This outline was created for the July 2006 Oregon bar exam. The law changes over time, so use with caution. If you would like an editable version of this outline, go to www.barexammind.com/outlines.

Fed Tax

I. Determining Income tax
    a. GI – Deductions = taxable income
    b. Taxable income x tax rate = tax
    c. Tax – credits = tax liability
II. BASIC approach to a Tax Question
    a. Talk about **gross income**
        i. What is includable in GI?
        ii. When must the GI be reported?
        iii. How is the GI taxed?
            1. ordinary income; or
            2. capital gain
        iv. Whose GI is it?
    b. Talk about **deductions**
        i. What is deductible?
        ii. When is it deductible?
        iii. How are any losses deducted?
            1. ordinary losses; or
            2. capital losses
    c. Maybe **corporate & partnership taxes**
        i. Choice of entity
        ii. Formation
        iii. Operations

GROSS INCOME

III. WHAT IS GI?
    a. Basics
        i. "Any accession to wealth, clearly realized, over which the taxpayer has complete dominion."
        ii. *In-kind*: "Noncash income equals the FMV of the property or services received."
        iii. Unless excluded by IRC, all economic benefits are income. "GI includes all income, from whatever source derived."
    b. EXCLUSIONS
        i. **Fringe benefits** for **employees**: cannot discriminate giving these benefits only to highly compensated employees
            1. health insurance:
                a. premiums paid and benefits from plan

2. life insurance:
    a. premiums on first $50,000 of coverage excludable
3. child/elder care:
    a. excludable up to $5,000/year
4. pension plan contributions:
    a. excludable within complicated limits
    b. *withdrawals are generally included in GI*
    c. penalties for withdrawal before age 59 ½
5. tuition assistance
    a. excludable up to $5,250/year
6. no-additional cost items
    a. stuff employer sells to public and costs employer nothing to give to away (eg, airline seats)
7. employee discounts
    a. purchase items at less than retail cost
    b. capped at employer's profit margin OR 20% of retail price for services
    c. n/a real estate and investments
8. working conditions
    a. item employee could deduct if he bought them himself (eg, office supplies, uniforms)
9. de minimis items
    a. coffee, doughnuts, occasional cab fare
10. on-premises meals and lodging
    a. if furnished on business premises for *convenience* of employer
11. commuting allowances
    a. parking, transit pass
12. employee achievement awards
    a. item of tangible personal property given for longevity on the job OR safety achievement;
    b. <u>meaningful ceremony</u> required

ii. **Gifts**

1. Def: "<u>transfer from detached and disinterested generosity</u>": ie, look to transferor's **subjective intent**
2. receipt of gift/inheritance not GI and NO LIMIT
3. BUT, *income* from gift property is taxed to donee (eg, dividend paid on gift stock)
4. BUT
    a. Any transfer from employer to employee is irrebutably presumed to be GI, UNLESS
    b. E is R's close relative

iii. **Other exclusions**

1. Life Insurance Proceeds
    a. are NOT GI (nor are pre-payments IF person is about to die)

                i. HOWEVER, if payments spread out over time, the *interest* component of the deferred payments is GI to beneficiary of the policy
    2. <u>Damages/Settlements</u>
        a. If replacing lost profits, generally GI.
        b. If replacing property (eg, condemnation proceeds; conversion), treated as a sale of property
        c. If restoring damage to property, treated as nontaxable up to property's *basis* – excess is *gain* on sale of property
        d. Punitive damages (replace nothing), always GI
    3. <u>Personal Injury Damages</u>
        a. If damages based on personal ***physical*** injury are excludable, *even though* they may include lost earnings [!]
        b. Other damages (eg, emotional damages and lost earnings based on emotional injury) must be included in GI,
            i. EXCEPT reimbursement for *medical expenses* arising from emotional distress
            ii. NB: if physical injury present, all damages for emotional distress arising out of that injury are excludable
    4. Scholarships
        a. Covering only tuition, fees, books, supplies
    5. Loans
        a. If loan discharged for *less than* full balance, then difference between what was owed and what you paid is "discharge of indebtedness" income
            i. EXCEPTIONS:
                1. forgiveness of loan as a gift
                2. adjustment of purchase price of property
                3. borrower is bankrupt or insolvent at time of discharge
                    a. insolvent = assets less than liabilities
                    b. but, taxpayer loses other tax benefits (eg, basis in property eliminated)

iv. **Other inclusions**
    1. Alimony received:
        a. Def: payment in <u>cash</u> to or for benefit of ex-spouse,
            i. Pursuant to a written instrument (settlement or divorce decree);
            ii. Payor and payee don't live together; and
            iii. If payee dies *before* payments complete, payor's obligation to pay ceases
            iv. BUT
                1. parties can agree in writing or in divorce decree not to treat it as alimony!!
        b. GI to recipient

