Chapter 4.
Income Exclusions

After reviewing this chapter, you should be able to:

1. Discuss the requirements for the exclusion of an item of income
2. Explain the rationale for excluding items from gross income
3. Identify the allowable exclusions for donative items of income: gifts, inheritances, life insurance proceeds, and scholarships
4. Describe the effect of employment-related exclusions on the after-tax compensation of employees
5. Discuss the non-taxable fringe benefits that a business may provide to its employees
6. Identify payments that represent returns of human capital and are excluded from income as capital recoveries: worker’s compensation, damage payments for personal injuries, and medical expense reimbursement payments
7. Discuss the exclusions from income allowed for investment-related items: municipal bond interest, stock dividends, discharges of indebtedness, and improvements by a lessee


*Some IRS publications may not be updated annually. Please check the IRS website to ensure that you are using the relevant version.

After identifying all the sources of income received during an accounting period, the next step in calculating taxable income is determining which, if any, of the income sources do not have to be included in the current period’s gross income. This step requires identification of income items that are subject to exclusion or deferral. The all-inclusive income concept of IRC Section 61 considers taxable any income received unless a specific provision can be found that exempts the item from taxation. Under the legislative grace concept, only Congress can provide such tax relief. In addition, tax relief provisions are strictly applied and interpreted, thereby explicitly limiting the scope of any tax relief provision to that which Congress intended. Congress has chosen to exempt certain items that otherwise meet the definition of gross income. Some of the relief provisions are designed as equity measures that relieve the item from double taxation. Other provisions are meant as incentives for taxpayers to engage in specific activities. Most incentive provisions have as their goal some social objective, such as encouraging firms to provide medical coverage for their employees. To provide a frame of reference, income exclusions are divided into four categories:

- donative items;
- employment-related items;
- returns of human capital; and
- investment-related exclusions.
**Donative items** are receipts of wealth that the individual receiving the item(s) did not earn and for which no future services are to be rendered; donative items are not the result of an investment. Because donative items represent realized increases in wealth, items in this class fit the definition of income. However, Congress, either for equity or incentive reasons, has determined that such gifts should not be taxed. Donative items include gifts and inheritances, life insurance proceeds, and scholarships (Publication 17, Other Income).

The value of property acquired as a gift has been excluded from income taxation since 1913. Although gifts are not subject to income taxation, the donor is subject to the gift tax rules by giving the gift. The exclusion of gifts from income tax is an equity measure that prevents double taxation. The U.S. Supreme Court developed the most authoritative definition of “gift” in 1960:

“A gift in the statutory sense . . . proceeds from a detached and disinterested generosity . . . out of affection, respect, admiration, charity, or like impulses . . . And in this regard, the most critical consideration, as the Court has agreed in the leading case here, is the transferor’s intention. What controls is the intention with which payment, however voluntary, has been made.”

People often make gifts to friends and relatives with no expectation of any consideration in return. The legislative grace concept requires a strict application and interpretation of the exclusion for gifts. Only the receipt of a gift is a non-taxable event; any subsequent earnings from property received as a gift are subject to taxation. Subsequent earnings may be in the form of income flows from the property or gains from the sale of the property. The donor’s intent in making the gift is controlling. If the gift was meant to be compensation for past, present, or future services, it is not really a gift, but is taxable as compensation.

The value of property received through inheritance has also been excluded from taxation. The rationale for exclusion follows that for a gift. Property held in an estate is subject to an estate tax; thus, the income tax exclusion for inheritances prevents double taxation of the property of a deceased taxpayer. The legislative grace concept requires that exclusions be strictly applied. In the case of inherited property, the exclusion is limited to the value of the property received. Any subsequent earnings from the inherited property are not excludable, that is, they are taxable.

Payments from life insurance upon the death of the insured generally are excluded from income tax (Publication 17, Other Income). Life insurance proceeds may, however, be included in the decedent’s gross estate and be subject to the estate tax. Life insurance proceeds resemble inheritances, which are excluded from income taxation. The exclusion of life insurance proceeds provides equity with other forms of inherited property. The exclusion of life insurance proceeds applies to such payments even if the payments are received in installments, although any earnings
in the installment payments are taxable. An exception to the exclusion for life insurance proceeds is made for amounts paid to the owner of a policy that was obtained for valuable consideration. If a taxpayer purchases or otherwise obtains for some valuable consideration a policy on the life of another, the receipt of the insurance proceeds is considered the realization of an investment. The amount received will be income to the extent that it exceeds the premiums and other consideration given for the policy.

This exception to the life insurance exclusion provisions does not apply to policies owned by partners or partnerships in which the insured is a partner or a corporate officer or a shareholder. Payments on such contracts are excluded because they are deemed to be for legitimate business purposes rather than for speculative gain. This type of life insurance on the death of a partner or a key employee usually is used to fund buy-out agreements and is necessary to ensure the continuation of the business in most cases. The payment-of-consideration exception to the exclusion for life insurance proceeds also does not apply to accelerated death benefits received under a life insurance policy by a terminally or chronically ill individual. Generally, accelerated death benefits for terminally or chronically ill people are excludable, although certain limitations may apply.

