Season 1 – Episode 5 - Unmasking Phantom Income: Understanding its Impact and Navigating Tax Implications

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we're unraveling the concept of phantom income. What is it? How can it happen to you? And most importantly, how can you plan for it? These are all questions we'll tackle in this episode. To start with, phantom income is not a term you'll find in the code or IRS regulations. Rather, it's a term used in tax discussions and writings to describe a type of income recognized for tax purposes. Even though no actual cash or other tangible benefits are received by the taxpayer, it can appear in several situations, such as imputed income, depreciation recapture, debt forgiveness, profit shares from partnerships and S corporations, and non-cash benefits. Let's start with imputed income. Imputed income is a term used in tax law to refer to the value of any benefits or services received by an individual which must be considered as part of income for income tax purposes.

These benefits or services might not be in the form of money, but because they have value, the IRS considers them to be income. Examples of imputed income can include employer provided benefits such as free housing or a company car. It's vital to report such benefits to avoid unexpected liabilities. That said, not all benefits provided by an employer are considered imputed income. Certain conditions can exclude them from being treated as such. Some of the primary exclusions include group term life insurance, de minimis benefits, education assistance, dependent care assistance, working condition benefits, and health insurance. For group term life insurance, the cost of up to 50,000 of group term life insurance coverage provided by your employer is not considered imputed income. If the coverage exceeds this amount, only the cost of coverage over 50,000 is treated as income for de minimis benefits. These are benefits so small or infrequent that it would be unreasonable or administratively impractical to account for them.

Examples might include personal use of the office copy machine, occasional snacks or coffee in the office, or an occasional meal or party for employees. For educational assistance, up to $5,250 per year in employer provided educational assistance may be excluded from income. For dependent care assistance, up to 5000 of benefits received under Dependent Care Assistance program can be excluded as well. Regarding working condition benefits, if your employer provides a benefit that would have been deductible as an ordinary and necessary business expense if you had to pay for it yourself, it's typically not considered imputed income. Examples include a company car used for business- or job-related education and for health insurance. Premiums paid by an employer for an employee's health insurance are typically not considered imputed income. Now, debt forgiveness is another example of phantom income. Debt forgiveness refers to the cancellation or forgiveness of a debt you owe by a lender.

In general, the IRS views forgiven debt as a form of income. The logic behind this is simple. When a lender forgives a debt, you're essentially receiving a financial benefit equal to the amount of the forgiven debt. Let's consider an example. Suppose you borrowed $20,000 to buy a car, and after paying off $8,000 of the loan, you run into financial difficulties. If your lender decides to forgive the remaining 12,000, this amount is considered debt forgiveness and under normal circumstances, is treated as income for tax purposes. This can also occur when a home is sold short or foreclosed, or when a credit card balance is forgiven. Now, thankfully, there's a law in the Internal Revenue Code that offers a tax break for this unfortunate event. Section 108 of the code provides exceptions to the general rule that a taxpayer must include the amount of debt forgiven or canceled by a lender in their gross income.

This section offers several exclusions from gross income for canceled debts, including insolvency, bankruptcy, farm debt, real property, business debt, and principal residence debt. However, these exclusions come with the stipulation the taxpayer must reduce certain tax attributes by the amount excluded from income. Tax attributes are certain deductions, credits losses, and basis of assets that could potentially reduce a taxpayer's future tax liability. When you exclude canceled debt from income under section 108, you have to reduce these tax attributes in a specific order outlined by the tax code by the amount of the canceled debt. This is done because the IRS doesn't want taxpayers to double dip by excluding debt income and then using these tax attributes to further reduce their taxable income in the future. So, for instance, suppose a taxpayer has a net operating loss of $20,000 and they exclude 15,000 of canceled debt from income under section 108 due to insolvency, they would have to reduce the net operating loss to 5000, which is the 20,000 minus the $15,000 of canceled debt.

So this means a taxpayer has less of a net operating loss due to carry forward to future years, which could potentially increase their future tax liability. However, the taxpayer does get an immediate benefit by not having to include the 15,000 of canceled debt income, which could have increased their current tax liability. Now, in the case of student loan debt forgiveness, the general rule used to be the same. However, under the American Rescue Plan Act of 2021, student loan forgiveness occurring between January 1, 2021 and December 31, 2025, is exempt from federal income tax. Let's say you had a student loan of $50,000, and due to certain qualifying circumstances, such as working in a public service job for a certain period, the entire remaining balance of your loan is forgiven within this period. Previously, you would have been taxed on the 50,000 as if it were income.

But under the new law, you don't have to pay federal income tax on the forgiven amount. It's crucial to note that this tax exemption only applies to federal income tax. State tax laws vary, and some states may still tax forgiven student loan debt as income. Phantom income can also materialize in the world of partnerships and scorpions, these entities are known as passthrough entities because they pass their profits directly to their owners or shareholders. The owners report these profits on their personal income tax returns and pay the tax at their individual rates. Phantom income occurs when an owner owes tax on their share of the company's profits, even if the company didn't distribute any cash. To help owners manage this potential issue, partnerships and S corporations can make tax distributions, which are payments made to the owners or shareholders specifically intended to cover their tax liabilities on the income they're allocated from the company.

