Chapter 5

Gross Income: Exclusions

LEARNING OBJECTIVES

LO.1- Recognize that statutory authority is required to exclude an item from gross income.

LO.2 - Identify the circumstances under which various items are excludible from gross income.

LO.3 - Determine the extent to which receipts can be excluded under the tax benefit rule.

LO.4 - Describe the circumstances under which income must be reported from the discharge of indebtedness.

LO.5 - Identify tax planning strategies for obtaining the maximum benefit from allowable exclusion

The Big Picture (1 of 3)

- Paul is a graduate accounting student and was an intern with a CPA firm this past summer
  - The CPA firm was so pleased with Paul's work that at the conclusion of his internship
    - He was given a bonus of $1,500 more than the firm had agreed to pay him
    - The extra amount was intended to help with his graduate school expenses
    - The CPA firm has offered him a full-time job after he completes his graduate program in December
- Because of his excellent academic record, Paul was awarded with a graduate assistantship that waives his tuition of $6,000 per semester and pays him $400 per month
  - Paul is required to teach a principles of accounting course each semester
  - Paul has used the $400 per month for books and for room and board

The Big Picture (2 of 3)

- In November, Paul was hit by a delivery van. The driver was found to be driving under the influence of alcohol. Paul suffered a severe injury to his right arm that delayed his starting date for work by three months. The delivery company's insurance company settled the case by paying the following damages:

Compensatory damages:	
Medical expenses	$ 30,000
Injury to Paul's right arm	100,000
Pain and suffering	50,000
Loss of income	15,000
Legal fees	25,000
Punitive damages	160,000
	$ 380,000

The Big Picture (3 of 3)

- Paul's mother was with him in the crosswalk. Fortunately, the van did not hit her, and she was not physically injured
  - She did suffer emotional distress and received $25,000 in the settlement
- Besides being Paul's friend, you also are a senior accounting major and have a keen interest in taxation
  - You tell Paul that you will look into the tax consequences of the settlement
- Read the chapter and formulate your response

Statutory Authority

- Items of income that are specifically designated as exclusion in gross income
- Exclusions are generally found in Sections 101 through 140
- Some exclusions
  - Intended as tax relief measures
  - To encourage and support certain activities
  - Relate to design of the income tax

Gifts and Inheritances (1 of 6)

- Gifts are nontaxable to donee if:
  - Transfer is voluntary without adequate consideration and
  - Made out of affection, respect, admiration, charity or like impulses
  - It is not intended to be for services rendered

Gifts and Inheritances (2 of 6)

- 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 (3 of 6)

- Transfers from employers to employees do not qualify as excludible gifts
  - May be excludible under other provisions, for example, employee achievement awards
  - Victims of a qualified disaster who are reimbursed by their employers for living expenses, funeral expenses, and property damage can exclude the payments from gross income

Gifts and Inheritances (4 of 6)

- Employee death benefits – Amount paid by employer to deceased employee's surviving spouse, children, or other beneficiaries
    - If decedent had a nonforfeitable right to payments (example – accrued salary), amounts are taxable to recipient as if the employee had lived and collected the payments

Gifts and Inheritances (5 of 6)

- Employee death benefits may be excludible as a gift if:
  - Paid to surviving spouse or children (not employee's estate)
  - Employer derived no benefit from payments
  - Surviving spouse and children performed no services for employer
  - Decedent had been fully compensated for services rendered, and
  - Payments made pursuant to board of directors' resolution under a general company policy

Gifts and Inheritances (6 of 6)

- Income in respect of a decedent – Income earned by an employee that was not received by the employee prior to his or her death
  - It is not an employee death benefit
  - It is taxable income to the decedent’s beneficiary

The Big Picture—Gifts to Employees

- Return to the facts of The Big Picture
- The $1,500 paid to Paul by his summer employer was compensation for his 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 his employer, Paul could not exclude the "gift"

Life Insurance Proceeds (1 of 5)

- Paid to the beneficiary because of the death of the insured are excluded from gross income

Life Insurance Proceeds (2 of 5)

- Life insurance proceeds are chosen to be exempt due to the following:
  - Life insurance proceeds serve much the same purpose as a nontaxable inheritance
  - Replace an economic loss suffered by the business

