

# Equity Compensation Strategies 2008

## Module 3 Exam

This document provides the Module 3 exam for the *Equity Compensation Strategies 2008* course of study. The exam is based on material appearing in the 2008 edition of the book *Equity Compensation Strategies*. Further information is available at [www.fairmark.com/ecs](http://www.fairmark.com/ecs).

- **Deadline.** Answers must be submitted no later than December 31, 2009.
- **Processing fee.** A processing fee of \$60 is required for this exam. The fee can be paid online at [www.fairmark.com/ecs/exams.htm](http://www.fairmark.com/ecs/exams.htm) (preferred method). You can also pay by check or provide credit card information on the attached answer sheet.
- **Submissions.** Fax the answer sheet to (224) 535-9440 or mail it to:  
Fairmark Press Inc.  
P.O. Box 6175  
Elgin, IL 60121
- **Continuing education.** Provide your CFP number for 6 hours of continuing education credit with a score of 70% or better.
- **Questions?** Call (630) 728-3835 or email [info@fairmark.com](mailto:info@fairmark.com).

## Module 3 Evaluation Form

Please fill out this evaluation form and submit it with your answer sheet.

---

	Strongly disagree				Strongly agree
Content was relevant	1	2	3	4	5
Learning objectives were met	1	2	3	4	5
Content was current and accurate	1	2	3	4	5
Explanations were clear	1	2	3	4	5
I would recommend to others	1	2	3	4	5

---

Comments/suggestions:

---

**Equity Compensation Strategies 2008**  
**Module 3 Answer Sheet**  
*Please Print Legibly*

Office Use
Date _____
Score _____

Name: \_\_\_\_\_

Company: \_\_\_\_\_

Address: \_\_\_\_\_

City, State, ZIP: \_\_\_\_\_

Telephone: \_\_\_\_\_

Email: \_\_\_\_\_

**Circle your response to each question**

- |             |             |             |
|-------------|-------------|-------------|
| 1. A B C D  | 13. A B C D | 25. A B C D |
| 2. A B C D  | 14. A B C D | 26. A B C D |
| 3. A B C D  | 15. A B C D | 27. A B C D |
| 4. A B C D  | 16. A B C D | 28. A B C D |
| 5. A B C D  | 17. A B C D | 29. A B C D |
| 6. A B C D  | 18. A B C D | 30. A B C D |
| 7. A B C D  | 19. A B C D | 31. A B C D |
| 8. A B C D  | 20. A B C D | 32. A B C D |
| 9. A B C D  | 21. A B C D | 33. A B C D |
| 10. A B C D | 22. A B C D | 34. A B C D |
| 11. A B C D | 23. A B C D | 35. A B C D |
| 12. A B C D | 24. A B C D |             |
-

## Equity Compensation Strategies

### Module 3 Exam Questions

1. Your client's option is intended to qualify as an incentive stock option. The option agreement says he may exercise the option for a period of up to one year after termination of employment, provided that the option has not otherwise expired. What is the effect of this provision on the status of the option as an incentive stock option?
    - A. An option with this provision cannot qualify as an incentive stock option.
    - B. The option will lose its status as an incentive stock option upon termination of employment.
    - C. The option will lose its status as an incentive stock option if it is exercised more than three months after termination of employment, except in case of death or disability.
    - D. The provision has no effect on the option's status as an incentive stock option.
  2. Which of the following would cause partial disqualification of an incentive stock option?
    - A. More than \$100,000 in incentive stock options were granted in a single year.
    - B. More than \$100,000 in incentive stock options became exercisable in a single year.
    - C. More than \$100,000 in incentive stock options were exercised in a single year.
    - D. More than \$100,000 in shares acquired from incentive stock options were sold in a single year.
  3. Your client avoids a disqualifying disposition of stock from exercising an incentive stock option if the disposition occurs:
    - A. After the end of the year of exercise.
    - B. More than one year after the date of exercise.
    - C. More than one year after the date of exercise or two years after the date the option was granted, whichever is earlier.
    - D. More than one year after the date of exercise or two years after the date the option was granted, whichever is later.
  4. Less than a year after exercising an incentive stock option your client transferred some of the shares to his wife and donated some of the shares to a charity. Which of these transfers resulted in a disqualifying disposition?
    - A. The transfer to his wife.
    - B. The charitable donation.
    - C. Both of these transfers.
    - D. Neither of these transfers.
  5. Your client exercised an incentive stock option, paying \$20,000 to buy shares worth \$100,000. Later in the same calendar year the stock price collapsed and she sold the shares for \$35,000. On her Schedule D for that year she should report:
    - A. A capital loss of \$65,000 (subject to the \$3,000 capital loss limitation).
    - B. A capital gain of \$15,000.
    - C. A sale at zero gain or loss.
    - D. Nothing.
-

