

Is Settling Now, Payment in January Constructive Receipt?

By Robert W. Wood

For cash basis taxpayers like lawyers and most law firms, if a check arrives by year end, it is income. As a cash basis taxpayer, you normally report income when you receive it. Accrual basis taxpayers (like most big companies) generally have income when their right to the income is final, such as sending out an invoice, even though the invoice isn't paid for some time. If the accrual basis taxpayer never gets paid, they later can write off the amount as a bad debt.

Cash basis taxpayers like lawyers can't write off a bill that is not paid because they never took it into income in the first place. That makes the cash basis sound pretty simple, you don't report income until you receive it. However, you have likely heard of the tax concept of constructive receipt. This tax rule only applies to cash basis taxpayers. And regardless of whether they know it, lawyers deal with constructive receipt issues all the time.

Suppose that a client agrees to settle a case in December but specifies that the money is to be paid in January. In which year is the amount taxable? It may depend on the documents. The mere fact that the client *could* have agreed to take the settlement in 2023 does not mean that the client has constructive receipt. The client is free to condition her agreement (and the execution of a settlement agreement) on the payment in 2024.

The key will be what the settlement agreement says before it is signed. If you sign the settlement agreement and condition the settlement on payment next year, there is no constructive receipt. In the same way, you are free to sell your house and insist on receiving installment payments, even though the buyer is willing to pay cash. However, if your purchase agreement specifies that you are to receive cash, it is too late to change the deal and say you want payments over time instead.

The legal rights in the documents are important. Legal settlement agreements work the same way, but there are some added wrinkles. If you settle toward the end of the year and say that payment is due in 30 days, what's the result? You and your client may be stuck with what the defendant decides to do. Even if the client was *supposed* to pay before the end of the year, if the money arrives in January, you got lucky, it is January income.

However, if the money arrives before year end, the IRS says it is income now, to both you and to your client. In fact, that is even the result if you do not send the funds to your client until January. A lawyer acts as the agent of the client. In the IRS view, that makes receipt by the lawyer receipt by the client too. Sometimes, there can be arguments that there are disputes over the funds, so they need to be escrowed. But these tax issues can be messy, and it is best to avoid the issue when you can.

One frequent year-end settlement glitch goes something like this. You settle late in the year, and the checks don't arrive until January. That's January income, right?

Probably, but what is the *date* on the checks? Defendants like the "accelerate deductions" mantra too, so there might be a flurry of payments at year end. If the money arrives in January, as a cash basis taxpayer, you and your client have a good case to say it's January income. But keep a copy of the check, and even the envelope if you can.

The big issue is likely to be for the client, at least if the payment is taxable. If it is a 100% tax-free physical injury settlement, it likely won't matter to the client which year it is. Even then, it is often wise for the client to disclose the settlement on their tax return, even if it is nontaxable. But how about a taxable settlement such as an employment case?

The problem with the year-end check is that the defendant will almost certainly issue IRS Forms 1099 (and W-2 if there are wages) to match the date on the checks. That means even if you and your client don't receive the funds until January, the Forms 1099 issued to you and your client – and to the IRS and the California Franchise Tax Board – will show that it was paid in December. Your client will have no choice but to report the payments for December.

They can explain the January delivery of the check, back the Form 1099 out of their tax return, and report it as next year's income. But many clients and their accountants will just go along with the December income to avoid fighting with the IRS. There can be client relations issues too. If you receive 100% of the proceeds in January and you sent the client their share in mid-January.

Then, around January 31, your client receives an IRS Form 1099 that says it was last year's income. They may not be pleased. Lawyers who receive a 1099 saying the payment was made in December when it arrived in January usually have an easier time tax-wise than their clients. The Form 1099 the lawyer receives will usually be a Form 1099-MISC, reporting as "gross proceeds paid to an attorney," in Box 10.

The tax forms the client receives will be Form 1099-MISC Box 3 (other income), Form 1099-NEC (nonemployee compensation), or Form W-2 for wages. All those tax forms and amounts are matched in the IRS system against the client's tax return to track if they reported it, and how. In contrast, the lawyer form is not generally tracked as income by the IRS.

Thus, if the lawyer records and reports the fee income in January, there is usually less to explain on the lawyer's tax return. The best solution to many of these dilemmas in a case settling near the end of the year is to think about it and specify what you and your client want before your client signs. That might be payment in 2022, in 2023, or some of each.

In fact, there may even be timing differences when lawyers and clients want to be paid. From a tax viewpoint for the client, it is easiest if the lawyer and client are paid at the same time. However, depending on the type of case and the tax treatment, it is often possible for a lawyer and client to be paid at different times (and in different tax years), if that is what they want.

Which should you and your client prefer at year-end, money in December or January? The classic answer is that January is usually best from a tax viewpoint. If you receive money in December, taxes are due on April 15, just four months later. But if you specify payment in January, your taxes are due April 15 a year later, about *16 months* away. For most people, that is worth a lot. Sure, you may have estimated tax payment requirements, but it's still useful time, and worth something.

There's an added plus for plaintiffs too. For lawyers, the fee income may be straightforward, but how about for the client? Depending on the type of case, your client's tax issues may be complex. Are they required to treat it all as taxable income? If they received a Form 1099, that is not always the last word.

For example, even if it was an employment case, is there an argument that some of it is for personal physical sickness and shouldn't be taxed? How about investment losses, property damage, equity losses, intellectual property, or insurance recoveries? Are there arguments that some or all the client proceeds are capital gain rather than ordinary income?

Even worse, is it clear that the plaintiff can deduct your legal fees? Since 2018, in many cases, it is not so clear if the plaintiff can deduct the lawyer's fees. At a minimum, some ingenuity might be needed. The U.S. Supreme Court ruled in a landmark tax case that even if a plaintiff receives settlement proceeds net of legal fees and never sees the portion sent to the plaintiff lawyer, the plaintiff is treated as receiving 100% of the funds for tax purposes. See *Commissioner v. Banks*, 543 U.S. 426 (2005).

In taxable cases – even partially taxable ones – your client wants to be able to deduct or offset the fees somehow. An added benefit of having the payment in January is that it can give the plaintiff 16 months to get tax advice, and to sort out what kind of tax choices they may have. Having 16 months to do that is a lot better than only having four months. Tax advisers, including tax preparers, get very busy every year in the run up to the annual April 15 filing deadline.

Splitting settlement payments into installments, with some in December and some in January, is popular too. Depending on amounts and income tax brackets, it can help with the taxes. Possible tax rate increases can also be worth considering. It does not look likely this year-end, but in some years, there are discussions in Congress about potential tax rate increases. That can sometimes make it attractive to get paid at year end, despite the usual advantages of calling for payment in January.

The bottom line is that it is worth thinking through what lawyers and their clients want when it comes to the timing of payments. Some defendants will care and will push back on requests of this nature. But many will not, so it pays to plan ahead and to ask for what you and your client want.

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