Chapter 4

Gross Income: Concepts and Inclusions

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LEARNING OBJECTIVES

LO.1 - Explain the differences between the economic, accounting, and tax concepts of gross income.

LO.2 - Describe the taxable years and tax accounting methods generally available to taxpayers and other tax reporting entities.

LO.3 - Identify the general sources of income and to whom they are taxable.

LO.4 - Apply the tax rules on alimony, loans made at below-market interest rates, annuities, prizes and awards, unemployment compensation, Social Security benefits, and foreign bank accounts.

LO.5 - Identify tax planning strategies for minimizing gross income and the present value of the related tax.

The Big Picture Calculation of Gross Income (1 of 3)

- In 2020, Dr. Cliff Payne opened his dental practice as a sole proprietorship with a December 31 year-end
- By the beginning of February, construction on his medical building was completed
- He also leased an office building and entered into a contract to make improvements
- He invested $12,000 in the stock of an unrelated corporation

The Big Picture Calculation of Gross Income (2 of 3)

- The following financial information shows the results of Dr. Payne's first year of operation:

Revenues (amounts billed patients for dental services)	$385,000
Accounts receivable: January 1	–0–
Accounts receivable: December 31	52,000

- During the year, Sam Jones, a contractor who owed Dr. Payne $4,000 for dental services, satisfied the account by installing solar panels on the roof of Dr. Payne's new medical building

The Big Picture Calculation of Gross Income (3 of 3)

- Based on his accounting records, he concludes that gross income for Federal income tax purposes is the $385,000 he billed his patients for dental services rendered
- Has Dr. Payne correctly calculated the gross income of this dental practice?
  - Read the chapter and formulate your response

Gross Income (1 of 4)

- Section 61(a) of the Internal Revenue Code defines the term gross income
- Definition – Except as otherwise provided in this subtitle, gross income means all income from whatever source derived
- Concept is interpreted broadly by the courts

Gross Income (2 of 4)

- Recovery of capital doctrine
  - Prevents income from being taxed more than once
    - Capital is the accumulation of previously taxed income
  - Supreme court has held that
    - Gross income is not synonymous with gross receipts
    - Rather, a taxpayer does not have income until recovering any amount of capital that might have been invested in the item sold

Gross Income (3 of 4)

- Economic and accounting concepts of income
  - Economists measure income as sum of
    - The value of goods and services consumed
    - Change in the value of net assets from the beginning to the end
  - Taxability of income follows the realization principle from accounting
    - Income is recognized (taxed) when realized
  - Mere appreciation in wealth (economic income) is not considered realized income

Gross Income (4 of 4)

- Income is recognized whether it is in the form of cash, or “in-kind” cash equivalents (that is, property or services)
  - The amount of income from “in-kind” receipts is equal to the FMV of the property or services

The Big Picture—Recovery Of Capital Doctrine

- Return to the facts of The Big Picture
  - Dr. Payne sells common stock for $15,000
    - He had purchased the stock for $12,000
  - Dr. Payne's gross receipts are $15,000
    - This amount consists of a $12,000 recovery of capital and $3,000 of gross income

Taxable Year (1 of 2)

- The annual accounting period, or taxable year, is generally a 12-month period
    - Taxable year for most individual taxpayers is the calendar year
    - A fiscal year can be elected if taxpayer maintains adequate books and records
        - A fiscal year is a 12-month period ending on the last day of a month other than December
            - Example: July 1 to June 30

Taxable Year (2 of 2)

- Income be recognized in the proper year for several reasons
- Taxpayer’s rate may vary across years
  - Taxpayer’s marginal tax rate can change from year to year
  - Congress may change the tax rates
  - Change in the taxpayer’s status
    - Example: person may marry, or business may be incorporated

Accounting Methods (1 of 2)

