(6) Gross Income and Exclusions

Edwin Renán Maldonado ©

Catedrático – Universidad de Puerto Rico

Seg. Sem. 2017-18

Textbook: Taxation of Individuals and Business Entities, Spilker

- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Taxation of Individuals and Business Entities, 2017 Ed., Spilker which is the textbook assigned for the course CONT 4076 – “Aspectos Contributivos de Individuos” at the University of Puerto Rico, Río Piedras Campus.

Learning Objectives

1. Apply the concept of realization and explain when taxpayers recognize gross income.

2. Understand the distinctions between the various sources of income, including income from services and property.

3. Apply basic income exclusion provisions to compute gross income.

GROSS INCOME

GROSS INCOME

1.1 Definition of Gross Income

GROSS INCOME

1.1 Definition of Gross Income

- §61(a): "gross income means all income from whatever source derived".

- Reg. §1.61-(a): "includes income realized in any form, whether in money, property, or services".

GROSS INCOME

1.2 Recognition of Income

GROSS INCOME

1.2 Recognition of Income

- Taxpayers report realized and **recognized** income on their tax returns for the year.
- Income that is excluded or deferred is not included in gross income.
  - Excluded income is never taxed.
  - Deferred income is taxed when recognized in a subsequent year.

GROSS INCOME

1.2 Recognition of Income

- Taxpayers recognize gross income when:

1. they realize the income,
2. they receive an economic benefit, and
3. the tax law does not provide for exclusion or deferral.

GROSS INCOME

1.2 Recognition of Income

1. Realization Principle

- Taxpayer engages in a transaction with another party, **and**
- Transaction results in a measurable change in property rights.
  - Ex. Assets or services are exchanged for cash, claims for cash, or other assets with determinable value.

GROSS INCOME

1.2 <u>Recognition of Income</u>

2. Economic Benefit

- Examples:
  - Being paid for services rendered;
  - Proceeds from property sales.
- Borrowed funds represent a liability, not gross income.

GROSS INCOME

1.2 <u>Recognition of Income</u>

2. Economic Benefit

- A common misperception is that taxpayers must receive cash to realize and recognize gross income.
- However, Reg. §1.61-(a) indicates that taxpayers realize income whether they receive money, property, or services in a transaction.

GROSS INCOME

Example 1

- During March, Gram paid no rent to her neighbor (also her landlord). Although the neighbor typically charges $350 per month for rent, he allowed Gram to live rent free in exchange for babysitting his infant son.

What income must Gram and Gram's neighbor realize and recognize on this exchange?

GROSS INCOME

Example 1

What income must Gram and Gram's neighbor realize and recognize on this exchange?

- Gram and the neighbor each must recognize $350 of income for March.
- The **neighbor** recognized $350 of rental receipts because this is the value of the babysitting services the neighbor received in lieu of a cash payment for rent from Gram (an economic benefit the neighbor realized through the exchange).
- **Gram** recognizes $350 of babysitting income, because this is the value of the services provided to her neighbor (an economic benefit was realized because Gram was not required to pay rent).

GROSS INCOME

1.2 Recognition of Income

3. No Exclusion or Deferral Provision

- Taxpayers who realized an economic benefit must include the benefit in gross income unless a specific provision of the tax code says otherwise, such as
  - the income is exempt, or
  - the income is deferred.

GROSS INCOME

1.3 Special Rules of Income Recognition

GROSS INCOME

1.3 **<u>Special Rules of Income Recognition</u>**

1. Return of capital principle

- The cost of an asset is called **<u>tax basis</u>**.
- Return of capital means the tax basis is excluded when calculating realized income.
  - Return of capital does not represent an economic benefit.
- Gain from the sale or disposition of an asset is included in realized income.

GROSS INCOME

Example 2

- Neighbor sold his house to Gram with a selling price of $100,000. Neighbor tax basis is $40,000.