Life Insurance Proceeds (3 of 5)

- Accelerated death benefits
  - Gain on cash surrender or transfer of life insurance policy by terminally or chronically ill individual is excludible
    - Exclusion for chronically ill is limited to amounts used for long-term care

Life Insurance Proceeds (4 of 5)

- Transfers for valuable consideration
  - If policy is transferred for valuable consideration, proceeds are taxable to the extent they exceed amount paid for policy plus subsequent premiums paid
  - Exceptions exist for policy transfers to the following:
    - The insured under the policy
    - A partner of the insured
    - A partnership in which the insured is a partner
    - A corporation in which the insured is an officer or shareholder
    - A transferee whose basis in the policy is determined by reference to the transferor’s basis
      - Applicable to policies transferred in a tax-free exchange or were received by gift

Life Insurance Proceeds (5 of 5)

- Investment earnings arising from the reinvestment of life insurance proceeds are generally subject to income tax
  - Beneficiary will elect to collect the insurance proceeds in installments
    - The annuity rules are used to apportion the installment payment between the principal element (excludible) and the interest element (includible)

Scholarships (1 of 2)

- An amount paid to or for the benefit of a student to aid in pursuing a degree at an educational institution
  - Nontaxable to the extent of tuition and related expenses (example – fees, books, supplies, and equipment required for courses)
    - Amounts received for room and board are taxable

Scholarships (2 of 2)

- Qualified tuition waivers or reductions by nonprofit educational institutions are excluded from income
  - Generally limited to undergraduate tuition waivers
  - Exception for graduate teaching or research assistants

The Big Picture—Compensation For Services

- Return to the facts of The Big Picture
- Paul was paid $400 a month by the university for teaching
  - This is reasonable compensation for his services
- Although he received the assistantship because of his excellent academic record, the monthly pay of $400 must be included in his gross income (compensation for his services)
  - However, the $6,000 graduate tuition reduction can be excluded from gross income

Damages (1 of 3)

- Tax consequences of receipt of damages
  - Depends on type of harm the taxpayer experienced
  - The taxpayer may seek recovery for:
    - Loss of income
    - Expenses incurred
    - Property destroyed, or
    - Personal injury

Damages (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
      - If the expense was deducted, the damages are generally taxable under the tax benefit rule

Damages (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, the taxpayer has a realized gain if damage payments exceed property's basis
  - Personal injury
    - Receives special treatment under the code

Compensation for Injuries and Sickness (1 of 3)

- Personal injury damages
  - Compensatory damages received on account of physical personal injury or physical sickness are excludible
    - Include 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 (paid by the person who caused the harm)

Compensation for Injuries and Sickness (2 of 3)

- Wrongful incarceration
  - Section 139F, exempts amounts received as damages for being wrongfully incarcerated
  - The exclusion applies to an individual convicted of a Federal or state crime who is later exonerated
- Workers' compensation
  - Although payments are intended to compensate for a loss of future income, workers' compensation is specifically excluded from gross income

Compensation for Injuries and Sickness (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

The Big Picture—Damages

- Return to the facts of The Big Picture
- The damages Paul received were awarded as a result of a physical personal injury
  - As a result, the compensatory damages can be excluded
  - Even the compensation for the loss of income of $15,000 can be excluded
- The punitive damages Paul received, however, must be included in his gross income
- Paul’s mother did not suffer a personal physical injury
  - Therefore, the $25,000 she received must be included in her gross income

Employer-Sponsored Accident and Health Plans (1 of 2)

- Premiums paid by employer for insurance coverage of employee, spouse, and dependents are deductible by the employer and excluded from the employee's income
- Employee has includible income when she or he collects the insurable benefits; two exceptions are provided
  - Payments received for medical care of the employee, spouse and dependents are excluded
  - Amounts received from insurance are not taxable when received for medical care or for permanent loss of body part or function

Employer-Sponsored Accident and Health Plans (2 of 2)

- Payments received for expenses that do not meet the Code's definition of medical care must be included in gross income
- Amounts received for medical expenses that were deducted on a prior return must be included in gross income

