Section 2: Income and Assets

2.1 Income

1. Taxability of wages, salaries, tips, and other earnings

The Following are Taxable Forms of Income:

- Employee Compensation
- Form W-2 Wages from your employer showing the pay you received for your services
- Advance commissions and other earnings
- Allowances and reimbursements.
- Back pay awards.
- Bonuses and awards.
- Employee achievement award.

The Following are Taxable Forms of Income:

- Government cost-of-living allowances
- Differential wage payments.
- Nonqualified deferred compensation plans.
- Note received for services.
- Severance pay
- Accrued leave payment.
- Outplace
- Employee Achievement Award

The Following are Taxable Forms of Income:

- Sick pay
- Social security and Medicare taxes paid by employer.
- Stock appreciation rights.
- Fringe Benefits
- Accident or Health Plan Benefits/ Sickness and Injury Received May be Taxable

Tip Income

Reportable tip income is money received in cash, check, and debit and credit cards transactions, of more than $20

If your total tips for any 1 month from any one job are less than $20, don't report the tips for that month to that employer. If you participate in a tip-splitting or tip-pool-ing arrangement, report only the tips you receive and retain. You are not required to report to your employer any portion of the tips you receive that you pass on to other employees. However, you must re-port tips you receive from other employees. The value of any noncash tips, such as tickets or passes should not be reported to an employer.

Prizes and Awards

Amounts received as prizes and awards are generally taxable.

There are exceptions:

- Scientific and literary achievements that are given to a recipient by a qualified charity or government unit
- Employee achievements must be given to employee for length of service or safety. The amount is limited to $400 per employee (or $1,600 if qualified plan)

Alimony Received

Amounts received for alimony payments are taxable income if:

- Payments are made in cash
- There is a written agreement
- Payments are not disguised child support or property settlement
- Payments cannot be made to payee's estate
- Payer and payee do not live in the same household

Alimony and Separate Maintenance Payments

Alimony is:

- Deductible by payor
- Includible in gross income of recipient

Alimony and Separate Maintenance Payments

Property settlements

- Transfer of property to former spouse
- No deduction or recognized gain or loss for transferor
- No gross income and carryover of transferor's basis for transferee

Alimony and Separate Maintenance Payments

Child support payments

- Payments made to satisfy legal obligation to support child of taxpayer
- Nondeductible by payor and not taxed to recipient (or child)

May be difficult to determine whether an amount received is alimony or child support

- If amount of payment would be reduced due to some future event related to the child (e.g., child reaches age 21), such reduction is deemed child support

Example: (slide 1 of 4)

Donna and David Steele recently married and have come to you for tax advice

- They both are employed, and they expect to have combined wages of $70,000 during the year

Donna recently completed an internship with a CPA firm

- The firm was pleased with her work and gave her a $1,500 bonus to help with her graduate school expenses at State University

Because of Donna's excellent academic record, the university awarded her a graduate assistantship that waived her tuition of $6,000 per semester and paid her $400 per month

- In exchange, Donna was required to teach a principles of accounting course each semester
- Donna used the $400 per month for books and incidental fees

Example: (slide 2 of 4)

- Donna paid $250 of interest on student loans from her undergraduate years
- Donna and David also received a wedding gift of $10,000 from her grandmother
  - The couple earned $250 of interest on a savings account they opened with the money
- David sold stock for $1,000 that was purchased two years ago for $5,000

Example: (slide 3 of 4)

- Late in the year, Donna was hit by a delivery van. The driver had a blood alcohol level of .12. Donna suffered a severe injury to her right arm that required her to miss work for a month or so
- The delivery company's insurance company settled the case by paying damages, itemized as follows:

Compensatory damages:		
Medical expenses	$ 30,000	
Injury to Donna's right arm	100,000	
Pain and suffering	50,000	
Loss of income	10,000	
Legal fees	25,000	
Punitive damages		160,000
		$375,000

Example: (slide 4 of 4)

- This is David's second marriage, and he pays alimony to his ex-wife

–He has custody of his 15-year-old son, Stephen, who lives with

Donna and David for nine months each year

- The Steele's rent their home, paid $3,500 of state income taxes, paid an $412 motor vehicle registration tax on their personal car, incurred additional medical expenses of $25,000, and made $2,500 of charitable contributions
- Without calculating Donna and David's tax liability, what are the tax implications of the transactions noted above?

–Are there other tax deductions or credits for which they may qualify

or other tax issues about which they should be made aware?

