**Chapter Two**

**Gross Income and Exclusions**

**Learning Objective 2.1 The Nature of Gross Income**

Gross income is the initial point of tax computation. Gross income is composed of the following items:

1. Compensation for services, including fees, commissions, fringe benefits, and similar items
2. Gross income derived from business
3. Gains derived from dealings in property
4. Interest
5. Rents
6. Royalties
7. Dividends
8. Alimony and separate maintenance payments
9. Annuities
10. Income from life insurance and endowment contracts
11. Pensions
12. Income from discharge of indebtedness
13. Distributive share of partnership gross income
14. Income in respect of a decedent
15. Income from an interest in an estate or trust

The general rule is that “all income from whatever source derived” that a taxpayer received must be included in gross income unless specifically excluded. Noncash items should be reported at a fair market value. Specific exclusions can be found in Table 2.2.

**Learning Objective 2.2 Interest and Dividend Income**

Interest and dividend income is part of gross income. If a taxpayer earns $1,500 or more in interest and dividends, the taxpayer must file a Schedule B with their return. Interest and dividends from cooperative banks, credit unions, domestic building and loan associations, domestic savings and loan associations, federal savings and loan associations and mutual savings banks are included.

Savings bonds come in three different forms, Series EE, Series HH and Series I. Series EE bonds are issued at a discount. In other words, the bond sells for a discounted value and is cashed in at a higher value. Series HH bonds are bonds that have interest paid semi-annually. Series I bonds do not pay interest until maturity, but earnings are adjusted for inflation on a semi-annual basis. Cash basis taxpayers report the increase in redemption value on a Series EE or Series I bond using one of the following methods:

1. The interest may be reported in the year the bonds are cashed or in the year they mature, whichever is earlier, or
2. The taxpayer may elect to report the increase in redemption value each year.

Dividends are one type of distribution paid to a taxpayer by a corporation. The three types of dividends are ordinary dividends, nontaxable distributions and capital gain distributions. The 2003, 2006 and 2010 tax acts enacted special lower tax rates for qualifying dividends, which were extended through the end of 2015. Dividends that do not qualify are taxed at ordinary rates.

|  |  |
| --- | --- |
| Ordinary Tax Bracket | Qualifying Dividend Tax Rate for 2015 |
| 10% and 15% | 0% |
| 25% through 35% | 15% |
| 39.6% | 20%\* |
| \*An additional 3.8% Medicare surtax on Net Investment Income including qualifying dividends applies to high-income taxpayers. (LO 1.9) | |

**Learning Objective 2.3 Alimony**

Alimony payments are deductible by the individual making the payments and tax­able income to the person receiving the payments. The term "alimony," for income tax purposes, includes separate or periodic maintenance payments made to a spouse or former spouse. Payments must meet certain requirements to be considered alimony. Rules for divorces prior to 1985 were different than they are now so consult the tax rules for that time period if reference to those particular rules are needed.

To qualify as alimony, payments must:

…be in cash and be received by spouse.

…be made under a decree of divorce/separation or associated written agreement

…cease upon the death of the spouse

…not be designated as anything other than alimony in the written agreement

…not be made to members of the same household

…not be child support payments

Payments contingent on age or marital status of child are not alimony and therefore nondeductible. Alimony paid by high-income spouse to low-income spouse will result in tax savings to high-income spouse.

Payments contingent on age or marital status of child are not alimony. They may be an important factor in determining which spouse is entitled to claim the dependency exemption for the child. Child support payments must be up to date before any amounts paid may be treated as alimony.

**Learning Objective 2.4 Prizes and Awards**

Prizes and awards are taxable income to the recipient. Contest winnings are taxable income. All other awards are also generally taxable, even if they are awards given for accomplishments and without solicitation by the taxpayer. If the prize or award is in the form of property (rather than cash), the fair market value of the property is included in the taxpayer's income. If a taxpayer refuses the prize, it is not considered income.

