The Conundrum of Constructive Receipt

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (http://www.woodporter.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (4th ed. 2009), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (4th ed. 2007), all available at http://www.taxinstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

In this article, Wood looks at the constructive receipt doctrine and at the kinds of legal impediments that can constitute substantial restrictions. He points out that constructive receipt concerns can often be addressed by good documentation.

Constructive receipt is one of those fundamental tax concepts that can have an impact across a variety of tax fields. Under the constructive receipt doctrine, a taxpayer has income when he has an unqualified, vested right to receive immediate payment.[1] The constructive receipt doctrine prevents a taxpayer from deliberately disregarding income that is available to him.[2] When one has an unfettered right to receive something, its actual receipt will be assumed, even if the taxpayer doesn't actually collect it until later. Constructive receipt trumps actual receipt.

The classic example is the bonus check that the employer makes available in December, but that the employee asks to have held until January 1. Despite normal cash accounting that would suggest the bonus is not income until actually paid, the employer tried to pay in December and made the check available. That makes it income to the employee in December, even though it is not collected until January.

Constructive receipt is an issue only under cash accounting. If you are an accrual basis taxpayer (as are most large corporations), you already have the concept of constructive receipt built into the accrual method. Under the accrual method, a taxpayer has income at the point when all events have occurred that fix the right to receive the income, and its amount can be determined with reasonable accuracy.[3]

Under the accrual method, all events have occurred to fix the right of income when the required performance occurs, payment is due, or payment is made, whichever happens first.[4] Accrual method taxpayers must accrue income when they have a legal right to income, regardless of when they receive it. Therefore, under the accrual method of accounting, you normally book income when you send out an invoice, not when you later collect it.

For taxpayers using the cash method (the vast majority of individuals and many small businesses), the risk of "pay me later" manipulations is simply too great for the tax law to ignore. Section 451, one of the accounting sections of the code, includes the constructive receipt rule. The regulations under it provide that a taxpayer generally has constructively received property when it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available for the taxpayer to draw on it if notice is given.[5]

On the other hand, income is not constructively received if the taxpayer's control is subject to substantial limitations or restrictions. In the real world, of course, the facts are often considerably more complex than the classic example of the year-end bonus. There is much discussion of what "substantial limitations or restrictions" actually means.

There are often line-drawing exercises over the extent to which the money was available and unrestricted. For example, what if the employer cuts the check on December 31 but tells the employee he can either drive 60 miles to pick it up or have it mailed? Many of those transactions occur, and although the employer may well book this as a December payment (and issue a Form W-2 or Form 1099 in that way), the recipient may have a legitimate position that it isn't income until received. Again, those mismatches occur frequently, and there's little to suggest there's manipulation going on.

Legal Rights Released

In the context of cases resolving litigation, lawyers and structured settlement brokers commonly must address constructive receipt concerns. For example, if a case settles and funds are paid to the plaintiff's lawyer, it is usually too late to structure the plaintiff's payments. Even though the plaintiff may not have actually received the money, his counsel has. A lawyer is the agent of his

[1] *Childs v. Commissioner*, 103 T.C. 634, 654 (1994), *Doc 94-10228*, *94 TNT 223-15*, *aff'd*, 89 F.3d 856 (11th Cir. 1996), *Doc 96-19540*, *96 TNT 133-7*.

[2] Rev. Rul. 60-31, 1960-1 C.B. 174.

[3] Reg. sections 1.446-1(c)(1)(ii) and 1.451-1(a).

[4] Rev. Rul. 84-31, 1984-1 C.B. 127.

[5] *See* reg. section 1.451-2.

client, so there is constructive (if not actual) receipt. Constructive and actual receipt often operate in tandem.

