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Gross Income Under IRC § 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must report gross income for the taxable year to determine the tax they must pay. The reporting of gross income has been among the most litigated issues in each of the National Taxpayer Advocate's Annual Report to Congress.¹ For this report, we analyzed 117 cases decided between June 1, 2012, and May 31, 2013. The majority of cases this year involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,² interest,³ dividends,⁴ and annuities.⁵

PRESENT LAW

IRC § 61 broadly defines gross income as “all income from whatever source derived.”⁶ The U.S. Supreme Court has defined gross income as any accession to wealth.⁷ However, over time, Congress has carved out numerous exceptions to and exclusions from this broad definition and has based other elements of tax law on the definition.⁸

The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.⁹ If the Commissioner determines a tax deficiency, the IRS issues a Statutory Notice of Deficiency.¹⁰ If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer bears the burden of proving that the determination is erroneous or inaccurate.¹¹

ANALYSIS OF LITIGATED CASES

In the 117 opinions reviewed for this report, gross income issues most often fall into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. A detailed list of all cases analyzed appears in Table 3 of Appendix III.

- 1 See, e.g., National Taxpayer Advocate 2012 Annual Report to Congress 637-642; National Taxpayer Advocate 2011 Annual Report to Congress 619-625.
- 2 Internal Revenue Code (IRC) § 61(a)(1). See, e.g., *Garber v. Comm'r*, 500 F. App'x 540 (7th Cir. 2013), *reh'g denied*, 2013 U.S. App. LEXIS 10454 (7th Cir. May 9, 2013), *aff'g* T.C. Memo. 2012-47.
- 3 IRC § 61(a)(4). See, e.g., *Cox v. Comm'r*, T.C. Memo. 2013-75.
- 4 IRC § 61(a)(7). See, e.g., *Clayton v. Comm'r*, T.C. Memo. 2012-188, *appeal docketed*, No. 12-73904 (9th Cir. Nov. 28, 2012).
- 5 IRC § 61(a)(9). See, e.g., *Buckardt v. Comm'r*, 474 F. App'x 612 (9th Cir. 2012), *aff'g* T.C. Memo. 2010-145.
- 6 IRC § 61(a).
- 7 *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431-33 (1955) (interpreting § 22 of the Internal Revenue Code of 1939, the predecessor to IRC § 61).
- 8 See, e.g., IRC §§ 104 (compensation for injuries or sickness); 105 (amounts received under accident and health plans); 108 (income from discharge of indebtedness); 6501 (limits on assessment and collection, determination of “substantial omission” from gross income).
- 9 IRC § 6001. See, e.g., *DiLeo v. Comm'r*, 96 T.C. 858, 867 (1991).
- 10 Internal Revenue Manual (IRM) 4.8.9.2 (July 9, 2013).
- 11 See IRC § 7491(a) (burden shifts only where the taxpayer produces credible evidence contradicting the Commissioner's determination and satisfies other requirements). See also *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citations omitted).

In 46 cases (more than 39 percent), taxpayers were represented, while the rest appeared *pro se* (without representation). Five of the 46 represented taxpayers (about 11 percent) prevailed in full or in part in their cases. Twelve of the 71 *pro se* taxpayers (almost 17 percent) prevailed in full or in part. Overall, taxpayers prevailed in full or in part in 17 of 117 cases (almost 15 percent).

Drawing on the full list in Table 3 of Appendix III, we have chosen to discuss cases involving damage awards, retirement distributions, discharge of indebtedness, and partnership income, as those issues were some of the most commonly litigated.

Damage Awards

When a damage award is received, the nature of the claim that was the basis for the settlement determines whether the proceeds are excludible from gross income.¹² In six of the cases we reviewed, the taxpayers challenged the inclusion of damage awards in gross income, and the IRS won every case.

