Taxation of Individuals and Business Entities (2020 ed.)

Chapters 4 & 5.

Filing Status.

Gross Income.

5-1

1

Learning Objectives

1. Determine a taxpayer’s filing status.
2. Apply the concept of realization.
3. Discuss the distinctions between the various sources of income, including income from services and property.

5-2

2

Filing Status (1 of 6)

- Each year, determine which one of the different filing statuses to use:
  Married filing jointly (MFJ)
    - Qualifying widow or widower (i.e., Surviving Spouse)
  Married filing separately (MFS)
  Single
  Head of household (HoH)

Filing Status (2 of 6)

- Married filing jointly
  - Must be married as of the last day of the year (Dec. 31)
    - If one spouse dies, the surviving spouse is considered to be married to decedent spouse at year end.
      - Exception – The surviving spouse remarries before year's end
  - Generally, both spouses are liable for any tax owed (called "joint and several liability" for tax)

Filing Status (3 of 6)

- Qualifying widow or widower
  - Available for the two years following the year of spouse's death
  - Surviving spouse does not qualify if remarries during two-year period.
  - Surviving spouse must maintain household for dependent child.
- Single
  - Unmarried on December 31 unless qualify for Head of Household

Filing Status (4 of 6)

- Married filing separately (MFS)
  - Taxpayers are married but file two Separate tax returns.
    - Typically not beneficial from tax perspective
      - Because total tax on two MFS returns is almost always ≥ one MFJ return's total tax
    - May be beneficial for non-tax reasons
      - Not liable for spouse's tax Owed

Filing Status (5 of 6)

- Head of household
  - 1) Unmarried at end of year
  - Not a qualifying widow or widower
  - Pay more than half the costs of keeping up a home during year for themselves (taxpayer)…
  - And a Qualifying Child or Relative lived in taxpayer’s home for more than half of the year
    - If parent(s), does not have to live in taxpayer’s home
    - Must be related…unrelated person living in taxpayer’s home does not qualify taxpayer for HoH status

Filing Status (6 of 6)

Head of household (continued)

- 2) Married individuals meeting qualifications of being an abandoned spouse which is if individual
  - Is married at end of year (or is not legally separated from the other spouse)
  - Does not file a joint tax return with the other spouse
  - Pays > ½ the cost of maintaining a household that serves as principal home for a qualifying child for more than half the year
  - Lived permanently apart from the other spouse for the last six months of the year

Filing Status Example (1)

Same facts as earlier except assume that last year Rodney passed away, and during the current year Anita did not remarry but maintained a household for Braxton and Tara, her dependent children. Under these circumstances, what would Anita’s filing status be?

a) Qualifying widow

b) Head of Household

c) Single

Filing Status Example Solution (1)

Answer: _________________ (which is the ________________________________)

Filing Status Example (2)

Back to original facts except assume Rodney and Anita divorced last year. During the current year, Braxton (age 12) lives with Anita and Anita pays all the costs of maintaining the household for herself and Braxton. Under these circumstances, what is Anita's filing status for the current year?

a) Head of Household

b) Single

Filing Status Example Solution (2)

Answer: ___________________(She is ________and pays more than half the cost of ___________________________________)

Filing Status Example (3)

Back to original facts except assume Rodney and Anita divorced last year. Rodney paid more than half the costs of maintaining a separate apartment that is the principal residence of his mother, whose gross income is $1,500. Because Rodney provided more than half of his mother’s support during the year, and because her gross income was only $1,500, she qualifies as Rodney’s dependent (i.e., as a Qualifying Relative). In these circumstances, what is Rodney’s filing status? a) Head of Household; b) Single

Filing Status Example Solution (3)

Answer: ____________________. Rodney paid more than half the costs of maintaining a separate household that is the principal home for his mother, _________________

_____________________________.

Realization and Recognition of Income

- **Gross Income**
  - Taxpayers report income that is both realized and recognized 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.

What Is Included in Gross Income? (1 of 2)

- Definition of gross income for tax purposes
  - §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"
- Taxpayers recognize gross income when:
  1) They receive an economic benefit
  2) They realize the income, and
  3) The tax law does not provide for exclusion or deferral.

What Is Included in Gross Income? (2 of 2)

- **Economic Benefit**
  - Borrowed funds represent a liability, not gross income.
- **Realization Principle**
  - Taxpayer engages in a transaction with another party result in a change in property rights.
- **Recognition**
  - Realized income is assumed to be recognized absent a deferral or exclusion provision.

Other Income Concepts (1 of 2)

- Return of capital principle
  - The cost of an asset is called **tax basis**.
  - 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.
  - Example: Lilly stock purchased for $600. It is sold later for $800. $600 is return of capital (i.e., *not* income). $200 is gain income.

Other Income Concepts (2 of 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.
    - Not common. Just be aware of this rule.

When to Recognize Income (1 of 2)

- Individual taxpayers file tax returns for a calendar-year period.
- Corporations often use a fiscal year-end.
- The method of accounting generally determines the calendar year in which realized income is recognized and included in gross income.

