beneficiary reaches normal retirement age, $1 of benefits is lost for each $3 of earnings over $34,440.
(3) If no more than $34,440 is earned in 2007 by a worker under normal retirement age for the entire year, no benefits are lost for that year.
(4) If more than $12,960 is earned in 2007 by a worker under the normal retirement age for the entire year, $1 of benefits is lost for each $2 of earnings over $12,960.

4. Taxation of Social Security

A. FICA (Social Security and Medicare) tax

(1) 7.65 percent FICA tax for employers and employees
(2) For 2007, the 6.20 percent Social Security tax is computed on the first $97,500 of the employee's wages. The 1.45 percent Medicare tax is computed on the employee's total wages.

B. Self-employment tax is imposed on self-employed people at a rate of 15.3 percent. This is a combination of 12.40 percent Social Security tax and 2.9 percent Medicare tax (no ceiling).

C. Income taxes on benefits (in 2007)

(1) Benefits 50 percent taxable. Fifty percent of benefits are included in gross income if a person's income plus half of his or her Social Security benefits is more than the following base amounts for that person's filing status.

(a) $32,000 for married couples filing jointly
(b) $0 for married couples filing separately, and the person lived with the spouse at any time during the year
(c) $25,000 for all other taxpayers

(2) Benefits 85 percent taxable. Eighty-five percent of benefits are included in gross income if a person's income plus half of his or her Social Security benefits is more than the following base amounts for that person's filing status.

(a) $44,000 for married couples filing jointly
(b) $0 for married couples filing separately, and the person lived with the spouse at any time during the year
(c) $34,000 for all other taxpayers

(3) If a person is married filing separately and lived with the spouse at any time during the year, up to 85 percent of benefits are included in gross income.

TOPIC 61: TYPES OF RETIREMENT PLANS

1. Qualified plan vesting schedule

A. Employee contributions are 100 percent vested immediately.
B. Employer matching contributions (i.e., contributions made by an employer on account of an employee contribution or elective deferral, or forfeiture allocated on the basis of employee contributions, matching contributions, or elective deferrals) made after 2001 must vest under a faster vesting schedule than in earlier years.

(1) Three-year vesting (also called Cliff vesting): 100 percent after three years
(2) Two- to six-year vesting: Graded vesting that must be at least as fast as the following schedule:

Years of Service	Vested Percentage
2	20
3	40
4	60
5	80
6	100

(3) This faster vesting schedule is also applicable to top-heavy plans, both before 2002 and after 2001.
(4) The portion of the benefit or account attributable to employer contributions other than matching contributions in years after 2001 remain subject to the five-year and three- to seven-year vesting standard.
(5) SIMPLE and SEP provide immediate 100 percent vesting.

2. Characteristics

A. Qualified retirement plans (QRP)

(1) The retirement plan is afforded special tax treatment for meeting a multitude of requirements of the Internal Revenue Code (IRC). Obvious tax advantages for a QRP include

(a) Employer (E/ER) is allowed an immediate tax deduction for amount contributed to the plan for a particular year.
(b) Employee/participant (E/EE) pays no current income tax on the amounts contributed by the E/ER on his or her behalf.
(c) Earnings are tax-exempt, allowing for tax-free accumulation of income and gains on investments.

- (d) Reduced income tax may apply to lump sum distributions to certain participants.
- (e) Income taxes on certain types of distributions may be deferred by rolling over (R/O) the distribution to an individual retirement account (IRA) or another (qualified or nonqualified) retirement plan.
- (f) Income taxes on certain types of distributions to a deceased participant's spouse may be deferred by R/O distribution to an IRA.
- (g) Installment or annuity payments are taxed only when they are received.

(2) Two major types of qualified plan categories

- (a) Defined benefit plan (DBP)
  - (i) The maximum allowable benefit payable from the plan is the lesser of 100 percent of salary or $180,000 per year (in 2007).
  - (ii) The maximum compensation base that can be used is $225,000 (in 2007).
  - (iii) Generally subject to Pension Benefit Guaranty Corporation (PBGC) insurance
  - (iv) Must satisfy minimum participation rule of Code Section 401(a)(26)
  - (v) Retirement benefit is certain.
  - (vi) Each DBP is subject to the minimum funding standard.
  - (vii) Deductible contribution is based on actuarial calculations and can vary from year to year.
- (b) Defined contribution plan (DCP)
  - (i) The maximum allowable annual contribution is the lesser of 100 percent of salary or $45,000 (in 2007).
  - (ii) The maximum compensation base that can be used is $225,000 (in 2007). Note that $45,000 is only 20 percent of $225,000.
  - (iii) Not subject to PBGC insurance
  - (iv) Not subject to minimum participation rule
  - (v) Deductible contribution limited to 25 percent of aggregate compensation
  - (vi) Retirement benefit is uncertain.

B. Nonqualified plans

(1) Characteristics and objectives

- (a) Alternative to qualified plans for executives
- (b) Few design restrictions regarding benefit structure, vesting requirements, or coverage
- (c) Designed to defer the payment of income taxes by employees until benefits are paid out
- (d) Employer deduction is deferred to the time of payout; deduction is matched to employee income.
- (e) Assets must be available to pay claims of creditors in order to avoid current taxation.
- (f) Limited benefit security for participants

(2) Nonqualified deferred compensation plan designs

- (a) Salary reduction plan: Gives participants the option to defer regular compensation, bonuses, or commissions
- (b) Supplemental executive retirement plan (SERP): Additional employer-provided benefits

C. Government plans (Section 457 plans)

(1) Section 457 of the Internal Revenue Code gives rules for governing nonqualified plans of government entities and nonprofit organizations.

(2) Characteristics

(a) Election to defer compensation must be made before the compensation is earned.
(b) The employer may discriminately choose any employee for coverage.
(c) Such plans are similar to a 401(k) plan, in which the maximum deferral limit that applies is $15,500 for 2007.

3. Types of qualified plans

A. Money purchase

(1) Employer is required to make contributions based on contribution formula—contributions are allocated as a percentage of compensation regardless of age (unlike target benefit plan).
(2) The plan is subject to minimum funding standard, whether or not the company made a profit.
(3) Forfeitures may be reallocated to remaining participants' accounts or applied to reduce employer contributions.
(4) Investment in sponsoring company's stock is limited to 10 percent.
(5) The plan can be integrated with Social Security.
(6) Younger employees accumulate more than they would with a DBP
(7) The plan generally does not produce as large a contribution and deduction for older employees as DBP.
(8) No guarantee of future benefits; the investment risk rests on the employee.

B. Profit sharing

(1) Employer contributions must be "substantial and recurring."
(2) Profits are not required in order to make contributions.
(3) Forfeitures may be reallocated among the remaining participants.
(4) Nondiscriminatory allocation of contributions
(5) No limit on how much can be invested in the sponsoring company's stock
(6) Can be integrated with Social Security
(7) Benefits the younger employee more than the older employee (owner). Younger employees accumulate more than they would with a DBP over time because of earnings, forfeitures, compounding effect, tax-deferred accumulation
(8) Profit sharing plans are usually recommended for upstart companies because:

(a) Profits may be nonexistent in the beginning years.
(b) Contributions are flexible.
(c) Earnings fluctuate from year to year.

(9) Do not provide as large a contribution deduction as a DBP
(10) No guarantee of future benefits; the investment risk rests on the employee.

C. Age-weighted

(1) An age-weighted profit sharing plan uses age and compensation to allocate contributions to participants. In this way, its concept is similar to that of a target benefit plan. The plan, therefore, benefits older employees because they have fewer years to retirement.
(2) To satisfy nondiscrimination requirements, this plan is tested under cross-testing rules.

D. Section 401(k) plan

(1) A Section 401(k) plan cannot exist on its own—it is not a stand-alone plan.

(a) Must be combined with a qualified retirement plan

(i) Profit-sharing plan
(ii) Stock bonus (employee stock ownership plan, ESOP)
(iii) Pre-ERISA (Employment Retirement Income Security Act) money-purchase plan

(b) May be combined with a salary reduction simplified employee pension (SARSEP) if established before January 1, 1997
(c) May be combined with a Savings Incentive Match Plan for Employees (SIMPLE)

(2) Types of 401(k) plans

(a) Traditional Section 401(k) is much like a profit-sharing plan.

(i) Can be funded entirely from employee salary reduction
(ii) Nondiscrimination testing, such as actual deferral percentage (ADP) and top-heavy rules apply.

(b) SIMPLE 401(k) plans and safe harbor 401(k) plans

(i) Exempt from nondiscrimination testing (ADP/ACP) actual contribution percentage
(ii) Funding requirements for employer

(3) Traditional and safe harbor 401(k) plans: Employee elective deferral amount is $15,500 in 2007. Catch-up contributions by employees age 50 or older is $5,000 in 2007.
(4) SIMPLE 401(k) plans: Lower annual elective deferral limits of $10,500 in 2007; catch-up amount is $2,500 in 2007.
(5) Two types of contributions

(a) Cash or deferred arrangement (CODA). Employee has the option of receiving an employer contribution (e.g., annual bonus)

(i) In cash and having it taxed currently, or
(ii) Deferring the cash by making it a tax-deferred retirement plan contribution (i.e., 401(k) plan)

(b) Salary reduction: Employee defers the receipt and taxation. The reduction amount is deducted from the paycheck and contributed to a retirement fund and accumulates tax deferred.

(6) In-service withdrawals by employees for certain "hardships" are permitted; these are not available in qualified pension plans.
(7) May not provide adequate retirement savings for employees who enter the plan at later ages
(8) All elective deferrals from all employer plans that cover the employee must be aggregated; deferrals are characterized as employer contributions to ensure that the sum of employee and employer tax-favored contributions do not exceed the 25 percent payroll limit and the limit on annual additions.
(9) Employees bear investment risk under the plan.
(10) Meets the employer's requirement of substantial and recurring contributions in profit sharing plans
(11) No integration with Social Security for just 401(k) plan

E. Employee stock ownership plan (ESOP)

(1) An ESOP must invest primarily in employer stock.
(2) Portfolio is 100 percent company stock; there are special diversification requirements for participants over age 55 with 10 years of service.
(3) May borrow to buy company stock: leverage ESOP (LESOP)
(4) ESOP can be integrated with Social Security; a LESOP cannot be integrated with Social Security.
(5) An ESOP plan (and stock bonus plan) makes sense for a corporation by

(a) Providing a market for the owner's closely held stock
(b) Giving tax deductions while having no effect on cash flows
(c) Protecting company stock from hostile takeovers

F. Stock bonus plan

(1) Benefit payments are usually made in shares of company stock. The participant can receive cash in lieu of stock.
(2) Diversified portfolio
(3) May not borrow to buy company stock
(4) Can integrate with Social Security

G. Thrift or savings plan

(1) Contributions are after-tax dollars; earnings are tax deferred.
(2) Employees are required to contribute (up to 6 percent) in order to be eligible to receive the employer's matching contribution.
(3) Hardship withdrawals are more liberal than with 401(k) plans.
(4) In a rollover: after-tax money to participant and earnings to IRA

H. Target benefit

(1) Forfeitures may be reallocated to remaining participants' accounts or applied to reduce employer contributions.
(2) Allocation of employer contributions is based on age-weighted formula—favors older employee.
(3) Investment in sponsoring company's stock is limited to 10 percent.
(4) Can be integrated with Social Security
(5) Provisions shared with defined contribution plan

(a) Employee assumes investment risk—no guarantee of future benefits.
(b) No ongoing actuarial determinations
(c) Forfeitures may be reallocated or used to reduce employer contribution.

(6) Provisions shared with defined benefit plan

(a) Plan benefits older employees (older employees may not receive a benefit as great as with a DBP).
(b) Actuarial determination for initial contribution level and formula for allocation contributions
(c) Subject to minimum funding standard: mandatory annual employer contributions

I. Defined benefit plan—Traditional

(1) Retirement benefits are definitely determinable—the benefit is defined by the formula in the plan.

(2) When the interest rate earned on plan assets is higher or lower than the actuarial assumptions, the employer increases or decreases its future contributions to the plan as needed to match the promised benefit (unlike target benefit plan).
(3) Plan formulas are geared to retirement benefits and not contributions (unlike cash balance plans).
(4) Actuary determines required contribution each year—minimum funding standard.
(5) Forfeitures must be used to reduce the employer's contribution.
(6) Employees accrue retirement benefits when eligible to participate, but are not vested until a minimum period of time is worked.
(7) Benefits must be paid to plan participants even if the plan is terminated.
(8) The plan can be integrated with Social Security.
(9) Greater tax-deductible contributions than through DCP.
(10) Rewards long-term employees with a substantial benefit even if close to normal retirement age
(11) Larger contribution to older employee—more beneficial to participants closer to retirement
(12) Investment risk rests on employer.
(13) Higher administration costs
(14) Plan benefits are not portable.
(15) Retirement benefits/distributions are not adjusted for cost of living (i.e., inflation).

J. Cash balance plan

(1) A cash balance plan is a defined benefit plan with features similar to those of a defined contribution plan.
(2) The distinguishing feature of a cash balance plan is that a separate account is established for each participant, using a hypothetical account balance. These hypothetical allocations and earnings are designed to imitate the actual contributions and earnings that would occur to an employees account under a defined contribution plan.
(3) Employee balances grow based on hypothetical earnings (i.e., interest credits). The interest rate varies from year to year and is communicated to the employee at the start of each year. The rate is not tied to actual performance of investments and is determined independently; the minimum rate cannot be more than the lowest standard interest rate, and the maximum rate cannot be less than the highest standard interest rate.
(4) Actuary determines required contribution each year—minimum funding standard.
(5) Plan can be integrated with Social Security
(6) Greater tax-deductible contributions than through DCP
(7) Forfeitures must be used to reduce employer's contribution.
(8) More beneficial to younger participants
(9) Employer must pay benefits in accordance with plan provisions even in low- or no-profit years.
(10) Investment risk rests on employer.
(11) Higher administration costs
(12) Benefits must be paid to plan participants even if the plan is terminated.
(13) Plan benefits are not portable.
(14) Retirement benefits/distributions are not adjusted for cost of living (i.e., inflation).

Exhibit 6.2 Comparison of Defined Contribution Plans

	Profit Sharing Plan	Stock Bonus or ESOP Plan	Money Purchase Plan	Target Benefit Plan
Employer Contribution (maximum deduction)	25% of covered payroll[1]			
Mandatory Employer Contribution	No, but "substantial and recurring"		Yes, as percentage of or flat sum	Yes, as stated in plan formula
Employee Contribution	401 (k) provisions, if permitted		401 (k) provisions are not permitted, but after-tax contributions are permitted	
Forfeitures	Reallocated or used to reduce employer contribution[2]			
Maximum "Annual Additions"[3] to Participant's Account	100% of compensation or $45,000, whichever is less			
Discriminatory Plan Test	Coverage tests, ADP/ACP test, and top heavy test			
Social Security Integration	Yes,[4] except LESOP only			

[1]LESOP only equals 25 percent deduction limit for principal payments and unlimited interest deduction.
[2]Forfeitures are generally reallocated for discretionary contribution plans.
[3]"Annual additions" are employer contributions (including 401 (k) elective deferrals), forfeiture allocations, and employee, nondeductible contributions.
[4]No integration with Social Security for only 401 (k) provision.

TOPIC 62: QUALIFIED PLAN RULES AND OPTIONS

1. **Qualified plan coverage and eligibility requirements**

   A. Age and service requirements: Employees must be eligible to participate in a qualified retirement plan within six months after the later of:

   (1) 21 and 1 (vesting schedule): Employee has reached age 21 and has met one-year service requirement: The employee is included in the plans vesting schedule.
   (2) 21 and 2 (100 percent vesting): Employee has reached age 21, and if the service requirement exceeds one year but does not exceed two years of service, the plan must provide full and immediate vesting of benefits.
   (3) Important: For 401(k) plans the maximum is one year.
   (4) An employer can exclude employees who are:

   (a) Covered by a collective bargaining agreement
   (b) Nonresident aliens

(c) Part-time employees who have worked less than 1,000 hours per year
(d) Employees who have worked less than one year
(e) Employees under age 21

B. Coverage requirements

(1) These requirements ensure that the "highly compensated employee" (HCE) is not getting more benefits at the expense of the "non-highly-compensated employee" (NHCE).
(2) One of two coverage tests must be satisfied for a plan to receive favorable tax treatment:

(a) The ratio percentage test: The percentage of NHCEs who benefit under the retirement plan must equal at least 70 percent of the percentage of HCEs who benefit under the plan.

Example: The Wise Corporation's defined benefit plan covers 70 percent of its NHCEs and 85 percent of its HCEs in the plan year. Does the company's plan meet the ratio percentage test? Yes, the plan does meet the ratio percentage test because the ratio percentage for the year is 82.3 percent ($0.70 \div 0.85$).

(b) The average benefits test. This is a two-prong test, and both conditions must be satisfied.

(i) The plan must benefit a class of employees that qualifies under the classification set up by the employer and found by the IRS not to be discriminatory in favor of HCEs.
(ii) The average benefit percentage for the eligible NHCEs must be 70 percent of the average benefit percentage for the eligible HCEs.

C. Minimum participation

(1) Occasionally referred to as the 50/40 test. For years after 1996, it applies to defined benefit plans only. For defined benefit plans, minimum participation must benefit the lesser of:

(a) 50 employees, or
(b) 40 percent of all employees

(2) *Example*: A law office has 125 employees. All employees are covered by the firm's defined benefit plan except for 70 associate attorneys and paralegals. The minimum participation requirement is satisfied because the plan covers at least the lesser of (1) 50 employees ($125 - 70 = 55$) or (2) 40 percent of all employees ($150 \times 40\% = 60$).

Note: The plan is also required to meet the minimum coverage requirement.

(3) Combining different plans of the same employer does not satisfy the requirement.

D. Actual deferral percentage test/actual contribution percentage test

(1) These are specific nondiscrimination tests for plans allowing salary deferrals and matching contributions (i.e., 401(k) plans).
(2) Actual deferral percentage test (ADP)

(a) This test compares the deferral rates of NHCEs relative to their compensation with the deferral rates of HCEs.
(b) The ADP of HCEs is limited by the ADP of NHCEs. If the ADP of HCEs is greater than the limit, HCEs must decrease their deferrals.
(c) The ADP of HCEs must not exceed the greater of:

(i) The ADP of all other employees times 125 percent, or
(ii) The lesser of

- The ADP of all other employees plus 2 percent, or
- The ADP of all other employees times 2

(d) Consider the following chart and illustration:

Exhibit 6.3 If the NHCEs defer						
If the NHCEs defer (on average)						
0.75%	2%	4%	6%	8%	10%	12%
Then the HCEs defer (on average)						
1.5%	4%	6%	8%	10%	12.5%	15%

If the ADP of NHCEs is less than 2 percent, HCEs may defer up to two times.
If the ADP of NHCEs is 2 percent to 8 percent, HCEs may defer an additional 2 percent.
If the ADP of NHCEs is more than 8 percent, HCEs may defer up to 125 percent.

(3) Actual contribution percentage (ACP) test

(a) Applies to employer matching contributions and after-tax employee contributions under all qualified DCP and employee contributions under a DBP, to the extent they are allocated to a separate account for each individual participant
(b) The ACP test is similar to the ADP test.

2. Integration with Social Security/disparity limits

A. Social Security provides greater benefit coverage for workers making less than the taxable wage base (TWB) and provides no additional coverage to those workers making more than the TWB. In other words, higher-income workers receive less retirement benefit than lower-income workers (i.e., less than the TWB) with respect to the Social Security retirement benefit.
B. The disparity in retirement benefit for the higher-income versus the lower-income workers can be "corrected" by integrating the Social Security benefit with the qualified retirement plan benefit. The disparity is allowed by the IRC as long as it is not considered discriminatory and regulatory limits are observed.
C. Defined benefit plan

(1) Excess method of integration with Social Security: The plan defines a compensation level called the integration level. The plan then provides a higher rate of benefits for compensation above the integration level.

Example: A plan has an annual benefit that is 30 percent of final average annual compensation plus 25 percent of compensation above the integration level. Steve retires with a final average compensation of $40,000. The integration level is $37,000. His annual retirement benefit is:

(a) 30 percent of final average compensation of $40,000, plus
(b) 25 percent of $3,000 ($40,000 − $37,000)
(c) The total benefit equals $12,750 ($12,000 + $750).

(2) The percentage spread between the benefit as a percentage of compensation above and below the integration level is restricted.

(a) Base benefit percentage: The percentage of compensation provided for compensation below the integration level

(b) Excess benefit percentage: The percentage of compensation above the integration level

(c) The excess benefit percentage cannot exceed the base percentage by more than ¾ of one percentage point for any year of service, or participant's years of service up to 35.

(d) *Example*: If a plan provides a benefit of 30 percent of final average compensation below the integration level, it cannot provide more than 56.25 percent of compensation above the integration level (the spread of 26.25 percent equals ¾ percent multiplied by 35 years).

(e) The maximum excess allowance—the spread between the base and excess benefit percentage—cannot be greater than the base benefit percentage. If a plan provides 10 percent of final average compensation below the integration level, then the excess benefit cannot exceed 20 percent. (A spread of 26.25 percent calculated from 35 years of service exceeds the maximum excess allowance.)

(3) Offset method of integration with Social Security. There is no integration level. The plan formula is reduced by a fixed amount or some formula amount designed to represent the existence of Social Security.

(a) No more than half of the benefit provided under the formula without the offset may be taken away by an offset.

(b) *Example*: If a plan provides for 50 percent of final average compensation with an offset, the lowest-paid employee must receive at least 25 percent of final average compensation.

D. Defined contribution plan

(1) Excess method only

(2) If the integration level equals the Social Security taxable wage base in effect ($97,200 in 2007), the spread in the allocation percentages above and below the integration level can be no more than the lesser of

(a) The percentage contribution below the integration level, or

(b) The greater of

(i) 5.7 percent

(ii) The old age portion of the Social Security tax rate

(3) *Example*: If a plan allocates a matching contribution plus forfeitures at the rate of 15.7 percent of compensation above the integration level, then it must allocate at least 10 percent of compensation below the level (making the difference 5.7 percent).

E. Plans with no Social Security integration: (1) LESOP, (2) SARSEP, (3) employer-matching 401(k) elective contributions.

3. Factors affecting qualified plan contributions or benefits

A. Tax consideration

(1) Deductible expense to the employer in the year of contribution

(2) Excluded from employer and employee current income

(3) Contribution is made from pretax dollars.

(4) Earnings are tax-deferred until distribution at retirement.

B. Nature of defined benefit: The highest annual benefit payable under the plan must not exceed the lesser of

 (1) 100 percent of the participant's compensation averaged over the three years of highest compensation, or
 (2) $180,000 (in 2007, and adjusted in $5,000 increments under a cost-of-living indexing formula). This limit is adjusted actuarially for retirement ages before age 62 and later than age 65.

C. Nature of defined contribution

 (1) The "annual additions" payable under the plan must not exceed the lesser of:

  (a) 100 percent of the participant's annual compensation, or
  (b) $45,000 (in 2007, and subject to increments of $1,000)

 (2) Annual additions include employer contributions, employee salary reductions, employee contributions, and plan forfeitures reallocated from other accounts.

D. Comparison of defined contribution and defined benefit

 (1) Only the first $225,000 of each employee's annual compensation (in 2007) can be taken into account in the plan's benefit or contribution formula.
 (2) The $225,000 compensation limit is scheduled to be indexed for inflation in increments of $5,000.
 (3) *Example*: If an employee has a 10 percent money-purchase plan and earned $300,000 in 2007, the maximum contribution for that employee is $22,500 (10 percent of $225,000).

E. Definition of compensation

 (1) Wages, salaries, fees for professional services, and other amounts received (without regard to whether an amount is paid in cash) for personal services rendered in the course of employment to the extent that the amounts are includible in income, whether earned from sources inside or outside the United States.
 (2) Elective or salary reduction contributions to a 401(k), or to 403(b) or SIMPLE plans or a similar arrangement
 (3) SEP contributions
 (4) Amounts contributed or deferred under a 457 plan
 (5) Elective or salary reduction contributions to a cafeteria plan (Section 125)

F. Multiple plans

 (1) Multiple plans will still be aggregated in applying the maximum contribution/benefit.
 (2) The administrative cost of multiple plans is higher than that of single plans.

G. Special rules for self-employed

 (1) A Keogh plan is a qualified retirement plan that covers one or more self-employed individuals of an unincorporated business.
 (2) A Keogh plan covers self-employed individuals who are not technically considered employees.
 (3) Any qualified retirement plan can be designed to cover self-employed individuals. It is usually designed as a profit-sharing plan or money-purchase plan.

(4) The maximum contribution under a defined contribution Keogh plan is $45,000 in 2007.

(5) "Earned income" takes the place of "compensation" for the self-employed in applying qualified plan rules.

(a) Earned income is defined as the self-employed individual's net income from the business after all deductions, including the deduction for Keogh plan contributions.

(b) A deduction for one-half of self-employment tax must be taken before determining the Keogh deduction.

(6) Adjusted percentage formula = plan contribution percentage (1 + plan contribution percentage).

(a) Maximum money-purchase plan contribution percentage = 100 percent/(1 + 100 percent) = 50 percent.

(b) Maximum profit-sharing plan contribution percentage = 25 percent/(1 + 25 percent) = 20 percent.

4. Top-heavy plans

A. Definitions

(1) Defined benefit plan. Top-heavy when more than 60 percent of the present value of the accrued benefits is allotted for key employees

(2) Defined contribution plan. Top-heavy when more than 60 percent of the total amount in the accounts of all employees is allotted to key employees

(3) SIMPLE 401(k) and safe harbor 401(k) plans are exempt from top-heavy requirements.

(4) A key employee (KE) is (in 2006)

(a) A more than 5 percent owner

(b) An officer with compensation in excess of $140,000 (indexed for inflation in increments of $5,000).

(c) A more than 1 percent owner with compensation in excess of $150,000

B. Vesting: If a plan is top-heavy, it must provide 100 percent vesting after three years of service or six-year graded vesting.

C. Effects on contributions or benefits

(1) If a plan is top-heavy, it must also provide minimum benefits or contributions for non-key employees.

(a) For defined benefit plans, the benefit for each nonkey employee during a top-heavy year must be at least 2 percent of compensation multiplied by the employee's years of service, up to 20 percent. The average compensation used for this formula is based on the highest five years of compensation.

(b) For defined contribution plans, employer contributions during a top-heavy year must be at least 3 percent of compensation.

(2) Super-top-heavy plan, if more than 90 percent of the total plan benefits are in favor of the key employees

(a) For DCP, contributions must be increased from 3 percent to 4 percent.

(b) For DBP, multiple is increased from 2 percent to 3 percent.

5. Loans from qualified plans

A. Allowed for all qualified plans if incorporated in the plan documents

B. For a loan not to be considered a "prohibited transaction," certain rules must be followed:

(1) Loans must be available to all participants and beneficiaries.
(2) Loans cannot be available to HCEs in greater proportions than to NHCEs.
(3) The loan must be made in accordance with plan documents.
(4) The loan must be made at a reasonable interest rate.
(5) The loan must be adequately secured (i.e., collateralized).

C. To avoid the loan's being characterized as a distribution

(1) The term of the loan must not exceed five years, unless used to acquire a principal residence.
(2) The loan amount must be the lesser of:

(a) $50,000, or
(b) 50 percent of the present value of the employee's vested account balance (or accrued benefit, in the case of a defined benefit plan)

(3) The plan document may allow a $10,000 minimum loan, even if this amount is greater than half of the present value. For example, an individual with an account balance of $17,000 could borrow up to $10,000.

D. Loans to self-employed persons (Keogh plans) are allowed as long as loans are available to all employees [Economic Growth and Tax Relief Reconciliation Act (EGTRRA) 2001].

TOPIC 63: OTHER TAX-ADVANTAGED RETIREMENT PLANS

1. Traditional IRA

A. Characteristics

(1) Eligible individuals can contribute up to the maximum contribution amount and possibly deduct this amount from current taxable income.
(2) Investment earnings are tax deferred.
(3) Premature withdrawals are subject to a 10 percent penalty.
(4) Withdrawals are not eligible for the special averaging tax computation that applies to certain lump sum distributions from qualified plans.
(5) An IRA cannot be established at age 70½, and withdrawals are required by April 1 of the year after the year in which the individual reaches age 70½.
(6) Loans are not available.

B. Prohibited investments include collectibles: artworks, rugs, antiques, metals, gems, stamps, coins, and other tangible property. An exception exists for U.S. gold coins, silver coins, and platinum coins.

C. Contribution rules

(1) Deduction limits

(a) Maximum annual deductible IRA contribution is the lesser of

(i) Maximum annual contribution amount, or
(ii) 100 percent of the individual's earned income, less contributions to a Roth IRA

(b) The maximum annual contribution amount is $4,000 in 2007.
(c) For individuals who have attained age 50 before the close of the tax year, an additional "catch-up" is allowed, $1,000 in 2007.

(2) Active participant restrictions

(a) An "active participant" is defined as an individual who actively participates in a qualified retirement plan, SEP, SIMPLE plan, TSA, or government plan.
(b) An individual is not an active participant in a defined contribution plan if only earnings are allocated to the individual's account.

D. Highly compensated

(1) To determine whether an employee is a highly compensated active employee for the determination year, two calculations are required: (1) look-back year and determination year.
(2) In the look-back year:

(a) The employee owns 5 percent of the employer, or
(b) Received compensation from the employer greater than $100,000 (as indexed in 2006); and, if the employer elects, is among the top-paid group of employees (top paid 20 percent of employees ranked by compensation)
(c) If the employer elects to use membership in the top-paid group, then the employer can choose to include fewer employees in the HCE group, even if those employees make more than $100,000. For example, if 35 percent of the employees earn more than $100,000 (as adjusted), including 5 percent owners, the top-paid group election will limit the selection of HCE group to 20 percent of employees.

(3) In the determination year:

(a) The employee owns 5 percent of the employer only.

(4) *Important:* The employee is an HCE if he or she meets either the look-back year or determination year conditions.
(5) *Example*: Assume an employer elects to use membership in the top-paid group. Jim, who started employment in 2006, has earned the following salaries each year:

Year	**Compensation**	**Status**
2006	$100,000	Excluded
2007	$105,000	Excluded
2008	$110,000	Excluded

Jim has earned more than $100,000 each year, but has been excluded from the HCE group because he is not a 5 percent owner or a member of the top-paid group. Now assume the employer does not elect to use membership in the top-paid group for 2007. For 2008, Jim is an HCE because for the look-back years he earned more than $100,000.

E. Controlled group

(1) IRS rules prevent employers from setting up multiple businesses whereby one business entity provides retirement plan benefits to key employees and another business entity that employs common-law workers provides zero benefits. When a control group relationship exists, all employees of the group are considered employees of a single

employer for the purpose of satisfying rules that govern QRP. A control group exists when there are:

(2) Parent-subsidiary relationships: There is = 80 percent common ownership by one or more companies in the group and the parent owns 80 percent of at least one company.

(a) Consider the following example:

Example: Corporation A owns 80 percent of Corporations B and C, and Corporations B and C each own 40 percent of Corporation D. Therefore, Corporation D is part of the parent-subsidiary controlled group because it is 80 percent owned by firms within the group.

(3) Brother-sister relationships. (1) Five or fewer people own 80 percent or more of the stock value and (2) the same five or fewer people own more than 50 percent of the stock or voting power of each corporation, taking into account the ownership of each person only to the extent that such ownership is identical with respect to each business (i.e., identical ownership test).

Example: ABC Corporation and XYZ Corporation are owned by four unrelated shareholders.

	Percentage of Ownership	
Shareholder	**ABC Corporation**	**XYZ Corporation**
Chris	80%	20%
Mark	10	50
Emma	5	15
Stan	5	15
TOTAL	100%	100%

The four shareholders together own more than 80 percent or more of the stock of each corporation, but they do not own more than 50 percent of the stock of each corporation, taking into account only the identical ownership as demonstrated:

Shareholder Identical Ownership Percentage

Chris 20% Mark 10 Emma 5 Stan 5 TOTAL 40%

ABC Corporation and XYZ Corporation do not constitute a controlled group of corporations.

(4) Affiliated service groups. Consist of a first service organization (FSO) and one or more "A" or "B" organizations. These groups were used to circumvent the controlled group rules originally set forth in ERISA. An FSO must be a professional service organization whose principal business is the performance of professional services of one or more of the following: CPA, actuary, architect, attorney, doctor, and engineer.

(a) "A" organization

(i) Is an owner (a shareholder or partner) of an FSO and
(ii) Regularly performs services for the FSO

(b) "B" organization

(i) A significant portion of "B" organization's business is the performance of services for the FSO, or "A" organization.
(ii) At least 10 percent owned by officers, HCEs, or owners of the FSO, or "A" Organization.

(c) An individual is an active participant in a defined benefit plan if he or she is eligible but declines to participate.
(d) Individuals who are not active participants can deduct contributions to an IRA regardless of what they earn.
(e) For an active participant, fully deductible contributions are allowed only if the taxpayer has AGI below specified limits. The deduction begins to decrease (phase out) when income rises above a certain amount and is eliminated altogether when it reaches a higher amount. These amounts vary, depending on filing status.

IRA Active Participant AGI Phaseout Ranges

Year	Single	Married Filing Jointly	Married Filing Separately
2007	$52,000–$62,000	$83,000–$93,000	$0–$10,000

(f) For taxpayers whose AGI falls between the phaseout levels, the followingcalculation can be performed to determine the deduction amount:
Deductible amount = maximum contribution – [maximum contribution × (AGI – filing status floor)/phaseout range)]
(g) *Example*: Steve and Julie are married filing jointly. They are both active participants and have combined adjusted gross income of $88,000 for 2007. They can each make a full contribution of $4,000 ($8,000 total) to their IRA account, but only a portion is deductible. Because the AGI is $5,000 more than the lower-level limit, they will each lose half of the deductible contribution. To calculate: $4,000 − [$4,000 × ($90,000 − $85,000)/$10,000] = $2,000. So each can deduct $2,000 ($4,000 total) for the tax year.
(h) For married taxpayers, the rules are different when only one spouse is an active participant. In this case, a $4,000 deductible IRA contribution is available for the nonactive participant spouse as long as the couple's AGI does not exceed $156,000 (2007). The deduction is phased out from $156,000 to $166,000, and is gone completely if the AGI is $166,000 or more. A deductible contribution is not available for the nonactive spouse if the couple file separate tax returns.
(i) *Example*: Assume that Rita is an active participant in a qualified retirement plan and her husband, Steve, is not. The combined AGI of Rita and Steve for the year is $200,000. Neither Rita nor Steve is entitled to a deductible contribution to an IRA in 2006.

(5) Time limits

(a) An IRA can be established any time prior to the due date of an individual's tax return, without extensions (even if given). The cutoff date is April 15 for most taxpayers.
(b) Because earnings are tax deferred, it is recommended to make contributions as early as possible to benefit from compounding.

(6) Nonrefundable credit—A limited nonrefundable tax credit is available for low-income taxpayers who make contributions to an traditional IRA.