Medical Reimbursement Plans

- One way to provide a medical reimbursement plan for employees is as follows:
  - The employer purchases a medical insurance plan with a high-deductible and then makes contributions to the employee's Health Savings Account (HSA)
    - Employer's contribution to HSA and earnings on funds in the account are excludible
    - Contributions limited to 100% of deductible amount for individual or family coverage
      - Monthly deductible amount is limited to one-twelfth of $3,500 under a high-deductible plan for self-only coverage (one-twelfth of $7,000 for an individual who has family coverage)
  - Withdrawals from HSA must be used to reimburse the employee for the medical expenses paid by the employee that are not covered under the high-deductible plan

Long-Term Care Insurance Benefits

- Employer-paid insurance premiums for employee's long-term care are excludible subject to annual limits
    - Premiums paid by the employer
    - Benefits collected under the employer's plan
    - Benefits collected from the individual's policy
- Individual who purchases his or her own policy can exclude the benefits from gross income
- Reduced by any amounts received from other third parties (for example, Medicare, Medicaid)

Meals and Lodging (1 of 2)

- Not taxable to employee if:
  - Furnished by the employer
    - On the employer’s business premises
    - For the convenience of the employer
  - In case of lodging, the employee is required to accept the lodging as a condition of employment

Meals and Lodging (2 of 2)

- From 2018 through 2025, the employer may only deduct 50% of the cost of the meals provided (rather than 100%)
  - After 2025, employers may not claim any deduction for these meals
- If the employer continues to provide such meals, their value remains as an exclusion for the employees

Other Housing Exclusions (1 of 2)

- Campus housing provided by the employer to an employee of an educational institution
  - If the employee pays annual rents equal to or greater than 5 percent of the appraised value of the facility, it is excluded and other wise, the deficiency must be included in the total income
- Ministers of the gospel and other religious leaders can exclude
  - The rental value of home furnished as compensation
  - Rental allowance paid to them as compensation, to the extent allowance is used to rent, buy or provide a home
  - The rental value of home owned by the minister

Other Housing Exclusions (2 of 2)

- Housing allowance is a compensation for the conduct of religious worship, the administration and maintenance of religious organizations, or the performance of teaching and administrative duties at theological seminaries
- Military personnel are allowed housing exclusions under various circumstances

Employee Fringe Benefits (1 of 3)

- Child and dependent care
  - Up to $5,000 per year of care costs paid for by the employer can be excluded ($2,500 if married and filing separately)
- Athletic facilities
  - Value of the use of athletic facilities located on employer premises can be excluded

Employee Fringe Benefits (2 of 3)

- Educational assistance programs
  - Employer-provided educational assistance for undergraduate and graduate education is excludible
    - Exclusion limited to $5,250 per year
    - Includes tuition, fees, books, and supplies
  - Do not cover
    - Meals, lodging, and transportation costs
    - Educational payments for courses involving sports, games, or hobbies

Employee Fringe Benefits (3 of 3)

- Adoption assistance programs
  - Employee adoption expenses paid or reimbursed by employer are excludible
    - Exclusion limited to $14,300 in 2020
    - Exclusion phases out as AGI increases from $214,520 to $254,520

Cafeteria Plans

- Allow employees to choose between cash and certain nontaxable benefits
  - If cash is chosen, the amount received is taxable
  - If a nontaxable benefit is chosen, the benefit remains nontaxable
- Provide tremendous flexibility in tailoring the employee pay package to fit individual needs

Flexible Spending Plans

- Allow employees to accept lower cash compensation in return for employer agreeing to pay certain costs without the employee recognizing income
- Annual inflation-adjusted cap applies to these plans ($2,750 in 2020)
  - Called *use or lose* plan since reduction in pay cannot be recovered if covered expenses are less than expected
- Recently issued IRS rules allow a 2½ month grace period (until the fifteenth day of the third month after the end of the plan year) to use the funds for qualified expenses

General Classes of Excluded Benefits

- No-additional-cost services
- Qualified employee discounts
- Working condition fringes
- *De minimis* fringes
- Qualified transportation fringes
- Qualified moving expense reimbursements
- Qualified retirement planning services
- Qualified military base realignment and closure fringes

