Question #1 of 22

Question ID: 1552755

Roscoe Stone has a concentrated position in an energy company. He would like to manage his concentrated position, but he has explicitly stated that he must retain ownership of the concentrated position. Which of the following techniques is Stone *most likely* to implement?

A) Staged diversification.

B) Completion portfolio.

C) Exchange fund.

Explanation

A completion portfolio is an index-based portfolio that, when added to the concentrated position, creates an overall portfolio with exposures similar to the investor's benchmark. It allows the investor to retain ownership of the concentrated position.

An exchange fund involves numerous investors (each with a concentrated position in a single stock with a low cost basis) contributing their holdings into a newly formed exchange fund and then each owning a pro rata share of the new fund. As a result, it involves giving up most of the ownership of the initial concentrated position, which is against Stone's objective.

A staged diversification strategy (e.g., selling stock over several years) is good in that it spreads the tax liability out over time, but it means losing ownership of the concentrated position, which is against Stone's objective.

(Module 20.3, LOS 20.g)

Question #2 of 22

Question ID: 1552738

Jason Lee lives in a tax jurisdiction with a flat tax rate of 20%, which applies to all types of income and capital gains. Assume that Lee has the following account types each with an initial contribution of $1 million:

- A tax-deferred account (TDA) earning 10%; tax deductions permitted on TDA contributions and assumed to be fully reinvested in the TDA
- A tax-exempt account (TEA) earning 10%

Assuming full liquidation in 20 years and no withdrawals before full liquidation, which of the following statements regarding Lee's accounts is *most* accurate?

A) The TEA will have the highest balance at the end of 20 years.

B) The TDA will have the highest balance at the end of 20 years.

C) The TDA and TEA will have the same balance at the end of 20 years.

Explanation

TDA balance: If a tax deduction were allowed with the TDA and the amounts fully reinvested in a TDA, a gross contribution can be made of \$1,000,000 / (1 – 0.20) = \$1,250,000 and the FV_{AT} = \$1,250,000 × $[(1 + 0.10)^{20}(1 - 0.20)]$ = \$6,727,500.

TEA balance: FV_{AT} = \$1,000,000 × $(1 + 0.10)^{20}$ = \$6,727,500.

(Module 20.2, LOS 20.d)

Question #3 of 22

Question ID: 1552746

Christina Mels is a private investor whose wealth is invested in exchange-traded funds (ETFs) and mutual funds. Which of the following statements is *most accurate* with respect to losses realized within the mutual funds?

A) The realized losses can be used to offset realized gains within the mutual fund.

B) The realized losses from the mutual funds can be used to offset realized gains in the ETFs.

C) The realized losses are distributed to shareholders.

Explanation

In many tax jurisdictions, losses realized within the mutual funds can only be offset against gains realized within the mutual funds. Losses from the mutual funds are not distributed to shareholders—and therefore, they cannot be used to offset realized gains in the ETFs.

(Module 20.3, LOS 20.f)

Question #4 of 22

Question ID: 1552724

Estate taxes are an example of a tax on:

A) the value of assets owned.

B) capital gains on assets transferred.

C) a percentage of assets gifted.

Explanation

Estate taxes are a tax based upon the value of assets owned by the decedent.

(Module 20.1, LOS 20.a)

Question #5 of 22

Question ID: 1552774

Peter McArthur lives in a tax jurisdiction that has a progressive tax structure and a $5 million lifetime gift exclusion. Gift and estate tax rates are 15% and 10%, respectively, and he expects to live for another five years. McArthur has $20 million in a private company investment with $18 million in unrealized gains. Based only the information provided, which of the following strategies would *best* achieve McArthur's objective of minimizing total taxes paid?

A) Gift the investment now to his only child.

B) Donate his investment to a qualified charity.

C) Leave the investment as a bequest to his only child.

Explanation

Donating the investment to charity is typically a tax-free transaction, even if the assets have significant unrealized gains. Additionally, the donation itself is likely to provide a tax credit/donation based on the fair market value of the investment at the time of the donation.

A gift will attract tax based on the value of the investment less the $5 million lifetime gift exclusion (assuming Peter has not used any of the gift exclusion yet).

A bequest will attract tax based on the value of the investment.

(Module 20.4, LOS 20.j)

Question #6 of 22

Question ID: 1552768

Which of the following equations represents the relative value of a gift *when the gift taxes are paid by the receiver*?