- There are two primary methods of accounting for tax purposes:
  - Cash receipts and disbursements method
  - Accrual method
- Other methods of accounting:
  - hybrid method – combination of cash and accrual method
  - Special accounting methods – example: installment method, percentage of completion method, completed contract method

Accounting Methods (2 of 2)

- Taxpayers can elect to use the installment method (a taxpayer may choose to spread the gain from an installment sale of eligible property)
- Certain contractors may elect to use either the percentage of completion method or the completed contract method
- Change in the accounting method requires the advance consent of the IRS

Cash Receipts Method

- Income is recognized in the year it is actually or constructively received in cash or cash equivalent
- An amount is constructively received when it is set aside and made available to taxpayer without substantial restrictions

The Big Picture—Constructive Receipt (1 of 4)

- Return to the facts of The Big Picture
  - On December 31, Dr. Payne has $10,000 in patients' checks that have not been deposited
    - One check for $3,000 is from a patient who asked him not to deposit it until after January 4, because her account did not contain sufficient funds to pay the debt

The Big Picture—Constructive Receipt (2 of 4)

- Under the cash method, Dr. Payne must recognize $7,000 income from the checks on hand
  - The checks are a cash equivalent that is actually received
- The income from the $3,000 check is neither actually nor constructively received
  - An insufficient account means the funds are not available

The Big Picture—Constructive Receipt (3 of 4)

- Return to the facts of The Big Picture
- Assume Dr. Payne elected to use the cash basis of accounting
  - On December 15, Dr. Payne sees a new patient at a cost of $2,000
  - However, before the services are performed, the patient agrees to a payment plan that requires payment to be made within 30 days after the services are performed
    - The services are performed on December 28, and the patient pays on January 15

The Big Picture—Constructive Receipt (4 of 4)

- At the year-end, Dr. Payne is not in constructive receipt of $2,000
  - Dr. Payne could have collected the fee prior to year-end
  - He was not yet entitled to the fee when he contracted to receive payments at a later date

Exceptions to Cash Receipts Method

- Original issue discount (OID) interest is taxable when earned rather than when interest is received
- OID rules do not apply to obligations with a maturity date of one year or less from the date of issue
- Series E and EE bonds are not subject to the OID rules
  - However, a cash basis taxpayer may elect to recognize the interest when earned

Accrual Method (1 of 3)

- Income is recognized in the year that it is earned regardless of when it is collected
- Income is earned when:
  - All events have occurred that fix taxpayer's right to receive income and
  - The amount can be determined with reasonable accuracy

Accrual Method (2 of 3)

- The accrual method is required for determining purchases and sales when inventory is an income-producing factor
- If rights to income have accrued but are subject to refund, the income is reported in the year of sale and deduction is allowed in the year when actual claims accrue

Accrual Method (3 of 3)

- Claim of right doctrine
  - If the payment is received before the dispute is settled, this right requires the taxpayer to recognize the income in the year of receipt
  - The taxpayer has the funds to pay tax. Therefore, the government should be allowed to collect tax rather than wait until the uncertainty is resolved

The Big Picture—Claim Of Right Doctrine

- Return to the facts of The Big Picture
- On completing construction improvements of the medical office building in 2020, the contractor submitted a bill
  - Dr. Payne refused to pay the bill, claiming the contractor had not met specifications
  - The contractor did not reach a settlement with Dr. Payne until 2021
- No income accrues to the contractor until 2021
  - If Dr. Payne had paid for the work, then filed suit, the contractor could not defer the income
    - The income would be taxable in 2020

Exceptions to Accrual Method

- Taxpayer can elect to defer recognition of income from advance payment for goods and services if same method of accounting is used for tax and financial reporting purposes
- This special method will result in differences in the timing of the reporting of revenue when financial reporting rules requires it to be reported over 3 or more years
- The special election is not available for unearned rent, interest, insurance premiums, and certain other advance payments which are taxed in the year of receipt