6. Your client exercised an incentive stock option, paying \$25,000 for stock worth \$225,000. Later that year the stock price collapsed and in December of the same year your client donated the shares to a charity. The value of the shares on the date of the charitable contribution was \$50,000. Your client's tax return for the year will reflect:
- A. No compensation income and a \$50,000 charitable contribution deduction.
  - B. \$25,000 of compensation income and a \$50,000 charitable contribution deduction.
  - C. \$200,000 of compensation income and a \$50,000 charitable contribution deduction.
  - D. \$200,000 of compensation income and a \$200,000 charitable contribution deduction.
7. For a given taxable year, your client's regular income tax is \$30,000 and his tentative minimum tax is \$34,000. For this year he must pay:
- A. \$34,000 of AMT.
  - B. \$34,000 of regular income tax.
  - C. \$30,000 of regular income tax and \$4,000 of AMT.
  - D. \$30,000 of regular income tax only.
8. In calculating alternative minimum taxable income, which of the following are allowed?
- A. Personal exemptions and state income tax deduction.
  - B. Personal exemptions but not state income tax deduction.
  - C. State income tax deduction but not personal exemptions.
  - D. Neither personal exemptions or state income tax deduction.
9. What is the range of values for the nominal tax rates under the AMT?
- A. 0% to 28%.
  - B. 26% to 28%.
  - C. 26% to 35%.
  - D. 28% to 35%.
10. Which of the following is an accurate statement about the AMT exemption amount?
- A. It is based on the number of personal exemptions.
  - B. It allows taxpayers to take a specific dollar amount of incentive stock option profit without paying AMT.
  - C. It is not available to taxpayers that are married filing separately.
  - D. It is phased out based on filing status and income level.
11. Your client wants an estimate of the amount of AMT she will pay if she exercises an ISO with a bargain element of \$10,000. The range of possibilities is:
- A. From zero to \$2,800.
  - B. From zero to \$3,500.
  - C. From 2,600 to \$2,800.
  - D. From \$2,600 to \$3,500.

12. Your client sells stock acquired three years ago under a nonqualified stock option for a long-term capital gain of \$200,000. Which of the following is an accurate statement about the tax consequences under the AMT?
- A. The gain may result in tax greater than 15% if it causes a reduction in the AMT exemption amount.
  - B. The 15% rate will apply but the amount of gain will be different.
  - C. The 15% rate for long-term capital gains will not apply.
  - D. The gain is not from ISO stock so it is not taxed under the AMT.
13. Which of the following must your client do to obtain the same tax treatment under the AMT as under the regular income tax for income from an incentive stock option?
- A. Sell the shares immediately after exercising the option.
  - B. Make a disposition within the same year the option was exercised.
  - C. Make a disqualifying disposition, whether or not in the same year the option was exercised.
  - D. Avoid making a disqualifying disposition.
14. Your client acquired shares by exercising an incentive stock option. Later in the same calendar year she sold those shares. Which of the following is a true statement about her AMT adjustment from these transactions?
- A. She will report an AMT adjustment only if the shares went UP in value between the date of exercise and the date of sale.
  - B. She will report an AMT adjustment only if the shares went DOWN in value between the date of exercise and the date of sale.
  - C. She WILL NOT report an AMT adjustment regardless of whether the stock went up or down.
  - D. She WILL report an AMT adjustment regardless of whether the stock went up or down.
15. Your client exercised an incentive stock option with a bargain element of \$5,000 and held the stock beyond the end of the year of exercise. How is the basis of the stock affected by the bargain element?
- A. Basis is increased for AMT purposes and regular income tax purposes.
  - B. Basis is increased for regular income tax purposes but not for AMT purposes.
  - C. Basis is increased for AMT purposes but not for regular income tax purposes.
  - D. Basis is not affected.