A) $\dfrac{[1+r_e(1 - t_{ie})]^n(1 - T_e)}{\left[\left(1 - T_g\right)\right]\left[1+r_g\left(1 - t_{ig}\right)\right]^n}$

B) $\dfrac{\left[\left(1 - T_g\right)\right]\left[1+r_g\left(1 - t_{ig}\right)\right]^n}{[1+r_e(1 - t_{ie})]^n(1 - T_e)}$

C) $\dfrac{\left[1+r_g\left(1 - t_{ig}\right)\right]^n}{[1+r_e(1 - t_{ie})]^n(1 - T_e)}$

Explanation

Equation #1 below shows the relative value of a *taxable* gift (numerator) when the *gift is subject to gift taxes* paid by the receiver compared to if it is gifted as part of an estate (denominator).

$$1.\ RV_{\text{taxable gift}} = \frac{FV_{\text{taxable gift}}}{FV_{\text{bequest}}} = \frac{\left[\left(1 - T_g\right)\right]\left[1+r_g\left(1 - t_{ig}\right)\right]^n}{[1+r_e(1 - t_{ie})]^n(1 - T_e)}$$

Equation #2 below shows the relative value of a *tax free* gift if it is gifted today (numerator) compared to if it is gifted as part of an estate (denominator).

$$2.\ RV_{\text{tax-free gift}} = \frac{FV_{\text{tax-free gift}}}{FV_{\text{bequest}}} = \frac{\left[1+r_g\left(1 - t_{ig}\right)\right]^n}{[1+r_e(1 - t_{ie})]^n(1 - T_e)}$$

Equation #3 is Equation #1, but it incorrectly reverses the numerator and denominator.

(Module 20.4, LOS 20.j)

Question #7 of 22

Question ID: 1552732

Frank Li is a Canadian citizen who owns real estate in the United States through a Canadian corporation. Li's beneficiaries are his children, who are Canadian citizens living in Canada. On Li's death, the value of the assets would be subject to:

A) U.S. taxes only.

B) both U.S. and Canadian taxes.

C) Canadian taxes only.

Explanation

Although investments in the United States may be subject to U.S. estate taxes, non-U.S. companies are not subject to U.S. taxation. Therefore, the shares of the Canadian corporation would pass to Li's beneficiaries and would be subject to Canadian taxes only.

(Study Session 18, Module 67.1, LOS 67.h)

Question #8 of 22

Question ID: 1552754

With no other information to go on, the lowest specific risk in a concentrated position would most likely be for the owner of:

A) investment real estate.

B) publicly traded common shares.

C) a privately held business.

Explanation

With nothing else to go on the public nature and liquidity would suggest the public shares should have the lowest specific risk.

(Module 20.3, LOS 20.g)

Question #9 of 22

Question ID: 1552785

A wealth owner is *most likely* to make a trust the beneficiary on a life insurance policy in which of the following circumstances?

A) The wealth owner wishes to leave money to a charity.

B) The ultimate beneficiary is a minor.

C) The tax on gifts is high.

Explanation

The trust can be structured to allow the trustee to use the trust assets to provide for the beneficiary's needs, but delay transfer of the assets until the minor is old enough to take responsibility for the assets. Given the case facts there is no particular reason not to make a direct distribution to the charity. It might even be better to make an outright gift now and get a tax deduction now. There is no information to assume gift tax rates would be treated differently for a direct payout or payout to a trust.

(Module 20.5, LOS 20.k)

Question #10 of 22

Question ID: 1552744

The client objective motivating a monetization strategy is *least likely* to be:

A) a tax efficient exit strategy.

B) provide funds to meet portfolio objectives.

C) increase portfolio systematic risk.

Explanation

Increasing systematic (market) risk is least likely. The client may need to increase, decrease, or leave systematic (market) risk unchanged. Decreasing non-systematic (or asset specific) risk, providing funds for portfolio objectives, and tax efficiency are common objectives in monetization.

(Module 20.3, LOS 20.f)

Question #11 of 22

Question ID: 1552771

When an investor makes a charitable gift of appreciated securities:

A) usually no gift transfer taxes are assessed.

B) the tax rate is based upon the gifting rate.

C) the recipient must pay the capital gains taxes.

Explanation

When an investor makes a gift of appreciated securities usually no gift transfer taxes are due, the investor donating the securities is allowed to take an income tax deduction in the amount of the fair market value of the securities, and no capital gains taxes are assessed so the investment continues to grow tax free at the charitable organization.

