Certified Financial Planner (CFP) Tax Planning Practice Exam (Sample)

Study Guide

Everything you need from our exam experts!

Questions

1. **What amount of installment sale income must a seller recognize in the current year if they sold an antique automobile?**
   - A. $7,667
   - B. $23,000
   - C. $7,334
   - D. $15,333

2. **What is the primary difference between a tax deduction and a tax credit?**
   - A. A tax deduction reduces taxable income; a tax credit reduces tax owed dollar for dollar
   - B. A tax credit is more beneficial than a tax deduction
   - C. A tax deduction is available only to businesses; a tax credit is for individuals
   - D. A tax credit can be carried forward; a tax deduction cannot

3. **What is Yukiko's maximum allowable investment interest expense deduction for the current year?**
   - A. $4,000
   - B. $3,500
   - C. $1,750
   - D. $5,000

4. **What typically triggers the need for income splitting in tax planning?**
   - A. Higher income earning sole proprietorships
   - B. Family members in lower tax brackets
   - C. Investment properties owned jointly
   - D. Dependents filing their own tax returns

5. **What are Required Minimum Distributions (RMDs)?**
   - A. Voluntary withdrawals from retirement accounts
   - B. Mandatory withdrawals from retirement accounts starting at age 73
   - C. Withdrawals designed to avoid penalties from early retirement
   - D. Selective withdrawals based on income levels

6. **Regarding the sale of Hayley's shares in the XYZ Growth Mutual Fund, which statement is accurate?**
   - **A. If she purchased shares in a different fund within 30 days, the $2,500 loss would be disallowed.**
   - **B. The basis in the newly acquired shares would include the disallowed loss amount.**
   - **C. She should wait at least 60 days after the sale to repurchase the shares.**
   - **D. The loss would be fully deductible as a capital loss.**

7. **What is the role of tax deductions in tax planning?**
   - **A. They increase taxable income**
   - **B. They reduce taxable income and thus lower tax liability**
   - **C. They are only applicable to businesses**
   - **D. They have no effect on tax liability**

8. **How is interest related to a rental property treated on a tax return if the property is for personal use?**
   - **A. It is reported as rental income.**
   - **B. It may be deductible as mortgage interest.**
   - **C. It is reported as capital gains.**
   - **D. It cannot be deducted under any circumstances.**

9. **What typically triggers an audit by the IRS?**
   - **A. Being selected randomly without any specific reason**
   - **B. High income levels alone**
   - **C. Discrepancies or red flags in submitted tax returns**
   - **D. Filing an amendment to a previous return**

10. **What is the implication of having different fiscal years for Mark and Beth on their tax filings?**
    - **A. They can file jointly**
    - **B. They may not use married filing jointly status**
    - **C. They must both file single**
    - **D. They can only file as qualifying widowers**

Answers

1. **D**
2. **A**
3. **B**
4. **B**
5. **B**
6. **A**
7. **B**
8. **B**
9. **C**
10. **B**

Explanations

1. **What amount of installment sale income must a seller recognize in the current year if they sold an antique automobile?**

   A. $7,667

   B. $23,000

   C. $7,334

   D. $15,333

When determining the amount of installment sale income a seller must recognize in the current year, it's important to understand the basics of the installment sale method. This approach allows the seller to recognize income as payments are received rather than all at once at the time of sale. The key components to consider when calculating the recognized income are the gross profit, the total contract price, and the payments received during the tax year. The formula used is: Recognized Income = (Payments Received in Current Year) x (Gross Profit Percentage) To arrive at the correct amount, one would typically have calculated the total gain from the sale, including the total selling price and the seller's basis in the asset. The gross profit percentage is calculated by dividing the total gain by the total contract price. Once you have this percentage, you apply it to the payments received during the year to determine how much income should be recognized for tax purposes in that year. In this scenario, if the recognized amount is $15,333, it is likely that this figure represents the calculated portion of the payments received that corresponds with the seller's gross profit on the sale of the antique automobile for that current tax year. This means the seller is only taxed on the portion of the gain that corresponds

2. **What is the primary difference between a tax deduction and a tax credit?**

   A. A tax deduction reduces taxable income; a tax credit reduces tax owed dollar for dollar

   B. A tax credit is more beneficial than a tax deduction

   C. A tax deduction is available only to businesses; a tax credit is for individuals

   D. A tax credit can be carried forward; a tax deduction cannot

The primary difference between a tax deduction and a tax credit lies in how they impact a taxpayer's financial situation, particularly in terms of taxable income and tax owed. A tax deduction reduces a taxpayer's taxable income, which in turn decreases the amount of income that is subject to taxation. This means that the taxpayer pays taxes on a smaller income base, leading to potential savings, but the actual amount saved depends on their tax rate. Conversely, a tax credit directly reduces the amount of tax owed on a dollar-for-dollar basis. For example, if a taxpayer owes $1,000 in taxes and qualifies for a $200 tax credit, their tax liability drops to $800. This makes tax credits generally more valuable than deductions because they have a direct effect on the amount of tax owed, regardless of the taxpayer's income level or tax bracket. The other options present various misconceptions about deductions and credits that don't accurately capture their fundamental differences or practical implications. Understanding the operation of deductions and credits is crucial for effective tax planning.

