

An Introduction to Four Basic Income Tax Concepts

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Learning Objectives

An understanding of the material in this chapter should enable you to

- 3-1. Explain the meaning of the term “gross income.”
- 3-2. Explain the doctrine of constructive receipt.
- 3-3. Explain the economic-benefit theory.
- 3-4. Explain the principle of assignment of income.

Chapter Outline

INTRODUCTION 3.2
 GROSS INCOME UNDER THE INTERNAL REVENUE CODE 3.2
 DOCTRINE OF CONSTRUCTIVE RECEIPT 3.5
 ECONOMIC-BENEFIT THEORY 3.13
 THE PRINCIPLE OF ASSIGNMENT OF INCOME 3.15
 CONCLUSION 3.17
 CHAPTER REVIEW 3.17

The hardest thing in the world to understand is the Income Tax.

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This [preparing my tax return] is too difficult for a mathematician. It takes a philosopher.

Albert Einstein

INTRODUCTION

In this chapter, we will examine four concepts that are essential in gaining a fundamental understanding of how the income tax laws work. The first is the concept of gross income. This concept is a guide to items and transactions that are subject to taxation. The second concept is the doctrine of constructive receipt, which applies in determining when an item of income will be taxed to a particular taxpayer. The third concept is the economic benefit theory. This theory helps to ascertain under what circumstances a taxpayer has realized income subject to taxation, even though no cash has been directly received by the taxpayer. The fourth concept is the principle of assignment of income. This principle deals with the question of to whom income is taxed in situations where the income is received by a taxpayer other than the taxpayer whose efforts generated the income.

In order to highlight some of the basic issues involved in these areas, a question-and-answer format will be used.

GROSS INCOME UNDER THE INTERNAL REVENUE CODE

Objective 3-1

gross income

Question: What is the meaning of the term “gross income”?

Answer: *Gross income* is income that must be included on a taxpayer’s income tax return. The Internal Revenue Code defines gross income as “all income from whatever source derived,” including (but not limited to) the following 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
- income from an interest in an estate or trust

Under this definition, the 15 items listed are examples of items includible in a taxpayer's gross income. They are by no means an exclusive list. In fact, the general rule for inclusion is that any item of income received by a taxpayer is includible in gross income unless a specific provision in the Internal Revenue Code specifically states that the item may be excluded. The rule that all items of income are includible in gross income unless the Code explicitly provides otherwise is an important fundamental income tax concept.

Question: What is the difference between “income” and “capital” for income tax purposes?

Answer: To begin with, “income” is subject to income taxation, while “capital” (including transactions in which a taxpayer receives a return of capital) is not. The trick is how to differentiate the receipt of income from the receipt, return, or replacement of a capital item. An example of a return of capital is where a taxpayer purchases 100 shares of corporate stock for \$50 a share and later sells the stock for the same amount per share. The sales proceeds of \$50 per share do not constitute gross income to the taxpayer, because the taxpayer already had that much money invested in the property. To the extent the taxpayer is receiving back only what was paid for the property, he or she does not have “gains derived from dealings in property.”

On the other hand, if the stock had been sold for \$70 a share, the difference of \$20 per share between the amount the taxpayer invested in the property and the amount he or she received for it would be includible in gross income.

Another example of an item that is not considered “income” is where a creditor receives repayment of the principal amount of a debt. The repayment of the principal by the debtor is not gross income to the creditor. The creditor is simply receiving back the amount of money that was, in a sense, “invested” in the debtor. However, any interest payments on the debt received by the creditor would generally be includible in gross income.

Question: What is the significance of the term “realization of income” for tax purposes?

Answer: In order for income to be taxable, the income must be “realized” or obtained by the taxpayer. For example, gain is generally not realized from dealings in property until there is a disposition of the property. The disposition is the event that causes the gain in the property to be realized by the taxpayer and therefore taxed. An increase in value without an event such as a disposition of the property does not result in taxation of gain. An individual taxpayer who uses the cash-basis method of tax accounting (discussed in more detail later in this chapter) is not taxed on income unless and until the income is actually or constructively received. As a general rule, there must be a “taxable event” (such as a sale of property, payment of a salary, or receipt of an economic benefit) that brings the income into the taxpayer’s possession.

