

Chapter 3. Gross Income Inclusions

After reviewing this chapter, you should be able to:

1. *Define income and recognize items included in income*
2. *Explain the principles used to determine who is taxed on a particular item of income*
3. *Apply the rules of IRC Section 61(a) to determine whether items such as compensation, dividends, alimony, and pensions are taxable*

Reference Material:* IRS Publication 17 – Your Federal Income Tax (2014)

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IRC Section 61(a) states that except as otherwise provided for under this subtitle, gross income means all income from whatever source derived, including, but not limited to, the following items. It then lists 15 items. This definition is not all-inclusive. It does not indicate whether specific items of income, such as insurance settlements, gambling winnings, or illegal income, are taxable. The phrase “except as otherwise provided” means that all sources of income are presumed to be taxable unless there is a specific exclusion in the income tax law. The IRS does not have to prove that an item of income is taxable; rather, the taxpayer must prove that the item of income is excluded. Therefore, gambling winnings and illegal income are taxable because no specific provisions in the tax law exclude those amounts from taxation. Gross income is not limited to amounts received in the form of cash. According to Treasury Reg. Section 1.61-1(a), income may be “realized in any form, whether in money, property, or services.” The important question is whether the taxpayer receives an economic benefit. If a taxpayer benefits from an item, it is taxable.

However, it is well established that taxpayers may exclude indirect benefits from gross income. An employer may make an expenditure that incidentally or indirectly benefits its employees. That expenditure is excludable if it is made to serve the business needs of the employer and any benefit to the employee is secondary and incidental. Congress has established rules for situations where expenditures are made primarily to benefit employees. While expenditures made by employers that primarily benefit employees generally are taxable, there are instances when such expenditures are not taxable. These rules permit employees to exclude certain fringe benefits, such as employee discounts, from gross income (Publication 17, Wages, Salaries and Other Earnings).

If it has been established that income is taxable, it is necessary to determine to whom it is taxable. Although such determinations are normally easy, there are circumstances where income is

not necessarily taxed to the person who receives it. If physical receipt of income was the only test, a family might reduce or eliminate its income tax by having income paid to children and other members who are in low tax brackets or have no tax liability. The Supreme Court has held in *Lucas v. Earl* that an individual is taxed on the earnings from his or her personal services. An agreement to assign income does not permit a person to avoid being taxed on the income. Later, in *Helvering v. Horst*, the Supreme Court extended the “assignment of income” doctrine to income from property. Income from property is taxed to the owner of the property. To transfer the income from property, the taxpayer must transfer ownership of the property itself. Married couples can file joint returns today, but that privilege was not available until after these cases. The assignment of income can be an issue today when other individuals, such as parents and children, are involved, and it can still be an issue if married couples file separate returns.

For federal income tax purposes, income is allocated between a husband and wife depending on the state of residence. Forty-one states follow common law property systems; nine states use a community property system (Publication 17, Filing Information). Alaska, for instance, has adopted an elective community property system. Under common law, income generally is taxed to the individual who earns the income, either through labor or capital. In the case of a married couple, if the wife owns stock separately in her name and receives dividends from the stock, the income is taxed entirely to the wife. Generally, the only joint income in a common law state is income from jointly-owned property.

In community property states, income may be either separate or community. Community income is considered to belong equally to the spouses. In all community property states, income from the personal efforts of either spouse is considered to belong equally to the spouses. Income from community property is considered community income. But even in community property states, couples can have separate property, meaning property that one spouse owned prior to marriage, and gifts and inheritances acquired by one spouse after marriage. Whether income from separate property is community or separate depends on state law. In some states, income from separate property is community income, but for other states it is not.

These rules are important if couples file separate returns. The community income rules can be a problem if one spouse conceals income from the other. Normally, each spouse is expected to report half of all community income. This treatment is inequitable if one spouse is not aware that the community income was earned. Special rules excuse an innocent spouse who fails to report community income on a separate return, provided that the spouse had no knowledge or reason to know of the income (Publication 555). A corresponding provision permits the IRS to include the entire amount in the income of the other spouse.

State law as discussed above determines whether a husband or wife is taxed on income. Earnings of a minor child are taxed to the child regardless of the state's property laws. A minor child's earnings from either personal services or from property are taxed to the child, not to the child's parents. Unearned income in excess of \$1,900 of a child who is age 18 at the close of the tax year or under age 24 if a student, may be taxed at the parents' tax rate if it is higher than the child's rate, commonly referred to as the Kiddie Tax. The parents may, however, elect to include the child's unearned income on their return; this is done by completing and attaching Form 8814 to the parents' return (Publication 17, Tax on Investment Income of Certain Children).

