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INCOME AND EXCLUSIONS FROM INCOME

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The subject assigned to me, "Income and Exclusions from Income," was outlined to include roughly those sections in the Internal Revenue Code of 1954 from 61 to 120, except those dealing with insurance, annuities, and capital contributions to corporations, which materially changed the former law as it existed in the Internal Revenue Code of 1939 as amended.

Gross Income

At the outset, probably only a few words on the general concept of income will be sufficient, leaving our major concern to those exclusions from gross income provided by the new statute. First, the concept of gross income, the beginning point in the determination of tax liability, is defined in Section 61 of the new code. While the language is somewhat similar to Section 22(a) of the old code, it is rearranged. The new Code Section 61 states, "Except as otherwise provided in this subtitle, gross income means all income, from whatever source derived, including (but not limited to) the following items." Notice the language, "income from whatever source derived" used in the new code has been lifted verbatim from the Sixteenth Amendment to the Federal Constitution. This was not the case with Section 22(a) of the old code. It would appear that whatever controversy may have existed as to whether or not the concept of gross income used in the old code, which had basicly remained unchanged since 1913, was as broad as the term "income" as used in the Sixteenth Amendment, has now been removed. It would appear that the intent of Congress in Section 61 of the new code was to make the concept of gross income, except for the statutory exclusions, as broad as constitutionally taxable income under the Sixteenth Amendment. But this somewhat theoretical change does not affect the basic concept of gross income. It is still the same dynamic concept it was under the old code, limited by the same judicial decisions and administrative rulings as to recovery of capital, severance, realization, legality, etc.

Statutory Exclusions

The material changes made by the Internal Revenue Code of 1954 are not in the basic concept of gross income itself but in the specific statutory inclusions and exclusions which the Congress has chosen on public policy grounds to include or exclude from gross income. These warrant detailed consideration.

Alimony and Separate Maintenance Payments

As you recall, the old law, Section 22(k), provided that periodic payments made under a decree of divorce or separate main-

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tenance or under a written instrument incident thereto was includable in the gross income of the wife. Installment payments discharging a part of an obligation, the principal sum of which is, in terms of money or property, specified in the decree, shall be considered periodic payments if such principal sum may be paid within a period ending more than ten years from the date of the decree. The new law makes two changes broadening this rule. First, Section 71 (a) (2) provides that where husband and wife are separated, not under a court decree, periodic payments made under a written separation agreement, executed after August 16, 1954, and based on the marital relationship, shall be income to the wife provided husband and wife do not file a joint return. The second change in Section 71 (a) (3) provides that where the wife is separated from her husand, periodic payments received by the wife after August 16, 1954, under a decree entered after March 1, 1954, requiring payments for support or maintenance, shall be includable in the gross income of the wife providing no joint return is filed. This latter provision will apparently cover all temporary alimony and support decrees granted under statute, permitting temporary support and maintenance during the divorce proceedings. It will also probably include periodic payments made under an interlocutory decree where the decree does not become final for a statutory period of time.

Payments made for support of minor children are still, as under the old law, not includable in the gross income of the wife, and the first payments made by the husband are considered to apply first toward the support of the children.

PRIZES, AWARDS AND SCHOLARSHIPS

Sections 74, 102 and 117 are related sections referring to gifts, scholarships, prizes and awards. Section 102 is a re-enactment of the exclusion of income from gifts, bequests, devises and inheritances. Sections 74 and 117 are new and to an extent qualify the gift rule. Section 74 (a) lays down the general rule that, except as provided in Section 117, gross income includes amounts received as prizes and awards. This is apparently intended to catch all commercial prizes not coming under the exception in Section 74 (b). It does not appear to require a lack of donative intent on the part of the giver, nor does it appear to require a lack of consideration, a lack of "something" passing from the receiver either to the giver or to a third party as in the *Washburn* case [1] where the Tax Court relied on the fact that the recipient had employed no capital, contributed no labor, made no wager, and did not become involved in any future obligations.

The exception to this general rule is then provided in Section 74 (b). Gross income does not include amounts received as prizes and awards given in recognition of religious, charitable, scientific,

[1] Washburn v. Commissioner, 5 TC 1333.

educational, artistic, literary, or civic achievement, but only *if* (1) the recipient was selected without any action on his part to enter the contest, *and* (2) the recipient is not required to render *substantial* future services as a condition. What constitutes *action on the recipient's part to enter the contest?* Does filing an entry blank make the prize taxable? Also, what constitutes rendering substantial future services? Is appearing on a program sufficient? Apparently either one of these acts on the part of the recipient would make the prize taxable.

Apparently this section is a partial codification of the decision of the Supreme Court of the United States in *Robertson v. United States*,[2] where the Court looked at the acceptance by the contestants of the offer tendered by the sponsor as the creation of an enforceable contract discharged by the rendering of services.