F. Distributions taken before 59½

(1) Nondeductible contributions are withdrawn tax free on a pro rata basis. Deductible contributions and earnings are treated as ordinary income and are subject to federal income tax.
(2) The formula for determining the nontaxable portion of an IRA distribution is
(Total nondeductible contributions/aggregate
IRA year-end account balances plus amount of IRA distribution) × IRA distribution

(3) Example: Assume that Margaret has made a deductible IRA contribution of $1,800 and a nondeductible contribution of $2,200 over the last two years. Margaret takes $1,000 out of her IRA on January 1. At the end of the year, her account balance is $4,500. Of the $1,000 withdrawn, $415 is treated as a partial return of nondeductible contributions. It is calculated as follows:

$$\frac{\$2{,}200}{\$4{,}500 + \$1{,}000} \times \$1{,}000 = \$400$$

Thus, $600 ($1,000 − $400) is included in Margaret's tax return.

(4) A 10 percent penalty tax is imposed unless an exception applies. The 10 percent penalty tax is imposed on the recipient of the distribution and applies only to the portion of the distribution included in gross income. The portion that represents the cost recovery (i.e., nondeductible contributions) is not subject to the 10 percent penalty.

(5) Example: Jim receives a $40,000 distribution from his IRA, of which $25,000 represents his nondeductible contributions. Because no exception applies, a 10 percent penalty of $1,500 [($40,000 − $25,000) × 10%] is imposed on Jim.

G. Excess contribution penalty

(1) If an individual contributes more to an IRA account than is allowed, the excess contribution is subject to a 6 percent excise tax. The penalty will be charged each year the excess contribution remains in the account. The individual can avoid paying the tax by withdrawing the excess contribution and any earnings before the due date of the federal income tax return.

(2) The earnings on the excess contributions are treated as gross income for the taxable year.

2. Roth IRA, including conversion analysis

A. Characteristics

(1) The contribution amount is limited each year, and is eliminated beyond a certain AGI level.
(2) Qualified withdrawals are entirely tax-free (this includes investment income, capital gains, and other gains).
(3) Premature withdrawals in excess of contributions are taxed in full and are subject to a 10 percent penalty.
(4) Contribution eligibility is not restricted by active participation.
(5) Contributions can be made after age 70½.
(6) A Roth IRA is not subject to minimum distribution rules until the death of the owner.
(7) Loans are not available.

B. Contribution rules

(1) Contribution limit

(a) The maximum annual deductible IRA contribution is the lesser of

(i) Maximum annual contribution amount, or
(ii) 100 percent of the individual's earned income, less contributions to traditional IRAs

(b) Nondeductible contribution = after-tax contribution.
(c) The maximum annual contribution amount is $4,000 in 2007.
(d) For individuals who have attained age 50 before the close of the tax year, an additional "catch-up" is allowed, $1,000 in 2007.

(2) Contribution AGI phaseout limits

(a) AGI used for these limits is "modified" AGI, which excludes taxable income from a conversion of a traditional IRA to a Roth IRA.
(b) The phaseout limits are as follows:

Unmarried individuals	$99,000 to $114,000
Married joint return filers	156,000 to $166,000
Married separate filers	$0 to $10,000

Example: Helen is a single taxpayer and has an AGI of $105,000 for 2007. Helen may make a contribution of up to $1,333 to the Roth IRA, computed as follows:

AGI
$104,000
Less: Applicable dollar amount
$99,000 difference
$10,000
Reduction to $4,000 (in 2007) limitation ($4,000 × $10,000 /$15,000) $2,667
Maximum Roth IRA contribution ($4,000 − $2,667) $1,333

(3) Time limits: Same as for traditional IRA
(4) Nonrefundable credit: Same as for traditional IRA
(5) Employer-sponsored Roth IRAs: Employers can sponsor a Roth IRA for an employee as a limited alternative to qualified plans.
(6) Qualified Roth contribution programs: Employers can amend their Section 401(k) and Section 403(b) plans to provide that a participant's elective deferrals go into a qualified Roth contribution program. This would be a separate account under a 401(k) or 403(b).

C. Rollovers (Roth conversions)

(1) An individual may make a qualified rollover contribution to a Roth IRA from a traditional IRA unless

(a) The individual's modified AGI exceeds $100,000, or
(b) The individual is married and files a separate return (There is one exception: See the following Section (4))

(2) The $100,000 AGI limit applies to both single individuals and married individuals filing joint returns.
(3) *Example*: Bart and Jill are married and file separate returns. Their combined AGI is $105,000. Neither Bart nor Jill can make a rollover from an IRA to a Roth IRA, because a married individual filing a separate return is ineligible to make this rollover. Therefore, this would also be true if their combined AGI were less than $100,000.
(4) *Exception:* The only exception to this joint filing requirement is for an individual who has lived apart from the spouse for the entire taxable year. In this case, the individual can be treated as not married and can file a separate tax return.
(5) The disadvantage of conversion of a traditional IRA to a Roth IRA is that the amount is fully taxable to the owner's ordinary income. The conversion amount is not included in AGI in determining whether the $100,000 limit has been reached. Thus, conversion accelerates all taxes on a traditional IRA that would otherwise be deferred.
(6) Qualified retirement plans must first be rolled over to a traditional IRA and then converted to a Roth IRA.

D. Conversion analysis (is it advisable to convert a traditional IRA to a Roth IRA?)

(1) For the same investment rates and tax rates, studies show that the Roth IRA always produces more money at retirement. If taxpayers invest the full contribution limit, the full amount is at work in a Roth and only the net investment is at work in a traditional IRA (because taxes will eventually be owed).

(2) *Example*: A taxpayer in the 28 percent marginal tax bracket when making a $4,000 (in 2007) contribution to a traditional IRA is really making only a net investment of $2,880; however, the taxpayer is investing the full $4,000 in the Roth IRA, not $2,880. It is highly likely that the taxpayer will find the $4,000 after-tax dollars to take full advantage of the ROTH IRA maximum contribution amount.

(3) Studies further show that a Roth IRA conversion produces better results than would be produced if the assets were left in a traditional IRA. This advantage is more pronounced if taxes are not paid out of the amount converted.

(4) The longer assets remain in a Roth IRA before withdrawal, the greater the advantage from the conversion.

(5) Exception: Because all income taxes are paid up front in the year of conversion, if future income tax rates are drastically reduced, the benefit of conversion diminishes.

E. Distribution rules

(1) A distribution from a Roth IRA is not includible in the owner's gross income if it is a "qualified distribution."

(a) Distributions of earnings are tax-free if the participant is at least age 59½ and the Roth IRA has been established for five or more years.
(b) Contributions are made with after-tax dollars and are never taxed.
(c) A five-year clock starts with the initial contribution to a Roth IRA.

(2) Withdrawals from a Roth are deemed to occur in a specific order.

(a) From excess contributions: Amounts that exceed the annual contribution limits. These generally are free from federal income tax except for gains (which may be subject to a 10 percent penalty if the individual is less than 59½ years old).
(b) From annual Roth IRA contributions: Sum of the aggregate annual contributions, for which no deduction was allowed (referred to as the contribution-first recovery rule). These are always recovered without federal income tax liability or penalty.
(c) From the taxed income component resulting from the first conversion contribution. These distributions are previously taxed amounts (basis) and are not subject to federal income tax. They may be subject to a 10 percent penalty.
(d) From conversion contributions made in later taxable years. Conversion contributions are considered on a first-in, first-out basis, and for this purpose all conversions that occur within a single taxable year are aggregated. These distributions are not subject to federal income tax. They may be subject to a 10 percent penalty.

Note: These first four categories are returned income tax free.

(e) From earnings (gain) on all contributions. Earnings on contributions are subject to federal income tax unless they are received in a qualified distribution. Taxable earnings are also subject to a 10 percent penalty if the individual is less than 59½ years old or an exception does not apply.

(3) Special rule for a conversion contribution distributed when a taxpayer is less than 59½ years old and before the end of the five-year period starting with the year in which the

conversion was made: The distribution is subject to the 10 percent premature distribution penalty, unless an exception under Section 72(t) applies. (*Note:* The special rule closes the loophole for the converted amount to be withdrawn immediately without penalty.)

(4) *Example*: Betty, age 29, converted and established a Roth IRA. She made an annual contribution of $100 in 2007. In the same year, she also converted a traditional deductible IRA worth $10,000 to a Roth IRA, which is credited with a $50 gain. In 2007, Betty removes $10,150 from her Roth IRAs. The following is a summary of taxable events:

(a) With respect to the 2007 conversion, Betty will have to include $10,000 (the taxable amount) on her federal income tax return for the year 2007.
(b) The $100 is treated as distributable first, but is not a qualified distribution. Nonetheless, the $100 amount is not taxable because of the ordering rules and is not subject to penalty.
(c) The $10,000 is treated as distributed next. This amount is not taxable for the same reason, but is subject to the 10 percent penalty tax unless a Section 72(t) exception applies. Under the special rule, the 5-year period started in 2002, the year in which the conversion amount being withdrawn was contributed.
(d) The $50 gain is treated as distributed last. The $50 is not a qualified distribution because Betty is less than 59½ years old. It is subject to federal income tax and 10 percent penalty tax, unless 72(t) applies.

3. Simplified employee pension (SEPs)

A. Characteristics common to defined contribution plans

(1) Annual employer tax-deductible contributions limited to 25% of compensation for common-law employees; for owner/employee the limit is 20 percent of net earnings.
(2) Subject to funding by the employer only
(3) Section 415(c), annual additions are limited to the lesser of 100 percent compensation or $45,000—this is the maximum amount that can be allocated to each participant. The same applies to other defined contribution type plans.
(4) The $225,000 (in 2007) compensation cap that applies to qualified plans also applies to SEPs.
(5) Nondiscrimination rules and top-heavy rules apply.
(6) Controlled group/affiliated services group rules apply.
(7) Participation in a SEP satisfies "active participant status" for determining deductible IRA contribution.
(8) The plan may integrate with Social Security.
(9) Direct employer contributions are not subject to Social Security (FICA) or federal unemployment (FUTA) taxes. Salary reductions are subject to FICA and FUTA.
(10) Plans established prior to January 1, 1997 may allow 401(k) provisions; that is, SARSEPs are "grandfathered" but no new such plans after January 1, 1997.

B. Characteristics UNIQUE to SEP

(1) Special coverage requirements:

(a) Covers all employees who are at least age 21, and
(b) Worked during three of the past five years, including contribution year (part-time employment counts in determining years of service), and
(c) Received compensation of more than $500 (in 2007)

(2) May exclude employee as "eligible" if he or she is

(a) A member of a collective bargaining unit
(b) A nonresident alien

(3) Contributions are fully discretionary, which gives employer full control and maximum flexibility; substantial and recurring contributions are not required.
(4) Deadline for contributions to a SEP is April 15, including extensions.
(5) Administration costs are very low; there are no annual filing requirements.
(6) The plan is totally portable because employees are always 100 percent vested.
(7) Distributions are not eligible for special averaging.
(8) Loans are not permitted.

C. Appropriate plan usage

(1) A SEP is a good choice for a small employer because

(a) Coverage rules are easier to work with than those of qualified plans.
(b) Shorter-term employees can be eliminated from the plan (less than three years).
(c) There are lower costs and administrative expenses.

(2) A SEP is a poor choice if an employer has many long-term part-time employees, because they will have to be covered by the plan.
(3) A profit-sharing plan should be chosen if an employer wants a more aggressive age-weighted or cross-tested allocation formula that benefits older, more highly compensated employees.

D. Distributions—same as traditional IRA
E. Salary reduction SEPs (SARSEPs)

(1) Plan must have been in place before January 1, 1997. Ongoing contributions and new participants may be added to "grandfathered" plans.
(2) Employer must have = 25 eligible employees in the preceding years.
(3) At least 50 percent of the eligible employees must participate.
(4) The employee must add together, each year, all elective deferrals to (1) salary reduction SEPs, (2) Section 401(k) plans, (3) SIMPLE IRAs, and (4) Section 403(b) plans. Elective deferrals are limited to $15,500 in 2007. The total must not exceed $15,500 in 2007. Employees who have reached age 50 have a catch-up provision of $5,000 in 2007.
(5) Special ADP test applies: Deferral percentage of each HCE must not exceed the ADP of all eligible NHCEs multiplied by 125 percent.

4. SIMPLE IRAs

A. Characteristics

(1) Plan is easy to administer.
(2) Benefits of a SIMPLE IRA are totally portable because employees are always 100 percent vested.
(3) Individuals can benefit from a broad range of investments.
(4) Plan can be funded in part from salary reductions by employees.
(5) Annual contributions are restricted to lesser amounts than provided by a qualified plan.
(6) Distributions are not eligible for 10-year averaging.
(7) If an employer adopts a SIMPLE IRA plan, it cannot maintain a qualified plan, SEP, 403(a) annuity, 403(b) plan, or 457 plan.

(8) Employee elective deferrals are excludable for income, employer contributions are deductible, earnings are tax-deferred.
(9) Direct employer contributions are not subject to FICA and FUTA taxes. Employee salary reduction contributions are subject to FICA and FUTA.
(10) There are no nondiscrimination testing and top-heavy rules.
(11) Two conditions must be met in order to be eligible to establish plan:

(a) Employer has no more than 100 employees (counting only those employees earning at least $5,000 in compensation). If the employer grows beyond the 100-employee limit, the law does allow the employer to sponsor the plan for an additional two-year grace period.
(b) Employer cannot maintain any other qualified plan, 403(b), 403(a) annuity, 457 plan, or SEP at the same time it has a SIMPLE.

B. Contributions

(1) Employees who earned at least $5,000 from the employer in any two preceding years, and are expected to earn $5,000 in the current year, can contribute $10,500 in 2007. Catch-up is $2,500 in 2007.
(2) Participants must be age 21 or older with one year of service (1,000 hours).
(3) The employer is required to make a contribution equal to either

(a) A dollar-for-dollar contribution up to a limit of 3 percent of the employee's compensation. This is permitted to be reduced at the option of the employer if

(i) The limit is not reduced below 1 percent.
(ii) The limit is not reduced for more than two years of a five-year period that ends (and includes) the year for which the election is effective.
(iii) Employees are notified of the reduced limit within a reasonable period of time.

Important: For the 3 percent match, the annual compensation limit does not apply.

Example: Baby Corporation sets-up a SIMPLE IRA plan in 2007. The president, Jim, earns compensation of $220,000. If Jim elects to defer $7,000, Baby Corporation must match an additional $6,750 (225,000 × 3%). Therefore, a total of $13,750 will be contributed to Jim's SIMPLE IRA.

(b) A 2 percent nonelective contribution for the matching contribution, but only if

(i) Eligible employees are notified that a 2 percent nonelective contribution will be made instead of a matching contribution, and
(ii) This notice is provided within a reasonable period of time.

Important: For purposes of the 2 percent nonelective contribution, the annual compensation limitation ($225,000 in 2007) does apply.

Example: Assume the same facts as in the earlier example, except that Baby Corporation has elected to make a nonelective contribution of 2 percent of compensation. Therefore, the total contribution made to Jim's SIMPLE IRA will equal $11,500 [$7,000 + $4,500 (2% × 225,000)].

C. Distributions

(1) Rollovers permitted:

(a) SIMPLE plan to SIMPLE plan
(b) SIMPLE plan to IRA or SEP if in SIMPLE plan for two years

(2) Discontinuing participation after two years, a SIMPLE is treated as a traditional IRA.
(3) Early withdrawals:

(a) 25 percent penalty if withdrawal is during first two years of participation
(b) 10 percent penalty after two years of participation

(4) Loans are not permitted.
(5) There is no protection under anticreditor provisions.

5. Section 403(b) plans (also called tax-deferred annuity plans or tax-sheltered annuity plans)

A. Eligibility

(1) If offered, such a plan must be offered to all employees regardless of age, service, or union affiliation.
(2) An organization must be one of the following to adopt a Section 403(b) plan:

(a) A tax-exempt employer described in Section 501(c)(3) of the Code
(b) An educational organization (most public schools and colleges)

(3) A self-employed duly ordained or licensed minister of a church who works for an employer that is not a qualified tax-exempt organization is treated as working for such an organization for the purposes of participating in a tax-sheltered annuity (TSA) plan.

B. Plan characteristics

(1) Funded by employee contributions
(2) Permitted rollovers:

(a) TSA to TSA, 401(k), or 457 plan maintained by a state/local government
(b) TSA to traditional IRA

(3) Not considered a qualified plan, although subject to similar restrictions
(4) A TSA is subject to ERISA if an employer contributes.

(a) Subject to ERISA's minimum vesting schedules, but seldom used—usually 100 percent vested
(b) Must comply with nondiscrimination tests

(5) A TSA is not subject to ERISA if the following conditions are met:

(a) Employee participation is voluntary.
(b) All rights under the annuity contract or the custodial account are controlled by the participant, participant's beneficiary, or his or her designee.
(c) The employer's involvement is primarily limited to activities such as collecting salary reductions for deposit into TSA accounts or providing information of the TSA vendors to the participants.

C. Plan investments limited to

(1) Annuity contracts
(2) Mutual fund shares
(3) Life insurance, with some restrictions
(4) Retirement income accounts (DCP) maintained by churches or certain church-related organizations

D. Contribution limits

(1) Employee salary reductions are subject to an annual limit—$15,500 in 2007.
(2) The limit of salary deferrals applies in the aggregate of all elective deferrals under 403(b), 401(k), SARSEP, and SIMPLE plans. Section 457(b) plans have separate limits that are not reduced by contributions to either a 401(k) or 403(b) plan.
(3) Salary reduction catch-up

(a) If an employee has completed 15 years of service for the employer, and the employer is (1) an educational organization, (2) a hospital, (3) a home health care agency, or (4) a church, synagogue or related organization, the elective deferral limit is increased by an additional sum equal to the lesser of

(i) $3,000,
(ii) $15,000, reduced by any amounts excluded from gross income for prior taxable years by reason of the catch-up provision, or
(iii) $5,000 times the employee's years of service with the employer, less all prior salary reductions with the employer

(b) Participants who are age 50 and over are eligible for additional elective deferrals—$5,000 in 2007.

(4) Total amount of tax-deferred employer and employee contributions to the employee's account is subject to the annual Section 415 limitation of the lesser of

(a) 100 percent of compensation, or
(b) $45,000

(5) For all employers, only the first $225,000 (in 2007) of each participant's compensation can be taken into account in any plan contribution formula.

E. Distributions

(1) Distributions are subject to the qualified plan distribution rules.
(2) In-service distribution

(a) Hardship withdrawals allowed
(b) Loans—subject to plan document

6. Section 457 plans

A. Eligibility—can be offered to all employees, or any group of employees, or even a single employee

(1) Employee of state and local governments, their agencies
(2) Employee of tax-exempt organization—Section 501(c)(3) organization, excluding church, synagogue, or any organization controlled by a church or synagogue

B. Funding the plan

(1) Governmental plans must be funded per the Small Business Job Protection Act (SBJPA) 1996 [Section 457(g)]. The governmental 457 plan holds all plan assets and income in trust, or in custodial accounts or annuity contracts, for the exclusive benefit of the participants and beneficiaries.
(2) A funded 457 plan for a nongovernmental tax-exempt organization is subject to ERISA. Such organizations can avoid ERISA requirements if they are designed to take advantage

of ERISA exemptions—for example, “unfunded plans” for highly compensated members only (i.e., top hat plans).

(a) Unfunded means that the 457 assets remain the property of the employer and subject to the claims of the employer’s creditors. The employee does not have any rights or security interest in the assets.
(b) If the assets are subject to the claims of the company’s general creditors, there is no constructive receipt by the participant, and therefore there is no receipt of income and taxes are deferred.

(3) Unfunded assets may be set aside in a reserve fund by the employer to provide the deferred compensation.

C. Contributions

(1) The amount deferred annually by an employee cannot exceed the lesser of 100 percent of compensation or applicable dollar limit—$15,500 in 2007.
(2) Participants in a 457 plan of a government employer who are age 50 and older are eligible for additional salary reduction contributions—$5,000 in 2007.
(3) Three-year catch-up provision—intended to provide an employee who did not make maximum annual deferrals in prior years to make higher contributions in anticipation of retirement

(a) Applied during the last three years prior to plan’s retirement, the limit of deferral is increased to the lesser of

(i) Twice the amount of the regularly applicable dollar limit, or
(ii) The sum of

- The otherwise applicable limit for the year, plus
- The amount by which the applicable limit in preceding years exceeded the participant’s actual deferral for those years

(b) The “final three-year” provisions cannot be used if the new “aged 50+ catch-up” provision is being used.
(c) Applies to all eligible 457 plans (not just eligible 457 governmental plans)

D. Distributions

(1) Plan distributions cannot be made before

(a) The calendar year in which the participant attains age 70½
(b) Severance from employment
(c) An unforeseeable emergency as defined in the regulations

(2) In-service distributions

(a) A one-time distribution by participant is allowed under the following conditions:

(i) Total amount payable may not exceed $5,000.
(ii) No deferred compensation has been made for at least two years.
(iii) Participant has not used this option previously.

(b) Mandatory cashout by the 457 plan—used to close small, inactive accounts in order to reduce administrative costs; allowed under following conditions:

(i) The accounts do not exceed $5,000.

(ii) No deferred compensation has been made for at least two years.
(iii) There has been no previous use of the cashout provision.

(3) Because this is not a QRP, there is no forward averaging option.
(4) Loans are permitted if allowed in the plan document.
(5) Participant may delay distribution one time if elected prior to start of distribution.

TOPIC 64: REGULATORY CONSIDERATIONS

1. Employee Retirement Income Security Act (ERISA)

A. Fiduciary is any person (e.g., trustee, plan administrator, employer—officer and director—plan sponsor, or investment adviser) who:

(1) Exercises any discretionary authority or control over plan management
(2) Exercises any authority or control over management or disposition of plan assets
(3) Renders investment advice for a fee or other compensation
(4) Has discretionary authority or responsibility over plan administration

B. IRS involvement

(1) All new plans must be submitted to the IRS for approval
(2) Monitors operation of existing plans
(3) Interprets existing law and issue regulations to be applied to all plans
(4) Rules on matters of employer deductibility of plan contributions

C. Department of Labor (DOL) involvement

(1) Monitors investment of plan assets and the actions of those in charge of administering plans
(2) Shares with the IRS oversight of prohibited transactions

D. Created the Pension Benefit Guarantee Corporation (PBGC)

(1) Mandatory insurance for defined benefit plans; annual premium $30/year/participant
(2) Plan termination insurance under PBGC

(a) Guaranteed (basic) benefits—nonforfeitable

(i) Retirement benefits
(ii) Death benefits in pay status
(iii) Survivor benefits in pay status
(iv) Disability benefits owed or in pay status

(b) Benefit must be a "pension benefit."
(c) Participant must be eligible for benefit at time of plan termination.
(d) Nonguaranteed benefits

(i) Retirement benefits in excess of PBGC limit
(ii) Medical insurance premiums/benefit

(e) Limitations

(i) Monthly payments only—no lump sum
(ii) Guaranteed monthly benefit cannot be greater than employee's gross monthly income during the five consecutive years of highest earnings.
(iii) Maximum age 65 monthly benefit adjusted annually along with the Social Security wage base (SSWB) changes ($3,971.59/monthly − $47,659/annually in 2006)

E. Qualified plan terminations

(1) General information

(a) QRP are established for the benefit of the participant and his or her beneficiaries.
(b) The plan must be permanent.

(2) Termination of plan

(a) Termination cannot be implemented arbitrarily.
(b) Termination must be because of business necessity.
(c) Termination must follow specific rules governing allocation of plan assets.

(3) Voluntary termination

(a) Standard termination. A single employer may terminate under this type of termination if the plan has sufficient assets for benefit liabilities. Plan assets must be distributed according to ERISA.
(b) Distress termination. A single employer may terminate under distress termination if the plan does not have sufficient assets to pay vested benefits (where employer is in bankruptcy (BK) proceedings or will be able to continue in business only if relieved of outstanding pension liabilities). Employer must provide to PBGC actuarial certification of asset values and benefit liabilities.

(4) Involuntary termination. The PBGC may terminate an underfunded plan for one or more of the following reasons:

(a) Plan does not comply with minimum funding standard.
(b) Plan cannot pay benefits when due.
(c) Plan has unfunded liabilities following a distribution of more than $10,000 to an owner.
(d) If plan is not terminated, loss to the PBGC is expected to be unacceptably high.

(5) Switching from DBP to DCP

(a) Requires the DBP to be terminated
(b) Creation of a new DCP
(c) Voluntary standard termination
(d) 100 percent vesting of affected participants
(e) Distribution of plan assets in accordance with ERISA

(6) Switching from a DBP to a cash balance plan

(a) Requires only amending the DBP
(b) Avoids vesting, distribution, and plan termination

(7) Priority for allocating plan assets (must precede asset reversion)

(a) Employee voluntary contributions
(b) Employee mandatory contributions
(c) Certain annuity payments in pay status
(d) Other guaranteed (insured) benefits
(e) Other vested benefits that are not guaranteed
(f) All other plan-provided benefits

(8) Reversion of residual assets to employee
   (a) 50 percent penalty on assets reversions
   (b) Penalty reduced to 20 percent if employer (1) transfers 25 percent of potential reversion amount to a replacement plan, or (2) increases the participants' accrued benefits by at least 20 percent.

2. DOL regulations—ERISA of 1974

A. Established guidelines for qualified and nonqualified employee benefit plans involving retirement income
B. Established nondiscriminatory rules for favored employee groups: highly compensated employees and key employees
C. Established vesting schedules for employees
D. Requires adequate funding of pension plans

3. Fiduciary obligations: ERISA requires that a fiduciary act "solely in the interest of the participants and their beneficiaries." A fiduciary must

A. Act for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administrating the plan.
B. Act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." This is the Prudent Man Rule.
C. Diversify investments of the plan "in order to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."
D. Act "in accordance with the plan document and instruments governing the plan inasmuch as these documents and instruments are consistent with ERISA provisions." This rule requires the fiduciary to strictly follow the terms of the plan document when making decisions.

4. Prohibited transactions (between a retirement plan and a disqualified person/party)

A. There are six prohibited transactions:
   (1) Sale, exchange, or lease of property
   (2) Lending money or extending credit
   (3) Furnishing goods, services, or facilities
   (4) Transfer to or use of plan assets by a disqualified person
   (5) If a fiduciary, dealing with plan income or assets in own account
   (6) If a fiduciary, receiving consideration for own account from a party involved in the plan transaction (cannot receive outside pay)

B. Disqualified persons/party for the purposes of Prohibited Transactions Rules
   (1) A fiduciary
   (2) Any person providing services to the plan
   (3) An employer or employee organization, any of whose members are covered by the plan
   (4) A 50 percent owner of (3)
   (5) A member of the family of (1), (2), (3), or (4)
   (6) A corporation, partnership, trust, or estate that is 50 percent or more owned by (1), (2), (3), or (4)

(7) An officer, director, 10 percent or more shareholder, highly compensated employee (earning at least 10 percent of the employer's total payroll), or a 10 percent or more partner or joint venture of person in (3), (4), or (5)

C. Tax consequences imposed on a plan committing prohibited transaction(s)—this is a two-tier penalty:

(1) A penalty tax equal to 15 percent of the amount involved in the prohibited transaction is imposed on all disqualified persons involved (individually and together) for each year or part thereof that the transaction remains uncorrected. The 15 percent penalty carries over from year to year, and a new 15 percent penalty is assessed each year. Because it is both a continuing transaction and a new transaction each year, this penalty tax pyramids.
(2) An additional penalty tax equal to 100 percent of the amount involved is imposed if the prohibited transaction is not timely corrected.

D. Exemptions from Prohibited Transactions Rules

(1) Receipt of benefits under terms of the plan
(2) Distribution of plan assets according to allocation provisions
(3) Loans available to plan participants and beneficiaries (see topic 76)
(4) Loans made to an ESOP
(5) Purchase or sale of qualifying employer securities by an individual account, profit sharing, stock bonus, thrift or savings plan, or ESOP, for adequate consideration and without commission
(6) Providing office space/services for the plan for "reasonable" compensation

5. **Reporting requirements**

A. Advance Determination Letter for new plans (i.e., not prototypes)
B. Prototype/model plans—IRS preapproved plans
C. Summary plan descriptions (SPD)—for communicating plan benefits to the participants and their beneficiaries

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TOPIC 65: KEY FACTORS AFFECTING PLAN SELECTION FOR BUSINESSES

Key factors affecting selection

1. **Owner's personal objectives**

A. Tax considerations: Maximize personal tax benefits.
B. Capital needs at retirement: Maximize personal retirement benefits and achieve retirement income goals/objectives.
C. Capital needs at death: Provide estate protection.

2. **Business's objectives**

A. Tax considerations: Reduce corporate income tax.
B. Cash flow situation and outlook: Variable, stable, or increasing cash flow; projected cash flow in the future
C. Employee demographics: Reward valued employees, motivate employees, reduce turnover, increase employee satisfaction.

D. Comparison of defined contribution and defined benefit plan alternatives

(1) Maximize the proportion of plan costs that benefit highly compensated employees.

(a) Defined benefit plans: These provide the maximum benefit for key employees when key employees are generally older than rank-and-file employees; they include service-based contributions or benefit formulas that are in favor of key employees.
(b) Age-weighting: Age-weighted plans constitute an allocation method to increase the contributions to a QRP for the benefit of the older HCEs by weighting for age and compensation. This is not discriminatory as long as the allocation method is applied uniformly to all participants.
(c) Cross-testing: With this method, nondiscrimination in a defined contribution plan is determined by looking at projected benefits under the plan at each employee's retirement age, rather than looking at the amounts contributed by the employer each year. New comparability plans are tested under cross-testing rules to satisfy nondiscrimination requirements.

(i) A new comparability plan is one in which the compensation percentage formula for one category (rather than strictly age) of participants is greater than the formula for other participants.
(ii) The plan must contain a definite predetermined formula for allocating contributions made to the plan participants.
(iii) Typically, substantial contributions are made for the favored and older employees, and much lower contributions for other employees.

(d) Section 401(k) plans: Traditional plans allow a higher rate of contribution to HCEs under the ADP test, as long as there is maximum participation by NHCEs. Safe harbor plans and SIMPLE 401(k) plans allow employers to avoid ADP/ACP testing.
(e) Social Security integration: Recall that Social Security favors the lower-income employees, that is, below the SSWB. It is, by design, discriminatory against the business owner and the more highly compensated employee.

(2) Provide a savings medium that employees perceive as valuable.

(a) Defined contribution plans. Every defined contribution plan has individual accounts, so each employee knows how much his or her personal benefit is worth.
(b) Cash balance plans. These plans tend to provide greater benefits to younger employees with shorter service, as compared with other defined benefit plans.
(c) Plans with employee participation. Section 401(k) plans allow an employee to make before-tax salary reductions.

(3) Provide adequate replacement income for each employee's retirement. A defined benefit plan is the best vehicle if adequate replacement income is an employer's objective. The following is a list of reasons:

(a) Defined benefit plans provide benefit based on final compensation, not necessarily years of service. Defined contribution plans provide benefits directly related to years of service, because newer employees cannot accumulate substantial savings.
(b) The employer guarantees the benefit. There is no investment risk for employees in a defined benefit plan.
(c) Employer funding is mandatory.
(d) The plan can provide maximum life insurance.

(4) Create an incentive for employees to maximize performance.

(a) Profit-sharing plans
(b) ESOP/stock bonus plans
(c) Any other defined contribution plan or cash balance plan

(5) Minimize turnover.

(a) Defined benefit plan versus defined contribution plan. Both plans reward employees who stay until retirement. Defined benefit plans provide benefits that are generally based on years of service; defined contribution plans have benefits that continue to grow with each year of service. However, defined contribution plans are generally portable, allowing employees to move between jobs.
(b) Graduated vesting—minimizes the cost of covering short-service employees.

(6) Encourage retirement: Defined benefit plan works best to encourage retirement because:

(a) No further benefits can be earned upon reaching designated retirement age in the plan.
(b) It designs a subsidized early retirement incentive.

(7) Maximize employer contribution flexibility. Profit sharing plans and SEPs offer the most flexibility. Other types of plans have less flexibility in one way or another.

TOPIC 66: INVESTMENT CONSIDERATIONS FOR RETIREMENT PLANS

(Fiduciary considerations and prohibited transactions are part of Topic 64.)

1. **Suitability**

A. Time horizon: the time in which a specific financial goal is expected to be reached
B. Feasibility of installation of a qualified plan

(1) Client objectives

(a) Personal objectives: Maximize personal tax benefits; maximize personal retirement benefits; achieve retirement income goal; provide estate protection.
(b) Business objectives: Reduce corporate income tax; reward valued employees; motivate employees; reduce employee turnover; increase employee job satisfaction.
(c) Altruistic objectives: Provide employees with retirement income; promote employee savings; provide flexible compensation; share profits; share ownership.

C. Constraints (to provide a plan that will meet the needs of the client.)

(1) Personnel characteristics, profile (age, service, compensation, etc.)
(2) Profits and cash flows (variable, stable, etc.)
(3) Profile of employees (long-term, part-time, etc.)
(4) Profile of the business owner (age, financial situation, etc.)
(5) Client sophistication and commitment (fiduciary responsibility, contributing for employees, administrative costs, etc.)
(6) Types of retirement plans available for specific forms of businesses

D. Liquidity and marketability: Liquidity is the ability to readily convert an investment into cash without loss of principal; marketability is the degree to which there is an active market in which the investment can be traded

E. Tax considerations

(1) General concerns with respect to retirement plans

(a) When selecting asset classes and investment vehicles, compare the expected return on different investments on a before-tax basis.
(b) Prior to distribution, retirement plan assets are exempt from income taxes.
(c) Investment strategies must be appropriate for tax-exempt growth (consider the use of annuities in an IRA).

(2) Unrelated business taxable income (UBTI)

(a) UBTI is gross income (in excess of $1,000) that is generated by a qualified retirement plan trust that is directly carrying on a trade or business not substantially related to the purpose of the trust.
(b) IRS has ruled that a qualified retirement plan that invests funds into a common trust fund has UBTI from the trust fund to the same extent as it would have had it made the same investment directly.
(c) If a common trust fund operated an active business, or an IRA purchased a limited partnership interest, income from that business or partnership would be UBTI when passed through to the qualified retirement plan or IRA.
(d) Passive income is not considered UBTI—dividends, interests, annuities, royalties, rents from real property, rents from debt-financed real property, and gains from the sale or exchange of capital assets.
(e) Nonpassive income considered UBTI

(i) Income from oil and gas drilling or other non-real-estate partnership interest. A QRP that invests in a publicly traded limited partnership (LP) is considered to be working in the partnership's business as if it were a general partner. Income (minus expenses) received by the QRP from this publicly traded LP is considered UBTI.
(ii) Dividends from stock purchased on margin, that is, debt-financed dividends

F. Risk tolerance considerations

(1) The risk tolerance level of the small business owner is an important determinant as to what asset classes and investment vehicles are selected, and the expected return for the QRP portfolio.
(2) The risk tolerance level assumed by the plan is based on the client's emotional temperament and attitudes.
(3) The required liquidity and marketability will impact the risk assumed in the portfolio.
(4) Recall the relationship between risk and return. The QRP portfolio should be structured to maximize the return for given level of risk, or in other words, minimize the risk for a given rate of return.
(5) Investment strategy will differ between DBP and DCP.

