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KEY INCOME TAX CONCEPTS

This is a follow-up to last month's issue in which we discussed the general sources of the federal income tax law, and provided an overview of the court system. In this issue, I will focus on some of the key concepts of income tax planning.

I find practitioners – particularly life insurance professionals who have not taken the CLU, ChFC, or CFP courses – often come to the wrong tax conclusion(s) or predict the wrong outcome of a tax-related transaction. They either fail to fully understand the basic income tax principles, or they simply overlook, or are unaware of, the potential (and mostly negative) tax implications that may be caused by the inter-related sections of the Code. Therefore, I'm going to cover a few of what I consider the most important and relevant income tax theories and principles.

Please keep in mind that in a relatively short commentary, we cannot delve into all the details, nor can we cover many important issues that will not be discussed here.

DEFINITION OF "INCOME" FOR TAX PURPOSES

The starting point in understanding income tax law is: What constitutes gross income? (Unfortunately, this is a concept which promoters of scams, schemes, and too-good-to-be-true dreams too often ignore or, at best, gloss over.)

A taxpayer's gross income is,

"all income from whatever source derived."

The key word is ALL. The scope of that single phrase is deliberately wide and all encompassing. Gross income includes – but is definitely NOT limited to – 15 specifically enumerated items:

- Compensation for services, including fees, commissions, fringe benefits, and similar items,
- Gross income derived from business,
- Gains derived from dealings in property,
- Interest,
- Rents,
- Royalties,
- Dividends,
- Alimony and separate maintenance payments,
- Annuities,
- Income from life insurance and endowment contracts,
- Pensions,
- Income from discharge of indebtedness,
- Distributive share of partnership gross income,
- Income in respect of a decedent, and
- Income from an interest in an estate or trust.

Think of it this way: Consider **any** item of income (whether derived from labor or capital) received by a taxpayer is includible in gross income – **unless** there is a **specific** provision of the Code that allows it to be excluded!

INCOME OR CAPITAL?

The distinction between income and capital is very important in tax law. Income is subject to taxation at ordinary income tax rates. On the other hand, capital, a return of a taxpayer's capital (basis) is not subject to income taxation. Although the difference at first glance appears to be obvious, in some cases, it most assuredly is not.

If a person buys 100 shares of stock for $90 a share and later sells that same stock for $90 a share, the proceeds of the sale constitute merely a return of this taxpayer's investment (his/her basis). So the money received, a return of capital, is not includible in gross income.

Conversely, if the stock were to be sold for $130 a share, the $40 per share difference between the amount invested and the amount received would be includible in gross income, and taxable at a capital gain rate – if held for the requisite period of time.

The return of money loaned is not income. Therefore, the repayment of a debt is not taxable to the lender – to the extent it is a recovery of principal. Of course, any interest received in addition to the principal would be taxable to the creditor-lender – at ordinary income rates.

REALIZATION OF INCOME

Even gross income is not reportable – unless and until it is "realized." Realization of income is the result of a "taxable event" or a triggering occurrence that marks the time when income becomes taxable. Typically, the taxable event is a disposition of the property in question through a sale or exchange, or a receipt of salary, or a measurable economic benefit.

A mere increase in value does not result in a taxation of gain. So the fact that a house or a stock or land goes up in value will not, by itself, be considered a taxable event – no matter how much appreciation occurs. There must be a disposition of ownership and control; and in the case of a cash-basis method of tax accounting there must be an actual or constructive receipt (explained below) of the proceeds for it to be reportable income.

Note that numerous provisions in the Code defer or even eliminate the taxation of specified types of realized income. The two most familiar provisions to financial service professionals are Section 1035 which defers taxation of like-kind exchanges of certain insurance products, and Section 101 which eliminates the income tax on the death proceeds of life insurance regardless of the amount or identity of the beneficiary (barring violation of the transfer for value rule).

REALIZATION OF "INVISIBLE" INCOME

Because of the broad definition of "gross income," planners should be aware that certain transactions trigger a totally unexpected and unwelcome income tax liability. For instance, income is realized if a creditor lends money (e.g., to finance life insurance premiums) but at some point for some reason discharges the debtor of the legal obligation to repay that debt. Generally, that release of liability results to the debtor in what is called "income from discharge of indebtedness." Why does that trigger taxable income? Because the debtor has received (albeit indirectly) a real and measurable monetary benefit; he or she or it no longer is legally bound to repay money borrowed under a binding obligation to repay.

