CHAPTER 2

Gross Income & Exclusions

Income Tax Fundamentals 2011

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Learning Objectives

- Understand and apply definition of gross income
- Determine tax treatment of income categories such as interest, dividends, alimony, etc.
- Calculate taxable portion of annuities
- Identify exclusions from gross income such as life insurance proceeds, fringe benefits, inheritances, etc.
- Apply rules governing inclusion of Social Security payments as income
Defining Gross Income

Gross income is “All income from whatever source derived”

This means all sources of income are included unless specifically excluded

- See Table 2.1 on page 2-3 for inclusions
- See Table 2.2 on page 2-3 for exclusions
- Non-cash items included at fair market value
- Barter transactions are includable

Note: Income from illegal activities is includable in gross income
Interest Income

- If total interest income > $1,500, must report on Schedule B (1040) or Schedule 1 (1040A)

- Interest is reported in year received for cash basis taxpayers
  - Fair market value of gifts/services a taxpayer receives for making long-term deposits or opening an account are taxable interest
US Government Bonds

- **Series EE bonds**
  - Purchase at discount and then redeem
    - Interest taxed each year as value increases
    - Interest taxed in year of maturity or year bonds are cashed in (whichever is earlier)

- **Series HH bonds**
  - Issued at face value
    - Pay interest semiannually and interest is taxed each year
    - Treasury stopped issuing 8/04, but there are still outstanding HH bonds that are paying interest

- **Series I bonds**
  - Purchase for face value
    - Earnings are adjusted semiannually for inflation
    - Interest taxed each year or at maturity
Dividend Income

3 kinds of dividends

- Ordinary dividends
  - Most common
  - Return of net income to shareholders
  - Schedule B (1040) when total dividend income > $1,500

- Nontaxable distributions
  - Return of original investment - not paid from corporation’s earnings and profits
  - Not included in taxpayer’s income
  - Reduces basis in stock

- Capital gain distributions (CGD)
  - When stock reaches zero basis, further distributions are CGD
  - Report on page 1 of 1040 or Schedule D
Tax Rates for Dividends

- 2003 and 2006 Tax Acts resulted in lower tax rates for "qualifying dividends"

- These special rates are set to sunset (expire) at end of 2010
  - “Qualifying dividends” are those that are received by an individual who has held stock for more than 60 days during the 120-day period, beginning 60 days before stock’s ex-dividend date

<table>
<thead>
<tr>
<th>Regular tax bracket</th>
<th>Qualifying Dividend Rate 2008-2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%, 15%</td>
<td>0%</td>
</tr>
<tr>
<td>Higher brackets</td>
<td>15%</td>
</tr>
</tbody>
</table>

- If not “qualifying”, dividends taxed at ordinary rates
Alimony

- Alimony is deductible to payer and taxable to payee
- Alimony payments must meet *five requirements* as follows (if subject to divorce agreement after 1984)
  - Must be in cash and received by ex-spouse
  - Must be made in connection with written instrument
  - Can’t continue after death of ex-spouse
  - Can’t be designated as anything other than alimony
  - Parties may not be members of the same household
Other Issues with Alimony

- Recapture provisions prevent front-end loading of alimony payments

- Property transfer is not alimony because it’s not cash
  - Transferor doesn’t have to recognize any gain on transaction
  - Transferee’s basis is same as transferor’s
Example

Complying with a 2010 written divorce decree, Frederik pays Shanna $1,800/month. The decree specifies that the payments will be reduced 40% when their daughter, in Shanna’s custody, becomes eighteen. How much can Frederik deduct per year as alimony?
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Solution
40% of each payment is considered nondeductible child support; therefore, $1,800 x 12 months x 60% = $12,960/year deductible alimony.
Child Support

- Child support is not deductible to payer and not taxable to payee
- If payer falls behind on child support, he/she must bring this current before any portion of payments can be considered alimony
- Rules differ for divorce agreements executed pre- and post-1985
Prizes/Awards

- Taxable amount equal to cash prize or fair market value of property
  - Exception: Employee awards of tangible personal property (up to $400) received for recognition of length of service or safety achievement are excludable. Up to $1,600 may be excluded, if it is granted under a “qualified plan award.”