        c. Deductible to payor
    2. Child support
        a. Not deductible by payor; not GI to payee
    3. Property Settlement
        a. Not GI; not deductible
    4. Disguising Child Support or Property Settlement as Alimony
        a. Would benefit payor b/c of additional tax deductions
        b. NB: payments are not alimony *to the extent* that they are reduced upon the *occurrence of an event relating to a child*
        c. NB: payments are not alimony to the extent they are *"loaded" unevenly into the first 2 years* following the dissolution of the marriage
    5. Stolen items
        a. GI to thief
    6. Illegal Income
        a. GI and must be reported
    7. Tax Benefit Rule
        a. Correction of past year's deductions to reflect change circumstances:
            i. Taxpayer took legitimate deduction in *prior* year;
            ii. Something happens in *current* year that is "fundamentally inconsistent" with the premise of the deduction; then
            iii. Must report as income in the *current* year the amount of the previous year's deduction
                1. Eg, state tax deductions claimed, but then refunded later
                2. EXCEPTION: if earlier deduction gave no tax benefit, then no worries

v. **Gains from Dealings in Property**
    1. When property is sold or exchanged, gain or loss is realized.
        a. NOT triggered unless and until there is a *realizing event*, such as a sale or exchange of the property
            i. Non-realizing events:
                1. mere increase/decrease in value
                2. gift, unless donee takes donor's debt and debt > basis)
                3. stock splits or reinvested dividends
        b. <u>computation</u> of gain/loss:
            i. amt realized – adjusted basis = realized gain (loss)
        c. amount realized
            i. what taxpayer got on the sale or exchange (cash and/or FMV of property)
        d. adjusted basis
            i. generally, the *cost* of the property (or FMV of property receive at date of receipt)

ii. Gift property basis:
    1. get live donor's basis ("carryover basis"); or
    2. get FMV of property on date of death ("stepped-up basis")
iii. Twist to lifetime gifts
    1. can't shift a loss to donee

2. Gambling
    a. Treated as sale: amount of bet is the basis
    b. Losses: deductible against gambling gains for the same year
3. Loans and Property
    a. Money you borrow goes into basis of property,
        i. BUT, what if buyer takes over mortgage?
            1. outstanding balance on the loan is treated as an additional *amount realized* on the sale
            2. buyer takes the outstanding loan as part of their basis
        ii. NB: assumed liability MUST be counted as an amount realized, even where it is NOT a part of the seller's basis
            1. if borrowed money goes to improve the property, then it goes into basis right away
            2. if borrowed money goes to something else, then only goes into basis if buyer assumes the liability
                a. but if home equity loan used for vacation and buyer does NOT assume, then it doesn't go into basis
    b. Depreciation [example p. 15 OICW]
        i. If property is
            1. producing income; and
            2. a type that will wear out eventually,
            3. then taxpayer can deduct part of its basis year by year until basis is zero.
4. Transfer of property to satisfy debt
    a. Treated as a sale of property; AR = debt paid off
5. EXCLUSIONS of gain
    a. No gain on sale of principal residence, if used for 2 of 5 years prior to sale
        i. Max $250k or married joint return $500k

IV. WHEN IS GI REPORTABLE?
    a. **Accounting methods**
        i. Cash method
            1. DEF: GI reported when taxpayer *actually* or *constructively* receives it

            a. <u>Constructive receipt</u>: when set aside for taxpayer, credited to account, or made available so taxpayer can draw upon it at any time
                i. Eg, interest; reinvested mutual fund dividends; (sometimes) damages placed in escrow account
        2. Deductions taken when taxpayer actually pays amount in question
    ii. Accrual method
        1. DEF: GI reported when all events have occurred which fix taxpayer's right to it AND amount can be determined with reasonable accuracy
        2. Deductions taken when
            a. All events have occurred which fix obligation to pay
            b. Amount can be determined with reasonable accuracy
            c. Economic performance occurs (ie, other party performs)
            d. NB: deductions occur sooner under accrual method than under cash method
    iii. Installment method
        1. each payment treated as *part gain, part return of basis*, under a mathematical formula
            a. BUT if installment method unavailable, then report gain at year of sale

b. **Claim of right doctrine**
    i. Income realized when taxpayer receives it
        1. under a *claim of right*,
        2. with no restrictions on spending it,
        3. even though there is some possibility that he amy have to return it in the future.
    ii. In contrast, disputed right to income is not presently taxable
    iii. NB: what if required to pay back money (eg, lose on appeal): two option for <u>corrections</u>:
        1. *deduct* repayment in current year; OR
        2. reopen prior year, determine tax paid in prior year, and take a *credit* against tax in current year

c. **Nonrecognition on Property Transactions** [bar exam favorite]
    i. There is a <u>realized</u> gain/loss, but circumstances warrant postponing of gain/loss, and thus it is not <u>recognized</u>
    ii. Examples of non-recognized events:
        1. transfer of property between live spouses
            a. transferee takes carryover basis as if it were a gift
        2. transfer of property from a dead spouse
            a. transferee gets stepped-up/down basis
        3. divorce property settlements
            a. treated as a gift with carryover basis
    iii. Like-kind exchange
        1. No gain/loss is recognized if:
            a. Business or investment property

b. Is exchanged
c. For other business or investment property of "like-kind" with property being given up in exchange

