Chapter 4

Gross Income: Exclusions

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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
(slide 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

Compensation for Injuries and Sickness (slide 1 of 3)

- 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

Other Fringe Benefits
(slide 2 of 3)

- 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:

Tax Year	Amount
2001	$78,000
2002	$80,000
2003	$80,000

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:

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