

Every Year-End Is Taxing

By Robert W. Wood

Year-end is a stressful time. Amidst year-end invoicing, collections, bonuses to consider, office and personal commitments, it can take a toll. But some things need doing, and tax-related issues feature prominently. Our tax system is annual, and most law firms, like individuals, operate on a calendar year basis.

That means December 31 is the cutoff for payments you make, and payments you receive. There are exceptions, of course, such as pension plan contributions that can be made up until tax return time. But mostly, you need to think of year-end as a hard deadline, and it is only natural to consider your tax posture in making a payment or receiving a payment in 2024 or 2025. Amid all the hubbub, would you prefer to receive payment in 2024, or during the first week in January 2025? "Pay me next year" requests are common this time of year with employers, suppliers, vendors, customers, and more.

If you are paid in December of 2024, taxes are due April 15, 2025. In contrast, if you are paid in early January 2025, taxes are due on April 15, 2026. It seems like an easy decision, but if tax rates may go up, that may cut the other way.

For 2025, tax increases seem unlikely. President-elect Trump has proposed extending his tax cuts, and they will be felt most strongly amongst high earners. This means that being paid in 2025 could be *better* for your taxes, assuming that Congress decides to go through with his proposed changes. But even if you decide a 2025 payment would be better for you or your firm, is it even possible to put off income you are about to receive?

On a cash basis, you might assume that you cannot be taxed until you actually receive money. Yet if you have a legal right to payment but decide not to receive it, the IRS can tax you under the doctrine of constructive receipt. It requires you to pay tax when you merely have a *right* to payment, even though you do not actually receive it. The classic example is a bonus check your employer tries to hand you at year-end.

You might insist that you'd rather receive it in January, thinking that you can postpone the taxes. However, because you had the right to receive it in December, is the IRS can say it is taxable then, even though you might not actually pick it up until January. Of course, as a practical matter, if your company agrees to delay the payment (and actually pays it to you and reports it on its own taxes as paid in January) you would probably be successful in putting off the income until the next year.

The IRS does its best to ferret out constructive-receipt issues, and disputes about such items do occur. The situation would be quite different if you negotiated for deferred payments before you provided the services. For example, suppose you are a consultant and contract to provide personal services in 2024 with the understanding that you will complete all of the services in 2024, but will not be paid until February 1, 2025.

Is there constructive receipt? There shouldn't be. In general, you can do this kind of tax deferral planning as long as you negotiate for it up front and have not yet performed the work. Some of the biggest misconceptions about constructive

receipt involve conditions. Suppose that you are selling an asset—stock, crypto, or real estate. A buyer offers you money and even holds out a check. Is this constructive receipt? No, unless you part with the asset. If you simply refuse the offer—even if your refusal is purely tax-motivated because you don't want to sell until January—that will be effective for tax purposes.

Because you condition the transaction on a transfer of legal rights (your title to the asset and presumably your delivery of it), there is no constructive receipt. Lawyers understand lawsuits and legal settlements. But even lawyers can become confused about constructive receipt tax issues. If you are a contingent fee lawyer, you might think that your fee is 99.9% earned after you've negotiated a good settlement and documented it, even before the client signs the agreement. After all, as the lawyer, you usually are not even signing the settlement agreement. All that remains for your 40% contingent fee to be fully payable is the client signing the settlement agreement.

However, that is quite a big condition. You are not legally entitled to your fee until the settlement agreement is signed. This time of year, many settlement agreements call for payment in January. As long as the payment details are in the settlement agreement before it is signed, there's no constructive receipt, even if you could have called for payment in 2024. If you are a plaintiff settling a lawsuit, you might refuse to sign the settlement agreement unless it states that the defendant will pay you in installments, or in a lump sum say, between January 2 and January 15.

Even though it may *sound* as if you could have gotten the money sooner, there is no constructive receipt because you conditioned your signature on receiving payment in the fashion you wanted. That is different from having already performed services, being offered a paycheck and delaying taking it. The plaintiff can ask for a structured settlement too, where the money is doled out over time. The settlement agreement can include structured legal fee provisions too, if you wish. If properly handled, the lawyer can be paid fees over time, rather than all at once. One can ask a defendant to pay in installments to a plaintiff, a lawyer, or both.

But the conventional treatment would be to have the defendant pay a third party like an annuity company that makes the structured settlement payments or structured legal fee payments over time. The documents must conform to IRS standards, so the documentation must be correctly done.

Tax issues in settlements are always worth considering. Whether you are the client or the lawyer, consider the bottom line after taxes, and timing too. For example, what if your client signs a settlement agreement that says the defendant will pay within 30 or 60 days. But the next thing you know, the defendant sends payment, which hits your account on December 28th.

Is that 2024 or 2025 income? The presumptive IRS position is that it is 2024 income, to both you and your client, even if you do not disburse the funds to yourself and to your client until January. The IRS says you are the agent of the

client, which means you receiving the proceeds is the same as your client doing so.

In a pinch, if you have a settlement sheet about fees and costs that you need the client to sign, you could perhaps argue that your firm protocol requires your client to sign it before you can release the client's money, or your fee. But that is likely to be a losing tax argument in an audit or tax dispute. That's one more reason to think about timing in any settlement, especially late in the year.

Of course, year end has other tax decisions too, such as writing those year-end checks to charity so you can deduct them, making business expense payments now rather than waiting until January, and so on. A classic tenet of tax planning is to try to defer income and to accelerate deductions where you can.

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