In certain situations, there can be a dispute as to whether a taxpayer has realized an item of income. The tax concept of realization has been fairly well developed both in court decisions and in the Internal Revenue Code, and it will be touched upon in certain other portions of this text. In general, income is taxable when it is realized by the taxpayer, although the Code does contain certain rules that defer or even eliminate the taxation of certain types of realized income.

Question: What are some examples of situations in which a taxpayer may unexpectedly be subject to income tax?

Answer: Certain items of gross income may result from situations in which the taxpayer does not expect to be taxed. A good example is the rule that imposes taxation on a debtor when that debtor is discharged or relieved of the obligation to pay a debt. As a general rule, the release of an obligation to pay a debt results in “income from discharge of indebtedness” to the debtor. The extent to which such income is taxed may be limited by specific rules regarding the financial position of the debtor. The underlying concept is that the debtor has received a monetary benefit from no longer having to repay money that was borrowed under a legal obligation to repay. Therefore the discharge of indebtedness is a taxable event that results in gross income, unless the discharge of the debt can be treated as a nontaxable gift.

As discussed in chapter 6, a gift is specifically excludable from the gross income of the donee under the Internal Revenue Code. However, there is frequently an issue of fact as to whether a given transaction is really a gift. The taxation of income from discharge of indebtedness is one area where the issue can arise. It may also arise in determining whether a given transaction is a taxable payment for the taxpayer’s personal services or merely a gift. In order for a payment to be treated as a gift, the donor must intend for the payment to be a gift and not a payment for services. Donative intent is a must in order to properly characterize a transaction as a gift. In an employer-

employee relationship, it will generally be presumed that payments are for services rendered and not a result of the employer's generosity or concern for the employee's personal welfare even if the employer was not legally obligated to make the payment. However, in certain cases, courts have decided that payments received by employees were nontaxable gifts from the employer. In any event, this is not a fertile ground for income tax planning because the IRS will generally treat such payments as taxable, unless the gift is a "de minimis" (minimal) payment, such as a holiday turkey or a similar item. The Code also specifically excludes certain (but not all) employee fringe benefits from the gross income of employees. A detailed discussion of fringe benefits is beyond the scope of this text.

Income does not have to be received in cash in order to be taxable. If income is received in a form other than cash, the general rule is that the fair market value of the property received is the amount includible in gross income. An example of noncash income subject to taxation is a barter transaction. If two taxpayers agree to exchange the performance of valuable services for each other, the exchange is taxable to each. For example, if an attorney performs legal services for a dentist in exchange for receiving root canal work, both the attorney and the dentist have realized gross income equal to the value of the services received. Although many transactions in the so-called "barter" economy are not actually reported on tax returns, they are still taxable as a matter of law.

Other common examples of noncash income will be discussed below in the context of the economic benefit theory.

DOCTRINE OF CONSTRUCTIVE RECEIPT

Objective 3-2

Question: What is the doctrine of constructive receipt?

Answer: Before answering that question directly, it is necessary to review what is meant by the *cash-receipts-and-disbursements* or *cash-basis* method of accounting. Most financial services professionals and their clients are cash-basis taxpayers, which means that they report income and pay taxes on that income only if it is received during the taxable year. Almost all individual taxpayers who do not own a trade or business (and many who do) use this method of accounting.

For example, suppose your client—a doctor using the cash-basis method of accounting—renders services but is not paid for them until January of next year. The income will not be includible in the doctor's income for this year (even though the services were performed this year) but it will be reportable next year.

In a nutshell, the cash-basis method of accounting means that an individual reports income in the year it is received. More formally stated, the

amount of any item of gross income is included in the taxpayer's gross income for the taxable year in which it is received, unless an accounting method is used in which such income is to be properly accounted for in a different taxable year.