TOPIC 67: DISTRIBUTION RULES, ALTERNATIVES, AND TAXATION

1. Defined benefit plan

A. Participant's benefits are fixed.

(1) Employer contributions vary.
(2) Employer assumes the investment risk.

(3) Prefers a conservative investment strategy to avoid wide swings in employer contributions, that is, actuarial determination for contributions to the plan are relatively consistent year to year.

(a) Defined contribution plan

B. Participant's benefits are variable.

(1) Employer contributions are fixed.
(2) Employee assumes the investment risk.
(3) Investments may be more aggressive.

C. Diversification and regulatory concerns

(1) Construct a diversified portfolio with investments that are not subject to the same investment risk. ERISA's fiduciary standards require portfolio diversification.
(2) Diversification will depend on fiduciary standards and the business owners' risk tolerance.
(3) An exception to diversification can occur when the investments can be prudently invested without diversifying.
(4) The plan's fiduciary must meet ERISA's definition and standards.
(5) The plan's trustee prepares a statement of investment policy and objectives.

2. Life insurance—allowed in QRP if the benefits are "incidental" to the overall plan

A. Defined contribution plan—cost of insurance (i.e., cost of current protection)

(1) For an ordinary policy (whole life), the premiums paid by the plan cannot exceed 50 percent of the contributions made to the plan on the participant's behalf.
(2) For a nonordinary policy [term, Universal Life (UL)], the premium cannot exceed 25 percent of the contribution made to the plan on the participant's behalf.
(3) The contract must be distributed to the participant or converted to a payout option of the start of benefits upon retirement.

B. Defined benefit plan—For an ordinary or nonordinary policy, the plan benefit (i.e., the insurance benefit) is limited to not greater than 100 times the expected monthly retirement income benefit. For example, if the potential pension benefit is $1,500/month, then the plan trustee could apply for $150,000 of insurance on the participant's life. The participant would be taxed (ordinary rates) on the term cost of insurance.

(1) Premature distributions

C. Penalties

(1) Distribution prior to age 59½
(2) Subject to 10 percent nondeductible penalty and taxed as ordinary income

D. Exception: Distribution or payment from a SIMPLE IRA within two years of the opening of the SIMPLE IRA is subject to a 25 percent penalty tax.

(1) The participant always has 60 days to undo the distribution.

E. Hardship withdrawal

(1) For qualified plans and 403(b) only: The participant must have a triggering event to qualify for a hardship withdrawal. A triggering event has occurred when the participant has demonstrated to the plan administrator an "immediate and heavy financial need."

(2) The IRS has issued safe harbor guidelines that define what constitutes an "immediate and heavy financial need" in order to give the employer guidance. The following is a list of safe harbor triggering events:

(a) Medical care for the participant, spouse, or any dependents of the participant
(b) Purchase of principal residence—applies only to the purchase, not mortgage payments
(c) Tuition and related education fees—must be for postsecondary education of participant, spouse, or children
(d) Prevention of eviction or foreclosure

(3) The client should understand that (1) he or she must still pay the 10 percent penalty, (2) the full distribution will be taxed as ordinary income, and (3) a six-month blackout exists on elective deferrals after a hardship withdrawal.
(4) The participant must exhaust all other options before taking out a hardship withdrawal.

F. IRC Section 72(t) for qualified plans. The following is a list of allowable distributions that will exclude an individual from paying the 10 percent penalty tax under IRC Section 72(t) for qualified plans only:

(1) Distributions made on or after the date on which the participant attains age 59½
(2) Distributions made to a beneficiary on or after the death of the participant
(3) Distributions attributable to the participant's becoming disabled
(4) Distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for life (or life expectancy) of the participant or the joint lives of the participant and his or her designated beneficiary. Distributions under this exception generally cannot be modified for five years unless another exception applied to the distribution when it initially commenced.
(5) Distributions made to an employee after separation from service after attainment of age 55
(6) A payment to an alternate payee pursuant to a qualified domestic relations order (QDRO)
(7) Distributions used to pay qualified higher education expenses (including graduate education expenses) for the individual, the individual's spouse, or any child or grandchild of either
(8) Distributions made on account of an IRS levy
(9) A dividend paid with respect to certain stock held by an ESOP
(10) Amounts transferred to an IRA of a spouse or former spouse under a divorce or separation instrument
(11) Corrective distributions

G. IRC Section 72(t) for tax-advantaged retirement plans. Tax-advantaged plans (IRA, Roth IRA, SEP, and SIMPLE) do not need a triggering event for the owner to remove funds. The owner can remove funds at anytime but is subject to a 10 percent penalty tax, in addition to the balance being taxed as ordinary income. The following is a list of allowable distributions that will exclude an individual from paying the 10 percent penalty tax under IRC Section 72(t) for tax-advantaged retirement plans only:

(1) Distributions made on or after the date on which the participant attains age 59½
(2) Distributions made to a beneficiary on or after the death of the participant
(3) Distributions attributable to the participant's becoming disabled
(4) Distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for life (or life expectancy) of the participant or the joint

lives of the participant and his or her designated beneficiary. Distributions under this exception generally cannot be modified for five years unless another exception applied to the distribution when it initially commenced.

(5) Distributions for medical expenses in excess of 7½ percent of adjusted gross income.
(6) Distributions for health insurance premiums made to an unemployed individual after separation from employment if the individual has received unemployment compensation for 12 consecutive weeks under any federal or state unemployment compensation law
(7) Distributions used to pay qualified higher education expenses (including graduate education expenses) for the individual, the individual's spouse, or any child or grandchild of either
(8) Distributions made for a first-time home buyer's expenses. There is a lifetime maximum of $10,000. The distribution must be used within 120 days to buy, build, or rebuild the principal residence of the individual, his or her spouse, or any child, grandchild, or ancestor of either. A person qualifies as a first-time home buyer if he or she had no present ownership interest in a principal residence during the preceding two years.
(9) Distributions made on account of an IRS levy
(10) Amounts transferred to an IRA of a spouse or former spouse under a divorce or separation instrument
(11) Corrective distributions

H. Substantially equal periodic payments (Section 72(t))
  (1) There is no minimum age requirement.
  (2) IRS does not require reason for taking withdrawals.
  (3) Payments must be made at least annually.
  (4) Three methods to calculate:
    (a) Life-expectancy method [e.g., required minimum distribution (RMD)]
      (i) Results in the exact annual payment required
      (ii) Results in the smallest payment
    (b) Amortization method: The account balance is amortized over the participant's life expectancy (or joint life expectancy) using a reasonable interest rate (i.e., expected investment return).
    (c) Annuitization method
      (i) Divide the account balance by an annuity factor that is based on a reasonable interest rate (e.g., 8 percent) and mortality factors (UP-84 Mortality Table).
      (ii) Results in the largest payment
  (5) Payments must continue for five years or until participant is age 59½, whichever is longer. If payment is changed (increased or decreased) prior to satisfying either condition, the 10 percent penalty is assessed back to dollar one plus interest.
  (6) Accounts need not be aggregated to begin Section 72(t) distribution.

I. The EGTRRA 2001 changed the operative phrase "separation from service" to "severance from employment." This allows distributions from plans that terminate after a merger or spin-off because the participant has severed his or her relationship with the original employer. This repeals the "same desk rule."

J. Differences in comparing qualified plans to IRAs under IRC Section 72(t). The following exceptions apply to IRAs, but not to qualified plans under IRC Section 72(t):

(1) IRAs allow distributions for health insurance premiums made to an unemployed individual after separation from employment if the individual has received unemployment compensation for 12 consecutive weeks under any federal or state unemployment compensation law.
(2) IRAs allow distributions made for a first-time home buyer. There is a lifetime maximum of $10,000.
(3) IRAs allow distributions used to pay qualified higher education expenses (including graduate education expenses) for the individual, the individual's spouse, or any child or grandchild of either.

K. The following exceptions apply to qualified plans, but not to IRAs under IRC Section 72(t):

(1) Distributions made to an employee after severance from service after attainment of age 55
(2) A payment to an alternate payee pursuant to a QDRO
(3) A dividend paid with respect to certain stock held by an ESOP

3. Election of distribution options

A. Lump sum distributions

(1) Must satisfy four conditions:

(a) Must be distributed in one taxable year
(b) Must represent the full account balance to the participant's credit from all qualified plans of a single type
(c) Lump sum payable

(i) For common-law employees (i.e., rank and file)

- Attainment of age 59½
- Death (available to designated beneficiary)
- Separation from service ("severance from employment")

(ii) For the self-employed owner

- Attainment of age 59½
- Death (available to designated beneficiary)
- Disability

(d) Must be made from

(i) Qualified pension plan (money purchase plan, target benefit, DBP)
(ii) Profit sharing plan
(iii) Stock bonus plan

(2) Taxation of a lump sum distribution

(a) Taxed as ordinary income
(b) Taxed-deferred if distribution is rolled over

(i) QRP to another QRP
(ii) QRP to tradition IRA or conduit IRA

(c) May qualify for 10-year forward-averaging tax treatment if the participant was born before January 1, 1936 (i.e., age 50 by January 1, 1986) if four conditions met:

(i) Participant must be at least age 59½.
(ii) Forward averaging must be applied to all lump sum distributions received during the year.

(iii) Employee must have been a plan participant for at least five years (waiver if distribution is due to death).
(iv) Only one forward-averaging election is allowed in a lifetime.

B. Annuity options

(1) All qualified pension plans must provide two forms of survivorship benefits for spouses:

(a) Automatic lifetime survivor benefit in the form of a qualified joint and survivor annuity (QJSA).

(i) Must provide annuity for life of the participant with a survivor annuity for the life of the participant's spouse.
(ii) Must provide survivor annuity that is not less than 50 percent nor greater than 100 percent of the annuity payable during the joint lives of the participant and spouse. For example, if $1,000 per month is payable during the joint lives, the annuity to the surviving spouse can be any specified amount from $500 per month to $1,000 per month.
(iii) The spouse's annuity must continue even if the spouse remarries.

(b) Automatic lifetime survivor benefit in the form of a qualified preretirement survivor annuity (QPSA)

(i) Provides survivor benefit if participant dies before retirement
(ii) The survivor annuity payable is the amount that would have been paid under a QJSA.

(2) Consent of nonparticipant spouse to waiver (or electing out) of QPSA and QJSA in favor of an optional benefit form selected by the participant must

(a) Be in writing,
(b) Acknowledge the effect of the waiver, and
(c) Be witnessed, either by a plan representative or a notary public

(3) Stock bonus, profit sharing, and ESOPs generally are exempt from the QJSA and QPSA requirements if two conditions are satisfied:

(a) There are no annuity options.
(b) The plan participant's account balance is payable to the participant's spouse in the event of the participant's death.

(4) Life annuity is an automatic form of benefit for an unmarried participant—provides monthly payments for life.
(5) Period certain annuity is another form, as an option to joint or single life annuity—period certain provides payments for a specified period of time.
(6) Other annuity benefit options

(a) A wide range of options increases the administrative costs of a qualified plan.
(b) The IRA makes it difficult to withdraw benefit options once they are established.

(7) Taxation of annuity payments

(a) Noncontributory basis (no cost basis). Full amount of benefit payment is includible in the participant's gross income and taxed as ordinary income.
(b) Contributory basis (taxable and nontaxable amount). The benefit payment consists of a taxable (includible) and a nontaxable (excludible) portion in gross

income.

(c) The participant's cost basis includes:

(i) Total after-tax contributions made by the employee
(ii) Total cost of life insurance protection reported as taxable income by the participant, if plan distribution is received under the same contract that provides the life insurance protection
(iii) Any employer contributions that were previously taxed to employee (nonqualified plan later becomes qualified)
(iv) Amount of any plan loans included in income as a taxable distribution

(d) In-service (partial) distribution. Partial distribution taken out before termination of employment

(i) Nontaxable and taxable amounts
(ii) Nontaxable amount equals

$$\text{Distribution} \times \frac{\text{Employee's cost basis}}{\text{Total account balance}}$$

(iii) Pre-1987 "grandfathered" rule—after-tax money can be withdrawn first (FIFO).
(iv) Taxable in-service distribution may be subject to early distribution penalty, and a mandatory withholding at 20 percent, unless transferred to an eligible retirement plan as a direct rollover.

(e) Total distribution. If an employee has a cost basis, one of two tables is used to determine the excludable portion of each monthly payment.

(i) For a single-life annuity, based on the age of the annuitant

Age of Participant	**Number of Monthly Payments**
55 and under	360
56–60	310
61–65	260
66–70	210
70 and over	160

(ii) For a joint and survivor annuity, based on the ages of both annuitants

Combined Ages of Both Participants	**Number of Monthly Payments**
Not more than 110	410
111–120	360
121–130	310
131–140	260
More than 140	210

(f) Once the cost basis is fully recovered, payments received subsequently are fully taxable. If the participant dies before the cost basis is fully recovered, an income tax deduction for the unrecovered basis is allowed on the participant's final income tax return.

C. Rollover

(1) Participant has constructive receipt of the money.
(2) Since 2002, amounts in Section 401(a) plans, Section 403(b) arrangements, or Section 457(b) plans maintained by a state or local government generally can be rolled over to

another Section 401(a) plan, Section 403 (b) arrangement, Section 457 (b) plan maintained by state or local government, or IRA.

(3) Since2002, after-tax employee contributions can be rolled over to other plans and IRAs.

(4) Since 2002, contributory IRA amounts can be rolled over to a Section 401(a) plan, Section 403(b) arrangement, Section 457(b) plan maintained by a state or local government, or another IRA.

(5) Surviving spouses can roll over distributions into their own 401(k), 403(b), IRA, or governmental 457.

(6) After two years in a SIMPLE plan, it may be rolled over to a traditional IRA or SEP plan without penalty. A SIMPLE to SIMPLE rollover is permitted at any time.

(7) A rollover must be completed within a 60-day period, unless waived by the IRS if it deems the account owner has undergone a personal or natural disaster beyond his or her control.

(8) Only one rollover per account per one year period is permitted.

(9) A rollover will be subject to 20 percent withholding if money is from QRP to participant.

(10) Distributions not eligible for rollover:

(a) Amounts distributed to satisfy RMD
(b) Amounts that are part of a series of equal periodic payments
(c) Hardship withdrawals
(d) Nontaxable portion of a distribution
(e) Elective contributions that are returned as a result of Section 415 limitations
(f) Corrective distributions of excess contributions and excess deferrals
(g) Loans in default that are deemed distributions
(h) Dividends on employer securities in an ESOP
(i) Cost of life insurance coverage

D. Direct transfer

(1) Transfer of QRP or IRA assets directly from custodian/trustee-to-custodian/trustee
(2) Participant does not have constructive receipt of the funds.
(3) Avoids the 20 percent mandatory withholding
(4) Multiple transfers are permitted via this method.

4. Required minimum distribution (RMD)

A. Rules

(1) RMD applies to qualified plans, IRAs, SEPs, SIMPLE IRAs, and Section 457 government deferred compensation plans.

(2) Minimum distributions must begin no later than April 1 of the calendar year following the later of

(a) The calendar year in which the employee attains age 70½
(b) The employee retires (not available for 5 percent owners of business or for an IRA owner)

(3) Use the balance as of December 31 of the year prior to the distributions year as the RMD calculation base.

(4) RMD is calculated separately for each IRA, but distributions can be taken from any account to satisfy the minimum.

B. Calculations

(1) Life expectancy method

(a) The required minimum is determined by dividing the owner's account balance by the appropriate life expectancy.

(b) To satisfy RMD rules, the entire interest must be distributed by the required beginning date, or the interest must be distributed over one of the following periods:

(i) Over the lifetime of the participant

(ii) Over the joint and survivor lives of the participant and a designated beneficiary

(iii) Over a period that does not extend beyond the life expectancy of the participant

(iv) Over a period that does not extend beyond the joint and survivor life expectancy of the participant and a designated beneficiary

(2) Three life expectancy tables

(a) Uniform Lifetime Table

(i) Table for determining minimum required distributions during the lifetime of the participant when the retirement benefit is in the form of an account balance

(ii) Used in situations in which the employee's spouse is either

- Not the sole designated beneficiary
- Is the sole designated beneficiary but is not more than 10 years younger than the employee

Exhibit 6.4 Uniform Lifetime Table (2002 Final Regulations)

Age of Employee	Distribution Period	Age of Employee	Distribution Period
70	27.4	86	14.1
71	26.5	87	13.4
72	25.6	88	12.7
73	24.7	89	12.0
74	23.8	90	11.4
75	22.9	91	10.8
76	22.0	92	10.2
77	21.2	93	9.6
78	20.3	94	9.1
79	19.5	95	8.6
80	18.7	96	8.1
81	17.9	97	7.6
82	17.1	98	7.1
83	16.3	99	6.7
84	15.5	100	6.3
85	14.8	101	5.9

(iii) *Example:* Mike reaches age 72 in 2007. His account balance in an IRA was $500,000 as of the end of 2006. His required distribution for 2007 is $19,532 ($500,000 ÷ 25.6).

(b) Joint and last survivor table

(i) The joint life expectancy of the participant and the spouse is used in situations in which the employee's spouse is either

- Sole designated beneficiary, or
- More than 10 years younger than the participant

(ii) If the designated beneficiary is changed to anyone other than the spouse, this table cannot be used.

(c) Single life table

(i) Used by designated beneficiaries, including spouse

- Spouse can recalculate each year.
- Nonspouse beneficiaries do not recalculate, but determine life expectancy for first year of distributions and subtract one year for each subsequent year.

(ii) Also applies to Roth IRA nonspouse beneficiaries

(iii) *Example*: Steve Brown dies in 2007 at age 61. He owns a Roth IRA worth $35,000. His son, Bill, inherits the Roth IRA at age 25. Bill must begin taking minimum distributions (tax-free) by December 2008, using the single life table. The initial life expectancy of 58.2 years is given in the table.

Exhibit 6.5 Single Life Table (2002 Final Regulations)

Age	Life Expectancy	Age	Life Expectancy
0	82.4	60	25.2
5	77.7	65	21.0
10	72.8	70	17.0
15	67.9	75	13.4
20	63.0	80	10.2
25	58.2	85	7.6
30	53.3	90	5.5
35	48.5	95	4.1
40	43.6	100	2.9
45	38.8	105	1.9
50	34.2	110	1.1
55	29.6	111	1.0

C. Penalties

(1) There is a 50 percent penalty on the amount not distributed that should be distributed.

(2) If the account value has decreased below the calculated minimum based on the December 31 balance, the account can be depleted with no 50 percent penalty for not taking the full amount required.

(3) A 50 percent penalty for shortfalls in RMD applies to traditional IRAs and may pertain to Roth IRAs. Roth IRAs are not subject to minimum required distributions during the lifetime of the participant. Therefore, there is no required beginning date during the lifetime of the participant. However, Roth IRAs are subject to minimum required distributions after the death of the participant.

5. Beneficiary considerations

A. Designated beneficiary

(1) Must be determined by September 30 of year following year of death
(2) Must be beneficiary as of the date of death

(a) Beneficiaries can be eliminated by a disclaimer, but not replaced or added after owner's death.
(b) To make a qualified disclaimer, the beneficiary must meet all of the following requirements:

(i) The disclaimer must be in writing.
(ii) The disclaimer must be received by the transferor of the asset no later than nine months after the date of death.
(iii) The person making the disclaimer cannot have accepted any of the assets prior to execution of the qualified disclaimer.
(iv) The person making the disclaimer cannot direct the assets being disclaimed.

(c) Disclaimers can stretch IRAs—for example, the primary beneficiary may disclaim and allow the IRA to pass to a much younger contingent beneficiary.

(3) Executors or trustees do not have the ability to choose a beneficiary after date of death.
(4) The first required distribution must be withdrawn by December 31 of the year following the year of death.
(5) If a beneficiary dies during the period between owner's death and the designation date of beneficiaries, the required distributions are calculated using the life expectancy of the beneficiary (as if designated).

Example: A father dies in 2007 and names his daughter as beneficiary. The daughter dies later in 2007, prior to being named as designated beneficiary (September 30, 2008). The grandchild inherits the retirement plan and must use the daughter's life expectancy in the new tables.

(6) Beneficiaries must be named under the plan documentation. If a beneficiary is named by the estate or will, he or she cannot be a designated beneficiary and cannot use the single life expectancy table for calculating distributions.

B. Death of owner prior to required beginning date (RBD)

(1) The entire benefit must be distributed within five years of the death of the participant. This rule has been dubbed the "five-year rule." An exception to the five-year rule exists. The life expectancy rule applies in all cases in which a deceased owner has a designated beneficiary. This means that distributions are made over the life expectancy of the designated beneficiary.
(2) Designated beneficiary is not the surviving spouse of the participant:

(a) To satisfy the life expectancy rule, the entire interest of the participant must be distributed over the life expectancy of the designated beneficiary.

(b) Minimum required distributions must begin by December 31 of the year following the year when the participant died.
(c) The applicable distribution period is determined by using the life expectancy table.

6. For each subsequent distribution calendar year, the previous year's life expectancy is reduced by 1.

(1) Designated beneficiary is the surviving spouse of the participant:

(a) To satisfy the life expectancy rule, the entire interest of the participant must be distributed over the life expectancy of the spouse.
(b) Minimum required distributions must begin by December 31 of the later of:

(i) The year following the year in which the participant died, or
(ii) The year in which the participant would have attained age 70½ had the participant survived.

(c) If the surviving spouse dies before benefits must begin under the life expectancy rule, the surviving spouse will be treated as if he or she were the participant. This means that the next beneficiary is the designated beneficiary of the now-deceased surviving spouse. This successor beneficiary is subject to the life expectancy rule or the five-year rule.

(2) If no designated beneficiary is named by the participant, the five-year rule applies.
(3) Roth IRAs

(a) All Roth IRA owners die before their required beginning dates.
(b) Distributions must be made in accordance with the five-year rule or the life expectancy rule.

B. Death of owner after RBD

(1) The entire balance must be distributed "at least as rapidly" as was the case before the participant died. The at least as rapidly rule is satisfied by using the longer of (using the single life table):

(a) The life expectancy of the designated beneficiary determined as of the year following the year when the participant died, or
(b) The remaining life expectancy of the participant, using the participant's birthday during the year of death, reduced by 1

(2) Sole designated beneficiary is the surviving spouse of the participant:

(a) Take distributions over his or her life expectancy by December 31 of the year following the owner's death.
(b) Recalculate for each subsequent year using the single life table.

(3) Designated beneficiary is not solely the surviving spouse of the participant:

(a) The at least as rapidly rule is satisfied by using the larger of the two numbers.
(b) For each subsequent distribution calendar year, further reduce the number by 1.

(4) If no designated beneficiary is named, the distribution period is the deceased owner's life expectancy calculated in the year of death and reduced by 1 for each subsequent year.
(5) In the year of death, the heirs must take the decedent's required distribution based on the method under which the decedent had been taking distributions. In later years, the required distributions depend on who is the chosen beneficiary.

(6) If the designated beneficiary is older than the owner, the designated beneficiary can use the owner's remaining life expectancy. For example, if a daughter dies after RBD and her father is beneficiary, the father can use the daughter's life expectancy for calculating RMD.

C. Election by surviving spouse to treat IRA of Rollover to IRA as owned by spouse

(1) If the surviving spouse makes a spousal rollover to an IRA, minimum distributions for the surviving spouse's life expectancy do not have to begin until April 1 of the year following the year the surviving spouse attains age 70½.
(2) The minimum distribution is based on the uniform lifetime table in regard to the surviving spouse. The surviving spouse can name a new beneficiary, such as a child.
(3) *Example*: Steve dies at age 82 having named his spouse, Sarah, age 75, as the beneficiary of his IRA. Sarah names their child, Bart, as the sole beneficiary. Sarah uses the uniform lifetime table to calculate the minimum distribution. In the year following Steve's death, Sarah is age 76 and her distribution period is 22. When Sarah dies, minimum distributions to Bart are determined based on his single life expectancy.

D. Multiple beneficiaries and separate accounts

(1) If more than one beneficiary is designated, required distributions are based on the age of the oldest beneficiary.
(2) Separate accounts can be established for each beneficiary at any time.

(a) But for each beneficiary to use his or her own life expectancy to calculate distributions, the separate accounts must be established by December 31 of the year following the year of the owner's death.
(b) Post-death investment gains and losses are allocated to the separate accounts on a pro rata basis.

(3) The separate accounts must be established by the designation date of September 30 to avoid the possibility of calculating a first-year distribution based on the life expectancy of the oldest designated beneficiary.
(4) If separate accounts are not created and beneficiaries that cannot be designated exist (charity), the account will be subject to the five-year rule. Consider paying off the charity's portion in full and then set up separate accounts for designated beneficiaries.

E. Trust as beneficiary

(1) There is a provision allowing an underlying beneficiary of a trust to be an owner's designated beneficiary for determining RMD when the trust is beneficiary
(2) Beneficiary documentation certifying designated beneficiaries on September 30 must be provided to the plan administrator by October 31 of the year following the year of the employee's death.
(3) If a trust is named beneficiary and a spouse is the sole beneficiary of the trust, the spouse cannot roll over the account into his or her own IRA account.
(4) Individual trusts cannot split into separate accounts, but if the IRA is payable to multiple trusts, then the rules for separate accounts can be used if divided prior to December 31.
(5) A beneficiary can be disregarded in determining the oldest beneficiary if the individual is a successor to the interest of another beneficiary.
(6) Clients should review documents to ensure designated beneficiaries are correct, especially if multiple IRAs exist or multiple beneficiaries have been designated.

7. Qualified domestic relations order (QDRO)

A. A domestic relations order is a judgment, decree, or order (including the approval of a property settlement) that is made pursuant to state domestic relations law (community property law) and that relates to the provision of child support, alimony payments, or marital property rights for the benefit of the spouse, former spouse, child, or other dependent of a participant.

B. A QDRO is a domestic relations order that creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to the participant under a qualified retirement plan and that complies with certain special requirements:

(1) Name and address of participant and alternate payee covered by the order,
(2) Amount or percentage of the participant's benefit to be paid by the QRP to each alternate payee or the manner in which such amount or percentage is to be determined,
(3) Number of payments or period to which the order applies, and
(4) The QRP to which the order applies

C. A state authority, usually a court or state agency or instrumentality, must issue the judgment, order, or decree or approve the property settlement before it can be a domestic relations order under ERISA.

D. Applies to all qualified retirement plans, 403(b) plans, and 457 plans

E. QDRO rules do not apply to IRAs, but the transfer of an individual's interest in an IRA to his or her spouse or former spouse under a divorce or separation agreement is not considered a taxable transfer made by the individual; and thereafter the IRA is treated as maintained for the benefit of the spouse or former spouse.

F. IRAs can be used to implement a QDRO if a direct transfer of the participant's interest in a retirement plan to the spouse is otherwise prohibited.

G. QDRO rules do not apply to nonqualified plans. However, there have been rulings that life insurance benefits under an employer-sponsored nonqualified plan, "are" subject to QDRO rules if a divorce decree specifies how the life insurance benefits must be distributed.

8. Taxation of distributions

A. Waiver (discussed earlier in regard to this topic but worth considering again) Consent of nonparticipant spouse to waiver (or electing out) of QPSA and QJSA in favor of an optional benefit form selected by the participant must

(1) Be in writing,
(2) Acknowledge the effect of the waiver, and
(3) Be witnessed, either by a plan representative or by a notary public

B. Cost basis recovery

(1) No tax is paid on contributions until a distribution is made. Tax is paid on net distribution, where the cost basis is recovered tax-free.
(2) Cost basis consists of the following:

(a) All employee contributions that have not been treated as deductions for federal income tax purposes
(b) Any loans that were included in the employee's income
(c) Any employee contributions that were included in the employee's income
(d) Any life insurance (PS-58) costs that were included in the employee's income

Note: Self-employed cannot include insurance cost in cost basis.

(3) Capital gains treatment: Lump sum distributions may be eligible for capital gains treatment.

(a) Only pre-1974 employer contributions are eligible.
(b) Only participants in a QRP who have attained age 50 by January 1, 1986 are eligible.
(c) Long-term capital gains tax rate is 20 percent.

(4) Net unrealized appreciation (NUA)

(a) If a lump sum distribution includes employer securities, the NUA in the value of the securities will not be taxed to the employee at the time of distribution.
(b) The amount of appreciation will be taxed when the employee sells the securities at long-term capital gains tax rates.
(c) Employee may elect to pay the tax on the amount of appreciation at the time the securities are distributed by including the amount in income.

MULTIPLE CHOICE QUESTIONS

Retirement Planning

1. ***Practice—Social Security*. If a client of yours is receiving Social Security benefits, which of the following items would be included in determining the taxation of the benefits?**

(1) Client's salary
(2) Spouse's salary
(3) Worker's compensation benefits
(4) Unemployment compensation
(5) Tax-free municipal bond interest

A. 1, 2, and 3
B. 3 and 5
C. 1, 3, and 4
D. 1, 2, 4, and 5

Ans. D

2. ***Practice—Social Security*. Which of the following would not have benefits available, either as individual benefits or family-related benefits?**

A. Worker's unmarried ex-spouse at retirement. They were married 11 years.
B. Worker's spouse at retirement
C. Worker's dependent child under age 18
D. Worker himself, age 60 and currently insured

Ans. D

3. ***Practice—Social Security*. Which of the following persons would be eligible for survivor benefits based on the worker's primary insurance amount (PIA), assuming the worker was age 61 and fully insured?**

(1) Child age 17 who is a freshman in college
(2) Wife age 49 with two children, ages 17 and 18, and both are in high school
(3) Wife age 59

(4) Wife age 61

A. 1 and 2
B. 1 and 3
C. 1 and 4
D. 3 and 4

Ans. C

4. *Practice—participation*. Which of the following employees cannot be excluded from a qualified plan?

Employee	Age	Service	Vesting
1	25	6 months	5 year
2	18	6 months	2–6 years
3	20	3 years	5 year
4	21	1 year	100% immediately
5	21	2 years	100% immediately

A. 1 only
B. 2 only
C. 1, 2, and 3
D. 4 and 5
E. 5 only

Ans. E

5. *Practice—vesting*. Joe has worked for ScottCo for two years. Yesterday, ScottCo established a profit-sharing plan with a three-year accelerated vesting schedule, and contributed $1,000 to Joe's account. What is Joe's vested account balance?

A. $0
B. $400
C. $600
D. $1,000

Ans. A

6. *Practice—plan eligibility*. John owns a business with 15 employees. He is sponsoring a qualified plan for the business. Which of the following employees can be excluded from plan participation?

(1) Employee A, age 23, who has worked for John part time for the last 1½ years (800 hours per year), earning a salary of $500 per month.
(2) Employee B, age 22, who has worked for John part time for the past two years (and is part of a collective bargaining agreement), earning $450 per month.
(3) Employee C, age 40, who has worked for John part time for the past 6 months, earning $300 per month.

A. 1 only
B. 1 and 2
C. 2 only
D. 1, 2, and 3

Ans. D

7. ***Practice—compensation*. Jason works for a company that sponsors a money purchase plan. Employer contributions are based on compensation. Which is/are included in the definition of compensation?**

    (1) Salary
    (2) Bonuses
    (3) Employee expenses reimbursed by employer
    (4) Bargain element upon exercise of a nonqualified stock option (NQSO)

    A. 1 and 2
    B. 2 and 3
    C. 1, 2, and 4
    D. All of the above

    Ans. C

8. ***Practice—integration*. Assume an 8% money purchase plan is integrated. What is the maximum permitted disparity?**

    A. 5.7%
    B. 7.65%
    C. 8%
    D. 13.7%

    Ans. A

9. ***Practice—ADP Test*. Davis, Inc. has a 401(k) plan where the non–highly compensated defer an average of 4%. If Steve and Tom are highly compensated, earning $90,000 and $100,000, respectively, how much can each defer?**

    A. $3,600/$4,000
    B. $4,500/$5,000
    C. $5,400/$6,000
    D. $6,000/$6,000
    E. $10,500/$10,500

    Ans. C

10. ***Practice—elective deferrals*. Lenny works for Avis, Inc. and defers $15,000 into its 401(k) plan. He also works a second job for Hertz, which also has a 401(k) plan. Can he defer into Hertz's 401(k) if he is not a shareholder of Hertz?**

    A. Yes, since he doesn't own stock in either company.
    B. Yes, up to $15,000 because they are separate employers.
    C. No, all elective deferrals are aggregated to the limit.
    D. No, he would exceed the 415 limits.

    Ans. C

11. ***Practice—annual additions*. Dave puts $11,000 into Texaco's 401(k) plan. In addition, Texaco adds $14,000 to his account. He also works for Zarco, and Zarco contributes $15,500 into a profit-sharing plan for Dave. Which of the following is true?**

    A. Zarco cannot make a contribution for Dave.
    B. Dave is limited to $45,000 as indexed.

C. Dave has valid additions limit is $15,500 (2007).
D. Dave's annual additions limit is $56,250 (25% of $225,000).

Ans. B

12. ***Practice—maximum contribution*. An employee earning $300,000 can have what maximum amount put into retirement plans with a 10% money purchase plan and a 401(k) plan with no employer match?**

A. $15,000
B. $30,000
C. $35,000
D. $38,000
E. $45,000
F. None of the above

Ans. D

13. Practice—SEP. For 2007, what is the maximum amount that can be contributed to a simplified employee pension (SEP)?

A. $15,000
B. $30,000
C. $40,000
D. $45,000

Ans. D

14. ***Practice—IRA*. Tom and Laura, a married couple, had $130,000 of adjusted gross income (AGI) this year. Tom participates in his company 401(k), and he contributed $6,000 this year. Laura does not participate in a retirement plan with her employer. If they each contribute the maximum to a traditional individual retirement account (IRA), what is their deduction?**

A. $0
B. $2,000
C. $3,000
D. $4,000
E. $5,000

Ans. D

15. ***Practice—IRA*. Which of the following are permitted investments in an IRA?**

A. Antique books
B. Krugerrand coins
C. Stamps
D. Publicly traded oil and gas partnership
E. Variable universal life insurance policy

Ans. D

16. ***Practice—Roth*. Mrs. Johnson dies with a Roth IRA. Which of the following is/are true?**

(1) Her husband could roll it into his Roth IRA.
(2) If her son is beneficiary, distributions must be completed within five years.
(3) There are no minimum distribution requirements.

(4) If she had the IRA for two years before her death, withdrawals within the next three years are not "qualified" distributions.

A. 1 and 4
B. 1, 2, and 4
C. 3 only
D. All of the above

Ans. A

17. ***Practice—Roth*. Your client, age 70, has AGI of $90,000 and files jointly with his wife. He participates in his employer's 403(b) plan, and has a current balance of $390,000 in the account. He is interested in converting the 403(b) to a Roth IRA. Which of the following is true?**

A. He can convert the 403(b) to a Roth IRA.
B. He must first convert the 403(b) to a traditional IRA, then convert to a Roth IRA.
C. He cannot convert because AGI is too high.
D. He cannot convert because he is still currently working for the employer.