When to Recognize Income (2 of 2)

- Accounting Methods
  - Corporations: generally, Accrual method
  - Individuals: Cash method
- Constructive Receipt
  - Taxpayer must realize and recognize income when it is actually or constructively received.
    - Constructive receipt is deemed to occur when the income is credited to the taxpayer's account

Who Recognizes the Income? (1 of 2)

- 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

Who Recognizes the Income? (2 of 2)

- **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.

Types of Income (1 of 11)

- Income from services (earned income)
  - Income from labor (most common source of gross income)
  - Generated by the efforts of taxpayer
- Income from property (unearned income)
  - Includes gains or losses from sale of property, dividends, interests, rents, royalties, and annuities

Types of Income (2 of 11)

- **Annuities**
  - An investment that pays a stream of equal payments over time
  - The tax law generally deems a portion of each annuity payment as a nontaxable return of capital and the remainder as income.
  - Taxpayers use the annuity exclusion ratio to determine the return of capital (nontaxable) portion of each payment.

    Annuity exclusion ratio = original investment / expected value of the annuity

Types of Income (3 of 11)

- For annuities with a fixed term, the expected value is the number of payments times the payment amount.
  - 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?
  - Answer: $3,400 because the exclusion ratio is $99,000/$150,000 or 66 percent.
- For annuities over a life, taxpayers must use IRS tables to determine the expected value based upon the taxpayer’s life expectancy.

Types of Income (4 of 11)

- **Property Dispositions**
  - Taxpayers 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:

$$\begin{array}{l} \text{Sales proceeds} \\ \underline{\text{Less : Selling expenses}} \\ = \text{Amount realized} \\ \underline{\text{Less : Basis (investment) in property sold}} \\ = \text{Gain (Loss) on sale} \end{array}$$

Types of Income (5 of 11)

- **Income from Flow-Through Entities**
  - Individuals may invest in various business entities.
  - The legal form of the business affects how the income generated by the business is taxed.
  - If the entity is a flow-through entity, such as a partnership or S corporation, the income and deductions of the entity "flow through" (i.e., go on the owner(s) of the entity (partners or shareholders) tax return(s))

- **Other Sources of Gross Income**
  - Income other than wages or property

Example of Income from a Flow-Through Entity (6 of 11)

- Josh and Jamie are equal partners in J&J Partnership
- The business had ordinary income of $10,000 this year
- What does each report on his/her 1040 as business income?
- ANSWER: $5,000 of income (i.e., Half of $10,000).
- QUESTION: How does the answer change if each received a $3,000 cash distribution this year?
- Business income each reports = $_______. __________ ___________________________________.

Types of Income (7 of 11)

– **Prizes and Awards**
  - Excluded only if made
    1) For scientific, literary, or charitable achievement and transferred to a qualified charity
    2) For employee length of service or safety achievement ($400 tangible property limit per employee per year)
    3) To Team USA athletes from U.S. Olympic Committee on account of their competition in Olympic and Paralympic games (AGI limit applies)
  - Conclusion: Prizes and Awards are income unless they meet one of the 3 exceptions above.

Types of Income (8 of 11)

– **Social Security Benefits**

- From 0% up to 85% of Social Security benefits received could be included in income—depends on the taxpayer’s filing status, amount of Social Security benefits received, and modified AGI.
- Modified AGI is generally regular AGI (including 50 percent of Social Security benefits) plus tax-exempt interest income.

Types of Income (9 of 11)

Single taxpayers (Substitute $32,000 for $25,000 and $44,000 for $34,000 if married filing joint income tax return)

1) If modified AGI + 50% of Social Security benefits ≤ $25,000, Social Security benefits are **<u>not taxable</u>** (i.e., 0% income)
2) If $25,000 < modified AGI + 50% of Social Security benefits ≤$34,000, **taxable Social Security benefits** are the **<u>lesser</u>** of (a) 50% of the Social Security benefits or (b) 50% of (modified AGI + 50% of Social Security benefits − $25,000). (i.e., > 0% and ≤ 50% income)
3) If modified AGI + 50% of Social Security benefits > $34,000, taxable Social Security benefits are the lesser of (a) 85% of Social Security benefits or (b) 85% of (modified AGI + 50% of Social Security benefits − $34,000), plus the lesser of (1) $4,500 or (2) 50% of Social Security benefits. (i.e., >50% & ≤85% income)

Types of Income (10 of 11). How much SSBs in income?

• Interest income	15,000
• Tax-Exempt interest(from muni bonds)	5,000
• Pension income	11,000
• Social security	16,000

- Prov. Inc. = all amounts except only half of SS = 15,000 + 5,000 + 11,000 + (½ × $16,000) = $39,000
- Excess over 2nd tier (39,000 − 34,000) = 5,000 x 85% =4250
  Plus lesser of: $4,500 or 50% of social security = $4500
  $8,750
- versus 85% of social security (i.e., 85% x $16,000) = $13,600
- Conclusion: $8,750 of social security received is Income. (Note: 8,750/$16,000 = 54.7%)

Types of Income (11 of 11)

- **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.
  - To provide tax relief for insolvent taxpayers—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.

End of Presentation