Question: Generally, then, a cash-basis taxpayer does not have to report income until and unless this person actually receives it. How does the doctrine of constructive receipt apply to this general rule?

Answer: There is an exception to the general rule that income is reported by a cash-basis taxpayer only when it is actually received. The exception is known as the theory or *doctrine of constructive receipt*. This doctrine might best be illustrated by restating two questions often asked of financial services professionals:

**doctrine of
constructive receipt**

1. Is the interest earned on accumulated policy dividends paid from traditional types of cash-value life insurance currently taxable to the policyholder at the time it is credited to the policyholder's account, even though the interest is not actually received by the policyholder at that time?
2. If a policyholder takes the maturity proceeds or cash surrender value of the life, endowment, or annuity contract in the form of a life income or in installments (rather than as a lump sum), is the entire gain on the policy taxable to him or her in the year of maturity or surrender?

Question: What is the problem? It is evident that in either case the policyholder does not have actual receipt of income.

Answer: In both situations above, the policyholder might have received income *constructively*, even though he or she has not actually reduced income to his or her possession. The problem is caused by a section of the income tax regulations that provides that income must be included in the taxpayer's gross income for the taxable year in which it is "actually or constructively received." This means that a taxpayer does not have to reduce income to actual possession before it has to be reported. An individual must report it as soon as it is either actually received or constructively received.

Regulations elaborate by stating that even though income is not actually reduced to a taxpayer's possession, the taxpayer is deemed to have constructively received it in the taxable year during which (1) it is credited to the taxpayer's account, (2) set apart for the taxpayer, or (3) otherwise made available to be drawn from at any time.

Question: These rules seem very strict. Are there exceptions?

Answer: The regulations qualify the constructive-receipt rules by stating that income is *not* constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. In essence, therefore, the implications of these regulations to cash-basis life underwriters and their cash-basis policyholders is that they must currently report any income that has become unconditionally subject to their demand, although in fact they have not chosen to actually receive or reduce that income to their possession.

The doctrine of constructive receipt might be considered the "Can I get it when I want it?" doctrine. When taxpayers decide to actually obtain items of income and only their volition stands between them and the income, they have constructively received the income at that time (and are therefore taxed on it).

Question: What is the reason for the doctrine?

Answer: The purpose of the constructive-receipt rules is to prevent taxpayers from unilaterally determining the tax year when an item of income is "received by" them for federal income tax purposes. Were it not for this doctrine, cash-basis taxpayers could shift, at will, the year in which they will report an item of income merely by not taking any steps to reduce that income to their possession. The rule prevents cash-basis taxpayers from avoiding taxes by putting off actual receipt of income until their tax circumstances are more favorable, tax rates are lower, or they have a lower amount of other includible income.

The thrust of the doctrine of constructive receipt may therefore be capsulized by the statement that a cash-basis taxpayer "may not deliberately turn his back upon income and thus select the year for which he will report it." If income is payable on the demand of a taxpayer in a given taxable year, he or she must include such amounts in his or her taxable income for that year. To hold otherwise would permit a taxpayer to defer taxable income by merely choosing not to exercise the right to receive it. Therefore the owner of a savings account cannot defer the year in which interest earnings must be reported by deciding in December not to walk into a bank but instead to wait until the following January to have that interest credited on his or her passbook.

Question: What is the effect when there are substantial limitations or restrictions placed on a taxpayer's right to receive income?

Answer: The regulations qualify the rules on inclusion of constructively received income by stating that income will not be constructively received if the taxpayer's control of its receipt is subject to substantial limitations or substantial restrictions. For example, suppose Lee, a pension consultant, signs a contract to perform actuarial services during this year. Lee actually performs those services during this year. However, the contract specifies that payment will not be made until 5 years from now. Lee has no right to require earlier payment. Because payment to Lee (a cash-basis taxpayer) was subject to a substantial restriction (that is, it was not payable until 5 years later), it should not be considered constructively received this year. Thus where a taxpayer is not legally entitled to receive payment in a year prior to actual receipt, this individual will not be held to have constructively received that income in the prior year.