16. Your client exercised an incentive stock option with a bargain element of \$50,000 and held the shares more than one year. The shares declined in value by \$30,000 and your client sold the shares for a remaining profit of \$20,000. In the year of sale your client had no other capital gains or losses. What is the result under the AMT in the year of sale?
- A. A capital gain of \$20,000.
  - B. A capital loss of \$30,000, subject to the \$3,000 capital loss limitation.
  - C. A capital loss of \$30,000, without regard to the \$3,000 capital loss limitation.
  - D. No capital gain or loss.
17. If your client makes a disqualifying disposition after the end of the year she exercised an incentive stock option, which set of tax rules may require her to report compensation income for the year of the disposition?
- A. The regular income tax only.
  - B. The AMT only.
  - C. Both of these.
  - D. Neither of these.
18. If your client makes a qualifying sale of ISO stock, which set of tax rules may require him to report compensation income in the year of the sale?
- A. The regular income tax only.
  - B. The AMT only.
  - C. Both of these.
  - D. Neither of these.
19. Last year your client exercised an incentive stock option and paid \$50,000 of AMT. If he had not exercised the incentive stock option he would have paid \$5,000 AMT because of personal exemptions and the itemized deduction for state and local taxes. His available AMT credit for the current year is:
- A. \$5,000.
  - B. \$45,000.
  - C. \$50,000.
  - D. \$55,000.
20. Last year your client exercised an incentive stock option and paid AMT. Her available AMT credit is \$30,000. This year she can claim some or all of the credit only if:
- A. She sells some or all of the ISO shares.
  - B. Her regular income tax is greater than her tentative minimum tax.
  - C. She sells some or all of the ISO shares AND her regular tax is greater than her tentative minimum tax.
  - D. She would otherwise pay AMT this year.
21. Your client exercised an incentive stock option last year and paid \$20,000 of AMT, all of which was eligible for recovery as AMT credit. This year he was able to claim \$15,000 of the AMT credit. Which of the following is an accurate statement about claiming the remaining \$5,000 of AMT credit?
- A. There will be no further opportunity to claim the credit.
  - B. The remaining credit carries over to one year only.
  - C. The remaining credit carries over for an indefinite number of years until all the ISO stock has been sold.
  - D. The remaining credit carries over for an indefinite number of years until the entire credit has been used.

22. A special rule effective in tax year 2007 permits recovery of AMT credit even in a year your client pays AMT but only if:
- A. The credit is from a tax year at least four years earlier.
  - B. The credit is greater than \$5,000.
  - C. The credit is less than \$5,000.
  - D. Your client's income is above a stated threshold.
23. Under ideal circumstances, what is the potential increase in after-tax profit that is achieved when converting ordinary income to long-term capital gain, assuming the amount of profit remains unchanged?
- A. 7%.
  - B. 15%.
  - C. 20%.
  - D. 31%.
24. Which tax brackets produce the greatest tax benefit when converting ordinary income to long-term capital gain?
- A. The highest tax brackets.
  - B. The middle tax brackets.
  - C. The lowest tax brackets.
  - D. All produce about the same tax benefit.
25. Your client is about to exercise all her incentive stock options, which were granted at different times over the years. The stock is now trading at \$40, and your client has options with the exercise price set at \$10, \$20 and \$30. Other things being equal, which of the options would be most favorable for the exercise and hold strategy?
- A. The options priced at \$10.
  - B. The options priced at \$20.
  - C. The options priced at \$30.
  - D. All should be considered equally favorable.
26. Your client exercised an incentive stock option with a bargain element of \$500,000 and paid \$140,000 of AMT. The following year she made a qualifying sale of these shares with a long-term capital gain of \$500,000 under the regular income tax and claimed \$75,000 of AMT credit. Assuming the AMT credit carryover has no value for your client, what is the overall tax cost the these transactions?
- A. \$215,000.
  - B. \$140,000.
  - C. \$75,000.
  - D. \$65,000.