1. ***What amount represents return of capital in this transaction?***
2. ***What amount represents the realized income?***

GROSS INCOME

Example 2

- Neighbor sold his house to Gram with a selling price of $100,000. Neighbor tax basis is $40,000.

1. ***What amount represents return of capital in this transaction?***
   - ***$40,000 (tax basis)***

GROSS INCOME

Example 2

- Neighbor sold his house to Gram with a selling price of $100,000. Neighbor tax basis is $40,000.

2. *What amount represents the realized income?*
   - ***$60,000 ($100,000 - $40,000)***

GROSS INCOME

1.3 Special Rules of Income Recognition

2. Recovery of amounts previously deducted

- Individuals typically claim deductions in the year paid.
- Deductions may sometimes be reimbursed or refunded in a subsequent year.
- Tax benefit rule - Refunds of expenditures deducted in a prior year are included in gross income to the extent that the refund reduced taxes in year of the deduction.

GROSS INCOME

<u>Example 3</u>

Last year Courtney reported $9,300 in itemized deductions including $3,500 of state income taxes paid <u>last year</u> (the standard deduction last year was $9,100).

In March of <u>this year</u>, Courtney received a $420 refund of the $3,500 in state income taxes paid last year.

Under the tax benefit rule, how much of the $420 refund, should Courtney include in her gross income <u>this year</u>?

GROSS INCOME

Example 3

$200.

The deduction of $420 only reduced Courtney's taxable income by $200 because the total itemized deductions ($9,300) cannot drop below the standard deduction ($9,100).

1.4 Timing of Income Recognition (When)

GROSS INCOME

1.4 Timing of Income Recognition (When)

1. Tax Periods

- Individual taxpayers file tax returns for a calendar-year period.
- Corporations often use a fiscal year end.

GROSS INCOME

1.4 <u>Timing of Income Recognition (When)</u>

2. Accounting Methods

- The method of accounting (*cash or accrual basis*) generally determines the year in which realized income is recognized and included in gross income.
- A taxpayer can choose the accounting method. However, the use of accrual method is compulsory under certain circumstances for <u>corporate</u> taxpayers.

GROSS INCOME

1.4 Timing of Income Recognition (When)

3. **Constructive Receipt**

- Taxpayer must realize and recognize income when it is actually or constructively received (**Judicial doctrine**).

GROSS INCOME

1.4 Timing of Income Recognition (When)

3. **Constructive Receipt**

- A constructive receipt is deemed to occur when:
  a. the income is credited to the taxpayers account,
  b. when the income is unconditionally available to the taxpayers,
  c. the taxpayer is aware of the income's availability, and there are no restrictions on the taxpayer's control over the income.

GROSS INCOME

Example 4

Courtney is a cash-method taxpayer. Based on her outstanding performance, Courtney earned a $4,800 year-end bonus. On December 28, Courtney's supervisor told her that her bonus was issued as a separate check and that Courtney could pick up the check in the accounting office anytime. Courtney did not pick up the check until January 2 of next year, and she did not cash it until late January.

When does Courtney realize and recognize the $4,800 income?

GROSS INCOME

Example 4

When does Courtney realize and recognize the $4,800 income?

- On December 28 of the current year.
- Courtney constructively received the check this year because it was unconditionally available to her on December 28, she was aware of the check's availability, and there were no restrictions on her to control over the check.
- Courtney must include the $4,800 bonus in gross income this year, even though she did not actually receive the funds until late January of next year.

GROSS INCOME

1.4 <u>Timing of Income Recognition (When)</u>

4. **Claim of Right**

- This doctrine was conceived when a taxpayer received income in one period but was required to return the payment in a subsequent period (**Judicial doctrine**).
- Income recognized when there are no restrictions on use of income (e.g., no obligation to repay).
- **Example**: A cash bonus paid to employees based on company earnings. (if there is a "clawback" provision that requires repayment if the company has an <u>earnings restatement</u>).

