Unit03. Gross Income: Inclusions

This week's objective is to increase our understanding of the concept of gross income as it is used in tax planning. In particular, the chapter focuses on

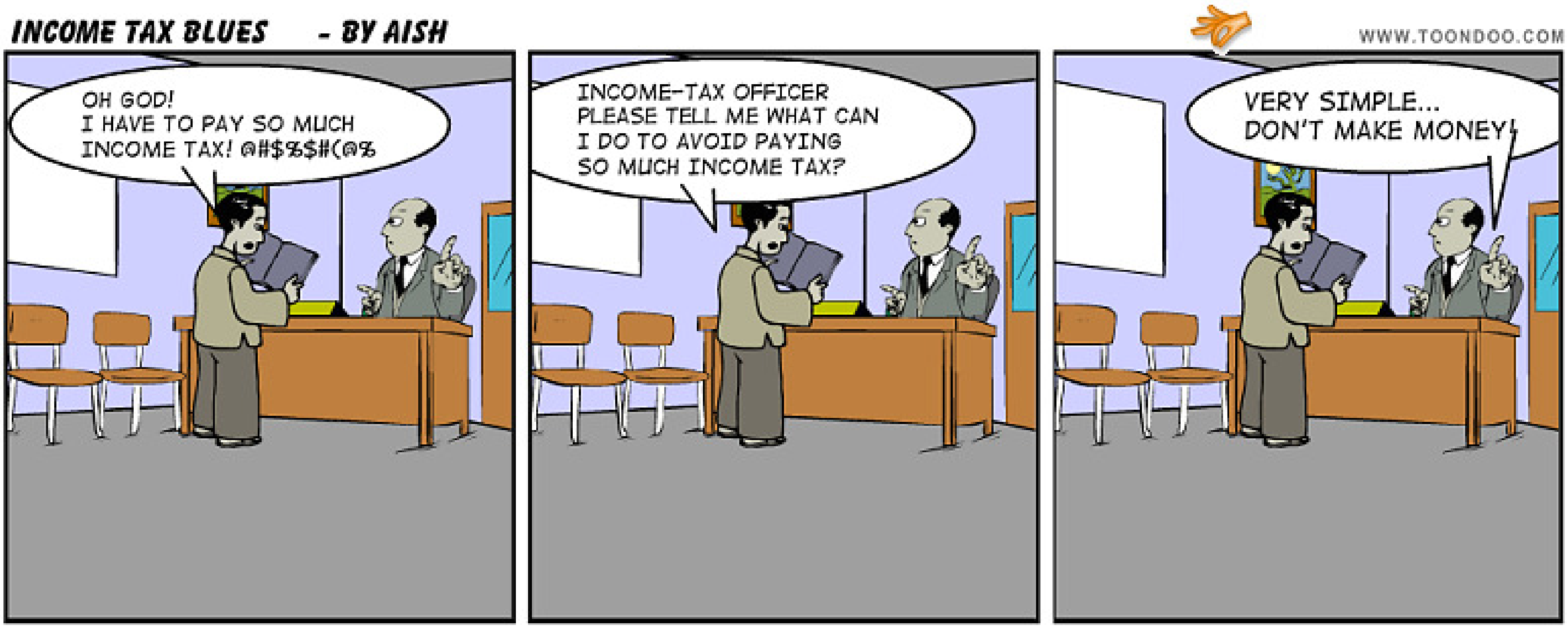
What: What is income?

Who: Who must include the item of income in gross income?

When: In which tax period is the income recognized?

Outline

1. Economic and accounting concepts of income
2. Tax concept of income
3. To whom is tax taxable
4. When is income taxable
5. Items of gross income
6. Other items of gross income
7. Tax planning considerations
8. Compliance and procedural considerations


INCOME TAX BLUES - BY AISH
WWW.TOONDOO.COM
OH GOD! I HAVE TO PAY SO MUCH INCOME TAX! @#$%$#(@%
INCOME-TAX OFFICER PLEASE TELL ME WHAT CAN I DO TO AVOID PAYING SO MUCH INCOME TAX?
VERY SIMPLE... DON'T MAKE MONEY!