Section 116 takes out of the category of prizes, amounts received as scholarships and fellowships at educational institutions, as well as services and accommodations supplied such as room and board and amounts received and used to cover travel, research, clerical help, or equipment which are incident to such scholarship or fellowship.

If the student is a candidate for a degree at an educational institution, Section 117(b)(1) states such grants are excludable from gross income to the extent that no services are required other than those ordinarily required of all candidates for the degree.

If the student or fellow is not a candidate for a degree, Section 117(b)(2) provides no exclusion unless the grantor is a tax exempt organization under Section 501(a) or a governmental unit, and then the exclusion is limited to $300 times the number of months the grant is received up to a maximum of thirty-six months. Section 117(b)(2) on non-degree students, makes no reference as to whether services are rendered or not. Apparently, however, if services were required, the grant would be included in gross income under the general provisions on compensation.

COMPENSATION FOR INJURIES OR SICKNESS

Sections 104, 105 and 106 provide a series of changes regarding employee accident and sickness benefits. Under the old law, amounts received as accident or health benefits under employer pension plans were exempt if paid under a contract of insurance but were taxable if paid under non-insured plans. The new law places all plans financed by the employer on a parity, whether insured or self-insured.

The rule under the new law is that amounts received from an employer by an employee through accident or health insurance for personal injuries or sickness generally are taxable to the extent attributable to contributions made by the employer which were not

[2] 343 U.S. 711.

includable in the gross income of the employee or if paid directly by the employer. But then three exceptions are made which take most of the cases out of the general rule and make such payments received by the employee non-taxable. The first exception applies if received directly or indirectly by the taxpayer to reimburse him for expenses he incurred for medical care of himself, his spouse or his dependents which were not taken as a medical deduction under Section 213 for a prior year. Under the tax benefit rule, amounts deducted in a prior year for medical expenses from which a tax benefit was received must be included in the gross income of the employee in the years received. The second exception includes amounts received by the employee for loss of a member, function or disfigurement of the body and computed with reference to the nature of the injury and not in relation to the time absent from work. The third includes amounts received in lieu of wages, not exceeding $100 per week paid due to absence from work due to injuries or sickness, after the first seven calendar days of absence or the full period if the employee was hospitalized at least one day on account of such injury or sickness.

In each of these three exceptions the amounts received by the employee would be excluded from gross income, whether paid as a result of an insurance contract, direct by the employer, or under a sickness and disability fund for employees maintained under the laws of a state or territory.

Section 106 now provides by statute in broad language that gross income of the employee does not include contributions made by the employer to an accident and health plan, whether made directly to the employee or by way of insurance premiums or whether made for one or many employees. This differs considerably from the law prior to the enactment of this section when only premiums paid by the employer on group health and hospitalization policies were excluded from gross income of the employee by administrative ruling.

RENTAL VALUE OF PARSONAGE

Section 107 is an expansion of Section 22(b) (6) of the old code which provided for exclusion from gross income of the rental value of a dwelling furnished a minister of the gospel. The new code expands this to include a rental allowance paid in cash if used to rent or provide a home.

INCOME FROM DISCHARGE OF INDEBTEDNESS

Section 108 carries forward, and expands, the exception provided in the old code in Section 22(b) (9) to the rule that gain must be recognized upon the non-gratuitious discharge of indebtedness for less than its tax basis to the extent the taxpayer is solvent after the discharge. The section has no bearing on those situations coming under the *American Dental Company* decision [3] where there

[3] Helvering v. American Dental Company, 318 U.S. 322.

are direct negotiations between debtor and creditor and a gratuitous cancellation of the debt containing donative intent, lack of consideration and the other elements for a valid gift. In such cases no gain need be included in gross income. Section 108 does provide an exception for those cases coming under the *Kirby Lumber Company* rule [4] where the elements of a valid gift are not present and the debtor is solvent after the discharge. It permits the debtor to exclude the gain from gross income to the extent that he reduces the tax basis of certain property. It is based on the logical theory that where a taxpayer is able to discharge his obligations for less than their face value it is evidence of a decline in the value of his property which is the security for his debts rather than evidence of a taxable increase in his net worth. Under Section 22(b) (9) of the old law the exception was limited to debts of a corporation evidenced by a security. Section 108 of the new law is broadened to include all indebtedness of a corporation and indebtedness incurred or assumed by an individual in connection with property used in his trade or business. The phrase used in case of an individual "in connection with property used in his trade or business" will require some interpretation. Apparently there must be some relationship between the indebtedness of the individual and the property of the individual used in his trade or business. The Report of the Committee on Finance of the United States Senate in discussing this section uses the phrase "in connection with the *acquisition* of property used in his trade or business."[5] This term "acquisition," would further narrow the indebtedness qualifying under the statute.

