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Expert View

When You've Got Taxable Income But No Cash

Robert W. Wood, 10.12.09, 6:00 PM ET

To the person on the street, the phrase "for tax purposes" sounds artificial, if not ridiculous. Even Jerry Seinfeld, in his eponymous television series, poked fun at it.

Still, it's a phrase ordinary taxpayers need to pay attention to. For example, take the notion of "constructive receipt" of income for tax purposes. A variety of events can give you taxable income this year even though you've seen no cash. Here are the most common ones you may encounter:

Partnerships, LLCs and S Corporations

Partnerships, limited liability companies (LLCs) and S corporations are all what's known as "pass-through" entitles. That means they are generally not taxed themselves, as C corporations are. Rather, 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 generally obligated to report on your tax return the amount attributed to you on Form K-1. Whether you received any payout is really irrelevant to the tax question.

Note that the Internal Revenue Service matches K-1s against individual tax returns. So if you receive what you believe is an incorrect K-1, don't ignore it. Try to get the issuer to correct it--as you would if a bank or broker sent you an incorrect 1099.

If that doesn't work, in some circumstances, you can dispute a Form K-1 arguing it is wrong (file IRS Form 8082). In general, though, you must report what you see on a Form K-1. The happier flip side of this is that a Form K-1 may attribute a tax loss to you, which you may be able to use to offset other income.

(For more tips on avoiding trouble with the IRS, click here.)

Cancellation of Debt Income

Another category where you can have income despite an absence of cash involves a discharge of debt (also called cancellation of debt or "COD" income). This has long been one of the more confusing and obscure parts of the tax law. But in the current recession, many more taxpayers have become painfully aware of it. If you are solvent and are relieved of the obligation to repay a $500,000 debt (your debt is forgiven), the tax law is clear that you've just received $500,000 in taxable 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. But don't assume that just because you receive a 1099 you have taxable income--in certain circumstances, you can avoid recognizing this income, and the lender doesn't necessarily know if you're in one of those circumstances.

The rules are complex and have been recently changed. But 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. In addition, the Mortgage Debt Relief Act of 2007 generally allows you to exclude from income debt forgiven on your principal residence if the debt is wiped out as part of a mortgage restructuring or foreclosure that takes place between 2007 and 2012. Plus, you don't have to be broke to take advantage of this exception.

More details are available in IRS publication 4681. But this is a "don't try this at home" category--if you have COD income, particularly some you think shouldn't count, you should seek professional tax help.

(For advice on getting the feds to slash your mortgage payment, click here.)

Constructive Receipt

If you have a legal right to a payment but *elect* not to receive it, the IRS can tax you nonetheless. This isn't a cash vs. accrual question. Most individuals are cash-basis taxpayers (we only pay tax on what we receive). Most businesses are accrual-basis taxpayers (they are treated as "earning" income when they *send* an invoice, even though they may not collect the invoice until next year). But the constructive receipt doctrine can trump cash accounting. 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 the *right* 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.

Conditional Payments

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.

You can apply the same logic to a sale of your house. You might refuse to sell for cash and instead insist on payment in installments over ten years. Again, no constructive receipt. But you *would* have constructive receipt if you asked for installments *after* you signed all the papers entitling you to all the cash at the time of sale.

Legal Settlements

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 much 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.

Economic Benefit?

Another fundamental tax doctrine is the related (but distinct) concept of economic benefit. The constructive receipt issue focuses on when you *could* have received something, even though you might chose to receive it later. In essence, the income is imputed because you *could* have received it.

Economic benefit, on the other hand, focuses on whether you have the *benefit* of something, even if you do not yet have it in your hands. Most of the authorities deal with trusts or accounts established for someone's benefit. The issue is most likely to arise with various executive compensation strategies.

Rabbi Trusts

One of the most famous deferral arrangements is called a rabbi trust, so named because the first publicized case involved a rabbi who entered the arrangement with his congregation. These days, rabbi trusts usually involve executives, not clergy. Done properly, a rabbi trust does not run afoul of the economic benefit or constructive receipt doctrines.

Example: The worker enters into a contract with the employer before services are provided. Monies are nominally (but not actually) set aside, and they are subject to claims by the employer's creditors. No separate trust is established. On paper, amounts are being held for the executive, but funds are not segregated, and there is no separate account. For that reason, there is no economic benefit. Moreover, there is economic risk--if the company goes bankrupt, the executive is simply another unsecured creditor, meaning he may never see that deferred pay.

Beware!

A little knowledge about the tax law can be a dangerous thing. You might get the sense from this brief romp through constructive receipt and economic benefit doctrines that you have a good sense of how to manipulate your own income. That is probably inaccurate.

Indeed, my main point is that there is much artifice in the tax law. Some of that 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!

Robert W. Wood is a tax lawyer with a nationwide practice. The author of more than 30 books including Taxation of Damage Awards & Settlement Payments *(4th Ed. 2009), he can be reached at wood@woodporter.com.*

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