3. What is Yukiko's maximum allowable investment interest expense deduction for the current year?

- A. $4,000
- B. $3,500
- C. $1,750
- D. $5,000

To determine Yukiko's maximum allowable investment interest expense deduction, it's important to understand the rules surrounding such deductions. The maximum deduction for investment interest expense is limited to the taxpayer's net investment income for the year. This means that if Yukiko has a specific amount of net investment income, her investment interest expense deduction cannot exceed that income, regardless of how much interest she paid. In this case, if the correct answer is $3,500, this implies that Yukiko's net investment income is likely around that amount, allowing her to deduct that entire figure. This highlights the importance of accurately calculating net investment income, which includes interest, dividends, and capital gains, as these are critical to knowing how much of the investment interest expense she can deduct. The other options reflect either higher potential deductions than her net investment income permits or do not match the calculated limit based on her actual investment income for the year. Therefore, the choice of $3,500 as her maximum allowable deduction is appropriate based on the limitation set forth by her net investment income.

4. What typically triggers the need for income splitting in tax planning?

- A. Higher income earning sole proprietorships
- B. Family members in lower tax brackets
- C. Investment properties owned jointly
- D. Dependents filing their own tax returns

The need for income splitting in tax planning is often triggered by family members in lower tax brackets. Income splitting involves distributing income among family members to take advantage of the lower tax rates applicable to those who earn less. This is particularly relevant when one family member has a significantly higher income than another, as it allows the family to optimize their overall tax liability by minimizing the combined tax burden. By shifting some of the higher earner's taxable income to a lower-earning family member, it can result in tax savings, as the lower income will often be taxed at a lower rate. In the context of other options, while high income-earning sole proprietorships may generate significant income, that alone does not create the same dynamic for income splitting unless family members are involved in the business. Investment properties owned jointly can present opportunities for deductions or credits but do not inherently require income splitting for tax efficiency. Lastly, dependents filing their own tax returns typically do so for independence or personal income, and while their lower tax situation could theoretically permit some level of income splitting, the primary trigger is primarily associated with family members actively working to minimize the tax impact through strategic allocation of income.

5. What are Required Minimum Distributions (RMDs)?

A. Voluntary withdrawals from retirement accounts

B. Mandatory withdrawals from retirement accounts starting at age 73

C. Withdrawals designed to avoid penalties from early retirement

D. Selective withdrawals based on income levels

Required Minimum Distributions (RMDs) are mandatory withdrawals that individuals must begin taking from their retirement accounts starting at age 73, according to current regulations. The IRS requires these distributions to ensure that individuals do not defer taxes indefinitely on their retirement savings. The goal is to encourage the depletion of tax-deferred accounts over the retiree's lifetime. As individuals reach the age of 73, they must calculate their RMD based on the account balance as of the previous year divided by a life expectancy factor published by the IRS. This ensures that individuals withdraw a portion of their retirement savings each year, thereby paying the necessary taxes on those funds. While voluntary withdrawals or early retirement penalties may represent withdrawal strategies, they do not encapsulate the mandatory nature and specific age requirement that defines RMDs. The income level-based withdrawals are also unrelated to RMDs, which are strictly focused on ensuring minimum distributions at a certain age regardless of income. This distinction highlights the regulatory framework and tax implications surrounding retirement fund distributions, emphasizing the importance of compliance with RMD rules to avoid penalties.

6. Regarding the sale of Hayley's shares in the XYZ Growth Mutual Fund, which statement is accurate?

A. If she purchased shares in a different fund within 30 days, the $2,500 loss would be disallowed.

B. The basis in the newly acquired shares would include the disallowed loss amount.

C. She should wait at least 60 days after the sale to repurchase the shares.

D. The loss would be fully deductible as a capital loss.

When dealing with capital gains and losses in the context of mutual funds and the Internal Revenue Code, it's crucial to understand the implications of the wash sale rule. This rule applies when a taxpayer sells a security at a loss and then repurchases the same security or substantially identical stock or securities within a 30-day period before or after the sale. Under these circumstances, if Hayley were to sell her shares in the XYZ Growth Mutual Fund and then repurchase shares in the same or a substantially identical fund within the 30-day window, the loss she incurred—$2,500 in this case—would indeed be disallowed for current tax purposes. This disallowed loss does not mean that Hayley loses it entirely; instead, it is added to the basis of the new shares she purchases. However, for the accuracy of the specific scenario presented, it highlights that immediate repurchase of the same mutual fund or a substantially similar one can affect the deductibility of capital losses. Therefore, the concern revolves around the timing of repurchase actions in relation to loss realization. Understanding this aspect of tax law is crucial for accurate tax planning, as it affects how capital losses and gains are recognized and utilized for tax benefits. Additionally, knowing the implications of wash sales helps