Let's consider an example. Imagine you're a 50% partner in an S corporation that made $100,000 in profits this year. Let's assume your personal tax rate is 30%. Even if the company retains all of its profits for reinvestment and doesn't distribute any cash to the partners, you would still be allocated 50% of the profits, or 50 grand, to report on your personal tax return. On a tax rate of 30%, you'd owe $15,000 in taxes on your share of the company's profits. But since the company didn't make any cash distributions, you might find yourself in a tricky situation where you owe tax without having received any cash from the company to pay it. Here's where tax distributions could come into play to help you with your tax liability. The company might distribute 15,000 to you specifically for this purpose. This way, you have the cash on hand to pay the tax you owe on your share of the company's profits.

However, tax distributions should be planned carefully, as they could impact the company's cash flow and other aspects of its operations. It's crucial for both the company and its owners to consult with a tax professional when planning these distributions. Now, noncash benefits, like winning a car on a game show or at a casino, can also give rise to phantom income. The IRS considers the value of these prizes as taxable income. If you find yourself on the winning end, you'll receive a W 2G form, which reports the value of your winnings. My recommendation is to consider taking the cash equivalent if offered. It might not be as thrilling as driving off in a new car, of course, but it'll give you more control over managing potential tax liabilities. Another situation where phantom income can come into play involves depreciation recapture under Section 1245 of the tax code.

To give you a little context, depreciation is the method by which a business deducts the cost of a tangible asset over its useful life. Section 1245 refers to the IRS's rules regarding the depreciation of personal property. When you buy an asset used for business, typically you want the largest deduction available with bonus depreciation. In Section 179 depreciation rules, you can write off most, if not all, of the cost of the equipment. You can do this even if you have financed the entirety of the asset. So let's say you sell an asset that has been depreciated fully and still has a balance owed to the bank. Section 1245 requires that the gain on the sale be treated as ordinary income to the extent of the depreciation you've previously claimed. So even though you've just sold an asset and received no cash, since you paid off the bank, you still have income on the entire sale price.

A way to plan around this is to take a forward-looking approach and not depreciate the asset fully in the first year, especially if you believe the asset is something you plan on selling in the near future. You can accomplish this by electing out of bonus and taking a specific amount of depreciation using Section 179. Section 179 is very powerful, and now you can choose the amount of depreciation to take initially. This is of course, valuable for phantom income purposes, but this is also valuable when you want to make sure your depreciation deduction is used up in higher tax brackets. For example, if you buy $100,000 piece of equipment and if you deduct all of it initially, some of the deduction will have put you in the 10% bracket. For instance, rather than 22% bracket, you would have reduced some of the tax benefit on the $100,000 asset.

The $100,000 depreciation deduction will be there for you over time. So if you can keep the deduction in the higher brackets, you will have saved more taxes over the years than you would had you taken it all up front. The concept of phantom income occurring with depreciation recapture and debt forgiveness can also occur when you sell an asset or a business using the installment method. The installment method applies whenever you sell an asset and receive a payment in a future year. Now, this is a great tax planning tool as you can spread the gains over multiple years. That said, if the asset has depreciation recapture or if it is financed and the debt is paid off, the installment method does not apply to that part of the sale and you will be treated as receiving cash for the debt payoff and the depreciation recapture will be reported in full and included income in the initial year of the sale.

To mitigate this impact, it is important to structure the sale with enough actual cash upfront to pay the tax in the first year. Now, in addition, if you're selling real estate, you can utilize something called a wrap sale. Now, a wrap sale or a wraparound sale is a form of real estate transaction typically used when selling property with an existing mortgage. In the context of installment sales, it's a creative financing option where the seller, rather than paying off their existing mortgage, keeps it in place and the buyer makes payments to the seller who continues to pay the original loan. The buyer's payments wrap around the original mortgage. The way this works in practice is that the buyer usually pays a down payment and then continues to make monthly payments to the seller, who remains responsible for the original mortgage. The seller usually charges the buyer an interest rate that is higher than the rate on the original loan, and the difference in these rates can provide the seller with additional profit.

A wrap sell is set up with a contract known as an installment land contract or contract for deed. This contract outlines the terms of the sale, including the purchase price, interest rate and the payment schedule. While a wrap sale can provide benefits to both the buyer and the seller, there are risk involved. If the buyer fails to make their payments to the seller remains on the hook for the original mortgage. Also, most mortgages have a due on sale clause, meaning the lender can demand full payment of the loan if the property is sold. If the lender chooses to enforce this clause and the seller can't pay, the lender could foreclose on the property. Because of these complexities and potential risk, it's crucial to seek legal and financial advice when considering a wrap sale. We've covered a lot today. Phantom income can be complex, but with understanding comes power.

Arm yourself with knowledge, seek advice from tax professionals, and you'll be well equipped to face phantom income issues before they occur.

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