International Business Times

10/05/19

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Beware Non-Cash Items IRS Says You Must Report On Your Taxes

One of the main presumptions of the U.S. tax system is that just about everything can be taxed as income. When it comes to taxes, most countries are more forgiving than the U.S. At tax time, you should think about all the income you collected for the prior year, but it's wise to worry about these issues all year long so you try to steer clear of problems. You don't want to discover you had huge phantom income when you are about to sign your tax return.

What might be taxable? It's easy to remember wages, since you receive an IRS Form W-2. It's also easy to remember income reported on Forms 1099, unless you are missing one. However, you might be surprised to learn that a variety of events can give you taxable income even though you've seen no cash. It can be annoying, or downright scary.

Take constructive receipt. This tax concept requires you to pay tax when you have a *right* to payment, even though you do not actually receive it. Is that possible? It sure is. If you have a legal right to a payment but elect not to receive it, the IRS can still tax you.

The classic example is a bonus check your employer tries to hand to you at year end. You might insist you'd *rather* receive it in January, so you can postpone the taxes. Because you had the *right* to receive it in December, it is taxable then, even though you might not actually pick it up until January.

Of course, if your company agrees (and actually pays and reports it in January) you would probably be successful in delaying the taxes until the next year. Still, the IRS might say you had the right to receive it earlier, and the IRS does its best to find constructive-receipt issues. The situation would be different if you negotiated up front for deferred payments *before* you provided the services. Some of the biggest misconceptions about constructive receipt involve conditions.

For example, say you are selling your watch collection, and a buyer offers you $100,000, even holding out the check. Is this constructive receipt? No, unless you part with the watch collection. If you simply *refuse* the offer—even if your refusal is purely tax-motivated—that will be effective for tax purposes. Because you conditioned the transaction on a transfer of the watch collection, there is no constructive receipt.

Similarly, if you are settling a lawsuit, you might refuse to sign the settlement agreement unless it states that the defendant will pay you in installments. It might *sound* as if you could have gotten the money sooner, but there is no constructive receipt because you conditioned your signature on receiving payment when you wanted it. Be very careful with legal settlements and their tax traps.

Under new tax laws, there is often with no deduction for legal fees, even though your lawyer deducted his cut of the settlement before paying you. Even though you didn't receive his fees, you have income. With legal settlements, it's best to get tax advice before you sign a settlement agreement.

Are there other non-cash tax gotchas? You bet. You can also have income without cash if you have a discharge of debt. It is also called cancellation of debt or "COD" income. Say a relative or the bank loans you money. You get the cash as a loan, but that is not income the IRS can tax. After all, you have to pay back the debt.

However, what if you are relieved of the obligation to repay the loan? If the loan is discharged that is usually taxed as income. Yes, it's great when a loan is forgiven, but taxes can be brutal. There used to be spotty reporting of COD income. But today, lenders are required to issue an IRS Form 1099-C reporting COD income to ensure you don't skip it on your tax return. Debts forgiven while you're in bankruptcy—or if not in bankruptcy when you are technically insolvent with more debt than assets—don't count as income.

Phantom income from legal entities can also be a surprise tax problem. Partnerships, limited liability companies (LLCs) and S corporations are taxed as pass-through entities. They are generally not taxed themselves. Instead, their owners are taxed. Each owner receives a Form K-1 that reports his or her appropriate share of the income (or loss).

That is true even if that income is retained by the business and not distributed to the owners. An IRS Form K-1 can report to the IRS that your share of the annual profits was $X, even if the business distributed no cash. You are obligated to report it, regardless of whether you received any payout. The IRS matches Forms K-1 against individual tax returns, so watch out. There is a way to dispute Forms K-1 or take other action, but you'll need professional help.

Non-cash income items can create tax problems, so be careful.

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