(Module 20.4, LOS 20.j)

Question #12 of 22

Question ID: 1552756

The purpose of a personal line of credit secured by company stock for the owner of a private business is generally to:

A) extract cash from the business so the owner can use the funds for personal purposes. ✓

B) convert the remaining ownership position to public stock. ✗

C) exit any responsibility for managing the business. ✗

Explanation

This is a monetization strategy that provides the owner with funds to use for other objectives. The shares are still owned and the owner still has control of the company. It does not convert shares to public stock, an IPO might accomplish that.

(Module 20.3, LOS 20.h)

Question #13 of 22

Question ID: 1552770

Maddie, 77, is wondering whether it would be wise to help her granddaughter, Emily, reduce her mortgage with funds Maddie plans to leave to Emily in her will. Maddie has $150,000 available to gift today and has a life expectancy of two years. If Maddie holds onto the funds she expects to earn 3.0% annually, subject to an effective rate of tax of 18%. The rate of return that Emily will receive is expected to be 4.5% annually which is effectively the rate of interest on the mortgage. Emily's effective tax rate on these funds will be 0%. If the tax on gifts is 40% and the tax on estate bequests is 35%, should Maddie gift the funds now assuming Emily pays the gift tax:

A) Yes, as the relative value of the taxable gift is greater than 1. ✗

B) No, as the relative value of the taxable gift is less than 1.

C) No, as the estate tax is less than the gift tax.

Explanation

$$\mathrm{RV_{taxable}} = \frac{\left[1+\mathrm{r_g}(1-\mathrm{t_{ig}})\right]^{\mathrm{n}}(1-\mathrm{T_g})}{\left[1+\mathrm{r_e}(1-\mathrm{t_{ie}})\right]^{\mathrm{n}}(1-\mathrm{T_e})}$$
$$= \frac{\left[1+0.045(1-0.0)\right]^{2}(1-0.40)}{\left[1+0.03(1-0.18)\right]^{2}(1-0.35)}$$
$$= \frac{0.6552}{0.6824} = 0.96$$

The relative value of the gift is less than 1.0, it would be more beneficial for the transfer to occur upon Maddie's death. Note that the answer choices all focus on RV considerations only so do not bring up other issues (e.g. there is another benefit in that by waiting, Maddie retains the ability to change her mind). Also the assumption of 0% tax on the mortgage interest was explicitly given and also reasonable. Interest is often tax deductible so $100 of interest costs $100 of pretax income and reduces after-tax disposable income by $100, an effective tax on the deductible interest of 0%.

(Module 20.4, LOS 20.j)

Question #14 of 22

Question ID: 1552736

An investor has €600,000 invested in equity in a TDA and €400,000 invested in bonds in a tax-exempt account. The relevant tax rate is 35%. What is the investor's asset allocation on an after-tax basis?

A) 69.8% in stocks and 30.2% in bonds.

B) 49.4% in stocks and 50.6% in bonds.

C) 44.9% in stocks and 55.1% in bonds.

Explanation

The investor has €390,000 [(€600,000 × (1 – 0.35)] invested in equity on an after-tax basis. The bonds in the tax-exempt account are not subject to taxation. On an after-tax basis, the investor has 49.4% in equity [390,000 / (390,000 + 400,000)] and the other 50.6% in bonds [400,000 / (390,000 + 400,000)].

(Module 20.2, LOS 20.d)

Question #15 of 22

Question ID: 1552764

The primary motivation for estate planning is to:

A) match investment horizon objectives.

B) maximize returns.

C) minimize taxes.

Explanation

The primary motivation for estate planning is to minimize taxes.

(Module 20.4, LOS 20.i)

Question #16 of 22

Question ID: 1552747

An investor who is looking for the greatest level of tax flexibility with the ability to offset realized gains and losses against all of his investments would benefit most from:

A) a mutual fund.

B) a separately managed account.

C) an exchange-traded fund.

Explanation

Separately managed accounts offer the most flexibility for tax management because realized losses and gains can be used across all of the investors' investment accounts. In contrast, mutual funds and ETFs do not distribute realized losses to shareholders directly—therefore, the losses cannot be offset.

(Module 20.3, LOS 20.f)

Question #17 of 22

Question ID: 1552751

Gertrude has a $1 million position in a single publicly-traded stock that constitutes 75% of her total investment assets. As Gertrude is about to retire, she is contemplating that a key objective is to ensure that she generates the highest cash flow from her investment assets during her retirement period. Which of the following objectives is Gertrude *least likely* to be considering when managing her concentrated position?

