Chapter 4.
Income Exclusions

After reviewing this chapter, you should be able to:

1. *Discuss the requirements for the exclusion of an item of income*
2. *Explain the rationale for excluding items from gross income*
3. *Identify the allowable exclusions for donative items of income: gifts, inheritances, life insurance proceeds, and scholarships*
4. *Describe the effect of employment-related exclusions on the after-tax compensation of employees*
5. *Discuss the non-taxable fringe benefits that a business may provide to its employees*
6. *Identify payments that represent returns of human capital and are excluded from income as capital recoveries: worker's compensation, damage payments for personal injuries, and medical expense reimbursement payments*
7. *Discuss the exclusions from income allowed for investment-related items: municipal bond interest, stock dividends, discharges of indebtedness, and improvements by a lessee*

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

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After identifying all the sources of income received during an accounting period, the next step in calculating taxable income is determining which, if any, of the income sources do not have to be included in the current period's gross income. This step requires identification of income items that are subject to exclusion or deferral. The all-inclusive income concept of IRC Section 61 considers taxable any income received unless a specific provision can be found that exempts the item from taxation. Under the legislative grace concept, only Congress can provide such tax relief. In addition, tax relief provisions are strictly applied and interpreted, thereby explicitly limiting the scope of any tax relief provision to that which Congress intended. Congress has chosen to exempt certain items that otherwise meet the definition of gross income. Some of the relief provisions are designed as equity measures that relieve the item from double taxation. Other provisions are meant as incentives for taxpayers to engage in specific activities. Most incentive provisions have as their goal some social objective, such as encouraging firms to provide medical coverage for their employees. To provide a frame of reference, income exclusions are divided into four categories:

- donative items;
- employment-related items;
- returns of human capital; and
- investment-related exclusions.

Donative items are receipts of wealth that the individual receiving the item(s) did not earn and for which no future services are to be rendered; donative items are not the result of an investment. Because donative items represent realized increases in wealth, items in this class fit the definition of income. However, Congress, either for equity or incentive reasons, has determined that such gifts should not be taxed. Donative items include gifts and inheritances, life insurance proceeds, and scholarships (Publication 17, Other Income).

The value of property acquired as a gift has been excluded from income taxation since 1913. Although gifts are not subject to income taxation, the donor is subject to the gift tax rules by giving the gift. The exclusion of gifts from income tax is an equity measure that prevents double taxation. The U.S. Supreme Court developed the most authoritative definition of "gift" in 1960:

> "A gift in the statutory sense . . . proceeds from a detached and disinterested generosity . . . out of affection, respect, admiration, charity, or like impulses . . . And in this regard, the most critical consideration, as the Court has agreed in the leading case here, is the transferor's intention. What controls is the intention with which payment, however voluntary, has been made."

People often make gifts to friends and relatives with no expectation of any consideration in return. The legislative grace concept requires a strict application and interpretation of the exclusion for gifts. Only the receipt of a gift is a non-taxable event; any subsequent earnings from property received as a gift are subject to taxation. Subsequent earnings may be in the form of income flows from the property or gains from the sale of the property. The donor's intent in making the gift is controlling. If the gift was meant to be compensation for past, present, or future services, it is not really a gift, but is taxable as compensation.

The value of property received through inheritance has also been excluded from taxation. The rationale for exclusion follows that for a gift. Property held in an estate is subject to an estate tax; thus, the income tax exclusion for inheritances prevents double taxation of the property of a deceased taxpayer. The legislative grace concept requires that exclusions be strictly applied. In the case of inherited property, the exclusion is limited to the value of the property received. Any subsequent earnings from the inherited property are not excludable, that is, they are taxable.

Payments from life insurance upon the death of the insured generally are excluded from income tax (Publication 17, Other Income). Life insurance proceeds may, however, be included in the decedent's gross estate and be subject to the estate tax. Life insurance proceeds resemble inheritances, which are excluded from income taxation. The exclusion of life insurance proceeds provides equity with other forms of inherited property. The exclusion of life insurance proceeds applies to such payments even if the payments are received in installments, although any earnings in the installment payments are taxable. An exception to the exclusion for life insurance proceeds is made for amounts paid to the owner of a policy that was obtained for valuable consideration. If a taxpayer purchases or otherwise obtains for some valuable consideration a policy on the life of another, the receipt of the insurance proceeds is considered the realization of an investment. The amount received will be income to the extent that it exceeds the premiums and other consideration given for the policy.

This exception to the life insurance exclusion provisions does not apply to policies owned by partners or partnerships in which the insured is a partner or a corporate officer or a shareholder. Payments on such contracts are excluded because they are deemed to be for legitimate business purposes rather than for speculative gain. This type of life insurance on the death of a partner or a key employee usually is used to fund buy-out agreements and is necessary to ensure the continuation of the business in most cases. The payment-of-consideration exception to the exclusion for life insurance proceeds also does not apply to accelerated death benefits received under a life insurance policy by a terminally or chronically ill individual. Generally, accelerated death benefits for terminally or chronically ill people are excludable, although certain limitations may apply.

A college student who is a candidate for a degree may exclude the value of a scholarship if the award does not require the student to perform any future services such as teaching, grading papers, or tutoring. The scholarship must be gratuitous in nature and not merely a form of compensation for past, present, or future services. However, amounts received by degree candidates from certain federal programs (for example, the National Health Service Corps Scholarship Program and the Armed Services Scholarship Program) are excluded from the recipients' income even though there is a future service obligation connected to the scholarship. The amount of the exclusion is limited to the direct costs of the student's college education. Direct costs consist of the student's tuition, fees, books, supplies, and other equipment required for the student's course of instruction. Amounts received in excess of the direct costs of the education are taxable. Individuals are not allowed to deduct personal living expenses. Students who receive amounts for personal living expenses must include those amounts in their income in order to provide equity with non-students, who are effectively taxed on income they spend for personal living expenses. Scholarships that are specified as being for the payment of a student's room and board are fully taxable.