Recently, the IRS addressed the topic of condemnation proceeds and the constructive receipt doctrine. In LTR 200944012 (July 27, 2009), *Doc 2009-23894*, *2009 TNT 209-34*, the IRS concluded that a taxpayer was not in constructive receipt of condemnation proceeds that had been deposited with the state treasurer during the time the taxpayer was contesting the condemnation. The ruling illustrates the linchpin that a release of legal rights can become.

The taxpayer was a commercial property operator that typically purchased commercial property and leased it to third parties. The city filed a condemnation action on one of the taxpayer's properties, depositing with the state treasurer the amount the city thought would be the probable taking price. The taxpayer objected to the condemnation proceedings, claiming affirmative defenses challenging the condemnation.

The money the city proposed to pay the taxpayer was sitting in an account ready for the taxpayer to take it. That might make you *think* the taxpayer should be taxed on the money. Indeed, the state's eminent domain law allowed a taxpayer to apply to withdraw a deposit at any time. However, withdrawal of the funds would operate as an abandonment of any challenge or defense to the city's right to take the property.

In the first year, the taxpayer did not apply to withdraw the deposit. Instead, the taxpayer continued to fight the condemnation action. In the second year, however, the taxpayer and the city reached a settlement, and the taxpayer received the deposit. The taxpayer made an election on that year's tax return to defer its gain under section 1033. The question in the ruling was whether the timing provisions of section 1033 were triggered in the first year or the second year.

In the first year, the monies were on deposit, and the taxpayer had the ability to withdraw the money. Traditional constructive receipt concepts might cause you to think the taxpayer should be taxed on the income at that point. Of course, it's a little more complicated than that.

After all, by withdrawing the money, the taxpayer would have had to release its claims and defenses to the condemnation. Those represented legal rights. In year 2, of course, the taxpayer did withdraw the money, at that point having reached a compromise with the city.

Sensibly, the ruling concludes that the state's requirement that the taxpayer abandon any challenges to the city's condemnation action was a substantial limitation or restriction on the money. That prevented constructive or actual receipt of the deposit in year 1. Therefore, the three-year condemnation reinvestment limit under section 1033(g) was triggered from the close of year 2, not year 1.[6]

[6]*See also Nitterhause v. United States*, 207 F.2d 618 (3d Cir. 1953) (regarding when the entitlement to condemnation monies arises).

Disputes as Limitations

The importance of a release of legal rights cannot be overemphasized because that topic comes up repeatedly. It is worth questioning the extent to which a release of legal rights affects constructive receipt of funds that have been set aside. More importantly, can such a release manipulate the constructive receipt doctrine?

For example, suppose that lawyer A and client B have a contingent fee contract calling for A to represent B in a contract dispute. If A succeeds and collects any money, the contract provides that B receives two-thirds and A retains one-third as its fee. Before the one-third/two-thirds split, however, costs are to be deducted from the gross recovery.

Suppose that A and B succeed in recovering $1 million in November 2010. Before receiving that money, however, A and B become embroiled in a dispute over the amount of costs in the case (costs total $50,000) and the appropriate fee. A and B agree that $25,000 of costs should first be deducted. However, B asserts that the other $25,000 in costs is unreasonable and should be borne solely by A.

Further, B asserts that a one-third fee is unreasonable, and that the most he is willing to pay is 20 percent as a legal fee. A and B try to resolve their differences, but cannot do so by the end of 2010. They come to you in January 2011 wanting tax advice, at which time the $1 million still remains in A's law firm trust account. What income must A and B report in 2010?

Disputed and Undisputed Amounts

Arguably, the key to this fact pattern is that most of the facts are not disputed. That is, A and B have explicitly or implicitly agreed on some things. They appear to have agreed that $25,000 in costs can be recouped, and that A 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 rather on $975,000.

However, it looks as if A 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 B, it is also not yet clear how much B will net from the case. Yet it is clear that the minimum B will get could be calculated by applying the provisions in the fee agreement.

Thus, taking the $50,000 as costs, B should receive two-thirds of $950,000, or $633,270. Even under A's reading of the fee agreement, that is the amount to which B is entitled. B might receive more if his arguments prevail.