IRC § 104(a)(2) specifies that damage awards (and settlement proceeds¹³) for injuries or sickness are taxable as gross income unless the amount was received “on account of personal physical injuries or physical sickness.”¹⁴ Congress added the “physical injury or physical sickness” requirement in 1996.¹⁵ The legislative history of the 1996 amendments to IRC § 104(a)(2) states that “[if] an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness...[but] emotional distress is not considered a physical injury or physical sickness.”¹⁶

Thus, a court cannot consider damage awards for emotional distress to be excludible from income, even if the emotional distress has resulted in “insomnia, headaches, [or] stomach disorders.”¹⁷ Note, however, that “[t]he injury need not be defined as a tort under state or common law.”¹⁸

In five cases, the taxpayers argued that their damage awards compensated, in whole or in part, for personal physical injuries or personal sickness, and the IRS won every case. For example, in *Blackwood v. Commissioner*, the taxpayers (husband and wife) alleged the termination of the wife’s employment exacerbated her depression, resulting in numerous symptoms, including insomnia, migraines, and nausea.¹⁹ The wife alleged wrongful termination, which resulted in her former employer awarding her \$100,000 in a settlement agreement. The taxpayers did not report the award on their joint return, relying on *Domeny v. Commissioner*²⁰ to argue that the flare-up of the wife’s symptoms was a physical sickness under IRC § 104(a)(2).²¹ In *Domeny*, the taxpayer’s multiple sclerosis caused vertigo, shooting pain in her legs, and

12 IRC § 104(a); *Comm’r v. Schleier*, 515 U.S. 323, 329-30 (1995).

13 See Treas. Reg. § 1.104-1(c)(1) (damages received, for purposes of IRC § 104(a)(2), “means an amount received (other than workers’ compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution”).

14 IRC § 104(a)(2).

15 Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996).

16 H.R. Rep. No. 104-586, at 143-44 (1996).

17 H.R. Conf. Rep. No. 104-737, at 301 (1996). The exclusion does apply to damages received as reimbursement for amounts paid for medical care attributable to emotional distress for which deductions are allowed under IRC § 213. IRC § 104(a)(2)

18 Treas. Reg. § 1.104-1(c)(2).

19 T.C. Memo. 2012-190, *appeal filed* (4th Cir. Jan. 17, 2013).

20 T.C. Memo. 2010-9.

21 T.C. Memo. 2012-190.

difficulty walking due to numbness in her feet.²² The Tax Court distinguished *Domeny* because Mrs. Blackwood's symptoms were not as severe as those Ms. Domeny suffered.²³

Specifically, five of the eight symptoms that Mrs. Blackwood alleged at trial were very similar to the non-exclusive list of emotional distress symptoms in the legislative history of § 104(a).²⁴ In addition, unlike the facts at issue in *Domeny*, a medical doctor did not diagnose Mrs. Blackwood's illness. Consequently, the court concluded that Mrs. Blackwood's depression and corresponding physical symptoms were not physical injuries or sickness, and that the damage award was not excludible from gross income.²⁵

Damage awards may also be excluded from gross income under common law doctrines. For instance, courts have ruled that settlement proceeds representing a return of capital, rather than lost profits, are excludible from gross income.²⁶ To determine whether a damage award is taxable, the court will ask, “[i]n lieu of what were the damages awarded?”²⁷

In *Cung v. Commissioner*,²⁸ the taxpayer viewed an online advertisement, listing a vehicle for a discounted price. When the taxpayer attempted to purchase the vehicle, the dealer said it would not honor the advertised price.²⁹ The taxpayer filed suit alleging breach of contract and other various violations of statutory law. The taxpayer and the dealer reached a settlement, which he excluded from his gross income, claiming “the award represented compensation to offset a loss.”³⁰ However, the taxpayer had sought specific performance, compensatory damages, and punitive damages, and the settlement agreement was silent as to the allocation of the award.³¹ The court ruled that the taxpayer “failed to carry his burden of showing that the proceeds represent what he claims they represent, lost value.”³² Moreover, because the taxpayer never owned the vehicle, the court ruled that there was no sale or exchange from which to determine lost value.³³

IRA Distributions

IRC § 61(a) defines gross income as “all income from whatever source derived, including (but not limited to)... (9) Annuities; ... and (11) Pensions.”³⁴ IRC § 408(d)(1) governs the tax treatment of distributions from individual retirement accounts (IRAs), and provides that they are included in gross income as amounts received as an annuity under IRC § 72.