Ans. B

18. ***Practice—SIMPLE*. Which of the following retirement plans, maintained by an employer, would also permit the employer to establish a SIMPLE plan?**

A. 401(k) plan
B. 403(b) plan
C. SEP
D. 457 plan

Ans. D

19. ***Practice—SIMPLE*. Tyler Rose, age 27, is an employee for a company that implemented a SIMPLE plan 12 months ago. Tyler made a contribution of $4,000, and his employer made a matching contribution of $4,000. The account is now worth $9,000. What are Tyler's options with respect to his SIMPLE IRA account?**

(1) Tyler can withdraw his entire account balance, even though he continues to work for SWAS Products.
(2) Tyler can roll over his SIMPLE IRA into his existing traditional IRA.
(3) Tyler will be subject to ordinary income taxes on amounts withdrawn from the SIMPLE.
(4) Tyler may be subject to a 10% early withdrawal penalty on amounts withdrawn from the SIMPLE.

A. 1 and 2
B. 1 and 3
C. 3 and 4
D. 1, 3, and 4
E. 1, 2, 3, and 4

Ans. B

20. ***Practice—review*. Which of the following plans permit in service withdrawals?**

(1) Defined benefit plans
(2) Stock bonus plans
(3) Profit-sharing plans

(4) Money purchase pension plans
(5) Target benefit plans

A. 1 and 2
B. 2 and 3
C. 2, 3, and 4
D. All of the above

Ans. B

21. ***Practice—review*. Which of the following plans permit 10-year averaging?**

(1) Profit sharing
(2) SEP
(3) 403(b) plans
(4) Target benefit plans
(5) IRAs

A. 1 and 2
B. 1, 2, and 3
C. 1 and 4
D. All of the above

Ans. C

22. ***Practice—review*. Which of the following plans require Pension Benefit Guaranty Corporation (PBGC) insurance?**

(1) Employee stock ownership plan (ESOP)
(2) Defined benefit
(3) Target benefit
(4) SEP
(5) Cash balance

A. 1 and 2
B. 1, 2, and 4
C. 2 and 5
D. 2, 3, and 5

Ans. C

23. **Which of the following plans allow integration?**

(1) SEP
(2) ESOP
(3) Money purchase plan
(4) Profit sharing
(5) Salary Reduction Simplified Employee Pension Plan (SARSEP)
(6) 401(k)

A. 1 only
B. 1 and 3
C. 1, 3, and 4
D. 1, 3, 4, and 6

Ans. C

24. ***Practice—plan selection*. Joe is age 52, and he just started a consulting company. He estimates that the average employment period for his employees will be three years. He would like to start a retirement plan that will favor older participants and contain an appropriate vesting schedule. He would also like the employees to bear the risk of investment performance. Which of the following plans is the most appropriate?**

A. SEP
B. Simple IRA
C. Target benefit plan
D. Defined benefit plan
E. Cash balance plan

Ans. C

25. ***Practice—plan selection*. Jane has owned her own company for 25 years. She is now 53 and wishes to retire at 63. She employs four people, mostly younger. If she wanted to establish a retirement plan with the highest benefit for her, assuming adequate cash flow, the most appropriate is:**

A. Cash balance
B. Defined benefit
C. Age-based profit sharing
D. Simple IRA
E. Tandem plan

Ans. B

26. ***Practice—plan selection*. Andy wants an uncomplicated deferral plan for himself and his staff of 15 employees. He is sued many times and would like creditor protection. You would recommend:**

A. Simple IRA
B. Simple 401(k)
C. Profit-sharing 401(k)
D. SARSEP

Ans. B

27. ***Practice—plan selection*. A company with 56 employees wants to provide its managers with a way to defer income for retirement. The company is willing to contribute a small amount. None of the regular workers are interested in contributing. Which plan is appropriate?**

A. 401(k)
B. Defined benefit
C. SEP
D. Simple IRA

Ans. D

28. ***Practice—loans*. Assume the following vested account balances in a qualified plan for different employees:**

Employee 1: $300,000
Employee 2: $80,000

Employee 3: $6,000
What is the maximum loan that can be taken?

(1) Employee 1: $150,000
(2) Employee 1: $50,000
(3) Employee 2: $50,000
(4) Employee 2: $40,000
(5) Employee 3: $10,000
(6) Employee 3: $6,000

A. 1, 3, and 5
B. 1, 3, and 6
C. 2, 4, and 5
D. 2, 3, and 6
E. 2, 4, and 6

Ans. E

29. ***Practice—NUA*. Bob is a participant in his company's ESOP. The company transfers 1,000 shares at $4/share to Bob's account. Years later, when the stock is $10/share, Bob retires. If he elects to receive the stock at retirement and sells it 5 years later for $15,000, what are the consequences?**

A. $15,000 ordinary income at time of sale
B. $4,000 ordinary income at distribution, $11,000 capital gain
C. $11,000 ordinary income at distribution, $4,000 capital gain
D. $10,000 ordinary income at distribution, $5,000 capital gain
E. $15,000 capital gain at time of sale

Ans. B

30. ***Practice—early withdrawal penalty*. Your client, age 56, retired from CorpCo last month, and would like to take a distribution from one of his retirement plans to pay for a vacation to Haiti. Which of the following plans would allow a penalty-free withdrawal?**

A. Traditional IRA
B. 401(k) from Valco, a company he left 10 years ago
C. 401(k) from CorpCo
D. Single-premium deferred annuity (post 82)

Ans. C

31. ***Practice—early withdrawal penalty*. Dave, age 55, just retired from VQT Corporation, where he participated in the 401(k) plan. Which of the following would permit a penalty-free withdrawal from his traditional IRA?**

A. Distributions made after separation from service after attainment of age 55
B. Distributions made to a qualified family member under a qualified domestic relations order (QDRO)
C. Distributions for higher-education costs for his child

Ans. C

32. ***Practice—RBD*. Mary had her 70th birthday on September 1, 2006. When would she be required to receive her first minimum distribution from her IRA?**

A. April 1, 2007
B. April 1, 2008
C. December 31, 2006
D. December 31, 2007

Ans. B

33. ***Practice—minimum distributions*. Tony, age 65, wants to defer his retirement from Widget, Inc. until age 75. He contributes 6% of his pay to the 401(k) plan, and his employer matches 100%. Which of the following are true?**

(1) He can contribute until he retires.
(2) He must start distributions at age 70½.
(3) He must start distributions at age 75.
(4) The 10% penalty will not apply.

A. 1 and 3
B. 2 and 4
C. 1, 2, and 4
D. 1, 3, and 4

Ans. D

34. ***Practice—minimum distribution*. John is age 70, and is `concerned about required minimum distributions from his traditional IRA. He wants to know whom he should name as the beneficiary of his IRA, if his goal is to minimize the required minimum distribution. You would recommend:**

(A) No beneficiary
(B) His 50-year-old wife
(C) His 30-year-old daughter
(D) His 8-year-old grandson

Ans. B

35. ***Practice—plan distributions*. After Alice's husband died, Alice (age 50), decided to take the $115,000 balance from his defined benefit (DB) plan in cash. If she did so, what is the amount of her check?**

A. $115,000 but subject to the 10% penalty
B. $115,000 with no 10% penalty
C. $92,000 but subject to the 10% penalty
D. $92,000 with no 10% penalty
E. Lump-sum distributions are not allowed from DB plans

Ans. D

36. ***Practice—annuity*. John is age 65 and retiring. His wife is age 70, and has been retired for several years. Both are in excellent health. Which of the following will provide the couple with the largest monthly payment over a short-term horizon?**

A. Single life annuity
B. Single life annuity with five-year sum certain
C. Joint and survivor annuity with 100% jointly and 50% to survivor
D. Joint and survivor annuity with 100% jointly and 100% to survivor

Ans. A

CHAPTER 7

ESTATE PLANNING

TOPIC 68: CHARACTERISTICS AND CONSEQUENCES OF PROPERTY TITLING

1. **Common law versus community property**

   A. Common law is a body of law that is based on custom and general principles and is embodied in case law. It is applied to situations not covered by statute. A husband and wife have equal ownership in all property under common law.
   B. Community property is all property that has been acquired by the efforts of either spouse during their marriage while living in a community property state. It does not include property acquired by only one of the spouses by gift, devise, bequest, or inheritance, or acquired by either spouse prior to their marriage—both spouses own community property equally.
   C. Classifying income in community property states

      (1) California rule: Income from community property is community property, as well as anything bought with that income. Income from separate property is separate property, as well as anything bought with that income.
      (2) Texas rule (Texas, Idaho, and Louisiana): Income earned from separate property during the marriage is community property, but the gain on separate property when sold is separate property.
      (3) *Example*: Steve and Liz live in California, a community property state. Steve owned a convertible Corvette before their marriage, which Liz now uses. Last year Liz's father gave her 1,000 shares of XYZ stock, which pays a quarterly dividend. Liz used the last dividend check to buy a mountain bike. Steve bought a kayak from money saved from his July paycheck. The stock and bike are Liz's separate property. The Corvette is Steve's separate property. All the other assets, including both salaries and the kayak, are community property.

2. **Sole ownership**

   A. Complete ownership with all rights

3. **Joint tenancy with right of survivorship (JTWROS)**

   A. On the death of one co-owner, the decedent's interest automatically passes to the surviving owner(s).
   B. The automatic right of survivorship inherent in joint tenancy prevails over other means of transfers at death, including a will and a trust instrument.
   C. In most states, one cotenant can unilaterally sever the joint tenancy without the knowledge or consent of the other tenant(s).
   D. Joint tenancies are commonly created among family members.

4. **Tenancy by the entireties**

   A. Tenancy by the entirety is like a joint tenancy in that it carries the right of survivorship, but it can be created only between husband and wife.
   B. It is unlike joint tenancy, in that neither spouse may transfer the property without the consent of the other.
   C. Where such a title is recognized, since it is available only to married couples, a divorce will cause a tenant by the entirety title to automatically convert into a tenant in common form of title.

5. **Tenancy in common**

   A. Like joint tenancy, tenants in common interests are held by two or more persons, each having an undivided right to possess property.
   B. Unlike joint tenancy, tenants in common interests may be owned in unequal percentages, and when one owner dies, the remaining owners do not automatically succeed in ownership.
   C. The decedent's interest passes through his or her estate, by will or by the laws of intestate succession. The interest can also be transferred to the trustee of a trust and passed according to the provisions of the trust.
   D. Tenancy in common is a preferred titling for nonrelatives.

6. **Trust ownership**

   A. A trust is a fiduciary relationship in which one person (the trustee) is holder of the title to property (the trust estate or trust corpus), subject to an equitable obligation to keep or use the property for the benefit of another (the beneficiary).
   B. The trust instrument is a written agreement between the settlor (the person creating and funding the trust) and the trustee that sets forth for whose benefit the trust is created, how the trust estate is to be managed, the duration of the trust, and the distribution of the corpus when the trust terminates.
   C. A trust passes property outside of probate.

7. **Uniform Transfer to Minors Act (UTMA) and Uniform Gifts to Minors Act (UGMA)**

   A. UGMA allows a simple method of making gifts to minors—no court supervision is required. UGMA allows transfer of securities, cash, life insurance, and annuities, but does not allow real property to be held in custodial form.
   B. UTMA was designed to replace UGMA. UTMA allows any property interest to betransferred, including real property.
   C. There are characteristics shared by UGMA and UTMA that are different from those of trusts.

      (1) A custodial gift may be created for only one person. In contrast, a trust can provide for multiple beneficiaries.
      (2) UGMA/UTMA is not a separate taxpayer—all income is taxable to the minor. In contrast, an irrevocable trust is a separate taxpayer offering preferential tax treatment.
      (3) Under UGMA/UTMA, donees usually receive the custodial property outright by age 21, but distributions from trusts may be delayed for a later age.

TOPIC 69: METHODS OF PROPERTY TRANSFER AT DEATH

1. **The probate process: Probate is the process by which a court validates the will of a deceased individual. Probate also involves all other matters in regard to the settlement of estates of deceased persons.**

   A. Testate succession

      (1) When a person dies leaving a will
      (2) This obligates the executor named in the will (after probate) to dispose of the decedent's property.

B. Intestate succession

(1) When a person dies without leaving a will
(2) An administrator is appointed by the court to dispose of the decedent's property.
(3) The state determines how the assets will be conveyed.
(4) Intestate succession laws

(a) Per stirpes distribution. Gives larger distributions to descendents of a closer degree of consanguinity (blood relationship) to the decedent
(b) Per capita distribution. Requires that all eligible descendents receive an equal share of the property

C. Advantages and disadvantages of probate

(1) Advantages

(a) Protects creditors
(b) Provides clean title to heirs or legatees
(c) Provides for the orderly administration of property
(d) Establishes title to property where there may be some question as to ownership

(2) Disadvantages

(a) Excessive cost
(b) Excessive delays
(c) Open to public scrutiny

D. Assets subject to probate

(1) Assets in which the decedent has sole title
(2) Assets held by tenancy in common
(3) Assets held as community property
(4) Assets disposed of by will
(5) Contract proceeds that are payable to the estate

E. Techniques of avoiding probate

(1) Creating joint tenancy with right of survivorship
(2) Creating a tenancy by its entirety
(3) Using trusts
(4) Establishing a funded revocable living trust
(5) Establishing a beneficiary (other than the estate) to transfer by contract, such as life insurance contracts and retirement plans

F. Ancillary probate

(1) This occurs when a person domiciled in one state dies and owns property in another state (usually real estate).
(2) It creates a special probate proceeding in the state in which the property is held.
(3) The will should contain a provision that appoints an ancillary executor for disposing the property.

2. Operation of law (title)

A. Operation of law refers to the passing of rights to a property from one person to another by the application of the established laws. This action uses laws specific to the situation and is done without any effort by the persons involved.

B. Examples of operation of law as it relates to property interests

(1) Joint tenancy with right of survivorship (JTWROS)

(a) Equal ownership and automatic survivorship
(b) Involves an undivided right to possess the property
(c) Not subject to probate

(2) Interests by the entirety

(a) This is like joint tenancy, but can be created only between a husband and wife.
(b) It is unlike joint tenancy, in that neither spouse can transfer property without the consent of the other spouse.
(c) Not subject to probate

(3) Tenancy in common (TC)

(a) Can be unequal ownership and includes no automatic survivorship
(b) Involves an undivided right to possess the property
(c) Subject to probate

(4) Community property (CP)

(a) Exists only between spouses
(b) CP is created immediately on acquisition of the property.
(c) No automatic survivorship: Decedent's share can be transferred to someone other than spouse, with the use of a will.
(d) Decedent's share is subject to probate.

(5) The extent of ownership interest in property

(a) Fee simple: Complete ownership with all rights (sell, gift, transfer, etc.). Property will pass through probate.
(b) Life estate: Ownership interest ceases at death. For example, Steve assigns his interest in a house to Sarah, his close friend, for her use to enjoy until her death. Sarah has received a life estate in the house.

3. Transfers through trusts

A. A trust is created to hold, manage, and distribute assets to the beneficiaries as indicated by the grantor of the trust. Property held in a trust is called the principal (also called the corpus or trust estate). Almost any form of property or asset can be included in a trust.
B. There are three major parties to a trust:

(1) Trustor (also called grantor, settlor, or creator): The person who creates the trust and whose property is used to fund the trust
(2) Trustee: The person or entity that takes legal title and manages the trust assets
(3) Beneficiary: The person who enjoys the beneficial interest in the trust

C. There are two principal forms of trusts:

(1) Inter vivos or living trust: Is activated immediately upon its creation. It is generally funded during the life of the trustor.
(2) Testamentary trust: Written into the will and implemented upon death. The funding mechanism is the probate process.

D. Transfers through trusts occur for five primary reasons:

(1) To provide for multiple beneficiaries
(2) To manage property in the event of incapacitation
(3) To protect beneficiaries from themselves and others
(4) To avoid probate
(5) To reduce transfer taxes

4. Transfers by contract

A. Transfer by contract refers to the passing of assets through:

(1) Life insurance contracts
(2) Annuities
(3) Qualified retirement plans
(4) Buy-sell agreements
(5) Prenuptial agreements

B. Transfer by contract avoids probate if the beneficiary is someone other than the estate.

TOPIC 70: ESTATE PLANNING DOCUMENTS

1. Wills

A. Legal requirements

(1) A will provides the testator with an opportunity to control the passing of his or her property and thus avoid intestacy.
(2) Requirements for making a will

(a) Generally any person 18 or older of sound mind
(b) Less mental capacity is required by law to make a will than to make a contract. The testator must know the nature and extent of the property and the natural objects of his or her bounty.
(c) Typically must be in writing, signed by the testator, and witnessed by at least two persons

(3) A will is revocable—revised or amended by codicils. Codicils are supplements to wills, executed under the same rules as wills.

B. Types of wills

(1) Holographic will: One written entirely by the testator, which is valid in some states without the formality of witnesses
(2) Nuncupative will: An oral will spoken by the testator during the last illness in the presence of the required number of witnesses
(3) Living will: A legal document executed by the testator declaring what medical treatment and procedures, such as life support, may or may not be used in the event that he or she becomes unconscious or incompetent
(4) Joint wills (also called mutual or reciprocal wills): Two separate wills that share reciprocal provisions for the disposition of property in the event of death by one of the parties
(5) Pour-over will: A will that distributes, at the testator's death, probate assets to a trust previously created

C. Avoiding will contests: An in terrorem clause provides that if a beneficiary unsuccessfully contests the validity of a will, the beneficiary bequest is void.

2. Powers of attorney

A. Defined

(1) A power of attorney is created by an individual, giving authority to another entity to act on the behalf of the individual. The power of attorney is usually witnessed and accredited.
(2) The person executing the power is called the principal, and the person appointed by the power is the attorney-in-fact.

B. Durable feature

(1) A durable power of attorney is not terminated by subsequent disability or incapacity of the principal. It is designed to cover the situation in which the principal becomes incompetent. A power of attorney that is not a durable power of attorney terminates upon disability or incompetence.
(2) A springing power of attorney does not become effective until the occurrence of a specified event.

C. For health care

(1) Applies to all situations in which the principal is unable to give "informed consent" with respect to a particular medical decision. It often gives the power to use or not to use artificial life-support systems.
(2) It always springs on incapacity.
(3) Such powers are recognized in almost all states, but state law varies in terms of the scope of authority of the attorney-in-fact.
(4) A major drawback is that this power is so powerful: It can place reluctant family members in the position of having to make a decision that is regretted later in life.

D. For property

(1) Durable power of attorney for property appoints a person to make decisions in regard to the principal's assets.
(2) It is generally effective upon execution (no springing) and continues until death of the principal.
(3) It is often used in place of a trust for smaller estates.
(4) It is often used for purposes of gift giving by the attorney-in-fact when the principal is elderly, and/or seriously ill, and not legally competent.

E. Special or limited powers

(1) A limited power is a special power.
(2) The extent of the power is limited only by the desires of the principal.

F. General powers

(1) An unlimited power is a general power.
(2) Broad general powers are intended to give the attorney-in-fact the right to act to the same extent the principal could have acted if available.

3. Advance medical directives (e.g., living wills)

A. An advance medical directive establishes a medical situation in which the testator no longer wants life-sustaining treatment (i.e., life-support systems to prolong life). A living will is a medical life-support directive.

B. It does not designate an agent to make medical decisions.
C. There are several drawbacks to living wills. They are generally very brief and vague, covering only a narrow range of outcomes, which are mostly in the area of life-sustaining treatment. No living will, no matter how detailed, can cover all possible medical outcomes. Most living wills apply only to terminal patients.
D. In some states, it may be appropriate to execute both a living will and durable power of attorney for health care to cover all areas.

4. Trusts

A. Clients may create trusts to manage their property if they become incapacitated or upon death.
B. Where the disabled (or decedent) settlor was serving as trustee at the time of the disability or death, most state laws allow a successor trustee to immediately take over the administration of the estate.
C. A living trust can be used for managing the disposition of property upon disability or death.

(1) Similarities of a living trust and a will

(a) Both serve as a guide for the disposition of property.
(b) Both have a fiduciary who is responsible for managing property.
(c) Both instruments are revocable and amendable, at least up until death of the person creating the instrument (a living trust generally becomes irrevocable at death of the grantor).

(2) Differences between a living trust and a will

(a) Dispose of different types of property: A living trust disposes of property owned by the trustee in trust for the trustor (decedent). A will disposes of probate property owned by the decedent at death.
(b) A living trust appoints a trustee, whereas a will nominates an executor.
(c) Formal execution requirements are stricter for a will. Witnesses are not required when signing the trust documents. However, the mental capacity necessary is at a higher standard for a trust.

D. Testamentary trusts are also a principal document of property disposition.

(1) This trust takes effect after death at the end of the probate process.
(2) It contains all provisions commonly found in a will and includes unique cases that relate to the trust documents.
(3) A testamentary trust must appoint a trustee and nominate an executor.

5. Marital agreements

There are some issues that may have to be addressed in planning a marriage. Premarital agreements are among the most widely used vehicles for marriage planning.

6. Business agreements (see topic 23)

Buy-sell agreements make sure an estate can sell a business interest for a reasonable price. The contract contains wording that binds the owner of a business to sell his or her share of a business at a specified price to a designated buyer, usually a partner(s) in the business.

TOPIC 71: GIFTING STRATEGIES

1. **Suitability of gifting as a planning strategy**
   The following are the requirements for a transfer to be viewed as a valid gift:

   A. The donor must be capable of transferring property.
   B. The donee must be capable of receiving and possessing the property.
   C. There must be delivery to, and some form of acceptance by, the donee or the donee's agent.
   D. The donor must not maintain any interest in the property.

2. **Techniques for gift giving**
   When designing a gifting program, a planner should consider:

   A. Giving assets with high rates of return, as opposed to assets with lower rates. This strategy can help avoid a buildup of revenue in the estate that would be taxed at the donor's tax rate.
   B. Giving income-producing property to eliminate the income tax payable by the donor on the property. For example, if the donor is in the highest tax bracket and the donee is in a low tax bracket, substantial tax savings within a family unit can result if the income-producing property is given to the donee.
   C. Giving growth assets rather than stagnant assets. This plan will prevent the post-gift appreciation from being taxed in the donor's gross estate.
   D. Giving assets with a high basis rather than a low basis. If an asset with a low basis is held until death, the receiver of the asset is subject to a step-up in basis equal to the fair market value at the time of death. If the asset is gifted, the basis remains the same for the donor and the donee.
   E. Selling assets whose value is less than their basis. Selling these assets results in a loss to the owner, which may possibly be deducted from the donor's income taxes.
   F. Avoid gifting installment obligations. The donor will have to recognize the entire untaxed proceeds at the time of transfer.
   G. Before gifting stock in an S Corporation to a trust, make sure the gift will not cause the loss of S Corporation status.

3. **Appropriate gift property**

   A. Income-producing property, such as rental property
   B. Property that is likely to grow substantially in value, such as life insurance, common stock, antiques and art, or real estate
   C. Property owned by the donor in a state other than his or her own state of residence. Such a gift will avoid ancillary probate at the time of the donor's death.
   D. Property, which has already appreciated, if the donor is contemplating selling it and the donee is in a lower tax bracket than the donor
   E. It is generally not a good idea to give away property that would result in a loss if sold, inasmuch as the donee cannot use the donor's loss. The appropriate strategy would be for the donor to sell the property, take the loss, and give away the cash proceeds.

4. Strategies for closely held business owners: Stock in a closely held corporation can often be an ideal asset for gift purposes, but care must be taken so that not too much stock is given away. If an estate retains too little closely held stock, it may fail the percentage tests that qualify it for privileged treatment. A minimum of 35 percent of the value of the adjusted gross estate (AGE) must consist of closely held stock to qualify for the Section 303 redemption or for the Section 6166 installment payment of estate taxes.

5. Gifts of present and future interest

A. The gift tax exclusion is available only for gifts of present interest; the exclusion does not apply to gifts of future interest.

B. For a gift to be considered a gift of present interest, the donee must have the immediate right to use, possess, or enjoy the property. A gift will be considered one of future interest if the right to use, possess, or enjoy the property is delayed.

C. In making a gift to a trust, the gift will be considered to be of present interest only if the beneficiary has the right to demand immediate custody of the property transferred.

D. The most common types of future interests

(1) Reversion: A future interest in property that is retained by the transferor after he or she transfers interest in property

Example: Steve transfers property in trust to Sarah for her life. The document does not explain what will happen to the property after Sarah's death. Steve has retained a reversionary interest. The trust property will belong to Steve when Sarah dies. If Steve dies before Sarah, the property will belong to his estate.

(2) Remainders: The right to use, possess, and enjoy property after all prior owners' interests end. Example: A businessperson gives money to a trust, which states that the income is to be paid currently to his or her child and upon termination of the trust the principal is to be transferred to his or her grandchildren. The value of the remainder interest to the grandchildren would not be eligible for the annual gift tax exclusion.

(3) The income beneficiaries receive a life estate or estate for years in the trust income (present value interest); remaindermen (beneficiary of trust corpus at termination of all other interests) receive the remainder at termination of the income interests (future value interest).

E. Statutory exceptions to present interest requirement

(1) Minor's trust or Section 2503(c) trust

(a) Considered a present interest gift and thus will qualify for the annual exclusion

(b) The property passes to the minor on attaining the age of 21 years. In the event of the minor's death before attaining age 21, it will be payable to the estate of the minor or as he or she may appoint under a general power of appointment.

(2) Uniform Gift to Minors Act (UGMA) or Uniform Transfer to Minors Act (UTMA)

(a) Considered a present interest gift and thus will qualify for the annual exclusion

(b) Each state has one or the other, UTMA being the more modern version of UGMA. These are statutory creations, requiring a custodial institution (usually a bank, securities institution, etc.) to hold the funds for the minor and a custodian to be the person responsible for the account.

(c) The funds stay under the domain of the custodian until the beneficiary is 21 (by statute in almost all states, although at least one state allows an 18-year-old to take control of his or her account). At age 21, the beneficiary has full rights and control over the balance of the funds.

(d) If the donor dies while being the custodian, the value is brought back into the donor's estate.

(e) Established for education purposes

(3) Section 529 plans

(a) The donor can donate this year's and the next four years' annual exclusion at one time and still qualify for annual exclusion.
(b) If the donor dies before the completion of the years for which the gift was made, the portion of the original transfer attributable to years in which the donor did not survive will be included in the donor's taxable estate.
(c) The donor may remain in control without inclusion in estate. The donor may change beneficiaries within a range of related parties if the original beneficiary does not need the money for college.

F. Common-law exemption—Crummey power

(1) For use in a trust that does not satisfy the requirements of Section 2503(c)
(2) Gifts placed in an irrevocable trust are a gift of a future interest, but by placing a lapsing power (Crummey power) to withdraw, a future interest is converted to a present interest. A Crummey power makes a transfer to a trust a gift of a present interest.

6. Tax implications

A. Income

(1) The main reason for making a gift of income-producing property is to eliminate the income tax payable by the donor on the property. For example, the tax savings are obvious when the donor is in a high income tax bracket and the donee is in a low income tax bracket.
(2) The age of the receiver matters. If the donee happens to be a child under the age of 14, the "kiddie tax" will be imposed on the net unearned income of the child.

B. Gift

(1) A planned gift program can minimize a donor's overall estate, minimize gift taxes, and maximize the overall after-tax income available to a family unit during the donor's lifetime.
(2) Valuation of gift

(a) The value of a gift is its fair market value on the date of the gift.
(b) Any consideration received by the donor reduces the value of the gift.

(3) Transfers made within three years

(a) Any gift tax paid on gifts within three years of death must be added to the gross estate. This is called the "gross-up" approach, which prevents the amount of the gift tax from escaping the estate tax.
(b) Gifts made within three years of death are not included in the gross estate of the donor. They are treated in the same way as any other post-1976 taxable gift (i.e., added to taxable estate). Exceptions to this general rule include property under Section 2036, transfers with life estate; Section 2037, transfers taking effect at death; Section 2038, revocable transfers; and Section 2042, proceeds of life insurance.

(4) Creation of joint ownership

(a) When property is purchased with the funds of one person and titled jointly, a completed gift is made.
(b) The most notable exceptions to this are titling of property jointly between husband and wife and titling of joint bank accounts and United States savings bonds.

(c) In the case of a joint bank account or United States savings bond, a completed gift is not made until the noncontributing joint owner draws upon the bank account or surrenders part of the bond for cash.

(5) Exercise of a general power of appointment

(a) A general power of appointment is subject to gift tax (versus a limited or special power of appointment).
(b) A general power of appointment is the power of the holder to appoint to the holder, the holder's estate, the holder's creditors, or the creditors of the holder's estate.
(c) This section must be kept in mind when creating trusts with Crummey powers, as Crummey powers are general powers of appointment.
(d) Events that trigger gift tax to holder of power of appointment

(i) Section 2514: Provides that the exercise or release of a general power of appointment shall be deemed a transfer of property by the individual possessing such power
(ii) Section 2514(e): Treats the lapse of a power as a release only to the extent that the property, which could have been appointed by exercise of such lapsed power, exceeds in value the greater of $5,000 or 5 percent of assets.

(6) Transfer of property cost basis

(a) Basic rule: Recipient (aka donee or transferee) takes donor's basis.

(i) Exception 1: When the transferred property is included in the donor's taxable estate at death, by being subject to Section 2036, 2037, or 2038, the inclusion gives the recipient a date-of-death fair market value as the basis.
(ii) Exception 2: When property is gifted that has a fair market value less than the donor's adjusted cost basis, the recipient's basis for future loss is the fair market value as of the date of the transfer and the recipient's basis for gain is the donor's original adjusted cost basis.

(b) *Example*: Bob has 100 shares of flyinghigh.com for which he paid $100 each. Today they are worth $5 each. Bob gives the shares to his daughter Samantha. Samantha now has two bases, one for future loss and one for future gain. Should she sell the stock for $4 each, she will have a loss (for purposes of offsetting other capital gains) of $1 per share. The possible tax benefit from the loss from $100 to $5 is forever gone. However, should the stock go up to $50, Samantha's basis is $100 (Bob's original adjusted basis), and thus there would be no loss or gain on the sale. Note that had Bob sold the stock for $50, he would have been able to claim a $50 per share loss to offset other gains. Samantha cannot take advantage of this loss. If the stock goes up to $150, Samantha's gain will be $50, the same as Bob would have had.

C. Estate

(1) The unified credit is a dollar-for-dollar reduction of any gift or estate tax due. Estate and gift taxes have not been "unified," in that the exclusion amount for each has been different since 2004. The gift tax unified credit remains at $345,800, which is equivalent to an exemption of $1 million. The estate tax, on the other hand, has a unified credit of $780,000 (in 2007).

(2) Example: Ben and his wife, Martha, make a $1,004,000 present interest gift in 2007 to their only son. The computation for each spouse is as follows:

Gift (split):	$502,000
Annual exclusion:	$12,000
Net gift:	$490,000
Tax on net gift:	$152,400
Unified credit:	$345,800
Net tax due	$0

To the extent that the credit is used during lifetime, it will have the effect of reducing the credit available against the estate tax. For estate tax purposes, there will be only a $193,400 credit left for each spouse (in 2007). Additional credits will be available as the unified credit increases in subsequent years.

TOPIC 72: GIFT TAXATION AND COMPLIANCE

1. Filing requirements

A. After giving a gift, the donor is required to complete a U.S. gift tax return, Form 709. The tax return must be filed before April 15 following the year of the gift.
B. A gift tax return must be filed by the donor in any calendar year that he or she gives:

(1) More than the annual exclusion to the donee
(2) A gift of a future interest, regardless of how small it is
(3) Total gifts exceeding $100,000 (indexed) to a noncitizen spouse
(4) A gift for which spouses elect gift splitting, even if the amount is less than the annual exclusion for each after the split

2. Calculation

A. Annual exclusion and applicable credit

(1) In 2007, the first $12,000 of gifts of a present interest made by a donor to each donee in each calendar year is excluded from the amount of the donor's taxable gifts.
(2) The first $125,000 by a donor to a spouse who is not a U.S. citizen is excluded.
(3) The annual exclusion is doubled to $24,000 (in 2007) by gift splitting with a spouse. Each spouse is deemed to have given half the gift, even though one spouse in actuality made the entire gift.
(4) Rules regarding annual gift tax exclusion

(a) A gift in trust is treated as a gift to a trust's beneficiary in determining how many annual exclusions are allowed.
(b) The amount of income interest in a trust qualifies for the annual exclusion if the trustee is required to distribute the income annually.
(c) The gift that is contingent upon survivorship is a gift of a future interest.
(d) A gift is a future interest if the donor's enjoyment depends on the exercise of a trustee's discretion.
(e) A gift must have an ascertainable value to qualify for the exclusion.

(5) The gift tax unified credit is $345,800 from 2002 to 2009, which is equivalent to an exemption of $1 million.

B. Split gifts

(1) Available only to married couples who file a joint return
(2) Must be selected on Form 709. It is filed by one taxpayer, and the other signs a consent for the gift splitting.
(3) Gifts of community property do not require gift splitting because each spouse is considered to own one-half of the community property.
(4) For any one year in which gift splitting is selected, all gifts made by either spouse (whether taxable or not) are considered to be split.
(5) Each gift that is split is considered to have been made one-half by each spouse, totally without regard to the source of the funds or assets actually transferred.
(6) *Example*: Myron and Myrna made the following gifts in 2007: Myron gave their daughter, Mona, 1,000 shares of ABC stock, which was trading at $22.50 per share. Myrna gave her mother's wedding ring to her daughter by her first marriage, Midge. The ring was worth about $15,000. They write a $30,000 check to their son, Michael, to help him with a down payment on a house. At the end of the year, Myrna gives Michael $5,000 cash to help him with personal expenses.
(7) Solution: Gift tax reporting is on Form 709, due on or before April 15, 2008, in either Myron's or Myrna's name and Social Security number, with the other signing as consenting. The gifts are listed in the following table:

Gift	**FMV (Fair Market Value)**	**Annual Exclusion in 2007**	**Taxable Gift each**
ABC stock to Mona	$22,500	$11,250 $11,250	$0.00
Ring to Midge	$15,000	$7,500 $7,500	$0.00
Check to Michael	$30,000	$12,000 $12,000	$3,000
Cash to Michael	$5,000	$0.00	$2,500
Total Taxable Gift each:			$5,500.00

C. Prior taxable gifts

(1) No prior taxable gifts: If this is the case, the tax rates from the unified federal estate and gift tax rate schedule are applied to the current year taxable gifts. Gift tax computation:

Total current year's gross gifts (fair market value)

Less:	One-half of value of gifts split with spouse
	Annual exclusions
	Marital deduction
	Charitable deduction
Equals:	Total taxable gifts
Calculate:	Tentative tax on total taxable gifts
Less:	Unified credit (not to exceed tentative tax)
Equals:	Current gift tax

Example: In 2007, Mary made a gift of XYZ stock worth $731,000 to her brother, Ralph. This is the first taxable gift ever made by Mary. The tentative tax on a $719,000 estate ($12,000 annual exclusion) is $236,830. When $236,830 of Mary's unified credit ($345,800 in 2007) is applied, no gift tax is due.

