

Gross Income from Employment

Chapter 5

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Gross Income Related to Employment

- ▶ Compensation for services is included in gross income
 - Salary
 - Wages
 - Self-employment & business income
 - Fringe benefits
 - Commissions
 - Fees
 - Tips
 - Anything received in return for services

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Foreign Earned Income

- ▶ Exclusion applies if a qualified individual has a tax home in a foreign country, and must either
 - (1) qualify as a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year (bona fide resident test) or
 - (2) qualify by being present in a foreign country or countries for at least 330 full days during any period of twelve consecutive months (physical presence test).
- ▶ Amount of Exclusion:
 - 2011 - \$92,900
 - 2012 - \$95,100

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Foreign Earned Income

- ▶ Bona fide resident
 - Intend to work there for indefinite/long-term period
 - Establish permanent quarters for self and family
- ▶ Physical Presence Test
 - 330 days in consecutive 12 months
 - Can begin on any day
 - Exemption prorated by number of days

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Foreign Earned Income Exclusion Example

Bill lives and works in France during 340 days out of the 365 days during the 2012 calendar year. He meets the physical presence test. The maximum amount of foreign earned income that he can exclude from his gross income is \$88,586 $[(340/365) \times \$95,100]$.

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Foreign Housing Costs

- ▶ Applies to housing costs considered to be paid by an employer
- ▶ Amount = total housing expenses less a base amount (16% of maximum annual exclusion)
- ▶ Cannot exceed 30% of maximum foreign earned income
- ▶ Reduces the foreign earned income exclusion by a like amount

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Exhibit 5.1

Options	Foreign Income Exclusion	Tax Credit for Foreign Taxes Paid	Deduction for Foreign Taxes Paid
Benefit	Taxpayer can exclude up to \$95,100 for 2012 of foreign earned income from gross income.	Taxpayer can claim credit for some or all of the taxes paid to the foreign country, including taxes on foreign earned income that exceeds the amount (\$95,100) of foreign earned income exclusion taken.	Taxpayer's foreign taxes paid may be deducted as an itemized deduction on Schedule A to reduce adjusted gross income.

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Fringe Benefits

- ▶ Taxable unless exception applies
- ▶ Excluded benefits must normally be offered on a non-discriminatory basis
 - If benefits available to highly-compensated (key) employees are not available for non-highly compensated employees, the benefit is discriminatory
 - May result in loss of exclusion for some or all employees

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HCE and Key Employees

- ▶ Highly Compensated Employee
 - Greater than 5% owner
 - Compensation in excess of
 - \$115,000 (2012)
- ▶ Key Employee
 - Greater than 5% owner
 - Greater than 1% owner with compensation > \$150,000
 - Officer with compensation > \$165,000 (2012)

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Employer Provided Medical Benefits

Medical Fringe Benefit	Employer	Employee
Health insurance premiums paid by employer	Deduct	Exclude
Employer contributions to a fund that provides medical benefits to employees	Deduct	Exclude
Payment of employee medical expenses ¹		
By the employer	Deduct	Exclude
By an insurance company	No Impact	Exclude
By a separate fund or trust	No Impact	Exclude
Reimbursement of employee medical expenses in the year paid by the employee		
Reimbursed by the employer	Deduct	Exclude
Reimbursed by an insurance company	No Impact	Exclude
Reimbursed by a separate fund or trust	No Impact	Exclude

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Employer Provided Medical Benefits

Medical Fringe Benefit	Employer	Employee
Reimbursement of employee medical expenses after the year paid by the employee*		
Reimbursed by the employer	Deduct	Tax Benefit Rule
Reimbursed by an insurance company	No Impact	Tax Benefit Rule
Reimbursed by a separate fund or trust	No Impact	Tax Benefit Rule

*If the employee used the standard deduction in the year paid, the reimbursement is excluded. If the employee itemizes deductions in the year paid, some or all of the reimbursement may be included in gross income based on the tax benefit rule. The tax benefit rule is discussed in Chapter 4.