- Read the chapter and formulate your response

Specific Inclusions Applicable To Individuals

The following provisions applicable to individuals are covered in this chapter:

- Alimony and separate maintenance payments
- Prizes and awards
- Unemployment compensation
- Social Security benefits

Income Sources

Income from personal services is taxable to the person who performs the services

- Fruit and tree metaphor

Income from property is taxable to the owner of the property

- Assignment of income is not permitted

Interest Income

Interest income accrues daily

- If interest bearing instrument (e.g., bonds) is transferred, must allocate interest income between transferor and transferee based on the number of days during the period that each owned the property

Dividends

Dividends are generally taxed to the party who is entitled to receive them

- Dividends on stock *transferred by gift* after declaration date but before record date are generally taxed to the donor

Dividends

Recent legislation has provided partial relief from double taxation of corporate dividends

- Generally, *qualified dividends* are taxed at the same marginal rates applicable to a net capital gain

Tax Rate That Applies to the Taxpayer's Ordinary Income	Tax Rate That Applies to Dividend Income
0, 10, or 15%	0%
25, 28, 33, or 35%	15%
39.6%	20%

Dividends

The following dividends are not eligible for the reduced tax rates

- Dividends from certain foreign corporations,
- Dividends from tax-exempt entities, and
- Dividends that do not satisfy the holding period requirement
  - Stock on which the dividend is paid must have been held for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date to qualify for the reduced tax rates

Dividends

Dividends from foreign corporations are eligible for qualified dividend status only if:

- The foreign corporation's stock is traded on an established U.S. securities market, or
- The foreign corporation is eligible for the benefits of a comprehensive income tax treaty between its country of incorporation and the United States

Income Received by an Agent

Income received by the taxpayer's agent is considered to be received by the taxpayer.

- A cash basis principal must recognize the income at the time it is received by the agent

Gains and Losses from Property Transactions

In order for gains (losses) to be recognized (included in gross income), they must be realized:

- Realized gain (loss) = amount realized – adjusted basis
  - Amount realized = selling price – costs of disposition
  - Adjusted basis = cost + capital additions – cost recovery

Gains and Losses from Property Transactions

- All realized gains are recognized unless a specific tax provision provides otherwise (e.g., nontaxable exchanges)
- Realized losses may or may not be recognized depending on the circumstances
  - Generally, losses on the sale or disposition of personal-use property are not recognized

Gains and Losses from Property Transactions

- Once recognized gains or losses have been determined, they must be classified as ordinary or capital
  - Ordinary gains are fully taxable
  - Ordinary losses are fully deductible
- Capital gains and losses are subject to special tax treatment

Gains and Losses from Capital Asset Transactions (slide 1 of 2)

Capital assets are defined as any property other than:

- Inventory,
- Accounts Receivable, and
- Depreciable property or real property used in a business
- Certain other property

Most personal use assets owned by individuals are capital assets

- Losses on these assets are not deductible

Gains and Losses from Capital Asset Transactions (slide 2 of 2)

Gains and losses from capital asset transactions must be netted

- Net gains and losses by holding period
- If excess losses result, tax treatment depends on whether taxpayer is an individual or corporation

Maximum Tax Rates for Net Capital Gains of Individuals

Classification	Maximum Rate
Short-term gains (held ≤ one year)	39.6%
Long-term gains (held > one year)	20%

Treatment of Capital Losses(slide 1 of 2)

Net capital losses of *individuals* are deductible *for* AGI up to $3,000 yearly

- Excess capital losses are carried over to the next tax year
- When carried over, capital losses retain their classification as short- or long-term

Treatment of Capital Losses (slide 2 of 2)

- Corporations must also net capital gains and losses
- Corporations are taxed differently on their net capital gains and losses
  - Net capital gains do not receive special tax treatment
  - Capital losses can only offset capital gains
    - Excess capital losses may not be deducted against ordinary income
    - Unused capital losses can be carried back 3 years and then carried forward 5 years to offset capital gains in those years

Interest on State and Local Government Obligations

- Interest from municipal bonds is tax exempt
  - Reduces borrowing costs of state and local governments
  - High-income taxpayers can increase after-tax yields with municipal bonds
  - Municipal interest is considered for Social Security benefits inclusion and may be considered for alternative minimum tax calculation

Tax Exempt Municipal Bonds Interest-Example

Includes in gross income interest income from the bank's money market account. Report but don't include in gross income the interest earned on Municipal Bonds.

Life Insurance Proceeds (slide 1 of 4)

Exempt income to beneficiary if paid solely due to death of insured

- Relationship to decedent not determinative

Life Insurance Proceeds (slide 2 of 4)

If owner of life insurance policy cancels the policy and receives the cash surrender value

- Gain must be recognized to extent amount received exceeds premiums paid on policy
- Loss is not recognized

Life Insurance Proceeds (slide 3 of 4)

Transfers for valuable consideration

- If policy is transferred for valuable consideration, proceeds are taxable to extent they exceed amount paid for policy plus subsequent premiums paid
- Exceptions exist for policy transfers:
  - To facilitate funding of buy-sell agreements,
  - Pursuant to a tax-free exchange, and
  - For receipt of a policy by gift

Life Insurance Proceeds (slide 4 of 4)

Investment earnings arising from the reinvestment of life insurance proceeds are generally subject to income tax

- E.g., Beneficiary elects to collect the insurance proceeds in installments
  - The interest portion of each installment is included in gross income

Discharge from Indebtedness

Income from the forgiveness of debt is taxable

- Certain discharge of indebtedness situations get special treatment:
  - Creditors' gifts
  - Discharges in bankruptcy and when debtor is insolvent
  - Discharge of farm debt
  - Discharge of qualified real property business indebtedness
  - Seller's cancellation of buyer's debt
  - Shareholder's cancellation of corporation's debt
  - Forgiveness of certain student loans
  - Discharge of indebtedness on taxpayer's principal residence that occurs between 2006 and 2017, and is the result of the financial condition of the debtor