GROSS INCOME

1.5 Taxpayer Recognizing the Income (Who)

GROSS INCOME

1.5 Taxpayer Recognizing the Income (Who)

- In addition to determining when taxpayers realize and recognize income, it is important to consider who (which taxpayer) recognizes the income.
- This question arises when an income-shifting strategy is involved:
  - Assignment of Income
  - Community Property Systems

GROSS INCOME

1.5 Taxpayer Recognizing the Income (Who)

1. Assignment of Income

- The assignment of income doctrine holds that the taxpayer who earns income from services must recognize the income.
- Income from property such as dividends and interest is taxable to the person who actually owns the income-producing property.
- To shift income from property to another person, a taxpayer must also transfer the ownership in the property to the other person.

GROSS INCOME

1.5 <u>Taxpayer Recognizing the Income (Who)</u>

2. Community Property Systems

- Nine states implement <u>community property systems</u>.
  - Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

GROSS INCOME

1.5 <u>Taxpayer Recognizing the Income (Who)</u>

2. Community Property Systems

- Rules:
  1. Half of the income earned from the <u>services of one spouse</u> is included in the gross income of the other spouse.
  2. Half of the income from <u>property held as community property</u> by the married couple is included in the gross income of each spouse.

GROSS INCOME

1.5 Taxpayer Recognizing the Income (Who)

2. Community Property Systems

- Rules:

3. Property that a spouse brings into a marriage is treated as that spouse's separate property. How income from separate property is treated varies across states (either treated as earned solely by spouse that owns property or equally by each spouse).

Types of Income

Types of Income

2.1 Source of Gross Income

Types of Income

2.1 Source of Gross Income

- Sección 61(a): "**Gross income** means all income from whatever source derived, unless excluded by law. Gross income includes income realized <u>in any form</u>, whether in money, property or services."

Types of Income

2.1 Source of Gross Income

- Consequently, we can classified gross income as realized from:
  1. services,
  2. property, and
  3. other source

Types of Income

2.1 Source of Gross Income

1. **Services**:
   a. Income from labor is the most common source of gross income.
   b. Generated by the efforts of taxpayer.
   c. Examples: Salary and wages (Unemployment compensation), services fees and business income.

Types of Income

2.1 <u>Source of Gross Income</u>

2. **Property**:
   a. Include gain or losses from sale of property, dividends, interests, rents, royalties, and annuities.
   b. Depends on types of income and types of transaction generating income.

Types of Income

Example 5 (Income realized from property)

Types of Income

<u>Example 5 (Income realized from property)</u>

- Gram purchased a $100,000 three-year certificate of deposit. At the year end, the CD account is credited with $4,100 of interest.

Gram will recognize $4,100 of interest income in her tax return.

Types of Income

<u>Example 6 (Income realized from rent income)</u>

Types of Income

<u>Example 6 (Income realized from rent income)</u>

- Courtney owns a condo in town that she rents to tenants. This year, the condo generated \$14,000 of <u>rental revenue</u>.
- Courtney incurred \$4,000 in real estate taxes, \$2,500 in utility expenses, \$500 in advertising expenses, and \$2,000 of depreciation.

What effect does the rental have on Courtney's gross income and taxable income?

Types of Income

Example 6 (Income realized from rent income)

Rental Revenue		$14,000
Expenses		
real estate taxes	$4,000	
Utilities	2,500	
Advertising	500	
Depreciation	2,000	9,000
Net Rental Income		**$ 5,000**

Types of Income

Types of Income Discussed

in this Presentation

Types of Income

<u>Types of Income Discussed in this Presentation</u>

- 2.2 Annuities
- 2.3 Property disposition
- 2.4 Flow-through entities
- 2.5 Alimony
- 2.6 Prizes and awards
- 2.7 Social securities benefits

Types of Income

Types of Income Discussed in this Presentation

- 2.8 Imputed income
- 2.9 Discharged of indebtedness

Types of Income

2.2 Annuities

Types of Income

2.2 Annuities

- An investment that pays a stream of equal payments over time.
- A portion of each annuity payment as a non-taxable return of capital and the remainder as gross income.