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Medical Savings Accounts

- ▶ Archer Medical Savings Accounts (MSAs)
 - Established 1996-2005 by employers with 50 or fewer employees
 - Must have high-deductible health insurance plan
 - Contributions by employer and employee
 - Max 65% deductible for individual, 75% for family
 - Distributions before 65 not used for medical expenses taxable, plus a 20% penalty applies
- ▶ Health Savings Account (HSAs)
 - Available beginning in 2006
 - Can be established by employer or employee
 - Contributions by employer or employee
 - Not greater than \$3,050 (for 2012 - individuals), \$6,150 (for 2012: - family)
 - Distributions before 65 not used for medical expenses taxable, plus 20% penalty applies

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New HSA Rules (2007)

- ▶ Contribution not tied to deductible
- ▶ If eligible during last month of year, deemed eligible for entire year
- ▶ Can make a one-time, tax-free IRA distribution to fund an HSA if the owner remains eligible for 12 months
- ▶ Employer can make one-time transfer to HSA from
 - Health reimbursement arrangement
 - Flexible spending plan

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Life Insurance

- ▶ Permanent Insurance
 - Taxable to employee
- ▶ Group Term Insurance
 - Cost of up to \$50,000 death benefit excluded
 - Amounts over this are taxable to employee
 - If plan discriminates, key employees must include cost of group term insurance in income
 - Greater of table cost or actual cost to employer

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Uniform Premium Table

Age	Cost per Month
Under 25	0.05
25 through 29	0.06
30 through 34	0.08
35 through 39	0.09
40 through 44	0.10
45 through 49	0.15
50 through 54	0.23
55 through 59	0.43
60 through 64	0.66
65 through 69	1.27
70 and older	2.06

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Group Term Life Insurance Exclusion Example

- ▶ Edward's employer provides him with \$80,000 of group term life insurance for which Edward pays none of the premiums. Edward is 56 years old at the end of the year.
 - He can exclude the cost of the first \$50,000 of coverage.
 - He must include \$154.80 (30 thousand x \$0.43 per thousand per month x 12 months) in his gross income.
 - This amount is generally reported as part of the employee's W-2 income.
 - If Edward pays any amount toward the cost of the insurance coverage, the taxable amount will be reduced by the amount of the payment.

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Other Common Fringe Benefits

- ▶ Employee Death Benefits
 - Excluded if:
 - Employer has no obligation to pay
 - Facts indicate gratuitous payment
- ▶ Disability Insurance
 - Benefits Taxable – Employer pays premium
 - Benefits Excluded – Employee pays premium

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Other Common Fringe Benefits

- ▶ Cafeteria Plans
 - Employee chooses cash or benefits
 - Benefits generally excluded from income
 - Avoids constructive receipt if:
 - Benefits are qualified
 - Plan does not favor HCEs
 - Nontaxable benefits to Key Employees < 25% of nontaxable benefits provided to all employees
 - Useful when benefit needs vary
 - Help control costs; show value of benefits

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Other Common Fringe Benefits

- ▶ **Flexible Spending Accounts (FSAs)**
 - Employee election to pay for medical/dependant care costs with pre-tax dollars
 - Salary reductions also exempt from payroll tax
 - Amounts not spent are forfeited
 - Entire amount available at beginning of year
 - No recovery by employer if employee terminates employment

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Other Common Fringe Benefits

- ▶ **Long-Term Care**
 - Activities of Daily living (ADL)
 - Eating
 - Bathing
 - Dressing
 - Toileting
 - Transferring
 - Contenance
 - Pays benefits if owner cannot perform 2 or more ADLs
 - Employer Paid Premiums deductible
 - Benefits not taxable if less than \$310/day (for 2012) or the actual cost of care
 - Not available through cafeteria plan or flexible spending account

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Other Employee Fringe Benefits

- ▶ **Meals**
 - For the convenience of the employer
 - On the employer's business premises
- ▶ **Lodging**
 - Same conditions for meals, plus
 - Employee required to accept as condition of employment
- ▶ **No-Additional-Cost Services**
 - Service offered for sale to customers
 - In line of business in which employee works
 - Employer incurs no substantial cost
 - Taxable to HCEs if plan is discriminatory

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Employee Fringe Benefits – No Additional Cost Exclusion Example

Commercial Airline permits its employees to enjoy personal travel on its scheduled flights at no charge and receive reserved seating. Because Commercial Airline foregoes potential revenue by permitting the employees to reserve seats, employees receiving free flights are not eligible for the no-additional-cost exclusion and must include the value of the flight in their gross income.

However, if the employees are not allowed to reserve seats and only board the flight if there is available capacity, then employees receiving those flights are eligible for the no-additional-costs exclusion and may exclude the value of the flight from their gross income.