This raises the central question of whether the taxpayer merely refrained from exercising a legal right to receive current payment or whether there was actually never a legal right to receive payment in the prior year. The answer is a question of fact that will be determined by examining the agreement between the parties in each situation. Court cases indicate that if there is any substantial limitation or restriction on either the time or the manner of payment of income, there can be no constructive receipt until the limitation or restriction is removed. There would be no constructive receipt, for example, if the Tyler Corporation raises Robert's salary but does not pay that salary increase until a later year when wage freeze rules are changed to permit payment. Robert will not be deemed to be in constructive receipt in the earlier year.

Question: How does the effect of substantial limitations or restrictions apply to life insurance?

Answer: The cash value of a life insurance policy earns interest, which is reflected in the increase in the policy cash value from year to year. Although a policyholder could easily reduce any gain reflected by the excess of the cash value over the cost of the contract, the policyholder is not required to include such gain in his or her gross income each year. This is because the right to receive that income is subject to substantial limitations or restrictions. In other words, to receive the gain the policyholder must complete a transaction that will affect the nature and extent of his or her valuable insurance coverage and contractual rights.

Question: Suppose amounts are credited or set apart for a taxpayer, but there are no funds to pay the promised amounts. What is the effect on an inability to pay amounts credited?

Answer: If the financial condition of the debtor makes payment of the income in question impossible, there will be no constructive receipt by the creditor. For example, suppose Pam loaned the Esposito Corporation \$10,000. In return Pam received an interest-bearing note. If the Esposito Corporation had insufficient funds to pay the interest, Pam would have no constructive receipt even if her account was credited with the interest on the corporation's books. Likewise, if the Martin Corporation issued a salary check to Oliver, an officer, but the corporation lacked the funds to pay the check, Oliver would not be taxed. This result would hold even if the Martin Corporation could have borrowed money or sold assets to pay the check.

Question: Specifically, how does the doctrine of constructive receipt affect life insurance?

Answer: At this point it is appropriate to answer the two questions asked earlier:

1. Is the interest earned on accumulated policy dividends paid from traditional types of cash-value life insurance currently taxable to the policyholder as soon as it is credited to the policyholder's account, even if the policyholder has not actually received the interest?
2. If a policyholder takes the maturity proceeds or cash surrender value of the life, endowment, or annuity contract in the form of a life income or in installments (rather than in a lump sum), is the gain on the policy taxable to him or her in the year of maturity or surrender?

The first question pertains to the time at which interest earned on policy dividends becomes taxable. The general rule is that the interest earned on policy dividends must be included in the policyholder's gross income for the first taxable year during which the policyholder has the right to withdraw the interest. This result applies even if the taxpayer, in fact, does not withdraw the interest. The key issue is the following: When can the policyholder withdraw the interest on the policy dividends? If the policy provides that interest can be withdrawn only on the policy's anniversary date, the interest income is not constructively received in the year prior to the anniversary date.

The second question pertains to the result that occurs when the maturity proceeds or cash surrender value of a policy are taken in the form of installments of lifetime payments rather than in the form of a lump sum. When an endowment contract matures (or an ordinary life contract is surrendered), gain on the lump sum available to the policyholder will be immediately taxable. However, if a policyholder decides to select an installment payment or annuity settlement option rather than taking the lump

sum that could be chosen at will, is the policyholder in constructive receipt of the lump sum? If there is a gain on the contract and if proceeds are constructively received, the full gain would be taxable—just as if the policyholder had actually received a lump-sum payment.

A constructive-receipt problem can occur in three typical situations. The first situation is when the policyholder elects *before* the maturity or surrender date to postpone receipt of the proceeds and take income in the form of an annuity or installments. In this case, however, the policyholder avoids constructive receipt since there is no point in time when he or she had an unqualified right to take the lump sum. The policyholder will be taxed on the gain reflected in each installment when he or she actually receives it.

