Exclusions Defined

- Items of income that are specifically designated as not included in gross income
- Exclusions are generally found in Sections 101 through 150
Gifts and Inheritances
(slide 1 of 5)

• Gifts are nontaxable to donee if:
  – Transfer is voluntary without adequate consideration, and
  – Made because of affection, respect, admiration, charity, or donative intent
Gifts and Inheritances
(slide 2 of 5)

- Inheritances are nontaxable to beneficiary
- Income earned on gifts or inheritances is taxable under normal rules
  - Example: Father gifts corporate bond to daughter. Gift is excluded from daughter’s gross income, but interest income earned after gift date is taxable to her.
Gifts and Inheritances
(slide 3 of 5)

• Transfers by employers to employees do not qualify as excludible gifts
  – May be excludible under other provisions, e.g., employee achievement awards
Gifts and Inheritances
(slide 4 of 5)

• Employee death benefits: amount paid by employer to deceased employee’s spouse, child, or others
  – If decedent had a nonforfeitable right to payments (e.g., accrued salary), amounts are taxable to employee
Gifts and Inheritances
(slides 5 of 5)

• Employee death benefits may be excludible as a gift if:
  • Paid to surviving spouse or children (not employee’s estate),
  • Employer derived no benefit from payments,
  • Surviving spouse and children performed no services for employer,
  • Decedent had been fully compensated for services rendered, and
  • Payments made pursuant to board of director’s resolution under a general company policy
Life Insurance Proceeds
(slide 1 of 4)

• Exempt income to beneficiary if paid solely due to death of insured
  – Relationship to decedent not determinative
Life Insurance Proceeds
(slide 2 of 4)

• If owner of life insurance policy cancels the policy and receives the cash surrender value
  – Gain must be recognized to extent amount received exceeds premiums paid on policy
  – Loss is not recognized
Life Insurance Proceeds
(slide 3 of 4)

• Accelerated death benefits
  – Gain on cash surrender or transfer of life insurance policy by terminally or chronically ill individual is excludible
    • Exclusion for chronically ill is limited to amounts used for long-term care
Life Insurance Proceeds
(slide 4 of 4)

- Transfers for valuable consideration
  - If policy is transferred for valuable consideration, proceeds are taxable to extent they exceed amount paid for policy plus subsequent premiums paid
  - Exceptions exist to facilitate funding of buy-sell agreements, transfers pursuant to a tax-free exchange and receipt of a policy by gift
Scholarships and Fellowships
(slide 1 of 2)

• An amount paid to or for the benefit of a student to aid in pursuing a degree at an educational institution
  – Nontaxable to extent of tuition and related expenses (e.g., fees, books, supplies, and equipment required for courses)
• Amounts received for room and board are taxable
Scholarships and Fellowships
(slide 2 of 2)

• Qualified tuition waivers or reductions by nonprofit educational institutions are excluded from income
  – Generally limited to undergraduate tuition waivers
  – Exception for graduate teaching or research assistants
• Personal injury damages
  – Compensatory damages received on account of physical personal injury or physical illness are excludible
    • All other personal injury damages taxable
      – Compensatory damages for nonphysical injury
      – All punitive damages
    – Payments solely for loss of income are also taxable
Compensation for Injuries and Sickness (slide 2 of 3)

- Workers’ compensation
  - Although may be payment for loss of wages, workers’ compensation is specifically excluded from gross income
Compensation for Injuries and Sickness (slide 3 of 3)

• Accident and health insurance benefits
  – Benefits received under policy purchased by taxpayer excludible
    • Even if benefits are substitute for income
Employer-Sponsored Accident and Health Plans (slide 1 of 2)

- Premiums paid by employer for insurance coverage of employee, spouse, and dependents are not taxable to employee.
- Amounts received from insurance are not taxable when received for medical care or for permanent loss of body part or function.
Employer-Sponsored Accident and Health Plans (slide 2 of 2)

- Medical savings accounts (high deductible insurance plans)
  - Employer contribution to employee MSA is excludible
    - Contributions limited to 65% of individual deductible (75% of family deductible)
  - Withdrawals from MSA excludible to the extent used for medical expenses not covered by insurance plan
Long-Term Care Insurance

• Employer paid insurance premiums for employee’s long-term care are excludible.

• Excludible benefits are limited to the greater of the following amounts:
  – $220 in 2003 (indexed amount for 2002 is $210) for each day patient receives long-term care.
  – The actual cost of the care.
    • Reduced by any amounts received from other third parties (e.g., damages received).
Meals and Lodging

• Not taxable to employee if:
  – Furnished by employer
    • On employer’s business premises
    • For convenience of employer
  – In the case of lodging, employee is required to accept lodging as a condition of employment
Other Fringe Benefits
(slide 1 of 3)

- Dependent care
  - Up to $5,000 of care costs paid for by employer can be excluded
- Athletic facilities
  - Value of use of athletic facilities located on employer premises can be excluded
• Educational assistance programs
  – Employer-provided educational assistance for undergraduate and graduate education is excludible
    • Exclusion limited to $5,250 per year
Other Fringe Benefits
(slide 3 of 3)

• Adoption assistance programs
  – Employee adoption expenses paid or reimbursed by employer are excludible
    • Exclusion limited to $10,160
    • Exclusion phases-out as AGI increases from $152,390 to $192,390
Cafeteria Plans