Note: Total gifts cannot include political contributions, direct payments for medical and hospital expenses, or direct payments of tuition.

(2) With prior taxable gift: Tax on gifts is cumulative. Previous taxable gifts "gross-up" present taxable gifts for tax computation purposes. That is, once you have used the lower tax rates, future taxable gifts will be at the progressively higher rates in the Code—that is, you can use each lower bracket only once; any subsequent taxable transfer must be taxed at the higher rates.

(3) The method to determine the effective tax on all subsequent taxable transfers is as follows:

Total current year's gross gifts (fair market value)

Less:	Annual exclusion(s) and deductions
Equals:	Current taxable gift
Plus:	Total prior taxable gift
Equals:	Total (current and prior) taxable gifts
Calculate:	Tentative tax on total taxable gifts
Less:	Tentative tax on total prior taxable gifts
Equals:	Tentative tax of current taxable gifts
Less:	Unused unified credit (not to exceed tentative tax)
Equals:	Current gift tax

Example: In 2007, Mary (see earlier example) gave an additional $512,000 of XYZ stock to her friend, Betty. The gift tax is as follows:

Total current year's gross gifts $512,000

Less:	Annual exclusion(s) and deductions	($12,000)
Equals:	Current taxable gift	$500,000
Plus:	Total prior taxable gift	$719,000
Equals:	Total (current and prior) taxable gifts	$1,219,000
Tentative tax on total taxable gifts		$435,590
Less:	Tentative tax on total prior taxable gifts	($236,830)
Equals:	Tentative tax of current taxable gift	$198,760
Less:	Unused unified credit ($345,800 − $236,830)	($108,970)
Equals:	Current gift tax	$89,790

D. Education and medical exclusions

(1) Qualified payments made directly to an educational institution for tuition are fully excluded from being taxable gifts.

(2) Qualified payments made directly to a provider of medical care are fully excluded from being taxable gifts.

(3) Gifts to political organizations are excluded from being taxable gifts.

E. Marital and charitable deductions

(1) Gifts to a U.S. citizen spouse are fully deductible, provided that they are not terminable interests.

(2) Charitable gifts are fully deductible.

F. Tax liability

(1) Taxable gifts

(a) Gifts made during life, which are either in excess of a donor's annual exemption or are not a present interest

(b) To the extent that tax is due, the taxpayer must utilize available unified credit.

(c) To the extent that unified credit is not available, the taxpayer must pay the tax by April 15 of the year following the year of the gift, to avoid penalties and interest.
(d) Any gift tax actually paid (no unified credit used) within three years of death will be included in the decedent's taxable estate. This equalizes the difference between "tax inclusive" and "tax exclusive" transfers.

(2) Net gifts occur when the donee agrees to pay any gift tax due. In this way, the gross amount of a gift is reduced by the amount of gift tax the donee pays. Rules for net gifts:

(a) The actual gift tax liability is lowered because the gift taxes paid reduce the value of the taxable gift.
(b) The donor's unified credit must be used to compute the donee's gift tax liability.
(c) For estate tax purposes, only the net amount of the gift is considered in the estate tax computation as an adjusted taxable gift.
(d) For income tax purposes, a net gift is treated as part sale and part gift to the extent that the gift tax paid by the donee exceeds the donor's basis in the property.

(3) Gift tax rates are cumulative. As a donor makes gifts that are subject to gift tax over the years, the previous years' gifts are added together with gifts made in the current year in order to determine the gift tax bracket for current gifts.

TOPIC 73: INCAPACITY PLANNING

1. **Disability or incapacity can be defined as the inability to act on one's own behalf.**
2. **Care of client's dependents—guardianships (also called conservatorships)**

A. A guardianship is a state-imposed arrangement that results from an action brought by an interested party; it requires a finding such as "mental illness," "incompetence," or the like.
B. The parties involved in a guardianship are

(1) The ward or protected person
(2) The guardian or conservator
(3) The state

C. Voluntary guardianship allows the ward to choose the guardian. It provides the protection of the court and state law, but it is relatively simple to dissolve and thus is often useful only as an interim arrangement in times of crisis or pending completion of other arrangements.

3. **Care of person and property**

A. Planning scenarios

(1) Provisions for managing the financial affairs of clients in the event they are unable to do so themselves (durable power of attorney, revocable living trust, and nominations of persons to serve as guardian or conservator)
(2) Providing support for clients who are no longer self-supporting and have not accumulated enough assets to maintain their cost of living
(3) Planning for long-term health care
(4) Protecting property from claims of the state or other government
(5) Planning for changing taxes

B. Comparison of management techniques

(1) Durable power of attorney versus conservatorship: The advantages of using the former for managing an incompetent person's property are as follows:

(a) It avoids both public proceedings and the need to determine the status of the principal.
(b) Various legal expenses and delays are avoided inasmuch as court appointment of a fiduciary is unnecessary.
(c) It is relatively uncomplicated and inexpensive to create and is easy for the principal and agent to understand.
(d) Title to the assets remains with the principal.

(2) Living trust versus conservatorship: The advantages of using the former for managing an incompetent person's property are as follows:

(a) The greater flexibility of a trust
(b) The determination by the grantor of what provisions will be included in the trust document, such as who will be the fiduciary (trustee), what the standard for incompetency will be, what the trustee's powers will be, and so forth
(c) Smaller administration costs, because a conservatorship requires frequent court approval of transactions
(d) Wider management authority, allowing the trustee to conduct more kinds of transactions with the grantor's property than would be possible under a guardianship or conservatorship
(e) *Exception:* With less court supervision, overreaching and abuse of power are more likely.

(3) Living trust versus durable power of attorney: The advantages of using the former for managing an incompetent person's property are as follows:

(a) Assurance that the transactions will be accomplished: Although some third parties may not recognize the authority of an agent under a durable power of attorney, the trustee's power to act according to the trust agreement must be honored (although most states will not compel a third party to follow the directions of an attorney-infact, states generally will compel others to recognize a trustee's authority over trust property).
(b) The management and distribution terms are usually more detailed in a trust.
(c) *Exception:* A trust is more costly to create and maintain.

4. Disability insurance—features of a good disability policy (see also topic 19)

A. Select a policy that covers partial disability, not total disability.
B. Select a policy that uses "your occupation" definition, not "any job" definition.
C. Select a policy that is guaranteed renewable and noncancelable.
D. Choose a policy that covers disability resulting from both accident and illness.
E. Choose a policy that pays at least through age 65.
F. Select a policy that pays at least 60 percent of take-home pay.
G. A three-month waiting period generally offers the best value for the premium dollars paid.
H. Cost-of-living adjustments should be included in the policy.
I. Standard-of-living adjustments should be included in the policy so that the insured can increase the benefit amount without a medical exam.

5. Long-term care insurance—features of a good long-term care policy (see also topic 20)

A. The policy should be guaranteed renewable for life.
B. A three-month waiting period generally offers the best value for the premium dollars paid.
C. The policy should provide coverage for skilled and intermediate care, as well as for custodial care, which does not require the engagement of licensed medical professionals.
D. Long-term care at home can be more attractive than a residential or nursing facility.
E. Select a policy that does not require the insured to be hospitalized before entering a nursing home for care.
F. Select a policy that provides long-term care coverage for Alzheimer's disease.
G. Choose a policy that provides for the anticipated rise in the cost of long-term care.
H. Select a policy that provides for a waiver of premiums in the event of disability and provides level premiums for life.
I. Select a policy that provides a favorable benefit period.

6. Medicaid planning

A. Medicaid is a joint federal and state program that provides assistance for health care to certain aged, disabled, or blind individuals. The intent is to provide help to needy individuals. This can be integrated with the requirements for Supplemental Security Income (SSI).
B. If a client's assets exceed a certain dollar value, the individual will be ineligible to receive Medicaid benefits. The income of the individual and spouse is also considered.
C. Distributions from an annuity do count for purposes of the income test, but do not count under the assets test.
D. The individual's personal residence is generally not included as an asset for purposes of Medicaid eligibility, but this really depends on the state law.
E. There are strict limits on transfers of assets to achieve Medicaid eligibility. For example, the value of any transfer of assets within 36 months before the individual makes an application for Medicaid will be considered an available resource. There are some exceptions, including transfers to children who are caretakers for their parents.
F. In general, for assets transferred to trusts, the look-back period is 60 months from the date the individual makes a Medicaid application or the date an individual enters a nursing home.
G. Assets in a revocable trust are considered to be available resources, regardless of when the trust was created. A 60-month look-back period applies to transfers between trusts.
H. Irrevocable special needs trust

(1) This is a bypass trust, which is not included in the gross estate of the beneficiary, and its assets are not counted for purposes of eligibility under Medicaid.
(2) The settlor retains the following powers:

(a) While competent, the power to act as trustee
(b) While not competent, the right to invade principal on the basis of health, education, maintenance, and support
(c) The power to appoint an unlimited amount of trust property to family members other than the trustor
(d) The power to change beneficiaries in order to reallocate the estate amount among the children

7. Viatical settlements (see topic 21)

8. Business disability coverage (see also topic 28)

A. The disability of business owners or key employees poses a serious risk to a business's financial health. The problem is especially evident in small businesses in which the workforce may not be large enough to have a backup for critical tasks. Even if the primary business is halted because of the disability of the owner or a key person, certain aspects of the business must continue (e.g., accounts payable and receivable).

B. Disability insurance can be written to cover business overhead, key person disability, salary continuation for owners or key persons, or a disability buy-sell agreement.

(1) Business overhead policies cover many of the ongoing operation costs of a business while the owner is totally disabled.

(2) Key person insurance allows a business to find a temporary replacement for a key person who has become disabled, replace lost revenue, fund the search for a replacement, and fund costs of training when a new person is found.

(3) Salary continuation is simply a plan to continue the salary of the disabled person.

(4) A buy-sell plan shifts the ownership of the company to one or more individuals. The cost of the buy-sell can be paid in a lump sum or in installments.

9. Social Security disability benefits (see topic 60)

TOPIC 74: ESTATE TAX CALCULATION AND COMPLIANCE

1. The gross estate

A. Inclusions

(1) Section 2033 includes in the gross estate the value of "all property to the extent of the (decedent's) interest therein."

(a) Generally includes property or interests considered "owned" by decedent

(b) Generally includes contingent interest

(c) Income in respect of a decedent (IRD)

(i) Rights to unpaid income possessed by decedent

(ii) Subject to income tax and estate tax

(iii) Income tax deduction for estate tax attributable to included value of the income right [Section 691(c)]

(iv) Retirement plans and annuities are major sources of IRD.

(2) Section 2034 includes in the gross estate dower and courtesy interest (fully deductible under the marital deduction).

(3) Section 2035 includes in the gross estate any gift tax paid on gifts within three years of death.

(4) Sections 2036, 2037, and 2038 cover transfers with retained interest (Section 2036), reversionary interest (Section 2037), or power to amend, alter, or revoke (Section 2038).

(a) Purpose of Sections 2036, 2037, and 2038

(i) Premised on the notion that the decedent has made a gift of property, but has retained a certain degree of control and enjoyment over the property, so the property is included in the gross estate

(ii) All require that the decedent has made a transfer of property for less than full consideration in money or money's worth.

(b) Section 2036 covers transfers with retained interest.

(i) Section 2036(a)(1) includes in the gross estate the value of any property in which the decedent has retained a life estate. The Code does not use the words life estate, but instead refers to the "the possession or enjoyment of, or the right to the income from, the property."

- *Example*: A person transfers to his son real estate as a gift, reserving a life estate.
- *Example*: A person transfers to his daughter a residence as a gift. The transferor continues to live in the residence rent free until death.

(ii) Section 2036(a)(2) includes property for which the decedent reserved the right either alone or in conjunction with any person to designate the persons who shall possess or enjoy the property or the income therefrom.

- *Example*: A decedent created a trust and was one of three trustees of the trust. The trust provided that the trustees, in their sole discretion, could pay trust income to the beneficiary or accumulate the income.
- A power limited by an ascertainable standard (support, health, education, or maintenance) is not within Section 2036(a)(2).

(iii) Section 2036(b) states that the retention of right to vote shares of stock of a controlled corporation is considered a retention.

(c) Section 2037 covers transfers taking effect at death.

(i) Two conditions must exist:

- Possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent.
- The decedent has retained a reversionary interest in the property, and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.

(ii) The statute says the term reversionary interest includes a possibility that property transferred by the decedent may return to the decedent or his or her estate or may be subject to a power of disposition by him or her.

(iii) The 5 percent test is only a test. If the 5 percent requirement is met, then the entire value of the interest subject to the reversion is included in the decedent's gross estate.

(d) Section 2038 includes transfers involving the power to alter, amend, revoke, or terminate.

(i) Generally synonymous with the power to designate the persons who shall possess or enjoy the property or the income therefrom

(ii) Under Section 2038, the property must be subject to the power at the time of the decedent's death.

(5) Section 2039 requires inclusion in the gross estate the value of any annuity or other payment received by the beneficiary. If an annuity pays a survivorship benefit to a named beneficiary, the present value of the future payments to the beneficiary is included in the

decedent's gross estate. This applies to pension and retirement plans that provide for a survivorship benefit.
(6) Section 2041 includes in the gross estate any property subject to a general power of appointment at the time of the decedent's death.
(7) Estate taxation of life insurance (see topic 80)

B. Exclusions

(1) Interests arising at death are not included (e.g., a wrongful death action).
(2) Frequently, creating an irrevocable life insurance trust or having other family members own the policy is done in an effort to keep the proceeds of the policy out of the estate.
(3) A power of appointment that is limited by an ascertainable standard relating to health, education, support, or maintenance is not a general power of appointment.

2. Deductions

A. Funeral expenses
B. Administrative expenses, including commissions, fees, court costs, and selling expenses for asset dispositions
C. Debt and mortgages
D. Certain taxes payable at death
E. Losses from administering the estate (such as casualty losses)

3. Adjusted gross estate (AGE) is defined in Section 6166 as gross estate less expenses, debts, and losses.

4. Deductions from the adjusted gross estate

A. Charitable contributions (see topic 79)
B. Transfers to surviving spouse (see topic 82)

5. Taxable estate is found by subtracting charitable deduction and marital deduction from the AGE.

6. Adjusted taxable gifts rule

A. Adjusted taxable gifts are defined as the taxable portion of all post-1976 gifts. A gift is taxable to the extent it exceeds any allowable:

(1) Annual gift tax exclusion,
(2) Gift tax marital deduction (similar to the estate tax marital deduction, but for lifetime gifts to a spouse), or
(3) Gift tax charitable deduction.

B. The sole purpose of the adjusted taxable gifts coming into the estate tax equation is to move the decedent's taxable estate up into the appropriate marginal rates.
C. Gross estate versus taxable estate

(1) If a gift is added to the gross estate, the value of the gift is the fair market value of the property as of the date of death (or alternative valuation date, if elected). Gifts that for any reason have been includable in a decedent's gross estate are not considered adjusted taxable gifts.
(2) If the taxable gift is added to the taxable estate, the value at the date of the gift applies.

7. Add the adjusted taxable gifts to the taxable estate to arrive at the tentative tax base.

8. Tentative tax calculation: The tentative estate tax is determined by applying the unified transfer tax rate from Section 2001(c) to the tentative tax base.

9. Credits

A. Gift tax payable

(1) The tentative tax is reduced by the gift tax paid or payable on gifts included in the tax base.
(2) Gift tax paid is a reduction of estate tax and not a credit.
(3) It is the dollar amount after application of the unified credit.

B. Unified credit

(1) The credit must be used the first time a gift tax or an estate tax is required to be paid. A taxpayer does not have the right to pay tax in lieu of using the unified credit.
(2) The total tax on the net gift or estate is calculated, then some or all of the credit as may be necessary is applied against total tax due and owing on a dollar-for-dollar basis. The balance, if any, is the net tax due.
(3) If the credit is not fully utilized in one transaction, the balance will carry over to another, later transaction. If credit remains after calculating any tax due at death, that credit vanishes and no one gets the benefit of it.
(4) The amounts of unified credit, and their applicable exclusion amounts, are as follows:

Year	Unified Credit	Exclusion Amount
2007	780,800	2,000,000
2008	780,800	2,000,000
2009	1,455,800	3,500,000

After 2009, estate tax is repealed.

C. Prior transfer credit

(1) The credit for taxes on prior transfers is available where the same property has been taxed in the estate of a person who died within 10 years before or 2 years after the decedent's death.
(2) The credit for tax on prior transfers is limited to the smaller of:

(a) The amount of the federal estate tax attributable to the transferred property in the transferor's estate
(b) The amount of federal estate tax attributable to the transferred property in the decedent's estate

(3) If the transferor died within two years before or two years after the present decedent's death, the credit is the smaller of the two limitations. If the transferor died more than 2 years before the decedent, the credit is reduced by 20 percent for each 2 years by which the death of the transferor preceded the decedent's death, up to 10 years.

D. State death tax
It does not reduce the total estate tax. It merely divides the total death taxes between the federal and state governments.

E. Federal estate taxes

(1) No prior gifts:

Gross Estate	
Less:	Total deductions
Equals:	Taxable estate
Calculate:	Tentative estate tax
Less:	Unified credit
Equals:	Total death taxes
Less:	State death tax credit
Less:	Other credits
Equals:	Federal estate tax

(2) With prior gifts:

Gross Estate	
Less:	Total deductions
Equals:	Taxable estate
Plus:	*Adjusted taxable gifts (post 1976)*
Equals:	*Estate tax base*
Calculate:	Tentative estate tax
Less:	*Gift taxes payable on post-1976 taxable gifts*
Less:	Unified credit
Equals:	Total death taxes
Less:	State death tax credit
Less:	Other credits
Equals:	Federal estate tax

TOPIC 75: SOURCES FOR ESTATE LIQUIDITY

1. **Sale of assets during lifetime**

   A. Assets that have a built-in loss are generally the best to sell. Death eliminates this potential tax benefit by stepping down the basis to date-of-death value.
   B. High-basis assets are also good to sell because there is little or no taxable gain.
   C. Low-basis assets are the least attractive to sell. Tax on these assets is eliminated if held until death, and the beneficiary receives a new basis at fair market value.

2. **Life insurance (see topic 80)**

TOPIC 76: POWERS OF APPOINTMENT

1. **Use and purpose**

   A. A power of appointment is a power to name someone to receive a beneficial interest in property. The grantor of the power is called the donor. The person receiving the power is called the holder or donee. The parties to whom the holder gives property by exercising the power are called the appointees. The persons who receive the property if the holder permits the power to lapse are called the takers in default.
   B. A power of appointment is "general" if there are no restrictions on the donee's choice of appointees. If there are restrictions, then the power is termed a *limited* or *special* power.

C. A power of appointment is used:

(1) When the estate owner wants someone else to make decisions concerning his or her property
(2) When the estate owner does not know the future needs of his or her beneficiaries or how many beneficiaries there will be
(3) When the assets would be subject to the generation-skipping transfer tax (GSTT) upon a taxable termination of the trust. The inclusion of assets in the estate of the holder results in a lower tax than GSTT because of a graduated rate schedule rather than a flat tax rate at the highest estate tax rate.
(4) When the estate owner desires to qualify assets for the marital deduction but would like to have a right to designate who will receive the property

2. General and special (limited) powers

A. 5 + 5 power

(1) The "5 or 5" power is useful for avoiding estate taxes as well as gift taxes. The right of invasion must be made noncumulative.
(2) Property subject to a general power will be included in the estate of the holder only to the extent that the property that could have been appointed by the exercise of the power, but has lapsed, exceeds the greater of:
   (a) $5,000
   (b) 5 percent of the total value of the funds subject to the power as valued at the time of the lapse
(3) Estate tax consequences
   (a) *Example*: Mark was the income beneficiary of a trust with assets of $200,000. Assume the value of the trust does not change. Mark was given a noncumulative power to withdraw $10,000 per year. He did not exercise the power, which resulted in a lapse each year. When Mark dies, only $10,000 is included in his gross estate. The lapse in prior years is ignored because the amount does not exceed the greater of $5,000 or 5 percent of the corpus of $200,000.
   (b) *Example*: Marge was income beneficiary of a trust with assets of $70,000. Marge was also given a noncumulative power to withdraw $10,000 per year (which she did not exercise). At the expiration of each year, Marge has released a general power to the extent of $5,000 (i.e., a $10,000 lapse minus the greater of $5,000 or 5 percent of $70,000 [$3,500]).
   (c) If Marge dies in the sixth year of the trust's existence and assets remain constant, Marge's gross estate would include $35,000 on account of this trust. The $35,000 consists of $10,000 on account of the power held by the decedent at the time of death and $25,000 on account of the lapse of the power in each of the prior five years.
(4) Gift tax consequences: Failure to exercise results in gifts to the remaindermen of the trust, with a reduction each year by the amount of the holder's (Marge) life estate in the lapsed amounts.
(5) Income tax consequences: If the beneficiary has a 5 or 5 power and fails to exercise the power in a given year, the beneficiary becomes the grantor of that portion of the trust over which the power has lapsed.

B. Crummey provisions

(1) Gifts placed in an irrevocable trust are gifts of a future interest, but by placing a lapsing power (Crummey power) to withdraw, a future interest is converted to a

present interest. A Crummey power makes a transfer to a trust a gift of a present interest.

(2) The beneficiary has a noncumulative right to withdraw a specified amount of property transferred to a trust within a specified period.

(3) If the right is not exercised, the annual transfer for the year remains in the trust for management by the trustee. If the right is exercised, the trustee must deliver the fund to the beneficiary.

(4) The lapse of the withdrawal power to the extent it exceeded the greater of $5,000 or 5 percent of trust corpus causes a taxable gift by the power holder to the remaindermen of the trust. Because the remaindermen (possibly unknown) do not have the power to withdraw the gift from the trust, the beneficiary made a future interest gift, which does not qualify for the annual exclusion.

(5) Two negative tax consequences of this taxable gift by the Crummey trust beneficiary:

(a) The beneficiary made a transfer subject to gift tax, which would use up some of his or her unified credit.

(b) The property subject to the lapsed power would be included in the beneficiary's estate for estate tax purposes as a transfer in which the interest has been retained, because the beneficiary usually has some continuing right to the trust (i.e., a life estate) property.

(6) The gift tax problem created by the lapse of a general power to trust property in excess of $5,000 or 5 percent of the trust corpus is resolved by the following:

(a) No gift tax is due by reserving in the beneficiary a power that keeps the lapse from being a completed gift. This is the power to direct where the trust property will go upon lapse of the withdrawal power.

(b) The estate tax problem is not avoided, but most Crummey trusts are intended to be paid out during the beneficiary's lifetime, so this should not be a problem.

C. Distribution for health, education, maintenance, and support

A power that is limited by an ascertainable standard relating to health, education, maintenance, or support (HEMS) is not a general power of appointment.

3. Tax implications

A. General power implications

(1) Section 2514 provides that the exercise or release of a general power of appointment shall be deemed a transfer of property by the individual possessing such power.

(2) Section 2514(e) treats the lapse of a power as a release only to the extent that the property, which could have been appointed by exercises of such lapsed power, exceeds in value the greater of $5,000 or 5 percent.

(3) Section 2041 includes, in the donee's gross estate, property subject to a general power of appointment at the time of the decedent's death.

B. Special or limited power implications

(1) The existence of a special power of appointment or the exercise, release, or lapse of such a right will not cause inclusion in the power holder's gross estate.

(2) No gift tax is imposed by the exercise, release, or lapse of a special power of appointment.

TOPIC 77: TYPES, FEATURES, AND TAXATION OF TRUSTS

1. **Classification**

   A. Simple and complex

   (1) A simple trust is considered merely a conduit for forwarding income to the beneficiaries, but no principal is distributed. The trust passes its income through to the beneficiaries, who then report the income with the same character that it had for the trust and who pay taxes on it according to their own marginal tax brackets.
   (2) A complex trust is an irrevocable trust that can either accumulate some fiduciary accounting income (FAI) (i.e., does not pay out all of the FAI for the year) or distribute principal.

   B. Revocable and irrevocable

   (1) Revocable living trust

   (a) Subject to the right of rescind and amend
   (b) Becomes irrevocable at the grantor's death
   (c) Includable in estate
   (d) No gift tax at time of creation

   (2) Irrevocable living trust

   (a) Cannot be revoked by the grantor after its creation except upon the consent of all the beneficiaries
   (b) Gift tax may apply at time of transfer.
   (c) Has income and estate tax benefits

2. **Rule against perpetuities**

   A. The rule against perpetuities is a law that requires a time period for a trust to terminate and distribute its property to a person.
   B. To satisfy the requirements of the rule, an interest must vest within 21 years after the death of someone at the moment of the transferor into an irrevocable trust. The interest must vest or fail to vest no later than 21 years after some life in being at the creation of the interest.
   C. A violation of the rule will cause the particular interest to be void and revert to the transferor or the transferor's successors.
   D. The rule does not take a wait-and-see approach; it does not allow us to wait and see whether any grandchildren are born after the grantor's death.
   E. It typically enables the transferor to control the disposition of property for his or her life, for the lives of the children, and for the grandchildren's lives, but no longer. A great-grandchild's interest will typically (but not always) vest after the 21-year period and thus will fail.

3. **Selected provisions**

   A. Spendthrift clause

   (1) A spendthrift provision (or spendthrift trust) is designed to protect trust assets from the "spendthrift" propensities of a trust's beneficiaries. A trust provision may prohibit a trust beneficiary from assigning his or her interest in the trust corpus. Such a provision will prevent creditors from reaching the trust assets by any legal or equitable process.

(2) Once trust income is paid to the beneficiary, the funds lose their trust character and may be attacked by creditors.

B. Perpetuity clause

(1) A clause in a will or trust that prevents interests from being ruled invalid under the rule against perpetuities
(2) Identifies the lives of all people in a trust that can be calculated

C. Other

(1) A sprinkling provision gives the trustee authority to allocate income and corpus among the trust beneficiaries in accordance with their needs. Thus, the trustee of a sprinkle trust has considerable flexibility to use discretion in providing for the unique needs of

(i) beneficiaries.

(2) A support provision limits the trustee's right of distribution to only as much of the trust's assets (income or principal) as the trustee deems necessary to discharge the grantor's obligation of support to one or more specified beneficiaries.

4. Taxation of trusts and estates

A. Trust income and federal estate income tax (see topic 49)
B. Federal gift tax implications

(1) *Revocable trust:* The transfer of property to a revocable trust does not result in a taxable gift because there has not been a completed gift.
(2) *Irrevocable trust:* The transfer of property to an irrevocable trust usually results in a taxable gift.

(a) The grantor is subject to gift tax liability on the actuarial value of both the income stream and the remainder interest transferred to the trust beneficiaries.
(b) The actuarial value of the gift may be reduced by the gift tax annual exclusion if a beneficiary has a "present interest," which can be created by giving a trust beneficiary an unrestricted right to the immediate use, possession, or enjoyment of property or income.

C. Federal estate tax implications

(1) Revocable trust: Assets are included in the deceased grantor's gross estate.
(2) Irrevocable trust: Assets transferred to an irrevocable trust will avoid both probate and inclusion in the deceased grantor's gross estate, if the grantor does not retain prohibited rights:

(a) A life income interest or right to use or enjoy trust property
(b) A right to change the beneficiary designation
(c) A right to change the trustee (unless the grantor's power is limited to parties not related or subordinate to the grantor)
(d) A right to determine the beneficial enjoyment of trust assets
(e) A reversionary interest of more than 5 percent

5. Estate Planning for Non-Traditional Relationships

A. Tax and nontax consequences of various estate plans (outright distributions, transfers in trust, etc.)

(1) Tax implications

(a) Income tax: Income (dividends, etc.) generated by the property will be taxed to the donee after the transfer. The donee's basis is the lesser of:

(i) The fair market value (FMV)
(ii) The donor's basis, with an adjustment for the gift tax paid

(b) Gift tax: Complete versus incomplete gifts. If a donor can unilaterally retrieve the gifted property, there has not been a completed transfer. Therefore, the gift tax is not triggered (contrast the tax implications of this with a completed gift with a retained interest). However, if the transfer is a completed gift, the donor will have a gift tax liability to the extent that the FMV of the gift on the date of the transfer is greater than the available annual exclusion and/or any permissible charitable or marital deductions.
(c) "Tax exclusive" nature of gifts: A donor will not pay gift tax on the funds that are used to pay the gift tax. In contrast, the estate tax is "tax inclusive," meaning that the estate will pay taxes on the funds that will be used to pay the estate taxes. Consequently, if all other factors are equal, from a transfer tax perspective, it is less expensive to transfer assets during lifetime than at death.
(d) Impact of gifting on the estate tax: A completed gift that does not involve a retained interest will usually affect a decedent's potential estate tax calculation by:

(i) Decreasing the value of the gross estate
(ii) Increasing the value of the adjusted taxable gift
(iii) Decreasing the tax base

(2) Custodial gifts (UGMA and UTMA)

(a) Income from custodial property is taxed to the minor (at a rate based on the kiddie tax) whether distributed or not, except to the extent that it is used to discharge a parental obligation of support (in the latter situation, it is taxed to the parent).
(b) Gift tax liability is triggered by the irrevocable transfer. Because the child is legal title holder, the gift is one of a present interest, qualifying each dollar of gifted custodial property for a dollar of annual exclusion (up to the applicable maximum annual limit).

(3) Section 2503(b) mandatory income trust

(a) Income tax: Unlike a custodial account, the trust is a taxable entity separate from the beneficiaries. However, because income must be distributed to the income beneficiaries, it is taxable to them at the appropriate tax rate.
(b) Gift tax liability is triggered by the irrevocable transfer. The mandatory distribution of income creates a present interest qualifying for an annual exclusion. However, because the gift to the trust is split between the income (present interest) and remainder (future interest) beneficiaries, only part of each dollar of gift property (the portion going to the income beneficiary) will qualify for the annual exclusion.

(4) Section 2503(c) minor's trust

(a) The trust is a separate taxable entity. Any income distributed to the minor is taxable to the minor in the year received. Income that is accumulated is taxed to the trust. Distribution at the termination of the trust is made tax free to the minor; the throwback rule does not apply to minors.

(b) Because the federal tax code mandates present interest treatment of gifts to a Section 2503(c) trust, the gift tax results are the same as for custodial accounts.

(5) Crummey trust

(a) Income tax: Because the transfer is irrevocable, there are no income tax implications to the grantor unless rights prohibited under the grantor trust rules have been retained.
(b) An irrevocable transfer creates a completed gift that can be offset by the annual exclusions, limited by the aggregate amount that the holders of the Crummey right are entitled to withdraw, because it is the withdrawal right that creates a present interest.

TOPIC 78: QUALIFIED INTEREST TRUSTS

1. Grantor retained income trusts (GRITs)

A. The acronym GRIT is used to refer to all grantor retained income trusts, including common law GRITs, GRATs, and GRUTs (see following sections (2) and (3)). Property is transferred into an irrevocable trust, where the grantor retains the right to income for a period of years, after which the trust ends and the property is transferred to the remaindermen. If the transferor survives the income period, all beneficial interest in the trust ceases, and the asset is out of the transferor's estate. However, the taxable gift value is included in the estate tax base as an adjusted taxable gift. If the transferor does not survive the income term, Section 2036(a) applies and the assets are included in the grantor's estate.
B. The primary purpose of a GRIT is to leverage the applicable exclusion amount (AEA) to avoid estate tax, not gift tax. The value of the gift made is calculated by taking the FMV of the property and reducing it by the retained interest. This equals the remainder interest that is considered a gift. This remainder interest is a future interest and is discounted. Therefore, the longer the term of the trust and the higher the Section 7520 rate, the smaller the gift value. The result is to freeze the value in the grantor's interest and transfer growth in value to the children, escaping larger gift and estate tax.
C. There is no reason to create a GRIT of any kind with a term that goes beyond 2009, because the estate tax is repealed at that time. In the post-EGTRRA (Economic Growth and Tax Relief Reconciliation Act) era, a GRIT is beneficial only if the term ends before the settlor dies and the settlor dies before 2010. If a settlor dies after 2009, assuming the estate

(1) tax remains repealed, the now distributed GRIT turns out to be a waste of time. The remaindermen receive the trust assets with a carryover basis. If the settlor had simply held on to the assets, the increase in basis would have been allocated to them.

2. Grantor retained annuity trusts (GRATs): Make fixed payments to grantor at least annually

3. Grantor retained unitrust (GRUTs): The required payment is determined each year as a percentage of the fair market value of the trust property. The value of the assets is recalculated each year.

4. Qualified personal residence trusts (QPRTs, or House-GRITs)

A. QPRTs can hold an interest in only one residence.
B. The grantor who survives the term of a QPRT does not have to vacate the residence, because he or she can rent it as a remainderman. The transaction must be at arm's length and at fair rental value.
C. The residence cannot be purchased from the trustee by the settlor, the settlor's spouse, or an entity controlled by them.

5. Tangible personal property trusts

A. The problem with setting up these trusts is that it is difficult to value a term interest for tangible personal property.

B. The zero valuation rule of Section 2702 does not apply to tangible property where:

(1) The failure of the interest holder to exercise rights would not have a substantial impact on the remainder interest.

(2) No depreciation deduction is allowed.

6. Limitations on the valuation of remainder interests of qualified interest trusts

A. Section 2702 limits the advantage of a grantor retained trust by valuing the income interest at zero when the transfer is made to a family member. This means that the entire value of the transferred property is subject to immediate gift tax (i.e., it is not discounted by the term). For gift tax purposes, the nonqualified retained interests are treated as if they were not retained.

B. To be qualified,a retained income interest must be paid annually and there must be a precise way of calculating the amount. There are four types of Section 2702 GRITs that avoid the zero valuation rule for the retained interest.

(1) GRATs

(2) GRUTs

(3) QPRTs

(4) Tangible personal property trusts

C. If the retained interest is a qualifying one, the zero valuation rule is avoided. If Section 2702 applies and the retained interest is not a qualified one, the interest is given a zero value.

D. Example: Jerry transfers $1 million into a trust, retaining the right to all income for 15 years. His two children are the remaindermen. The income interest is valued at zero because it is neither a GRAT nor a GRUT. The result is that the entire $1 million value is a taxable gift.

TOPIC 79: CHARITABLE TRANSFERS

1. Considerations for contributions and transfers

A. An unlimited amount of property can be transferred to qualified charities without incurring federal gift taxes. As with the marital deduction, there is no limit to the size of the gift tax charitable deduction.

B. The charitable organization incurs no income tax liability as a result of the gift and is not subject to income tax on the income derived from the property transferred.

C. A transfer made during an individual's life will not only provide an income tax deduction but will also remove property from the taxpayer's estate. In contrast, a testamentary bequest to a qualified organization will only remove property from the taxpayer's estate.

D. Reasons for making a lifetime gift to a charity (rather than to a noncharitable beneficiary): To use the unlimited charitable deduction to either reduce or avoid gift tax liability while removing the value of the asset (including any appreciation) from the donor's potential gross estate

2. To qualify for a charitable income tax deduction (see topic 58)

A. Public charities are the charitable, educational, scientific, religious, medical, and related nonprofit organizations that are publicly supported. Examples include Red Cross, United Way, universities, hospitals, churches, synagogues, and the like. Groups that aid or prevent

cruelty to children or animals and governmental units that use donations solely for public purposes are included in this category.