1. Economic and Accounting Concepts of Income

- Economic concept:
  - Income has two components:
    - Wealth that flows to individuals
    - Changes in value in individuals' wealth, including
      - Unrealized gains
      - Gifts & inheritances considered income
  - Study Example 3-1
- Accounting concept:
  - Income is measured by a transaction approach.
    - Income realized as result of completed transactions
  - Study Example 3-2

2. Tax Concept of Income

Overview

- The income tax law essentially has adopted the accounting concept of income rather than the economic concept because of
  - Administrative convenience
    - The economic concept is too subjective in that individuals will have to report the value of unrealized gains (i.e., the appreciation on a piece of land). Often these valuations are very subjective.
    - Example: If a piece of land owned by the taxpayer appreciates during the year, it is difficult to assess exactly by how much it has appreciated. Just look at the property tax valuation problems.
  - The wherewithal-to-pay concept
    - Taxing unrealized appreciations can cause cash flow problems for taxpayers.
    - Example: Even if we were able to ascertain that the appreciation is $30,000, at 20% tax rate the taxpayer has to come up with $6,000 cash to pay tax. That may be difficult for some taxpayers because they have not realized the $30,000 gain.

2. Tax Concept of Income

Gross Income Defined - Code Definition

- Code Sec. 61 includes in gross income "all income from whatever source derived." Specific examples are
  - Compensation for services, Business income, Gains from sale or exchange of property, Interest, Rents, Royalties, Dividends, Alimony, Annuities, Income from certain life insurance contracts, Pensions, Income from the discharge of indebtedness, Distributive share of partnership or S-corporation income, Income in respect of a decedent, and Income from an estate or trust (See PAK Page 3-4 for the 15 item list)

2. Tax Concept of Income

Gross Income Defined - Form of Receipt and Indirect Economic Benefit

- Form of receipt
  - Gross income is not limited to cash
  - §1.61-1a, income may be "realized in any form, whether in money, property, and services"
  - Study Examples 3-3, 3-4, 3-5, 3-5, and 3-7.
- Indirect economic benefit
  - Taxpayers may exclude indirect benefits from gross income.
  - Examples of these indirect benefits are work uniform, employee discounts.

3. To whom Is Income Taxable?

Overview

1) Assignment of income
2) Allocating income between married people
3) Income of minor children

3. To whom Is Income Taxable?

1) Assignment of Income

- Income from personal services is taxed to the taxpayer who rendered the services, and income from property is taxed to the owner of the property.
  - Supreme Court in Lucas v. Earl (1930) - Ruled that individual taxed the earnings from his personal services
  - Helvering v. Horst (1940) - Ruled that assignment of income doctrine applies to property
- Today with married couple mostly filing joint returns this issue does not arise often. It is an issue today
  - when other individuals such as parents and children are involved.
  - when married couples filing separate returns.

3. To whom Is Income Taxable?

2) Allocating Income between Married People

- If income needs to be assigned between married couples (for filing separate return purposes), the income allocation between husband and wife is dependent on state law.
  - Common law property system
    - Used in 42 states, including Utah
    - Income taxed to person who earns it or who owns the income-producing property
    - Joint income comes from jointly owned property
  - Community property states
    - Used in nine states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin).
    - All income deemed to be earned equally by spouses except income from separate property
    - Separate property
      - Property owned by each spouse ***prior*** to marriage
      - May be community income or separate income, depending on state of residence
- Study Example 3-8

3. To whom Is Income Taxable?

3) Income of Minor Children

- Children are taxed on their own earned income.
- Unearned income of minor under 24 may be taxed at parent's higher rate
  - See "Kiddie Tax" in Unit02


I WARNED YOU TO PAY TAXES ON YOUR TOOTH FAIRY INCOME....
SASHA
MALIA
MIKE LUCKOVICH

4. When Is Income Taxable?

Overview

- The year in which income is taxed depends on the taxpayer's accounting method. Three methods are used:
  1) Cash method
  2) Accrual method
  3) Hybrid method
- The taxpayer can chose which method to use but the IRS has the power to change the method if the IRS thinks the method used does not clearly reflect income.

