PERSPECTIVE

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Year-end Invoices, Payments And Tax Deferral, Oh My! A Guide For Lawyers

By Robert W. Wood

Year-end is always a stressful time, even in a normal year. Amidst year-end invoicing, collections, bonuses to consider, office and personal gifts, and all those holiday parties, it can take a toll. Of course, this year is different, in just about every way. Eggnog via Zoom? But some things still need doing, and taxes are one of them.

Our tax system is annual, and most law firms, like individuals, operate on a calendar year. That means December 31 is the cutoff for payments you make, and payments you receive. There are exceptions, of course, such as pension plan contributions that can be made up until tax time on April 15th. But mostly, you need to think of it as a hard deadline.

This pandemic year is wildly different, and there's one more thing that doesn't happen every year: political change. President Elect Biden has tax plans, and California too has proposed hiking taxes. Amid all the hubbub, would you prefer to receive payment in 2020, or during the first week in January?

"Pay me next year" requests are common this time of year with employers, suppliers, vendors, customers, and more. After all, if you are paid in December of 2020, taxes are due April 15, 2021. If you are paid in early January 2021, taxes are due April 15, 2022. It seems like an easy decision, but many people assume that taxes may go up, which may cut the other way.

President Elect Biden has proposed hiking tax rates from 37% to 39.6%, plus taxing long-term capital gains and qualified dividends at ordinary income tax rates on income above $1 million. He also proposed a big tax increase on death. Whether the Senate ends up controlled by Democrats or Republican after the Georgia run-off could be key. But even if you decide what you want, can you ever put off income you are about to receive?

On a cash basis, you might assume that you *cannot* be taxed until you actually receive money. Yet if you have a legal right to payment but decide not to receive it, the IRS can tax you under the doctrine of *constructive* receipt. It requires you to pay tax when you merely have a *right* to payment, even though you do not actually receive it. The classic example is a bonus check your employer tries to hand you at year-end.

You might 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. As a practical matter, if your company 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 the income until the next year.

However, even here, the IRS might say that 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 2018 with the understanding that you will complete all of the services in 2018, but will not be paid until Feb. 1, 2019. Is there constructive receipt? There shouldn't be. 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.

Lawyers understand lawsuits and legal settlements. But even lawyers get confused about these constructive receipt tax issues, for good reason. If you are a contingent fee lawyer, you probably think that your fee is 99.9% after you've negotiated a good settlement and documented it, even before the client signs the settlement agreement. After all, as the lawyer, you usually are not even signing the settlement agreement. All that remains for your 40% contingent fee to be fully payable is the client signing the settlement agreement.

If you are a plaintiff 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.

The plaintiff can ask for a structured settlement too, where the money is doled out over time. Surprisingly, that tax rule covers lawyers too. The settlement agreement can include structured legal fee provisions too. If properly handled, that way the lawyer will be paid fees over time, rather than all at once. One big key is making sure that the settlement agreement is not yet signed.

More generally, of course, tax issues in litigation are almost always present. Whether you are the client or the lawyer, consider the bottom line after taxes. There are often IRS taxes on legal settlements and legal fees. And even in this unusual and strange year, those who do not plan ahead might just end up with an unexpected IRS Form 1099 or even worse.

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