Certain employee achievement awards made in recog­nition of length of service or safety achievement can be excluded from income. As a rule, the maximum excludable amount is $400; but if the award is given through a "qualified plan" the maximum exclusion increases to $1,600.

**Learning Objective 2.5 Annuities**

An annuity is an investment that pays periodic payments to the purchaser for the remainder of his/her life. Standard mortality tables, based on the current age of the annuitant, are used to calculate the annuity amount.

Each annuity payment received contains an element of taxable income and an element of tax-free return of the original purchase price. To calculate the taxable portion of the payment, the tax law provides two methods: the simplified method or the general rule.

The Simplified Method

Taxpayers are generally required to use the simplified method to calculate the taxable amount of annuities started after November 18, 1996. Non-qualified plan annuitants and some annuitants age 75 and over still have to use the general rule rather than the simplified method. To calculate the taxable amount, the IRS provides a Simplified Method Worksheet. The exclusion ratio is calculated at the start of the annuity and remains constant.

The General Rule

Prior to implementing the simplified method, the general rule ratio used to calculate the amount excluded for most annuities. The calculation is as follows:

**Investment in the Contract x Amount Received = Excluded Amount**

**Annual Payment x Life Expectancy**

**For annuities started before 1987:** The exclusion ratio above is used for the life of the annuity holder (even after he/she had recovered all of his/her investment in the annu­ity); however, if the annuitant dies before recovering his or her entire investment in the contract, the unrecovered portion is lost.

**For annuities started after 1986:** The maximum exclusion is limited to the annuitant’s investment in the annuity. Once the taxpayer's investment is recovered, any additional amounts received are fully taxable. If the taxpayer dies before the entire investment in the contract is recovered, then any un-recovered amount is permitted as a miscellaneous itemized deduction (not subject to the 2 percent floor) at the time of the annuitant’s death.

Employee Annuities

If an employer makes periodic payments to a retirement annuity on behalf of an employee and the payments are made to a qualified retirement plan, the contributions by the employer are not taxable to the employee in the current year. Because the contri­butions are not taxable when they are made, they are not considered part of the employee's investment in the contract when calculating the exclusion ratio.

**Learning Objective 2.6 Life Insurance**

Life insurance proceeds are excluded from gross income. To be excluded, proceeds must be paid to the beneficiary by reason of the death of the insured. If the proceeds are taken over several years instead of in a lump sum, the insurance company pays interest on the unpaid proceeds. The interest is generally taxable income.

Early payouts of life insurance and viatical settlements can be excluded from gross income for terminally ill taxpayers and excluded from gross income for a chronically ill taxpayer to the extent the proceeds are used to pay for long-term care. These exclusions require certification by an M.D.

**Learning Objective 2.7 Gifts and Inheritances**

The fair market value of gifts and inheritances may be excluded from taxable income, but income received from the property after the transfer is taxable. Also, gifts given in the business setting are considered taxable income even if no obligation for payment existed. However, if a gift recipient provides a service in return for the gift, even if no obligation exists, it is presumed that the gift is income for the service performed.

**Learning Objective 2.8 Scholarships**

Scholarship dollars awarded to degree candidates that are used to pay room and board are taxable income. Scholarship dollars spent for tuition, fees, books, and course-required supplies and equipment are exempt. Payments received by students for part-time employment including work-study are taxable as compensation.

**Learning Objective 2.9 Accident and Health Insurance**

Taxpayers may exclude from income the entire amount received from accident or health insurance plans for payment of medical care. Taxpayers may also exclude any premiums paid by a taxpayer's employer from income. If the employer pays premiums on behalf of the employee for health, accident, or long-term care insurance, the employer may deduct them. Most accident and health care policies also pay fixed amounts to the insured for loss of the use of a member or function of the body. Such amounts are also excluded from income.