22 T.C. Memo. 2010-9.

23 T.C. Memo. 2012-190.

24 *Id.* (citing H.R. Conf. Rept. No. 104-737, at 301 n.56 (emotional distress includes symptoms such as “e.g., insomnia, headaches, stomach disorders”).

25 T.C. Memo. 2012-190.

26 See, e.g., *Milenbach v. Comm’r*, 318 F.3d 924, 933 (9th Cir. 2003) (citations omitted), *aff’g* 106 T.C. 184 (1996).

27 *Milenbach v. Comm’r*, 318 F.3d 924, 932 (9th Cir. 2003) (quotations omitted), *aff’g* 106 T.C. 184 (1996).

28 T.C. Memo. 2013-81.

29 *Id.*

30 *Id.*

31 *Id.*

32 *Id.* (citing *Milenbach*, 318 F.3d at 933).

33 T.C. Memo. 2013-81.

34 IRC § 61(a).

Taxpayers in at least eight cases argued that a portion of their IRA distributions were excluded from gross income, and a taxpayer prevailed in part in only one case. For example, in *Bernard v. Commissioner*, the taxpayers (husband and wife) mischaracterized IRA distributions as proceeds of sale instead of ordinary income.³⁵ The taxpayers argued that because capital gains within their IRAs increased the cost basis in the accounts, they were entitled to report part of the distributions as return of capital not subject to tax, and part as long-term capital gains, which are taxed at a lower rate than ordinary income.³⁶ The court corrected the taxpayer by stating, “Gains within IRAs are not taxed, but accumulated income included in distributions is taxed in accordance with the provisions of section 408(d).”³⁷ In other words, the entire IRA distribution is generally taxable as ordinary income unless part of it represents a return of nondeductible contributions to the account, or the taxpayer transfers the funds into a qualified retirement account. Consequently, the taxpayers had to include their IRA distributions in gross income.

At least five taxpayers challenged the taxability of their IRA distributions arguing the “rollover provision” under § 408(d) applied. The “rollover provision” generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt.³⁸ For example, in *Phillips v. Commissioner*, the taxpayer withdrew funds from an IRA, and elected to transfer the funds to a savings account rather than a qualified retirement account or IRA.³⁹ The taxpayer claimed the amount of the distribution was not includible in gross income because he merely made an error in rolling over the funds.⁴⁰ Because the taxpayer did not transfer the funds into a qualified retirement account once he discovered his mistake, he did not meet his burden of proving he took “every reasonable expected step” in making a rollover contribution to a qualified retirement account.⁴¹

Discharge of Indebtedness

We reviewed eight cases in which taxpayers disputed the IRS’s determination that a discharge of indebtedness was taxable income, and in four cases taxpayers prevailed in full or in part. A taxpayer’s gross income generally includes income from any discharge of indebtedness.⁴² Under certain circumstances, however, a taxpayer can exclude the amount of discharged indebtedness from gross income. In this regard, IRC § 108(a) provides, subject to limitation, that a taxpayer may exclude income from the discharge of indebtedness if the discharge occurs in bankruptcy, when the taxpayer is insolvent, if the indebtedness is qualified farm or business real estate debt, or if the indebtedness is qualified principal residence indebtedness discharged before January 1, 2014.⁴³ The creditor issues a Form 1099-C, *Cancellation of Debt*, to the taxpayer for cancelled debts of \$600 or more.⁴⁴ If a creditor has discharged a debt the taxpayer owes, the taxpayer must include the discharged amount in gross income, even if it is less than \$600, unless one of the exceptions in IRC § 108(a) applies. The issuance of a Form 1099-C is not dispositive of whether or

35 T.C. Memo. 2012-221.

36 *Id.*

37 *Id.*

38 IRC § 408(d)(3)(A)(i), (ii); *Schoof v. Comm’r*, 110 T.C. 1, 7 (1998).

39 T.C. Memo. 2013-42.

40 *Id.*

41 *Id.* (citing *Wood v. Comm’r*, 93 T.C. 114, 115-18 (1989)).