Of course, if the forgiveness of indebtedness is considered a gift, for example, if a mother forgives her daughter's debt, the event will not result in income taxation to the daughter, but it may result in a gift tax liability to the mother.

Speaking of gifts, there are dozens of cases in which the taxpayers argued that the payments received were gifts, while the IRS argued that they were payments for personal services. The IRS and the Courts will examine the facts of each case to ascertain whether or not a given transfer or payment is a gift.

The essential elements of a gift (for gift tax purposes) are:

1. A donor legally competent to make a gift,
2. A clear and unmistakable intent on the donor's part to make a gift,
3. A donee legally capable of receiving the gift,
4. A transfer in a form sufficient to vest legal title to the property in the donee,
5. A delivery to the donee that evidences the donor's surrender (i.e., relinquishment) of dominion and control over the property.

For federal income tax purposes, the single most important of these five factors is the donor's motive (intent). The intent of the donor or transferor is instrumental in the determination of whether the payment in question constitutes a gift.

Of course, if the parties' characterization of the payment is not determinative, then an objective inquiry must be made. To prove a "transfer" is a gift, there must be a showing that the payment was made out of affection, respect, admiration, charity, or like impulses – rather than the "constraining force of any moral or legal duty" or from the "incentive of anticipated benefit."
Beware: Income may be reportable even through the taxpayer does not have physical possession of it (see the discussions of constructive receipt and the economic benefit theory below). And income does not have to be received in cash, nor does a check or other physical transfer have to take place for a taxable event and tax liability to occur.

If income is received in a form other than cash, generally the taxpayer must treat as income the fair market value (FMV) of the property received. For instance, if I barter a gold ingot for a new Canon camera, or if I perform legal services for my plumber in return for his fixing my heater (clearly his time is more valuable than mine in terms of the rate of normal hourly billing), both parties have received "income" (in the tax sense) equal to the value of the services each received.

This realization of "invisible" income was what occurred with respect to equity and reverse split-dollar arrangements, when one party was enriching another. Since the benefit (or enrichment) from the arrangement was not a gift, there was a taxable event whenever the legal right to the shifted wealth occurred (even though the recipient-taxpayer did not actually receive cash or a check, and did not withdraw anything from the policy he/she/it owned). One party (the employer) was enriching the other (the employee) through the life insurance policy owned by the employee or his/her trust.

THE DOCTRINE OF CONSTRUCTIVE RECEIPT

There are two ways taxpayers account for income. The less common is called "accrual" basis accounting, which is used most often in a trade or business. Under the accrual method, income must be reported in the tax period during which it is earned – even if it is not actually received until much later.

But the more common method is the "cash" basis method, whereby income is reported only in the tax period during which it is received. Almost all taxpayers other than trades or businesses (and even a lot of them) use the cash basis method of accounting.

What does all of this have to do with the doctrine of constructive receipt? A lot. Under the cash basis method of accounting, a taxpayer does not normally report income until it is received. But the constructive receipt doctrine is an exception to that rule. Under this doctrine, even though a cash basis taxpayer does not have actual receipt (i.e. has not reduced the income to his or her possession), if it is "constructively" received, it is currently taxable. This makes a cash basis taxpayer taxable on income at the earlier of two events: the actual receipt of income or its constructive receipt.

Formally, the doctrine of constructive receipt provides that, even though income has not actually been reduced to a taxpayer's possession, it is constructively (i.e. deemed to have been) received in the taxable year in which it is (think CSO):

1. credited to the taxpayer's account, or
2. set apart for the taxpayer, or
3. otherwise made available for the taxpayer to withdraw at any time.

Think of this as the "Can I get it when I want it?" doctrine. When only a taxpayer's volition stands between the income and the taxpayer's hands, it is considered constructively received. So income credited to a taxpayer's bank account is taxable, whether or not he/she actually chooses to take it.

The reason for the constructive receipt rule is obvious: were there no such rule, the taxpayer could arbitrarily and unilaterally decide the tax year when an item of income would be "received" for income tax purposes. By merely postponing the actual taking of income, a cash basis taxpayer could engineer the reporting of income to lower tax bracket years.

The rule prevents this ability to "turn your back on income" and select the year in which to report it. Returning to our bank account example, the rule blocks a taxpayer from deferring realization of interest income earned in December of a given year until a later year by merely deciding not to walk into the bank and taking his/her money.