The second situation is when a policyholder does *not* make an election before the maturity or surrender date. Were it not for a special provision in the Internal Revenue Code, the policyholder would be considered to be in constructive receipt of the lump sum when it became available. However, because of this special provision, a policyholder will not be deemed to be in constructive receipt of the lump sum (1) within 60 days after the lump sum becomes payable and (2) if before receiving any payment in cash, the policyholder exercises an option or agrees with the insurer to take the proceeds in the form of a life income annuity or other installment-type settlement.

The third situation occurs when a policyholder decides to give up the right to withdraw principal, leaves proceeds on deposit, and receives only the interest that those proceeds generate. Constructive receipt in this case can be avoided only if an election to receive interest is made *before* the maturity or surrender date. Thus the 60-day extension is allowed only for the election of a life income or other installment-type settlement and not for an election to leave proceeds on deposit at interest.

Question: Does the doctrine of constructive receipt affect agreements to defer compensation?

Answer: It is in the area of deferred compensation that the doctrine of constructive receipt proves to be most complex and troublesome. The reason for deferring compensation is quite simple: If all or a part of an individual's current earnings are not payable by an employer until a specified date, or if those earnings are spread out over a number of years in the future when the individual is in a lower income tax bracket, the net after-tax compensation will be increased. Therefore it is possible to defer the tax of a cash-basis employee or independent contractor, but this deferral requires careful planning.

Basically there are two types of deferred-compensation methods: funded and unfunded. A funded deferred-compensation agreement entails the actual

deposit of funds by the employer into a trust, escrow, or custodial account. Unfunded deferred compensation implies that no funds are irrevocably set aside (that is, outside the corporation's control and beyond the reach of its creditors) by an employer. In this case, the employee must rely solely on the employer's unsecured promise and ability to pay the deferred amount (plus any interest that is applicable) in the future. Taxation generally depends not only on whether the agreement is funded or unfunded but also on whether the rights of the employee whose income is deferred are forfeitable or nonforfeitable.

Where the agreement can be classified as funded (according to the definition above), the deferred compensation will be taxable to the employee in (1) the first year the employee's rights are not subject to a substantial risk of forfeiture, or (2) the first year the employee's rights can be transferred to another party (that is, assigned free of the substantial risk of forfeiture).

If the agreement can be classified as unfunded (according to the definition above), such compensation will not be taxable until it is actually paid to the employee provided (1) the agreement to defer the compensation is made *prior* to the time the compensation is earned, and (2) the employer's promise is not secured by specific assets. In other words, the obligation may not be evidenced by specified financial instruments, such as a negotiable note. If these two requirements are met, constructive receipt will be avoided until the deferred compensation is actually received. This is because receipt of the compensation is not within the employee's control. This result will apply regardless of whether such compensation was or was not forfeitable by the employee. Therefore even if the employee had a nonforfeitable right to such compensation, no tax would be imposed until actual receipt since the agreement was unfunded.

For example, suppose the Rawlins Corporation offered Elaine a 5-year employment contract to entice her to join. The agreement provides that Elaine will be paid \$50,000 a year currently, plus an additional \$10,000 of nonforfeitable deferred compensation credited to a reserve account each year. However, Elaine will receive the money only upon her retirement, death, or disability. Elaine receives neither notes from the corporation nor evidence of its debt other than the agreement signed by the corporation and Elaine. She is to receive the deferred salary in 10 equal annual installments.

Even though the compensation that has been deferred is nonforfeitable, Elaine does not have constructive receipt. The agreement to defer the compensation was made before Elaine earned it. The Rawlins Corporation did not put aside funds in an escrow account for her benefit. In no way did the Rawlins Corporation secure its promise to Elaine other than through an employment agreement, and thus she has no right to the funds. They have not been credited or set apart so that she may draw from them at will. All Elaine has is a promise by the Rawlins Corporation to be paid income upon her

retirement, death, or disability. Nothing has been placed beyond the access of the corporation's creditors, and no control over the funds has been given to Elaine. Likewise, upon retirement, death, or disability, when the Rawlins Corporation's promise matures and Elaine becomes entitled to receive installment payments, there is still no constructive receipt. The only income subject to her unqualified control is the installment payment she actually receives each year. These payments, of course, will be taxable income when actually paid to Elaine.

