

Chapter 3

Determining gross income

Key concepts

- Taxable income is the base against which tax rates are applied to compute the taxpayer's tax liability. Taxable income is gross income less allowable deductions.
- There are many differences between income for tax purposes and income for financial accounting purposes because they have different goals.
- All forms of income must be included in gross income unless they are specifically excluded. For various social, economic, and political reasons, certain items are excluded from gross income and thus not subject to income tax.
- Under the return of capital principle, a taxpayer's investment (basis) can be recovered tax-free; that is, excluded from gross income.

1. What is income?

All income from whatever source derived.

No income is recognized until it is realized.

There are many exclusions.

a. Taxable versus gross income

The IRC applies uniformly, regardless of whether a TP is a business or individual.

b. Tax versus financial accounting

Goals of financial accounting and tax reporting are very different.

Financial accounting relies on conservatism, which understates income when uncertainty exists.

Financial accounting often relies on estimates and probabilities.

Differences may be timing differences and temporary OR

Differences may be permanent.

Deferred tax assets or deferred tax liabilities

c. Return of capital principle

Gross income excludes the return of capital, cost recovery.

If TP receives an amount through a loan, TP does not have income.

2. When is income recognized?

Marginal tax rate may change.

Tax law may change.

Time value of money makes TP want income taxed in a later year and expenses deductible in an earlier year.

a. The tax year

Calendar

Fiscal

Once a tax year is established, it cannot be changed without IRS approval.

May result in a short tax year and return.

b. Accounting methods for reporting income must clearly reflect income

Cash method

Doctrine of constructive receipt- must recognize income when it is credited to your account, set apart, or made available in some other way. Income is not constructively received if (1) TP is not yet entitled to the income, (2) Payer has insufficient funds, or (3) There are substantial limitations or restrictions placed on actual receipt.

If a business carries inventory, must use accrual method to account for sales and purchases. The hybrid allows the accrual method to be used for inventory sales and COGS and the cash method for other income and expenses.

Businesses with average annual gross receipts of \$10M or less can account for the cost of inventory at year-end as an asset but are permitted to account for their sales on the cash basis. The business is allowed to defer income recognition until payment is received.

A corporation with average annual gross receipts of more than \$5M is prohibited from using the pure cash method for tax purposes. PSC can use the cash method.

Accrual method

Income is earned when all events have occurred that establish the right to the income and the income amount can be determined with reasonable accuracy (the all events test).

Claim of right doctrine requires a TP to recognize income when payment is received as long as the TP's use of the money is unrestricted, regardless of whether the money may have to be repaid later. If TP must return the income later, a deduction is allowed in the repayment year.

Wherewithal to pay- TP should be taxed on income at the time they are able to pay. So, prepaid rent, royalties and interest are taxed when received. Accrual basis TPs may defer recognition of some prepaid items. Recognition of deposits for the purchase of goods generally can be deferred if the TPs method used to account for the sale is the same for both accounting and tax purposes. Prepayments for services are deferred if the services will be performed by the end of the tax year following the prepayment year.

Installment method allows gain (does not apply to losses) to be recognized as proceeds are received rather than recognizing the entire gain in year of sale.

Cannot be used for the sale of inventory, personal property regularly sold on the installment plan, depreciable property between a taxpayer and a controlled entity, and the sale of stock or securities traded on an established stock market.

Installment method cannot be used for financial accounting.

Mandatory unless TP elects not to use it by reporting the entire gain in year of sale.

Long-term contracts

Completed contract method-no income is recognized or deductions taken, until the contract is complete. Can only be used for certain home construction contracts and construction contracts that will be completed within a two-year period by a TP whose average annual gross receipts do not exceed \$10,000,000.

Percentage-of-completion-income is recognized each year the contract progresses.

3. Who recognizes income?

Assignment of income doctrine (fruit and tree) involves the transfer of rights from one party to another.

Community property laws

The filing of joint returns by a married couple allows spouses to be taxed as if each earned half of the couple's combined income.

4. Sources of income

Interest

Interest on state and local bonds is excluded from federal income tax. Any G/L on the sale of such bonds is included.

Zero coupon bonds pay interest only at maturity.

Private activity bonds are obligations issued by a governmental unit that fund private business activities. Interest on certain PABs is taxable. Ex. Bonds issued to finance an industrial development project that will be leased to private enterprises.

Original issue discount bonds

1. Original issue discount bonds- Section 1272

OID is the excess of stated maturity value over the issue price.

OID bonds are issued at a price below the stated maturity value.

OID bonds pay interest at maturity.

Both cash and accrual taxpayers must recognize the OID as it accrues.

Exceptions

OID is zero for relatively small discounts; that is, discounts that are less than 1/4% times the # of full years to maturity.

OID can be deferred until received on any debt instrument if its maturity date is one year or less from the date of issue.

Series E and EE US government bonds. TP is not required to report interest until bonds mature. TP may elect to report the interest income on an annual basis. If you make this election, the OID on similar government bonds purchased in the future must also be amortized.