For a discharge of indebtedness which does qualify under the statute, the taxpayer may elect to exclude such gain from gross income by filing a consent, to the regulations prescribed under Section 1017, to have the amount excluded from gross income applied in the reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which the discharge occurred. The reduction shall be made as of the first day of the taxable year or as of the date of acquisition if acquired during the year. While no regulations have been issued on this section yet, Regulations 118, interpreting similar language in the old code, stated that the reduction of basis of the assets was to be made in the following order: (1) any specific property, whether or not subject to a purchase money lien, if the indebtedness was incurred to purchase that property; (2) any property (except inventory or notes and accounts receivable) against which there was a lien other than a purchase money lien; (3) all other property except inventory and receivables; (4) inventory and notes and accounts receivable.[6]

[4] United States v. Kirby Lumber Company, 294 U.S. 1.

[5] Report of the Committee on Finance of the United States Senate to accompany H. R. 8300, p. 186.

[6] Stanley and Kilcullen, *The Federal Income Tax,* 1954 Code Edition, Pamphlet No. 1, p. 60.

INCOME TAXES PAID BY LESSEE

Section 110 of the Internal Revenue Code of 1954 provides for a rather narrow exception to a general rule of income taxation handed down by the Supreme Court of the United States in 1929. While the statutory exception itself is relatively unimportant, the fact that it became necessary for the Congress to grant special relief is of importance to tax practitioners. In *Old Colony Trust Company v. Commissioner*,[7] the United States Supreme Court held that where there is a contractual agreement to receive income which includes a promise by the payor to also pay the federal income tax of the recipient on such income, the payment of the tax for the recipient constitutes additional taxable income. This means for a cash basis taxpayer that each year as the subsequent tax is paid, it would become additional taxable income and could continue on chronologically indefinitely if the contract were so interpreted under the law of the state in which it was executed. If the recipient of the income were reporting on the accrual basis, the Supreme Court of the United States and the lower courts have apparently approved the pyramiding of the tax. The formula for the computation of such a tax would be the amount of income originally paid divided by 100 per cent minus the effective rate of tax. For example, the tax on $1,000 of original income, if the recipient were in the 20 per cent bracket, would be [1,000 ÷ (100 − 20)] − 1,000, or $250. If the recipient were in a bracket where the effective rate of tax was 80 per cent, the pyramided tax on the original $1,000 of income would be $4,000. As the effective rate of the tax approaches 100 per cent, the tax on the original income will approach infinity. Section 110 provides special relief in certain cases where a lease was entered into before January 1, 1954. If both lessee and lessor are corporations and, under the lease, the lessee is obligated to pay or to reimburse the lessor for any part of the income tax imposed upon the lessor with respect to the rentals, then such payments for the tax are excludable from the gross income of the lessor and are not deductible by the lessee. The moral to Section 110 is to avoid any contract which contains a promise to pay the federal tax on certain income payments. The Congress may not be so benevolent in granting relief by special legislation in your case.

COMBAT PAY OF MEMBERS OF ARMED FORCES

Section 112 re-enacts and extends the provisions of the old code Section 22(b) (13) regarding combat pay of members of the armed forces. Briefly, the provision excludes from gross income the monthly compensation of an enlisted man and the first $200 per month of a commissioned officer for any month during any part of which the taxpayer served in a combat zone or was hospitalized as a result of wounds, disease, or injury incurred while serving in

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[7] 279 U.S. 716.

a combat zone. As you recall, the President of the United States, under the power granted him by this section, declared Korea and adjacent waters a combat zone by executive order. This exclusion provision, which would, under the old code, have expired December 31, 1954, is extended under Section 112 to cover any induction period under present or future draft legislation.

Section 692 likewise extends the forgiveness features of old Section 154 which would have expired January 1, 1955, to cover any individual who dies during any induction period while in active service in the armed forces in a combat zone or as a result of wounds, disease, or injury incurred while so serving. His tax for the year of death and any prior taxable year ending on or after the first day he so served in a combat zone after June 24, 1950, are forgiven. Also any prior years' taxes unpaid at the date of such death are cancelled.

DIVIDEND EXCLUSIONS AND CREDITS

Section 116 contains the new provision for the partial exclusion from gross income of dividends received by an individual. Its companion measure, Section 34, provides a credit against the tax based on dividends received by individuals. These two provisions are a step in the direction of granting relief from double taxation where income is received by an individual from a corporation where the income has already been taxed against the corporate entity. Both sections apply only to taxable years ending after July 31, 1954. The credit provided in Section 34 is 4 per cent of the dividends received after July 31, 1954, from domestic corporations and included in gross income. Notice it applies only to dividends received after July 31, 1954. There are two further limitations as to the amount of such calculation which can be deducted. The credit cannot exceed the tax as calculated less the foreign tax credit. The tax cannot be reduced below zero. It also cannot exceed 2 per cent of taxable income for taxable years ending before January 1, 1955, or 4 per cent of taxable income for years ending after December 31, 1954.

