Phantom Merger Income Then Death: True Double Whammy

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No one wants to receive taxable income but no cash. Sometimes the problem is liquidity, getting something that has value and is taxable but that you can't sell. Sometimes, it is worse, truly getting somethign that hardly seems to have value.

In extreme cases, it can mean that you have to liquidate other assets to be able to pay the tax bill. That's one reason for extreme caution in corporate reorganizations. f you are doing a share swap and ending up with stock in the acquiring company, you would be pretty upset if you found out after the fact that it was taxable.

Of course, a supposedly tax-free reorganization that ends up being taxed after all is rare. Still, it does happen. If you combine that kind of unhappy circumstance with death, well, the hits just keep on coming.

In *A.J. Santangelo* [DC-MS, 2014-1 USTC ¶50,222 (2014)], the court faced a messy case of constructive receipt, albeit in a deal that was supposed to involve cash. Constructive receipt is that awkward tax doctrine that tax advisers understand but many taxpayers find hard to fathom. It applies to cash basis taxpayers, causing them to pay tax sometimes even when they did not receive any cash.

Cash basis taxpayers must report money unconditionally subject to their demand as income even if they have not received it. However, there is no constructive receipt if the amount is available only on surrender of a valuable right or if there are substantial limits on the right to receive it. It is this latter element of the constructive receipt doctrine that so often causes taxpayers real fits.

In *Santangelo*, we meet Natalie Santangelo, who reported on the cash basis. She owned 21,534 shares of common stock in HCA, Inc. The stock was divided into two certificates: one for 7,178 shares and the other for 14,356 shares.

Rather than turning the certificates over to a broker or bank to hold, Natalie did it the old fashioned way. She kept possession of the physical stock certificates or at least tried to. And that lead to some of the tax problems her heirs would have after her death.

Deal Closing

In November 2006, HCA merged with Hercules Acquisition Corporation. As part of the deal, the holders of the HCA common were to receive $51 per share, and their stock would be cancelled. Pursuant to the cash merger agreement, HCA deposited the funds with a paying agent on November 20, 2006.

Natalie was therefore eligible to receive $1,098,234 on that date. To collect, she was required to surrender her physical stock certificates or follow the steps outlined in the merger agreement for shareholders who had misplaced or lost their certificates. Did she do so?

Unfortunately, no. In fact, although the funds for her shares were available in November 2006, neither Natalie nor her daughter, Rita, took action. Rita held a power of attorney, so she could have handled it, too. Neither of them even tried to collect the proceeds before Natalie's death on March 29, 2007.

Lucky Find?

In November 2007, Natalie's family found the stock certificate for 7,178 shares. So they redeemed it, depositing the proceeds in the Estate account on January 8, 2008. But they never found the second stock certificate for 14,356 shares.

However, the Estate eventually collected the money attributable to that certificate the following year. The Estate followed the steps outlined for a lost certificate and received the final payment on October 19, 2009.

Information Matching

Exactly how this all might have been reported might well have been debated were it not for the Form 1099. In fact, HCA issued a Form 1099 indicating that Natalie received taxable proceeds in the full amount in 2006. That probably sounded quite unfair to the Santangelo family since the money did not materialize until 2008 and 2009.

In October 2007, after Natalie's death, the Estate hired an accountant, Alice Van Ryan, and filed Natalie's 2006 tax return. Following the advice of Ryan, the Estate claimed the full $1,098,234 as income on her 2006 return. That was the amount reflected on the Form 1099.

Do Over

Later, that decision did not look so good to the Estate or the heirs. As a result, the co-executors sought a refund for 2006 in the amount of $152,903. The Estate took the position that the income should not have been claimed in 2006 because it was not actually received in 2006.

Not surprisingly, the IRS denied the refund, concluding that the income was properly claimed on the 2006 tax return because it was constructively received. The co-executors then sued for a refund. Of course, they had to deal with the constructive receipt doctrine.

They argued that the three-year delay in obtaining the funds negated constructive receipt. After all, they claimed, how could one be considered as having the right to just collect the money when in fact it took a whole three years to get it with diligent efforts! It was actually a creative argument, although the court was not impressed.

The court noted that the co-executors failed to cite any legal authority for it to negate the constructive receipt doctrine. The court also noted that the Fifth Circuit, to which this case is appealable, has applied constructive receipt to even longer delays.

The co-executors also claimed that the constructive receipt doctrine did not apply because HCA was actively resisting making the payment. That gave a legal impediment to the payment much beyond a mere delay. The funds, the co-executors argued, were therefore subject to substantial limitations or restrictions.

What Legal Restrictions?

Tax advisers will recognize that this was a more nuanced and persuasive argument than the first one. After all, there can be different legal interpretations of contracts, and disputes about payment can and do arise. Having some correspondence or even pleadings about such a dispute can clearly make the difference in a case of the constructive receipt doctrine.

Unfortunately, the court agreed with the IRS that there was no evidence in the record to show that there really had been any dispute at all. HCA was willing to pay the amount, and the taxpayer simply had to present the certificates or follow the rules to claim they were lost. Accordingly, the court found that IRS properly assessed the tax in 2006 consistent with the doctrine of constructive receipt.

Unfortunate cases of this sort may be the best reason for having shares held in street name by a broker. It seems likely that this result could have been avoided. In fact, in all likelihood, the account would have been credited in 2006.

On these facts, though, Natalie was in constructive receipt of income from a stock sale triggered by a merger in 2006. That was so even though neither she nor her daughter attempted to access the funds before her death the following year.

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