The United States levies taxes on worldwide income, meaning that U.S. citizens and residents are subject to tax on all income they receive, regardless of the source. To provide relief from double taxation for U.S. citizens working in foreign countries, the tax law allows individuals two options, which are discussed below.

Taxpayers may include the foreign-earned income in their taxable income, calculate the U.S. tax on the income, and take a tax credit for any foreign taxes paid. The amount of the allowable tax credit is the lesser of the actual foreign taxes paid or the U.S. tax that would have been paid on the foreign-earned income (Publication 17, Other Credits). Under a second option, individuals may exclude up to $100.800 in 2015 and $99,200 for 2014 of foreign-earned income for each full year they work in a foreign country. To take advantage of these options, an individual must either be a bona fide resident of the foreign country or be present in the foreign country for 330 days in any 12 consecutive months (including vacations).

The largest class of exclusions is certain payments made to or on behalf of an employee by an employer. This category of exclusions is costly in terms of the tax revenue lost to the government, because the payments are deductible by the employer and yield no tax revenue because of the exclusion from income granted the employee. These relief provisions are intended to provide equity in cases of double taxation and to encourage employers and employees to engage in the specified activity.

When one person or entity pays the expenses of an individual in an employment setting, the person whose expenses are paid generally has taxable income. The law does, however, exempt from taxation the payment of the following employee expenses by an employer:

- payments to qualified pension plans (Publication 17, Wages, Salaries and Other Earnings);
- the cost of group term life insurance, up to $50,000 per employee (Publication 17, Wages, Salaries and Other Earnings);
- health and accident insurance premiums (Publication 17, Wages, Salaries and Other Earnings);
- de minimis benefits; and
- the cost of some meals and lodging provided by the employer.

The favorable tax treatment accorded these items has encouraged employers to provide more and more of an employee’s compensation in the form of excludable fringe benefits.

Many companies provide pension plans for their employees. Several allowable variations of such plans permit employers and employees to make payments into the plans and receive favorable tax treatment (Publication 17, Wages, Salaries and Other Earnings). Such plans are referred to as qualified pension plans. Payments made by an employer to an employee’s account in a qualified pension plan are not taxable in the period in which the payments are made. The tax on such payments is deferred until the employee actually withdraws the payments from the plan. This is not a true exclusion on which a tax is never paid, but a deferral of income recognition to a future period.

In addition, the earnings on amounts paid into such plans and any amounts that employees pay into such plans are deferred from taxation until they are withdrawn from the plan.

One of the most popular employee benefits is the exclusion of the premiums paid by an employer on the first $50,000 face amount of group term life insurance (Publication 17, Wages, Salaries and Other Earnings). This exclusion is available only for term insurance that is provided to a group of employees on a non-discriminatory basis. Payments made on whole life policies, term insurance purchased for individuals, or plans that discriminate in favor of highly compensated individuals are not eligible for exclusion. If an employee's qualified group term policy has a face value greater than $50,000, the premiums paid on the coverage in excess of $50,000 are taxable to the employee. The amount an employee must include in income is based on the IRS's uniform premium cost tables and varies with the employee's age.

Premiums paid by an employer to purchase health and accident insurance coverage for employees (and their dependents) are excluded from the employee's income (Publication 17, Wages, Salaries and Other Earnings). The exclusion also applies to companies that choose to "self-insure" by making payments to a fund that is used to pay employees' medical expenses. If a self-insured medical plan discriminates in favor of highly compensated employees, the amounts paid for medical expenses of the highly compensated employees covered by the plan are included in the individual's taxable income.

The value of meals provided to an employee free of charge may be excluded from the employee's income if the meals are provided on the employer's business premises and the provision of the meals is "for the convenience of the employer." Cash meal allowances generally are taxable because they are not meals provided by the employer. To satisfy the "convenience of the employer" requirement, the provision of the meals must have a substantial non-compensatory business purpose.

To exclude the value of employer-provided lodging, the acceptance of the lodging must be a condition of employment. That is, the employee has no choice but to live in the employer-provided housing.

The tax law also allows the exclusion of four general types of employment-related fringe benefits:

- no-additional-cost services;
- employee discounts;
- working-condition fringe benefits; and
- de minimis fringe benefits.

No-additional-cost services and employee discounts must be made available to employees on a non-discriminatory basis and must be in the same line of business in which the employee works. A hotel chain may let hotel employees stay free at any of its hotels on a space-available basis with no tax consequences to the employee. If, however, the hotel chain also gives free hotel rooms to employees of its rental car business, the FMV of the hotel room is taxable to the employee. Reciprocal agreements between companies in the same line of business are allowed. To exclude employee discounts, the discount must be made available to all employees on a non-discriminatory basis and the goods or services provided must be in the same line of business. The excludable discount on goods is limited to the gross profit percentage on the goods purchased. Excludable service discounts are limited to 20 percent. Any employee discount on services in excess of 20 percent is taxable to the employee.

A working-condition fringe benefit is any item provided to the employee that would have been deductible by the employee as an employee business expense if the employee had paid for the item. This class of fringe benefits includes dues to professional organizations, professional journals, uniforms, and similar items. The payment of parking by an employer has been designated as a working-condition fringe benefit and is limited to $250 per month for 2015, and is limited to parking at or near the workplace. It does not include the cost of parking at or near the employee's home (Publication 17, Wages, Salaries and Other Earnings). An employer may also pay up to $130 per month in 2013 for commuter highway vehicle transportation and transit passes for their employees without the employees being taxed on the benefit (Publication 17, Wages, Salaries and Other Earnings). It should be noted that working-condition fringe benefits could be given on a discriminatory basis. A company can provide free parking only to its officers and the fringe benefit will remain tax-free (up to the $240-per-month maximum exclusion).

