**Chapter Two**

**Gross Income and Exclusions**

**2020**

**Learning Objectives (Slides 2-3)**

* The Learning Objectives provide students with a brief overview of what they will learn in this chapter.
  + LO 2.1 Apply the definition of gross income.
  + LO 2.2 Describe salaries and wages income reporting and inclusion in gross income.
  + LO 2.3 Explain the general tax treatment of health insurance.
  + LO 2.4 Determine when meals and lodging may be excluded from taxable income.
  + LO 2.5 Identify the common employee fringe benefit income exclusions.
  + LO 2.6 Determine when prizes and awards are included in income.
  + LO 2.7 Calculate the taxable and nontaxable portions of annuity payments.
  + LO 2.8 Describe the tax treatment of life insurance proceeds.
  + LO 2.9 Identify the tax treatment of interest and dividend income.
  + LO 2.10 Describe the tax treatment of municipal bond interest.
  + LO 2.11 Identify the general rules for the tax treatment of gifts and inheritances.
  + LO 2.12 Describe the elements of scholarship income that are excluded from tax.
  + LO 2.13 Describe the tax treatment of alimony and child support.
  + LO 2.14 Explain the tax implications of using educational savings vehicles.
  + LO 2.15 Describe the tax treatment of unemployment compensation.
  + LO 2.16 Apply the rules governing inclusion of Social Security benefits in gross income.
  + LO 2.17 Distinguish between the different rules for married taxpayers residing in community property states when filing separate returns.
  + LO 2.18 Describe the inclusion and exclusion of cancellation of debt income.

**Learning Objective 2.1 The Nature of Gross Income (Slides 4-6)**

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. Annuities
9. Income from life insurance and endowment contracts
10. Pensions
11. Income from discharge of indebtedness
12. Distributive share of partnership gross income
13. Income in respect of a decedent
14. 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 the fair market value.
* Slide 5 has a partial list of inclusions; a more comprehensive list can be found in Table 2.1 in the text.
* Slide 6 has a partial list of exclusions; a more comprehensive list can be found in Table 2.2 in the text.

**Learning Objective 2.2 Salaries and Wages (Slides 7-11)**

Wages are the primary way of earning income in the United States.

* More than 80% of taxpayers include some amount for wages.
* Employers report wages on Form W-2, and employees report the amount in Box 1 on Line 1 of Form 1040.
  + Boxes 2 through 12 are used to record other types of wages, tips, and compensation.

The Knowledge Check on slides 10-11 confirms that students understand what information is recorded in Box 2 on a W-2 form.

* Box 1 reports taxable compensation (taxable wages, salary, bonuses, awards, commissions) found on Line 1 of taxpayer’s Form 10 40.
* Box 2 reports amount of federal income tax withheld.
* Boxes 3 through 6 report wages subject to Social Security and Medicare taxes, as well as taxes.
* Box 8 reports allocated tips.
* Box 10 reports flexible spending contributions to a dependent care program.

**Learning Objective 2.2a Employee versus Independent Contractor (Slides 12-15)**

Business owners are required to determine if individuals are employees or independent contractors.

* The employer withholds income taxes, withholds and pays Social Security and Medicare taxes, and pays unemployment tax on wages paid to an employee.
* Employer does not withhold or pay taxes to contractors; must provide an information return.

Classification is a function of law, not choice. However, the tax code does not define “employee” in any meaningful way. The common law definition relies on degree of control and independence, divided into three categories:

* Behavioral: Does the business control what and how the worker does his or her job?
* Financial: Are the business aspects of the worker’s job controlled by the payer?
* Relationship: Are there written contracts or employee benefits? Will the relationship continue and is the work performed a key aspect of the business?

The discussion on slides 14-15 asks students to determine whether a specific individual is an employee or an independent contractor. Guide students to consider the amount of control and independence the worker has in the behavioral, financial, and relationship categories.

**Learning Objective 2.3 Accident and Health Insurance (Slide 16)**

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 their 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 (Slide 17)**

Meals and lodging provided by the employer are generally excluded from income if the following tests are met:

* The meals are provided by an employer on business premises during working hours solely for the benefit of the employerbecause the employee must be available for emergency calls or is limited to short meal periods
  + - Under the TCJA, only 50% of the cost of these meals is deductible by the employer.
* The lodging is provided by an employer on business premises and must be accepted as a requirement for employment.

