Chapter 3

Gross Income: Concepts and Inclusions

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Gross Income (slide 1 of 3)

- Definition: Gross income includes all income from whatever source derived, unless specifically excluded under the Code
- Concept is interpreted broadly by the courts

Gross Income (slide 2 of 3)

- Taxability of income follows the realization principle from accounting
  - Income is recognized (taxed) when realized
- Mere appreciation in wealth (economic income) is not considered realized income

Gross Income (slide 3 of 3)

- Income is recognized whether it is in the form of cash, or "in-kind" cash equivalents (i.e., property or services)
  - The amount of income from "in-kind" receipts is equal to the FMV of the property or services
- Income does not include recovery of the taxpayer's capital investment

Accounting Periods

- Taxable year is generally a 12-month period
  - Taxable year for most individual taxpayers is the calendar year
  - Fiscal year can be elected if taxpayer maintains adequate records
    - Fiscal year is a 12-month period ending on the last day of a month other than December
      - Example: July 1 to June 30

Accounting Methods

- There are 3 primary methods of accounting for tax purposes:
  - Cash receipts
  - Accrual
  - Hybrid

Cash Receipts Method (slide 1 of 2)

- Income is recognized in the year it is actually or constructively received in cash or cash equivalent
- An amount is constructively received when it is set aside and made available to taxpayer without substantial restrictions

Cash Receipts Method (slide 2 of 2)

- Examples of constructive receipt
  - Interest on a savings account is taxable when added to the account balance even though taxpayer does not withdraw the interest
  - Dividends mailed on December 31, 2002 which arrive in taxpayer's mail January 3, 2003 are taxable in 2003. The dividend was not available to the taxpayer until 2003.

Exceptions To Cash Receipts Method

- Original Issue Discount (OID) interest is taxable when earned rather than when interest is received
- Series E and EE bonds are not subject to the OID rules. However, a taxpayer may elect to recognize the interest when earned.

Accrual method (slide 1 of 2)

- Income is recognized in the year that it is earned regardless of when it is collected
- Income is earned when:
  - All events have occurred that fix taxpayer's right to the income, and
  - The amount can be determined with reasonable accuracy

Accrual Method (slide 2 of 2)

- Claim of right doctrine
  - Requires <u>amounts</u> <u>received</u> to be included in income even though the amount is in dispute and might be returned to the payor at a later date
  - If payment has not been received, no income is recognized until the claim is settled

Exceptions to Accrual Method
(slide 1 of 2)

- Taxpayer can elect to defer recognition of income from advance payment for goods if same method of accounting is used for tax and financial reporting purposes

Exceptions to Accrual Method
(slide 2 of 2)

- Prepayment for services is recognized when earned if services will be performed by the end of the tax year following the year of receipt
- Prepaid rents or interest income are always recognized in the year received rather than when earned

Hybrid Method

- A combination of cash and accrual methods
- Generally, used when inventory is a material income-producing factor
  - Use accrual method for determining sales and cost of goods sold
  - Use cash method for other income and expenses

Income Sources (slide 1 of 4)

- Income from personal services is taxable to the person who performs the services
  - Fruit and tree metaphor
- Income from property is taxable to the owner of the property
  - Assignment of income is not permitted

Income Sources (slide 2 of 4)

- Interest income accrues daily
  - If interest bearing instrument (e.g., bonds) is transferred, must allocate interest income between transferor and transferee
- Dividends are generally taxed to the party who is entitled to receive them
  - Dividends on stock transferred by gift after declaration date but before record date is generally taxed to the donor

Income Sources (slide 3 of 4)

- Income from pass-through entities is taxable at the owner level rather than at the entity level
- Pass-through entities include:
  - Partnerships
  - S corporations
  - Estates and trusts

Income Sources (slide 4 of 4)

- Community property issues
  - Community vs. separate property
    - Community income is allocable equally to each spouse
    - Separate income may be allocable to owner-spouse
  - Separate property may produce community income (e.g., TX, LA)
  - No allocation of community income for some spouses living apart for entire year and filing separately

Alimony and Separate Maintenance Payments (slide 1 of 4)

- Alimony is:
  - Deductible by payor
  - Includible in gross income of recipient

Alimony and Separate Maintenance Payments (slide 2 of 4)

Payments may qualify as alimony if:

1. The payments are in cash
2. The agreement or decree does not specify that the payments are not alimony
3. The payor and payee are not members of the same household at the time the payments are made
4. There is no liability to make the payments for any period after the death of the payee

Alimony and Separate Maintenance Payments (slide 3 of 4)

- Property settlements
  - Transfer of property to former spouse
  - No deduction or recognized gain or loss for payor
  - No gross income and carryover of payor's basis for recipient
  - Front-loading of alimony payments
    - Alimony recapture (gross income) for payor
    - Deduction from gross income for recipient

Alimony and Separate Maintenance Payments (slide 4 of 4)

- Child support payments
  - Payments made to satisfy legal obligation to support child of taxpayer
  - Nondeductible by payor and not taxed to recipient (or child)
- If amount of payment would be reduced due to some future event related to the child (e.g., child reaches age 21), such reduction is deemed child support