The Internal Revenue Service has allowed the use of so-called *rabbi trusts* in connection with deferred-compensation agreements without imposing current taxation on the funds placed in the trust to be paid later to the employee. The employee avoids current taxation only if the funds in the trust can be reached by the creditors of the employer. The *rabbi trust* was a significant development in terms of how the IRS regards the doctrine of constructive receipt, since it involved setting aside funds for the payment of deferred compensation without the arrangement being treated as a "funded" agreement.

Question: How is the use of life insurance in deferred-compensation agreements affected by the doctrine of constructive receipt?

Answer: Life insurance or annuity policies are often used by an employer to finance its obligation under the deferred-compensation agreement. For example, suppose the Mitchell Corporation executed a deferred-compensation contract with Sam, a key employee. The agreement stated that Mitchell would credit a specific sum on behalf of Sam to a bookkeeping account each month for the entire term of the contract. (This agreement is unfunded, since no amounts are set aside in trust or in an escrow account beyond the reach of the corporation's creditors.)

The Mitchell Corporation could invest all or any portion of the amount credited to Sam. Payout would not commence until the earlier of (1) Sam's 65th birthday, (2) his death prior to retirement, or (3) his disability. At that time the value of the account would be paid out in equal installments over a period of 10 years to Sam or to his named beneficiary. To finance this liability under the agreement, Mitchell purchased a life insurance contract. Mitchell applied for, owned, and was beneficiary of the contract. The policy was carried as a corporate asset on the Mitchell Corporation's books and was subject at all times to the claims of its general creditors.

The employee under this type of deferred-compensation contract will be successful in avoiding constructive receipt of the money set aside. The employee will recognize no income until the taxable year in which the income is actually received (or it is made available to the employee in some other way). The rationale is that the employee has no present interest in

either the account or the policy, both of which are general assets of the employer. Note that the agreement gave the employee or his or her beneficiary no direct interest in any specific account, insurance or annuity policy, or in any other employer assets. The account merely served as a measure of the employer's liability for bookkeeping purposes.

ECONOMIC-BENEFIT THEORY

Question: What is the economic-benefit theory?

Objective 3-3

economic-benefit
theory

Answer: Sec. 61 of the Internal Revenue Code defines gross income as including “income from whatever source derived. . . .” In cases dealing with this section of the Code, courts have held that the language of the section is “broad enough to include as taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected.” This concept has appropriately been entitled the *economic-benefit theory* or *doctrine*. Its purpose is to force an employee to include in income any compensation regardless of its form. It has been applied to situations involving a *payment in kind* or where an employer has made available to an employee the *equivalent of cash*.

Question: How does this principle differ from the doctrine of constructive receipt?

Answer: The constructive-receipt doctrine forces the inclusion of income when the employee has an unqualified choice—to take or not to take income set apart or credited to his or her account. The economic-benefit theory or doctrine, on the other hand, forces the inclusion of income, even if the employee *cannot* take the income. All that is necessary under the economic-benefit theory is that the employee receive from an employer the equivalent of cash, something with a (1) current, (2) real, and (3) measurable value.

For example, if Pete is given the right to receive his bonus in cash or in the form of a nontransferable annuity with no currently accessible cash values, he has constructive receipt of the bonus regardless of the choice he makes. The reason is that he has the unrestricted right to take the cash. Alternatively, if Pete was given no choice as to the form of his bonus—if it was only available to him in the form of a nontransferable, single-premium deferred annuity with no currently accessible cash value—he would not have constructively received his bonus. This is because he can neither take cash nor draw down cash values from the annuity. Still, he would realize current income. He has received a promise from an insurance company, a financial institution in the business of making such promises, that he will receive benefits (his bonus) in the future.