- Game show and reality TV show winners should be aware that prizes/awards are taxable
Prize/Award Example

Example
Josef, an employee of Vesuvius Statuaries LLC, receives a clock for 20 years of service valued at $1,500 and the award is not considered a “qualified plan award;” how much is excludable from Josef’s gross income?
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Solution
$400 is excluded and $1,100 would have to be included in Josef’s gross income calculation.
Annuities/Pensions

- An annuity is an instrument that a taxpayer buys (usually at retirement) in return for periodic payments for the remainder of his/her life.
- The taxable portion of these periodic payments is calculated based on:
  - Mortality tables provided by IRS
  - The annuity purchase price
Annuities/Pensions

General Rule

- Payments received are both taxable (income) and nontaxable (return of capital)
- Must calculate amount to exclude from income

1. First, calculate exclusion ratio

   \[ \frac{\text{Investment in Contract}}{(\text{Annual payment} \times \text{Life expectancy})} \]

2. Secondly, find the amount to exclude

   \[ \text{Exclusion Ratio} \times \text{Annual Amount of Annuity Received} \]
Example
Din has saved $750,000 in his retirement account and uses it to purchase an annuity. His annuity equals $4,800/month and the IRS tables show he is expected to live 19 years. How much is excludable from tax each year of Din’s retirement? Assume that Din is required to use the general rule.
Example
Din has saved $750,000 in his retirement account and uses it to purchase an annuity. His annuity pays $4,800/month and the IRS tables show he is expected to live 19 years. How much is excludable from tax each year of Din’s retirement? Assume that Din is required to use the general rule.

Solution
$750,000/($4,800 \times 12 \text{ months} \times 19 \text{ years}) = .685 \text{ exclusion ratio}

.685 = 68.5\% \text{ of amount is excluded from tax}

.685 \times ($4,800 \times 12 \text{ months}) = $39,456 \text{ annual exclusion}
Annuities/Pensions – Simplified Method

- Individuals generally required to use this method to calculate taxable amount from an annuity - if annuity payments commenced after 11/18/96

- Taxpayer must fill in worksheet provided by IRS
  - See pp. 2-13 and 2-14 for example of simplified method worksheet
Employee Annuities

- Employers may make periodic payments to retirement plans on behalf of their employees.
- These payments are not taxable to the employee in the current year.
- They are not considered part of investment when calculating exclusion ratio.
Life insurance proceeds are excluded from gross income if:

◦ Proceeds paid to beneficiary by reason of death of the insured
  and
◦ Beneficiary has an insurable interest

Note: Interest on proceeds paid over several years is generally taxable income
Life Insurance Proceeds Example

Example

Karina dies on 6/15/10, leaving her husband, Dann, a $500,000 life insurance policy. The proceeds will be paid out to Dann $100,000 per year plus interest for 5 years.

In the current year, Dann receives $105,000 ($100,000 + $5,000 interest). How much is taxable to Dann in the current year?
Example
Karina dies on 6/15/10, leaving her husband, Dann, a $500,000 life insurance policy. The proceeds will be paid out to Dann $100,000 per year plus interest for 5 years. In the current year, Dann receives $105,000 ($100,000 + $5,000 interest). How much is taxable to Dann in the current year?

Solution
Dann must include the $5,000 of interest income in his gross income calculation; the face value of $100,000 is not taxable.
Viatical Settlements

- Also known as accelerated death benefits
- Viatical settlements are excludable from gross income in certain situations
  - Chronically or terminally ill taxpayer collects early payout from insurance company or sells/assigns policy to a viatical settlement provider
    - *Terminally ill* patient must have certification from MD stating that he/she reasonably expected to die within 24 months
    - *Chronically ill* must have certification from MD stating the he/she is unable to perform daily living activities unassisted
Life Insurance Policy
Transferred for Value

- If policy is transferred for value, then all or part of the proceeds may be taxable to recipient

Taxable amount = Proceeds from death of insured
- Cash surrender value (at time of transfer)
+ Premiums paid by purchaser to keep policy active

- Exception: if policy is transferred for value to partner of insured, a partnership in which insured is a partner or a corporation in which insured is an officer, then policy proceeds are *not* taxable
Life Policy Transfer Example

Example
Bianca transfers a life insurance policy with a face value of $25,000 and cash surrender value of $4,000 to Yvette as payment for services rendered. Yvette pays premiums of $500 per year for a total of $1,500 in the ensuing 3 years; Bianca dies and Yvette collects the $25,000. How much must Yvette include in her gross income?

How would this answer differ if Yvette and Bianca were partners in a partnership?
Example

Bianca transfers a life insurance policy with a face value of $25,000 and cash surrender value of $4,000 to Yvette as payment for services rendered. Yvette pays premiums of $500 per year for a total of $1,500 in the ensuing 3 years; Bianca dies and Yvette collects the $25,000. How much must Yvette include in her gross income? How would this answer differ if Yvette and Bianca were partners in a partnership?