42 IRC § 61(a)(12).

43 IRC § 108(a)(1)(A)-(E).

44 IRS, Instruction for Forms 1099-A and 1099-C, *Acquisition or Abandonment of Secured Property and Cancellation of Debt* (2013).

when the debt is discharged.⁴⁵ A debt is deemed to have been discharged, and Form 1099-C is required, if (and only if) an “identifiable event” has occurred.⁴⁶

In *Pinn v. Commissioner*, the taxpayers (brothers) each received loans from a trust secured by the cash values of their death benefits sufficient to cover the loans.⁴⁷ The taxpayers defaulted on the loans but the trust did not cancel the loans or consider them uncollectible.⁴⁸ The Commissioner argued the balances of the loans were discharged indebtedness because the taxpayers failed to pay the loans when due and the taxpayers’ rights to the death benefit were too contingent to be a sufficient form of collateral.⁴⁹ While the court recognized that the death benefits were contingent on certain future events, their usefulness as collateral for the loans was still sufficient.⁵⁰ The court held the Commissioner was premature in asserting income from the discharged debts because future events to divest the collateral from the taxpayers had not occurred.⁵¹ Therefore, the “identifiable event” had yet to occur, and the taxpayers’ defaulted loans did not result in a discharge of indebtedness includible in their gross incomes.⁵²

Another exception to the inclusion of discharge of indebtedness income is taxpayer insolvency at the time of the discharge.⁵³ The amount of gross income excluded cannot exceed the amount by which the taxpayer is insolvent.⁵⁴ The amount by which the taxpayer is insolvent is defined as the excess of liabilities over the fair market value of the taxpayer’s assets immediately before the discharge.⁵⁵

In *McAllister v. Commissioner*⁵⁶, the Commissioner argued that the amount shown on a Form 1099-MISC the taxpayer received from his former employer was fully includible in gross income as nonemployee compensation, rather than income from the cancellation of a loan extended by the employer. The court determined that the 1099-MISC memorialized the forgiveness of the debt, and analyzed whether the taxpayer’s gross income should be reduced due to insolvency.⁵⁷ The court generally accepted the taxpayer’s valuation of his assets and liabilities, except for the value of two real properties he owned in different states.⁵⁸ The taxpayer valued one of the properties based on a comparable sale in the same neighborhood, and another based on the local property tax assessment.⁵⁹ In both instances, the court held the taxpayer did not meet his burden of proving his valuation, and valued each property based on the taxpayer’s purchase price.⁶⁰ Thus, the court’s property values for insolvency purposes were greater than the amount

45 *Kleber v. Comm’r*, T.C. Memo. 2011-233 (citation omitted).

46 Treas. Reg. § 1.6050P-1(a)(1), (b)(2)(i)(A)-(H) (describing different scenarios that signify when an “identifiable event” has occurred). See also *Friedman v. Comm’r*, 216 F.3d 537, 547-49 (6th Cir. 2000), *aff’g* T.C. Memo. 1998-196.

47 T.C. Memo. 2013-45.

48 T.C. Memo. 2013-45. The IRS learned of the default when the trust listed the loans as in default on an information return it filed with the IRS.

49 *Id.*

50 *Id.*

51 *Id.*

52 *Id.*

53 IRC § 108(a)(1)(B).

54 IRC § 108(a)(1)(3).

55 IRC § 108(d)(3).

56 T.C. Memo. 2013-96.

57 *Id.*

58 T.C. Memo. 2013-96.

59 *Id.*

60 *Id.*

the taxpayer claimed in his insolvency argument. Consequently, the taxpayer was only entitled to exclude from gross income a portion of the amount shown on the Form 1099-MISC.