Tax Benefit Rule

If taxpayer receives a deduction for an item in one year and in a later year recovers all or a portion of the prior deduction, the recovery is included in gross income

- Amount included in income is limited to the amount for which a tax benefit was received

Imputed Interest on Below-Market Loans (slide 1 of 4)

Interest is imputed, using Federal government rates, when a loan does not carry a market rate of interest

- Imputed interest = the difference between the amount that would have been charged at the Federal rate and the amount actually charged

Applies to:

- Gift loans
- Compensation-related loans
- Corporation-shareholder loans
- Tax avoidance loans

Imputed Interest on Below-Market Loans (slide 2 of 4)

Type of Loan		Lender	Borrower
Gift	Step 1	Interest income	Interest expense
	Step 2	Gift made*	Gift received
Compensation related	Step 1	Interest income	Interest expense
	Step 2	Compensation expense	Compensation income
Corporation to shareholder	Step 1	Interest income	Interest expense
	Step 2	Dividend paid	Dividend income

Imputed Interest on Below-Market Loans (slide 3 of 4)

Gift loans

- Exemption for loans of ≤ $10,000 between individuals
  - If loan proceeds are used to purchase income-producing property, the following limitation applies
- On loans of $100,000 or less between individuals
  - Imputed interest is limited to borrower's net investment income for year
  - No imputed interest if net investment income is $1,000 or less

Imputed Interest on Below-Market Loans (slide 4 of 4)

$10,000 exemption also applies to compensation-related and corporation-shareholder loans

- No exemption if principal purpose of loan is tax avoidance
  - Makes practically all loans of this type suspect

Interest expense imputed to borrower may be deductible

Imputed Interest On Gift Loans Example:

- If a loan is a gift and the granter is not a shareholder in the personal service corporation
- Imputed interest must be computed annually with regard to the granter and the grantee if:
  - The principal amount of the loan exceeds $100,000 and
  - The loan proceeds were invested in an income-producing asset

Improvements on Leased Property

Improvements made to leased property

- Excluded from landlord's gross income unless the improvement is made to the property in lieu of rent

Example: (slide 1 of 4)

Using the accrual method, gross income recognized by Cliff Payne's corporation is $385,500

- This includes $385,000 of revenue earned from providing services to patients and $500 of interest income earned on the money market account
  - $500 of school district bond interest is excluded from gross income

Example: (slide 2 of 4)

Dr. Payne's gross income includes $120,000 of salary earned during the year

- Even though he did not cash his December paycheck until January
  - He constructively received the income since it was readily available to him

Dr. Payne may be able to reduce his taxable income by the imputed interest expense on the below-market loan from his parents

The increase in value on his stock does not result in gross income until he sells the stock and realizes a gain or loss.

Example: (slide 3 of 4)

What If?

- Rather than electing the accrual method, what if Dr. Payne had chosen to use the cash method of accounting for his business?
  - Using the cash method is acceptable for certain personal service corporations

Example (slide 4 of 4)

What If?

- While using the cash method would reduce the company's gross income from $385,000 to $333,000 ($385,000 amount billed less $52,000 still to be received), this is only part of the picture
- Using the cash method might result in some of the corporation's expenses not being deducted until they are paid in a future year

Prizes and Awards

General rule: FMV of item is included in income

- Exceptions:
  - Taxpayer designates qualified organization to receive prize or award (subject to other requirements)
  - Employee achievement awards of tangible personal property made in recognition of length of service or safety achievement (limits apply)

Unemployment Compensation

Unemployment compensation is taxable in full

Unemployment Compensation

Amounts received from unemployment compensation plans are considered substitutes for earned income and are always taxable. Current law provides that unemployment compensation benefits are includible in gross income.

Unemployment compensation generally includes any amounts received under the unemployment compensation laws of the United States or of a state. This includes state unemployment insurance benefits and benefits paid to you by a state or the District of Columbia from the Federal Unemployment Trust Fund.

Unemployment Compensation

Unemployment compensation also includes:

- Railroad unemployment compensation benefits, but not worker's compensation.
- Supplemental unemployment benefits received from a company financed fund are not considered unemployment compensation for this purpose. These benefits are fully taxable as wages, and are reported on Form W-2, *Wage and Tax Statement.*

Unemployment Compensation

Unemployment compensation also includes:

Unemployment benefits from a private fund to which voluntarily contributions are made. These benefits are taxable only if the amounts received are more than the total contributions to the fund. This taxable amount is not unemployment compensation; it is reported as other income on form 1040 Individual Income Tax Return.

Unemployment Compensation

A form 1099-G should be issued showing the amount of any unemployment compensation paid during the year.

If a taxpayer received unemployment compensation, they may be required to make quarterly estimated tax payments. However, taxpayers can choose to have federal income taxes withheld.