No-Additional-Cost Services

- Value of the services is nontaxable if:
  - Employee receives services (not property)
  - Employer incurs no substantial additional cost, including foregone revenue, in providing the services
  - Services offered are in the ordinary course of business in which the employee works
  - Exclusion is not allowed to highly compensated employees unless it is available on a nondiscriminatory basis

Qualified Employee Discounts

- Are nontaxable if:
  - Exclusion is not on real property or investment property
  - Property or services must be from the same line of business in which the employee works
  - In case of property, exclusion is limited to the gross profit component of the customer price
  - In case of services, exclusion cannot exceed 20% of the customer price on services

Working Condition Fringes

- Not taxable if the employee could deduct the cost of items if they had actually paid for them
  - Can be made available on a discriminatory basis and still qualify for the exclusion

De Minimis Fringes (1 of 2)

- These benefits are so small that accounting for them is impractical and thus excludible
  - Examples include:
    - Occasional supper money or taxi fare for employees because of overtime work
    - Occasional personal use of company copying machine
    - Occasional company cocktail parties or picnics for employees
    - Certain holiday gifts of property with a low fair market value

De Minimis Fringes (2 of 2)

- Subsidized eating facilities operated by employer are excluded if:
  - Located on or near employer’s business premises
  - Revenue equals or exceeds direct operating costs
  - Nondiscrimination requirements are met

Qualified Transportation Fringes (1 of 2)

- This fringe benefit is designed to encourage the use of mass transit for commuting to and from work
  - Includes:
    - Transportation in commuter highway vehicle and transit passes
      - Annual limit on the exclusion for 2020 is $270 per month
    - Qualified parking
      - Annual limit on the exclusion for 2020 is $270 per month
  - May be provided directly by the employer or may be in the form of cash reimbursements

Qualified Transportation Fringes (2 of 2)

- The TCJA of 2017 prohibits employers from deducting qualified transportation fringe benefits provided to employees [§ 274(a)(4)]
  - If the employer provides the benefit, though, the employee may exclude it from income within the limits stated above

Qualified Moving Expenses Reimbursements

- Prior to enactment of the TCJA of 2017, employer payment or reimbursement of employee’s qualified moving expenses was excludible
  - For 2018 through 2025, the exclusion only applies to members of the Armed Forces on active duty

Qualified Retirement Planning Services

- Value of any retirement planning advice or information provided by an employer who maintains a qualified retirement plan is excluded from income
  - Designed to motivate more employers to provide retirement planning services

Qualified Military Base Realignment and Closure Fringe

- Payments made under the Demonstration Cities and Metropolitan Development Act of 1966 are excluded from income

Nondiscrimination Provisions

- For no-additional-cost services, qualified employee discounts, and qualified retirement planning services
  - If the plan is discriminatory in favor of highly compensated employees, these key employees are denied exclusion treatment
  - Non-highly compensated employees can still exclude these benefits from income

Group Term Life Insurance

- The premium on the first $ 50,000 of group term life insurance protection are excludible from the employee’s and former employee’s gross income
- The benefits of this exclusion are available only to employees
- Proprietors and partners are not considered employees

Foreign Earned Income (1 of 2)

- Income from personal services rendered in a foreign country can be either:
    - Included in taxable income and then claim a credit for foreign taxes paid or
    - Excluded from U.S. gross income
- To qualify for the exclusion, taxpayer must be either:
    - A *bona fide* resident of the foreign country or
    - Present in a foreign country at least 330 days during any 12 consecutive months

Foreign Earned Income (2 of 2)

- Exclusion amount is limited to $107,600 for 2020
  - For married persons, both with foreign earned income, the exclusion is computed separately for each spouse
  - Congress recently decreased its benefit by requiring a special tax computation
    - The tax on taxable income after the foreign earned income exclusion is calculated using the tax rate that would apply if the excluded foreign earned income were included in gross income

Interest on Certain 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

Corporate Distributions to Shareholders

- Taxable to the extent of payments made from either current or accumulated earnings and profits (E&P)
- Distributions in excess of earnings and profits are treated:
  - As nontaxable return of capital to the extent of stock basis (which is reduced)
  - As capital gain to extent in excess of basis