4. When Is Income Taxable?

1) Cash Method

- The cash method is used by most individuals, with income being reported in the year of actual or constructive receipt.
- Constructive receipt occurs when
  - the taxpayer has access to the income, b
  - but does not actually receive it (i.e., interest credited to a savings account).
- No constructive receipt if
  - It is subject to substantial limitations
  - Payor does not have funds necessary to make payment
  - Amount is unavailable to taxpayer
- Exceptions to basic cash method
  - Interest on Series E or EE Savings Bonds
  - Special rules apply to farmers and ranchers
  - Small taxpayer exception for inventories
- Study Examples 3-11, 3-12, and 3-13.

4. Is Income Taxable?

2) Accrual Method

- Taxpayers generally report income in the year the income is earned (i.e. when "all events" have occurred to fix the right to income, and the amount of income can be determined with reasonable accuracy).
  - Example: property sold with title transferred on 12/31/2010. Money is not received until 1/3/2011. The sales proceeds are taxable for the year 2010.
- Prepaid income
  - Generally taxable when received
  - Exceptions in Rev. Proc. 2004-34: May defer payments for future services to the year following the year in which the payment is received.
  - Study Example 3-15

4. When Is Income Taxable?

3) Hybrid Method

- This method is most often used in small business that maintain inventories and are required to use accrual method of accounting for purchases and sales of goods.
  - Accrual method for purchases and sales
  - Cash method in computing all other income and expenses
- Cash method is usually preferred over accrual method due to simplicity and flexibility. See “STOP & THINK” on Page 3-12 for a discussion.

5. Items of Gross Income

Overview

1) Compensation
2) Business income
3) Gains from dealing in property
4) Interest
5) Rents and royalties
6) Dividends
7) Alimony and separate maintenance payments
8) Annuities and pensions
9) Income from life Insurance and endowment contracts
10) Income from discharge of indebtness
11) Income passed through to taxpayer

5. Items of Gross Income

1) Compensation, 2) Business Income, 3) Property Dealings

- Compensation - Payment for personal services.
  - Examples: salaries, wages, fees, commissions, tips, bonuses.
- Business income – Gross profit (total revenue – total cost)
- Gains from dealings in property – Gains realized from property transactions.
  - There are over 30 nonrecognition rules to allow taxpayers to postpone the recognition of gains and losses from certain types of property transactions, such as gains from the sale of a personal residence.

5. Items of Gross Income

4) Interest

- Interest – Compensation for the use of money.
  - Interest is generally included in gross income.
  - An exclusion for interest on municipal bonds is available as long as the bonds are not (1) issued for certain private activities, (2) issued in excess of the statutory limit, (3) guaranteed by the federal government, or (4) issued for the purpose of acquiring higher interest investments (arbitrage).
  - An exclusion is also available for interest from Series EE U.S. saving bonds if the proceeds are used to pay certain college expenses for the taxpayers or dependents. The exclusion is phased-out over certain AGI levels.
  - Study Example 3-16 and Example 3-17

5. Items of Gross Income

5) Rents and Royalties

- Rents and royalties
  - Gross income includes rents and royalties. Security deposits are not income until forfeited.
  - Losses from these activities may be subject to the passive loss rules (See Chapter I8).
  - Leasehold improvements in lieu of rent are included in gross income at their FMV upon completion. Leasehold improvements not in lieu of rent are not gross income.
  - Amounts received by the lessor to cancel or modify a lease are included in gross income
  - Study Examples 3-18 and 3-19

5. Items of Gross Income

6) Dividends (1 of 2)

- Dividends are included in shareholder gross income
  - Results in double taxation if it's a C Corporation
  - Flow-through firms can be used to avoid double taxation
- To reduce the effect of double taxation, individuals are taxed at
  - 15% on dividends (for taxpayers whose marginal tax rate is >15%)
  - 0% if taxpayer is in 10% or 15% tax bracket
  - Must hold stock for at least 60 days
  - Study Examples 3-20 and 3-21
- Distributions are taxable only to extent they are out of corporate earnings and profits
  - Study Example 3-22

5. Items of Gross Income

6) Dividends (2 of 2)

- Stock dividends – distribution of company stock as dividends
  - Not taxable because they are not realized income, unless cash is offered as an alternative to stock.
  - Study Example 3-23
- Capital gain dividends – distributed by Mutual Fund companies
  - Taxed at long-term capital gain rates
- Constructive dividends – shareholder-employee compensation payments, etc.
  - Taxed as regular dividends
  - Study Example 3-24