How much should A and B each 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 A and B 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, that does not appear to be the appropriate treatment. Indeed, the positions of the parties seem clear that each is already entitled to *some* money. That gives rise to income, regardless of whether they actually receive the cash. If they have a legal right to the money and could withdraw it, that is constructive receipt, if not actual receipt.

Any talk of withdrawal should invite discussion of restrictions and partial agreements. For example, what if you consider that while the above are the negotiating positions of A and B, neither of them will agree to any distributions, treating the entire amount as disputed? Does that mean neither have any income in 2010? Does it matter what documents are prepared?

The answer to the latter question is surely yes. Good documentation always goes a long way in helping to achieve tax goals. For example, if there is some kind of escrow agreement acknowledging that all of the money is in dispute and prohibiting any withdrawal until the parties agree, that may forestall immediate income.

If there is a document each party signs agreeing that they disagree and that no party can withdraw any amount until they both agree in writing, that should be pretty convincing. I am not sure it is dispositive. It may be hard to deny that the parties' positions speak for themselves and that some portion of the funds is undisputed. Besides, there is also the strong argument that because the lawyer is the client's agent, settlement monies in the hands of the lawyer are, for tax purposes, already received by the client.

That raises another point, which relates to the defendant in this example. The defendant paid the $1 million in 2009. Depending on the nature of the payment, it seems reasonable to assume that the defendant will deduct it in 2009. It will likely issue one or more Forms 1099 too, probably to both A and B in the full amount of $1 million each. How will A and B treat it?

There may be a variety of possibilities. Assuming both A and B 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 treat the income (or lack thereof).

Escrow vs. QSF

But it does invite questions as to the nature of the escrow itself. Is it an escrow, or could it be a qualified settlement fund (QSF)? A QSF seems better than an escrow. If the fund is a QSF, the defendant would be entitled to its tax deduction, and yet neither A nor B would be taxed on the fund's earnings. The fund itself would be taxed.

On those facts, it seems unlikely that the escrow could be a QSF. A QSF is typically established by a court order and remains subject to the court's continuing jurisdiction.[7] Yet in our example, there is no court supervision of the escrow.

If the fund is merely an unsupervised escrow (as seems likely here), either A or B should be taxable on the earnings in the fund, but not on the principal until the dispute is resolved and the disputed amount is distributed. Unlike a QSF, escrow accounts are typically not separately taxable, so one of the parties must be taxable on the earnings of the escrow account. Who is taxed can be determined by the agreement of the parties, or in the case of some types of escrows used in like-kind of exchanges or preclosing of property, by regulations under section 468B.[8]

The escrow holding the disputed amounts between A or B clearly is not one holding property for a like-kind exchange or, for that matter, a preclosing escrow. Therefore, the escrow would presumably be taxable to the beneficial owner of the funds held in escrow. When income from property held by an escrow benefits (or will be used to satisfy the legal obligations of) a person who caused the property to be held in escrow, that person is deemed to be the owner of the property. The income of that property is includable in the beneficial owner's gross income, even though that person may never actually receive it.[9]

Either A, B, or both of them could be viewed as beneficial owners under the analysis in this article. Therefore, the need for proper documentation — in particular an agreement regarding who will be taxed on the disputed funds while held in escrow — becomes obvious.

Conclusion

It's probably safe to assume that most cash basis taxpayers do not want to be taxed on monies until they actually receive them. However, when the constructive receipt doctrine applies, that is precisely what can happen. Constructive receipt can often be avoided through careful planning, proper documentation, and consultation with a competent professional tax adviser. Tread carefully, and be thorough in your documentation.

[7] Reg. section 1.468B-1(c)(1).

[8] *See* reg. section 1.468B-6 and B-7.

[9] Rev. Rul. 77-85, 1977-1 C.B. 12, *modified on other grounds*, Announcement 77-102.