Stock Dividends

- Stock dividends (for example, common stock issued to common shareholders) are not taxable
    - If shareholder has the option to receive stock or cash, the gross income is taxable whether the shareholder receives cash or stock

Educational Savings Bonds (1 of 2)

- Interest on Series EE U.S. government savings bonds may be excluded from income if:
  - Proceeds are used to pay for qualified higher educational expenses and
  - Bonds are issued to a person at least 24 years old
- Exclusion is phased out once modified AGI exceeds threshold amount

CENGAGE

Educational Savings Bonds (2 of 2)

- The phaseout begins at $ 82,350 ($ 123,550 on a joint return)
- The phaseout is completed when MAGI exceeds the threshold amount by more than $ 15,000 ($ 30,000 on a joint return)

Qualified Tuition Program (1 of 2)

- Amounts contributed must be used to pay qualified higher education expenses
- Qualified higher education expenses include:
  - Tuition, fees, books, supplies, room and board, and equipment required for enrollment or attendance
  - Computers and peripheral equipment, including software that provides access to the Internet
- Tuition paid to public, private, and religious K-12 schools are also included

Qualified Tuition Program (2 of 2)

- Earnings on contributions, including discounted tuition for plan participants, are not taxable if used for qualified higher education expenses
  - Refunds from program are taxable to the extent they exceed contributions

Coverdell Education Savings Account

- Used to save for K-12 education as well as postsecondary education expenses
- The contributions are limited to $ 2,000 in a year
- The beneficiary must be under 18 or must be a special needs beneficiary
- The income to the beneficiary is nontaxable provided the funds are used for qualified education expenses

Qualified ABLE Programs (§ 529A plans) (1 of 2)

- The qualified ABLE (Achieving a Better Life Experience) program was created to assist individuals who became blind or disabled before age 26
- The qualified ABLE program allows for § 529A plans, or ABLE plans, similar in concept to § 529 plans
  - The program must be established by a state
  - The ABLE account must be for the benefit of a designated beneficiary's disability expenses, and
  - The beneficiary must have a disability certification from the government

Qualified ABLE Programs (§ 529A plans) (2 of 2)

- Contributions to the account must be in cash and may not, in aggregate, exceed the annual gift tax exclusion for the year ($15,000 for 2020 and 2019)
  - Contributions to the account are not deductible
- The tax benefit of an ABLE account is that its earnings are not taxable
  - Distributions from the account also are not taxable provided they do not exceed the qualified disability expenses of the designated beneficiary
- The TCJA of 2017 permits certain rollovers from a § 529 account to an ABLE account (for 2018 through 2025)

Tax Benefit Rule

- If taxpayer claims 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

Income from Discharge of Indebtedness (1 of 2)

- Income from the forgiveness of debt is taxable
    - Certain discharge of indebtedness situations get special exclusion treatment:
        - Creditors' gifts
        - Discharges under Federal bankruptcy law
        - Discharge that occur when the debtor is insolvent
        - Discharge of farm debt of a solvent taxpayer
        - Discharge of qualified real property business indebtedness
        - Seller's cancellation of buyer's indebtedness

Income from Discharge of Indebtedness (2 of 2)

- Shareholder's cancellation of corporation's indebtedness
- Forgiveness of certain student loans
- Discharge of indebtedness on taxpayer's principal residence that occurs between January 1, 2007, and January 1, 2021, and is the result of the financial condition of the debtor

Refocus on the Big Picture (1 of 2)

- You have looked into Paul’s tax situation and have the following information for him:
- Compensation - The amount Paul was paid for his internship is compensation for services rendered and must be included in his gross income
  - This includes both his base pay and the $1,500 bonus
- Graduate assistantship - The tuition waiver of $6,000 is excluded from Paul’s gross income
  - The related payments of $400 per month are intended as a form of compensation and must be included in his gross income

Refocus on the Big Picture (2 of 2)

- Damages - Damages awards that relate to personal physical injury or sickness can be excluded from gross income if payments are for compensatory damages
  - All of the compensatory damages of $220,000 can be excluded from gross income
  - The punitive damages of $160,000 must be included in Paul's gross income
  - Likewise, the compensatory damages of $25,000 received by Paul's mother must be included in her gross income
    - Emotional distress does not qualify as personal physical injury or sickness