7. What is the role of tax deductions in tax planning?

A. They increase taxable income

B. They reduce taxable income and thus lower tax liability

C. They are only applicable to businesses

D. They have no effect on tax liability

Tax deductions play a crucial role in tax planning as they reduce taxable income, which subsequently lowers tax liability. When an individual or entity claims a tax deduction, it essentially lowers the amount of income that is subject to taxation. For instance, if a taxpayer has an annual income of $50,000 and claims $10,000 in deductions, the taxable income is effectively reduced to $40,000. This reduction leads to a smaller tax bill because taxes are levied on the lower amount. Furthermore, the logic behind utilizing tax deductions is central to strategies aimed at optimizing tax outcomes. By identifying eligible deductions, taxpayers can maximize their savings and make informed decisions regarding spending, investment, and other financial activities. This is critical not just for individuals, but also for businesses, as they often utilize deductions to manage their overall tax burden effectively. Overall, understanding the role of tax deductions empowers taxpayers to engage in more effective tax planning, allowing them to keep more of their income and make strategic financial choices.

8. How is interest related to a rental property treated on a tax return if the property is for personal use?

A. It is reported as rental income.

B. It may be deductible as mortgage interest.

C. It is reported as capital gains.

D. It cannot be deducted under any circumstances.

When it comes to personal use rental property, the treatment of interest on a tax return is particularly important. In cases where a property is used for personal purposes, mortgage interest typically may be deductible as mortgage interest, adhering to the guidelines set forth by the IRS. This deduction is available for qualifying mortgage interest on property used as a personal residence. Taxpayers can typically deduct mortgage interest on their primary home and possibly a second home, contributing to the overall taxable income computation. However, the deductibility of interest does depend on various factors including the classification of the property and the proportion of personal versus rental use. In contrast, the other options describe scenarios that do not accurately apply to the treatment of interest for personal use rental properties. Rental income, capital gains, and complete nondeductibility under the given circumstances do not align with the typical tax treatment of mortgage interest on personal use properties. Thus, the ability to deduct this interest provides a significant tax benefit to property owners, making it a key aspect of tax planning for rental property owners who also occupy their properties personally.

9. What typically triggers an audit by the IRS?

A. Being selected randomly without any specific reason

B. High income levels alone

C. Discrepancies or red flags in submitted tax returns

D. Filing an amendment to a previous return

An audit by the IRS is typically triggered when there are discrepancies or red flags in submitted tax returns. This can include inconsistencies between reported income and third-party documents, unusual deductions that are significantly higher than the norm for a specific income level, or failure to report all income sources. The IRS uses sophisticated algorithms and data analysis techniques to identify returns that present anomalies, raising the likelihood that further scrutiny is warranted. While a random selection for audit does occur, it is not a common or primary trigger. High income levels alone do not necessarily provoke an audit unless accompanied by unusual activity or discrepancies. Filing an amendment, on the other hand, does not inherently lead to an audit but may draw the attention of the IRS if the amendment itself shows substantial changes that deviate from previously reported information. Thus, discrepancies or significant red flags in tax returns are the most critical factors that compel the IRS to initiate an audit.

10. What is the implication of having different fiscal years for Mark and Beth on their tax filings?

A. They can file jointly

B. They may not use married filing jointly status

C. They must both file single

D. They can only file as qualifying widowers

When Mark and Beth have different fiscal years, this creates a situation where they may be restricted in the tax filing status they can use. Generally, married couples are allowed to file jointly, which can provide them with various tax benefits. However, in order to file jointly, both spouses must have the same tax year. Since fiscal years can differ, this means that they do not align in terms of their accounting and tax periods. For tax purposes, the IRS requires that both spouses be on the same fiscal year to qualify for the married filing jointly status. Therefore, if Mark and Beth are on different fiscal years, they may not utilize this beneficial filing status, leading them to explore other options that are available to them under different filing statuses. This understanding is important for planning and making tax-efficient decisions, especially for married couples, as the choice of filing status can significantly affect their tax liability and eligibility for certain credits and deductions.