Types of Income

2.2 Annuities

- Taxpayers use the annuity exclusion ratio to determine the return of capital (non-taxable) portion of each payment.
- **Annuity exclusion ratio** = $\dfrac{\text{original investment}}{\text{expected value of the annuity}}$
- For annuities with a fixed term, the expected value is the number of payments times the payment amount.

Types of Income

Example 7

- In January, Gram purchased an annuity for $99,000. The annuity pays her $10,000 per year for the next 15 years.

How much of each $10,000 payment should Gram include in her gross income?

Types of Income

Example 7

How much of each $10,000 payment should Gram include in her gross income?

Annuity exclusion ratio = $\frac{\$99{,}000}{\$150{,}000}$ = 66%

66% x $10,000 = $6,600 excluded

3,400 taxable

$10,000

Types of Income

2.2 <u>Annuities</u>

- For annuities over a life, taxpayers must use IRS tables to determine the expected value based upon the taxpayer's life expectancy.

- See page 5-12 – "Table for Expected Return Multiple for Ordinary Single-Life Annuity"

Types of Income

2.3 Property Dispositions

Types of Income

2.3 Property Dispositions

- Taxpayers usually realize a gain or loss when disposing of an asset.
- Taxpayers are allowed to recover their investment in property (tax basis) before they realize any gain.

EXHIBIT 5-2 Formula for Calculating Gain (Loss) from Sale of an Asset

Sales proceeds
Less: Selling expenses
= Amount realized
Less: Basis (investment) in property sold
= Gain (Loss) on sale

Types of Income

Example 8

On December 31, Gram sold her 50 shares of Acme Corporation stock for $40 per share. Gram also paid $150 of broker's commissions on the sale. Gram originally purchased the shares in April of this year for $30 per share.

How much gross income does Gram recognize from the stock sale?

Types of Income

<u>Example 8</u>

How much gross income does Gram recognize from the stock sale?

Sales Proceed	$2,000
Less: Selling expenses	<u>150</u>
Amount realized	$1,850
Less: Tax basis ($30 x 50)	<u>1,500</u>
Gain on sale	**<u>$ 350</u>**

Types of Income

2.4 Flow-through Entities

Types of Income

2.4 Flow-through Entities

- Individual may invest in various business entities.
- The legal form of the business affects how the income generated by the business is taxes.

Types of Income

2.4 Flow-through Entities

- If the entity is a flow-through entity such as:
  1. a partnership
  2. S corporation, or
  3. an LLC entity with one owner

  the income and deductions of the entity "flow through" to the owners of the entity (partners or shareholders), and the owner must report the income in his/her individual income tax return.

Types of Income

Example 9

Suppose that Courtney is a 40% partner in KJZ Partnership.

KJZ reported $20,000 of business income and $3,000 of interest income for the year. KJZ also distributed $1,000 of cash to Courtney.

What amount of gross income from her ownership in KJZ would Courtney report for the current year?

Types of Income

Example 9

What amount of gross income from her ownership in KJZ would Courtney report for the current year?

Business Income:	$8,000	($20,000 x 40%)
Interest Income	1,200	($3,000 x 40%)
Total Income	$9,200	

Observe that Courtney would not include the $1,000 distribution because it was a return of her investment.

Types of Income

2.5 <u>Alimony</u>

For tax purposes alimony is defined as:

- a transfer of <u>cash</u> made under a written separation agreement or divorce decree,
- the <u>separation or divorce decree</u> does not designate the payment as nonalimony,
- in the case of legally separated (or divorced) taxpayers under a separation or divorce decree, the spouses do <u>not live together</u> when the payment is made, and
- the payments <u>cannot continue after the death</u> of the recipient.

Types of Income

2.5 Alimony

Types of payment that do not qualify as alimony:

- property divisions, and
- child support payments fixed by the divorce or separation agreement.

Types of Income

2.6 Prizes and Awards

Types of Income

2.6 Prizes and Awards

- **Inclusion**: Prizes, awards, and gambling winnings, such a as raffle ("**rifa**") or sweepstake prizes ("**sorteos**") or lottery winnings, are included in gross income.