Hybrid Method

- A combination of cash and accrual methods
- Generally, used when inventory is a material income-producing factor
- For example:
  - Use accrual method to account for sale of goods and cost of goods sold
  - Use cash method for other income and expenses
- Beginning in 2018, more types of businesses can use the cash method and not account for inventory
  - The hybrid method is not likely to be commonly used

Income Sources (1 of 2)

- Income from personal services is taxable to the person who performs the services
  - Fruit and tree metaphor
  - Services performed by an employee for an employer's customers are considered performed by the employer
    - Employer is taxed on the income from the services provided to the customer, and the employee is taxed on any compensation received from the employer
- Income from property is taxable to the owner of the property
  - Assignment of income is not permitted

Income Sources (2 of 2)

- Interest income accrues daily
  - If interest bearing instrument (for example, bonds) is transferred, interest income must be allocated between transferor and transferee based on the number of days during the period that each owned the property

The Big Picture—Services of an Employee (1 of 2)

- Return to the facts of The Big Picture
  - Assume that instead of operating as a sole proprietorship, Dr. Payne incorporated his dental practice to limit his liability
    - He entered into an employment contract with his corporation and was to receive a salary
    - All patients contract to receive their services from the corporation
      - Those services are provided by the corporation’s employee, Dr. Payne

The Big Picture—Services of an Employee (2 of 2)

- Return to the facts of The Big Picture
  - Thus, the corporation earned the income from patients' services and must include the patients' fees in its gross income
  - Dr. Payne must include his salary in his gross income
    - The corporation is allowed a deduction for the reasonable salary paid to Dr. Payne

Dividends (1 of 4)

- Unlike interest, dividends do not accrue on a daily basis
- Dividends are generally taxed to the party who is entitled to receive them
  - The shareholder of record as of the corporation's record date
- Dividends on stock transferred by gift after declaration date but before record date are generally taxed to the donor

Dividends (2 of 4)

- Recent legislation has provided partial relief from double taxation of corporate dividends
  - Generally, dividends received are taxed at the same marginal rate that is applicable to a net capital gain
    - Depending on the individual's taxable income, capital gain tax rates of 0%, 15%, and 20% apply

Dividends (3 of 4)

- The following dividends are not eligible for the reduced tax rates
  - Dividends received by corporations
    - Corporations are permitted a dividend received deduction ranging from 50%-100% of dividend received from another domestic corporation
  - 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

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

Income from Partnerships

- A partnership is not a separate taxable entity
  - Files an information return (Form 1065)
    - Provides data necessary for determining each partner's distributive share of partnership's income and deductions
    - Each partner reports distributive share of partnership's income and deductions
      - Reported in year earned, even if not actually distributed
    - Because a partner pays tax on income as the partnership earns it, distributions are treated as a tax-free recovery of capital

Income from S Corporations

- A small business corporation may elect to be taxed similarly to a partnership
  - Referred to as an S corporation
    - The shareholders, rather than the corporation, pay the tax on the corporation's income
    - Generally, shareholders report their share of the corporation's income and deductions for the year, even if not actually distributed

Income from Estates and Trusts

- Beneficiaries of estates and trusts
  - Generally, taxed on the income earned by the estates or trusts that is actually distributed or required to be distributed to them
  - Any income not taxed to the beneficiaries is taxable to the estate or trust

Income in Community Property States (1 of 2)

- All property is deemed either to be separately owned by one spouse or to belong to the marital community
  - Community income is allocable equally to each spouse
  - Separate income are allocable to owner-spouse in few states
- Separate property may produce community income (example – Idaho, Texas)
- Income from personal services is generally treated as if one-half is earned by each spouse

Income in Community Property States (2 of 2)

- A spouse is taxed only on his or her actual earnings from personal services
- Conditions to be satisfied:
  - The spouse live apart for the entire year
  - They do not file a joint return with each other
  - No portion of the earned income is transferred between the individuals

Alimony and Separate Maintenance Payments (1 of 4)