Imputed Interest on Below-Market Loans (slide 1 of 3)

- Interest is imputed, using Federal government rates, when a loan does not carry a market rate of interest
- Applies to:
  - Gift loans
  - Compensation-related loans
  - Corporate-shareholder loans
  - Tax avoidance loans

Imputed Interest on Below-Market Loans (slide 2 of 3)

- Gift loans
  - Exemption for loans of $10,000 or less
  - Limitation on imputed interest on loans of $100,000 or less between individuals
    - Imputed interest is limited to borrower's net investment income for year
    - No imputed interest if net investment income is $1,000 or less

Imputed Interest on Below-Market Loans (slide 3 of 3)

- $10,000 exemption also applies to compensation-related and corporation-shareholder loans
  - No exemption if principal purpose of loan is tax avoidance
- Interest expense imputed to borrower may be deductible

Annuity Income
(slide 1 of 6)

- Purchaser pays fixed amount for the right to receive a future stream of payments
  - Generally, early collections and loans against annuity ≤ increases in cash value are included in gross income
  - Amounts > increases in cash value are treated as a recovery of capital until cost recovered; additional amounts are included in income
  - Early distributions may also be subject to a 10% penalty

Annuity Income

(slide 2 of 6)

- The exclusion ratio is applied to annuity payments received under contract to determine amount excludable:

$$\text{Exclusion ratio} = \frac{\text{Investment in contract}}{\text{Expected return under contract}}$$

- Once investment is recovered, remaining payments are taxable in full

Annuity Income

(slide 3 of 6)

- Examples:
  - Taxpayer pays $10,000 for annuity that will pay $1,000 a year
    - A: For a term of 15 years
    - B: For lifetime (life expectancy = 15 years)
  - Exclusion ratio for A & B =

$$\frac{\$10{,}000}{\$15{,}000} = .667$$

Annuity Income

- Example (cont'd)
  - A: 15 years of annuity payments
    - Years 1-15: $333 taxable and $667 excludable

Annuity Income

(slide 5 of 6)

- Example (cont'd)
  - B: Lifetime payments and taxpayer lives 18 years
    - Years 1-15: $333 taxable and $667 excludable
    - Years 16-18: $1,000 taxable
  - B: Lifetime payments and taxpayer lives 10 years
    - Years 1-10: $333 taxable and $667 excludable, and $3,330 deduction (FROM AGI) on final return

Annuity Income

(slide 6 of 6)

- Simplified method for annuity distributions from qualified retirement plan available
  - Exclusion amount is investment in contract divided by number of anticipated monthly payments (table amount based on age)

Prizes and Awards

- General rule: FMV of item is included in income
- Exceptions:
  - Taxpayer designates qualified organization to receive prize or award (subject to other requirements)
  - Employee achievement awards of tangible personal property made in recognition of length of service or safety achievement

Group Term Life Insurance

- Exclude premiums paid by employer on first $50,000 of coverage
- Premiums on excess coverage are included in gross income
  - Inclusion amount based on IRS provided tables

Unemployment Compensation

- Taxable in full

Social Security Benefits
(slide 1 of 6)

- Up to 85% of benefits may be taxable
- Taxability based on taxpayer's modified adjusted gross income (MAGI)
  - MAGI = AGI + foreign earned income exclusion + tax exempt interest
- Two formulas for computing taxable benefits

Social Security Benefits

(slide 2 of 6)

- Formula 1

  Include in income the lesser of:

  .50 (Social Security Benefits), or

  .50 [MAGI + .50 (SSB) - base amount]

  Base amounts:

  – $32,000 MFJ,
  – $0 MFS and not living apart,
  – $25,000 for all other taxpayers

Social Security Benefits

(slide 3 of 6)

- Formula 2

  Include in income the lesser of:

  - .85(Social Security benefits), or
  - Sum of: .85[MAGI + .50(Social Security benefits) – second base amount], and the lesser of:
    - Amount included through application of the first formula
    - $4,500 ($6,000 for married filing jointly).

- Base amounts:
  - $44,000 MFJ,
  - $0 MFS and not living apart
  - $34,000 for all other taxpayers

Social Security Benefits

(slide 4 of 6)

- Example of Social Security income:
  - A: Married with AGI = $30,000; tax exempt interest income = $3,000; Social Security benefits = $10,000
  - B: Married with AGI = $40,000; tax exempt interest income = $6,000; Social Security benefits = $10,000

Social Security Benefits

(slide 5 of 6)

- Example (cont'd)

  A: Formula 1: Lesser of:

  .50 ($10,000) = $5,000, or

  .50 [($30,000 + $3,000) + .50 ($10,000) - $32,000)] = $3,000

  Therefore, $3,000 of Social Security benefits included in gross income

Social Security Benefits
(slide 6 of 6)

- Example (cont'd)
  - B: Formula 2: Lesser of:
    - .85 ($10,000) = $8,500, or
    - Sum of
      - .85[($40,000 + $6,000) + .50 ($10,000) - $44,000] = $5,950, and
      - Lesser of:
      - .50 ($10,000) = $5,000, or
      - $6,000

Therefore, $8,500 of Social Security benefits included in gross income

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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