B. Contributions qualifying as charitable deductions for income tax purposes must meet the following requirements:

(1) They must be made to qualifying organizations.
(2) They must be gifts of property and not the value of time or services provided.
(3) They must be made before the close of the year in which the deduction is to be claimed.
(4) They must have a value greater than any benefit received from the qualifying organization. (Only the value in excess of the benefit received is deductible.)
(5) They must be gifts of the donor's entire interest in the property, unless made in accordance with special rules.
(6) They must be claimed by the taxpayer as itemized deductions. (No charitable deduction has been allowed to nonitemizers since 1986.)

3. Charitable remainder trusts (CRTs)

A. Characteristics

(1) The donor retains a limited right to enjoy the property while receiving an income tax deduction and reducing federal estate tax.
(2) The CRT must have at least one non-charitable income beneficiary.
(3) The CRT must have an irrevocable remainder interest to be held for or paid to a charity.
(4) The grantor has the right to change the charitable remaindermen without causing inclusion in the grantor's estate.
(5) The funding date is critical for determining whether a trust qualifies as a CRT. If the trust is not funded, an income tax charitable deduction cannot be claimed and the assets are included in the estate.
(6) The beneficiary may receive the income for a period not exceeding 20 years or for life, and the remainder goes to the charity.

B. Charitable remainder unitrusts (CRUTs)

(1) The income tax deduction equals the total value of property minus present value of retained interest income.
(2) The income recipient is a noncharitable beneficiary, which is usually the donor.
(3) A fixed percentage of the net fair market value of the principal, revalued annually, must be payable to the noncharitable beneficiary.
(4) The percentage payable to the noncharitable beneficiary must be not less than 5 percent or more than 50 percent of the annual value.
(5) The remainder interest at inception must be greater than or equal to 10 percent of the original value of the property transferred to the trust.
(6) The remainderman is the charity.
(7) Additional contributions are permitted.
(8) May have sprinkling provision
(9) When income is insufficient for payout, the trustee can pay up to income and make up the deficiency in subsequent years.
(10) Can hold tax-exempt securities

C. Charitable remainder annuity trusts (CRATs)

(1) The income tax deduction equals the total value of property minus present value of retained interest income.

(2) The income recipient is a noncharitable beneficiary, which is usually the donor.
(3) A fixed amount or fixed percentage of the initial value of the trust must be payable to the noncharitable beneficiary.
(4) The annuity percentage must be not less than 5 percent or more than 50 percent of the initial fair market value of all the property transferred in trust.
(5) The remainder interest at inception must be equal to 10 percent of the original value of the property transferred to the trust.
(6) The remainderman is the charity.
(7) Additional contributions are not allowed.
(8) May have sprinkling provision
(9) Must invade corpus when income is insufficient for payout
(10) Can hold tax-exempt securities

4. Charitable lead trusts

A. Characteristics

(1) A charitable lead trust differs radically from the charitable remainder trusts in that the donor in the charitable lead trust gives away an income stream and receives a remainder interest.
(2) The donor places income-producing property in a reversionary trust and directs that the trust income be transferred to a designated charity for a period of time not to exceed 20 years. At the end of this "lead" time, the property reverts to the donor or to some other noncharitable beneficiary.
(3) The benefit the donor receives is a very large income tax deduction in the year that the trust is funded, the value of the deduction being the present value of the total anticipated income during the lead period when the charity receives the income. If done right, the value of the remainder interest can equal zero, resulting in a full deduction of the current value of property transferred to the trust.
(4) The trust must be set up as a grantor trust, making the annual income taxable to the donor (but can purchase tax-exempt securities to lower tax liability of the donor), unless it is established at the grantor's death. As such, these trusts are generally established at the transferor's death.

B. Charitable lead unitrusts (CLUTs)

(1) A fixed percentage of the net fair market value of the principal, revalued annually, must be payable to the charitable beneficiary.
(2) The percentage payable to the charitable beneficiary must be not less than 5 percent or more than 50 percent of the annual value.
(3) Additional contributions are permitted.
(4) Can pay up to income and make up deficiency in subsequent years

C. Charitable lead annuity trusts (CLATs)

(1) A fixed amount or fixed percentage of the initial value of the trust must be payable to the charitable beneficiary.
(2) The annuity percentage must be not less than 5 percent or more than 50 percent of the initial fair market value of all the property transferred in trust.
(3) Additional contributions are not allowed.
(4) Must invade corpus when income is insufficient for payout

5. Pooled income funds

A. Created and maintained by a public charity instead of a private donor
B. The donor must contribute an irrevocable, vested remainder interest to the charity.
C. The property is commingled with property transferred by other donors.
D. The funds cannot invest in tax-exempt securities.
E. No donor or income beneficiary can be a trustee.
F. The donor must retain for him- or herself (or one or more named income beneficiaries) a life income interest.
G. Each income beneficiary must receive a pro rata share of income, annually, based on the rate of return earned by the fund.
H. Sprinkling is not allowed.
I. Additional contributions are allowed.

6. Private foundations

A. A private foundation can be set up by either a corporation or a trust and is generally organized by a family to accomplish charitable goals. The foundation allows the family and other interested parties to make contributions, gifts, and bequests, which the foundation will then distribute to public charities.
B. Many family foundations are created to perpetuate the family name in a charitable setting while simultaneously acting as a conduit for charitable distributions to be made.
C. Private foundations differ from public ones in that instead of merely collecting and distributing for charitable activities, they conduct charitable activities of their own.
D. Properly organized and operated, a foundation is exempt from federal income tax, and gifts and bequests made to it are deductible.

7. Other types of charitable gifts

A. Net income with makeup CRUT (NIMCRUT)

(1) Payments to the beneficiary are limited to the lower of

(a) The set percentage
(b) The actual income of the trust

(2) Allows for a provision to “make up” when income is less than the set percentage.
(3) Used as an alternative to pension plans by investing in low-income-producing assets in early years (when donor’s income is high) and high-income-producing assets in later years (when donor’s income is low).

B. Wealth replacement trust: irrevocable life insurance trust used in conjunction with a charitable remainder trust to replace the asset the heirs of the donor would be losing

8. Income tax charitable deduction limitations (see also topic 58)

A. Tax and nontax characteristics of specific forms of charitable transfers including alternative minimum tax considerations

(1) A charitable contribution to a qualified charity reduces current income taxes (assuming the donor itemizes deductions). Because the top marginal income tax bracket is currently 35 percent (in 2007), the income tax savings to an individual making a gift to charity will generally be greater than previously when the top marginal rate was lower.
(2) No federal gift tax is payable on a gift to a qualified charity regardless of the size of the gift.

(3) Gifts to qualified charities can reduce the federal estate tax, with the amount of the deduction limited only by the value of the gift (i.e., the donor's entire estate can be left to charity, and a deduction will be allowed for the entire gift).
(4) The charity itself will pay no tax upon the receipt of either a lifetime gift or a bequest.
(5) Generally, no income tax will be payable by a qualified charity on income earned by donated property.
(6) If an otherwise deductible charitable contribution to a college or university entitles the donor to purchase tickets for athletic events, 80 percent of the contribution will be deductible.

B. For federal income tax purposes, there are percentage limitations on the amount that can be claimed as a charitable contribution deduction; these depend on the types of property transferred (see topic 58).

TOPIC 80: USE OF LIFE INSURANCE IN ESTATE PLANNING

1. Advantages and disadvantages

A. Advantages

(1) To provide an income to the decedent's family
(2) To provide cash for payment of the decedent's debts, estate expenses, and taxes—at a "discount," and if arranged properly, with no associated probate costs or death taxes
(3) To fund business continuation agreements

B. Disadvantage: If set up improperly, death proceeds may be included in the gross estate.

2. Ownership and beneficiary designation

A. Selecting owner and beneficiary when the estate is less than the applicable exclusion amount (AEA)

(1) No transfer taxes are expected, so there are no tax consequences.
(2) The selection is easy and flexible.

B. Spouse as owner and beneficiary when estate is likely to exceed AEA

(1) Naming either spouse as owner or beneficiary of a policy on the life of a spouse will subject the proceeds to transfer taxation at least at the second death. To minimize taxes, neither spouse should be designated owner or beneficiary of an insurance policy on the life of the other.
(2) A taxable gift occurs when the noninsured spouse is named owner and someone else is beneficiary. To minimize taxes, name whichever spouse is selected as both the owner and beneficiary to avoid gift tax consequences.

C. Child as owner and beneficiary

(1) If a child is named owner and beneficiary, he or she can turn over the proceeds to provide liquidity to the estate. However, any transfer of funds to the estate is treated as a gift unless the child is the sole beneficiary of the estate.
(2) To avoid making a gift, the child could purchase estate assets or lend money to the estate.

3. Life insurance trusts
Irrevocable trust as owner and beneficiary

A. Irrevocable life insurance trust (ILIT) is best choice.

(1) The trust must be irrevocable or IRC Section 2038 will draw the insurance proceeds into the trustor's estate.
(2) The trustor cannot be named as beneficiary because of Section 2036(a). The trustee is both the owner and beneficiary (usually the uninsured spouse).
(3) A second-to-die policy should be considered if the sole purpose is to pay estate taxes at the death of the second spouse. A term policy should be considered if the couple are younger and have less wealth and the purpose is to replace the financial contribution of the deceased spouse.

B. Impressive outcomes of an ILIT

(1) Excludes the insurance proceeds from income taxation and estate taxation for both spouses
(2) Excludes the insurance proceeds from the probate estates of both spouses
(3) The annual exclusion can be used for gifts to the trust to pay premiums
(4) Ensures that the responsible party will have the needed liquidity after death
(5) Makes proceeds available to the surviving spouse for health, education, maintenance, and support

4. Gift and estate taxation

A. Estate taxation

(1) The decedent's adjusted taxable gift includes the date-of-gift value less the annual exclusion for any life insurance policy the decedent transferred after 1976 and more than three years before death (Section 2001).
(2) If the decedent owned a life insurance policy on the life of another person, the replacement cost of the policy is included in the decedent's gross estate (Section 2033). The three-year rule does not apply to a policy on another's life.
(3) Life insurance proceeds on the life of the decedent are included in the gross estate if the decedent made a transfer of any incidents of ownership in the policy within three years of death [Section 2035(a)].
(4) Life insurance proceeds receivable by a personal representative or receivable by other beneficiaries are included in the gross estate if the decedent possessed any of the incidents of ownership at death (Section 2042).
(5) The transfer must be complete and irrevocable. The donor must give up all incidents of ownership.

(a) The insured must survive three years after the transfer of ownership in order for the insurance to be effectively moved from the estate [Section 2035(a)].
(b) The proceeds of a policy may be included in a decedent's estate even though he or she possessed incidence of ownership in only a fiduciary capacity—for example, as trustee.
(c) Paying premiums is not an incident of ownership.

B. Gift taxation

(1) Transfers of life insurance

(a) Transfers of ownership during life will trigger a gift in the approximate amount of the cash value of the policy.

(b) Gift tax can arise at the death of the insured if the owner and beneficiary are different. For example, assume a wife buys a policy on her husband and names her daughter beneficiary. When the husband dies, she has made a gift to her daughter for the amount of the proceeds.
(c) If a donor makes a gift of a life insurance policy and then dies within three years of making the gift, the value of the proceeds will be brought back into the donor's estate.
(d) Premiums paid within three years by the insured on a policy the insured does not own will not be pulled back into the estate under Section 2035. These premiums may constitute a taxable gift if they exceed the annual exclusion.
(e) A transfer by gift of a policy of insurance is subject to gift tax, based on the valuation of the policy at the time of the gift, not on the value of the proceeds at the time of death.

(2) Gifts of life insurance are valued under different rules:

(a) If the gift is a paid-up life insurance policy, its value is the replacement cost for a comparable contract with the same company.
(b) If the gift is a new policy purchased for another person or is transferred immediately after purchase, the value of the gift is the gross premium paid by the donor.
(c) If the gift is an existing policy for which future premiums are payable, its value is the policy's "interpolated terminal reserve" plus the unearned portion of the paid premium. (This means that the value of the policy's reserve at the date of gift plus the amount of the gross premium paid, which is not yet earned by the insurer, would be the value of the policy.) Note that the portion of the premium the insurer has not earned yet by providing insurance coverage is really owed to the premium payer, who has already paid for the protection not yet received.
(d) *Note:* If a life insurance policy is transferred to an irrevocable trust, the transfer is a gift of a future interest to the beneficiary of the trust. The value of the gift will be determined by whichever of the previous three rules would be applicable. The donor-grantor cannot use the $11,000 (in 2003) annual exclusion, because a gift in trust is a gift of a future interest, not a present interest.

5. Income taxation (see topic 22)

A. The general rule is that the proceeds of a life insurance policy paid by reason of death are not includible in the deceased's or the beneficiary's gross income for federal income tax purposes.
B. There is an exception to this general rule, the transfer for value rule. If the life insurance policy is acquired by another for a valuable consideration, the difference between the policy's death proceeds and the purchaser's cost basis is includible in the beneficiary's gross income.
C. The transfer for value rule does not apply to gifts of policies. In addition, the rule does not apply to the following purchasers:

(1) The insured (or the insured's grantor trust)
(2) The insured's partner or a partnership in which the insured is a partner
(3) A corporation in which the insured is a shareholder or officer
(4) The insured's spouse or incidental to a divorce
(5) A purchaser whose adjusted basis is determined by reference to the transferor's adjusted basis

D. The IRS has issued regulations allowing chronically ill and terminally ill insureds to receive "living" or accelerated benefits from their insurance policies, and beneficiaries can avoid income tax on the death benefit.

TOPIC 81: VALUATION ISSUES

1. Estate freezes

A. Definition of estate freezes

(1) The primary goal is a reduction in estate taxes by fixing the value of estate assets at current levels. The owner accomplishes the freeze by transferring the appreciation rights to another individual during the owner's lifetime.

(2) It often is a transaction involving a corporation or partnership, in which the owner of the business transfers interests in property (i.e., common stock) with anticipated future appreciation to a younger family member, while retaining rights in income and principal in the property (i.e., preferred stock).

B. Corporate and partnership recapitalizations (Section 2701)

(1) Section 2701 is known as the special gift tax valuation rule, which addresses estate freezes. The gift tax value of a transfer is determined by using Section 2701 special valuation rules to value the interests in the property retained by the transferor.

(2) Code Section 2701 values certain retained interest at zero, resulting in a higher value of the transferred interest, unless an exception exists.

(3) The special valuation rules of Section 2701 apply if the following occur:

(a) A transfer of an interest in a corporation or partnership to a family member of the transferor is made.

(b) Immediately after the transfer, the transferor or family member holds a retained interest.

(4) The following types of transfers are excluded from coverage under Code Section 2701:

(a) Transfers for which market quotations on an established securities market are readily available on the date of transfer for either the interest transferred or for the interest retained by the transferor

(b) Transfers in which the retained interest is of the same class or proportionately the same class as the transferred interest

(c) Transfers that proportionately reduce each class of interest held by the transferor and applicable family members immediately before transfer

C. Transfers in trust

(1) In determining the value of a transfer of an interest in trust for the benefit of a family member, the value of the retained interest is zero unless the retained interest is a qualified interest. The rule does not apply to incomplete gifts or a transfer of an interest in a personal residence that is inhabited by the holder of a term of interest.

(2) A qualified interest is as follows:

(a) Any interest that consists of a right to receive fixed payments at least annually

(b) Any interest that consists of a right to receive amounts that are payable at least annually and are a fixed percentage of the fair market value of the property in trust

(c) Any noncontingent remainder interest if all other interests in the trust consist of interests described in the items listed previously

2. Valuation issues with family partnerships and limited liability companies (LLCs)

A. Purpose and requirements

(1) Advantages

(a) Gifts of family limited partnership interests are advantageous, because discounts for lack of marketability and minority interests are available to reduce the gift tax value of limited partnership interests. These discounts mean substantial reduction from the value of the underlying business assets, thereby saving transfer costs.
(b) Limited partnership interests can provide some protection against creditors.
(c) The family partnership is more likely to stay intact when there are failed marriages among the owner's children, because the business assets themselves are not under the control of the children.

(2) A family partnership must meet the following three requirements:

(a) Capital invested in the business must be a material income-producing factor. A personal service partnership is not a good candidate for a family partnership.
(b) The donor of the partnership interests must be paid reasonable compensation for services to the partnership.
(c) The share of partnership income attributed to a donee's interest cannot be proportionately greater than the income interest attributed to the donor's interest. Nevertheless, if the donor's interest is a 10 percent general partnership interest and the donees receive 90 percent limited partnership interests, the donees are entitled to 90 percent of the partnership net income.

(3) Family limited partnerships are generally not recommended unless the owners have a net worth of approximately $3 million. Setting up a family limited partnership requires attorney's fees and appraisal fees for the limited partnership interests. Appraisal fees are also required at the time gifts are made of limited partnership interests. Preparation of partnership returns and K-1s will also require some accounting fees.

B. Minority discounts

(1) A minority discount is a valuation discount allowed for an interest in a business because the interest is not a controlling interest.
(2) In most situations, more than 50 percent of the voting shares constitutes a controlling interest, and less than 50 percent is a minority interest.
(3) A minority interest discount is based on a number of factors, including the inability of a minority owner to realize his or her pro rata share of the entity's net assets by liquidating his or her interests in the entity and his or her lack of control over corporate policy.

(i) For transfer tax valuation, minority discounts between 15 and 50 percent are obtainable.

(4) Factors influencing the size of the discount include the overall quality of management, composition of other share holdings, size of the business, history of profitability, existence of business opportunities not currently being exploited, and degree of the company's financial leverage.

C. Marketability discounts

(1) Because of the lack of an established market (i.e., restricted stock, stock in a closely held business, and partnership interest), certain stocks are invariably more difficult to sell than business stock that is publicly traded.
(2) For transfer tax valuation, marketability discounts between 15 and 50 percent are obtainable.
(3) These discounts apply to both minority and majority interests.
(4) Factors influencing the size of the discount include the extent of the resale restrictions, Securities and Exchange Commission (SEC) restraints on marketability, the dollar value of the stock, the firm's growth expectations, and the size of the company's total assets and equity.

D. Blockage discounts

(1) Large quantities of a stock listed on an exchange can receive a blockage discount if selling them at one time could have a depressing effect on the market price.
(2) If the block represents a controlling interest in the corporation, possibly even triggering a higher price, a premium may be attached to its value.
(3) Blockage discounts may be available for other property, such as a large number of paintings left in the estate of a prominent artist.

E. Key person discounts

(1) A discount may be allowed for a business that lost a key person (i.e., the decedent) who was responsible for its goodwill.
(2) In practice, the IRS will require an executor to show that the loss could not have been avoided by such actions as the purchase of key person life insurance or by other means.

3. Valuation techniques and the federal gross estate tax

A. Selecting valuation date for estate accounts

(1) Date of death
(2) Alternative valuation date

B. Fair market value: For federal transfer taxes, the fundamental principle of valuation is that tax is generally imposed on the fair market value of the property as of the date of the transfer. Fair market value is defined as the price that a willing buyer would pay a willing seller where both had reasonable knowledge of the relevant facts of the transaction and neither was under any compulsion to buy or to sell.

C. The principle of fair market value applies to a wide variety of properties and situations, but there are important exceptions.

(1) Valuing real estate

(a) The value of real property depends on the location, size, shape, condition, defects, physical quality, zoning laws, and any other factors unique to the land.
(b) A co-ownership discount is available where one of the co-owners refuses to sell his or her interest either to the estate or to a third party and refuses to buy the interest held by the estate. This lack of cooperation impairs the marketability, and thus the value, of the real property, so a discount is allowed.

(2) Valuing insurance policies

(a) When the donor (owner) of a life insurance policy is not the insured, the value of the gift is the replacement cost of the policy.

(b) Replacement cost is determined in different ways for different policies.

(i) On a paid-up or a single-premium policy, the value is the replacement cost, which is the single premium the insurer would charge for a comparable contract of equal face value on the life of a person who was the insured's age (i.e., at the time of death).

(ii) On an established whole life policy, the value is found by adding any unearned portion of the last premium to the interpolated terminal reserve. The interpolated terminal reserve is the value of the reserve held by the insurer for a policy and calculated as of a given date.

(iii) For a term policy, the value of the policy is the unused premium. The same rules apply to valuing a life insurance policy when the deceased owned the policy but was not the insured.

(3) Valuing annuities

(a) Commercial annuities are annuity contracts issued by companies regularly engaged in sales of annuities, and they are valued at the price at which the company issues comparable contracts.

(b) For a private annuity contract, the value is determined by the present value of the future payments required under the contract.

(4) Valuing bonds

(a) The fair market value of publicly traded bonds is the mean between the highest and lowest quoted selling price on the date of death (or alternate valuation date).

(b) If there was no trading in the bond on the valuation date, the mean prices on the closest trading dates are weighted inversely by the number of days from the valuation date.

(c) Series EE bonds are valued at their redemption price (market value) as of the date of death. These bonds are neither negotiable nor transferable, and the only definitely ascertainable value is the amount at which the Treasury will redeem them.

(d) Certain U.S. Treasury bonds, called "flower bonds," may be redeemed at par value if they were owned by the decedent at date of death and are used to pay federal estate taxes. These bonds are valued at the higher of market price or par value.

(5) Valuing stock

(a) The fair market value of publicly traded stock is the mean between the highest and lowest quoted selling prices on the applicable valuation date.

(b) If there was no trading of the stock on the valuation date, IRS regulations require use of the mean of the high and low prices on the nearest trading dates before and after the valuation date and then weighting these mean prices. The mean price calculated for a trading date two days from the valuation date will be weighted twice as much as a mean price for a trading date four days from the valuation date.

(c) *Example*: If the mean price was $10 two days after (or before) the valuation date and was $11 four days before (or after) the date, the valuation date price will be $10.33.

(d) *Solution*: ($10 × 4 + $11 × 2) / 6 = $10.33

(6) Valuing closely held stock—Valuing the stock of a closely held corporation is difficult because of the lack of an organized market. As with real estate, there are many factors

to consider in valuing closely held stock. Among of the factors to consider are the following:

(a) Nature of the business and history of the enterprise
(b) Outlook for the economy and for the specific industry in which the company operates
(c) Book value of the stock
(d) Earning capacity of the company
(e) The company's dividend paying capacity
(f) Goodwill
(g) Any recent sales of the stock and the size of the block of stock being valued
(h) Fair market value of the stock of comparable companies in the same or similar business and whose stock is publicly traded

(7) Valuing life estates, remainders, and reversions

(a) The fair market value of life estates, remainders, and reversions is their present value.
(b) The calculation of present value is done by consulting the appropriate IRS tables for the present worth of an annuity, of an income interest, and of a remainder interest. The tables show the factors for these three present worth calculations at various interest rates (or discount rates).
(c) There is a separate table showing the factors to use when the annuity or income interest is for a term certain (fixed number of years) and when the annuity or income interest is payable for the life of a designated person. Another table provides the factors to use when an annuity or income interest is payable for the joint lives of "A" and "B"; that is, the income is paid to "A" and "B" and then to the survivor for life.

TOPIC 82: MARITAL DEDUCTION

Note: The estate tax is supposed to be eliminated for estates of decedents who die after 2009. As such, most estate planning will focus on postponing taxes, with the hope that at least one spouse lives to 2010 or beyond.

1. Characteristics

A. There is currently no limitation on the amount of property that may qualify for the marital deduction.
B. The deduction does not apply to a terminable interest.
C. Advantages of the 100 percent marital deduction

(1) Simple and inexpensive
(2) Surviving spouse gets complete control over the assets.

D. Disadvantages of the 100 percent marital deduction

(1) Decedent's unified credit is unused.
(2) The estate tax between the two spouses may be higher for the reason stated in the preceding item (1), assuming the second death occurs before 2010. Both estates are taxed as one estate at the death of the surviving spouse, so the larger the estate, the higher the rate of tax on the top dollar.

2. Terminal interest rule and exceptions

A. A terminable interest is defined as an interest that ends upon an event or contingency. For example, a spouse initially gets an interest in the property, but this interest terminates upon some event (usually death) and the interest then passes to someone else.
B. A terminal interest is defined as a property interest with three characteristics:

(1) It is subject to some future absolute or contingent termination of the surviving spouse's interest.
(2) The possibility of termination is created by the decedent, and there will be a shift in the interest.
(3) Some other person or entity (other than the surviving spouse and his or her estate) will possess or own the property.

C. Exceptions to terminable interest

(1) Under Section 2056(b)(3), if the only condition whereby the surviving spouse's interest may terminate is death in a common disaster or within six months of the decedent's death and such death does not occur
(2) Under Section 2056(b)(5), if the surviving spouse is entitled to all the income for life and the surviving spouse has a general power of appointment
(3) Under Section 2056(b)(7), if the personal representative elects to deduct the value of qualified terminable interest property (QTIP)
(4) Under Section 2056(b)(8), if property is transferred to a qualified charitable remainder trust, where the surviving spouse is the only noncharitable beneficiary

3. QTIP planning and the prior transfer credit

A. The first spouse to die has power of the ultimate disposition of property.
B. For a property transfer to receive QTIP treatment, the following two conditions apply:

(1) An irrevocable election must be made by the donor spouse or by the executor for QTIP, and
(2) The surviving spouse must receive a qualified income interest for life. Income from the trust must be paid at least annually to the surviving spouse.

C. A *qualified income interest* is defined as follows:

(1) The surviving spouse must be entitled to receive all income from the property; in other words:

(a) Some form of distribution of income is mandatory.
(b) Accumulation is not permitted.
(c) Only a spouse can receive the income; no other beneficiaries are permitted.

(2) Income must be paid at least annually.
(3) No person may assign any part of the property to any person other than the surviving spouse.
(4) For federal estate tax purposes, the value of the property is taxable in the surviving spouse's gross estate.

D. Property treated as QTIP and that qualifies for the marital deduction in the owner's estate tax return must be included in the surviving spouse's gross estate. When such QTIP

property is later dispersed from the surviving spouse's estate, the executor of the estate is entitled to seek repayment from the recipients for estate taxes paid on the surviving spouse's estate. If reimbursement is not sought, the beneficiaries of the estate may be deemed to have made a gift to the persons from whom reimbursement could have been obtained.

E. Sometimes called a "C" trust or a "Q" trust

4. Special planning for noncitizen spouses

A. IRC Section 2056(d) disallows the marital deduction if the surviving spouse is not a U.S. citizen.
B. If the spouse becomes a citizen before the federal estate tax return is filed (within nine months), IRC Section 2056(d) does not apply. However, the spouse must have been a U.S. resident at the time of the decedent's death.
C. The marital deduction is allowed for property placed in a qualified domestic trust (QDOT) that passes to a non-U.S. surviving spouse.

(1) The executor makes an irrevocable election.
(2) Requires at least one trustee to be a U.S. citizen or U.S. corporation
(3) The trustee has the right to withhold estate tax on distribution.
(4) U.S. laws preside over the qualified domestic trust (QDOT), so whenever a trustee distributes any principal from the trust, estate taxes must be paid to the U.S. Treasury.
(5) U.S. Treasury is given the right to collect taxes at the second death, no matter where the spouse is domiciled. This rule prevents a surviving spouse from taking a marital deduction in the United States and then exiting the country to avoid estate taxes.
(6) To qualify for the marital deduction, the property passing to the QDOT for the noncitizen spouse must also meet all rules pertaining to the marital deduction.

5. Marital deduction and bypass planning

A. A bypass trust (also known as a nonmarital trust or a "B" trust) is generally used to take advantage of the unified credit. Planners sometimes use a method in which a testator's assets are placed in A, B, and Q trusts.
B. A bypass trust is funded with assets equal to the exemption equivalent, and the remaining property is divided in any desired proportion between an A and a QTIP trust.
C. The assets transferred to the bypass trust are taxed at the first spouse's death even though the use of the unified credit results in no tax being due. It bypasses the surviving spouse's estate (or some other income beneficiary's estate) for tax purposes.
D. The bypass trust gives the spouse a right to income, as well as access to principal for purposes of health, education, support, or maintenance, without the property being included in his or her estate at death.
E. Highly appreciated assets are often placed in a bypass trust to freeze the value for estate tax purposes at the death of the first spouse.
F. Upon the death of the first spouse, trusts B and C are funded and become irrevocable. The surviving spouse can control the distribution of assets only according to the terms of those trusts. (He or she may or may not be given a limited power to appoint corpus or to withdraw limited to an ascertainable standard—health, education, maintenance, and support.
G. Trust A can be amended or revoked by the surviving spouse.

TOPIC 83: DEFERRAL AND MINIMIZATION OF ESTATE TAXES

1. **Deductions and credits: There are many ways to obtain deductions from and credits for estate taxes:**

   A. Interspousal gifting: Can create significant estate tax savings. By making gifts from a "wealthier" spouse to a "poorer" spouse, large amounts of property can be removed from an estate.
   B. Charitable deductions: Outright transfers to qualified charities are 100 percent deductible for both estate and gift tax purposes.
   C. Funeral, debts, losses: Cost of the funeral, debts of the decedent, losses incurred during estate administration, and debts of the estate are all deductible from estate taxes.
   D. Credit for pre-1977 gifts: The amount of this credit is limited to the lesser of the gift tax or the estate tax on property that is included in the estate.
   E. Prior transfer credit: A tax credit is allowed where property is included in the transferor's taxable estate and the transferee dies within 10 years of the transferor. The inherited property does not have to be found in the transferee's estate.
   F. Foreign death taxes: A credit is allowed for most, but not all, foreign death taxes paid on property that is included in the U.S. gross estate and situated in a foreign country.

2. **Lifetime planning techniques:** Developing an estate plan should result in a set of recommendations that allow for the best use, conservation, and transfer of the client's wealth. In 1996, the Certified Financial Planner Board of Standards, Inc., identified the following steps in the financial planning process:

   A. The planner must take the lead in explaining to the client the estate planning process. Planners must make their role clear and should set forth their responsibilities in an engagement letter, spelling out the services to be preformed. Planners must also make the client aware of his or her own tasks, including gathering data, working with the planner to implement the plan, and informing the planner of any changes that may affect the original plan.
   B. A planner must obtain sufficient information about the client and the client's family in order to make recommendations that are worthwhile. Estate planning opportunities exist for wealthy married couples seeking to transfer an estate to the next generation, single wealthy parents, young couples with minor children, couples whose children are grown, or any other of a myriad of family statuses. The planner may want to consider family members for positions such as executor, guardian, and trustee. The planner must be sensitive to special concerns (e.g., health needs, children with drug addictions). In these situations, consider trust planning that provides for long-term asset management.
   C. After gathering the essential information, the planner reviews the facts and prepares preliminary recommendations; the planner should be prepared to offer alternatives as well. The most common recommendations fall into two areas: planning for property transfers and planning for the client's incapacity and/or death.
   D. The key purpose of the plan is to efficiently distribute the client's wealth to the appropriate persons, in the appropriate amounts, and at the appropriate time. To do this, the planner must keep in mind the following considerations that relate to more specific estate planning goals:

      (1) Deciding whether to use a trust or some other means to avoid probate
      (2) Examining alternatives to reduce and possibly eliminate transfer taxes at the death of the client and the client's spouse
      (3) Considering lifetime transfers, partly to reduce transfer costs and partly to shift taxable income to a person in a lower tax bracket

(4) Arranging to provide the needed liquidity at the client's death or disability
(5) Devising a strategy to unwind the client's business affairs in a manner that maintains the greatest income and value for the survivors

E. After the planner and the client iron out the specifics of the plan, together they should start the process of implementing the plan. Contact an attorney to draft transfer documents that will be executed by the client. Use an insurance agent to prepare the appropriate insurance contracts. If necessary, contact the bank that houses the trust department the client wishes to use as a trustee. The client should feel comfortable with the bank's trust department personnel, including their investment philosophy and how they relate to trust beneficiaries.

F. Laws change, and the client's personal situation and objectives may change. The planner should, from time to time, meet with the client and monitor the plan's progress. By keeping current, the planner can periodically suggest appropriate revisions to the plan. Events that are likely to require plan revision include marriage, divorce, birth of a child, new legislation, and new court decisions.

3. Postmortem planning techniques (see topic 88)

TOPIC 84: INTRAFAMILY AND OTHER BUSINESS TRANSFER TECHNIQUES

1. Characteristics

A. Family partnership

(1) A single or multiple type of partnership interest owned solely and exclusively by a member of a family
(2) Partnership interests are often gifted from an older family member to a younger one.

B. Stock recapitalization or partnership capital freeze

(1) Involves restructuring of an entity's capital structure through the creation of at least two capital classes (corporate shares or partnership interests), and then the exchange of one capital class for another
(2) With a recapitalization, a senior family member usually exchanges common shares that bear all future appreciation for preferred voting shares that have a fixed (par) value. The common shares are then gifted to a junior family member.
(3) With a partnership capital freeze, a senior family member usually exchanges a regular partnership interest for a fixed partnership interest that has a preferred right to income distribution. Through gifts, junior family members usually receive regular partnership interests that have sole rights to any partnership appreciation.

C. Personal holding company

(1) A C Corporation formed for the purpose of transferring appreciated property in other companies to the new holding company in exchange for its stock
(2) The corporation is taxed as a personal holding company if it meets two concurrent tests: (1) Five or fewer shareholders must own more than one-half of outstanding stock, (2) and at least 60 percent of the company's adjusted ordinary gross income must be "personal holding company income" such as dividends, interest, rents, or amounts received in return for personal services.
(3) It is usually capitalized with a large amount of nonvoting common stock and a small amount of voting common stock. The owner maintains control through the voting stock

while systematically gifting the nonvoting common stock to other family members to limit the future appreciation includable in his or her own estate to that on the smaller number of voting shares.

2. Techniques

A. Buy-sell agreements

(1) A buy-sell agreement is a contract binding the owner of a business interest to sell the business interest for a specified or determinable price at his or her death or disability and a designated purchaser to buy at that time.
(2) If a fixed price is used in the buy-sell agreement, the IRS will take a long look at it. Planners should suggest the client use a formula that allows for the business value to increase or decrease as time passes. If a formula is not appealing, then an appraisal of the business at the time of the decedent's death will help avoid the IRS's scrutinizing the value of the agreement.

B. Installment notes

(1) Installment sales provide for payment of the purchase price over a period of years. Such sales allow the estate to recognize the capital gains as payments are received, rather than all at once.
(2) This technique can also be beneficial to the buyer, inasmuch as the buyer is not required to complete the buy-sell agreement with one lump sum. Sometimes an installment sale is part of a family transaction.

C. Self-canceling installment notes (SCIN)

(1) A self-canceling note in usually triggered by the death of the person holding the note. The note may be canceled before full payment is received.
(2) The initial value of an SCIN is less than an installment note, so the buyer has to give additional consideration in the form of a higher principal amount or higher interest rate.
(3) In determining the higher principal payments, the IRS tables can be used to determine the likelihood of the note holder's death. The older the individual, the greater the consideration.
(4) Planners may recommend an SCIN when estate tax rates exceed marginal income tax rates.