- Alimony and separate maintenance payments made under an agreement entered into on or before December 31, 2018, are:
  - Deductible by payor
  - Includible in gross income of recipient
- For payments related to pre-2019 agreements, income is shifted from the income earner to the income beneficiary
  - Has a legal right to the income and is better able to pay the tax on the amount received

Alimony and Separate Maintenance Payments (2 of 4)

- Payments may qualify as alimony if:
  - Payments are in cash
  - Agreement or decree does not specify that the payments are not alimony
  - Payor and payee are not members of the same household at the time the payments are made
  - There is no liability to make the payments for any period after the death of the payee

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Alimony and Separate Maintenance Payments (3 of 4)

- Property settlements
  - Transfer of property to former spouse
  - Transferor neither entitled to deduction nor recognizes gain or loss
  - No gross income and carryover of transferor’s basis for transferee
  - Front-loading of alimony payments
    - Alimony recapture (gross income) for payor
    - Deduction from gross income for recipient

Alimony and Separate Maintenance Payments

- Child support payments
  - Payments made to satisfy legal obligation to support the child of taxpayer
  - Use the money for child's benefit
  - 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 (for example, child reaches age 21), such payment is deemed child support

Imputed Interest on Below-Market Loans (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

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

The table below presents the effect of certain below-market loans on the lender and borrower

Type of Loan	Lender	Borrower
Gift	Interest income Gift made	Interest expense Gift received
Compensation-related	Interest income Compensation expense	Interest expense Compensation income
Corporation to shareholder	Interest income Dividend paid	Interest expense Dividend income

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

- Gift loans
  - Exemption for loans of $10,000 or less between individuals
    - If loan proceeds are used to purchase income-producing property, the exemption does not apply
    - On loans of $100,000 or less between individuals
      - Imputed interest is limited to borrower's net investment for year
      - No imputed interest if net investment income is $1,000 or less
      - This limitation for loans of $100,000 or less do not apply if a principal purpose of a loan is tax avoidance

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Imputed Interest on Below-Market Loans (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

Income from Annuities (1 of 6)

- Purchaser pays fixed amount for the right to receive a future stream of payments
  - Generally, early collections over the cost of the contract is included in gross income
  - Increase in the cash value of the contract is not immediately taxable as it is subject to substantial restrictions

Annuity Income (2 of 6)

- For collections on and after the annuity starting date:
  - The exclusion ratio is applied to annuity payments received under contract to determine amount excludable:
  - $$\text{Exclusion ratio} = \frac{\text{Investment in contract}}{\text{Expected return under contract}}$$
- Once investment is recovered, remaining payments are taxable in full
- If the annuitant dies before recovering the investment, the unrecovered cost is deductible in the year the payments cease

Annuity Income (3 of 6)

- Examples:
  - Taxpayer pays $10,000 for annuity that will pay $1,000 a year
    - A: For a term of 15 years
    - B: For lifetime (life expectancy = 15 years)
  - Exclusion ratio for A & B $= \dfrac{\$10{,}000}{\$15{,}000} = 0.667$

Annuity Income (4 of 6)

- Example (continued)
  - A: 15 years of annuity payments
    - Years 1-15: $333 taxable and $667 excludable

Annuity Income (5 of 6)

- Example (continued)
  - B: Lifetime payments and taxpayer lives 18 years
    - Years 1-15: $333 taxable and $667 excludable
    - Years 16-18: $1,000 taxable each year
  - B: Lifetime payments and taxpayer lives 10 years
    - Years 1-10: $333 taxable and $667 excludable, and $4,444 deduction on final return

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Annuity Income (6 of 6)

- The simplified method is required for allocating basis to the annuity payments received from a qualified retirement plan
  - Exclusion amount is employee's investment in contract divided by number of anticipated monthly payments

Prizes and Awards (1 of 2)

