

Study Unit Two

Income and Farms

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Businesses define gross income the same as individuals. Also like individuals, some business transactions do not currently recognize or indefinitely exclude recognition of income, but instead defer recognition until a later period. This study unit also covers unique aspects of self-employment income and farm income.

2.1 Gross Income

The Internal Revenue Code (IRC) defines gross income as all income from whatever source derived except as otherwise provided.

Section 61(a) enumerates types of income that constitute gross income. The list is not exhaustive.

- Compensation for services, including fees, commissions, and fringe benefits
- Gross income derived from business
- Gains derived from dealings in property
- Interest
- Rents
- Royalties
- Dividends
- 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 (income earned but not received before death)
- Income from an interest in an estate or trust

Other types of income also constitute gross income unless a statute specifically provides for their exclusion.

Business Income

Gross income includes all income from a trade or business.

- Gross income from a business that sells products or commodities is

$$\begin{array}{r}
 \textbf{Gross sales (receipts)} \\
 - \text{ Cost of goods sold} \\
 + \text{ Other gross income (e.g., rentals)} \\
 \hline
 = \text{ Gross income from the business }
 \end{array}$$

- Cost of goods sold (COGS) is essentially treated as a return of capital. A return of capital is not income for tax purposes. Typically, COGS for a tax year is

$$\begin{array}{r}
 \textbf{Beginning inventory} \\
 + \text{ Inventory purchased during year} \\
 - \text{ Year-end inventory} \\
 \hline
 = \text{ COGS }
 \end{array}$$

- COGS should be determined in accordance with the method of accounting consistently used by the business.
 - State and local sales taxes imposed on a buyer, which are required to be collected and paid to state or local governments, are not income. When a sale is completed, the amount of sales tax charged to the customer becomes a liability, or money owed.
-

Prepaid Income

Generally, amounts that are received in advance for future services are required to be included in the year of receipt. However, accrual-basis taxpayers can elect to defer recognition until the time of performance, up to the year after the payment date.

Discharge of Debt

Gross income includes **discharge (cancellation) of indebtedness** when a debt is canceled in whole or part for consideration.

- If a debtor performs services to satisfy a debt, the debtor must recognize the amount of the debt as income. However, income is not recognized from a canceled debt to the extent the payment would have been a deduction.
- If a creditor gratuitously cancels a debt, the amount forgiven is treated as a gift.

When a taxpayer excludes discharge of indebtedness, the taxpayer must reduce his or her tax attributes in the following order:

- NOLs
- General business credit
- Minimum tax credit
- Capital loss carryovers
- Basis reductions

NOTE: However, the taxpayer may first elect to decrease the basis in depreciable property.

Generally, the creditor will send the taxpayer Form 1099-C listing the amount of cancellation of debt to be reported.

Gross income **does not include** discharges that

- Occur in bankruptcy.
- Occur when the debtor is insolvent but not in bankruptcy.
 - The maximum amount that can be excluded is the amount by which liabilities exceed the FMV of assets.
- Are related to qualified farm indebtedness.
- Are related to a purchase-money debt reduction in which a seller reduces the debt and the debtor is not in bankruptcy and is not insolvent. The discharge is treated as a purchase price adjustment.

Other Taxable Income

Examples of other taxable income include the following:

- Gross income such as the **recovery of tax benefit** items in a prior year

Example 2-1 Recovery of Tax Benefit -- Bad Debt

Taxpayer writes off bad debt in Year 1. In Year 7, the debtor pays Taxpayer the principal of the debt written off, which must be included in gross income because the deduction in Year 1 reduced the tax liability.

- Amounts recovered during the tax year that did **not** provide a tax benefit in the prior year are excluded.

Example 2-2 Recovery Not Providing a Tax Benefit

Taxpayer pays state income tax in excess of the standard deduction and itemizes deductions. Subsequent refunds in excess of the applicable standard deduction must be included in gross income. However, if Taxpayer elected the standard deduction, the refund would not be included because no tax benefit from payment of state income tax was realized.

- A similar rule applies to credits.
- Prizes and awards
- Gasoline or fuel credits or refunds
- Gambling winnings (e.g., lottery and raffle winnings)
- Jury duty fees
- Income from the rental of personal property if the taxpayer engages in the activity for profit but is not in the business of renting property
- Income from an activity not engaged in for profit (e.g., hobby income)
 - Hobby-related expenses are not deductible.
- Reimbursements for items deducted in an earlier tax return (e.g., state income taxes, bad debts, and medical expenses)
- Advances of wages and commissions
 - Such advances are considered income when received.

- Supplemental wages, which are compensation paid in addition to an employee's regular wages
 - They do not include payments for travel reimbursements paid at the federal government per diem rate.
- Finance reserve income
- Scrap sales
- Cooperative patronage dividends

Assignment of Income

Gross income includes income attributable to a taxpayer even though the income is received by other taxpayers. This doctrine imposes the tax on income on those who earn it, produce the right to receive it or enjoy the benefit of it when paid, or control property that is its source.

Example 2-3 Assignment of Income

Swift, a life insurance salesperson, directs his employer to pay his commissions to his daughter. The commissions paid to Swift's daughter are gross income to Swift.

- The doctrine applies to income earned by personal services or derived from property.

Example 2-4 Assignment of Interest Income Earned on Securities

Taxpayer makes a gift of interest earned on securities to her 20-year-old daughter who attends college. The interest is gross income to Taxpayer.

- Assignment of an income-producing asset is effective to shift the gross income to the assignee.

Example 2-5 Assignment of Interest Income from Transferred Securities

Taxpayer gives the underlying securities to her 20-year-old daughter. Interest earned after the transfer is gross income to the daughter.

- Effective assignment requires that
 - The transfer of property be complete and bona fide,
 - No control is retained over either the property or the income it produces, and
 - The transfer take place before the income is actually earned.