PERSPECTIVE

Los Angeles | Daily Journal

DECEMBER 29, 2025

If You Don't Receive Payment In 2025 But *Could* Have, Is It 2025 Income?

By Robert W. Wood

THis sounds like a silly question. How could something be income in 2025 if you don't collect it until 2026? Welcome to the tax concept of constructive receipt. According to the IRS, you have income when you have an unqualified, vested right to receive it. Asking for payment later doesn't change that. The idea is to prevent taxpayers from deliberately manipulating their income.

The classic example is a check available in December which you ask to have held for you until January. Individuals are cash basis taxpayers filing annually, and it is usually not income until you receive it. But if you *could have* collected it, the IRS can tax it in December, even if you wait until January. This is an issue for cash method taxpayers like individuals, but accrual basis taxpayers (like most large corporations) have constructive receipt built into the accrual method.

The accrual method says you have income when all events occur that fix your right to it. In accrual accounting, you book income when you send out an invoice, not when you collect it. But for individuals and other cash basis taxpayers, the IRS worries about "pay me later" shenanigans. The tax regulations say you have constructive receipt when income is credited to your account or made available.

On the other hand, there is no constructive receipt if your control is subject to substantial limitations or restrictions. How does this work with legal settlements? Suppose a plaintiff orally agrees to settle a case in December but requires the money to be paid in January. In which year is the amount taxable? The mere fact that the plaintiff *could have* agreed to take the settlement in Year 1 does not mean the client has constructive receipt.

The plaintiff is free to condition executing a settlement agreement on the payment in Year 2. If you sign the settlement agreement and condition the settlement on payment next year, there is no constructive receipt. If you sign and the check does not show up until Year 2, that's also okay, it's Year 2 income. But if you sign in Year 1, and the defendant pays you *or your lawyer* in Year 1, it's too late to hold out to cash it until Year 2.

Let's focus on payment to your lawyer. What if your lawyer receives the funds in Year 1, say December 24, 2025, but does not disburse the client's share until January 5, 2026? Is that income to the client in 2025 or 2026? You could argue either way, but the classic IRS position—upheld in tax cases—is that this is *2025* income, even if the lawyer doesn't pay the client until *2026*.

For tax purposes, a lawyer is the agent of his client, so there is constructive or even actual receipt. The lawyer has the funds, and the client has a legal right to demand his share immediately. Some lawyers and clients with a year-end settlement like this argue that the client would need to sign forms, or another internal release with the lawyer to free up the cash. Those arguments can work in some cases, and there can be fee disputes between lawyers and clients that can play into it.

But usually, when the lawyer receives settlement proceeds, the client is deemed to receive the client's share. Normally, it is the IRS who is birddogging issues of this sort, trying to move income from a later year to an earlier year. That makes sense, as most taxpayers want to *defer* income and *accelerate* tax deductions when they can. That is a classic tenet of tax planning.

But could a taxpayer ever argue for reporting in first year in our end of year lawyer payment example? Yes, if the argument about the lawyer being the client's agent works for the IRS, it can work for the taxpayer too. It is not uncommon for taxpayers to pick up IRS arguments and to use them to their advantage. For example, sometimes the IRS argues that one taxpayer has ordinary income rather than capital gain on a particular set of facts.

The next taxpayer—who has what might look like a capital loss—picks up the IRS argument and uses it to argue that his loss is an ordinary loss instead of a capital loss. It's a kind of tax version of what's good for the goose is good for the gander. In this context, at the end of 2025, it is the same kind of thing.

Why might someone be especially thinking about this as the end of 2025 draws near? In December 2024, Congress passed a tax law to make many wildfire settlements tax free, but the law expires at the end of 2025. There is a bill in congress to extend it, but there's little sign it will pass by the end of 2025. As a result, some fire victims are likely to argue that if they can get their settlements in place with the funds arriving in their *lawyer's trust account* before 2026, the IRS's traditional position about constructive receipt should apply.

The bipartisan *Protect Innocent Victims of Taxation After Fire Extension Act* would make the tax exemption of the *Federal Disaster Tax Relief Act* permanent, but this tax bill has not yet passed, and it may not for some time. Unless it passes quickly, ideally before January 1, there is likely to be some scrambling by fire survivors and their lawyers to try to get in under the wire of the currently scheduled December 31, 2025 expiration of the current exclusion.

Robert W. Wood *practices law with www.WoodLLP.com, and is the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This discussion is not intended as legal advice.*