27. Your client has exercised an incentive stock option with a bargain element of \$100,000. If she holds all the shares through the end of the year she will pay \$28,000 of AMT. Assuming no change in the share value, how will her tax situation change if she changes to a strategy where she sells just enough shares immediately after exercising to eliminate the AMT?
- A. She will pay less tax in the year of exercise and the same tax in the year of sale.
  - B. She will pay less tax in the year of exercise but more in the year of sale.
  - C. She will pay the same amount of tax in the year of exercise but less in the year of sale.
  - D. She will pay the same amount of tax in the year of exercise but more in the year of sale.
28. Your client holds an incentive stock option with \$500,000 of built-in profit and a nonqualified stock option with \$1,000,000 of built-in profit. He wants to use the income from the nonqualified stock option to absorb some of the potential tax benefit of the incentive stock option. Which of the following must he AVOID doing?
- A. Exercising the nonqualified option in a year earlier than the incentive stock option.
  - B. Exercising the nonqualified option in the same year as the incentive stock option.
  - C. Exercising the nonqualified option in the year the ISO stock is sold.
  - D. Exercising the nonqualified option in a year later than the year the ISO stock is sold.
29. Your client exercised an incentive stock option with a \$500,000 bargain element in January and held all the shares. The stock value has declined by \$300,000 and she plans to sell the shares in the middle of December to reduce her tax liability. Which of the following is an accurate statement about this approach?
- A. Selling the shares at this time will not reduce her tax liability.
  - B. Selling the shares may reduce her tax liability, but only if she avoids buying replacement shares within the same year.
  - C. Selling the shares may reduce her tax liability, but only if she avoids buying replacement shares within 30 days before or after the sale.
  - D. Selling the shares may reduce her tax liability without regard to whether she buys replacement shares.
30. If your client intends to hold enough shares after exercising an incentive stock option to incur a substantial AMT liability, which of the following describes the time when it is generally best to exercise the option?
- A. As early as possible in the year.
  - B. Any time before April 15.
  - C. As late as possible in the year.
  - D. Any time in the year is equally good.

31. Your client has an unused AMT credit of \$100,000 after selling all his ISO stock. Which of the following accurately describes this credit?
- A. It is an asset that may reduce tax in the future.
  - B. It is a potential liability that may increase tax in the future.
  - C. It may increase or decrease your client's future tax, depending on circumstances.
  - D. It will neither increase nor decrease your client's future tax.
32. Your client plans to make a qualifying sale of ISO stock and in the same year exercise additional incentive stock options and hold the shares. Combining these two actions in the same year will prevent her from claiming AMT credit on the sale of the ISO stock. Assuming these transactions are otherwise appropriate, which of the following choices would generally make sense?
- A. Postpone the exercise of additional incentive stock options to the next year.
  - B. Postpone the sale of the ISO stock to the next year.
  - C. Postpone both transactions to the next year.
  - D. Postpone neither transaction to the next year.
33. Your client has sold all his ISO stock and still has some unused AMT credit. Which of the following is an accurate statement about use of this credit?
- A. He can expect to use \$3,000 per year of the credit.
  - B. He can expect to use \$3,000 per year of the credit only if he has an AMT capital loss carryover.
  - C. He can expect to use \$3,000 per year of the credit only if he does not exercise more incentive stock options.
  - D. There is no reason to expect credit recovery at a rate of \$3,000 per year.
34. Your client is allowed to use stock she already owns to pay the purchase price of an incentive stock option. She is considering using the approach because of a rule treating this transaction in part as a tax-free exchange. How does the anti-pyramid rule affect the availability of tax-free exchange treatment?
- A. This treatment is not available if she uses ISO stock to pay the exercise price.
  - B. This treatment is not available if she uses stock other than ISO stock to pay the exercise price.
  - C. This treatment is not available if she uses ISO stock or ESPP stock that has not satisfied the special holding period.
  - D. This treatment is not available if she uses stock acquired using the same ISO.

35. Your client received an incentive stock option granted pursuant to an early exercise plan. She chose to exercise the option before the shares were vested, and immediately filed a section 83b election. What is the IRS view of the section 83b election in this situation?
- A. The election is not effective and will be disregarded.
  - B. The election is effective for AMT purposes but disregarded for regular income tax purposes.
  - C. The election is effective only if your client makes a disqualifying disposition.
  - D. The election is fully effective for AMT and regular income tax purposes.