2. Like-kind: [review examples pp. 21-22 OICW]
   a. Real estate and personal property CANNOT be like-kind
      i. Eg, standing timber (realty), cut timber (personalty)
   b. All real estate treated as like-kind with all other realty
   c. Disqualified assets:
      i. Personal use assets
      ii. Stocks, bonds, notes
      iii. Inventory held for sale to customers
   d. Basis on exchanged property becomes carryover basis on the new property (this is how gain postponed)
   e. Boot
      i. Receipt of $ or non-like-kind property in addition to non-like kind property
      ii. Gain is <u>recognized</u> up to lesser of:
         1. the realized gain; or
         2. amount of the boot
      iii. NB: if recognized gain is smaller than boot, remaining boot reduces carryover basis so that will eventually be recognized as gain
      iv. Mortgages:
         1. if buyer assumes mortgage, treat mortgage liability as "boot" paid to seller
3. Involuntary conversion
   a. Condemnation; conversion; destroyed property
   b. If taxpayer uses $ payment for the property given up, then taxpayer can buy similar/related property within a statutory replacement period ("rollover" provision) and elect NOT to recognize the gain
      i. $ not spent on property, then extra $ is treated as boot
   c. Basis carries over from converted asset
   d. Replacement period
      i. Begins when conversion takes place and ends 2 years after end of that year (ie, more than 2 years and less than 3)

V. HOW IS GI TAXED: ORDINARY INCOME OR CAPITAL GAIN?
   a. Long-term (held more than one-year) capital gains taxed at lower rate than ordinary income
   b. Capital losses (short and long term) have special limitations
      i. Deductible only against capital gains and up to $3,000 of ordinary income
         1. Remainder must be carried forward
   c. Identifying:
      i. Capital gain or loss is only two things:

        1. dividends on corporate stock
        2. gain or loss on sale/exchange of capital asset
    ii. NB: losses on sales/exchanges on personal use property
        1. NOT deductible at all, BUT
        2. gains on sales generate capital gain
    iii. Real estate used in business; copyright on music created by the taxpayer
        1. capital gain
        2. ordinary loss
    iv. stock in corporation, bonds, mutual fund shares; any other asset held for investment
        1. capital gain
        2. capital loss
    v. personal use assets
        1. capital gain
        2. nondeductible loss
    vi. inventory; equipment and vehicles used in business; copyrights other than music
        1. ordinary income
        2. ordinary loss
    vii. individual's personal services
        1. ordinary income
        2. nondeductible loss

VI. WHOSE GI IS IT?
  a. Personal service income must be taxed to provider, no matter to whom it is actually paid.
  b. Income from one's property can be taxed to someone else, but only in narrow circumstances:
    i. Outright gift of entire property to donee
    ii. Gifts of present income (eg, life estate) will NOT shift income if donor retains right to future interest
    iii. Gifts in trust where grantor retains power (to revoke or to change beneficiary) will NOT shift income
    iv. Gifts to irrevocable trusts will shift income either to trust or beneficiaries
  c. Kiddie tax:
    i. All unearned income ($800 + $800) of child under 18 is
    ii. Taxed to parents highest marginal tax rate
    iii. NB: unearned income is anything other than $ earned for his or her own personal service

DEDUCTIONS

VII. WHAT IS DEDUCTIBLE?
  a. **Classifying deductions**
    i. Above the line: goes from GI to AGI
    ii. Below the line: takes AGI to Taxable Income
  b. **General rules of deductions**

i. Generally no deduction of any kind for personal, family, or living expenses
ii. BUT, all "ordinary and necessary" expenses of business or investment activity are generally deductible