Social Security Benefits

- If taxpayer's income exceeds a specified base amount, up to 85% of benefits may be taxable
- Two formulas for computing taxable benefits

Specific Exclusions Applicable To Individuals

Certain items are specifically excluded from an individual's income, including:

- Gifts and Inheritances
- Scholarships
- Certain damages
- Workers' Compensation
- Accident and Health Insurance Benefits
- Interest on Educational Savings Bonds

Gifts and Inheritances (slide 1 of 3)

Gifts are nontaxable to donee if:

- Transfer is voluntary without adequate consideration, and
- Made out of affection, respect, admiration, charity, or donative intent

Gifts and Inheritances (slide 2 of 3)

Inheritances are nontaxable to beneficiary

- Income earned on gifts or inheritances is taxable under normal rules
  - Example: Father gifts corporate bond to daughter. Gift is excluded from daughter's gross income, but interest income earned after gift date is taxable to her.

Gifts and Inheritances (slide 3 of 3)

- Transfers by employers to employees do not qualify as excludible gifts
  - May be excludible under other provisions, e.g., employee achievement awards

Gifts to Employees

A $1,500 bonus was paid to Donna by a CPA firm as compensation for services rather than a gift

- The payment was most likely not motivated by the employer's generosity, but as a result of business considerations
- Even if the payment had been made out of generosity, because the payment was received from her employer, Donna could not exclude the "gift"

Scholarships and Fellowships

An amount paid to or for the benefit of a student to aid in pursuing a degree at an educational institution

- Nontaxable to extent of tuition and related expenses (e.g., fees, books, supplies, and equipment required for courses)
  - Amounts received for room and board are taxable

Scholarships Example:

A State University waives $6,000 of tuition each semester for all graduate teaching assistants

- The tuition waived is intended as compensation for services and is included in gross income.
- Therefore, the $6,000 tuition waiver received each semester is compensation for her services.

- $400 is also received each month for compensation for services.
  - The fact that the funds are used for educational expenses does not change the tax treatment of the compensation.

Damages (slide 1 of 3)

Tax consequences of receipt of damages

- Depends on type of harm taxpayer experienced
- The taxpayer may seek damages for:
  - Loss of income
  - Expenses incurred
  - Property destroyed
  - Personal injury

Damages (slide 2 of 3)

Tax treatment of damages received for:

- Loss of income
  - Generally, taxed the same as the income replaced
    - Exceptions exist related to personal injury

Reimbursement for expenses incurred

- Not income, unless the expense was deducted
  - Damages that are a recovery of the taxpayer's previously deducted expenses are generally taxable under the tax benefit rule

Compensation for Injuries and Sickness (slide 1 of 3)

Personal injury damages

- Compensatory damages received on account of physical personal injury or physical illness are excludible
  - Includes amounts received for loss of income associated with the physical personal injury or physical sickness

All other personal injury damages are taxable

- Compensatory damages for nonphysical injury
- All punitive damages

Damages (slide 3 of 3)

Tax treatment of damages received for:

- Property damaged or destroyed
  - Treated as an amount received in a sale or exchange of the property
    - Thus, taxpayer has realized gain if damage payments exceed property's basis
- Personal injury
  - Receives special treatment

Damages-Example

Damages were awarded as a result of a physical personal injury

- Therefore, all of the compensatory damages can be excluded.
- Also compensation for the loss of income can be excluded.

- Punitive damages received, however, must be included in her gross income.

Compensation for Injuries and Sickness (slide 2 of 3)

Workers' compensation

- Although may be payment for loss of wages, workers' compensation is specifically excluded from gross income.

Compensation for Injuries and Sickness (slide 3 of 3)

Accident and health insurance benefits

- Benefits received under policy purchased by taxpayer are excludible
  - Even if benefits are substitute for income

Different rules apply if the accident and health insurance protection was purchased by the individual's employer

Educational Savings Bonds

Interest on Series EE U.S. savings bonds may be excluded from income if:

- Proceeds used to pay for qualified higher educational expenses
- Bonds issued after 12/31/89, and
- Bonds issued to person at least 24 years old

Exclusion is phased-out once modified AGI exceeds threshold amount

Surtax on Unearned Income of Higher Income Individuals

- 3.8% Medicare Contribution on Unearned Income

- Imposed on the lesser of:
  - Net Investment Income, or
  - Modified AGI in excess of threshold amount

- Threshold Amounts
  - MFJ - $250,000
  - MFS - $125,000
  - All other taxpayers - $200,000
-

Tax Treatment for Net Losses by Individuals

- Only $3,000 of net capital losses may be deducted in one year
  - Use short-term losses first
  - Carryover net loss > $3,000- Any excess may be carried over to subsequent years to be deducted against capital gains up to $3,000 of other kinds of income

- Capital gains and losses of conduit entities flow-through to owners' returns

Section 2: Income and Assets

2. Interest (taxable and non-taxable)

Interest Income

Most interest received or is credited to an account that you can withdraw without penalty is **taxable income** in the year it becomes available to you. But, some interest you receive may be tax-exempt.

Form 1099-INT or Form 1099-OID should be provided if the interest payments are $10 or more.

Interest Income

This included interest on bank accounts, money market accounts, certificates of deposit, and deposited insurance dividends. Certain distributions, commonly referred to as dividends, are actually taxable interest. They include dividends on deposits or on share accounts in cooperative banks, credit unions, domestic building and loan associations, domestic federal savings and loan associations, and mutual savings banks.

Interest Income
Examples of taxable interest include:

Interest income from Treasury bills, notes and bonds, which is subject to federal income tax, but is exempt from all state and local income taxes.