De minimis fringe benefits are items that are too small to permit a reasonable accounting (Publication 17, Wages, Salaries and Other Earnings). These include items such as personal use of the office photocopier and free coffee in the employees' lounge. Also included in this category are employee parties and small holiday gifts. This exclusion is based on administrative convenience; in other words, the cost of accumulating the information necessary to tax such items would exceed the revenue derived from taxing the items.

Several other employer-paid fringe benefits are also excludable from income. An employee may exclude up to $5,000 per year of employer-provided childcare and dependent care services ($2,500 for married filing separately) (Publication 17, Child and Dependent Care Credit). The value of the use of an employer's athletic facility may also be excluded if the facility is on the employer's premises and substantially all of its use is by employees and their families. In addition, up to $5,250 in payments made for tuition and books for undergraduate-level courses is excludable if the payments are made from a non-discriminatory educational assistance program (Publication 17, Wages, Salaries and Other Earnings).

A cafeteria plan is a menu of tax-free benefits offered at the employer's cost. The rules for cafeteria plans allow employers to offer any benefit that is not specifically excluded by the tax law. Each employee is allowed to choose a certain dollar amount of benefits from the menu or may choose to take the cash cost of the benefits. Employees who do not want to take their entire allowable dollar amount in tax-free benefits can take the cash equivalent of the benefits. Employees who choose the tax-free benefits are not taxed on the value of the benefits; however, those who elect to receive cash are taxed on the amount of cash received. To receive this favorable treatment, the employer must make the benefits of the plan available to all employees on a non-discriminatory basis. All benefits received from a plan that discriminates in favor of highly compensated employees are included in gross income.

Another type of benefit is the flexible spending account (FSA), commonly called a reimbursement account, which is funded by salary reduction. FSAs are often cafeteria plan items. For FSAs, employees have an annual amount withheld from their salary that is used to pay medical expenses or childcare costs. For 2015, the annual medical FSA limit is $2,550 and the childcare limit remains at $5,000. As the costs are incurred, the employer reimburses the employee from the account. Amounts paid into the account by the employee are not included in the employee's gross income. These arrangements let employees pay for medical costs and childcare with before-tax dollars rather than after-tax dollars. Regulations governing FSAs do not permit the company to return unused payments to the employee. Employees make an annual election of the amount they want deposited in the account. Any amounts put into an FSA that are not spent during the year are retained by the plan and are not available to the employee in subsequent years. The employee loses any payments that are not reimbursed during the plan year.

In 1996, Congress created a program to determine if alternative forms of health care delivery systems could provide adequate medical coverage at lower costs. Self-employed individuals and employers with no more than 50 employees could establish Medical Savings Accounts (MSAs) beginning in 1997 (Publication 17, Wages, Salaries and Other Earnings) to pay the medical expenses of themselves and their employees. To be eligible for an MSA, the individual must be covered by a high-deductible health plan (HDHP) and cannot be covered under any other health plan. The program is now called the Archer MSA. The tax benefits from participating in an MSA are that employer contributions are excluded from income and individual contributions are deductible for AGI. Earnings on amounts in an MSA are excluded from income; distributions from an MSA for medical expenses generally are excluded from income; and unused amounts from one year's contributions may be carried forward to pay future medical expenses. The tax effect of an

MSA is similar to that of a flexible benefits plan without the use-or-lose feature. The maximum annual contribution is a percentage of the deductible under the high-deductible plan (65 percent for individuals and 75 percent for families) (Publication 969). New MSAs could not be established after 2005, but those in existence can be retained.

Health Savings Accounts (HSAs) have effectively replaced MSAs because the benefits are better. HSAs are tax-favored vehicles that allow taxpayers to use pre-tax money to pay medical expenses. To be eligible, an individual must have only an HDHP.

The taxpayer, the taxpayer's family, an employer, or anyone else may make contributions to HSAs. Contributions up to an annual limit (inflation-adjusted after 2006) are deductible as an above-the-line deduction by the taxpayer who holds the HSA. Contributions can be rolled into an HSA from other HSAs or MSAs.

Employer contributions up to the annual limit are not included in an employee's income for income or employment taxes, and are not deductible by the employee.

For 2015, the contribution limit is $3,350 for self-only coverage and $6,650 for family coverage, which includes all other coverage. HSA-eligible individuals over 55 years old may contribute an extra $1,000 annually. Any unused amounts can be used in later years.

Individuals sometimes receive payments that are intended either to reimburse them for the cost of injuries or to compensate them for injuries in such a way as to make them whole. These types of payments are not deemed to increase wealth; rather, they are viewed as a return of human capital lost because of injury or sickness. They are treated as a capital recovery that is not subject to tax. Payments that are meant to replace lost income do not constitute a return of human capital and are generally taxable. Various types of payments received as compensation for injury or sickness are excluded from gross income. The list of excluded payments includes:

- workers' compensation payments received as compensation for personal injury or sickness (Publication 17, Wages, Salaries, and Other Earnings);
- damage payments received due to personal physical injury or physical sickness;
- payments received for personal injuries or sickness that are paid from health and accident policies purchased by the taxpayer (Publication 17, Wages, Salaries, and Other Earnings); and
- payments received from employer-provided health and accident insurance if the payments:
  - are made for the permanent loss or loss of use of a member or function of the body, or for permanent disfigurement of the body;
  - are based on the nature of the injury and are computed without reference to the period of time the employee is absent from the workplace; and

- reimburse the taxpayer for expenses incurred for medical care.