Types of Income

2.6 Prizes and Awards

- **Exclusion 1**:
  1. Awards made for scientific, literary, or charitable achievement, and
  2. transferred to a qualified charity.

Requirements:

- The recipient was selected without any action on his part to enter the contest.
- The recipient is not required to render substantial future services as condition to receive the prize or award.
- The payor of the prize or award transfers the prize or award to a federal, state, or local governmental unit or qualified charity such a church, school, or charitable organization designated by the taxpayer.

Types of Income

2.6 <u>Prizes and Awards</u>

- **Exclusion 2**:

  (1) Awards for length of service or safety achievement.

<u>Requirements</u>:

- These nontaxable awards are <u>limited to $400</u> of tangible property other than cash per employee per year.
- The award is not excluded from the employee's income if circumstances suggest it is disguised compensation.

Types of Income

2.7 Social Security Benefits

Types of Income

2.7 Social Security Benefits

- Taxpayer is required to include up to 85 percent of Social Security Benefits in gross income depending on:
  - the taxpayer's filing status,
  - Social Security Benefits, and
  - modified AG.

The calculation is complex, to say the least.

Types of Income

2.7 <u>Social Security Benefits</u>

- Modified AGI is:
  - regular AGI (excluding Social Security benefits),
  - **plus** tax-exempt interest income,
  - **excluded** foreign income, and certain other deductions for AGI.

Types of Income

2.7 Social Security Benefits

- **Single and Married Filing Jointly Taxpayers**
  - (1) If **modified AGI** + 50% of Social Security benefits <= $25,000 (single) or $32,000 (married),
    - Social Security benefits are **not taxable**.
  - (2) If $25,000 (single) or $32,000 (married) < **modified AGI** + 50% of Social Security benefits < = $34,000 (single) or $44,000(married),
    - **taxable Social Security benefits** are the **lesser** of (a) 50 percent of the Social Security benefits or (b) 50 percent of (modified AGI + 50% of Social Security benefits - $25,000 (single) or $32,000 (married)).
  - (3) If modified AGI + 50% of Social Security benefits > $34,000 (single) or $44,000 (married),
    - **taxable Social Security benefits** are the **lesser** of (a) 85 percent of Social Security benefits or (b) 85 percent of (modified AGI + 50% of Social Security benefits - $34,000 (single) or $34,000 (married)), plus the lesser of (1) $4,500 (single) or $6,000 (married) or (2) 50 percent of Social Security benefits.

Types of Income

2.8 <u>Imputed Income</u>

- Besides realizing direct economic benefits like wages and interest, taxpayers sometimes realize indirect economic benefits that they must include in the gross income as imputed income.

Examples:

- Certain <u>employee discounts or low interest loans</u> generate income via indirect benefits.

Types of Income

2.8 <u>Imputed Income</u>

1. **Employee Discount**
   - A bargain purchase by an employee from an employer results in a <u>taxable compensation</u> income to the employee,
   - A bargain purchase by a shareholder from a corporation results in a <u>taxable dividend</u> to the shareholders, and
   - A bargain purchase between family members is deemed to be a <u>gift</u> from one family member to the other.

Types of Income

2.8 Imputed Income

1. **Employee Discount**

- The tax law does provide a limited exclusion for employee bargain purchases. Specifically, employees may exclude (as income)
  - A discount on employer-provider goods as long as the discount does not exceed the employer's gross profit percentage on all property offered to sale to customers, and
  - Up to 20% employer-provided discount on services.
- Discounts in excess of these amounts are taxable as compensation.

Types of Income

Example 10

- As part of her compensation package, EWD (employer) agreed to provide John (employee) with EWD architectural design services (to improve his house) at a substantial discount. EWD provided John with services valued at $35,000 but charged her only $22,000 for the services.

How much of the discount must John include in gross income?

Types of Income

Example 10

How much of the discount must John include in gross income?