Interest Income

Examples of taxable interest include:

Savings Bond interest; however, unless you elect to include the interest in income each year, you generally will not report interest on Series EE and Series I U.S. Savings Bonds until the earlier of when the bonds mature or when they are redeemed or disposed of. However, there is an exclusion from income if certain Series EE and Series I bonds are used to pay certain qualified higher education expenses during the same year and you meet other requirements. Please refer to slide 5 for examples of non taxable income

Interest Income

\Examples of nontaxable interest include:

- Interest redeemed from Series EE and Series I bonds issued after 1989 may be excluded from income if used to pay for qualified higher educational expenses during the year and you meet other requirements for the Educational Savings Bond Program.
- Interest on some bonds used to finance government operations and issued by a state, the District of Columbia, or a U.S. possession is not taxable at the federal level but the interest is reported as tax-exempt interest received during the tax year.

Interest Income

Examples of nontaxable interest include:

- Interest on insurance dividends left on deposit with the U.S. Department of Veterans Affairs is nontaxable interest.
- **Original Issue Discount Instruments**
- If a bond, note or other debt instrument was originally issued at a discount, part of the original issue discount may have to be included in income each year as interest.

Interest Income

Examples of nontaxable interest include:

Nominee Recipient

There are times when you may receive a Form 1099 for interest in your name that actually belongs to someone else. In this case, the IRS considers you a nominee recipient and it may be necessary for you to file with the IRS and furnish to the other owners a Form 1099 INT.

Section 2: Income and Assets

3. Dividends and Other Distributions from Mutual Funds, Corporation, and Other Entities

Dividends

Dividends are generally taxed to the party who is entitled to receive them.

Dividends are distributions of money, stock, or other property paid by a corporation or by a mutual fund. Dividends may also be issued through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some dividends received are actually interest income.

Dividends

The most common kinds of distributions are:

- Ordinary dividends,
- Capital gain distributions, and
- Nondividend distributions.

Most distributions are paid in cash (check). However, distributions can consist of more stock, stock rights, other property, or services.

Most corporations use Form 1099-DIV to show you the distributions you received from them during the year

Dividends

Recent legislation has provided partial relief from double taxation of corporate dividends

- Generally, *qualified dividends* are taxed at the same marginal rates applicable to a net capital gain

Tax Rate That Applies to the Taxpayer's Ordinary Income	Tax Rate That Applies to Dividend Income
0, 10, or 15%	0%
25, 28, 33, or 35%	15%
39.6%	20%

Dividends

The following dividends are not eligible for the reduced tax rates:

- Dividends from certain foreign corporations,
- Dividends from tax-exempt entities, and
- Dividends that do not satisfy the holding period requirement

  Stock on which the dividend is paid must have been held for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date to qualify for the reduced tax rates

Dividends

Dividends from foreign corporations are eligible for qualified dividend status only if:

- The foreign corporation's stock is traded on an established U.S. securities market, or
- The foreign corporation is eligible for the benefits of a comprehensive income tax treaty between its country of incorporation and the United States.

Section 2: Income and Assets

4. Rental Income and Expense)
Vacation Homes, Not-for Profit
Rentals, Calculation of Depreciation)

Rental Income and Expenses

Cash or the fair market value of property or services you receive for the use of real estate or personal property is taxable to you as rental income. In general, you can deduct expenses of renting property from your rental income. You can generally use Form 1040, Schedule E, *Supplemental Income and Loss*, to report income and expenses related to real estate rentals. If you provide substantial services that are primarily for your tenant's convenience, report your income and expenses on Form 1040, Schedule C, *Profit or Loss From Business (Sole Proprietorship)*. Report income and expenses related to personal property rentals on Form 1040, Schedule C or Form 1040, Schedule C-EZ, *Net Profit From Business*, if you are in the business of renting personal property, and directly on lines 21 and 36 of Form 1040, *U.S. Individual Income Tax Return*, if you are not.

Rental Income and Expenses

Rental income includes:

Amounts paid to cancel a lease – If a tenant pays you to cancel a lease, this money is also rental income and is reported in the year you receive it.

Advance rent – Generally you include any advance rent paid in income in the year you receive it regardless of the period covered or the method of accounting you use.

Expenses paid by a tenant – If your tenant pays any of your expenses, those payments are rental income. You may also deduct the expenses if they are considered deductible expenses.

Rental Income and Expenses

Security deposits – Do not include a security deposit in your income if you may be required to return it to the tenant at the end of the lease. If you keep part or all of the security deposit because the tenant breaks the lease by vacating the property early, include the amount you keep in your income in that year. If you keep part or all of the security deposit because the tenant damaged the property and you must make repairs, include the amount you keep in that year if your practice is to deduct the cost of repairs as expenses. To the extent the security deposit reimburses those expenses, do not include the amount in income if your practice is not to deduct the cost of repairs as expenses. If a security deposit amount is to be used as the tenant's final month's rent, it is advance rent that you include as income when you receive it, rather than when you apply it to the last month's rent.