Payments from a state workers' compensation fund and payments received under the Federal Employees' Compensation Act are excluded from taxation (Publication 17, Wages, Salaries, and Other Earnings). These payments are made to workers who become unable to work as a result of a work-related injury. Although the payments are somewhat of a substitute for earned income, Congress has provided relief from taxation for such payments because they are related to an injury suffered on the job and help taxpayers as they recover from their injuries. As such, they help to restore the human capital of the individual. This is not true for unemployment compensation benefits. Unemployment compensation is meant to be a substitute for income and is therefore subject to tax.

Prior to 1996, a damage payment received for any personal injury or sickness was excluded from taxation. In 1996, Congress limited the exclusion to compensatory damage payments received for a personal *physical* injury or personal *physical* sickness and medical payments for emotional distress. Under this provision, if the action creating the payment has as its origin a physical injury or physical sickness, all payments received, other than punitive damage payments, are excluded, regardless of whether the recipient is the injured party. In addition to compensatory damages, courts often award punitive damages or loss-of-income damages. Congress has restricted the exclusion for loss-of-income damage payments to payments related to personal physical injury or personal physical sickness, and has made all punitive damages taxable regardless of the action creating the payment.

An employer may provide health and accident insurance policies to an employee, or the taxpayer may purchase such insurance separately. In either case, payments for medical expenses from such policies are excluded from income because they make the taxpayer whole. An important distinction between employer- and taxpayer-purchased policies is that all health and accident insurance payments from policies purchased by an individual taxpayer are excluded from taxation (Publication 17, Wages, Salaries, and Other Earnings). The exclusion for payments from employer-provided policies is limited to those for medical care, loss of body parts, and payments made for specific types of injuries. Amounts received as disability payments (sick pay or wage continuation plans) from an employer-provided health and accident plan are included in gross income. The same payments made from a plan purchased by the individual taxpayer are excluded from gross income. The disparity in treatment is intended to be an incentive to individuals to purchase adequate health insurance.

A problem sometimes arises with reimbursements for medical care when an individual takes an allowable medical deduction for non-reimbursed medical expenses in one tax year and then is reimbursed for those expenses in a subsequent year. Individuals are allowed to deduct non-reimbursed medical expenses as an itemized deduction only if they exceed 10 percent of the individual's AGI. For tax years through December 31, 2016, the limit is 7.5% for taxpayers over 65. Under the tax benefit rule, any reimbursed amount that was deducted in a prior year must be included in taxable income in the year of the reimbursement if a tax benefit resulted from the deduction (Publication 17, Other Income).

Several exclusions in the income tax law provide relief from taxation on certain investment-related transactions. These include exclusions from income for certain municipal bond interest (Publication 17, Interest Income) and the receipt of a stock dividend (Publication 17, Dividends and Other Distributions).

The Supreme Court has ruled that the receipt of a stock dividend does not constitute a realization of income. A dividend paid in stock of the same company (a stock split or stock dividend) is merely slicing the pie into smaller ownership units, with no resulting increase in shareholder wealth. The value of the shareholder's interest does not change; it is merely spread over more ownership units. However, if the recipient of the stock dividend has the option to receive cash in lieu of stock, the dividend is taxed as if the cash option had been selected. In this case, the shares of stock are deemed to have a cash value, and are taxable.

In general, interest income is fully taxable when received by a taxpayer. Interest on savings accounts and from investments in corporate bonds is included in gross income (Publication 17,). The law provides for the exclusion of interest earned on bonds issued by state and local governments of the U.S., as well as those of U.S. possessions (called municipal bond interest) (Publication 17, Interest Income). The exclusion from tax does not include interest on U.S. government obligations such as Treasury bills, nor does it apply to interest received on foreign government obligations. Municipal bond interest is excluded because it enables municipalities to raise money for projects at lower interest rates than comparable taxable bonds.

Taxpayers who sell their principal residence may be able to exclude from income any gain on the sale, up to $250,000 (or $500,000 on a joint return in most cases). If they can exclude all the gain, they do not report the sale on their tax return. If they cannot exclude the gain, it is taxable, and they report it on Schedule D (Form 1040). However, taxpayers cannot deduct a loss on the sale of a principal residence. To qualify to exclude gain on a principal residence, the taxpayers must have lived in the home for two of the previous five years (Publication 17, Selling Your Home).

Other provisions allow exclusion of income in certain discharge-of-indebtedness situations (Publication 17, Other Income) and for improvements made by a lessee of property.

Under the general principles of income recognition, the borrowing of money is not a taxable event, because the borrower is under an obligation to repay the loan. Similarly, the repayment of the loan principal does not generate taxable income. If a lender forgave all or a portion of a borrower's debt, the borrower could realize an increase in wealth as a result of the reduction of liability. The borrower who is relieved of a debt has obtained a claim of right to the amount of the debt forgiven. This increase in wealth, known as a discharge of indebtedness, is generally taxable to the borrower (Publication 17, Other Income).

The tax law provides an exception to the general rule of taxability of a discharge of indebtedness when the borrower is insolvent, both before and after the forgiveness of the debt (Publication 17, Other Income). This exception includes any debt reduction as a result of a bankruptcy proceeding. However, if the discharge makes the debtor solvent, the debtor must recognize income to the extent that the debtor is solvent after the debt reduction. A taxpayer who has a positive net worth after the forgiveness of debt is deemed to have the wherewithal-to-pay, up to the amount of the solvency.

When a taxpayer is allowed to exclude discharge of indebtedness income because of insolvency, any tax attributes the taxpayer has in relation to the debt must be reduced by the amount of the exclusion. Tax attributes that must be reduced include net operating loss (NOL) carry-forwards, capital loss carry-forwards, and the basis of property purchased with the debt. A second exception to the taxability of debt discharges applies to taxpayers who have been negatively affected by depressed real estate markets.