Value of services	$35,000
John's cost of the services	22,000
Discount on services	$13,000
Nontaxable discount ($35,000 x 20%)	7,000
Taxable discount (in excess of 20%)	$ 6,000

Types of Income

2.8 Imputed Income

2. **Low Interest Loans**.
   a. For low interest loans, the amount of imputed income is the difference between the amount of interest using the applicable federal interest rate and the amount of interest the taxpayer actually pays.

Types of Income

2.8 Imputed Income

2. **Low Interest Loans**.

   b. To eliminate any tax advantages of below-market loans, the tax law requires the lender and borrower to treat the transaction as if:

   - The borrower paid the lender the difference between the applicable federal interest rate and the actual interest paid (the difference is called imputed interest).
   - The lender then returned the imputed interest to the borrower.

Types of Income

2.8 Imputed Income

2. **Low Interest Loans**.

   c. Imputed interest rules do not apply to aggregate loans of $10,000 or less between the lender and borrower.

Types of Income

Example 11

- At the beginning of January, EWD provides John with a $100,000 zero-interest loan. Assume that the applicable interest rate is 4%. John used the loan proceeds to acquire several personal-use assets (to improve his house).

What amount is John required to include in gross income in the current year?

Types of Income

<u>Example 11</u>

What amount is John required to include in gross income in the current year?

Loan principal $4,000 x 4% = $4,000 interest.

John will also incur an imputed interest expense of $4,000 for the year, and

EWD will also (a) report $4,000 of interest income, and (b) deduct $4,000 of compensation expense.

Types of Income

2.9 Discharge of Indebtedness

Types of Income

2.9 Discharge of Indebtedness

- When a taxpayer's debt is forgiven by a lender, the taxpayer must usually include the amount of debt relief in gross income
  - Exceptions exist for certain types of loans.
- To provide tax relief for insolvent taxpayer, taxpayers with liabilities, including tax liabilities, exceeding their assets—a discharge of indebtedness is not taxable.
- If the discharge of indebtedness makes the taxpayer solvent, the taxpayer recognizes taxable income to the extent of his solvency.

Exclusion Provisions

Exclusion Provisions

3.1 General

Exclusion Provisions

3.1 General

- Congress allows certain specific types of income to be excluded or deferred.
  1. Subsidize or encourage particular activities, or
  2. To mitigate inequity.

Exclusion Provisions

Types of Exempt Income Discussed in this Presentation

Exclusion Provisions

Types of Exempt Income Discussed in this Presentation

- 3.2 Municipal interests
- 3.3 Gain on sale of personal residence
- 3.4 Fringe benefits
- 3.5 Education related exclusions
- 3.6 Gifts and Inheritances
- 3.7 Life insurance proceeds

Exclusion Provisions

Types of Exempt Income Discussed in this Presentation

- 3.8 Foreign earned income
- 3.9 Sickness and injuries
- 3.10 Deferral provisions

Exclusion Provisions

3.2 Municipal Interest

Exclusion Provisions

3.2 Municipal Interest

- Bonds issued by state and local governments located in the United States, and this exclusion is generally recognized as a subsidy to state and local governments.

Exclusion Provisions

3.3 Gain on the Sale of Personal Residence

Exclusion Provisions

3.3 <u>Gain on the Sale of Personal Residence</u>

- Taxpayers may exclude up to <u>$250,000</u> ($500,000 if married filing jointly) of gain on the sale of their principal residence.

Exclusion Provisions

3.3 Gain on the Sale of Personal Residence

- Must satisfy ownership and use tests.
  - Taxpayers must have owned the residence for a total of two or more years during the five-year period ending on the date of the sale.
  - Taxpayer must have used the property as her principal residence for a total of two or more years.
- Any excess gain generally qualifies as long-term capital gain.