- Allows employees to choose between cash and certain nontaxable benefits
  - If cash is chosen, the amount received is taxable
  - If a nontaxable benefit is chosen, the benefit remains nontaxable
Flexible Spending Plans

• Allows employees to accept lower cash compensation in return for employer agreeing to pay certain costs without the employee recognizing income
  – Called a *use or lose* plan since reduction in pay cannot be recovered if covered expenses are less than expected
Classes of Nontaxable Employee Benefits

- No-additional-cost services
- Qualified employee discounts
- Working condition fringes
- De minimis fringes
- Qualified transportation fringes
- Qualified moving expense reimbursements
- Qualified retirement planning services
No Additional Cost Services

• Are nontaxable if:
  – Employee receives services (not property)
  – Employer incurs no substantial additional cost in providing the services
  – Services offered are within line of business in which employee works
  – Benefit is offered on nondiscriminatory basis
Qualified Employee Discounts

• Are nontaxable if:
  – Discount is not on realty or investment property
  – Item discounted is from same line of business in which employee works
  – Discount cannot exceed gross profit on property or 20% on services
  – Benefit is offered on nondiscriminatory basis
Working Condition Fringes

- Not taxable if employee could have deducted cost of item if they had actually paid for them
  - Includes personal use of auto by full-time auto salespeople and employee business expenses that would be eliminated by the 2 percent floor on miscellaneous deductions
De Minimis Benefits (slide 1 of 2)

- These benefits are so small that accounting for them is impractical
- Examples include:
  - Supper money
  - Occasional personal use of company copying machine,
  - Company cocktail parties
  - Picnics for employees
De Minimis Benefits (slide 2 of 2)

- Subsidized eating facilities operated by employer are excluded if:
  - Located on or near employer’s premises
  - Revenue equals or exceeds operating costs
  - Nondiscrimination requirements are met
Qualified Transportation

- This fringe benefit is designed to encourage the use of mass transit for commuting to work
  - Includes:
    - Transportation in commuter highway vehicle and transit passes (limited to $100 per month)
    - Qualified parking (limited to $190 per month)
- Employee can choose between employer-provided benefit and cash without loss of exclusion
Moving Expenses

• Employer reimbursement of employee’s moving expenses is excludible
  – No deduction is allowed for reimbursed moving expenses
Qualified Retirement Planning Services

- Value of any retirement planning advice or information provided by employer who maintains a qualified retirement plan is excluded from income
- Designed to motivate more employers to provide retirement planning services
Foreign Earned Income
(slide 1 of 3)

• Income from personal services in a foreign country can be excluded from income
• To qualify for the exclusion, must be either:
  – A bona fide resident of foreign country, or
  – Present in foreign country at least 330 days during any 12 consecutive months
Foreign Earned Income
(slide 2 of 3)

- Exclusion amounts are as follows:

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$78,000</td>
</tr>
<tr>
<td>2002</td>
<td>$80,000</td>
</tr>
<tr>
<td>2003</td>
<td>$80,000</td>
</tr>
</tbody>
</table>
Foreign Earned Income
(slide 3 of 3)

- Example of foreign earned income exclusion:
  - Taxpayer lived in Japan from August 1, 2002 to July 19, 2003. For 2003, taxpayer has $90,000 foreign earned income.
  - Exclusion for 2003 = $43,836 (200/365 x $80,000)
Interest on State and Local Government Obligations

- Interest from municipal bonds is tax exempt
  - Reduces borrowing costs of state and local governments
  - High-income taxpayers can increase after-tax yields with municipal bonds
  - Municipal interest is considered for Social Security benefits inclusion and may be considered for alternative minimum tax calculation
Dividends

- Taxable to extent paid out of either current or accumulated earnings and profits (E&P)
  - Treated as ordinary income
- Dividends in excess of E&P are treated:
  - As return of capital to extent of stock basis (which is reduced)
  - As capital gain to extent in excess of basis
Stock Dividends

- Stock dividends (e.g., common stock issued to common shareholders) are not taxable.
  - If shareholder has the option to receive stock or cash, the dividend is taxable whether the shareholder receives cash or stock.
Educational Savings Bonds

• Interest on Series EE U.S. Savings Bonds may be excluded from income if:
  – Proceeds used to pay for qualified higher educational expenses
  – Bonds issued after 12/31/89, and
  – Bonds issued to person at least 24 years old

• Exclusion is phased-out once modified AGI exceeds threshold amount
Qualified Tuition Programs

- Amounts contributed must be used to pay qualified higher education expenses (tuition, fees, books, supplies, room and board, and equipment)
  - Earnings on contributions, including discounted tuition for plan participants, are not taxable if used for qualified higher education expenses
  - Refunds from program are taxable to the extent they exceed contributions
Tax Benefit Rule

• If taxpayer receives a deduction for an item in one year and in a later year recovers all or a portion of the prior deduction, the recovery is included in gross income
  – Amount included in income is limited to the amount for which a tax benefit was received
Discharge from Indebtedness

- Income from the forgiveness of debt is taxable
  - Certain discharge of indebtedness situations get special treatment:
    - Creditors’ gifts
    - Discharges in bankruptcy and when debtor is insolvent
    - Discharge of farm debt
    - Discharge of qualified real property indebtedness
    - Seller’s cancellation of buyer’s debt
    - Shareholder’s cancellation of corporation’s debt
    - Forgiveness of certain student loans
If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

Dr. Donald R. Trippeer, CPA
donald.trippeer@colostate-pueblo.edu
Colorado State University-Pueblo