The second situation illustrates the economic-benefit theory. The secured promise of an insurance company or banking company to pay income in the future can be currently and adequately valued and is therefore immediately taxable. This is unlike the naked promise of an employer that is, in effect, a non-negotiable, nonassignable agreement generally incapable of valuation. This is so because the employer's promise is subject, according to the courts, to the hazards of economic and business conditions regardless of the size or financial state of the employer.

The following case may further illustrate the distinction between the doctrine of constructive receipt and the economic-benefit theory. An employer established a trust for the benefit of one of its key employees. The employer placed \$10,500 in the trust that year. The trustee was directed to pay that employee \$5,000 the next year and the balance in 2 years. In other words, the deferred compensation was irrevocably set aside in a trust and payable over a 2-year period. The court held that in the first year the amount of \$10,500 was fixed and irrevocably paid out by the employer for the sole benefit of the taxpayer. The court recognized that the employee technically had neither actual nor constructive receipt of the trust money. During that year he had no right whatsoever to draw from those funds. Therefore the court reasoned that there was a substantial limitation on the employee's control that prevented constructive receipt. However, the court concluded that the employee did have an *actual receipt of the economic or financial benefit* conferred on him in that first year. This was the year in which the employer established the irrevocable trust for the employee's benefit in which the employee's rights were nonforfeitable. In such a case, the employee would pay tax on the present value of the right to receive \$5,000 1 year later and an additional \$5,500 2 years later.

Even though the funds were not immediately subject to his actual expenditure, they were there solely for his benefit. Therefore the amount of income he is to realize in the year in which the funds were set apart for his benefit must be measured by the amount of money paid, appropriately discounted to reflect the postponement of possession or enjoyment. Even this discount would not be allowed if the funds were placed in an interest-bearing account on which the employee would ultimately receive the interest.

Question: How might the economic-benefit theory be applied in a life insurance situation?

Answer: There are several life insurance related situations in which the economic-benefit theory is applied. One such situation is the taxation of employees covered under a qualified pension or profit-sharing plan that contains life insurance on their lives. Another situation is where an employee receives group life insurance in excess of the \$50,000 excludible limit.

Alternatively, an employee may own an individual policy insuring his or her own life and designate a chosen beneficiary for the death proceeds, and the employer may pay the premiums on the policy. The payment of such premiums is taxed as compensation to the employee. Although the employee owning the policy receives no outright cash payment, the funding of the life insurance policy provides a clear economic benefit to the employee and results in taxation of that benefit. An employee's coverage under a split-dollar life insurance arrangement with the employer can also result in taxation to the employee under the economic benefit theory. The IRS has issued regulations that specify the income tax treatment of split-dollar plans. Their tax treatment depends on the type of plan being used, the ownership configuration of the policy, how the policy's cash value is allocated between the employer and the employee, and other factors. The arrangement can be taxed under either an economic benefit theory or a loan theory using imputed interest rules. Taxation of split-dollar plans can become quite complicated.

THE PRINCIPLE OF ASSIGNMENT OF INCOME

Objective 3-4**assignment
of income**

Question: What is the principle of assignment of income?

Answer: The principle of *assignment of income* requires the taxpayer whose personal efforts generate income or who is the owner of property that generates income to report or declare the income on his or her own tax return. It provides that the taxation of income cannot be shifted from one taxpayer to another merely by transferring or assigning to another taxpayer the right to receive the income. This principle was developed in the tax law mostly through judicial decisions. Litigation with the IRS arose as a result of the efforts of crafty taxpayers to shift the taxation of income to other taxpayers (such as family members) whose marginal rate of taxation was lower than their own. Such techniques would result in lower overall taxes for the parties concerned. The issue here is not what income is taxable or when it is taxable, but rather *to whom* it is taxable.

Question: How does the principle of assignment of income operate?

Answer: The principle operates in two basic ways: first, by requiring that income that is generated by the performance of personal services be taxed to the person who performed the services; and second, by requiring that income generated by property be taxed to the taxpayer who owns the property. For example, suppose an executive of a large corporation enters into a written contract with her son providing that her salary from the corporation be paid directly to her son. Even though the son actually receives the income under this arrangement, it will still be taxable to the executive because it was her

personal services rendered for the company that produced the income. The income would also be treated as a gift to the son. Another example would be where a father arranges for the income from his portfolio of corporate securities to be paid directly to his daughter. Again, even though the daughter receives the income, the father is still taxed on the income because he is the owner of the underlying property.