Exclusion Provisions

3.4 <u>Fringe Benefits</u>

Exclusion Provisions

3.4 Fringe Benefits

- The value of these benefits is included in the employee's gross income as compensation for services.
- Certain fringe benefits, called "qualifying" fringe benefits, are excluded from gross income:
  - Medical and dental health insurance coverage.
  - Life insurance coverage.
  - *De minimis* (small) benefits.

Exclusion Provisions

Fringe Benefits

EXHIBIT 5-3 Common Qualifying Fringe Benefits (excluded from employee's gross income)

Item	Description
Medical and dental health insurance coverage (§106)	An employee may exclude from income the cost of medical and insurance coverage and dental health insurance premiums the employer pays on an employee's behalf.[40]
Life insurance coverage (§79)	Employees may exclude from income the value of life insurance premiums the employer pays on an employee's behalf for up to $50,000 of group-term life insurance.
De minimis (small) benefits §132(a)(4)	As a matter of administrative convenience, Congress allows employees to exclude from income relatively small and infrequent benefits employees receive at work (such as limited use of a business copy machine).

Exclusion Provisions

3.5 Education-Related Exclusions

Exclusion Provisions

3.5 Education-Related Exclusions

- As an incentive for taxpayers to participate in higher education, Congress excludes certain types of income if the funds are used for higher education.

Exclusion Provisions

3.5 Education-Related Exclusions

1. **Scholarships**

- Students seeking a college degree can exclude scholarships that pay for required tuition, fees, books, and supplies.
  - **Exception**: Exclusion applies only if the recipient is not required to perform services in exchange for receiving the scholarship.
    - **Exception to the Exception**: Tuition waivers for student employees and teaching and research assistants.

Exclusion Provisions

3.5 Education-Related Exclusions

2. **529 Plans/Education Savings Accounts**

- Taxpayers are allowed to exclude from gross income earnings on investments in qualified education plans such as <u>529 plans</u> and <u>Coverdell education savings accounts</u> as long as they use the earnings to pay for qualifying educational expenditures.

Exclusion Provisions

3.5 Education-Related Exclusions

3. **Series EE Saving Bonds**

- Taxpayers can elect to exclude interest earned on Series EE savings bonds when the redemption proceeds are used to pay qualified higher education expenses
- The exclusion of interest on Series EE savings bonds is restricted to taxpayers with modified AGI below specific limits.

Exclusion Provisions

3.6 Gift and Inheritances

Exclusion Provisions

3.6 Gift and Inheritances

- Individuals may receive property as gifts or from a decedent's estate (an inheritance).
- While the receipt of property is most certainly real income to the recipient, the value of gifts and inheritances are excluded from gross income because these transfers are subject to the Federal Gift and Estate tax.

Exclusion Provisions

3.7 Life Insurance Proceeds

Exclusion Provisions

3.7 <u>Life Insurance Proceeds</u>

1. **Exclusion:**

- Amounts received <u>due to the death</u> of the insured are excluded from the income of the recipient.
- Similar to inheritances, life insurance proceeds are typically subject to the Federal Estate tax. (Not in Puerto Rico)
- Exclusion available for accelerated death benefits in certain circumstances.

Exclusion Provisions

3.7 Life Insurance Proceeds

2. **Taxable:**
   a. If the proceeds are paid over a period of time rather than in a lump sum, a portion of the payments represents interest and must be included in gross income.
   b. Exclusion generally does not apply when
      - a life insurance policy is transferred to another party for valuable consideration, or
      - taxpayer cancels life insurance contract and receives proceeds in excess of previous premiums paid.

Exclusion Provisions

3.8 Foreign Earned Income

Exclusion Provisions

3.8 Foreign Earned Income

- U.S. citizens are subject to tax on all income whether it is generated in the United States or in foreign countries.
- Because most foreign countries also impose tax on income earned within their borders, U.S. citizens could be subject to both U.S. and foreign taxation on income earned abroad.
- To provide relief from this potential double taxation, Congress allows taxpayers to exclude foreign-earned income (personal services performed) up to an annual maximum amount.