Examples of expenses that you may deduct from your total rental income include:

Depreciation – Allowances for exhaustion, wear and tear (including obsolescence) of property. You begin to depreciate your rental property when you place it in service. You can recover some or all of your original acquisition cost and the cost of improvements by using Form 4562, *Depreciation and Amortization*, (to report depreciation) beginning in the year your rental property is first placed in service, and beginning in any year you make improvements or add furnishings.

Repair Costs – Expenditures made to keep your property in good working condition but do not add to the value of the property.

Examples of expenses that you may deduct from your total rental income include:

Operating Expenses – Other expenditures necessary for the operation of the rental property, such as the salaries of employees or fees charged by independent contractors (groundkeepers, bookkeepers, accountants, attorneys, etc.) for services provided.

If you are a cash basis taxpayer, you cannot deduct uncollected rents as an expense because you have not included those rents in income. Repair costs, such as materials, are usually deductible.

There are special rules relating to the rental of real property that you also use as your main home or your vacation home.

If you do not use the rental property as a home and you are renting to make a profit, your deductible rental expenses can be more than your gross rental income, subject to certain limits.

Section 2: Income and Assets

5. Gambling Income and Allowable Deductions (e.g., W2-G Documentation)

Gambling Income and Losses

The following rules apply to casual gamblers. Gambling winnings are fully taxable and you must report them on your tax return. Gambling income includes but is not limited to winnings from lotteries, raffles, horse races, and casinos. It includes cash winnings and the fair market value of prizes such as cars and trips.

A payer is required to issue you a Form W-2G , *Certain Gambling Winnings*, if you receive certain gambling winnings or if you have any gambling winnings subject to federal income tax withholding. You must report all **gambling winnings** on your Form 1040 as "Other Income" (line 21), including winnings that are not subject to withholding. In addition, you may be required to pay an estimated tax on your gambling winnings. For information on withholding on gambling winnings, refer to Publication 505, *Tax Withholding and Estimated Tax*. If you are considered a nonresident alien of the United States for income tax purposes and you have to file a tax return, you must use Form 1040NR, *U.S. Nonresident Alien Income Tax Return*. Refer to Publication 519, *U.S. Tax Guide for Aliens*, and Publication 901, *U.S. Tax Treaties*, for more information.

Gambling Income and Losses

You may deduct **gambling losses** only if you itemize deductions. However, the amount of losses you deduct may not be more than the amount of gambling income reported on your return. Claim your gambling losses on Form 1040, Schedule A as an "Other Miscellaneous Deduction" (line 28) that is not subject to the 2% limit. A nonresident alien of the United States cannot deduct gambling losses.

It is important to keep an accurate diary or similar record of your gambling winnings and losses. To deduct your losses, you must be able to provide receipts, tickets, statements or other records that show the amount of both your winnings and losses. Refer to Publication 529, *Miscellaneous Deductions*, for more information.

Section 2: Income and Assets

6. Tax treatment of forgiveness of debt (e.g., 1099C, foreclosures)

Tax Treatment of Forgiveness of (1099C, Foreclosures)

A debt includes any indebtedness whether you are personally liable or liable only to the extent of the property securing the debt. Cancellation of all or part of a debt that is secured by property may occur because of a foreclosure, a repossession, a voluntary return of the property to the lender, abandonment of the property, or a principal residence loan modification.

In general, if your debt is canceled, forgiven, or discharged you will receive a Form 1099-C , *Cancellation of Debt*, and must include the canceled amount in gross income unless you meet an exclusion or exception. If you receive a Form 1099-C but the creditor is continuing to try to collect the debt, the creditor may not have canceled the debt. You should verify with the creditor your specific situation; you might not have cancellation of debt or taxable income.

Tax Treatment of Forgiveness of (1099C, Foreclosures)

If property secured your debt and the lender takes that property in full or partial satisfaction of your debt, you are treated as having sold that property and may have a taxable gain or loss. The gain or loss on such a deemed sale of your property is an issue separate from whether any cancellation of debt income associated with that same property is includable in gross income. See Publication 544, *Sales and Other Dispositions of Assets*, and Publication 523, *Selling Your Home* for detailed information on reporting gain or loss from repossession, foreclosure or abandonment of property.

Canceled debts that meet the requirements for any of the following exceptions or exclusions are not taxable.

Debt Cancellations or Reductions that Qualify for EXCEPTION to Inclusion in Gross Income:

- Amounts specifically excluded from income by law such as gifts, bequests, devises or inheritances
- Cancellation of certain qualified student loans
- Canceled debt, that if it were paid by a cash basis taxpayer, would be deductible
- A qualified purchase price reduction given by a seller
- Any Pay-for-Performance Success Payments that reduce the principal balance of your home mortgage under the Home Affordable Modification Program

Canceled Debt that Qualifies for EXCLUSION from Gross Income:

- Debt canceled in a Title 11 bankruptcy case
- Debt canceled during insolvency
- Cancellation of qualified farm indebtedness
- Cancellation of qualified real property business indebtedness
- Cancellation of qualified principal residence indebtedness
- The exclusion for qualified principal residence indebtedness provides tax relief on canceled debt for many homeowners involved in the mortgage foreclosure crisis currently affecting much of the United States. The exclusion allows taxpayers to exclude up to $2,000,000 ($1,000,000 if married filing separately) of canceled qualified principal residence indebtedness.