c. **"Personal" deductions**
   i. Personal Exemption
      1. one for taxpayer, spouse, and each dependent: $3,300
         a. dependent is either:
            i. qualifying child: child, sibling, niece or nephew who:
               1. lives with taxpayer 6+ months
               2. under 19 (or 24 if full-time student)
               3. and don't provide more than ½ of his own support [support can come from someone other than taxpayer claiming deduction]
               4. NB: children of divorced parents: look to divorce decree, if silent, to custodial parent
            ii. Qualifying relative:
               1. taxpayer provides more than ½ of support and is not someone else's qualifying child
   ii. Alimony paid
   iii. Casualty losses
      1. uninsured losses from "sudden and unexpected event" or from theft
      2. floor of 10% of AGI plus $100
   iv. Medical expenses
      1. uninsured medical bills
      2. insurance premiums
      3. floor of 7.5% of AGI
   v. Charitable deductions
      1. ceiling of 30-50% AGI; excess carries over to next year
      2. Important:
         a. Contributions of property deductible at FMV, no recognition of gain
         b. BUT,
            i. If dealer in property, can only deduct basis
            ii. Autos, boats, planes deductions capped at amount charity sells for
         c. Must be a gift, if quid pro quo, the value of thing returned reduces deduction
   vi. Interest
      1. deductible if:
         a. incurred in a business
         b. if used for investment, deductible only against income from investments
         c. personal life interest NOT deductible, except:

i. home mortgage interest (on up to 2 houses) *below the line*:
    1. acquisition indebtedness (buy or improve): limited to $1,000,000
    2. home equity indebtedness (limited to $100,000)

ii. student loan interest *above the line*:
    1. up to $2,500 per year
    2. starts to phase out at $50k/100k

vii. State and Local Taxes
    1. personal income and property taxes
    2. all such taxes paid buy business

d. **Profit-motivated deductions vs. Personal**

i. Hobbies
    1. activity not engaged in for profit is only deductible as personal expenses
    2. look to taxpayer's primary intent; case-by-case determination
        a. expertise; time spent; elements of recreation
    3. hobby expenses *only deductible against* hobby income

ii. Attorney fees
    1. deductibility of fees incurred depends on nature of the claim
        a. for Defendant:
            i. look to *origin* of the claim.
                1. personal: no deduction
                2. business or investment activity: deduction
        b. for Plaintiff
            i. look to *type of relief* plaintiff is seeking:
                1. no taxable recovery: no deduction
                2. taxable damages: deduction, win or lose
    2. Everyday advice
        a. Related to business/investment: deductible
        b. Relates to personal life: not deductible
    3. Tax advice
        a. ALWAYS deductible

iii. Home offices
    1. no deduction, UNLESS uses home office *exclusively* for business use; AND
    2. must be principle place of business; place to meet clients; or structure detached from house

iv. Vacation homes
    1. the more days of personal use, the smaller the % of depreciation, maintenance, etc, you can deduct

v. Child care/Elder care
    1. No deduction, BUT limited tax <u>credit</u>
    2. 20-35% of income; cap $3000 for one dependent; $6000 for two or more

vi. Travel
    1. deductible, IF primary purpose of trip is business or investment
        a. commuting to work is NOT deductible
    2. meals 50% deductible if stay away overnight
vii. Business Meals
    1. 50%
viii. Business Entertainment
    1. only if "bona fide business discussion" before or after entertainment
    2. 50% and need receipts
ix. Work clothes
    1. only if specialized clothing not adaptable to general wear
x. Education as business expense
    1. only continuing education to "maintain or improve" skills for a job taxpayer already has
    2. never for something that entitles person to enter a new field
    3. Tax Credits
        a. Hope credit
        b. Lifetime learning credit

e. **Business and Investment Deductions**
    i. All ordinary and necessary expenses to carry on the business are deductible,
    ii. What can't you deduct?
        1. lobbying
        2. unreasonable compensation paid to business owners
        3. highly unusual expenses
        4. illegal payments

VIII. WHEN IS IT DEDUCTIBLE?
    a. Current expenses
        i. Deductible right away
    b. Capital expenditures
        i. Placed into basis of asset and deducted when asset is sold
        ii. Examples:
            1. purchase price of property that lasts for more than one year
            2. transaction costs of buying/selling
            3. improvements to property
            4. long-term benefit: bar exam: "looks like a deduction, but is there a long-term benefit? If yes, then call it a capital expenditure

CORPORATE TAX

IX. CORPORATE AND PARTNERSHIP TAX
    a. Choice of entity?
        i. Corporation: expressly incorporated
            1. C-corp: double taxation: corporate profits and dividends
                a. Any public company is a C-corp

            2. S-corp: pass-thru
                a. Max 100 shareholders; no preferred stock
        ii. Partnership/LLC: not expressly incorporated
            1. pass-thru entity: company never pays taxes; partners pay tax on their share
    b. Formation
        i. Nonrecognition transaction, similar to a like-kind exchange
    c. Operations
        i. C-corp
            1. company pays tax on profits
            2. shareholders pay tax on dividends as income
        ii. S-corp; partnership
            1. partner pays tax on all profits, *even if it does NOT get distributed that year*