Section 116 provides for an exclusion from gross income of an individual of dividends up to $50 and shall apply to the dividends first received in such year.

In case of a joint return, if each spouse owns in his or her own name stocks producing dividends of $50 each, a $100 exclusion is permitted. If the stocks are held in joint tenancy, the answer is not clear whether $50 or $100 can be excluded, but there is some precedent in the administrative holding that in case of partially tax exempt bonds held in joint tenancy interest on principal in the amount of $10,000 can be excluded on a joint return for doubling the $50 exclusion. There is also an argument for excluding $100 in those cases where under state law of a transfer in joint tenancy, it cannot be shown that the grantor did not part with the

beneficial title, dominion and control, and that he can revert the beneficial title to the whole of the property to himself.

Neither the credit under Section 34 nor the exclusion under Section 116 is allowed to non-resident aliens taxed under Section 871(a) (not engaged in business in the United States and gross income of not more than $15,400). The credit under Section 34 is not available to a taxpayer who files form 1040A (Section 6014(a)) but is apparently available to an individual filing the short form. The exclusion is apparently available in either case.

The term "dividends" used in both sections refers to dividends from domestic corporations and implies dividends as defined in Section 316. The intent of the statute is to allow the benefit only in those cases where the income has been previously subject to the corporate tax. Certain types of dividends are specifically disqualified from the benefit by statute due to the type of corporation making the distribution (Section 34(c) and 116(b)). Falling in this category are life insurance companies, China Trade Act corporations, exempt charitable organizations, exempt farmers' cooperative associations, and corporations engaged in business with possessions of the United States.

Further limitations on dividends which may qualify are those implied in Section 316, that the distribution be out of earnings and profits accumulated after February 28, 1913, or out of earnings and profits of the taxable year. Thus, any distribution representing a return of capital would not qualify, even though it might exceed the taxpayer's basis and be taxable as capital gain. For the ordinary corporation, a distribution out of capital gains to the corporation would qualify. In case of a regulated invested company, capital gains returned to shareholders as dividends do not qualify; earnings' dividends do qualify, subject to limitations provided in Section 854.

One other point, if the stock is owned by a partnership, Section 702(a) (5) provides that each partner shall take into account separately his distributive share of the partnership's qualifying dividends received both for the credit under Section 34 and the exclusions under Section 116. In other words, the benefits are not lost where the income is funneled through a partnership.

Likewise, in case of an estate or trust, Section 642(a) (3) provides that both the benefit of the credit and the exclusion will apply to both the fiduciary or the beneficiaries, depending on whether the income was distributed or distributable.

MEALS AND LODGING FURNISHED FOR CONVENIENCE OF EMPLOYER

The last new sections of the Internal Revenue Code of 1954 which I was asked to cover are 119 and 120, relating to meals or lodging furnished an employee. The general rule still applies that meals and lodging furnished an employee by his employer are a form of income in kind and includable in gross income. Section 119 now codifies, with some changes, the exception to this general

rule laid down by both judicial decisions and administrative rulings, that where the meals and/or lodging were furnished for the convenience of the employer, their value was excludable from gross income. But under the new code, the meals must be furnished on business premises of the employer; and in case of lodging, the employee is required to accept such lodging on the business premises of this employer. In one respect the new code is a broadening of the convenience of the employer rule. Under the old rulings, the convenience of the employer test was applied to determine whether or not the item was income or compensation at all; under the new code, it is an exclusion. If the parties had agreed by contract that the meals and/or lodging were a part of the compensation, that was final. Under Section 118, even though the meals and lodging are made part of compensation by "the provisions of an employment contract or of state statute fixing terms of employment," the value thereof may still be excluded from gross income specifically by the new code.

However, the old test as to what constitutes "for the convenience of the employer" will apparently still apply. The furnishing of meals and lodging must be essential to the performance of the employment, with the major benefit therefrom accruing to the employer and only an incidental benefit running to the employee. In other words, not all meals and lodging furnished on the premises are non-taxable to the employee under the new code.

Section 120, which is new, provides for the exclusion of a statutory subsistence allowance not exceeding $5 per day received by a police officer of a state, territory, or local government. Amounts excluded under this provision cannot be deducted as expenses, except insofar as the expenses exceed the allowance.

SITUATION WANTED

Young (26) attorney, presently practicing in Chicago, desires association with a Denver law firm. Illinois graduate, member of Illinois and Michigan Bars. Address all inquiries to Box 11, 525 Mile High Center, Denver 2, Colorado.