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Other Employee Fringe Benefits

- ▶ **Qualified Employee Discounts**
 - Excluded from income if
 - Products – no more than cost of goods
 - Services – no more than 20%
 - If plan is discriminatory, HCEs must recognize discount
- ▶ **Working Condition Fringe Benefits**
 - Employee would have been entitled to a deduction if paid personally

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Other Employee Fringe Benefits

- ▶ **De Minimis Fringe Benefits**
 - Any property or service where the value is so small as to make accounting impractical
 - Supper money
 - Employer provided eating facilities if provided on non-discriminatory basis
- ▶ **Qualified Transportation**
 - Transportation to work, transit pass, parking
 - Commuting limit: \$230 per month (for 2012)
 - Parking limit: \$125 per month (for 2012)
 - Bicycle Reimbursement: \$20 per month
 - May be discriminatory

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Other Employee Fringe Benefits

- ▶ **Qualified Moving Expense Reimbursements**
 - Excluded from income if paid by employer
 - Requirements covered in Chapter 6
- ▶ **Qualified Retirement Planning Services**
 - Excluded if employer maintains qualified plan
 - Information about the qualified plan, plus general advice and information
 - If discriminatory, HCEs must recognize income
- ▶ **Athletic Facilities (on premises)**

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Other Employee Fringe Benefits

- ▶ **Educational Assistance Programs**
 - Up to \$5,250 excluded from income per year
 - Written plan
 - Can cover tuition, fees, books, supplies, and equipment
 - Undergraduate and Graduate Education
 - May not be used for sports, games, or hobby classes
- ▶ **Dependent Care Assistance**
 - Up to \$5,000 excluded from income, but no more than earned income
 - Must allow the employee to work
 - Nondiscrimination requirements apply

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Other Employee Fringe Benefits

- ▶ **Tuition reduction granted to employees of educational institutions**
 - Generally applies to undergraduate education
 - Graduate education excluded if student performs teaching or researching activities
- ▶ **Adoption Assistance Programs**
 - Maximum exclusion is \$12,650 (for 2012)
 - Phase-out applies (\$189,710 - \$225,210 for 2012) (\$182,520 - \$222,520 for 2010)
 - Must meet nondiscrimination requirements

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Other Employee Fringe Benefits

- ▶ **Employee Achievement Awards**
 - Must be tangible personal property
 - To \$1600 or \$400 if not qualified

- ▶ **Combat Pay and Military Benefits**
 - Excluded Items
 - Combat zone pay
 - Housing and subsistence allowances
 - Death gratuity payments

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Other Employee Fringe Benefits

- ▶ **Parsonage**
 - Value of home or rental allowance furnished to minister is excluded

- ▶ **Frequent Flier Miles**
 - Announcement 2002-18
 - Frequent flyer miles and other promotional benefits (through rental car agencies or hotels) attributable to taxpayer's business that are exchanged for free travel and upgrades etc., are not currently considered income taxable.

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Income Taxation & Employer Retirement Plans

- ▶ Involves **Doctrine of Constructive Receipt**
- ▶ **Employee Deferrals**
 - Election made before income earned
 - Excluded from current income
- ▶ **Employer Contributions**
 - Excluded from employee's current income
- ▶ **Plan Earnings**
 - Tax deferred until distributions are made
- ▶ **Plan Distributions**
 - Generally taxed as ordinary income
 - Not subject to payroll taxes
 - Early distributions penalty - 10%

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Special Retirement Plan Issues

- ▶ **Roth 401(k) and 403(b)**
 - No tax deferral
 - Subject to minimum distribution rules
 - Distributions tax free if
 - Account open for 5 years
 - Made after age 59½, disability, or death

Special Retirement Plan Issues

- ▶ **Stock Options**
 - **Non-Qualified Stock Options (NQSO)**
 - Grant: no income recognition
 - Exercise: ordinary income on gain
 - **Incentive Stock Option (ISO)**
 - Grant: no income recognition
 - Exercise: no income recognition
 - LTTCG if held for 2 years from date of grant and 1 year from date of exercise

Exhibit 5.6

	NQSO	ISO
At Grant Date	If Strike Price ≥ FMV No Income Tax Consequence	No Income Tax Consequence
At Exercise Date	Ordinary (W-2) Income* = FMV - Exercise Price	No Ordinary Income AMT Preference = FMV - Strike Price
At Sale Date	Long-Term or Short-Term Capital Gain / Loss Depending on Holding Period Basis = FMV at Date of Exercise	If stock was held for 2 years from date of grant and 1 year from date of exercise: Gain = LTTCG If holding period not met, gain is treated as ordinary (W-2) income.

* This result can be changed if the taxpayer makes an election under IRC Section 83(b).