**Learning Objective 2.5 Employee Fringe Benefits (Slides 18-21)**

All fringe benefits must be included in an employee’s gross income, unless specifically excluded by law. (See Table 2.3 in the text for more details.)

**Flexible Spending Accounts**

Employers may form plans that allow employees to set aside money from their salary before it is taxed to pay for one or more expenses.

* These expenses, in 2020, include the following:
  + Dependent care accounts (maximum of $5,000)
  + Health care accounts (up to $2,750 per year)
* Under the “use-it-or-lose-it” provision, employers can allow $500 of unused amounts to be carried over into the next year or offer a 2½-month grace period the following year.
* For FSA s that permit a grace period, a temporary COVID-19 provision was passed that would allow the grace period to extend to December 30, 2020.

**Group Term Life** **Insurance**

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

**Education Assistance Plans**

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

* This exclusion requires existence of a written plan.

**No-Additional-Cost Services**

Employees may receive tax-free services from their employer, in the major line of business in which they are employed.

* 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 markup 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.

* Examples: Use of company car for business or subscription to an appropriate professional journal (e.g., a tax journal for a CPA firm)

**De Minimis Fringe Benefits**

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

* Examples: 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, their spouses, and their 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 or 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.
* The poll on slide 21 asks student to consider if a couple with two children should put $2,000 in a health care FSA, a dependent care FSA, or an educational assistance plan. There is no correct answer. The FSAs have a “use-it-or-lose-it” policy, so those may be a riskier choice. But if the couple is sure they will use it, it might make sense to put the money there, and then take the money allocated in their budget for that item and put that elsewhere.

**Learning Objective 2.6 Prizes and Awards (Slides 22-25)**

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.

The poll on slide 25 asks students to consider whether a game show contestant should take a cash prize or a car said to be worth more than the cash prize. There is no correct answer. The contestant would have to pay taxes on either prize, so the decision may depend on whether or not she has the money available to pay the taxes on the value of the car. However, if she does not want to keep the car, it might make sense for her to take the car, sell it, and pay taxes from the proceeds—still netting more money than the cash prize.

**Learning Objective 2.7 Annuities (Slides 26-31)**

An annuity is an investment that pays periodic payments to the purchaser for the remainder of his or 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**

Taxpayers are generally required to use the “simplified” method to calculate the taxable amount of annuities started after November 18, 1996.

* *Note*: Nonqualified plan annuities 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 was used to calculate the amount excluded for most annuities. The calculation for the excluded amount is as follows:

Investment in contract × Amount received = Excluded amount

Annual payment × 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.

Slides 30-31 provide an example of an annuity calculation using the general rule.

**Learning Objective 2.8 Life Insurance (Slides 32-38)**

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 certain terminally ill taxpayers and
  + For chronically ill taxpayers to extent proceeds to pay for long-term care.
    - These exclusions require certification by a medical doctor.
* If a policy is transferred for value, then all or part of the proceeds may be taxable to the recipient.
* Theproceeds at the death of the insured are taxable to the extent they exceed the cash surrender value of the policy at the time it was transferred, plus the amount of the insurance premiums paid by the purchaser.
* Exception: Transfers to a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or a shareholder do not cause the policy proceeds to be taxable.

**Learning Objective 2.9 Interest and Dividend Income (Slides 39-49)**

Interest and dividend income is part of gross income.

* A taxpayer who earns more than $1,500 in interest and dividends must file Schedule B.

U.S. 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 semiannually. They are no longer issued by the Treasury as of August 31, 2004.
  + Series I bonds do not pay interest until maturity, but earnings are adjusted for inflation on a semiannual 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 include ordinary and qualified 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.

|  |  |
| --- | --- |
| **Income Level** | **Qualifying Dividends and Long-Term Capital Gains Rates\*** |
| Married filing jointly: |  |
| $0–$80,000 | 0% |
| $80,001–$496,600 | 15% |
| > $496,600 | 20% |
| Single: |  |
| $0–$40,000 | 0% |
| 40,001–$441,450 | 15% |
| > $441,450 | 20% |
| Head of household: |  |
| $0–$53,600 | 0% |
| $53,601–$469,050 | 15% |
| > $469,050 | 20% |
| \*An additional 3.8% Medicare surtax on net investment income, including qualifying dividends, applies to high-income taxpayers. | |

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

The Knowledge Check on slides 48-49 asks students to recall the most common way that corporations distribute money to their shareholders.