D. Private annuities

(1) A private annuity is an exchange of an asset for an unsecured promise by the buyer to pay an annuity for the life of the transferor.
(2) A private annuity commonly provides life payments to the annuitant. Taking the payments in this way allows the annuitant to spread the capital gains from the sale, rather than accepting them in one lump sum.
(3) The private annuity contract must be unsecured, so the annuitant-to-be should make sure the entity making the annuity payments is sound financially.
(4) A private annuity allows a person with a large estate to remove possible future appreciation from the estate and spread out capital gains, both actions reducing current income tax.

E. Transfer in trust

(1) If a grantor seeks to freeze estate values, a transfer in trust will often fill the need.
(2) Transfers in trust work by splitting property into two parts: remainder interest and income interest.

3. Federal income, gift, and estate implications

A. Buy-sell agreements

(1) Gift taxation: Generally, there is no gift taxation unless the buyout agreement gives the purchaser an unqualified present purchase right at a contract price below fair market value.

(2) Income taxation

(a) The selling owner, usually the estate of the deceased, sells a capital asset subject to capital gain treatment. However, there is usually no capital gain treatment because the buyer receives a stepped-up basis at fair market value.

(b) The selling party is taxed on the proceeds of the business as dividends, to the extent of the corporation's earnings, unless the corporation qualifies for IRC Sections 302 and 303.

(3) Estate taxation

(a) To set the estate tax value of a business equal to its buyout agreement price, agreements must meet Section 2703(b) requirements:

(i) The agreement must be a bona fide arrangement.

(ii) The agreement must not be a device to transfer the property to members of the decedent's family for less than full and adequate consideration.

(iii) The terms of the agreement must be comparable to similar arrangements entered into by persons in an arm's-length transaction.

(b) The requirements ensure a value reasonably close to the value of the business interest at time of transfer.

(c) Example: If a surviving owner, a son, is allowed to buy the decedent parent's $1 million business interest at $250,000, this would be in violation of the first two requirements.

B. Installment notes

(1) Gift taxation: No gift tax consequences if it is a bona fide sale for full and adequate consideration

(2) Income taxation

(a) Can defer capital gains over several years

(b) Interest paid to seller is treated as ordinary income (tax-deductible for buyer if qualified); principal is return of capital and capital gain.

(c) Losses are never reported.

(d) Two events trigger immediate recognition of remaining gain to the seller:

(i) The seller sells the installment note.

(ii) The seller cancels the installment note.

(e) Consequences of (1) and (2): The seller has received taxable income. The income is equal to the difference between the cost basis and the value of the payments forgiven.

(3) Estate taxation

(a) Keeps postsale appreciation out of the seller's gross estate

(b) When the holder of an installment note dies, only the present value of the installment note is included in his or her gross estate.

(c) If the transfer was a partial gift (less than full and adequate consideration paid), the date-of-death value of the property sold less actual consideration paid is included in the estate.

C. Self-canceling installment notes

(1) Gift taxation—To avoid gift taxes, the buyer will have to make additional principal payments or pay higher interest rates. In determining the higher principal payments, the IRS tables can be used to determine the likelihood of the note holder's death.

(2) Income taxation

(a) The decedent note holder must report the difference between the fair market value and the basis on the estate's income tax return upon cancellation. The gain is income in respect of decedent.

(b) No income tax deduction is allowed, inasmuch as the note is not in the gross estate.

(3) Estate taxation: The value of the SCIN at the note holder's death will not have to be included in the holder's gross estate.

D. Private annuities

(1) Gift taxation

(a) No taxable gift

(b) Value of property transferred equals present value of annuity.

(2) Income taxation

(a) Each payment is split into three parts:

(i) Investment in the contract. Tax free

(ii) Gain in asset. Taxed as capital gain

(iii) Balance after investment in the contract and the gain in asset are removed.

1. Taxed as ordinary income

(b) Once the annuitant reaches original life expectancy, all investments in contract and gains have been paid, and future payments are solely ordinary income.

(c) The unrecovered basis is deductible as a loss if the annuitant does not reach life expectancy.

(d) The person or entity making the annuity payments cannot deduct any portion of the payments.

(3) Estate taxation

(a) No estate tax

(b) Lifetime annuity terminates at the death of the annuitant.

(c) If the annuity is worth less than the property transferred, then the original transaction is ruled a gift and the gross estate includes the entire date-of-death value of the property, reduced by payments already received. This is deemed a Section 2036(a) transfer with a retained interest.

E. Transfers in trust (general tax objectives)

(1) Gift taxation

(a) Keeps retained interest value at zero

(b) No gift tax for transfers to qualified charities

(2) Income taxation

(a) Grantor pays trust income.
(b) Grantor has income tax deduction for charitable trusts.

(3) Estate taxation—removes assets and/or postappreciation from the estate

TOPIC 85: GENERATION-SKIPPING TRANSFER TAX (GSTT)

1. Transfers subject to the GSTT

A. If at an individual's death property is passed to someone two generations younger than the owner, a generation-skipping transfer tax will be imposed. The tax deters grandparents from passing assets to their grandchildren and thus denying the government of tax dollars for another generation. The IRS wants property in an estate to be taxed in each generation. This tax is imposed at the highest federal estate and gift tax rate (45 percent in 2007). The amount of gift tax depends on whether the transfer involves a direct skip, a taxable distribution, or a taxable termination.

B. Direct skip

(1) A transfer subject to an estate or gift tax, made to a skip person
(2) *Example*: A gift from a grandparent to his or her grandchild, or a transfer to a trust in which all the beneficiaries are skip persons
(3) The transferor pays the GST tax in a direct skip at the time of transfer.
(4) The tax in a direct skip is tax exclusive. The taxable amount does not include the amount of generation-skipping tax.
(5) *Example*: A grandfather makes a lifetime gift to his granddaughter, Martha, in 2007. Assume no exemptions are available. The grandfather pays a generation-skipping tax of $490,000. However, the tax is paid out of additional assets of the grandparent, and not out of the gift. The full $1,120,000 is passed to the grandchild.

C. Taxable distributions

(1) Any distribution of income or corpus from a trust to a skip person that is not otherwise subject to estate or gift tax
(2) *Example*: A distribution from a trust to a grandson of the grantor is considered a skip-person distribution.
(3) The transferee pays the GST tax in a taxable distribution. If the trust pays the tax for the transferee, the payment is treated as an additional taxable distribution.
(4) The tax payable upon a taxable distribution is tax inclusive. This means the amount subject to tax includes

(a) The property
(b) GST tax itself

(5) *Example*: If a trustee makes a taxable distribution of $10,000 of trust income to a grandchild in 2007, the tax is 45 percent of $10,000, or $4,500. It must be paid out of the property passing to the grandchild. Therefore, the grandchild nets only $5,500.

D. Taxable terminations

(1) Termination by death, lapse of time, release of power, or otherwise, of an interest in property held in trust results in the skip person's holding all the interests in the trust.

(2) Example: Ben leaves his life income to his son, Bart, and the remainder goes to his granddaughter, Melanie. The son's death terminates his life interest and it passes to Melanie, a skip person.
(3) A taxable termination cannot occur as long as one nonskip person has a present interest in the property.
(4) There is no taxable termination if an estate or gift tax is imposed on the nonskip person at termination.
(5) The trustee pays the GST tax in a taxable termination.
(6) The tax payable upon a taxable termination is tax inclusive because the property subject to the transfer includes the generation-skipping tax.

2. Impact of the GSTT on lifetime transfers

A. Outright transfer of cash or property

(1) A GST is any transfer of property by gift or at death, to any person who, under federal tax law, is assigned to a generation that is two or more generations below that of the transferor.
(2) Two or more generations refers to grandchildren and great nieces and nephews and any generations beyond. People belonging to these generations are referred to as skip persons.
(3) GSTT is a separate tax from the unified gift and estate tax and is in addition to these taxes. It is possible that the total cost of making a property transfer can exceed the value of the gift.
(4) A flat tax equal to the highest gift and estate tax rate is imposed on every generation-skipping transfer.
(5) There is a special rule called the predeceased ancestor exception. This rule will "move up" lower generations if the parent in the line of descent dies before the transfer. The predeceased ancestor exception applies only if the parent was deceased at the time of transfer.
(6) The GSTT applies to:

   (a) Property placed in trust
   (b) Transfers involving the creation of life estates
   (c) Remainders
   (d) Insurance and annuity contracts

(7) Generation assignment

   (a) Related persons are assigned to the ancestral chain relating back to the grandparents of the transferor, except that the spouse of the transferor is always assigned to the same generation as the transferor or descendant.
   (b) Unrelated persons are assigned to the transferor's generation if they are not more than 12½ years younger than the transferor; otherwise, unrelated persons are assigned to succeeding generations on the basis of 25 years for each generation (i.e., first younger generation—12½ to 37½ years younger than transferor).

B. Transfer in trust

(1) A gift in trust that qualifies for the gift tax annual exclusion may still be subject to the GSTT. The gift in trust will qualify for the GSTT annual exclusion only if the trust meets the following two requirements:

   (a) The trust must state that it will make no distribution to any person other than the beneficiary during his or her lifetime.

(b) At the beneficiary's death, the trust assets must be includable in the beneficiary's gross estate for federal estate tax purposes.

(2) To fulfill these requirements, grandparents often set up a separate trust for each grandchild. Crummey trusts or Section 2503(c) trusts can generally be designed to take advantage of the GSTT annual exclusion.

3. Exemptions and exclusions for the GSTT

A. Outright lifetime gifts that qualify for the gift tax annual exclusion are excluded from GST tax.

B. The GSTT exemption

(1) For a married couple, each spouse has a GSTT exemption. Therefore, each spouse can use some or all of his or her GSTT exemption to avoid GST tax. In this way, the exemption can be doubled.

(2) A flat tax equal to the gift and estate tax at the highest rate is imposed on every generation-skipping transfer.

Year	**Exemption**	**GSTT Rate**
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	Tax repealed	Tax repealed

*Plus increases for indexing for inflation

C. Qualified transfer payments (educational and medical): Payments of educational or medical expenses are excluded from GST tax.

TOPIC 86: FIDUCIARIES

1. Duties of fiduciary

A. *Fiduciary* is simply a generic title given to individuals and organizations that have been given the power to manage assets owned by another. Persons considered fiduciaries include an executor, administrator, personal representative, and custodian.

B. The following duties generally apply to fiduciaries:

(1) Exercise loyalty in making decisions concerning the estate. As a fiduciary, one is expected to act for the benefit of the estate's beneficiaries. Confidentiality is implied in this duty.

(2) Exercise care, diligence, and prudence in handling the estate's property. This duty requires the fiduciary to act "with the skill and care that a prudent man or woman would exercise in administering his or her own affairs."

(3) Preserve and protect estate assets. Preservation can include providing adequate security for coin, stamp, art, and other types of collections. It also includes a duty to protect capital and to make investment assets productive. In dealing with investments, it is the fiduciary's conduct, rather than investment results, that is reviewed.

2. Selection of fiduciary

A. Look for the following qualities when selecting a fiduciary:

(1) Likelihood of the person chosen to outlive the testator

(2) Skill in managing legal and financial affairs

(3) Familiarity with the testator's estate and the testator's wishes
(4) Strong integrity coupled with loyalty to the testator
(5) Impartiality and absence of conflicts of interest

B. The following are three of the most often used fiduciaries:

(1) Family member or friend

(a) Choosing a family member or a friend will often help with administration costs, and such persons normally possess a strong degree of loyalty.
(b) Weakness: Knowledge of legal and financial issues is usually limited. Longevity may also be an issue.

(2) Corporate executor

(a) Banks usually do an adequate job in managing estate assets. They have experience in handling legal and financial affairs, their longevity is strong, and they can be impartial when dealing with conflicts.
(b) Weakness: Banks are usually unfamiliar with the decedent's family and may have trouble deciding who gets minor personal effects for which the decedent did not give guidance. Many banks also require the estate to be of a certain size before agreeing to be executor.

(3) Attorney

(a) Probate attorneys usually do a good job in managing assets during the probate period, because they possess substantial knowledge in this area. Depending on the attorney, financial dealings may or may not be a strong point.
(b) Weakness: Administration costs will usually be high, because an attorney executor may hire another attorney to represent the estate. There may be conflicts of interest; an attorney who anticipates becoming a fiduciary may insert an exculpation clause in the will, which would shelter the attorney from simple negligence acts.

TOPIC 87: INCOME IN RESPECT OF A DECEDENT (IRD)

1. IRD assets

A. From Treasury Regulation Section 1.691 (a)-1(b):

(1) In general, the term *income in respect of a decedent* refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his [or her] taxable income for the taxable year ending with the date of his [or her] death or for a previous taxable year under the method of accounting employed by the decedent.

B. IRD is income that the decedent earned but, because of his or her death, was not constructively received and is not includable in his or her taxable income. An example is salary earned but not paid. Because the taxpayer was not paid until after his or her death, it could not be included on his or her final income tax return.

C. Examples of IRD

(1) If the decedent completed all events sufficient to close a sale, but did not collect the proceeds before death, the amount collected after death will be IRD.
(2) If the decedent had a contingent claim to sales proceeds, the completion of the agreement after death will result in IRD.

(3) Dividends on stocks paid after the stockholder's death
(4) The forgiveness of debt on an installment note
(5) Distributions made after death from a qualified plan or IRA

2. **IRD income tax deduction**

A. IRD is subject to both the estate tax and income tax. Some of this double taxation can be offset:

(1) The recipient of the IRD is entitled to an income tax deduction for that portion of the estate taxes attributed to including IRD in the gross estate.
(2) An income tax deduction is allowed for generation-skipping transfer taxes ascribed to IRD items included in a taxable termination, or direct skips caused by the transferor's death.

B. A deduction is allowed each year the IRD is included in income. To compute the deduction, all items treated as IRD in the gross estate are aggregated. The total is reduced by all DRD (deductions in respect of a decedent) to arrive at net value. The value of the IRD is the lesser of the amount included in the gross estate or the amount included in income. Once the net value is determined, estate taxes are recomputed by excluding the net value from the gross estate. The difference between the original estate tax and the recomputed estate tax is the IRD deduction.

TOPIC 88: POSTMORTEM ESTATE PLANNING TECHNIQUES

1. **There are almost always many decisions to make after a death occurs. Postmortem estate planning primarily entails:**

A. Filing the appropriate tax returns
B. Making the proper elections
C. Planning estate distributions
D. Determining whether any disclaimers can and should be made
E. Selecting the appropriate valuation date for assets

2. **Qualified disclaimers**

A. A disclaimer is one means of changing the original estate plan. A disclaimer is simply a formal refusal of an inheritance of property from a decedent. Such a refusal is still a taxable gift unless one satisfies the IRC requirements for a "qualified disclaimer." Under the qualified disclaimer rules, an estate beneficiary may avoid receipt of the property bequeathed by the deceased, thereby avoiding any gift tax.
B. A qualified disclaimer must meet the following requirements:

(1) The disclaimer must be irrevocable and unqualified.
(2) The disclaimer must be in writing.
(3) The disclaimer must be delivered to the grantor or grantor's legal representative within nine months of the date of transfer or within nine months after a minor turns 21 years of age.
(4) The disclaiming person must not receive any benefit from the property disclaimed and must not have any control over the disposition of the property after disclaiming.

C. A qualified disclaimer is also used to reduce estate taxes.
D. Example: The Beaver disclaims a bequest from his father. The property may then pass to June, his mother, under the residuary clause of his father's (Ward) will. This transfer will be eligible for the marital deduction, and no estate tax will be due on the transferred property. On the other hand, June may elect to disclaim a bequest from Ward to reduce the amount of property qualifying for the marital deduction and to take advantage of the unified credit

(i.e., using a bypass trust). This disclaimer will reduce the estate tax when June dies, thus reducing overall estate taxes on both estates.

E. Some estate planners use a disclaimer trust. A disclaimer trust is created under the terms set forth in the will of a decedent. A disclaimer trust has the following attributes:

   (1) It is irrevocable.
   (2) Any property the surviving spouse disclaims will be transferred to the trust.
   (3) Earnings from the trust will be paid to the spouse at specified intervals.
   (4) The surviving spouse cannot retain any rights to invade the principal.
   (5) If the surviving spouse remarries, at his or her death the trust assets will pass to a beneficiary other than the surviving spouse.
   (6) The surviving spouse has only a life interest, so the assets will not be included in the gross estate of the surviving spouse.
   (7) The trust assets will not qualify for the marital deduction, so the decedent's estate will make greater use of the unified estate tax credit.

3. Alternative valuation date

A. An executor can make election to value an estate six months after the date of death, only if it reduces the value of the estate for tax purposes.

B. The alternate valuation date is used when property within an estate declines in value after the decedent's death. Likely candidates for this valuation method are securities or stock in a closely held business, which can decline during the period of estate settlement.

C. All assets disposed of between the date of death and the alternative valuation date are valued on the date of disposition.

D. All wasting assets are valued as of the date of death, regardless of selecting the alternative valuation date.

   (1) Annuities
   (2) Leases
   (3) Patents
   (4) Installment sales

4. Relief provisions for business owners' and farmers'/ranchers' estates

A. Deferral of estate taxes (Section 6166)

   (1) Allows estate tax for a closely held business to be paid over 14 years

      (a) The first four payments are interest-only payments starting on the one-year anniversary of the original due date.
      (b) Starting in the fifth year, the estate pays the estate tax in 10 installments.

   (2) The interest paid on the deferred tax is at a lower rate than the regular rate for underpaid tax payments.
   (3) Three conditions must be satisfied:

      (a) The value of the decedent's interest in the business must be at least 35 percent of the value of the adjusted gross estate.
      (b) Must be an interest in a closely held business

         • Sole proprietorship
         • Partnership in which at least 20 percent of the capital interest is included in the decedent's gross estate or that has 15 or fewer partners

- A corporation in which at least 20 percent of the voting stock is included in the decedent's gross estate or that has 15 or fewer shareholders

(c) The business must have been carrying on trade at the time of the decedent's death.

B. Corporate stock redemptions (Section 303)

(1) In general, when closely held corporations buy back stock from its shareholders, the proceeds must be treated as dividend income unless it falls under Section 303.
(2) If an estate qualifies for Section 303, the proceeds received from the redemption are classified as capital gain, usually long-term; if an estate does not qualify for Section 303, the proceeds are treated as ordinary income.
(3) Under this rule, stock may be redeemed from an estate equal to the total amount of all estate taxes, inheritances taxes, estate administration costs, and funeral expenses.
(4) The owner's death steps up the adjusted basis in the stock, so there is little to no gain reported.
(5) Certain requirements must be met to qualify for this tax treatment:

(a) The stock to be redeemed must be included in the decedent's gross estate.
(b) The value of the stock included in the gross estate must exceed 35 percent of the decedent's AGE.

- Stock in two or more corporations may be combined for this percentage requirement if 20 percent or more of the outstanding stock of each corporation is included in the decedent's gross estate.
- This percentage test must be met both before and after adding to the gross estate the property transferred within three years of death.

(c) One cannot redeem more than the total of federal and state death taxes, GSTT, administration and funeral expenses. The executor cannot use the Section 303 redemption to pay debts of the estate.
(d) Only those beneficiaries responsible for paying estate taxes can employ the Section 303 redemption. If stock is left to one heir and the taxes are payable out of the residuary estate passing to a different heir, the Section 303 redemption is not available.

C. Special use valuation [Section 2032(a)]

(1) Under Section 2032(a) of the Internal Revenue Code, an executor may elect special use valuation for real estate used in a closely held business or for farming.
(2) The reduced valuation is made on the basis of the current actual use rather than its highest and best use.
(3) Example: Assume a farm was originally located outside a city, but urban growth has approached the farm. The FMV of the farm is significantly higher than the value of its actual use. If taxes were levied on its FMV, the heirs would probably have to sell the farm. However, valuation at its actual use enables the heirs to continue to carry on with business.
(4) The maximum reduction allowed by special use valuation is $900,000 in 2006. The maximum reduction of $900,000 will be indexed for inflation.
(5) There are five requirements under Section 2032(a).

(a) The property must be held for "qualified use" and actively managed by the decedent and the decedent's family for five out of eight years prior to the decedent's death.

(b) The value of the real and personal property ("qualified property") portion must equal at least 50 percent of the gross estate after deduction of secured debt and mortgages.
(c) The real property portion must be at least 25 percent of the gross estate after deduction of secured debt and mortgages.
(d) The qualifying property must pass to qualifying heirs. The heirs sign a recapture agreement stating that the taxes saved will be recaptured by the government if the heirs do not continue the qualified use for at least 10 years after the decedent's death.
(e) On the date of the decedent's death, the real estate must be used as a farm or in a closely held business.

TOPIC 89: ESTATE PLANNING FOR NONTRADITIONAL RELATIONSHIPS

A. Children of another relationship: Techniques to avoid disinheritance are placing property in joint tenancy with right of survivorship (WROS), establishing trusts, and lifetime gifting.
B. Cohabitation

(1) Not eligible to take advantage of the marital deduction. This means that estate taxes cannot be deferred.
(2) Liquidity is a primary consideration.
(3) Wills containing specific bequests are very important.

C. Adoptions

(1) For probate, an adopted child is able to inherit from the adopted parent but not from the natural parent who gave up the child.

D. Same-sex relationships

(1) Not eligible to take advantage of the marital deduction. This means that estate taxes cannot be deferred.
(2) Liquidity is a primary consideration.
(3) Wills containing specific bequests are very important.

MULTIPLE CHOICE QUESTIONS

1. *Practice—wills*. Which of the following should be included in a will?

(1) Provision for guardians for minors
(2) Funeral instructions
(3) Transfer of IRA assets
(4) Attestation clause

A. 1 and 2
B. 1 and 4
C. 3 and 4
D. 1, 2, 3, and 4

Ans. B

2. ***Practice—trust provisions*. Steve Smith wants to place some assets in a trust for his 19-year old son, Stewart. Stewart has had drug problems over the past few years. What would be an appropriate provision for Steve to include in the trust document?**

   A. Self-proving provision
   B. Pour-over provision
   C. Spendthrift provision
   D. Alienation provision

   Ans. C

3. ***Practice—trusts*. Which type of trust is required to distribute all income to the beneficiaries annually?**

   A. Simple
   B. Complex
   C. Sprinkling
   D. Crummy

   Ans. A

4. ***Practice—charitable trusts*. Your client wants to set up a charitable trust that pays him an income stream that keeps up with inflation. Which of the following would be the best alternative?**

   A. Charitable remainder annuity trust (CRAT)
   B. Charitable lead annuity trust (CLAT)
   C. Charitable remainder unitrust (CRUT)
   D. Charitable lead unitrust (CLUT)

   Ans. C

5. ***Practice—charitable trusts*. Your client has some highly appreciated property that he would like to donate to charity. Assuming he needs current, guaranteed cash flow, which of the following would be the best alternative?**

   A. CRAT
   B. CLAT
   C. Pooled income fund
   D. Outright donation to charity

   Ans. A

6. ***Practice—technique review*. Which of the following technique if used will not result in a taxable gift?**

   A. Grantor retained annuity trust (GRAT)
   B. Qualified personal residence trust (QPRT)
   C. Self-canceling installment note (SCIN)
   D. Grantor retained unitrust (GRUT)

   Ans. C

7. ***Practice—estate planning*. Janice owns a $4 million home that she would like to transfer to her 6-year old son when he reaches age 21. Which of the following strategies may be appropriate?**

   A. Qualified domestic trust (QDOT)
   B. Qualified domestic relations order (QDRO)

C. QPRT
D. Qualified terminable interest property (QTIP)

Ans. C

8. ***Practice—QPRT*. Which of the following statement(s) is/are true regarding a QPRT?**

(1) With a QPRT, the grantor must survive the trust term to realize any estate tax savings.
(2) After the trust term, the house will revert back to the grantor.
(3) The grantor will have a taxable gift upon the creation of the QPRT.
(4) QPRT is generally inappropriate for vacation homes.

A. 1 only
B. 1 and 2
C. 1 and 3
D. 2 and 4
E. 2, 3, and 4

Ans. C

9. ***Practice—estate techniques*. Match the following:**

(1) Seller receives payments over time, income reported as received; present value of payments in estate
(2) Transferor receives payments over time, income reported as received, property out of estate at end of term
(3) A capital-sensitive entity used to split income and reduce estate
(4) Business transfer that provides income to family member and income tax deduction for donor
(5) Transferor receives payments over time; income reported as received, payments cease at death

A. Family limited partnership
B. GRAT
C. Installment sale
D. Private annuity
E. Sale leaseback

Ans. (1) C, (2) B, (3) A, (4) E, (5) D

10. ***Practice—gifting*. Frank gave his daughter a $42,000 Lexus, his son a $38,000 Corvette, and his wife an $80,000 Mercedes. His wife gave $10,000 each to the son and daughter. If he also gave $100,000 to a university and a remainder interest worth $36,000 to his brother, what are total taxable gifts?**

A. $54,000
B. $64,000
C. $74,000
D. $84,000
E. $92,000
F. None of the above

Ans. E

11. ***Practice—incapacity planning*. Susan is concerned about planning for incapacity. She wants to establish a plan that allows her to maintain complete control over her assets that will survive incapacity. What would be the best strategy?**

A. General power of attorney

B. Durable power of attorney
C. Pay-on-death (POD) bank account
D. Totten trust

Ans. B

12. ***Practice—probate/gross estate*. Match the following (can use more than once):**

(1) enants in common
(2) ommunity property
(3) enants by the entirety
(4) POD designation
(5) IRA (no named beneficiary)

A. probate estate only
B. gross estate only
C. both probate and gross estate
D. neither probate or gross estate

Ans. (1) C, (2) C, (3) B, (4) B, (5) C

13. ***Practice—gross estate*. Which of the following techniques are generally implemented to reduce an individual's gross estate?**

(1) Family limited partnership
(2) POD arrangement
(3) QPRT
(4) Revocable living trust

A. 1 and 2
B. 1 and 3
C. 2 and 4
D. 1, 3, and 4

Ans. B

14. ***Practice—taxable estate*. Kelly recently died in a car accident. She left behind assets worth $30 million. Which of the following are deductions from the gross estate in arriving at the taxable estate?**

(1) Funeral expenses
(2) Prior gift taxes paid
(3) Generation-skipping transfer tax (GSTT) paid
(4) Cost of maintaining estate assets

A. 1 and 2
B. 1 and 4
C. 2 and 3
D. 1, 2, and 4
E. 2, 3, and 4

Ans. B

15. ***Practice—property interest*. Which of the following pass through probate?**

(1) Fee simple
(2) Joint tenancy (with rights of survivorship)
(3) Tenancy in common
(4) Tenancy by the entirety
(5) Community property

A. 1 and 3
B. 2 and 4
C. 1, 3, and 5
D. All of the above

Ans. C

16. ***Practice—probate estate*. Which are included in probate estate?**

(1) A transfer-on-death account with decedent and his son
(2) Insurance policy owned by decedent (spouse is the insured)
(3) General power of appointment held by decedent
(4) Real estate owned tenants by entirety
(5) Real estate owned as community property

A. 2 and 4
B. 2 and 5
C. 5 only
D. All of the above

Ans. B

17. ***Practice—life insurance*. John changed ownership of a life insurance policy and died two years later. Under which of the following would the policy not be in his estate?**

(1) Policy transferred to wife
(2) Policy transferred to ex-wife
(3) He was not the insured
(4) Policy transferred to irrevocable life insurance trust (ILIT)
(5) Policy transferred as viatical settlement

A. 1, 2, and 3
B. 3 and 5
C. 3, 4, and 5
D. 1, 2, 3, and 4

Ans. B

18. ***Practice—power of appointment*. Match the following (can use more than once):**

(1) Expires when grantor dies
(2) Includible in estate of holder
(3) Allows for property to be assigned to creditors
(4) Can direct property owned by someone else

A. General power of appointment
B. Special power of appointment
C. Both
D. Neither

Ans. (1) D, (2) A, (3) A, (4) C

19. ***Practice—deathbed gifts*. James gave property to his father Mike. On the date of the gift, the property had a fair market value (FMV) of $90,000 and a basis of $50,000. Mike died nine months later, when the property's FMV was $100,000. Mike left everything he owned to James. What is James's basis in the property?**

A. $0
B. $50,000

C. $90,000
D. $100,000

Ans. B

20. ***Practice—deathbed gifts*. Val had a basis in an asset of $150,000. He gave the asset to his father, who was terminally ill. His father died six months later, when the asset was worth $250,000. Val sells the asset for $310,000. What is Val's capital gain?**

A. $0
B. $60,000
C. $100,000
D. $160,000

Ans. D

Use the following to answer questions21 through 23:
During the year, Sarah established an irrevocable trust with Crummey provisions for her daughter, Whitney. The trust document provides that the income from the trust will be paid to Whitney each year, with the remainder passing to Sarah's granddaughter at Whitney's death. During the year, Sarah contributed $100,000 of non-dividend-paying stock to the trust.

21. ***Practice—Crummey power*. If Whitney exercises her demand right, how much can she withdraw from the trust during the first 30 days?**

A. $0
B. $5,000
C. $12,000
D. $100,000
E. 5% of trust value

Ans. C

22. ***Practice—Crummey power*. If Sarah dies two years after making the gift, how much of the $100,000 gift will be included in her gross estate?**

A. $0
B. $5,000
C. $11,000
D. $100,000
E. 5% of trust value

Ans. A

23. ***Practice—Crummey power*. If Whitney dies, how much of the trust is included in her gross estate?**

A. $0
B. $5,000
C. $11,000
D. $100,000
E. 5% of trust value

Ans. A

24. ***Practice—A, B, C Trusts*. Which of the following trusts qualify for the marital deduction?**

(1) Marital trust
(2) Bypass trust

(3) QTIP trust
(4) Estate trust

A. 1 only
B. 2 only
C. 1 and 3 only
D. 1, 3 and 4 only

Ans. D

25. *Practice—A, B, C Trusts*. In which of the following trusts is the spouse the ultimate beneficiary when the trust terminates?

A. A Trust
B. B Trust
C. C Trust

Ans. A

26. *Practice—QTIP*. If Steve dies and leaves his second wife the right to use the residence for her life, will it qualify as QTIP property?

A. No, it is not left in a trust.
B. No, it is a terminable interest.
C. Yes, if the QTIP election is made.
D. Yes, if she has the right to appoint it at her death.

Ans. C

27. *Practice—GSTT*. After using $1,011,000 of her GSTT exemption, Anna gave $70,000 to her great-grandson. What is the minimum GSTT due?

A. $0
B. $4,500
C. $10,000
D. $11,000
E. $16,500

Ans. A

28. *Practice—QDOT*. In which of the following situations would a QDOT be appropriate?

A. Decedent is a U.S. citizen.
B. Decedent is a non-U.S. citizen.
C. Surviving spouse is a U.S. citizen.
D. Surviving spouse is a non-U.S. citizen.

Ans. D

29. *Practice—alternative lifestyles*. Two men have lived together for eight years in a community property state. They want to leave all of their assets to each other when they die. What is the best way to accomplish their goal?

A. Die intestate.
B. Title property as joint tenants by the entirety.
C. Leave assets to each other in their wills.

Ans. C

Exhibit 7.1 **Retirement Chart**

Broad Category	Category	PENSION				Profit Sharing							
		Defined Benefit		Defined Contribution				ESOP	LESOP	401K			
		Defined Benefit	Cash Balance Plan	Money Purchase Plan	Target Benefit Plan	Profit-Sharing Plan	Stock Bonus Plan	Defined Contribution Plan	Defined Contribution Plan	Traditional	Roth	Thrift	New Comparability
1 Overview	Who is favored by the plan	Older employees	Younger employees	Younger employees	Older owner(s)	Young employees	Young employees	Employer	Employer	Younger employees because of longer com-pounding time	Those anticipating high retirement income	Younger employees	Older
1 Overview	Works best with what organizations	All organizations are eligible.	Those who want to change from defined benefit plans, but all are eligible	All organizations are eligible.	All organizations are eligible.	All organizations are eligible.	All organizations that issue stock are eligible.	Private, closely held corporations	Private, closely held corporations	All organizations are eligible.	All eligible 401(k)plans	Considered outdated because of new Roth provision	All organizations are eligible.
1 Overview	Brief Description of Plan	Provide a certain defined benefit @ time of participant's retirement usually based on # years of service and salary.	Promised employer funding is usually based on % of salary and a guaranteed % of earning per year.	Account balance to provide for retirement benefit.	Defined contribution plans that establish a fixed contribution formula based on initial actuarial determination of the contributions required to meet a targeted benefit level.	Defined contribution plan that enables employer to make discretionary, but "substantial and recurring" contributions in 2 out of every 5 years.	Defined contribution plan that enables employer to make discre-tionary, but "substantial and recur-ring" contri-butions in 2 out of every 5 years, which may include company stock.	Stock bonus plans that reward employees with both ownership in the corporation and tax deductions.	Stock bonus plans that have the ability to borrow.	Combination of pretax deferred contribution by employees and contributions (via match and/or outright contribution) by employer. Asset grow tax deferred until distribution.	After Dec. 31, 2005, employee elective deferral contributions consist of after-tax dollars and qualified distributions will be non taxable and not subject . to penalties.	Employer allows employee to make after-tax contributions. Earnings grow tax free until distribution. Typically employer matching contributions equal a fixed percentage of employee contributions.	Restrict higher rates of employer contributions to highly compensated employees. May allow different allocations among different groups of plan participants; may allow groups to be determined by salary,

(continued)

Broad Category	Category	PENSION				Profit Sharing							
		Defined Benefit		Defined Contribution				ESOP	LESOP	401K			
Broad Category	Category	Defined Benefit	Cash Balance Plan	Money Purchase Plan	Target Benefit Plan	Profit-Sharing Plan	Stock Bonus Plan	Defined Contribution Plan	Defined Contribution Plan	Traditional	Roth	Thrift	New Comparability
													service, position, or even a combination of these categories; may allow the owner to receive a much larger allocation, as a percentage of pay, than other plan participants; and may allow an owner to select those participants he would like to reward with larger allocations.
2 Legal	Promise	Pay a pension at retirement	Employer promises certain lump sum at retirement age, based on a formula or flat dollar amount.	Account balance at retirement.	Account balance at retirement; benefit level may/may not be reached depending on performance of investments.	Account balance at retirement	Account balance at retirement	Employee bears risk of insolvency.	Employee bears risk of insolvency.	Account balance at retirement	Account balance	Fully vested account balance	Account balance at retirement

2 Legal	Subject to PBGC	Yes	Yes	No	No	No	No	No	No	No	No	No	No
2 Legal	Anti-alienation Protection	Yes	Yes	Yes	yes	No	No	No	No	Yes	No		Yes
2 Legal	Eligibility	Standard later of age 21 or 1 year of service; special later of age 21 or 2 years of service and 100% vested	Standard later of age 21 or 1 year of service; special later of age 21 or 2 years of service and 100% vested	Standard later of age 21 or 1 year of service; special later of age 21 or 2 years of service and 100% vested	Standard later of age 21 or 1 year of service; special later of age 21 or 2 years of service and 100% vested	Age 21 and 1 year of service or 2 years with 100% vesting	Age 21 and 1 year of service or 2 years with 100% vesting	Age 21 and 1 year of service or 2 years with 100% vesting	Age 21 and 1 year of service or 2 years of service or 2 years with 100% vesting	Standard; exception—employer *may* make employee wait 2 years to enter the plan if all benefits are fully vested. *Not* allowed to make it a requirement to complete more then 1 year of service as a condition of participation	Standard later of age 21 or 1 year of service (1,000 hours)	Voluntary, but employee must agree to contribute in order to receive matching funds. Usual 1 year or 2 with immediate vesting. Liberal w/drawal privileges	
2 Legal	Coverage Tests	Must pass either ratio % test or average benefits test *and* 50/40 test	Must pass either ratio % test or average benefits test and 50/40 test	Must pass either ratio % test or average benefits test	Must pass either ratio % test or average benefits test	Safe harbor test; ration % test; average benefit test (must satisfy at least one of these tests)	Safe harbor test; ration % test; average benefit test (must satisfy at least one of these tests)	None	None	Safe harbor test; ration % test; average benefit test (must satisfy at least one of these tests)		Coverage, ADP/ACP and top heavy	

(continued)

Broad Category	Category	PENSION				Profit Sharing							
		Defined Benefit		Defined Contribution				ESOP	LESOP	401K			
		Defined Benefit	Cash Balance Plan	Money Purchase Plan	Target Benefit Plan	Profit-Sharing Plan	Stock Bonus Plan	Defined Contribution Plan	Defined Contribution Plan	Traditional	Roth	Thrift	New Comparability
2 Legal	Vesting	5-year cliff or 3–7 graded unless top-heavy plan	5-year cliff or 3–7 graded unless top-heavy plan	5-year cliff or 3–7 graded unless top-heavy plan	5 year cliff or 3–7 graded unless top-heavy plan	5-year cliff or 3–7 graded unless top-heavy plan	5-year cliff or 3–7 graded unless top-heavy plan	The standard 5-year cliff vesting schedules and the graduated 3–7-year vesting schedules apply unless the plan is top heavy or if the employer selects a 2-year eligibility rule. If the plan is top heavy, the vesting period is reduced to a 3-year cliff or a 2–6-year graduated vesting schedule.	The standard 5-year cliff vesting schedules and the graduated 3–7-year vesting schedules apply unless the plan is top heavy or if the employer selects a 2-year eligibility rule. If the plan is top heavy, the vesting period is reduced to a 3-year cliff or a 2–6-year graduated vesting schedule.	All employee deferral contributions are 100% vested. Employer matching contributions and earnings on this match vest @ top-heavy vesting schedule or 2–6-year graduated *or* 3-year cliff.	Immediate	Immediate for employee contributions. Employer contributions typically more liberal than provisions of typical profit-sharing plan.	

