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WHAT TYPES OF INCOME ARE NOT TAXABLE?

By Victor Sy, CPA, MBA

While the IRS is not thrilled about it, yes, there are **exclusions from income**. Exclusions should not be confused with deductions from gross income that must be shown on the return. Exclusion generally does not even have to be shown on the return.

The following are some income items that are exempt under the Constitution, by act of Congress, and under the provisions of foreign tax treaties designed to prevent double taxation:

1. Generally, amounts received under a **life insurance** contract paid by reason of the death of the insured are excluded from gross income. If the proceeds are left with the insurer, any interest earned and paid becomes income to the recipient.
2. The value of property acquired by bequest, device or **inheritance** is excluded from gross income. The income flowing from such property is not exempt.
3. The value of a **gift** is excludable from gross income but any income from such gift including profit upon sale is taxable.
4. Compensation received under a **Workers' Compensation Act** for personal injuries or sickness as well as damages received under a suit or settlement of a claim on account of personal injuries or sickness are exempt from tax. The same is true with amounts received under accident and health insurance policies. A personal injury lump sum award is also excludable from gross income.
5. Damages received on account of **personal injuries** are excludable from income. (The IRS has maintained though that damages not involving physical injury or sickness and which are measured by lost wages are taxable). **NEW: To extend the tide of abuses in this area, the new Health Act specifically taxes punitive damages received on account of personal injuries or sickness. It also specifically provides that emotional distress is not considered physical injury or physical sickness and, therefore, taxable.**
6. Damages received from actions based on **age, race, or sex discrimination** violations are excluded. Damage awards that are in the nature of severance pay other than compensation for personal injury are taxable.
7. Employer contributions to **accident or health plans, group legal services, and childcare services** are not reportable by the employees.
8. Payments up to \$5,250 per year received by an employee for tuition fees, books, supplies under a written **employer's educational assistance** program may be excluded from gross income. Any excess is includable in the employee's gross income and is subject to employment tax withholding.
9. The **rental value of a dwelling furnished to a minister** of the gospel is exempt from tax, as is a rental allowance that is used to rent or provide a home. This is very favorable to ministers who can deduct

mortgage interest and real property taxes even if the amounts have been previously excluded from the minister's gross income.

10. Amounts received as a [qualified scholarship](#) by an individual who is a candidate for a degree of a qualified educational organization is excluded if the amounts are used for qualified tuition and related expenses such as fees, books, supplies, and equipment required for courses of instruction. Any amount representing payment for teaching, research or other services are taxable.
11. Generally, a taxpayer realizes income to the extent of [debts that are forgiven](#). However, a taxpayer need not recognize income from the cancellation of debts in bankruptcy proceedings.
12. Pension annuity or similar payments for personal injuries or sickness resulting from [combat-related](#) services in the Armed Forces is exempt. Retirement pay, however, is not exempt.
14. Enlisted members of the Armed Forces may exclude all pay received while they serve in a [combat zone](#) (including operation Desert Storm) or are hospitalized as a result of wounds, disease or injury while serving in a combat zone.
13. [Subsistence allowances](#) and the value of quarters furnished or amounts received by enlisted personnel and officers of the Armed Forces as commutation of quarters are not taxable income. Housing and cost of living allowances to cover excess cost of quarters and subsistence while on permanent duty outside the US are also exempt.
15. [Veterans' benefits](#) under any law administered by the Veteran Administration are exempt from income tax. This includes amounts paid to veterans or their families in the form of education, training, subsistence allowances, disability, pension payments, grants for homes, and pensions.
16. [Damage awards](#) for lost income are ordinary income and are taxable to the recipient. Return of capital is tax-free unless the recovery amount is in excess of basis (cost) that then becomes ordinary income.
17. Damages to [business reputation](#) are usually considered loss of earnings and are taxable.
18. [Sickness and accident insurance benefits](#) from plans paid by employees on contributions are non-taxable. However, payments to an employee from a health insurance plan entirely paid by employers are taxable.
19. Payments from state [sickness or disability](#) funds like California's SDI fund are generally excluded from income.
20. Watch out for conflicting Tax Court decisions on [contingency fees paid to lawyers](#).