Exclusion Provisions

3.8 <u>Foreign Earned Income</u>

1. **Exclusion of Foreign Earned Income**

- A maximum of $101,300 (2016) of <u>foreign earned income</u> can be excluded from gross income for qualifying individuals. **<u>Computed on a daily basis</u>**.
- To be eligible for the foreign earned income and housing exclusions, the taxpayer must have her tax home in a foreign country and
  1. be considered a resident of the foreign country, or
  2. live in the foreign country for 330 days in a consecutive 12-month period.

Exclusion Provisions

Example 12

- Courtney is considering a transfer to EWD's overseas affiliate where she will be paid \$120,000 next year for 340 days in residence.

How much of the expected \$120,000 salary can Courtney exclude?

Exclusion Provisions

Example 12

How much of the expected $120,000 salary can Courtney exclude?

$94,104 [$101,300 full exclusion × 340/365 (days in foreign country/days in year)].

Exclusion Provisions

3.8 <u>Foreign Earned Income</u>

2. **Exclusion of Foreign Housing**

- **Rule**: Taxpayers meeting the requirements for the foreign-earned income exclusion may also exclude from income reasonable housing costs (provided by an employer) that exceed 16% of the statutory foreign-earned income exclusion amount for the year, or $16,208 in 2016 (16% x $101,300 = $16,208).
- **Exclusion**: The exclusion is limited to a maximum of $14,182 in 2016.

Exclusion Provisions

Example 13

- Assume that Courtney is considering a transfer to EWD's overseas affiliate. EWD will also pay for her housing while overseas ($25,000).

How much of the $25,000 housing payments may Courtney exclude?

Exclusion Provisions

Example 13:

How much of the $25,000 housing payments may Courtney exclude?

Housing payment	$25,000
Taxable ($101,300 x 16%)	16,208
Nontaxable (**exclusion**)	$ **8,792**

The exclusion does not exceed $14,122.

Exclusion Provisions

3.8 Foreign Earned Income

- Rather than claim this exclusion, taxpayers may deduct foreign taxes paid as itemized deductions or they may claim the foreign tax credit for foreign taxes paid on their foreign-earned income.
- Taxpayers who elect to use the exclusion may revoke the election for later years and use the foreign tax credit or deduct foreign taxes paid. **However**, once a taxpayer revokes the exclusion election, she may not reelect to use the exclusion before the sixth tax year after the tax year the revocation was made.

Exclusion Provisions

3.9 <u>Sickness and Injury</u>

Exclusion Provisions

3.9 Sickness and Injury

- Several exclusion provisions apply to taxpayers who are sick or injured to reflect their inability to pay the tax and facilitate recovery.

Exclusion Provisions

3.9 Sickness and Injury

1. **Payments Associated with Personal Injury**
   - Awards that relate to physical injury or sickness or are payments for the medical costs of treating emotional distress are excluded from gross income.
   - Other payments including punitive damages are fully **taxable**.

Exclusion Provisions

3.9 Sickness and Injury

2. **Health care reimbursement:** Reimbursements by health and accident insurance policies for medical expenses paid by the taxpayer are excluded from gross income.

Exclusion Provisions

3.9 Sickness and Injury

3. **Disability insurance**
   - Also called wage replacement insurance.
   - Pays the insured individual for wages lost when the individual misses work due to injury or disability.
   - If an individual purchases disability insurance directly, any disability benefits are excluded from gross income,
   - If the individual's employer purchases the disability insurance and the individual excludes the benefit from her compensation, then disability benefits are **taxable**.

Exclusion Provisions

3.9 <u>Sickness and Injury</u>

4. **Workers' compensation:** Payments from workers' compensation plans are excluded from gross income.

Exclusion Provisions

3.10 Deferral Provisions

Exclusion Provisions

3.10 Deferral Provisions

- Allow taxpayers to defer (but not permanently exclude) the recognition of certain types of realized income.
- Transactions generating deferred income include
  1. installment sales.
  2. like-kind exchanges.
  3. involuntary conversions, and
  4. contributions to non-Roth qualified retirement accounts.