Section 61(a) states that gross income includes, but is not limited to, 15 specifically listed types of income.

Compensation is payment for personal services. Personal services include salaries; wages; fees; commissions; tips; bonuses; and specialized forms of compensation such as director's fees; jury fees; marriage fees received by clergymen; fringe benefits; retirement plan contributions; and stock options (Publication 17, Wages, Salaries, and Other Income). There are exclusions, however, for a variety of employer-provided fringe benefits, such as group term life insurance premiums, health and accident insurance premiums, employee discounts, contributions to retirement plans, and free parking. There is also a limited exclusion applicable to foreign-earned income.

Gross income usually refers to the total amount received from a particular source. In the case of businesses that provide services, the gross business income is the total amount billed for services. In the case of manufacturing, merchandising, and mining, gross income is the total sales proceeds less the cost of the goods sold. The cost of goods sold is, in effect, treated as a return of capital. The return of capital is not income, and therefore cannot be subject to income tax.

Gains realized from property transactions are included in gross income unless a non-recognition rule applies. Taxpayers may deduct the cost of property to determine the gain from a property transaction. The tax law contains over 30 non-recognition rules that allow taxpayers to postpone the recognition of gains and losses from certain types of property transactions or to permanently exclude it. Capital gains are taxed at special tax rates. Individuals may deduct only \$3,000 per year (\$1,500 if married and filing a separate return) of net capital losses from other income (Publication 17, Reporting Gains and Losses). Losses from the sale or disposition of an asset held for personal use are not deductible.

Interest is compensation for the use of money. Taxable interest includes interest on bank deposits, corporate bonds, mortgages, life insurance policies, tax refunds, most U.S. government obligations, and foreign government obligations. Interest on obligations of states, territories, and U.S. possessions and their political subdivisions is tax-exempt. Bonds issued by school districts,

port authorities, toll road commissions, counties, and fire districts are also exempt. Taxpayers may, however, purchase and eventually redeem Series EE bonds tax-free if they use the proceeds to pay certain college expenses for themselves, a spouse, or dependents (Publication 17, Interest Income). The exclusion is computed on Form 8815, which is filed with the annual tax return. The exclusion is not available to married taxpayers who file separate returns.

Rents and royalties are included in gross income (Publication 17, Rental Income and Expenses). Prepaid rent is taxable when received. Security deposits, which are refundable to tenants upon the expiration of a lease, are not included in gross income. Royalties are proceeds paid to an owner by others who do business under some right belonging to the owner. Royalties from copyrights, patents, and oil, gas, and mineral rights are all taxable as ordinary income.

Amounts received by a lessor to cancel, amend, or modify a lease also are taxable. Improvements made by a lessee that increase the value of a leased property are included in the lessor's income **only if the improvements are made in lieu of paying rent or if rent is reduced because of the improvements**. In such situations, the lessor must include the fair market value (FMV) of the improvements in gross income when they are made to the property.

Dividends distributed to shareholders are taxable only if they are made from either the corporation's current earnings and profits or are accumulated earnings and profits (Publication 17, Dividends and Other Corporate Distributions). Distributions in excess of current and accumulated earnings and profits are treated as a non-taxable recovery of capital. Such distributions reduce a shareholder's basis in the stock, but not below zero. Distributions in excess of the basis of the stock are classified as capital gains. A stock dividend is a distribution by a corporation to its shareholders of the corporation's own stock. Simple stock dividends are not taxed because there is no real change in the ownership, taxpayer's interest, or the risks faced by the taxpayer. However, if a shareholder has the option of receiving either cash or stock, the shareholder is taxed even if he or she opts to receive stock. A non-taxable stock dividend has no effect on a shareholder's income in the year received. The basis of the old shares is allocated between the old shares and the new shares. The holding period for the new shares starts on the same date as the holding period of the old.

Capital gain dividends are distributions paid to you or credited to your account by mutual funds (or other regulated investment companies) and real estate investment trusts (REITs) of capital gains from the sales of investments in the fund (Publication 17, Dividends and Other Corporate Distributions). These dividends also include any undistributed capital gains allocated to shareholders by investment companies. Capital gain dividends are long term regardless of how long the shareholder has owned the stock of the regulated investment company.