- Gross income – FMV of any prizes and awards (other than exempted scholarships)
- Exceptions:
  - The prize or award is received in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement (e.g., Nobel Prize, Pulitzer Prize)
  - The recipient transfers the prize or award to a qualified governmental unit or nonprofit organization
  - The recipient was selected without any action on his or her part to enter the contest or proceeding
  - The recipient is not required to render substantial future services as a condition for receiving the prize

Prizes and Awards (2 of 2)

- Exclusion of employment achievement awards made in the form of tangible personal property but not cash or cash equivalents
  - Award must be made in recognition of an employee's length of service or safety achievement
  - The ceiling on the excludable amount for an employee is $ 400 per year
  - The ceiling on the excludable amount for an employee is $ 1,600 per year, if the award is made as a part of tax qualified plan

Unemployment Compensation

- Unemployment compensation is taxable in full
- It is sponsored and operated by the states and Federal government
- It is to provide a source of income for people who have been employed and are temporarily out of work

Social Security Benefits (1 of 4)

- Benefits included are based on 2 factors:
    - Taxpayer's ability to pay
    - The amount of benefits considered to be a recovery of the taxpayer's contributions, or a recovery capital
- Up to 85% of benefits may be taxable
- Taxability based on taxpayer's modified adjusted gross income (MAGI)
    - MAGI = AGI (excluding Social Security) + foreign earned income exclusion + tax exempt income
- If MAGI plus 50% social security benefits (provisional income) does not exceed a threshold amount ($32,000 for married filing jointly or $25,000 for single taxpayers), the taxpayer need not include any social security benefits in gross income

Social Security Benefits (2 of 4)

- If provisional income exceeds the threshold
  - The amount included in gross income is equal to 50% of the amount by which the provisional income exceeds the threshold, limited to 50% of the benefits themselves
  - If the taxpayer's provisional income also exceeds a second threshold ($44,000 or $34,000), the amount included in gross income is equal to 85% of the amount that provisional income exceeds the higher threshold, plus the smaller of:
    - Amount determined in point 1, above, or
    - 50% of the difference between the 2 threshold amounts ($6,000 for married filing jointly or $4,500 for a single taxpayer)
- The threshold amounts for married taxpayers filing separately is zero

Social Security Benefits (4 of 4)

- Examples of Social Security income:
  - A: Married with AGI = $30,000; tax exempt interest income = $3,000; Social Security benefits = $10,000
    - Portion of social security benefit to be included in gross income = 50% of ($30,000 + $3,000 + $5,000 - $32,000) i.e. $3,000 limited to 50% of $10,000 i.e. $5,000 = $3,000
  - B: Married with AGI = $40,000; tax exempt interest income = $6,000; Social Security benefits = $10,000
    - Portion of social security benefit to be included in gross income = 50% of ($40,000 + $6,000 + $5,000 - $32,000) i.e. $9,500 limited to 50% of $10,000 i.e. $5,000 = $3,000

FBAR

- FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR)
  - Must be filed with Treasury Department if aggregate balance of all foreign bank, brokerage, and similar financial accounts exceeds $10,000 at any time during the year
  - Filed electronically
  - Filed separately from Form 1040
    - Schedule B of Form 1040 includes questions about foreign accounts
  - Due by April 15 with automatic extension to October 15
  - Large penalty for non-filing – as much as 50 percent of the value of the foreign accounts

Tax Planning

- Techniques for accomplishing the strategy:
    - Minimize income included in gross income
    - Defer the recognition of income
    - Shifting income to other taxpayers

Refocus on the Big Picture

- Using the accrual method of accounting, Dr. Cliff Payne has correctly calculated the gross income of his sole proprietorship
  - He will report the $385,000 amount on Schedule C of Form 1040
- What if Dr. Payne elects the cash method of accounting? He will only report the following:

Revenues	$385,000
Plus: Accounts receivable: January 1	–0–
Less: Accounts receivable: December 31	(52,000)
Gross income	$333,000