Series E and EE can be exchanged for HH to continue to postpone the recognition of income until maturity.

Series EE bond interest is excluded if parents use the bond proceeds to pay tuition and fees of qualified higher education.

Exclusion is phased out @ MAGI \$59,850(single) and \$89,750(MFJ).

Completely phased out at \$74,850 and \$119,750.

To be eligible for the exclusion, the TP must be at least 24 years old when the bonds are issued.

2. Market discount bonds- You buy issued bonds at a price below maturity after issue. TP usually waits until redemption to recognize income. Income is ordinary and recognized when bonds are redeemed.

Face \$50,000

Your cost \$46,000

3. Below market rate and interest free loans/ BETWEEN RELATED PARTIES

Interest must be imputed at the federal rate.

Gift loans

Employment-related loans/compensation and deductions

Corporation-stockholder loans/ dividend income and no deduction

Gift loan exceptions

Loans of \$10,000 or less are exempt from imputed interest rates.

Gift loans of \$100,000 or less

Imputed interest on loan cannot exceed the borrower's net investment income for the year.

Further, if borrower's NII for the year does not exceed \$1000, the imputed interest is deemed to be zero and the loan has no effect.

So, gift loans that do not produce much income for the borrower or loans that are used for personal expenses escape imputed interest rules.

Problem #28

Problem #29

Dividend income can be received as cash, property or stock.

The 2003 Tax Act reduced the tax rates for most corporate dividends to the same tax rates as long-term capital gains (15/5 % rates) for individuals. Prior to this change, dividend income was taxed as ordinary income.

If DI is used in a dividend reinvestment option plan, TP has TI now.

Dividends that credit unions and savings and loan associations pay on deposits are actually interest.

Mutual funds pay dividends from the gains they realize on sale of investment assets. These dividends are actually capital gain distributions.

Simple common stock dividends that are paid on a common stock investment are generally nontaxable. A split is a stock dividend. The SH realizes no increase in wealth from a stock dividend or split. Allocate basis across all shares.

If some common SHs receive stock and others receive cash, both dividends are taxable.

Annuity income

Investment in annuity contract

Expected return from the contract X Annuity received = Nontaxable portion

If the annuitant lives longer than expected and recovers her full investment before death, additional payments are all GI. If the annuitant dies prematurely, the unrecovered cost is deductible on the annuitant's final tax return.

Transfers from others

Prizes and awards are included in GI.

Government transfer payments

Need-based payments are excluded from GI, welfare, school lunches, and food stamps.

Unemployment comp is taxable.

Social security benefits

Since 1993, as much as 85% of an individual's SS benefits received may be included in income.

Single individuals with less than \$25,000 and married couples with less than \$32,000 MAGI are not taxed on any SS benefits.

Single individuals with MAGI between \$25,000 and \$34,000 and married couples with between \$32,000 and \$44,000 may be taxed on up to 50% of SS benefits.

Single with more than \$34,000 and married with more than \$44,000 of MAGI may be taxed on up to 85% of benefits.

MAGI includes tax-exempt interest income and one-half SS benefits. These are added to AGI.

Legal settlements

Awards for lost business income are taxable.

Awards for injury to reputation are taxable.

Recoveries for damages to property are included to extent they exceed the basis.

Compensatory damages for physical injury are excluded.

Punitive damages are included.

Damages for emotional distress are included (except for amounts paid for medical care).

Worker's comp is excluded.

Divorce

Property settlements are nontaxable. Basis stays the same.

Alimony is taxable to the recipient and a deduction FOR by the person who pays it.

Child support is not taxable to the recipient and not deductible by the person who pays it.

Discharge of indebtedness

No GI is recognized when a TP borrows money.

If TP repays the debt with appreciated property, TP has income.

Forgiveness of debt is income.

Tax benefit rule

If a TP claims a deduction for an item in one year and in a later year recovers all or part of the amount deducted, the recovery is included in income in the year received. The amount that is included in income is limited to the extent of tax benefit received by the deduction.

5. Exclusions

Gifts and inheritances are excluded from GI of the TP who receives them.

Life insurance proceeds paid because of insured's death are excluded.

Cash surrender value is the investment element of life insurance. Inside buildup is not TI unless the TP liquidates the policy and the CSV exceeds the total premiums paid.

Accident and health insurance benefits received by individuals themselves, spouses, or dependents are excluded from GI.

If employer pays premiums for disability insurance, all payments are taxable. If employee pays, none are taxable. If employer and employee share the cost, a ratable portion equivalent to the employer's contribution is GI to employee.

Scholarships for tuition, fees, books and similar educational expenses are not taxable. If the scholarship covers personal living expenses this portion is TI. Any grant received for services is taxable.

Other exclusions

Leasehold improvements

Fringe benefits provided by an employer

\$250,000/\$500,000 gain on sale of principal residence

6. Jurisdictional issues

International

Taxpayers subject to U.S. taxation

State and local taxation