Solution

Yvette must include $19,500 in income [$25,000 – (4,000 + 1,500)]. If Yvette and Bianca were partners in a partnership, the entire proceeds ($25,000) would be tax-free.
Gifts & Inheritances

- Inheritances are excluded from income
  - Any income generated from property received after transfer is taxable
  - Estate may incur taxes

- Gifts received are excluded from income
  - A gift is defined by the courts as a voluntary transfer of property without adequate consideration
  - Gifts in business settings usually considered taxable income
  - If recipient renders services for the gift, amount is taxable
Scholarships

- Scholarships received for fees, books, tuition, course-required supplies or equipment are excluded from income.
- Must include scholarship amounts in income for:
  - Any amounts applied to room and board
  - Any amounts received as compensation for required work (including work study)
Employer Paid Accident & Health Insurance Premiums

- Taxpayers may exclude from income the total amount received for
  - Payment of medical care
  - Payment for loss of a body member or function (called accidental death and dismemberment)

- Premiums paid by employer on employee’s behalf are excluded from income
  - For medical insurance
  - For accidental death and dismemberment (AD&D) insurance
Meals and Lodging

- Meals and lodging provided by employer are generally excluded from income (if following tests are met)

1. Meals provided by employer on premises during working hours solely for the benefit of the employer because employee must be available for emergency calls or is limited to short meal periods.

2. Lodging provided by employer on premises and must be accepted as a requirement for employment.
Municipal Bond Interest

- Taxpayer may exclude interest on state and local government obligations (called “muni bonds”) from federal taxation
- After-tax return for tax-free bond calculated as follows

\[
\text{After-tax return} = \frac{\text{Tax-free interest rate}}{1.00 - \text{taxpayer’s tax rate}}
\]
Municipal Bond Interest Example

Example
Gopal is in the 33% federal income tax bracket and invests in a Nashville City Bond paying 6%. What taxable interest rate will yield the same after-tax return?
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Solution

Taxable interest rate equivalent = 8.96%

\[
\frac{.06}{1.00 - .33} = .0896
\]
Social Security Benefits

- Part of Social Security benefits may be included in gross income
  - Maximum inclusion amount = 85%

- Inclusion based on taxpayer’s Modified AGI (MAGI)
  - MAGI = AGI + tax-exempt interest (and other items)

- If \([\text{MAGI} + (50\%)(\text{SS benefits})] < \text{base amount}\) then benefits are not includable

*If this number exceeds base amount, must compute taxable portion. See pages 2-21 – 2-22 for sample worksheets on how to calculate includable Social Security benefits.*
Calculating Taxable Amount of SS Benefits

If \([\text{MAGI} + (50\%) \times \text{(SS benefits)}]\) exceeds base amount as follows:

<table>
<thead>
<tr>
<th>Base Amount</th>
<th>Filing Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>$32,000</td>
<td>MFJ</td>
</tr>
<tr>
<td>$ 0</td>
<td>MFS</td>
</tr>
<tr>
<td>$25,000</td>
<td>All others</td>
</tr>
</tbody>
</table>

...then, the taxable amount is calculated by completing the Simplified Taxable Social Security Worksheet
Unemployment Compensation

- Unemployment compensation payments are fully taxable
- These payments are deductible on some state’s income tax returns
Employer-Provided Spending Accounts

- Employer-sponsored plan allowing employees to set aside pretax dollars for:
  - Dependent care (up to $5,000/year)
  - Medical/dental/optical care
  - Health insurance co-pays
  - Prescription costs
  - Public transport/parking up to certain limits

- Can result in significant tax savings for employee

- “Use-it-or-lose-it” provision
  - If amounts are left in plan after certain date, EE loses them
Employee Fringe Benefits

- May exclude certain fringe benefits from gross income, such as:
  - Employer-paid premiums for group term life insurance (face value up to $50,000)
  - Qualified employee discounts with exceptions
  - Working condition fringe benefits
    - Excludable if you could deduct item on your own as an employee
    - For example, a subscription to professional journal,
  - De minimis fringe benefits
    - These are immaterial and not worth tracking
  - Tuition reduction
    - Different rules for undergraduate vs. graduate
  - Value of membership to athletic facilities
  - Retirement planning services
  - Other excludable fringes
The End