**Learning Objective 2.10 Municipal Bond Interest (Slides 50-52)**

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 – Tax rate)

Slides 51-52 walk students through an example of an individual trying to determine what taxable interest rate will yield the same after-tax return as a municipal bond.

**Learning Objective 2.11 Gifts and Inheritances (Slide 53-55)**

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

* Income received from property after the transfer is taxable.
* Gifts received are excluded from income.
  + A gift is defined by the courts as a voluntary transfer of property without adequate consideration.
* Gifts given in the business setting are considered taxable income.
  + If a gift recipient provides service in return for the gift, it is presumed that the gift is income for the service performed.

The discussion on slides 54-55 ask students to consider whether a gift received as a thank you for a service provided is taxable income. In this case, even if there was no obligation to give this gift, gifts in a business setting are considered taxable income.

**Learning Objective 2.12 Scholarships (Slide 56)**

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 programs are taxable as compensation.

**Learning Objective 2.13 Alimony (Slides 57-58)**

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.
* Alimony payments must meet the following five requirements:
  + Payments must be in cash and received by ex-spouse.
  + Payments must be made in connection with written instrument.
  + Payments cannot continue after death of ex-spouse.
  + Payments cannot be designated as anything other than alimony.
  + Parties may not be members of the same household.
* Prior to December 31, 2018, alimony was deductible by the payor and includable in income by the recipient.
* The TCJA eliminated the deduction for alimony; conversely, the recipient need not include alimony received as income.

**Property Transfers**

* A spouse who transfers property in settlement of a marital obligation is not required to recognize any gain as a result of the property’s appreciation.

**Child Support**

* Child support is not deductible to payer and not taxable to payee.
* It is an important factor, however, in determining which spouse gets dependency exemption.

**Learning Objective 2.14 Educational Incentives (Slides 59-66)**

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.
  + There is 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.
* Qualified higher education expenses include tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.

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

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

**Higher Education Expenses Deduction**

* In 2017, taxpayers were allowed an “above-the-line” deduction for qualified tuition and related expenses.
* The deduction expired at the end of 2017, but was restored retroactively through the end of 2020.
* The deduction is $4,000 for single/head of household taxpayers with AGI below $65,000 and married filing jointly taxpayers with AGI below $130,000.

**Learning Objective 2.15 Unemployment Compensation (Slide 67)**

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

* It is reported on Form 1099-G.
* These payments are deductible on some states’ income tax returns.

**Learning Objective 2.16 Social Security Benefits (Slide 68)**

* 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 modified adjusted gross income (MAGI).

**Base Amounts Table**

|  |  |
| --- | --- |
| **Base Amounts** | **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 |

**Learning Objective 2.17 Community Property (Slides 69-70)**

* State law governs how income derived from property held by a married couple, either jointly or separately, is allocated between spouses.
* Nine states practice a community property system: All property is deemed to be either separate property or community property.
  + Separate property includes property acquired by a spouse before marriage or received after marriage as a gift or inheritance.
  + All other property owned by a married couple is presumed to be community property: Each spouse is automatically taxed on half of the income from community property.
* When married spouses residing in a community property state do not live together, the tax law contains an exception to the community property rules.
* Under this special provision, a spouse will be taxed only on his or her actual earnings from personal services. For this provision to apply, the following conditions must be satisfied:
* The individuals must live apart for the entire year,
* They must not file a joint return.
* No portion of the earned income may be transferred between the spouses.

**Learning Objective 2.18 Forgiveness of Debt Income (Slide 71)**

* Cancellation of debt is an economic benefit to person who receives debt relief.
* Amount forgiven is considered income, with the following exclusions:
* The taxpayer is bankrupt or insolvent at the time the debt is cancelled or reduced
* The debt is qualified real property business debt
* The debt is qualified principal residence debt
* The debt is certain types of student loan debt that is forgiven under certain conditions

**Case Study (Slide 72)**

The Case Study considers the case of a college student at an expensive private university. She receives reduced tuition and a scholarship, and also gets a part-time job on campus. Students are asked to refer to Publication 970 to determine what portion of this package is taxable and then prepare a letter to the student explaining it.

**Summary (Slides 73-74)**

The Summary slides review the eighteen Learning Objects, covering what the students should have learned in this lesson.