Taxpayers other than corporations can elect to exclude from income some cancellation of qualified real property business indebtedness. Qualified real property business indebtedness is debt incurred or assumed in connection with real property used in a trade or business that is secured by that real estate. Only debt incurred before 1993 qualifies for the exclusion, unless it is incurred to refinance previously incurred qualified debt or is qualified acquisition debt. Qualified acquisition debt is debt incurred to acquire, construct, or substantially improve real property that is secured by such debt. The amount of the exclusion for qualified real property debt is the lesser of the property's adjusted basis or the excess of the principal amount of the debt immediately before the discharge over the FMV of the property that secures the debt. Note that part two of the exclusion formula effectively restricts the application of this relief provision to situations in which the amount of debt on the property is greater than the property's FMV. The adjusted basis of the property must be reduced by any amounts excluded under this provision.

The exclusion income for cancellation of debt (COD) for qualified real property was extended to acquisition indebtedness on principal residences by the Mortgage Forgiveness Debt Relief Act of 2007. It applies to certain debt discharged between January 1, 2007 and December 31, 2014.

Taxpayers could avoid taxable income on the cancellation of acquisition indebtedness of up to $2 million, provided that the debt was incurred in the acquisition, construction, or substantial improvement of their principal residence. Refinanced debt qualifies as acquisition indebtedness if the amount of the refinancing does not exceed the original debt.

To claim a principal residence, the taxpayer must have owned and used the home as a principal residence during two or more of the last five years. The amount excluded from gross income is limited to the excess of the amount discharged over the amount of indebtedness that was not qualified, if the entire discharged mortgage is not qualified principal residence indebtedness.

Amounts excluded from gross income reduce the taxpayer's basis in the property (Publication 4681, Canceled Debts). The tax law provides that a property owner does not have income when a lessee makes improvements to the owner's property or when such improvements revert to the property owner at the termination of the lease. This allows the property owner to defer the gain in the value of the property from the improvements until the property is sold, at which time it is assumed that the owner will have the wherewithal-to-pay the tax on the increased value from the improvements by the lessee. The exclusion from income for improvements by a lessee does not apply when the improvements are made in lieu of rent. In that case, the lessee is paying the rent in the form of the improvement rather than in cash. Under the cash equivalent approach to income recognition, the value of such improvements is included in income.

Review Questions

● 1. Bernice is the beneficiary of a $50,000 insurance policy on her father's life. If she receives the proceeds in installments from the insurance company that carries the policy, she will receive $10,500 per year for five years. Bernice decides to take the $50,000 in a lump-sum payment and invest the funds herself. Of the $50,000 received:

a. the interest income for each year is tax-free
b. only $5,000 is tax-free as a death benefit
c. all $50,000 is taxable income
d. all $50,000 is tax-free

● 2. Damien paid $22,000 in premiums on an endowment life insurance policy with a face value of $55,000. Upon reaching 65, Damien collected the face value of the policy. In the year of collection, Damien will report:

a. no income
b. $22,000 of taxable income
c. $33,000 of taxable income
d. $55,000 of taxable income

● 3. Mrs. Jones, a widow whose husband died in November, chose to receive the proceeds of her husband's $150,000 life insurance policy in 20 yearly installments of $10,000 each. The payments are based on a guaranteed interest rate. How much of each payment is interest income to be included in Mrs. Jones's gross income each year?

a. no income
b. $2,500
c. $10,000
d. $140,000

● 4. Tony and Linda are married, and this year they have AGI of $64,000. This year, they adopted a child who does not have special needs, taking advantage of their employer's written adoption assistance program. They spent $4,600 in connection with the adoption, all of which was paid by the employer in accordance with the adoption plan. How much of the employer-paid adoption costs must be included in their income?

a. zero
b. $2,300
c. $4,000
d. $4,600

● 5. To exclude gain on the sale of a principal residence, the taxpayers must have:

a. paid off the mortgage before the sale
b. sold it to a family member
c. died before the sale
d. lived in the property for two out of the previous five years

● 6. Cassandra receives a $6,000-per-year scholarship from State University. The university specifies that $4,000 is for tuition, books, supplies, and equipment, while $2,000 is for room and board. In addition, Cassandra works part-time at the campus library and earns $3,000 to cover other expenses. Her gross income is:

a. zero
b. $2,000
c. $3,000
d. $5,000

● 7. Kelly's employer purchased a disability income policy from an insurance company on behalf of all of its employees. The employer paid for two-thirds of the premiums, and the employees paid for the other one-third. Subsequently, Kelly received $900 per month for six months that he was unable to work. Kelly will be taxed on:

a. zero
b. $1,800
c. $3,600
d. $5,400

● 8. The following items were received as court awards and damages. All should be included in ordinary income by the taxpayer who received them, except:

a. compensation for lost wages
b. compensatory damages for physical injury
c. damages for breach of contract
d. interest on damages for breach of contract

● 9. Rose was in an automobile accident involving a drunk driver while she was going to work. The doctor advised her to stay home for six months due to her injuries. The resulting lawsuit was settled and Rose received the following amounts:

- compensation for lost wages – $40,000
- physical injury damages – $10,000
- punitive damages – $25,000

How much of the settlement must Rose include in ordinary income on her tax return?

a. zero
b. $25,000
c. $40,000
d. $65,000

● 10. Marty is a key employee of Dixie Corporation. The corporation provides Marty with $100,000 of group term insurance coverage. The premium attributable to the coverage in excess of $50,000 is $800. The uniform one-month group term premium is $1 per $1,000 of coverage. How much must Marty include in income due to the policy?