Canceled Debt that Qualifies for EXCLUSION from Gross Income:

Generally, if you exclude canceled debt from income under one of the exclusions listed above, you must reduce certain tax attributes (certain credits, losses, basis of assets, etc.), within limits, by the amount excluded. You must file Form 982 , *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to report the amount qualifying for exclusion and any corresponding reduction of those tax attributes. For cancellation of qualified principal residence indebtedness that you exclude from income, you must only reduce your basis in your principal residence.

Section 2: Income and Assets

7. Treatment of a U.S. citizen/resident with foreign income (e.g., individual tax treaties, form 2555) Other income (e.g., scholarships, fellowships, Social Security benefits, barter income, independent contractor income, hobby income, alimony, non-taxable combat pay

Scholarships, Fellowships, and Grants

- A scholarship is generally an amount paid or allowed to a student at an educational institution for the purpose of study. A fellowship grant is generally an amount paid or allowed to an individual for the purpose of study or research. Other types of grants include need-based grants (such as a Pell Grant) and Fulbright grants.
- If you receive a scholarship, a fellowship grant, or other grant, all or part of the amounts you receive may be tax-free.
- Scholarships, fellowship grants, and other grants are **tax-free** if you meet the following conditions:
- You are a candidate for a degree at an educational institution that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities; and
- The amounts you receive are used to pay for tuition and fees required for enrollment or attendance at the educational institution, or for fees, books, supplies, and equipment required for courses at the educational institution.

You must include in gross income:

- Amounts used for incidental expenses, such as room and board, travel, and optional equipment.
- Amounts received as payments for teaching, research, or other services required as a condition for receiving the scholarship or fellowship grant. However, you do not need to include in gross income any amounts you receive for services that are required by the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program.
- Generally, you report any portion of a scholarship, a fellowship grant, or other grant that you must include in gross income as follows:

Social Security Benefits

Social Security Benefits. Note that although Social Security benefits are analogous to an annuity, the annuity rules do not apply. The exclusion is dependent upon the taxpayer's modified adjusted gross income and two sets of base amounts for the year.

a. Modified adjusted gross income (MAGI) is the taxpayer's adjusted gross income from all sources (other than Social Security) plus the foreign earned income exclusion and any tax-exempt interest received.

b. First base amount set. In this case, the base amount is:

(1) $32,000 for married taxpayers who file a joint return.

(2) $0 for married taxpayers who do not live apart for the entire year but file separate returns.

(3) $25,000 for all other taxpayers.

c. Second base amount set. In this case, the base amount is:

(1) $44,000 for married taxpayers who file a joint return.

(2) $0 for married taxpayers who do not live apart for the entire year, but file separate returns.

$34,000 for all other taxpayers.

Bartering Income

Bartering is the exchange of goods or services. Usually there is no exchange of cash. An example of bartering is a plumber exchanging plumbing services for the dental services of a dentist. You must include in gross income in the year of receipt the fair market value of goods or services received from bartering.

A barter exchange is an organization whose members contract with each other (or with the barter exchange) to exchange property or services. The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.

Independent Contractor

Business income may include income received from the sale of products or services. For example, **fees** received by a person from the regular practice of a profession are business income. **Rents** received by a person in the real estate business are business income. A business must include in income payments received in the form of property or services at the fair market value of the property or services.

Alimony and Separate Maintenance Payments

Alimony Rules

a. Exception to general rule for who is the taxpayer. The alimony rules run counter to the general rule for determining who is the taxpayer.

(1) Generally, income is taxable to the person who earns the income or owns the property that produced the income, rather than taxing the person who receives the benefits of the income.

In the case of alimony, the rationale is that the taxpayer should be the one who benefits from the income.

b. Qualifications. To qualify as alimony, ALL of the following requirements must be satisfied:

(1) The payments must be in cash.

(2) The agreement (or court order) must not say the payments are not alimony (a double negative).

Alimony and Separate Maintenance Payments

(3) The spouses must be living apart (i.e., not members of the same household) at the time the payments are made.

(4) The payments must cease upon the death of the payee.

c. Tax consequences. In effect, the rules allow the spouses to determine by contract the tax consequence of payments between former spouses.

(1) Alimony is deductible from the gross income of the payor.

Alimony is includible in the gross income of the recipient.

Child Support Payments. Child support payments to the custodial spouse are not deductible by the payor because the payments merely satisfy a legal obligation that would exist regardless of whether the spouses were divorced

Section 2: Income and Assets

8. Other Income Unearned Income, Taxable Recoveries

Unearned Income, Taxable Recoveries

Prepaid/deferred income. When the taxpayer receives income from services before the services have been provided, in the past the IRS required the accrual basis taxpayer to report the income in the year of receipt. However, the IRS's position has been strongly resented by taxpayers and their accountants because taxing the income before it is earned results in a mismatching of revenues and expenses from the services. That is, if all of the services would be rendered by the end of the tax year following the year of the advance payment, the services could be accounted for using the accrual method. More recently, the IRS modified the "one-year" rule in Revenue Procedure 2004-34.

