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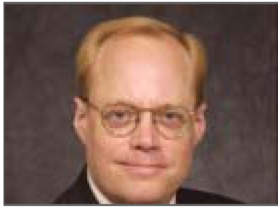

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Three Surprising Non-Cash Items IRS Says You Must Report On Your Taxes

To the person on the street, the phrase "for tax purposes" sounds artificial, if not ridiculous. A variety of events can give you taxable income even though you've seen no cash. Here are the most common ones you may encounter:

1. Cancellation of Debt Income. One category where you can have income despite an absence of cash involves a discharge of debt (also called cancellation of debt or "COD" income). If you are solvent and are relieved of the obligation to repay a debt (your debt is forgiven), the tax law says you've just received the forgiven debt as income. In most cases, lenders are required to issue a Form 1099-C reporting this COD income to ensure you don't omit it from your tax return. there are a few key exceptions to be aware of: Debts forgiven while you're in bankruptcy–or if not in bankruptcy when you are technically insolvent with more debt than assets–don't count as income.

2. Partnerships, LLCs and S Corporations. Phantom income from entities can be a big problem. Partnerships, limited liability companies (LLCs) and S corporations are pass-through entitles. That means they are generally not taxed themselves, their owners are taxed. Each owner receives a Form K-1 that reports his or her appropriate share of the income (or loss) even if that income is retained by the business and not distributed to the owners. You are obligated to report it, regardless of whether you received any payout. The IRS matches K-1s against individual tax returns.

3. Constructive Receipt. If you have a legal right to a payment but elect not to receive it, the IRS can tax you nonetheless. Constructive receipt requires you to pay tax when you merely have a right to payment even though you do not actually receive it. The classic example of constructive receipt is a bonus check.

Suppose your employer tries to hand it to you at year end, but you insist you'd rather receive it in January, thinking you can postpone the taxes. Wrong. Because you had the right to receive it in December, it is taxable then, even though you might not actually pick it up until January.

On the other hand, if your company actually 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 recognition of the income until the next year. Yet even in this circumstance, the IRS might contend you had theright to receive it in the earlier 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 2009 with the understanding that you will complete all of the services in 2009, but will not be paid until Feb. 1, 2010. Is there constructive receipt? No. 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 you are selling your watch collection. A buyer offers you $100,000 and even holds out a check. Is this constructive receipt? No, unless you part with the watch collection.

If you simply refuse the offer—even if your refusal is purely tax-motivated because you don't want to sell the watch collection until January—that will be effective for tax purposes. Because you condition the transaction on a transfer of legal rights (your title to the watch collection and presumably your delivery of it), there is no constructive receipt.

If you are settling a lawsuit, you might refuse to sign the settlement agreement unless it states that the defendant will pay you in installments. 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.

Tax issues in litigation are huge, and you should consider the bottom line after taxes, not before taxes. In fact, when settling litigation, you should always address taxes, preferably *before* you sign. Otherwise you may end up with a Form 1099 you would rather not have.

There is much artifice in the tax law. Some of it can be helpful, and some of it is decidedly hurtful. If you have ever received a Form K-1 reporting phantom income to you when you received no cash, you know exactly what I mean!

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