a. zero
b. $50
c. $600
d. $800

● 11. A department store sold a stereo to an employee for $300, even though the retail price was $500. The markup in the electronics department is 40 percent of retail. The store also sold him a $100 service contract on the stereo for $80. Such discounts are available to all employees. How much should be recognized by the employee from these transactions?

a. zero
b. $20
c. $200
d. $220

● 12. All of the following fringe benefits paid for by the employer may be excluded from an employee's gross income, except:

a. membership fees in professional organizations
b. recreational facilities
c. unused airline seats for airline employees flying "standby"
d. discounts of up to 50 percent on services

● 13. Which of the following fringe benefits should be included in an employee's gross income?

a. a free or discounted commercial airline flight for personal use offered by a manufacturer of machine tools
b. a no-additional-cost service
c. a qualified employee discount
d. a working-condition fringe benefit

● 14. Baker Drilling is an offshore exploration and production company. It requires its employees to be on 24-hour call and consequently gives them a $400-per-month housing allowance and a $200-per-month food allowance. Faye, an employee of Baker, receives a salary of $25,000 per year (which does not include the allowances). Faye will be taxed each year on:

a. $25,000
b. $27,400
c. $29,800
d. $32,200

● 15. Disregarding scheduled expiration dates, all of the following are fringe benefits excludable from the taxable income of an employee except:

a. up to $5,000 of an employer-financed dependent-care assistance program
b. up to $5,250 of an employer-paid educational assistance plan for undergraduate education
c. the employee's choice of a statutory non-taxable fringe benefit under a cafeteria plan in which one of the options not chosen was to receive a cash payment
d. a refund to the employee of the end-of-year unused portion of a qualified FSA established for medical expenses

● 16. Bob filed his tax return, properly claiming head of household filing status. His employer paid or provided the following to Bob:

- wages – $44,000
- FMV of qualified dependent care – $3,000
- premiums for $50,000 group term life insurance – $500
- medical insurance premiums – $500

How much of this income should Bob report?

a. $44,000
b. $47,000
c. $47,500
d. $48,000

● 17. Ben has been assigned to the Paris office of ABC Corporation. He arrived in Paris on November 1 two years ago and does not return to the United States until March 5 this year. During his stay in Paris, Ben earned $7,000 two years ago, $42,000 last year, and $8,800 this year. This year, Ben may exclude:

a. zero
b. $8,800
c. $13,326
d. $80,000

● 18. AB Corporation enters into a plan with its creditors and reduces its debts from $300,000 to $200,000. AB's assets are worth $260,000. AB has an NOL of $70,000, a general business credit carry-over of $8,000 and depreciable property with a basis of $100,000. No election is made to reduce the basis of the depreciable property before the other attributes are reduced. As a result of the negotiation, AB Corporation's NOL is reduced to:

a. zero
b. $30,000
c. $40,000
d. $70,000

● 19. Bob, an employee of Modern Corp., receives a fringe benefit (in lieu of a salary increase) of $200. Bob is in a 28 percent tax bracket. The fringe benefit is non-taxable to Bob and is not deductible as an itemized deduction. Bob's after-tax savings from receiving the tax-free benefit is:

a. zero
b. $56
c. $100
d. $145

● 20. An employer offered the following transportation fringe benefits. All should qualify for a complete exclusion from employee gross income except:

a. transit passes costing $100 per month
b. parking costing $250 per month
c. transit passes costing $290 per month
d. parking costing $240 per month

● 21. Hal pays for a business lunch with Sam, one of his clients. If Hal is reimbursed under an accountable plan by his employer, he must:

a. include the cost of his own lunch on his tax return as income
b. include the cost of both lunches on his tax return as income
c. include 50 percent of the lunch costs on his tax return
d. not report the lunch costs on his tax return

● 22. Tiffany wants to participate in the dependent-care assistance program offered by her employer. What is the dollar limitation on the assistance exclusion each year?

a. $450
b. $960
c. $2,000
d. $5,000

● 23. Russ chose the following fringe benefits under his employer's cafeteria plan. Which of his chosen benefits will be taxable?

a. $50 cash per pay period
b. group term life insurance of $20,000
c. medical insurance on his family
d. dental and medical expenses

● 24. Sylvia loaned her son $4,000 to help him buy a new computer. Several months after he purchased the computer, but before he repaid the $4,000, Sylvia's son graduated. Sylvia told her son that she was "tearing up" the $4,000 note as a graduation present. How should Sylvia's son treat the amount forgiven?

a. taxable income in the year of the loan
b. taxable income in the year of forgiveness
c. excludable gift in the year of the loan
d. excludable gift in the year of forgiveness

● 25. John is a carpenter and owns some rental property. He spends considerable time fixing up the property. He normally charges $30 an hour for his services. The value of his labor is:

a. included in taxable income
b. not included in taxable income
c. included in taxable income if over $400
d. included in taxable income if over $600

● 26. To find the gain when property is sold, which of the following is deducted from the selling price?

a. original cost when depreciation has been taken
b. the realized gain
c. the recognized gain
d. the adjusted basis

● 27. Which one of the following fringe benefits allows for discrimination between highly compensated employees and other employees?

a. working-condition benefits
b. qualified employee discounts
c. de minimis fringe benefits
d. no-additional-cost services

● 28. The maximum foreign-earned income exclusion in 2015 is:

a. $72,000
b. $75,000
c. $82,500
d. $100,800

● 29. For a taxpayer who is not insolvent or under bankruptcy proceedings, the discharge of debt is generally:

a. taxable
b. non-taxable
c. partially taxable
d. treated as capital gain

● 30. On April 14, Sally was given $15,000 worth of City of Boise bonds for her 18th birthday. On June 30, Sally redeemed the $750 annual interest coupons. How much taxable income should Sally recognize as a result of the gift and the receipt of the bond interest?

a. zero
b. $375
c. $750
d. $15,000

Review Question Solutions

1.	D
2.	C
3.	B
4.	A
5.	D
6.	D
7.	C
8.	B
9.	D
10.	D
11.	A
12.	D
13.	A
14.	D
15.	D
16.	A
17.	B
18.	B
19.	B
20.	B
21.	D
22.	D
23.	A
24.	D
25.	B
26.	D
27.	A
28.	D
29.	A
30.	A

Explanations of Review Question Solutions

1. The correct answer is D, all $50,000 is tax-free. Payments from life insurance upon the death of the insured are generally excluded from income tax (Publication 17, Other Income, and Publication 525, Life Insurance Proceeds).