Unearned Income, Taxable Recoveries

The notice permits an accrual basis taxpayer to defer recognition of income for advance payments for services to be performed after the end of the tax year of receipt. The portion of the advance payment that relates to services performed in the tax year of receipt is included in gross income in the tax year of receipt. The portion of the advance payment that relates to services to be performed after the tax year of receipt is included in gross income in the tax year following the tax year of receipt of the advance payment. Neither Revenue Procedure 71-21 nor Revenue Procedure 2004-34 applies to prepaid rent or prepaid interest.

Unearned Income, Taxable Recoveries

Example:

Loan versus income. The receipt of loan proceeds is not a taxable event because the taxpayer’s net worth is not increased. Customer utilities deposits more nearly resembled a loan than a prepayment of income. Therefore, the utility was not required to recognize as prepaid income the receipt of the customer deposit. No income was realized until the deposit was forfeited by the customer.

Section 2: Income and Assets

9. Constructive Receipt of Income
(Cash vs. Accrual)

When is Income Reported?

- Accounting Method chosen by a taxpayer dictates when income is reported
  - Cash Method: Taxpayers report income when cash is actually or constructively received
  - Accrual Method: Taxpayers report income when it is earned
  - Hybrid Method: Taxpayers mix accrual and cash methods

Cash Method

- Cash method taxpayers must follow the Constructive Receipt Concept
  - Exceptions to the cash method:
    - Taxpayers who sell inventory must use the accrual method for inventory
    - Taxpayers must use the accrual and the effective interest method with Original Issue Discount securities
    - Taxpayers who hold Series EE Bonds may elect to use the accrual method

Accrual Method (slide 1 of 2)

Under tax law, income is accrued when

- All events have occurred that fix the right to receive the income, and
- The amount of income earned can be determined

Accrual Method (slide 2 of 2)

Exceptions:

- Wherewithal-to-Pay concept requires income be reported in the year pre-payment is received for rents, insurance, interest and royalties
- One year deferral is allowed for some pre-payments
  - Report amount = Financial Accounting in first year
  - Balance amount in full in second year
- Pre-payments for goods may be accrued if the payment is less than the Cost of Goods Sold

Hybrid Method

Taxpayers may mix the cash and accrual methods, using accrual for sales of inventories and cash for other revenues and expenses

Exceptions to All Methods

Installment Sales Method: Any time one payment is received after the year of sale, taxpayers must recognize income proportionately as the selling price is received unless they elect to report in the year of sale

Long-term Construction Contracts: The percentage-of-completion method must be used for all long-term construction

Section 2: Income and Assets

10. Constructive Dividends

Constructive Dividends

If you receive a taxable stock dividend or stock generally is taxable as a constructive distribution.

Section 2: Income and Assets

11. Passive Income and Loss

Passive Income and Loss

- Generally, losses from passive activities that exceed the income from passive activities are disallowed for the current year. You can carry forward disallowed passive losses to the next taxable year. A similar rule applies to credits from passive activities.
- Passive activities include trade or business activities in which you do not materially participate. You **materially participate** in an activity if you are involved in the operation of the activity on a regular, continuous and substantial basis. In general, rental activities, including rental real estate activities, are also passive activities even if you do materially participate. However, rental real estate activities in which you materially participate are not passive activities if you qualify as a real estate professional. Additionally, there is a limited exception for rental real estate activities in which you **actively participate**.

Passive Income and Loss

The rules for active participation are different from those for material participation. You can find guidelines for determining material participation, the rules for determining who is a real estate professional and what is active participation, and the special rules that apply to the income and losses from a passive activity held through a publicly traded partnership (PTP) in Publication 925, *Passive Activity and At-Risk Rules*.

Generally, you may deduct in full any **previously disallowed passive activity loss** in the year you dispose of your entire interest in the activity. In contrast, you may not claim **unused passive activity credits** upon disposition of your entire interest in the activity. However, you may elect to increase the basis of the credit property in an amount equal to the portion of the unused credit that previously reduced the basis of the credit property.

Section 2: Income and Assets

13. Royalties and Related Expenses

Royalties and Related Expenses

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

In most cases you report royalties on Schedule E (Form 1040), Supplemental Income and Loss. However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your income and expenses on Schedule C or Schedule C-EZ (Form 1040).

- **Copyrights and patents.** Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties generally are based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.
- **Oil, gas, and minerals.** Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Royalties and Related Expenses

- **Depletion.** If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see chapter 9 of Publication 535.
- **Coal and iron ore.** Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, see Publication 544.
- **Sale of property interest.** If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment as explained in the Instructions for Schedule D (Form 1040). For more information on selling section 1231 property

14.Taxable refunds, credits, or offsets of state and local taxes

There is a requirement to report refunds, credits or offsets of state or local income taxes received. If a taxpayer did not receive a 2016 Form 1099-G, the taxpayer should check with the government agency that made the payments to them. That agency may have made the form available only in an electronic format. Instructions are available from the agency to retrieve this document. Any taxable refund received, should be reported, even if a Form 1099-G has not been received.

Taxable refunds, credits, or offsets of state and local taxes

A refund, credit, or offset of $10 or more of these taxes is reportable on Form 1099-G.

If a taxpayer did not itemize deductions, they may not be required to report a refund of a state and local taxes.

If recipients deducted the tax paid to a state or local government on their federal income tax returns, any refunds, credits, or offsets may be taxable to them.