A college student who is a candidate for a degree may exclude the value of a scholarship if the award does not require the student to perform any future services such as teaching, grading papers, or tutoring. The scholarship must be gratuitous in nature and not merely a form of compensation for past, present, or future services. However, amounts received by degree candidates from certain federal programs (for example, the National Health Service Corps Scholarship Program and the Armed Services Scholarship Program) are excluded from the recipients’ income even though there is a future service obligation connected to the scholarship. The amount of the exclusion is limited to the direct costs of the student’s college education. Direct costs consist of the student’s tuition, fees, books, supplies, and other equipment required for the student’s course of instruction. Amounts received in excess of the direct costs of the education are taxable. Individuals are not allowed to deduct personal living expenses. Students who receive amounts for personal living expenses must include those amounts in their income in order to provide equity with non-students, who are effectively taxed on income they spend for personal living expenses. Scholarships that are specified as being for the payment of a student’s room and board are fully taxable.

The United States levies taxes on worldwide income, meaning that U.S. citizens and residents are subject to tax on all income they receive, regardless of the source. To provide relief from double taxation for U.S. citizens working in foreign countries, the tax law allows individuals two options, which are discussed below.
Taxpayers may include the foreign-earned income in their taxable income, calculate the U.S. tax on the income, and take a tax credit for any foreign taxes paid. The amount of the allowable tax credit is the lesser of the actual foreign taxes paid or the U.S. tax that would have been paid on the foreign-earned income (Publication 17, Other Credits). Under a second option, individuals may exclude up to $92,900 in 2011, $91,500 in 2010, $91,400 in 2009, and $87,600 in 2008 of foreign-earned income for each full year they work in a foreign country. To take advantage of these options, an individual must either be a bona fide resident of the foreign country or be present in the foreign country for 330 days in any 12 consecutive months (including vacations).

The largest class of exclusions is certain payments made to or on behalf of an employee by an employer. This category of exclusions is costly in terms of the tax revenue lost to the government, because the payments are deductible by the employer and yield no tax revenue because of the exclusion from income granted the employee. These relief provisions are intended to provide equity in cases of double taxation and to encourage employers and employees to engage in the specified activity.

When one person or entity pays the expenses of an individual in an employment setting, the person whose expenses are paid generally has taxable income. The law does, however, exempt from taxation the payment of the following employee expenses by an employer:

- payments to qualified pension plans (Publication 17, Wages, Salaries and Other Earnings);
- the cost of group term life insurance, up to $50,000 per employee (Publication 17, Wages, Salaries and Other Earnings);
- health and accident insurance premiums (Publication 17, Wages, Salaries and Other Earnings);
- de minimis benefits; and
- the cost of some meals and lodging provided by the employer.

The favorable tax treatment accorded these items has encouraged employers to provide more and more of an employee’s compensation in the form of excludable fringe benefits.

Many companies provide pension plans for their employees. Several allowable variations of such plans permit employers and employees to make payments into the plans and receive favorable tax treatment (Publication 17, Wages, Salaries and Other Earnings). Such plans are referred to as qualified pension plans. Payments made by an employer to an employee’s account in a qualified pension plan are not taxable in the period in which the payments are made. The tax on such payments is deferred until the employee actually withdraws the payments from the plan. This is not a true exclusion on which a tax is never paid, but a deferral of income recognition to a
future period. In addition, the earnings on amounts paid into such plans and any amounts that employees pay into such plans are deferred from taxation until they are withdrawn from the plan.

One of the most popular employee benefits is the exclusion of the premiums paid by an employer on the first $50,000 face amount of group term life insurance (Publication 17, Wages, Salaries and Other Earnings). This exclusion is available only for term insurance that is provided to a group of employees on a non-discriminatory basis. Payments made on whole life policies, term insurance purchased for individuals, or plans that discriminate in favor of highly compensated individuals are not eligible for exclusion. If an employee’s qualified group term policy has a face value greater than $50,000, the premiums paid on the coverage in excess of $50,000 are taxable to the employee. The amount an employee must include in income is based on the IRS’s uniform premium cost tables and varies with the employee’s age.

Premiums paid by an employer to purchase health and accident insurance coverage for employees (and their dependents) are excluded from the employee’s income (Publication 17, Wages, Salaries and Other Earnings). The exclusion also applies to companies that choose to “self-insure” by making payments to a fund that is used to pay employees’ medical expenses. If a self-insured medical plan discriminates in favor of highly compensated employees, the amounts paid for medical expenses of the highly compensated employees covered by the plan are included in the individual’s taxable income.

The value of meals provided to an employee free of charge may be excluded from the employee’s income if the meals are provided on the employer’s business premises and the provision of the meals is “for the convenience of the employer.” Cash meal allowances generally are taxable because they are not meals provided by the employer. To satisfy the “convenience of the employer” requirement, the provision of the meals must have a substantial non-compensatory business purpose.

To exclude the value of employer-provided lodging, the acceptance of the lodging must be a condition of employment. That is, the employee has no choice but to live in the employer-provided housing.

The tax law also allows the exclusion of four general types of employment-related fringe benefits:

- no-additional-cost services;
- employee discounts;
- working-condition fringe benefits; and
- de minimis fringe benefits.