Constructive dividends are also included in income. At times, the same individuals are both shareholders and employees. A corporation may not deduct dividends paid to shareholders, but is permitted to deduct reasonable compensation. Questions can be raised as to whether amounts identified as compensation are actually disguised dividends. If an amount called compensation is unreasonable, it will be disallowed, and will be determined to be constructive dividends. Often the reasonableness of compensation is determined by comparing the compensation paid to employee-shareholders with amounts paid to others performing similar services. Constructive dividends may arise in situations where the shareholder is also a landlord, a vendor, or a creditor. Constructive dividends often are intended to result in a deduction to the corporation and taxable income to the shareholder. Other constructive dividends are intended to produce a non-reportable benefit to the shareholder, or even a deduction to the corporation without income to the shareholder.

Alimony is carefully defined by the tax law: any payment pursuant to a divorce or legal separation must be classified as alimony, child support, or a property settlement for tax purposes (Publication 17, Alimony). The treatment of a payment depends on its classification. Alimony is deductible by the payor spouse and is taxable to the payee spouse. Neither child support payments nor property settlements have any tax ramifications; that is, they are not subject to tax to the payee spouse or deductible by the payor spouse. The tax law has very specific rules that distinguish alimony, child support, and property settlements. Under current law, a payment to or for a spouse under a divorce decree or separation instrument is alimony if the spouses do not live together and all of the following requirements are met:

- the payment is in cash;
- the instrument does not designate the payment as **not** being alimony;
- the spouses are not members of the same household at the same time the payments are being made and are legally separated under a decree of divorce or separate maintenance;
- payments terminate at the death of the recipient spouse; and
- the payment is not designated or treated as child support.

Property settlements are a division of property pursuant to a divorce. In general, each spouse is entitled to the property brought into the marriage and a share of the property accumulated during marriage. A division of property does not result in any income to either spouse, nor does either spouse receive a tax deduction. The basis of property received by either spouse as a result of the divorce or separation remains unchanged.

Alimony recapture is one unusual rule found in the current tax law that relates to alimony (Publication 17, Alimony). This recapture provision was established to prevent a large property settlement that might take place after a divorce from being treated as alimony so as to produce a

deduction for the payor. Recapture occurs if payments decrease sharply in either the second or third year.

Annuities are a series of regular payments that will continue for a fixed period of time or until the death of the recipient. Individuals receiving an annuity are permitted to exclude their cost, but are taxed on the remaining portion of the annuity. The following steps should be followed to determine the non-taxable portion of the annuity:

- determine the expected return multiple. This is the number of years the annuity is expected to continue and can be a stated term or can continue for the remainder of the taxpayer's life. In the latter situation, the expected return multiple is determined by referring to a table developed by the IRS;
- determine the expected return by multiplying the amount of the annual payment by the expected return multiple;
- determine the exclusion ratio by dividing the investment in the contract (the cost) by the expected return; and
- determine the current year's exclusion by multiplying the exclusion ratio by the amount received during the year.

After the entire cost of an annuity has been recovered, the full amounts of all future payments are taxable. If an individual dies before recovering the entire cost, the cost not recovered can be listed as an itemized deduction on that individual's final return (Publication 17, Miscellaneous Deductions). Insurance companies and businesses with retirement plans often compute the taxable portion of annuities and report the amounts to recipients on Form 1099.

Pension and other qualified retirement plan distributions frequently are paid in the form of an annuity. Both the employer and the employee often contribute funds to such plans during the years of employment. When an employee retires, the amounts contributed and the income accumulated becomes available to the retired employee. In some cases, the retired employee has the option of receiving a lump-sum payment or an annuity. The employee's cost basis is limited to amounts contributed by the employee that were previously taxed to the employee. The employee may recover this cost tax-free. The employee's cost does not include employer contributions. A simplified method must be used to determine the taxable portion of an annuity paid from a qualified retirement plan if the annuity start date is after November 18, 1996 (Publication 17, Retirement Plans, Pensions and Annuities). Many pensions contain provisions that allow taxpayers to withdraw amounts before the normal starting date. Under current law, an amount withdrawn from a pension before the starting date is considered to be partly a recovery of the employee's contributions and

partly a recovery of the employer's contributions. After all contributions have been withdrawn, additional withdrawals are fully taxable. In addition to being subject to the regular income tax, any early withdrawal may also be subject to a ten percent non-deductible penalty. Also see Publication 17 for a list of exceptions to the early withdrawal penalty.

A life insurance payment of the policy's face amount received because of the death of the insured is not taxable (Publication 17, Interest Income). If the proceeds are left with the insurance company and interest is earned, the interest payments are taxable.