Stock Option Tax Consequence Example

June 20, 2010	Samantha granted ISO 100 shares at \$10 per share (FMV)	No income tax consequence
February 20, 2011	Samantha exercises option (FMV = \$14 per share)	No income tax consequence
July 25, 2012	Samantha sells shares for \$1,700	LTCG = \$700

If holding period requirements are not met by Samantha, then the \$700 gain is income taxable as:
 $\$400 ((\$14 - \$10) \times 100 \text{ shares}) = \text{Ordinary Income}$
 $\$300 = \text{Capital Gain}$

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Government Required Benefits

- ▶ Unemployment Compensation
 - Included in income, unless after-tax contributions made
- ▶ Workers' Compensation
 - Covers medical, rehab, lost income due to injuries and sickness
 - Benefits excluded from income
- ▶ Social Security
 - Taxation depends on income (Modified AGI)

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Social Security Taxation

- ▶ Modified AGI = AGI +
 - *Excluded Municipal Bond Interest*
 - Excluded foreign earned income and housing allowances
 - Excluded U.S. Savings Bond Interest
 - Excluded adoption assistance benefits
 - Deducted student loan interest expense
 - Excluded income from Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico
 - Deduction for domestic production activities

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Social Security Taxation

Base Amount	
50%	\$32,000 Married taxpayers filing jointly
	\$0 Married taxpayers filing separately who do not live apart for the entire year
	\$25,000 All others
Adjusted Base Amount	
85%	\$44,000 Married taxpayers filing jointly
	\$0 Married taxpayers filing separately who do not live apart for the entire year
	\$34,000 All others

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Social Security Taxable Income

- ▶ If MAGI plus one-half of Social Security benefits exceeds the relevant base amount, **but not** the adjusted base amount, then the amount of benefits included in gross income is the lesser of:
 - 50% of Social Security benefits, or
 - $50\% \times [\text{MAGI} + (50\% \times \text{Social Security benefits}) - \text{base amount}]$

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Taxable Income Does Not Exceed the Adjusted Basis Amount Example

JoAnn, an unmarried taxpayer using the single filing status, received \$15,000 of Social Security retirement benefits this year. She also received \$5,000 of interest income, \$3,000 of dividend income, and \$18,000 of income from her retirement plan during the year.

Since her MAGI (\$26,000) plus one-half of her Social Security benefits ($0.5 \times \$15,000 = \$7,500$) exceeds her base amount (\$25,000) but not her adjusted base amount (\$34,000), she must calculate her includible Social Security benefits using the previous "50% formulas."

Half of her Social Security benefits is \$7,500. The second formula yields an inclusion amount of \$4,250 [$0.5 \times (\$26,000 + \$7,500 - \$25,000)$].

She must include the lesser of the two amounts (\$4,250) in her gross income.

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Social Security Taxable Income

- ▶ If MAGI plus one-half of Social Security benefits **exceeds** the adjusted base amount, the amount of benefits included in gross income is the lesser of:
 - 85% of Social Security benefits, or
 - $85\% \times [\text{MAGI} + (50\% \times \text{Social Security benefits}) - \text{adjusted base amount}]$, *PLUS*
 - Lesser of: Amount included from "50% formulas" *OR* \$4,500 (\$6,000 for married filing jointly; \$0 for married filing separately)

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Taxable Income Exceeds the Adjusted Basis Amount Example

JoAnn, an unmarried taxpayer using the single filing status, received \$15,000 of Social Security retirement benefits this year. She also received \$5,000 of interest income and \$48,000 of income from her retirement plan during the year.

Since her MAGI (\$53,000) plus one-half of her Social Security benefits ($0.5 \times \$15,000 = \$7,500$) exceeds her adjusted base amount (\$34,000), she must calculate her includible Social Security benefits using the "85% formulas."

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Taxable Income Exceeds the Adjusted Basis Amount Example (cont.)

3. $0.85 \times \$15,000 = \$12,750$
4. $0.85 \times [\$53,000 + (0.50 \times \$15,000) - \$34,000] = \$22,525$
plus the lesser of the amount calculated using the "50% formulas."
1. $0.50 \times \$15,000 = \$7,500$
2. $0.50 \times [\$53,000 + (0.50 \times \$15,000) - \$25,000] = \$17,750$

The lesser amount is \$7,500

The formula 4 total is the lesser of \$30,025 ($\$22,525 + \$7,500$) OR \$27,025 ($\$22,525 + \$4,500$)

The lesser of the formula 3 or 4 amounts is \$12,750. Therefore, \$12,750 of the Social Security benefits must be included in JoAnn's gross income.

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Chapter Summary

- ▶ See Exhibits 5.9 and 5.10
 - Summary of Gross Income Items and
 - Summary of Exclusions from Gross Income