5. Items of Gross Income

7) Alimony and Separate Maintenance Payments

- Any payment pursuant to a divorce must be classified as one three categories for tax purpose:
  - Alimony
    - taxable for the person who receives it.
    - deductible by the person who pays it.
    - Issue of recapture – prevent the payer from deducting too much alimony. Study Examples 3-27 and 3-28
  - Child support
    - not taxable nor deductable.
  - Property settlement
    - not taxable
- Study Examples 3-25, 3-26

“It’s another get-well card from your ex-wife. I never realized how many words rhymed with alimony.”

5. Items of Gross Income

7) Annuities and Pensions (1 of 2)

- Annuities are partially included in gross income based on a calculation involving the excess of the expected return over the taxpayer's cost.
- How to compute the non-taxable portion (exclusion)?
  - Expected return multiple: actual year of annuity or IRS multiple (Table 3-1) if it’s an annularity for life.
  - Expected return = annual payment x expected return multiple
  - Exclusion ratio = cost of annuity / expected return
  - Current year’s exclusion = exclusion ratio x annual payment
  - Study Example 3-29
- The exclusion is applied to each receipt in a particular tax year until the cost is fully recovered.
- If the taxpayer dies before the entire cost is recovered tax free, any unrecovered cost is deducted on the decedent's final income tax return.

5. Items of Gross Income

8) Annuities and Pensions (2 of 2)

- A pension is essentially an annuity where the cost of the annuity is paid by the employer, partly or fully.
- Qualified pensions use a simplified method to determine the taxable portion of the payments.
  - Exclusion = Employee contribution $ / # of anticipated payments (see Page 3-22 for statuary IRS table)
  - Note this exclusion is a monthly number
  - Study Example 3-30
- Early withdrawal (advanced payments)
  - Early withdrawal is considered part employer and part employee contribution.
  - Early withdrawals before age 59 ½ are also subject to 10% penalty.
  - Study Example 3-31

5. Items of Gross Income

9) Income from Life Insurance and Endowment Contracts

- The face amount of life insurance received is not taxable.
- If the proceeds are left with the company and interest is earned then the earned interest is taxable.
- Proceeds collected by the insured prior to death (i.e. endowment-type policy) which exceed premiums paid are treated as income.
- More details will be discussed in later units.

5. Items of Gross Income

10) Income from Discharge of Indebtness

- Generally, the forgiveness of debt is included in gross income.
- Exceptions to this general rule exist for bankruptcy and certain other insolvency situations and will be discussed in later units.

5. Items of Gross Income

11) Income Passed Through to Taxpayer

- Income from flow-through entities taxed directly to owners
  - Income from partnership
  - Income from S corporation
  - Income in respect of a decedent
  - Income from an estate or trust
  - Income from RIC or REIT

