**Chapter Two**

**Gross Income and Exclusions**

**2019**

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

Gross income is the initial point of tax computation and 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”* must be included in gross income unless specifically excluded.

* Noncash items should be reported at a fair market value.
* Specific exclusions canbe found in Table 2.2.

**Learning Objective 2.2 Salaries & Wages Income**

* Wages are primary way of earning income in U.S.
* Reported on Form W-2, and then employee reporting Box 1 on Line 1 of Form 1040
* Figure 2.1 illustrates W-2

**Learning Objective 2.3 Accident & 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.

**Learning Objective 2.4 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 lodging provided by an employer if the lodging is located on the business premises and must be accepted as a requirement of employment.
* Meals provided by employer for employee are excludable, but employer, under TCJA, may only deduct 50% of cost of providing meals

**Learning Objective 2.5 Employee Fringe Benefits**

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

**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, in 2018, include
  + Dependent care accounts (maximum of $5,000)
  + Medical flexible spending accounts (up to $2,650 per year)
  + Public transportation and parking at work (up to $260/month).

**Group Term Life-Insurance**

Employers may pay for up to $50,000 of group term life insurance for employees.

**Education Assistance Programs**

Employer may provide up to $5,250 of excludable tuition assistance.

* Requires existence of a written plan.

**No-Additional-Cost Services**

Employees may receive tax-free services from their employer, if it is in major line of business in which employed.

* For example - an airline employee’s free standby airplane ticket (employee is flying at no additional cost to the employer).

**Qualified Employee Discounts**

Employees may receive tax-free discounts from their employer

* On services, limited to 20% of typical customer price
* On merchandise, limited to mark up on product

**Working Condition Fringe Benefits**

Employees may exclude from income any property or services provided by the employer that would be excluded from income anyway.

* For example: use of company car for business or subscription to an appropriate professional journal (for example, a tax journal for a CPA firm).

***De Minimis* Fringe Benefits**

Some benefits are so minimal that accounting for them is impractical.

* For example: occasional use of office equipment for personal use, Christmas turkeys, picnics, etc.

**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.

* 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 onsite

**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 2.6 Prizes and Awards**

Prizes and awards are taxable income to the recipient.

* Other awards are also generally taxable, even if they are awards given for accomplishments and without solicitation by the taxpayer.
* 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 2.7 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
* 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.*

* *Note*: 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**

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*.

* 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 2.8 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 are excludable
* Payouts from viatical settlements can be excluded from gross income:
  + For terminally ill taxpayers and
  + For a chronically ill taxpayer to extent proceeds pay for long-term care.
    - These exclusions require certification by an M.D.

**Learning Objective 2.9 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, must file a Schedule B
* 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.
  + 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.
  + *Note:* Cash basis taxpayers report the increase in redemption value on a Series EE or Series I bonds
* Dividends are one type of distribution paid to a taxpayer by a corporation
* Types of dividends are:
  + Ordinary dividends, nontaxable distributions and capital gain distributions.
    - There are special lower tax rates for qualifying dividends.
    - *Note:* Dividends that do not qualify are taxed at ordinary rates.

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| **Income Level** | **Qualifying dividends and long-term capital gains rates\*** |
| **MFJ** $0-$77,200 | 0% |
| $77,201-$479,000 | 15% |
| > $479,001 | 20% |
| **SINGLE** $0-$38,600 | 0% |
| $38,601-$425,800 | 15% |
| > $425,801 | 20% |
| **HOH** $0-$51,700 | 0% |
| $51,701-$452,400 | 15% |
| $452,401 | 20% |
| \*An additional 3.8% Medicare surtax on Net Investment Income including qualifying dividends applies to high-income taxpayers. (LO 1.9) | |

* Interest reported on Form 1099-INT (Box 1)
* States may not tax interest from U.S. government obligations (reported in Box 3)
* Tax-exempt interest reported in Box 8
* Dividends reported on Form 1099-DIV
  + Ordinary dividends (Box 1a); qualified dividends (Box 1a); capital gain dividends (Box 2a)
  + Capital gains dividends are reported on Schedule D

**Learning Objective 2.10 Municipal Bond Interest**

* Interest income earned on state or local government bonds is exempt from federal tax.

*Note:* The interest exclusion encourages high-income taxpayers to lend money to state and local governments at lower interest rates.

After-tax return = Tax-free interest rate/(1.00 – tax rate)

**Learning Objective 2.11 Gifts and Inheritances**

The fair market value of gifts and inheritances may be excluded from taxable income

* But income received from property after the transfer is taxable.
* Gifts given in the business setting are considered taxable income
  + If gift recipient provides service in return for gift, presumed that gift is income for the service performed.

**Learning Objective 2.12 Scholarships**

Scholarship dollars awarded that are used to *pay room and board are taxable*

* 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 2.13 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.

* *Note: 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.
  + 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 2.14 Educational Incentives**

Qualified Tuition Programs (QTP) allow taxpayers to buy in-kind tuition credits for qualified higher education expenses or to contribute to an account

* Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible education intuition.
  + No income limit on the amount of contributions to the QTP
  + Contributions are *not* tax deductible.
  + The contributions are considered gifts and thus subject to gift tax rules.
* TCJA now includes tuition in connection with enrollment at elementary/secondary public, private, or religious schools
* Distributions from QTPs may be taken in the same year as education credit (Chapter 6), as long as amount distributed is not used to calculate the credit.

Educational savings accounts (ESAs) are established to pay for qualified higher ed expenses.

* The maximum annual contribution to these plans is $2,000.
* Contributions can be made until the designated beneficiary reaches 18.
* Can’t contribute to an ESA in the same year a contribution is made to a QTP
* Contributions to ESAs are phased out {AGI of $95,000-$110,000 (S) and $190,000-$220,000 (MFJ)}
  + Contributions must be made by April 15 of following tax year.

Higher Education Expense Deduction – ‘above-the-line’ deduction for qualified tuition/related expenses

* No longer available, but this deduction has previously been extended a number of times
* Deduction is $4,000 for single/head of household with AGI below $65,000, and married filing jointly with AGI below $130,000.

**Learning Objective 2.15 Unemployment Compensation**

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

**Learning Objective 2.16 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**

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| --- | --- |
| **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 |