

# At Year End, the IRS Polices Constructive Receipt

By Robert W. Wood

Everyone seems to believe that federal income tax rates will go down in the new year (no, California tax rates will not!). So, accelerating tax deductions and deferring income when you can makes sense. Still, constructive receipt is a fundamental concept in the tax code.

The IRS says you have income when you have an unqualified, vested right to receive it. Asking for payment *later* doesn't change that. See *Childs v. Comm'r*, 103 T.C. 634, 654 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996). The classic example is a bonus check available in December that an employee asks his employer to hold until January. The IRS can treat it as income in December.

The tax regulations say that a taxpayer has constructive receipt when income is credited to the taxpayer's account, set apart, or otherwise made available to be drawn upon. See Treas. Reg. Section 1.451-2. On the other hand, there is no constructive receipt if your control is subject to substantial limitations or restrictions. Many tax questions turn on these limitations, and lawyers often have to face these tax issues — whether they know it or not.

Suppose a client agrees orally to settle a case in December, but specifies that the money is to be paid in January. In which year is the amount taxable? The mere fact that the client *could* have agreed to take the settlement in Year 1 *does not* mean the client has constructive receipt.

The client is free to condition his agreement (and the execution of a settlement agreement) on the payment in Year 2. The key will be what the settlement says before it is signed. If you sign the settlement agreement and condition the settlement on payment next year, there is no constructive receipt.

If funds are paid to the plaintiff's lawyer trust account, the IRS treats the lawyer's receipt also as receipt by the client of the client's share. Say a lawyer receives settlement proceeds in December, and holds the client's money until January. The IRS says the client is taxed in December. The lawyer is deemed to have receipt of his or her fees too, even though they remain in the trust account.

On the other hand, there are situations where disputes can block receipt. Suppose that Larry Lawyer and Claudia Client have a contingent fee agreement calling for Larry to represent Claudia in a contract dispute. If Larry succeeds and collects, the fee agreement provides that Claudia receives two-thirds and Larry retains one-third as his fee. Before effecting the one-third/two-thirds split, however, costs are to be deducted from the gross recovery.

Suppose that Larry and Claudia succeed in recovering \$1 million in 2016. Before receiving that money, however, Larry and Claudia become embroiled in a dispute over the costs (\$50,000) and the appropriate fee. Larry and Claudia agree that \$25,000 of costs should first be deducted. However, Claudia claims that the other \$25,000 in costs is unreasonable and should be borne solely by Larry.

Furthermore, Claudia asserts that a one-third fee is unreasonable, and that the most she is willing to pay is 20 percent as a legal fee. Larry and Claudia try to resolve their differences but cannot do so by the end of 2016. In January 2017, the \$1 million remains in Larry's law firm trust account. What income must Larry and Claudia report in 2016?

Larry and Claudia appear to have agreed that \$25,000 in costs can be recouped, and that Larry is entitled to at least a 20 percent fee. Of course, it is not yet clear if that 20 percent fee should be computed on \$950,000, or on \$975,000. However, Larry is entitled to at least \$25,000 in costs, and to at least a \$190,000 fee, for total income of \$215,000. Perhaps that is undisputed.

Looking at Claudia, it is not yet clear how much she will net from the case. Yet the minimum Claudia will get would be by applying the provisions in the fee agreement.

Thus, taking the \$50,000 as costs, Claudia should receive two thirds of \$950,000, or \$633,270. Even under Larry's reading of the fee agreement, this is the amount to which Claudia is entitled. She might receive more if her arguments prevail.

How much should Larry and Claudia report as income? You might say that you don't have enough information to make that decision, and you would probably be right. After all, you don't really know whether Larry and Claudia have agreed that partial distributions can be made, or if they are taking the position that they won't agree to *anything* unless the entire matter is resolved.

However, the positions of the parties seem clear that each is already entitled to *some* money. If they have a legal right to the money and could withdraw it, that is, constructive — if not actual — receipt. However, good documentation can go a long way to helping to achieve tax goals. An escrow agreement acknowledging that *all* of the money is in dispute and prohibiting any withdrawals until the parties agree, might contraindicate income.

If each party agrees that they *disagree*, and that no party can withdraw *any* amount until they both agree in writing, it may be persuasive, even if it is not *dispositive* to the IRS. It may be hard to argue with the fact that the parties' positions speak for themselves, and that some portions of the funds are undisputed. Besides, there is a strong sentiment that a lawyer is merely the client's agent. Presumptively, settlement monies in the hands of the lawyer are already received by the client for tax purposes.

Let's consider the defendant too. The defendant paid the \$1 million in 2016, and the defendant will probably deduct it in 2016. It will likely issue one or more IRS Forms 1099, probably to both Larry and Claudia in the full amount of \$1 million each. How will Larry and Claudia treat those Forms 1099?

There may be a variety of possibilities. Assuming both Larry and Claudia argue the *entire* amount is in dispute, one approach might be to footnote Form 1040, line 21 (the "other income" line), showing the \$1 million payment. Then, they might subtract the \$1 million payment as disputed and in escrow and therefore not income, netting zero on line 21. There is probably no perfect way to do this.

Around year end, who hasn't heard someone say "pay me next year." Form W-2 or 1099 reporting of transactions are likely to carry weight, but you might be surprised at how many times the IRS catches constructive receipt issues. They can spoil an otherwise good legal settlement or transaction.

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