6. Other Items of Gross Income

Overview

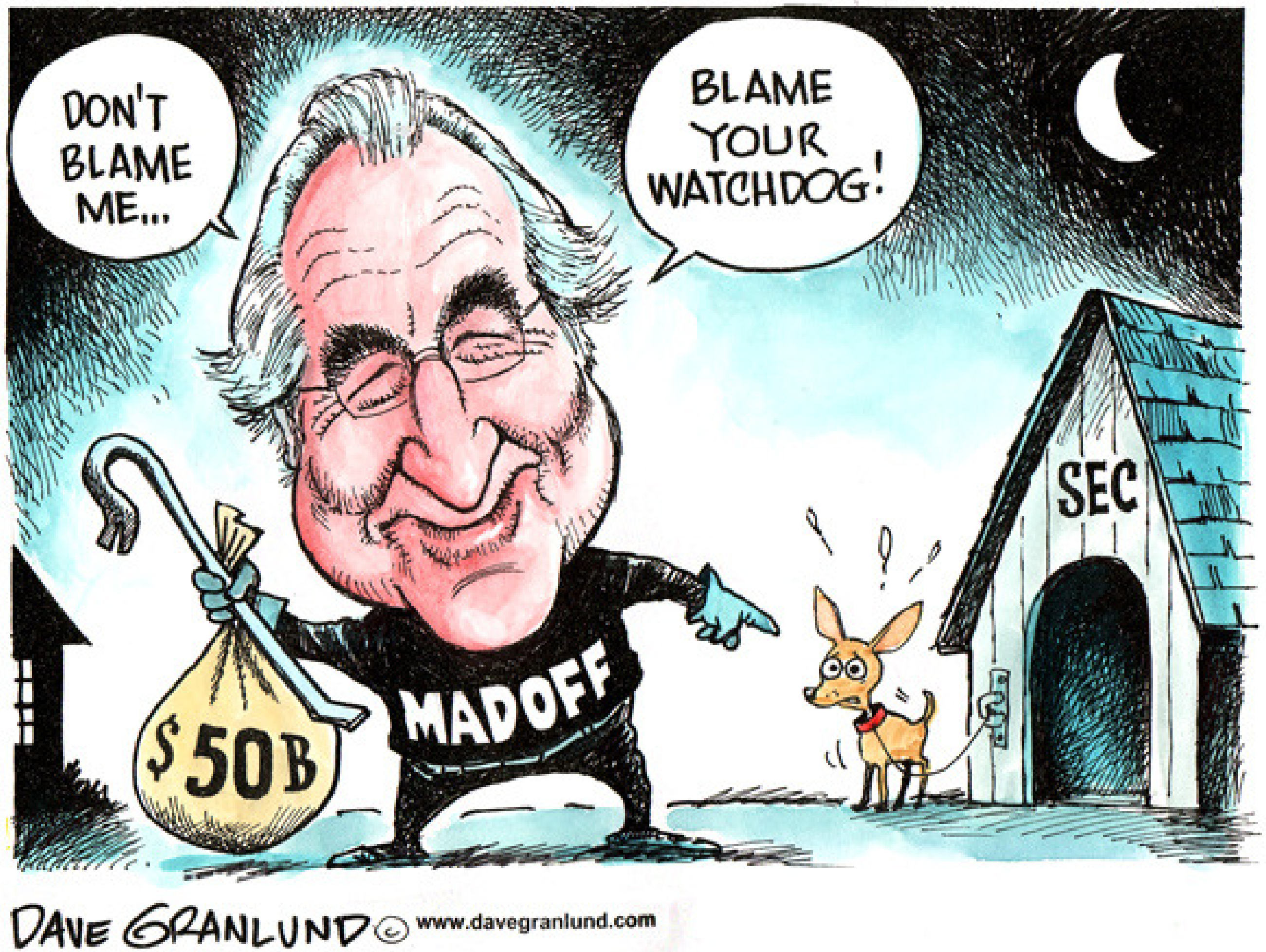
1) Prizes, awards, gambling winnings, and treasure
2) Illegal income
3) Unemployment compensation
4) Social security benefits
5) Insurance proceeds and court awards
6) Recovery of previously deducted amounts
7) Claim of rights

6. Other Items of Gross Income

1) Prizes, 2) Illegal Income, 3) Unemployment Compensation

- Prizes, awards, gambling winnings, and treasure finds – taxable
  - Study Example 3-32
- Illegal income (e.g. embezzlement proceeds, ransom, bookmaking profits, robbery proceeds, sales of illegal narcotics, and bribes) – taxable, and important in convicting criminals.
- Unemployment compensation – taxable, with $2,400 exclusions in 2009

Illegal, and Taxable …



6. Other Items of Gross Income

4) Social Security Benefits

- Social security benefits – up to 85% taxable
  - Excluded from gross income before 1984.
  - Between 1984 and 1993 up to 50% taxable
  - From 1994 on up to 85% taxable
- Taxable amount depend on provisional income and filing status
  - Provisional income (PI) = AGI (excluding SS) + tax-exempt interest – foreign income +50% SS
  - Married filing jointly: PI <=32000 no SS tax
  - Single: PI <25,000 no SS tax
  - Study Example 3-33 for details

6. Other Items of Gross Income

5) Insurance Proceeds and Court Awards

- The potential inclusion of insurance proceeds and court awards in gross income is affected by the reason the amounts were received.
  - Recoveries of lost profits whether as insurance proceeds or damages are includible in gross income.
  - Amounts received because of personal injury or sickness are generally excluded from gross income.
  - Punitive damages awarded on the basis of sickness or physical injury are taxable.
  - Study Example 3-34

6. Other Items of Gross Income

6) Recovery of Previously Deducted Amounts

- On occasion, a taxpayer may deduct an amount in one year but recover the amount next year.
  - Examples: medical expenses deducted in Year 1 but reimbursed in Year 2. State income tax withholding deducted in Year 1 but partially refunded in Year 2.
- Recovery of previously deducted amounts are generally taxable
- Study Examples 3-35, 3-36, and 3-37 for details.