Forgiveness of debt (also known as canceled debt) is a taxable event (Publication 17, Other Income). The person who owed the money must report the amount forgiven as income unless one of several exceptions found in the tax law applies.

Flow-through entities are not subject to income taxation, as the taxable income is taxed directly to the owners of the entity rather than the entity itself. IRC Section 61 specifically lists three instances where income flows through the entity:

- the distributive share of a partnership's income;
- income relating to a decedent; and
- income from an interest in an estate or trust.

Similar treatment is accorded S corporation income (Publication 17, Other Income). The income that is produced by the entity merely flows through to the owner or beneficiary of the entity.

Prizes, awards, gambling winnings, and found property are taxable. Winnings in contests, competitions, and quiz shows, as well as awards from an employer to an employee in recognition of some achievement in connection with his or her employment, are taxable whether received as cash or in the form of other property (Publication 17, Other Income).

Income from illegal activities is taxable (Publication 17, Other Income). This includes but is not limited to income from bribes, kickbacks, and the dealing or production of illegal drugs. Some people find this part of the tax law surprising, but this tax liability is the basis for many criminal convictions, given that few criminals report their illegal income. It is not necessary to prove that an individual had illegal income, only that the individual had income that was not reported.

Unemployment compensation is fully taxable for both government-financed programs and employer-financed benefits (Publication 17, Other Income).

Social Security benefits were excluded from gross income until 1984. As of 1994, up to 85 percent of Social Security benefits may be taxable (Publication 17, Social Security and Equivalent Railroad Retirement Benefits).

Under IRC Section 86, the portion of Social Security benefits that is taxable depends on the taxpayer's provisional income and filing status. Provisional income is computed using the following formula:

AGI (excluding Social Security)	\$XX,XXX
plus: tax-exempt interest	XXX
excluded foreign income	XXX
50 percent of Social Security benefits	<u>XXX</u>
Provisional income	\$XX,XXX

For married couples filing jointly, if provisional income is \$32,000 or less, no Social Security benefits are taxable (Publication 17).

For single taxpayers, if provisional income is \$25,000 or less, no Social Security benefits are taxable (Publication 17).

The result of the computation excludes from gross income the Social Security benefits received by lower-income individuals, but taxes a portion (up to 85 percent) of the benefits received by taxpayers with higher incomes. The term "Social Security" refers to basic monthly retirement and disability benefits paid under Social Security and also to tier-one railroad retirement benefits. It does not include supplementary Medicare benefits that cover the cost of doctors' services and other medical benefits.

Insurance proceeds or court awards received because of the destruction of property are included in gross income only if the proceeds exceed the adjusted basis of the property. Involuntary conversion provisions permit taxpayers to avoid being taxed if they reinvest the proceeds in a qualified replacement property. If the proceeds are less than the property's adjusted basis, they reduce the amount of any deductible loss. Proceeds from insurance guarding against loss of profits because of casualty are taxable. If a taxpayer has to sue a customer to collect income owed to the taxpayer, the amount collected is taxable just as it would have been if the taxpayer had collected the income without going to court. IRC Section 104(a)(2) excludes "damages (other than punitive damages) received due to personal physical injuries or sickness." Moreover, amounts collected because of physical injury suffered in an automobile accident are excluded from gross income.

The tax benefit rule applies when a taxpayer deducted an amount in one year but recovers the amount in a subsequent year (such as state income tax withholding deducted on Schedule A as an itemized deduction). The amount recovered must be included in the gross income in the year it is recovered (Publication 17, Other Income). Cash-basis taxpayers encounter this situation more often than accrual-basis taxpayers because their expenses generally are deductible in the year they are paid. If the amount was overpaid, the taxpayer can anticipate a refund. Any recovery of a previously deducted amount may lead to income recognition. Several rules should be noted:

- if the refund or other recovery occurs in the same year, the refund or recovery reduces the deduction and is not reported as income;
- interest on the amount refunded is taxable and is not subject to the tax benefit rule; and
- the character of the income reported in the year of repayment is dependent on the type of deduction previously reported. If the taxpayer deducted a short-term capital loss in one year, the subsequent recovery would be a short-term capital gain.

A taxpayer who recovers an amount deducted in a previous year must report as gross income the amount recovered in the current year. The amount recovered need not be included in income, however, if the taxpayer received no tax benefit. A tax benefit occurs only if the deduction reduced the tax for the year. Tax benefit may be absent in other situations. A taxpayer's total itemized deductions may have been less than the standard deduction, or the expense may have been less than the applicable floor. If only a portion of an expense produces a tax benefit, then only that portion has to be reported as income.