A) Optimize tax efficiency.

B) Reduce risk.

C) Generate liquidity.

Explanation

The facts suggest that Gertrude needs to generate liquidity from the portfolio to meet her retirement spending needs. As well, in generating the highest cash flow, it clearly implies that she wants to optimize tax efficiency to maximize the after-tax cash flows. There are no facts to directly suggest that Gertrude is wanting to reduce the risk caused by the wealth concentration.

(Module 20.3, LOS 20.g)

Question #18 of 22

Question ID: 1552772

When an investor makes a charitable gift of appreciated securities, in most instances the investor is:

A) able to take a deduction in the amount of the current fair market value of the gift.

B) able to take a deduction in the amount of the capital gain.

C) not able to take a deduction.

Explanation

When an investor makes a gift of appreciated securities to a charitable organization, in most countries the investor is able to take a deduction in the amount of the current fair market value of the gift.

(Module 20.4, LOS 20.j)

Question #19 of 22

Question ID: 1552748

Marcy invested $500,000 in a mutual fund at the beginning of the year. At the end of the year, if her investment value remained $500,000, she:

A) would not have to pay income taxes.

B) could be required to pay income taxes.

C) would only have to pay taxes if she had dispositions from the mutual fund.

Explanation

Although Marcy's investment value has not appreciated, she would be required to pay taxes if the fund manager sold some of the underlying holdings and realized capital gains, which would be distributed to all shareholders. Marcy would not necessarily have to pay taxes if she had dispositions from the mutual fund because those dispositions could have occurred at a loss, the latter of which would not require an income tax payment.

(Module 20.3, LOS 20.f)

Question #20 of 22

Question ID: 1552733

Dora Sandro is an Italian citizen with a substantial equity investment portfolio in the United States. In consultation with her tax advisor, she determined that her U.S. investment portfolio would be subject to 30% withholding tax on dividends, while capital gains on stocks would not be taxed by the United States. Sandro should *most appropriately* consider:

A) high-growth, low-dividend equities.

B) low-growth, high-dividend equities.

C) low-growth, low-dividend equities.

Explanation

The most tax-advantageous investment strategy would emphasize high-growth stocks (because capital gains are not subject to U.S. tax) with low-dividend yields (because dividends are subject to withholding taxes).

(Study Session 18, Module 67.1, LOS 67.h)

Question #21 of 22

Question ID: 1552784

In relation to trusts, which of the following is *least* correct?

A) In a revocable trust the settlor who funds the trust is likely to be responsible for the trust's tax liabilities.

B) **In a discretionary trust the trustee has complete discretion to distribute the assets and income earned in the trust.**

C) An individual concerned with future legal liabilities should most likely consider an irrevocable trust.

Explanation

The trustee of a discretionary trust has discretion to make decisions consistent with the directions in and intent of the trust document; not unlimited discretion. Thus the statement of complete discretion is least correct. The other statements are true. Revocable trusts normally have no tax advantages and the grantor remains responsible for the tax liabilities of the trust. An irrevocable trust may have legal advantages in sheltering the trust assets from claims on the grantor.

(Module 20.5, LOS 20.k)

Question #22 of 22

Question ID: 1552769

Hans, 70, is considering gifting up to the tax-free limit of €200,000 to his son to help reduce the estate tax (25%) that would be payable when he passes away. Hans' effective tax rate is 20% and his son's effective tax rate is 30%. If Hans is expected to pass away in 10 years, what is the relative value of making the gift? Assume both Hans and his son earn a 5% annual pretax rate of return on the funds.

A) **1.33.**

B) 1.57.

C) 1.27.

Explanation

$$\mathrm{RV}_{\text{tax-free}} = \frac{\left[1+\mathrm{r_g}(1-\mathrm{t_{ig}})\right]^{\mathrm{n}}}{\left[1+\mathrm{r_e}(1-t_{\mathrm{ie}})\right]^{\mathrm{n}}(1-T_{\mathrm{e}})}$$

$$= \frac{\left[1+0.05(1-0.30)\right]^{10}}{\left[1+0.05(1-0.20)\right]^{10}(1-0.25)}$$

$$= \frac{1.4106}{1.1102} = 1.27$$

(Module 20.4, LOS 20.j)