2 legal	Who May Establish Plan	No restrictions; all entity types may establish	No restrictions; all entity types may establish	No restrictions; all entity types may establish		5-year cliff or 3–7 graded unless top-heavy plan	5-year cliff or 3–7 graded unless top-heavy plan	Employer (i.e., corporation)	Employer (i.e., corporation)	Employer (i.e., corporation, partnership, LLC, proprietor-ship). AFTER 1996 - TAX EXEMPT entities also allowed to establish 401(k) plans. NOT ALLOWED are Government entities unless grand-fathered due to prior exis-tence of the plan before (5/6/86).	Corporations, partnerships, LLCs, proprietor-ships, tax-exempt entities	Corporations, partnerships, LLCs, proprietor-ships, tax-exempt entities	
2 Legal	ADP/ACP	Yes	Yes	Yes		Yes	Yes	No	No	YES; ADP most often will not fail as all employees in this plan are considered HC employees.	No	Yes	Comparabil-ity plan may continue to cross test if each eligible NHCE receives an allocation rate of at least 5% of compen-sation, or, if less, one-third of the highest allocation rate provided

(continued)

Broad Category	Category	PENSION				Profit Sharing							
		Defined Benefit		Defined Contribution				ESOP	LESOP	401K			
		Defined Benefit	Cash Balance Plan	Money Purchase Plan	Target Benefit Plan	Profit-Sharing Plan	Stock Bonus Plan	Defined Contribution Plan	Defined Contribution Plan	Traditional	Roth	Thrift	New Comparability
													under the plan. A new comparabil-ity plan would not have to sat-isfy these gateways if it has broadly available allocation rates or certain age-based allocation rates.
2 Legal	Experts Required?	Actuary and pension experts required annually	Actuary and plan administrator	None	Yes; initial (actuary); no annual actuarial certification	No	No	ESOP trustee or plan sponsor	ESOP trustee or plan sponsor	None	No	No	No
2 Legal	Setup Difficulty?	Most onerous	Less complex than defined benefit	Easy		Easy	Easy	Can be expensive	Can be expensive	Easy	Minimal expense	Moderate	
2 Legal	Top Heavy Rules Apply	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	
2 Legal	Reporting Required	Yes, Form 5500 reporting	Yes, Form 5500 reporting	Yes, Form 5500 reporting		Yes	Yes	If the employer's securities are not regularly traded on an established market, an independent	If the employer's securities are not regularly traded on an established market, an independent	W-2; subject to payroll taxes Social Security withholding applicable up to $90K: Medicare		W-2	

								appraisal must be made to determine the fair market value of the trust fund for purposes of valuing the participant's account at the end of each plan year.	appraisal must be made to determine the fair market value of the trust fund for purposes of valuing the participant's account at the end of each plan year.	wage applicable uncapped)			
2 Legal	Conversion to Roth and Others	N/A	N/A	N/A	N/A	Can be rolled over to another 401 plan; 403 b arrangement or section 457 or IRA	Can be rolled over to another 401 plan; 403 b arrangement or section 457 or IRA	N/A	N/A	Yes	N/A	Only to another plan that accepts after-tax contributions or into a traditional IRA. Direct rollover only	
3 Funding	Mandatory Funding Standards	Yes, based on actuarial calculations	Yes, based on actuarial equivalents done annually	Yes, based on plan document	Yes, per plan formula determined by actuary at plan inception	Generally no	Generally no	None	None		None	Within a range established by plan	Employers do not have to make a contribution every year.
3 Funding	Annual Contribution Limits	N/A Employer funds based on actuarial info	None by employee/ employer amount needed to reach retirement goal	Employer contributions limited to 25% of compensation	Employer contributions limited to 25% of compensation	Employer contributions limited to 25% of compensation	Employer contributions limited to 25% of compensation	25% of covered compensation	25% of covered compensation	2006–2008 $15,500 annual limit (excluding catch-up contribution)	Up to $15,500 with NO AGI limitation	25% of total covered compensation	Employer contributions limited to lesser of 25% of compensation or 45,000 for 2007

(continued)

Broad Category	Category	PENSION						Profit Sharing					
		Defined Benefit		Defined Contribution				ESOP	LESOP	401K			
		Defined Benefit	Cash Balance Plan	Money Purchase Plan	Target Benefit Plan	Profit-Sharing Plan	Stock Bonus Plan	Defined Contribution Plan	Defined Contribution Plan	Traditional	Roth	Thrift	New Comparability
3 Funding	Forfeitures Allocated	To reduce future employer costs only	To reduce future employer contributions only	To reduce future employer costs *or* increase employee benefits	Reallocated or applied to reduce employer contribution	Generally reallocated; may be used to reduce employer contribution	Generally reallocated; may be used to reduce employer contribution	There is forfeiture reallocation in that nonvested account balances of terminated participants are usually reallocated to remaining participants' accounts.	There is forfeiture reallocation in that nonvested account balances of terminated participants are usually reallocated to remaining participants' accounts.	Nonforfeitured accrued benefits payable to surviving spouse upon participant's death	N/A	Reduce employer contribution or reallocated based on compensation ratio, not balances	
3 Funding	Credit for Prior Service	Yes	Yes	No. However, contribution formula can include years of service.		No	No	None	None	None	N/A	No	
3 Funding	Coverage Compensation Limit	Only salary up to $225,000 considered	Benefits provided under plan less of $180,000 annually or 100% of high 3-year average	Only salary up to $225,000 considered	Only salary up to $225,000 considered	Only salary up to $225,000 considered	Only salary up to $225,000 considered	$225,000	$225,000	25% of total covered compensation	N/A	Employer contribution 25% of total covered compensation	
3 Funding	Defined Benefit Maximum	100% of salary up to $180,000	Lump sum promised at retirement	N/A	N/A	N/A	N/A	N/A	N/A	N/A	None	None	

3 Funding	Defined Contibution Maximum	N/A	N/A	Lesser of 100% of compen-sation or $45,000	Lesser of 100% of compen-sation or $45,000	Lesser of 100% of compen-sation or $45,000	Lesser of 100% of compen-sation or $45,000	Contribution limit of 25% of covered compen-sation (limited to $225,000)	Contribution limit of 25% of covered compen-sation (limited to $225,000)	Lesser of 100% salary or $45,000 (for 2007) (excluding catch-up amount)	N/A	If allowed, plan must specify range and right to change amounts.	
3 Funding	Employee Deferral Maximum	N/A unless Plan allows after-tax contributions (rare)	N/A	May permit voluntary after-tax contributions		401(k) provisions allowed	401(k) provisions allowed	Flexible contributions are permit-ted and the employer is not required to make specific annual con-tributions.	Flexible contributions are permit-ted and the employer is not required to make specific annual con-tributions.	$15,500 (2006–2008) or up to 25% of employee's salary	After-tax contribution	Plan dictates	
3 Funding	Contribution Phaseout	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	Up to $15,500	Up to $15,500 no AGI limitation	Plan dictates up to $15,000	
3 Funding	Deduction Phaseout	N/A	N/A	NA	N/A	N/A	N/A	N/A	N/A	N/A	None	N/A	
3 Funding	Catchup Contributions	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	50 years or older (2006–2008) allowed extra $5,000	Yes	Yes, $5,000 maximum	
3 Funding	Social Security Integration	Yes	Yes	Yes, excess only		Yes	Yes	No	No	None	N/A	No	
4 Investment	Investment Risk	Employer	Employer	Employee	Employee	Employee	Employee	Employee	Employee	Employee	Employee	Employee	
4 Investment	Employer Securities	<10%	<10%	<10%		No limit	No limit	100%	100%	None	N/A	Possible	
4 Investment	Separate Investment Accounts	No accrued benefits; statements only	No account statements are hypothetical.	Yes		Yes	Yes	Yes	Yes	Yes—must keep it separate from employer's assets. If commingled,	Yes and separate record keeping of contributions and earnings allocatable	Yes, contributions are paid to a trust.	

(continued)

Broad Category	Category	PENSION				Profit Sharing							
		Defined Benefit		Defined Contribution				ESOP	LESOP	401K			
		Defined Benefit	Cash Balance Plan	Money Purchase Plan	Target Benefit Plan	Profit-Sharing Plan	Stock Bonus Plan	Defined Contribution Plan	Defined Contribution Plan	Traditional	Roth	Thrift	New Comparability
										must separate at earliest date possible, but must be completed by the 15th day of the month following the deferral.			
4 Investments	Investment vehicles required/ allowed	Assets selected to meet actuarial requirements	Sponsor responsible	Employer can direct investments or employee may be allowed		Decided by trustee; plan may allow participants to direct	Decided by trustee; plan may allow participants to direct	Invest in qualifying employer securities	Invest in qualifying employer securities		No life insurance and collectables	As permitted by plan; minimum of three options; life insurance allowed	
5 Distribution	Qualified Joint and Survivor Annuity	Yes	Yes	Yes		No	No	No	No	Yes—unless (1) upon death; non forfeitured accrued benefits are payable to surviving spouse. (2) does not elect the payment of benefits in the form of annuity	N/A		

5 Distribution	Qualified Pre Survivor Annuity	Yes	Yes	Yes		No	No	No	No	YES—if death before attaing normal retirement age (aka "term insurance policy")	N/A		
5 Distribution	Lump Sum Distributions	In some cases yes	Yes, distribution must be greater of PV calculated under ERISA rate or the hypothetical account balance	If plan document allows		Yes		One of the principal benefits of stock bonus plans is net unrealized appreciation (NUA)	One of the principal benefits of stock bonus plans is net unrealized appreciation (NUA)	Yes, upon termination of employment receive special tax treatment by meeting four requirements: (1) entire full account balance. (2) made within 1 taxable year (3) due to death; attainment of age $50\frac{1}{2}$, separation of service (4) must have participated in the plan at least 5 taxable years prior to tax year of distribution.	Yes	As specified by plan; may be cash, installments, or employer stock	

(continued)

Broad Category	Category	PENSION				Profit Sharing							
		Defined Benefit		Defined Contribution				ESOP	LESOP	401K			
		Defined Benefit	Cash Balance Plan	Money Purchase Plan	Target Benefit Plan	Profit-Sharing Plan	Stock Bonus Plan	Defined Contribution Plan	Defined Contribution Plan	Traditional	Roth	Thrift	New Comparability
5 Distribution	Lump Sum Special Tax Treatment		Special 10-year forward averaging	10-year forward averaging; pre-74 cap gain; NUA		Yes, if born before 1936	Yes, if born before 1936	Favorable tax treatment on stock distributions (NUA)	Favorable tax treatment on stock distributions	See above	FIFO	10-year forward averaging; pre-74 cap gain; NUA	
5 Distribution	10-year Forward Averaging	If participant born before 1/1/1936 available	If born before 1936	If participant born before 1/1/1936 available		Yes, if born before 1936	Yes, if born before 1936	No	No	Yes, if lump sum is qualified; born before 1/1/36	No	Yes	
5 Distribution	Mandatory Distribution	Only from termination, early retirement, normal retirement, and death, and no later than April 1 the year following year turning 70½	Only from termination, early retirement, normal retirement, and death, and no later than April 1 the year following year turning 70½	Only from termination, early retirement, normal retirement, death, no later than April 1 the year following year turning 70½		Only from termination, early retirement, normal retirement, death, no later than April 1 the year following year turning 70½	Only from termination, early retirement, normal retirement, death, no later than April 1 the year following year turning 70½	Plan participants can elect to receive substantial equal periodic payments of their account balance not less than once per year after the participant separates from service. The substantially equal periodic payments must be for a period no longer than 5 years,	Plan participants can elect to receive substantial equal periodic payments of their account balance not less once per year after the participant separates from service.	At termination: may elect to take cash as ordinary taxable income, rollover to qualified plan.	Only after death	Retirement, death, disability, or termination	

								unless the participant's account balance is valued at more than $890,000.					
5 Distribution	Hardship Distributions	No	No	No		Participant must have a triggering event, which means an immediate and heavy financial need.	Participant must have a triggering event, which means an immediate and heavy financial need.	No	No	Yes; must pay income taxes on the distribution and early withdrawl penalties may apply.	Yes, death, disability, medical >7.5% AGI, QDRO, education expense, payment of health premium if unemployed > 12 weeks.	Yes, definition of *hardship* is dictated by plan and usually very liberal (i.e., not subject to 401(k) standard).	
5 Distribution	In Service Withdrawals	No	No	No		As provided by plan usually for death, termination, or retirement	As provided by plan usually for death, termination, or retirement	No	No	May allow for in-service withdrawl (plan dependent)	No	Usually permitted	
5 Distribution	Plan Loans	Only if allowed by plan documents	Only if allowed by plan documents	Only if allowed by plan documents	Only if allowed by plan documents	Yes	Yes	Corporation can borrow against stock.	Corporation can borrow against stock.	Generally allowed to participate in the plan documents	No	If permitted, limited to lesser of $50,000 or 50% of vested interest (w/ < $10,000 exception) and repaid within 5 years. Purchase residence exception. Reasonable interest.	

(continued)

Broad Category Comparability	Category	PENSION				Profit Sharing							
		Defined Benefit		Defined Contribution				ESOP	LESOP	401K			
		Defined Benefit	Cash Balance Plan	Money Purchase Plan	Target Benefit Plan	Profit-Sharing Plan	Stock Bonus Plan	Defined Contribution Plan	Defined Contribution Plan	Traditional	Roth	Thrift	New
5 Distribution	Rollovers	Yes, if plan allows lump sum distribution	Yes, if allowed by plan	Only if allowed by plan documents		Yes	Yes	No	No	Yes	Only to another plan that accepts after-tax contributions or into a traditional IRA. Direct rollover only	Only to another plan that accepts after-tax contributions or into a traditional IRA. Direct rollover only	
5 Distribution	Early Withdrawal Penalty Exclusions	Death; disability; 59½; Early retirement after 55; Med exp in excess of 7.5% AGI; equal payments until death	Certain permature distributions are subject to penalties	Death; disability; 59½; 55 and separation from service; med exp in excess of 7.5% AGI; equal payments until death; QDRO	Death; disability; 59½; 55 and separation from service; med exp in excess of 7.5% AGI; equal payments until death; QDRO	Death; disability; 59½; 55 and separation from service; med exp in excess of 7.5% AGI; equal payments until death; QDRO	Death; disability; 59½; 55 and separation from service; med exp in excess of 7.5% AGI; equal payments until death; QDRO	Death; disability; 59½; 55 and separation from service; med exp in excess of 7.5% AGI; equal payments until death; QDRO	Death; disability; 59½; 55 and separation from service; med exp in excess of 7.5% AGI; equal payments until death; QDRO	Death; disability; 59½ Early Retirement after 55; Med Exp in excess of 7.5% AGI; Equal Payments until Death	Plan must be in place at least Five Years; FIFO, 59½, after death of owner, after disability of owner. First home distribution will trip 10% penalty (Keir p. 92)	Funds must accumulate at least two years and plan must specify any other limitations.	

Broad Category	Category	Age Based	IRA		SEP	SARSEP	SIMPLE		403 B		457 Plans		
			Traditional	Roth		No longer offered	IRA	401K	Traditional	Roth	Eligible Funded Government	Eligible Unfunded Tax Exempt	Ineligible
1 Overview	Who is favored by the plan	Older	Younger employees	Those anticipating high retirement income	Small Companies; small employers	Small Companies; small employers	Younger employees	Same as simple IRA	Younger employees	Younger employees	Rank and file employees and key management of government employer	Key management HCs for Tax exempt organizations	Highly compensated or top management only
1 Overview	Works best with what organizations	All organizations are eligible	Individual with no qualified plan, spouse with no qualified plan and/or lower joint earned income.	N/A	All organizations are eligible.	All organizations are eligible.	Small employers (100 employees or less)	Same as simple IRA	501(c)3 nonprofit corporations, teachers	501(c)3 nonprofit corporations, teachers	Only available to state and local governments and their agencies	Only available to employees of tax exempt organizations. Sect 501c3 organization; excludes church synagogue or organizations controlled by either	Governmental entities (rare) and tax-exempt entities under 501c
1 Overview	Brief Description of Plan	An Age-Weighted Plan is a profit sharing plan in which the employer contribution is allocated to provide an assumed retirement benefit at	Defer salary pretax, deferral of gains on long-term basis and withdrawals $70\frac{1}{2}$ at ordinary income rates.	Contributions are non-deductible and qualified distributions excluded from individual's taxable income. Outside of any	Provide for employee contributions to ind employee IRAs; employees own/manage their IRAs.	Provide for employer contributions to into employee IRAs; employees own/manage their IRAs.	Employer and employee enter into agreement. Employee elects salary reduction, employer matched a % with a contribution.	Same as simple IRA	403b or TDA or TSA is tax-deferred retirement plan offered to employees of educational systems, non-profits and religious organizations to compete	403b or TDA or TSA is tax-deferred retirement plan offered to employees of educational systems, nonprofits and religious organizations to compete	Nonqualified deferred compensation plan for state and local government employees and their deferred compensation; holds all plan assets	Nonqualified deferred compensation plan for tax exempt organizations excluding churches; funded 457 plan for non government tax exempt	Nonqualified deferred compensation plans for state and local government employers and tax exempt employers. Only HC employees

(continued)

Broad Category	Category	Age Based	IRA		SEP	SARSEP	SIMPLE		403 B		457 Plans		
			Traditional	Roth		No longer offered	IRA	401K	Traditional	Roth	Eligible Funded Government	Eligible Unfunded Tax Exempt	Ineligible
		normal retirement age. The age-weighted allocation, when accumulated to normal retirement age (i.e., 65), would purchase an equivalent		employee/ owner-based planned.					with other employers. Contribut-ions grow tax-deferred until distributed to employee.	with other employers. Contribu-tions grow tax deferred until distributed to employee.	in trust or custodian accounts or annuity contracts for exclusive benefit of participants; contributions to 457 plans are separate in the annual deferral amount of the employee.	is subject to ERISA; organizations can avoid if they stay unfunded; employees participate through salary reduction.	or top management may participate; also called tophat plans.
1 Legal	Promise	Account balance at retirement	None	None	None; risk taken by employee	None; risk taken by employee	None	None	No promise made. Risk taken by employee		Cash balance	Cash balance	Cash balance
2 Legal	Subject to PBGC	No	No	N/A	No	No	No	No	No		No	No	No
2 Legal	Anti-Alienation Protection	Yes	No	N/A	No	No	Not qualified	No	Yes		No	No	No
2 Legal	Eligibility			Neither active status nor age is relevant. Contribu-tions may continue past age 70½	If employer contributes: (1) all employees at least 21; (2) earn at least $300 (indexed 450 in 2006) in current year; (3)	If employer contributes: (1) all em-ployees at least 21; (2) earn at least $300 (in-dexed 450 in 2006) in cur-rent year; (3) performed	Employees who earned $5,000 in any two preceding calendar years, and expected to earn $5000 in current year	Same as simple IRA	Standard later of age 21 or 1 year of service; special later of age 21 or 2 years of service and 100% vested. Educational		Available only to employees of state and local governments and their agencies.	Available only to em-ployees of tax-exempt organizations Section 501c3 organizations; excludes churches, synagogues,	Only highly compensated HC or top management may participate.

					performed services in 3 of past 5 calendar years; Also part-time workers meeting service requirements	services in 3 of past 5 calendar years; Also part-time workers meeting service requirements			institute can use age 26 (100% vested)			or organi-zations, controlled by either; unfunded plans for the highly paid, “tophat plans”.	
2 Legal	Coverage Tests		None	None	All Employees who meet eligibility rules	All Employees who meet eligibility rules	None	Safe harbor plan that satisfies minimum contribution or matching tests; no ADP or ACP required.	IRS nondiscrimination for a qualified plan: ratio % or average benefits.		N/A	N/A	N/A
2 Legal	Vesting			N/A	100% ownership by employees, no vesting provisions	100% ownership by employees, no vesting provisions	Immediate	Immediate	5-year cliff vesting or 3–7-years graded unless topheavy		Immediate	Immediate if funded plan	Amounts contributed subject to “substantial risk of forfeiture; participant is considered a general creditor; risk is condi-tioned upon unsecured status of employee, employees future performance of substantial services; employer agrees to pay a certain amount after

(continued)

Broad Category	Category	Age Based	IRA		SEP	SARSEP	SIMPLE		403 B		457 Plans		
			Traditional	Roth		No longer offered	IRA	401K	Traditional	Roth	Eligible Funded Government	Eligible Unfunded Tax Exempt	Ineligible
													a specified period; if participant terminates employment before stated payment periods, all funds may be forfeited.
2 Legal	Who May Establish Plan?		Taxpayer with no qualified plan, spouse with no plan, or spouse with combined AGI below threshold, taxpayer with plan but opts out of plan . . . does not receive contributions or make contributions to a plan.	Single taxpayers with MAGI up to $110,000 and married filing jointly with MAGI up to $160,000	Employer	Employer	Employer with 100 employees or less	Same as Simple IRA	Public education systems, tax-exempt 501(c)3, and employers of ministers, amateur sports associations and hospital service organizations		Available only to state and local governments and their agencies	Available only to employees of tax exempt organizations. Sect 501(c)3 organizations; excludes churches, synagogues, or organizations controlled by either.	Governmental entities (rare) and tax exempt entities under 501(c)
2 Legal	ADP/ACP		No	N/A	No	No	No	Safe Harbor Plan	ADP/ACP applies when employer makes matching contributions		N/A	N/A	N/A

2 Legal	Experts required?	No	No	No	No	No	No	No	No	N/A	No	No	No
2 Legal	Setup Difficulty?		Easy	Easy	Easy	Easy	Simple Form 5305 or 5304	Qualified plan—same setup as 401,000	Easy	N/A	Easy	Easy	Easy
2 Legal	Top-Heavy Rules Apply		N/A	N/A	Yes	ADP of HC cannot be >125% of ADP	No	Safe harbor	Yes		N/A	N/A	N/A
2 Legal	Reporting Required		None	Form-8606	None	None	None	None	W-2		No	Only on funded plans for unfunded tax exempt	No
2 Legal	Conversion to Roth and Others		Yes, if single or MFJ with AGL < 100K, no if MFS. Value of conversion must include in taxable income	Possible to recharacterize contributions as trade IRA if MAGI limits reached, in a particular year	Yes; Single or MFJ w/AGI < 100,000; MFS no conversion	Yes; Single or MFJ w/AGI < 100,000; MFS no conversion	after two years to IRA, qualified plan, 403,457		can be converted to Roth		Qualify for tax free rollover to IRA, SEP, 403b or another 457 or qualified plan; QDRO; distribution from a government 457 is same as for qualified plan	Qualify for tax free rollover to 457	no rollover allowed
3 Funding	Mandatory Funding Standards			None	No; Contributions are fully discretionary from year to year	No; Contributions are fully discretionary from year to year	Must match up to 3% of earnings (no limit) or up to $10,000	Must match 3% of covered compensation ($225,000) up to limit of $10,000 employer match cannot be reduced to low of 1% for more than 2 out of 5 years.	no mandatory funding. Elective employee contributions.	Roth 403b requires contributions to be held within plan for five years minimum.	No	No	No

(continued)

Broad Category	Category	Age Based	IRA		SEP	SARSEP	SIMPLE		403 B		457 Plans		
			Traditional	Roth		No longer offered	IRA	401K	Traditional	Roth	Eligible Funded Government	Eligible Unfunded Tax Exempt	Ineligible
3 Funding	Annual Contribution Limits	Employer contributions limited to lessor of 25% of compensation or $45,000 for 2007	$4,000 with phaseout between $52–$62,000 Single, $83–$93,000 MFJ and $156–166,000 M one spouse no qualified plan	Up to $15,500 subject to phase outs as stated	Employer contributions limited to lesser of 25% of compensation or $45,000 for 2007	Employer contributions limited to lesser of 25% of compensation or $45,000 for 2007	$10,000 and $2500 catchup	Same as simple IRA	$15,500 plus $5,000 catchup over age 50. Total contributions (including employer) of $45,000		Employer can contribute but very unusual; employee deferrals only	Employer can contribute but very unusual; employee deferrals only	Employer can contribute but very unusual; employee deferrals only
3 Funding	Forfeitures Allocated		None, immediate vesting	N/A	No immediate vesting	No immediate vesting	None, immediate vesting	None, immediate vesting	No forfeitures on vested balances		N/A	N/A	N/A
3 Funding	Credit for Prior Service		None	N/A	None	None	None	None	None		None	None	None
3 Funding	Coverage Compensation Limit		See above	N/A	On salary of $225,000	On salary of $225,000	No limit	On salary of $225,000	$225,000 cap for formula		N/A	N/A	N/A
3 Funding	Defined Benefit Maximum		None	N/A	N/A	N/A	N/A	N/A	N/A		N/A	N/A	N/A
3 Funding	Defined Contribution Maximum		None	N/A	lesser of 100% earnings or $45k. $5000 catchup >=age 50.	lesser of 100% earnings or $45k. $5000 catch up >=age 50.	$10,000	$10,000	Lesser of 100% earnings or $45k. $5000 catchup >=age 50.		N/A	N/A	N/A
3 Funding	Employee Deferral Maximum		Lesser of 100% of earned income or $4,000	N/A	N/A	$15,500 ($20,500 > age 50)	Lesser of salary or $10,000	Same as simple IRA	$15,500 ($20,500 > age 50)		Lesser of salary or $15,500+ 5,000 if over 50; last 3 years premiun to retirement lesser of 100%	Lesser of salary or $15,500	No limit

											compensa-tion or 200% of normal limit; age 50+ catchup not available		
3 Funding	Contribution Phaseout		IRA reduc-tion subject to above phase out calculated as $4,000* (AGI-lower limit/10000	Single from $95-$110k. MFJ from $150–$160,000 MFS $0-$10,000	N/A	N/A	N/A	N/A	No phaseout applies		N/A	N/A	N/A
3 Funding	Deduction Phaseout			Not deductible	N/A	N/A	N/A	N/A	No deduction phaseout		N/A	N/A	N/A
3 Funding	Catch-Up Contributions		$1,000 over 50 subject to phaseout	No	N/A	$5,000 > age 50	$2,500	If employer allows $2,500	$5,000 > age 50		5,000 if over 50; last 3 years premi-um to retire-ment lesser of 100% compensation or 200% of normal limit; age 50+ catch-up not available	None	None
3 Funding	Social Security Integration		N/A	No	Yes	Yes			No. Will not reduce benefits		N/A	N/A	N/A
4 Investment	Investment Risk		Employee	Self-directed	Employee	Employee	Employee	Employee	Employee		Employee	Employee	Employee
4 Investment	Employer Securities		N/A	N/A	N/A	N/A		100%	No		No	No	No
4 Investment	Separate Investment Accounts		Yes	Yes	Yes	Yes	Yes	Yes	Yes, separate employee investment accounts		Yes, all plan assets must be held in trust or custodial accounts or annuities for benefit of participants.	Property must remain property of employer subject to claims of creditors	Property must remain property of employer subject to claims of creditors

(continued)

Broad Category	Category	Age Based	IRA		SEP	SARSEP	SIMPLE		403 B		457 Plans		
			Traditional	Roth		No longer offered	IRA	401K	Traditional	Roth	Eligible Funded Government	Eligible Unfunded Tax Exempt	Ineligible
4 Investments	Investment vehicles required/ allowed		No life insurance and collectibles	No life insurance and collectibles	No life insurance and collectibles	No life insurance and collectibles	No life insurance or collectibles	Life and health insurance allowed	Annuity contracts, mutual funds, life insurance, retirement income accounts (churches).		Broad selection	Broad selection	Contribu- tions are subject to risk of forfeiture.
5 Distribution	Qualified Joint and Survivor Annuity		N/A	N/A	N/A	N/A	N/A	N/A	Yes		N/A	N/A	N/A
5 Distribution	Qualified Pre Survivor Annuity		N/A	N/A	N/A	N/A	N/A	N/A	Yes		N/A	N/A	N/A
5 Distribution	Lump Sum Distributions		Yes	Yes	Balance can be withdrawn from IRA.	Balance can be withdrawn from IRA.	No	Yes in 401(k)	Yes		Yes	Yes	Yes
5 Distribution	Lump Sum Special Tax Treatment			No	No	No			Yes, if born before 1/1/36, a portion taxed at 20% LTCG, balance over 10 years.		No	No	No
5 Distribution	10 Year Forward Averaging		No	No	No	No			Yes, substantially equal payment over 10 years.		No	No	No

5 Distribution	Mandatory Distribution		Yes, April 1 of year after reaching $70\frac{1}{2}$	Only after death of owner	April 1 following the later of year of age $70\frac{1}{2}$ or retirement if not a 5% owner	April 1 following the later of year of age $70\frac{1}{2}$ or retirement if not a 5% owner	April 1 of calendar year age $70\frac{1}{2}$ or year employee retires	Same as simple IRA	April 1 following the later of year of age $70\frac{1}{2}$ or retirement if not a 5% owner		Subject to normal RMD rules may extend if working past $70\frac{1}{2}$	Subject to normal RMD rules may extend if working past $70\frac{1}{2}$	Subject to normal RMD rules may extend if working past $70\frac{1}{2}$
5 Distribution	Hardship Distributions		Yes, death, age $59\frac{1}{2}$, disability, substantially equal pay-ments med-ical > 7.5% AGI, QDRO, education expense, first time home up to $10,000, payment health premium if unemployed >12 weeks	Yes, death, age $59\frac{1}{2}$, disability, substantially equal pay-ments med-ical > 7.5% AGI, QDRO, education expense, first time home up to $10,000, payments health premium if unemployed >12 weeks	Yes, age $59\frac{1}{2}$ or death, disability	Yes, age $59\frac{1}{2}$ or death, disability	Yes, death, disability, medical, education, first time home purchase, health insurance premium for unemployed, QDRO	Immediate and heavy, medical, education, home purchase, mortgage payment, funeral expenses	Yes, medical, principal residence, postsec-ondary tuition, prevent eviction. Not for beach house on Montserrat		Unforseeable emergencies and must be defined by plan	Unforseeable emergencies and must be defined by plan	None
5 Distribution	In Service Withdrawals		No	No	No	No	Yes, but possible 10% penalty if before $59\frac{1}{2}$ and if made within first 2 years of participation 25% penalty	Yes, after 2 years	Yes, pre and post $59\frac{1}{2}$		If plan allows, one time avail-able subject to < $5000; no deferred comp in last 2 years; not used option previously	If plan allows, one time avail-able subject to < $5000; no deferred comp in last 2 years; not used option previously	No
5 Distribution	Plan Loans		No	No	No	No	No	Yes	Loans permitted, repaid within 5 years or treated as income		If plan document allows	If plan document allows	No

(continued)

Broad Category	Category	Age Based	IRA		SEP	SARSEP	SIMPLE		403 B		457 Plans		
			Traditional	Roth		No longer offered	IRA	401K	Traditional	Roth	Eligible Funded Government	Eligible Unfunded Tax Exempt	Ineligible
5 Distribution	Rollovers		Yes, to a Roth, IRA, SEP, qualified plan, 403b, or government 457 1 × per year.	Only to another plan that accepts after-tax contributions or into a traditional IRA. Direct rollover only.	Yes from 1 SEP to another or to a Roth or individual IRA, qualified plan, TSA, or governmental 457 plan to an Individual IRA. In past to SARSEP but to longer since 1996	Yes from 1 SEP to another or to a Roth or individual IRA, qualified plan, TSA, or governmental 457 plan to an Individual IRA. In past to SARSEP but no longer since 1996	Yes to another simple IRA, IRA after 2 years, or SEP	Yes to another qualified plan, IRA	Yes, to another qualified plan or IRR.		Rollovers to IRA allowed	Rollovers to IRA allowed	None permitted
5 Distribution	Early Withdrawal Penalty Exclusions		See hardship withdrawals	Plan must be in place at least 5 years; FIFO; $59\frac{1}{2}$, after death of owner, after disability of owner, 10,000 First Home distribution.	Medical, disability, hardship withdrawals	Medical, disability, hardship withdrawals	except for hardship, and if not $59\frac{1}{2}$ penalty is 25% in first 2 years, 10% after 2 years	Except for hardship, 10% penalty before $59\frac{1}{2}$	Death, disability early retirement age 55, medical expenses >7.5% AGI.		Subject to 10% no exclusion	Subject to 10% no exclusion	Subject to 10% no exclusion

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