There is, however, an important condition. Income is not constructively received if the taxpayer's control of its receipt is subject to "substantial" limitations or restrictions. An example of a substantial limitation would be if the contract under which a taxpayer works stipulates that the service must be completed to the satisfaction of the other party this year, but no payment will be made until the following year. In other words, if a taxpayer has no legal right to money in a given year, or is contractually barred from payment until a later year, the doctrine of constructive receipt cannot be applied to cause taxation in a year prior to the actual receipt of income. So if Jo-Ann, a cash basis taxpayer, is awarded a bonus in December but it is not paid until February of the following year, she is not deemed to be in constructive receipt of the bonus in the year when it was awarded.

The constructive receipt doctrine often raises the questions of what is a limitation or restriction, and whether or not that limitation or restriction is "substantial" enough so as to render the doctrine inapplicable. Typically, the courts will examine all the facts and circumstances before answering these questions on a case-by-case basis.

THE ECONOMIC BENEFIT THEORY

I started the discussion of key income tax fundamentals by stating that the definition of gross income is exceptionally broad, and it includes "all income, from whatever source (and in whatever form) derived" (emphasis added). And, all income is taxable – absent a specific provision in the Code to the contrary.

In fact, this language has been construed so broadly that any economic or financial benefit conferred by an employer on an employee as compensation is taxable – regardless of the form or mode by which that benefit/enrichment is conferred. This is called the economic benefit theory, under which an employee must include in income any compensation (regardless of its form) including a payment in kind, or where the employer makes available to the employee the equivalent of cash, or money, or money's worth.

Note that this is a major step beyond the constructive receipt doctrine. There, an individual becomes taxable when he/she can choose to "take it or leave it." (The question with respect to constructive receipt is, "Can he have it when HE wants it?") Here, income is currently taxable – even if the employee cannot reach out and touch (and take) the income! The economic benefit theory requires current taxation of income at the first moment the employee receives from his/her employer the "equivalent of cash," that is, something with a current, real, and measurable value.

Two common examples of where the economic benefit theory can be found are group life insurance and life insurance inside a qualified retirement plan. Another is the income taxation of split-dollar life insurance. In all three instances, the employee is currently taxed on the value of the economic benefit provided by his or her employer. What is taxable is the current insurance protection made available to the employee by the employer. The value of this benefit is measured by what once was called P.S. 58 rates and is now called Table 2001 rates in the case of life insurance inside a qualified pension or profit-sharing plan. Likewise, Table 2001 rates are used for endorsement and certain non-equity collateral assignment split dollar arrangements.

The current group term life insurance protection taxable to the employee is measured by Table I rates. In each case, the employee is deemed to have received a benefit measured by the premium necessary to provide the net insurance protection at his/her attained age.

THE ASSIGNMENT OF INCOME DOCTRINE

The last fundamental principal we will cover here (but certainly not the only ones used by the IRS and the Courts) is the assignment of income doctrine. It basically says, income is taxable to the earner or owner, and therefore the taxpayer whose personal efforts generate income is taxable on that income, as is the owner of property taxable on any income that property produces. (If you own the "tree," you are taxable on its "fruit.")

Again, the reason the rule exists is obvious: were there no assignment of income doctrine, it would be easy for a taxpayer to shift the taxation of income he/she earned to a family member in a lower income tax bracket – merely by assigning it to that person. So the assignment of income doctrine addresses the question of, "To whom is income taxable?"

The operation of the assignment of income doctrine is relatively simple. Income generated by the performance of services is taxed to the performer. Income generated by property is taxed to the owner of the property. So even if an executive directs his company or employer to pay his salary to his 16-year-old daughter and it does so, the executive (who worked for the money) and not the daughter (who received and cashed the check) will be taxable. And even if a wealthy woman tells her stockbroker to pay dividends on stock she owns to her son, the mother (as owner of the income-producing property) and not the son will be taxable.

It is not possible to shift taxation of income received for performance of services to another taxpayer. However, it is possible to shift the earnings on property to another taxpayer – by making a timely (before the income is generated) and bona fide transfer (by gift or by sale) of the property. Therefore, if the mother in the example above had given her son the stock last year, any income it earns after the gift will be taxed to the son rather than to her. This requires a real relinquishment of dominion and control over the property (stock) by the transferor (mother).

CONCLUSION

A strong working knowledge as well as understanding of the operation of the fundamentals and key principles, theories, and doctrines of federal income tax law is essential in financial, wealth management/transfer, employee benefit, retirement, and charitable planning. Gaining the requisite knowledge and keeping current as to tax law changes, court decisions and IRS rulings, et cetera, are particularly important in gauging both the practical and legal viability of new concepts or planning techniques, and innovative product applications in the sophisticated markets.