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**INCOME TAX I
FALL 2025
BOGDANSKI**

**FINAL EXAMINATION
(Three and a half hours)**

INSTRUCTIONS

This examination is in two parts. Part One consists of 36 multiple-choice questions (Questions 1 through 36). Part Two consists of two essay questions (Questions 37 and 38). An hour and a half (90 minutes) is recommended for the multiple-choice questions, and two hours is recommended for the essay questions (one hour per essay question).

At the end of the three and a half hours, you must turn in this set of questions in the original envelope in which this set came. You must submit all your answers using Exemplify. No credit will be given for anything written on this set of questions. Only your electronic answer file will be graded.

Use of any electronic device during this exam, other than a device on which you are taking the exam using Exemplify, is strictly prohibited. If you need it, the calculator function in Exemplify is activated.

In determining grades, each multiple choice question will count for 1 point, and each essay question will count for 24 points. Therefore, you should budget your time according to the allocation noted for each part of the exam. Experience has shown that failure to budget one's time appropriately can result in a drastic lowering of one's overall grade on this examination.

For the multiple-choice questions, choose the best answer to each question posed. Choose one, and only one, answer to each question. Although an incorrect answer earns no credit, there is no penalty for an incorrect answer on the multiple-choice questions, so it is in your interest to answer every question, guessing if necessary.

In the essay questions, pay close attention to the final portion, or "call," of each question. Failure to respond to the matters called for will result in a low score for the question. On the other hand, discussion of matters outside the scope of the call of the question will not receive credit.

In your essays, be sure to explain as thoroughly as possible your answers to the questions posed. Your reasoning, discussion, and analysis are often as important as any particular conclusion you reach.

Unless otherwise specified, assume that all of the transactions and events described in the questions take place in 2025, all taxpayers described in the questions are individuals and U.S. citizens, and all taxpayers described in the questions report their income on the cash method and the calendar year for federal income tax purposes. Any references to the "Code" mean the Internal Revenue Code of 1986, as amended.

PART ONE – MULTIPLE-CHOICE QUESTIONS
(90 minutes)

PART TWO – ESSAY QUESTIONS
(Two hours)

QUESTION 37
(One hour)

Rae is an executive officer of Xco, a corporation. Xco's stock is publicly traded on a national stock exchange. In 2025, Xco grants a stock option to Rae in recognition of her service to the company. The option is not an "incentive stock option" as described in the Code. Under the option, which is fully vested at the time it is granted, Rae has the right, for three years, to purchase from Xco up to 100,000 shares of Xco stock for \$10 per share. The option is immediately exercisable at the time Rae receives it. It is scheduled to expire three years from the date of the grant. At the time the option is granted to Rae, Xco's stock is trading on the public market at \$10 per share. By its terms, the option may not be sold or otherwise transferred.

Xco's fortunes decline, and in 2027, under pressure from the corporation's shareholders, Rae decides to retire from corporate life. At her retirement party, held the weekend after Rae's last day on the job, Xco's president presents Rae with a check drawn on Xco's bank account for \$100,000. "It's our gift to you for all you've done here," the president tells Rae. "You are much loved, and your personal touch will be missed." On that date, Xco's stock is trading on the public market at \$8 per share, and the stock price remains at that level, or lower, for two more years. Rae never exercises her stock option.

Upon leaving Xco, Rae turns her attention to planning for her family's financial future. As part of that process, she transfers to her grandson, Sam, a portion of her personal art collection. This includes a sculpture that Rae purchased many years earlier for \$2,000. At the time of the gift to Sam, the sculpture has a fair market value of \$50,000. A few years after he receives the sculpture, Sam sells it through an art gallery. The sale price is \$60,000 cash. Sam pays the gallery a \$6,000 commission. Sam invests the net proceeds of the sale in the stock market.

Soon after retirement from Xco, Rae pursues a second career as a stand-up comedian. She audits several courses on comedy writing and theater at a state university, paying \$10,000 in tuition. After wowing audiences with hilarious material at local amateur "open mike" events, Rae is hired by comedy clubs in other parts of the country. Her subscription web site, RaeSaysStuff.com, quickly becomes highly profitable. Rae invests in a new wardrobe to wear on stage during her performances.

What are the federal income tax consequences to Rae, Xco, *and* Sam of each of the transactions and events just discussed, with and without any available elections? Be sure to discuss the amount, timing, and character (ordinary or capital) of each item of income, gain, loss, deduction, or credit, and the basis of each item of property, at each stage of the transactions and events.

Discuss.

(End of Question 37)

QUESTION 38
(One hour)

Andy makes a good living as a landlord. Andy's activities in leasing out his various commercial and residential rental properties are a full-time job. In 2025, Andy buys a vacant duplex, known as "the Plex," for \$500,000. The Plex consists of two residential apartments, side by side, in a single building.

Of the \$500,000 purchase price, Andy borrows \$400,000 from a bank, granting to the bank a nonrecourse mortgage on the Plex. The other \$100,000 of the purchase price is paid by Andy from Andy's personal savings. Andy also pays from his own funds the \$2,000 fee of an attorney who represented Andy in connection with purchasing the Plex. As specified in the sale contract, the other transaction expenses are paid by the seller.

In the weeks following the purchase, Andy replaces the furnace and all the windows in the Plex, and makes various routine repairs that had been neglected under the duplex's prior owners. Andy pays a total of \$38,000 for the upgrades and deferred maintenance just described, out of his savings.

Once the Plex is refurbished, early in 2026, Andy begins renting the two units to unrelated tenants. In 2026 and 2027, Andy takes \$40,000 of depreciation deductions with respect to the Plex. Assume that this is the correct amount of depreciation deductions for those years.

Through the end of 2027, Andy makes all the required payments of principal and interest on the mortgage loan from the bank. These payments include \$20,000 of principal, so that the outstanding principal balance on the loan is reduced to \$380,000.

On the first day of 2028, Andy exchanges the Plex for a large vacant lot that Andy plans to hold for long-term appreciation. At the time of the exchange, the Plex has a fair market value of \$600,000, so that Andy's "equity" in the Plex, after taking into account the mortgage, is \$220,000. The other party to the exchange, Emma, takes the Plex subject to the mortgage. At the time of the exchange, the vacant lot has a fair market value of \$220,000. After the exchange, Andy owns the vacant lot free and clear of any mortgages and encumbrances.

What are the federal income tax consequences to Andy of each of the transactions and events just discussed, with and without any available elections? Be sure to discuss the amount, timing, and character (ordinary or capital) of each item of income, gain, loss, deduction, or credit, and the basis of each item of property, at each stage of the transactions and events.

Explain.

(End of examination)