Partnership Income

A partnership's income is not taxed at the entity level, but generally is reported on the partners' individual income tax returns.⁶¹ Partners recognize "pass-through" income from the partnership equal to their distributive shares of the partnership items.⁶² The partner's adjusted basis in his or her interest in the partnership equals the amount of his or her cash contributions plus the basis of other contributed property, and the basis is increased by the partners' distributive share of partnership income and decreased by distributions and losses.⁶³ Partners generally do not recognize gain or income on partnership distributions except to the extent that the distribution exceeds the partner's adjusted basis in the partnership interest immediately before the distribution.⁶⁴

In *Cvancara v. Commissioner*, the taxpayers (husband and wife) formed a partnership to operate a private elementary school.⁶⁵ Two of the taxpayers' children were enrolled in the school,⁶⁶ and the taxpayers continuously made contributions to the partnership during the time their children were enrolled.⁶⁷ The Commissioner challenged certain of the Cvancaras' claimed deductions for partnership losses on the grounds that they had insufficient bases in their partnership interests.⁶⁸ The taxpayers argued that the amounts they contributed to the partnership were capital contributions and had properly increased their interests' bases. The Commissioner argued that the amounts should be recast as tuition payments and should not augment the partnership interests' bases. The court held that the taxpayers' payments constituted capital contributions because the school needed operating capital and the taxpayers did not make payments in anticipation of receiving a benefit from the school.⁶⁹ As a result, the payments increased the taxpayers' bases in their partnership interests and the court allowed the taxpayers' claimed losses.

Accounting Method

If the IRS determines that a method of accounting "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."⁷⁰ Under the cash receipts and disbursements method (cash method), all items that constitute gross income shall be reported in the taxable year in which they were actually or constructively received.⁷¹ On the other hand, under the accrual method, income must be reported in the taxable year when all the events have occurred that fix the right to receive the income and the amount of income can be determined

61 IRC § 701.

62 IRC § 702(a).

63 IRC §§ 705, 722.

64 IRC § 731(a)(1).

65 *Cvancara v. Comm'r*, T.C. Memo. 2013-20.

66 *Id.*

67 *Id.*

68 See IRC § 704(d) (partner's distributive share of a partnership loss allowed only to the extent of the partner's adjusted basis in the partnership).

69 T.C. Memo. 2013-20.

70 IRC § 446(b).

71 Treas. Reg. §1.446-1(c)(1)(i).

with reasonable accuracy.⁷² Unlike the cash method, income realized under the accrual method may or may not be recognized in the year of receipt.

Another issue litigated in *Cvancara v. Commissioner, supra*, was whether the partnership employed the proper accounting method to reflect its income. The partnership received advance payments for tuition whose recognition it deferred until the subsequent year under the accrual method.⁷³ The Tax Court held that the partnership had properly elected the accrual method and properly deferred reporting the advance payments. The Commissioner contended that the partnership's use of the cash method for expenses showed the accrual method was not in fact in use. The court held that since the Commissioner had not exercised his discretion to require the partnership to change to the cash method, its finding that the partnership had adopted the accrual method was dispositive and that the partnership's "purported use of the cash method to calculate its expenses [did] not alter our conclusions."⁷⁴ Consequently, the partnership was entitled to use the accrual method of accounting and the taxpayers reported their share of the partnership income in the correct year.

CONCLUSION

Taxpayers litigate many of the same issues regarding gross income year after year, due to the complex nature of what constitutes gross income. Over the years, the courts have consistently interpreted gross income broadly and construed exclusions and exceptions narrowly. Most cases considering the inclusion of income under IRC § 61 were decided for the IRS. A major source of gross income litigation again this year was the inclusion of damage awards. However, the number declined from ten such cases litigated last year down to six this year. Notwithstanding this decrease, all taxpayers that challenged the inclusion of their damage award in gross income were overruled by the courts just as they were last year. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.

Another source of litigation this year was disputes about the classification of IRA distributions. This litigated matter increased from only two cases last year to eight this year. Out of those cases, five taxpayers litigated the rollover provision of IRC § 408. The court upheld the Commissioner's determination, and ordered partial relief in one case.

Taxpayers litigated eight discharge of indebtedness income cases, and prevailed, in whole or in part, in half of those cases. We anticipate an increase in discharge of indebtedness cases particularly with respect to the insolvency exception in the future because of the expiration of qualified principal residence indebtedness exclusion under IRC § 108(a)(1) on January 1, 2014.

⁷² Treas. Reg. §1.446-1(c)(1)(ii).

⁷³ T.C. Memo. 2013-20. The payments were made in 2005 and 2006, but were tuition payments for 2006 and 2007, respectively.

⁷⁴ *Id.*