6. Other Items of Gross Income

7) Claim of Rights

- A taxpayer may receive funds, which have disputed ownership. Under the claim of right doctrine, the taxpayer must report the disputed amount as income, unless the use of funds is restricted.
  - Study Examples 3-38, 3-39
- If the taxpayer is subsequently required to repay the disputed amount, a deduction is available in the year of repayment. An adjustment may be available if the taxpayer's marginal tax rate in the year of inclusion exceeds the taxpayer's marginal tax rate in the year of deduction.

7. Tax Planning Considerations

Overview

1) Shifting income
2) Alimony
3) Prepaid income
4) Taxable, tax-exempt, or tax-deferred bonds
5) Reporting savings bond interest
6) Deferred compensation arrangements

7. Tax Planning Considerations

1) Shifting income, 2) Alimony, 3) Prepaid Income

- Shifting income
  - Shifting income from high-bracket taxpayers to low-bracket taxpayers can reduce the overall family tax burden.
  - Watch out for gift-tax problems
  - Additional administrative expenses should be considered into this type of planning
- Alimony
  - Deductible by payor and includible by payee
  - If the payee's marginal tax rate is lower than the payor's marginal tax rate, which is often the case, there is tax saving overall.
  - Study Example 3-41
- Prepaid income – taxed when payment is received
  - One would want to receive prepaid income if income can be shifted from a year with a high marginal tax rate to a lower marginal tax rate.
  - Study Example 3-42

7. Tax Planning Considerations

4) Bonds, 5) Reporting Savings Bonds Interest

- Taxable, tax-exempt, or tax-deferred bonds
  - Which type is better will depend on the different yields and the tax-payer's marginal tax rate
  - One needs to compare present value of after-tax returns
  - Study Example 3-43
- Reporting savings bond interest
  - It may be a tax advantage to report interest from U.S. Savings bonds owned by minor children on an annual income tax return. If the amount of interest is less than the standard deduction, such annual reporting will result in no tax. This approach will avoid the bunching of income in the year of redemption.

7. Tax Planning Considerations

6) Deferred Compensation Arrangements

- Deferred compensation can be used as a means of avoiding the constructive receipt of income.
- Study Example 3-44 for details.

8. Compliance and Procedural Considerations

- Gross income is summarized on Form 1040 from various supporting schedules
  - Wage and salary directly on the form
  - Schedule B – Interest and Dividends
  - Schedule C – Business Income
  - Schedule D – Capital gains
  - Schedule E – Rents and Royalties
  - Schedule F – Farm Income
- Study Example 3-45

Addition Things to Study

- Answers to Selected Textbook Problems:
- 3-5, 3-8, 3-11, 3-18, 3-30, 3-35, 3-46, 3-52, 3-55, 3-62, 3-63, 3-64
  - http://www.fcs.utah.edu/~fan/fcs5530/Answers%20to%20Selected%20Problems/AnswersSelectedUnit03.pdf
- Self-study Quizzes on Publisher's website:
  - http://wps.prenhall.com/bp_pope_fedtax_2010/120/30826/7891703.cw/index.html
  - Homework Assignment for Unit03 (Graded)
  - PAK, Chapter 3 Problems: 3-34, 3-39, 3-44, 3-48, 3-50, 3-56
  - Please go to Week 3 folder on course Homepage to find the link. You can also access it directly through the "Assignments" link.
- Discussion Topic for Unit03(Graded)
  - Don't forget to post your thoughts on the discussion topic of the week.
  - Go to the Week 3 folder on course Homepage to find the link. You can also access it directly through the "Discussions" link.