2. The correct answer is C, $33,000 of taxable income. If a taxpayer cashes in his or her life insurance policy before death for the cash surrender value, the entire value of the cash-out (cash received, $55,000) minus the sum of the payments made by the taxpayer over the life of the life insurance contract ($22,000) is taxable to the taxpayer in full in the year of the cash-out of the policy (Publication 525, Life Insurance Proceeds).

3. The correct answer is B, $2,500, Treasury Reg. Section 1.101.4. The taxable portion of the payments received on the life insurance policy on the death of the insured is equal to the amount of the yearly payments ($10,000) times the number of years (20) to give the entire expected payout ($200,000) of the life insurance annuity. Divide the total amount of the non-taxable lump-sum cash award ($150,000) by the total value of the life insurance annuity ($200,000) to get the non-taxable percentage (75 percent). The taxable percentage of payments (25 percent) is 100 percent minus the non-taxable percentage (75 percent). Multiply the taxable percentage (25 percent) by the payment ($10,000) to get the total amount of the payment subject to tax ($2,500) (Publication 525, Life Insurance Proceeds).

4. The correct answer is A, zero. Under IRC Section 23, an employee may exclude amounts paid or expenses incurred by his or her employer for qualified adoption expenses connected with the employee's adoption of a child, if the amounts are furnished under an existing adoption assistance program and are known to the employee before the expenses are incurred. To determine the taxable and non-taxable amounts, you must complete Part III of Form 8839, Qualified Adoption Expenses (Publication 525, Fringe Benefits, and Publication 968).

5. The correct answer is D, lived in the property for two out of the previous five years preceding the sale (Publication 17, Selling Your Home, and Publication 523).

6. The correct answer is D, $5,000. A scholarship or fellowship is not taxable if it is a qualified scholarship (any amount received for tuition and fees required for enrollment in an educational institution and as required for books, fees, supplies, and equipment, granted to a degree candidate at an educational organization) and is not a stipend. The $4,000 for tuition and books is exempt, but the $2,000 for room and board and the $3,000 for part-time work in the library is taxable compensation, for a total gross income of $5,000 (Publication 17, Other Income).

7. The correct answer is C, $3,600. Amounts received as disability payments, sick pay, or wage-continuation plans from an employer-provided health and accident plan are included in gross income. The same payments made from a plan purchased by the individual taxpayer are excluded from gross income. The amount of the payments is $900 for six months, or $5,400 (Publication 525, Disability Pensions). The payments that are taxable are the employer-paid ones: $3,600, or two-thirds of the $5,400 total.

8. The correct answer is B, compensatory damages for physical injury. There are three true options and one false. IRC Section 104(a)(2) excludes damages, except for punitive damages, received on account of personal injuries or sickness (Publication 525, Other Income).

9. The correct answer is D, $65,000. This is similar to number 8 above. The IRC excludes damages (except for punitive damages) that are received on account of personal injuries or sickness. Compensation for lost wages in most circumstances is considered the same as if the taxpayer had received the wages himself and would be taxable (Publication 525, Other Income).

10. The correct answer is D, $800. If an employee's qualified group term policy has a face value greater than $50,000, the premiums paid on the coverage in excess of $50,000 are taxable to the employee. The question gives the answer on line three (Publication 525, Fringe Benefits).

11. The correct answer is A, zero. The tax law allows the exclusion of four general types of employment-related fringe benefits: no-additional-cost services; employee discounts; working-condition fringe benefits; and de minimis fringe benefits (Publication 525, Fringe Benefits). The employee discounts must be made available to all employees on a non-discriminatory basis; the goods and services must be in the same line of business; and the excludable discount is limited by the gross profit percent on merchandise and 20 percent on services. The discounts are within those limits with no excess allowed, as that would require the company to recognize the excess as compensation income.

12. The correct answer is D, discounts of up to 50 percent on services. See number 11 for explanation. Service discounts are limited to 20 percent, not 50 percent. All the others are allowable fringe benefits with no inclusion as taxable income on Form W-2 (Publication 525).

13. The correct answer is A, a free or discounted commercial airline flight for personal use offered by a manufacturer of machine tools. The fringe benefit should be in the same line of business as the business providing it. The tax law allows the exclusion of four general types of employment-related fringe benefits: no-additional-cost services (b), employee discounts (c), working-condition fringe benefits (d), and de minimis fringe benefits (Publication 525, Fringe Benefits).

14. The correct answer is D, $32,200. Cash meal allowances generally are taxable because they are not provided by the employer on the employer's premises. To exclude the value of employer-provided lodging, the lodging must be a mandatory requirement of the job. Therefore, the $400 cash lodging allowance and the $200 cash meal allowance are fully taxable for all 12 months, resulting in $7,200 of additional wages, for a grand total of $32,200, including normal wages of $25,000 (Publication 525, Fringe Benefits).