**Learning Objective 2.10 Meals and Lodging**

Meals and lodging provided by employers to employees for the convenience of the employer are generally not considered part of compensation and so are not included in employee’s taxable income. Taxpayers may exclude from income the value of meals provided by an employer if the meals are for the convenience of the employer, served on the business premises of the employer, provided during working hours because employee/taxpayer must be available for emergency calls or because the employer limits employees to short meal periods. Taxpayers may exclude from income the value of lodging provided by an employer if the lodging is located on the business premises and must be accepted as a requirement of employment.

**Learning Objective 2.11 Municipal Bond Interest**

Interest income earned on state or local government bonds is exempt from federal tax. The interest exclusion encourages high-income taxpayers to lend money to state and local governments at lower interest rates.

**Learning Objective 2.12 Unemployment Compensation**

Unemployment compensation is fully taxable and must be included in the taxpayer’s gross income.

**Learning Objective 2.13 Employee Fringe Benefits**

All fringe benefits must be included in an employee’s gross income unless specifically excluded by law.

**Flexible Spending Accounts**

Employers may form plans which allow employees to set aside money from their salary before it is taxed to pay for one or more expenses. These expenses include dependent care accounts (maximum of $5,000 to cover the costs of caring for a dependent child), medical flexible spending accounts (used to cover medical expenses up to $2,550 per year), public transportation (up to $130/month) and parking at work (up to $250/month).

**Group Term Life-Insurance**

Employers may pay for up to $50,000 of group term life-insurance for employees as a tax-free fringe benefit.

**No-Additional-Cost Services**

Employees may receive tax-free services from their employer as long as it is in the major line of business in which they are employed. An example would be airline employee’s free standby airplane ticket because the employee is flying at no additional cost to the employer.

**Education Assistance Programs**

Employer may provide up to $5,250 of excludable tuition assistance. This requires existence of a written plan.

**Qualified Employee Discounts**

Employees may receive tax-free discounts from their employer, as long as the discounts are available to all fulltime employees **and they are not** real estate or personal property held for investment.

**Working Condition Fringe Benefits**

Employees may exclude from income any property or services provided by the employer that would be excluded from income anyway. Examples include use of a company car for business, a subscription to an appropriate professional journal (for example, a tax journal for a CPA firm) or the use of demo cars by car salesmen/women.

***De Minimis* Fringe Benefits**

Some benefits are so minimal that accounting for them is impractical. Included in this category is the occasional use of office equipment for personal use, Christmas turkeys, picnics, etc.

If an employer provides subsidized meals, employees may exclude meals from their income if 1) lunchroom is in or near employer’s business, 2) the lunchroom is covering its operating costs, 3) meals are provided to all employees without discrimination.

**Tuition Reduction**

Employees of educational institutions can exclude the value of a tuition reduction from their income if it was for undergraduate work and is available to all employees. The exclusion applies to employees, spouses, and dependents if a tuition reduction plan exists for them. Graduate students can only exclude tuition reductions if they work at the same school where they are teaching or doing research.

**Athletic Facilities**

Employees may exclude from gross income the value of the use of an athletic facility located on the business premises used primarily by employees.

**Retirement Planning Fringe Benefit**

Qualified retirement planning services are any retirement planning services provided to an employee and his/her spouse by an employer maintaining a “qualified employer plan.” The exclusion does not apply to services that may be related to tax preparation, accounting, legal or brokerage services.

**Learning Objective 2.14 Social Security Benefits**

Many taxpayers may exclude all of their Social Security earnings from gross income. Middle and upper income Social Security recipients may have to include up to 85% of their benefits in taxable income. The amount of benefits taxable is based on the taxpayer’s MAGI (Modified Adjusted Gross Income).

**Base Amounts Table**

|  |  |
| --- | --- |
| **Base** | **Applies to** |
| $32,000 | Married filing jointly |
| $0 | Married filing separately but did not live apart for the entire year |
| $25,000 | All other taxpayers |