Question: How can a taxpayer successfully shift the burden of taxation of income to another taxpayer who is in a lower tax bracket?

Answer: In the case of income generated by most types of personal services, there is no reliable planning technique that can legally shift taxation to another taxpayer. In addition to the general assignment of income principle, there are various statutory roadblocks set up in the tax law to defeat or discourage such efforts. The best example of a legitimate shift in the taxation of personal service income is not useful for planning purposes: where a taxpayer dies before receiving income for services rendered and the income becomes “income in respect of a decedent” that is taxable to the beneficiary who receives it.

In the case of income generated by the ownership of property, a bona fide transfer of the ownership of the property will result in the income from the property being shifted for tax purposes to the transferee. Suppose that in the example discussed above, the father transferred outright ownership of his portfolio of securities to his daughter rather than merely assigning the income to her. The income earned on the securities after the transfer would then be taxable to the daughter because she would be the owner of the property.

This requirement of transfer of property ownership is often referred to as the doctrine of “the fruit and the tree.” This metaphor indicates that in order to shift the burden of taxation, the entire “tree” or underlying asset—and not merely the “fruit” or income generated by it—must be transferred to another taxpayer. The economic reality of such situations is that the property owner must relinquish control of property in order to avoid taxation on its income. This is a more difficult decision than simply assigning the income from the property to another person or entity.

Question: Must there be an outright transfer of property to another person to shift the burden of taxation of income from the property?

Answer: There need not always be an outright transfer. For example, minor children are limited by law in how they are able to control and manage property. In situations where parents wish to shift the taxation of income to children, certain types of trusts can be used to hold ownership of property while effectively shifting taxation. However, the principle that the donor

must relinquish ownership and control over the property still holds. The trust must be drafted in a way that complies with applicable federal, state, and local tax and property laws. Trusts used for income-shifting purposes include so-called “Sec. 2503(b) income trusts” and “Sec. 2503(c) accumulation trusts,” which are named for the Internal Revenue Code provisions that govern them. The specific provisions and techniques used in such trusts are not covered in detail in this text.

CONCLUSION

The four concepts discussed in this chapter are fundamental to an understanding of the income tax law. Each of them is represented in various ways by portions of the Internal Revenue Code, by judicial decisions, by IRS practices, and by other elements of tax law authority. These concepts help students of the tax law to know the specific tax result of a given transaction or situation and also to understand why the result occurs.

CHAPTER REVIEW

Key Terms

gross income
doctrine of constructive
receipt

economic-benefit theory
assignment of income

Review Questions

Review questions are based on the learning objectives in this chapter. Thus, a [3-3] at the end of a question means that the question is based on learning objective 3-3. If there are multiple objectives, they are all listed.

1. What are 15 items that are *specifically* included in gross income under the Internal Revenue Code? [3-1]
2. How is the tax concept of income differentiated from the tax concept of capital? [3-1]
3. Don purchases stock at \$30 a share. The price per share goes up to \$50 in one week. Has he realized income? Explain. [3-1]
4. Does your client, Mrs. Eidson, have income when interest earned on her life insurance policy dividends is credited to her policy account? Explain. [3-2]

5. Under what circumstances will an employee be taxed on compensation under the economic-benefit theory? [3-3]
6. Paul is the sales manager for the Freeman Corporation. The company pays premiums on a \$100,000 whole life policy owned by Paul insuring his life. Paul has named his wife as beneficiary. What is the relevant income tax concept and its implications to Paul? [3-3]
7. Describe the principle of assignment of income. [3-4]
8. John Jones, an agent for Podunk Mutual, assigns his renewal commissions to his 25-year-old daughter, Jane. In this situation, explain who the taxpayer is for income tax purposes as well as the principle of tax law that applies here. [3-4]

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