15. The correct answer is D, a refund to the employee of the end-of-year unused portion of a qualified FSA established for medical expenses. There are three true options and one false one. An employee may exclude up to $5,000 per year of employer-provided childcare and dependent services (Publication 525, Fringe Benefits). Up to $5,250 in payments for tuition and books for the undergraduate-level courses is excludable if the payments are made from a non-discriminatory educational assistance fund (Publication 525, Fringe Benefits). Employees who choose the tax-free benefits under a qualified cafeteria plan are not taxed on the value of the benefits unless they take the cash in lieu of the benefits; that is taxable. With a flexible benefits plan or a salary reduction plan, the employee loses any payments that are not reimbursed during the plan year (Publication 525, Other Sickness and Injury Benefits).

16. The correct answer is A, $44,000. An employee may exclude up to $5,000 per year of employer-provided childcare and dependent services (Publication 525, Fringe Benefits). An employer's premium payments for the first $50,000 face amount of group term life insurance on the employee are a tax-free employee fringe benefit (Publication 525, Fringe Benefits). Premiums paid by an employer to purchase health and accident insurance coverage for employees and their dependents are excluded from the employee's income (Publication 525, Fringe Benefits).

17. The correct answer is B, $8,800. A taxpayer may include foreign-earned income in his taxable income, calculate the U.S. tax on the income and take a tax credit for foreign tax paid, or exclude up to the annual exclusion amount in foreign-earned income for each full year he works in a foreign country, as long as he is a bona fide resident of the foreign country for 330 days in any 12 consecutive months. It appears that Ben qualifies to exclude the entire amount of this

year's income of $8,800 (Publication 54). This publication, which is relatively narrow in its scope, contains information of value to U.S. citizens and residents working outside the U.S.

18. The correct answer is B, $30,000. Generally, the amount of the discharge of indebtedness is taxable to the borrower; however, if the borrower is insolvent at the time of the discharge, only that portion of the discharge that renders the borrower solvent is taxable. The debtor must recognize income to the extent that the debtor is solvent after the debt reduction. In this instance, the debtor must recognize $60,000 as income. The excluded amount of $40,000 ($100,000 discharged less $60,000 income) would reduce the taxpayer's NOL (Publication 17, Other Income).

19. The correct answer is B, $56. The non-taxable fringe benefit ($200) multiplied by the tax bracket of the taxpayer (28 percent) equals the after-tax savings from the fringe ($56) (Publication 17, Tax Table).

20. The correct answer is B, transit passes costing $130 per month. The exclusions for qualified parking and for transit pass fringe benefits are subject to monthly limits on the exclusions. If the benefit has value that is more than these limits, the excess must be included in income (Publication 525, Fringe Benefits).

21. The correct answer is D, not report the lunch costs on his tax return. An employee does not pay tax on an advance, reimbursement, or other expense allowance received under an "accountable plan" (Publication 17, Car Expenses and Other Employee Business Expenses).

22. The correct answer is D, $5,000. An employee may exclude up to $5,000 per year of employer-provided childcare and dependent services (Publication 525, Fringe Benefits).

23. The correct answer is A, $50 cash per pay period. Premiums paid by an employer for the first $50,000 face amount of group term life insurance on the employee are a tax-free employee fringe benefit (Publication 525, Fringe Benefits). Premiums paid by an employer to purchase health and accident insurance coverage for employees and their dependents are excluded from the employee's income (Publication 525, Fringe Benefits). Employees who choose the tax-free benefits under a qualified cafeteria plan are not taxed on the value of the benefits unless they take the cash in lieu of the benefits; that is taxable.

24. The correct answer is D, excludable gift in the year of forgiveness. Normally, forgiveness of debt would result in taxable income in the year the debt is forgiven, unless the taxpayer is insolvent at the time the debt is forgiven. This is a special circumstance where the creditor is a close family member; in this case, the forgiveness of debt is a gift to the taxpayer's son, which is subject only to gift tax if the total gifts received in a calendar year exceed $12,000. A true gift is not subject to income tax (Publication 525, Other Income).

25. The correct answer is B, not included in taxable income. The question refers to the value of an individual's time in working on a personal project, such as home improvement; the value of one's time, unless actually paid in cash or other compensation, is not taxable (Publication 535, Other Expenses).

26. The correct answer is D, the adjusted basis. The basis of property is adjusted (increased to include the amount of the capital expenditures with respect to the property or decreased to reflect depreciation allowed or allowable). When a taxpayer sells or exchanges property at a price higher than his cost, or the adjusted tax basis, he realizes a gain; if he receives less than the adjusted basis, it is a loss (Publication 17, Basis of Property).

27. The correct answer is A, working-condition benefits. Working-condition fringe benefits can be given on a discriminatory basis (Publication 525, Fringe Benefits).

28. The correct answer is D, $100,800. Taxpayers may include foreign-earned income in their taxable income, calculate the U.S. tax on the income, and take a tax credit for foreign tax paid, or exclude up to the annual exclusion amount in foreign-earned income for each full year they work in a foreign country, as long as they are bona fide residents of the foreign country for 330 days in any 12 consecutive months (Publication 54).

29. The correct answer is A, taxable. The borrower who is relieved of debt has obtained a claim of right to the amount of the debt forgiven. This forgiveness of debt, known as discharge of indebtedness, is generally taxable to the borrower, unless the borrower is insolvent or going through bankruptcy proceedings.

30. The correct answer is A, zero. Interest on state and local bonds for state, district, and tribal governments and political subdivisions is exempt from federal tax (Publication 17, Interest Income). Giving bonds as a gift in which the bond interest is subject to federal income tax, such as a bond of a U.S. obligation, would result in the interest being earned by the donee of the bond, and not the recipient, if the bond interest was earned in the hands of the donee.