**Chapter 5**

**Gross Income and Exclusions**

**What is income?**

IRC Section 61(a) defines income as: “Gross income means all income from whatever source derived.”

**Three Requirements for Recognizing Income:**

Taxpayers recognize income when (1) they receive an economic benefit, (2) they realize the income, and (3) no tax provision allows them to exclude or defer the income from gross income for that year.

**(1)** Does the taxpayer have an increase in wealth (i.e., does the taxpayer derive an economic benefit)?

**(2)** Is the income realized?

Income is realized when:

1. A taxpayer engages in an arms-length transaction with another party; **AND**

2. The transaction results in a measurable change in property rights.

**(3)** Does the income have to be recognized?

Any economic benefit realized is income that is generally required to be recognized unless the IRS says otherwise.

**Example:** Susie and James both own food trucks. Susie sells cupcakes, while James sells gourmet sandwiches. James buys one of Susie’s cupcakes for $5. Later, Susie buys one of James’ sandwiches for $5. Does Susie recognize income?

**Example:** Same facts as above, but James does not want to take cash out of his register before the end of the day. Instead, he offers to trade Susie a sandwich for one of her cupcakes. She accepts the sandwich. Does Susie recognize income?

**See In-Class Problems Handout**

***Other income concepts***

**Form of receipt** – A common misconception is that taxpayers must receive cash to realize and recognize gross income.

**Return of capital principle** – taxpayers are not taxed on the unrecovered portion of their investment.

**Example:** Jennifer purchased a piece of land for $23,000 in 2009. In 2019, Jennifer sold the land in an arms’ length transaction for $36,000. What is the gain on the transaction? What if Jennifer sold the land for $16,000 instead?

***When is income recognized?***

Three items that determine when income recognition occurs:

1) Accounting method

Accrual method – income is recognized when earned and expenses are deducted when liabilities are incurred (mostly used by corporations).

Cash method – income is recognized when received and expenses are deducted when paid (mostly used by individuals).

2) Constructive receipt doctrine

The taxpayer realizes and recognizes income when it is actually or constructively received.

3) Claim of right doctrine

An item is income when the taxpayer receives it and there is not a clear and definite obligation to repay the item in the future (e.g., there are no restrictions on the taxpayer’s use of the income).

**Example:** A bank loans you money that you must repay in five years. Do you include this in your income? Why?

***Who earns (recognizes) the income?***

Assignment of income doctrine – The taxpayer who earns the income must pay the tax.

**Income Sources – Three Types**

1) Earned income – income generated by the efforts of the taxpayer

Examples: Salary, tips, income from a trade or business, bonuses

2) Unearned income – income that comes from property (does not require labor)

Examples: dividends, rents, investments, interest

3) Other – income from flow-through entities; imputed income or income in kind

*Types of Unearned Income*

1) Interest income – taxable unless specific provision that states otherwise

**Example:** Your father gives you a $100,000 bond on May 31st. The bond pays interest annually on December 31st at a rate of 8%. Who receives the interest?

Who pays the tax on the interest income and how much interest income is taxable to each party, if at all?

2) Dividends – taxable, but qualified dividends are taxed at a rate of approximately 15%

3) Rent and royalty income – taxable (related deductions are FOR AGI deductions)

4) Property dispositions (sales) – taxed on gains and deduct losses; can be taxed at a preferential rate.

Sales Proceeds

Less: Selling expenses

= Amount realized

Less: Basis in the property

= Gain (loss) on sale

*Other Sources of Income*

1) Income from flow-through entities – partnerships or S-corporations

a. Taxpayer owns a percentage of the flow through entity

b. Taxpayer is taxed on his/her percentage of income and deducts his/her percentage of expenses as FOR AGI deductions

2) Alimony – payments made pursuant to a divorce or separation agreement. Taxpayer who receives the alimony has taxable income. Taxpayer who pays the alimony has a FOR AGI deduction.

Criteria:

1. Cash payment

2. Pursuant to a written agreement

3. Payment is for no other purpose

4. Payments stop at death, at least

5. Not members of the same household

Child support? – Not alimony.

Property settlements? – Not alimony.

**Example:** George and Marcie got divorced on January 1, 2018. As a couple, they collected garden gnomes. To keep the collection together, the divorce agreement states that George will pay Marcie $1,500 each month for the next year as compensation for her portion of the gnome collection. How much of the payment is included in Marcie’s income?

**Example:** Jerry and Jessica got divorced December 31, 2018. The divorce agreement states that Jerry will pay Jessica child support payments of $100,000 per year until their twins turn 18. Once the children are 18, Jerry will pay Jessica $65,000. If Jerry pays Jessica $100,000 in the year the twins turn 18, how much should be treated as child support and how much is alimony?

How does your answer change if the divorce agreement was executed on January 10, 2019?

3) Prizes, Awards, and Gambling Winnings – taxable income (include in gross income)

i. Exceptions:

(a) Prize for a scientific, literary, or charitable achievement (e.g., Nobel Prize) that the taxpayer immediately donates to a qualified not-for-profit organization.

(b) Employee awards for length of service or safety that are less than or equal to $400 per employee/year of tangible property (not cash).

(c) Winners of the Olympic and Paralympic Games – exclude the value of the medal and any cash award for winners with income of $1 million or less.

ii. Deduct gambling losses and related gambling expenses to the extent of gambling winnings (miscellaneous itemized deductions).

4) Social Security Benefits – partially taxable if the taxpayer is not a low-income individual

5) Unemployment Income – fully taxable

6) Discharge of Indebtedness – taxpayer’s debt is forgiven by lender

Does the taxpayer receive an economic benefit?

Is the discharge of indebtedness taxable income?

Exception: If taxpayer is insolvent (liabilities > assets) *both before and after* the debt forgiveness, then the forgiven amount is tax-free.

**Exclusions**

*Exclusions that Encourage Certain Behaviors*

1) Municipal bond interest

2) Employment-related exclusions – fringe benefits in addition to salary

a. medical and dental health insurance premiums

b. life insurance – premiums up to $50,000 of group-term life insurance are excluded from income

c. de minimis benefits – excluded, but why?

d. retirement contributions – excluded in the current period, but will be taxed in the future

3) Education-related exclusions

a. Employee educational assistance programs

b. scholarships if used for books, tuition, and other items required for class

c. proceeds from investments in qualified education plans (529 plans or Coverdell education savings accounts), if used for qualified education expenses

*Exclusions that Mitigate Double Taxation*

4) Gifts and inheritances

5) Life insurance proceeds – excluded if taken in a lump sum

a. What if the proceeds are taken over time?

*Sickness and Injury-Related Exclusions*

6) Workers’ compensation – income from a work-related injury

7) Personal injury payments

a. all payments associated with *physical injury or sickness* are excluded

b. emotional distress: payments are excluded if the emotional distress is related to physical injury, otherwise they are included in gross income

c. *punitive* damages are fully taxable, even if for physical injury or sickness

8) Health care reimbursements from a health or accident insurance policy – excluded if reimbursed for medical expenses paid by the taxpayer

9) Disability insurance – pays individuals for lost wages due to disability or injury

a. disability payments from an insurance plan purchased *by the taxpayer* are excluded

b. What constitutes a purchase?

c. If *employer* purchased the disability insurance, any payments from the policy are taxable income to the employee. If *employee* purchased the disability insurance, any payments from the policy are excluded from the employee’s gross income, i.e., not taxable.