Constructive Receipt and the Substantial Restrictions Limitation

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THE GENERAL RULE FOR INCOME INCLUSION is found in IRC Sec. 451(a). For a cash-basis taxpayer, items of income should be included in the gross income total for the year that the taxpayer receives that income. Treas. Regs. Sec. 1.451-2 explains that a taxpayer need not have physical possession for an amount to be included in gross income. Income that is set aside for the taxpayer, credited to an account, or otherwise made available is *constructively received* by the taxpayer. If the taxpayer's control is subject to "substantial limitations or restrictions," however, the income isn't considered to be received. The difficulty is that neither the IRC nor the Regulations precisely define "substantial limitations or restrictions," so understanding of this phrase and its operation comes from reviewing judicial interpretations and their application.

Overview of Constructive Receipt

Determination of whether or not income has been constructively received is made on a factual basis. Slight differences in facts require the tax professional to examine a case carefully before using it as a precedent. Constructive receipt requires an unqualified vested right to receive income—there can be no condition, limitation, or restriction that prevents the taxpayer from having unrestricted access to his or her money without penalty. The taxpayer, however, can't waive a present right to receive income—in other words, the taxpayer may not "turn his back" on income that is already earned. But if the taxpayer requests deferral of payment prior to receiving an unqualified vested right to income, constructive receipt doesn't occur.

Avoiding control is essential if a taxpayer seeks to avoid income recognition. The limitations or restrictions preventing constructive receipt, however, can't be imposed by the taxpayer. In *Williams* [CA-5, 55-1 USTC ¶9220], a taxpayer attempted to defer income recognition by using an escrow account. At the taxpayer's request, the entire sales price of the transaction was paid to an escrow account. The Fifth Circuit declared "a 'self-imposed limitation' created by the seller-taxpayer is legally ineffective to shift taxability on escrowed funds one year to the next."

The Tax Court has followed *Williams* but without broadening its scope. *Williams* has been restricted to a situation where the taxpayer has a present right to receive income and a self-imposed arrangement is negotiated to delay recognition.

Substantial Restrictions

What is sufficient to prevent "control" of the funds by a taxpayer? There are several categories of restrictions that limit the taxpayer's control:

- Contingencies that must occur before control vests,
- Restrictions on the use of income,
- The loss of a valuable right if control vests immediately, and
- Lack of the power to collect money made available to

the taxpayer.

Here are some judicial interpretations that help illustrate the types of restrictions.

Contingencies or Conditions: In *Vestal* [CA-8, 74-1 USTC ¶9407], the taxpayer and the IRS reversed roles. The taxpayer desired immediate recognition of income, and the IRS invoked the doctrine of constructive receipt to postpone recognition to a time the value of the rights was much higher.

In 1962, Vestal provided investment services to obtain future rights to fractional shares of an oil and gas partnership. In addition to granting the future rights, the agreement also provided that a partner would not convey any interest to Vestal until that partner had recovered his initial investment plus 6% interest compounded semiannually. In 1962, the value of Vestal's rights was estimated to be $29,375. The value of the rights wasn't included in Vestal's income in 1962. Invoking the doctrine of constructive receipt and substantial limitations, the IRS maintained that the rights conveyed by the 1962 contract were "contingent, conditional, and speculative and, as a matter of law, did not constitute income taxable to Vestal in 1962."

Citing numerous cases, the opinion affirmed that judicial precedent is "loath to assess any present tax consequences" when there are unmet conditions or contingencies, such as the partners' right to recover their investment with interest.

Restrictions on the Use of Income: If the taxpayer isn't free to control the disposition of the funds, there is no constructive receipt. In *Kershaw Manufacturing* [20 TCM 443], the company calculated and accrued cash bonuses on their books. Employees were told that 25% of the profits were going to be paid to the employees as stock bonuses. Employees were called into the company office and told to sign for their stock. What the employees actually signed was the back of a bonus check. The employee then received a check stub showing withholding tax, social security deduction, and net bonus, plus the appropriate shares of stock based on the par value of the preferred stock.

The Commissioner contended that this was simply a two-step process to issue a stock bonus. The Tax Court agreed that the checks were never under the control of the employees and weren't income.

Loss of a Valuable Right or Property: If receipt or control of income requires the taxpayer to give up a valuable right or property, a substantial limitation exists. For example, in Rev. Rul. 68-482 [1968-2 CB 186], the IRS ruled that taxpayers would not be in constructive receipt of increases of the cash surrender value of life insurance policies because the policy must be surrendered in order to receive the cash.

In *Fromson* [94-2 USTC ¶50,425], the taxpayer was awarded damages, plus post-judgment interest and court costs arising from a patent infringement suit. The taxpayer received a check for damages but not the interest or court costs. Upon advice of counsel, the taxpayer returned the check for fear of forfeiting the interest and court costs. The Claims Court stated that the taxpayer's belief that cashing the check might prejudice his right to collect interest and court costs wasn't reasonable. Since no valuable right was forfeited, the check was income in the year received.

Power to Collect: Treas. Regs. Sec. 1.451-2(a) implies that the power to collect funds must be present. Constructive receipt occurs when the taxpayer has income "credited to his account set apart for him or otherwise made available *so that he may draw upon it at any time*…" (emphasis added).

In *Hornung* [47 TC 428], the taxpayer was notified at 4:30 p.m. on Sunday, December 31, 1961, that he had won a Corvette as the Most Valuable Player in the 1961 NFL Championship game. He received the keys to the car on January 3, 1962. Since the game took place in Green Bay, Wis., and the Corvette was in New York, the taxpayer didn't have constructive receipt until 1962. As a practical matter, there was no way for the taxpayer to take physical possession of the car in 1961. The Tax Court ruled that there was no constructive receipt because the taxpayer had no keys or title to demonstrate his ownership, no control over the car, and its delivery wasn't available on demand.

Another restriction is the solvency of the debtor required to make a payment to the taxpayer. Courts have taken a practical position on this issue. No matter how fixed, certain, and unfettered the taxpayer's right to income, if the debtor can't pay, there is no constructive receipt.

Recognition or Deferral

A cash-basis taxpayer may have to recognize income before he/she actually receives the money. Income that is set aside for the taxpayer, credited to an account, or otherwise made available is treated as being constructively received by the taxpayer and thus must be recognized. The key to recognition or deferral is an unrestricted present right of the taxpayer to control the disposition of the income. If substantial limitations or restrictions hinder the taxpayer's right of access to income, then recognition can be deferred. Taxpayers who seek to defer income recognition must avoid an unqualified right to control that income. ■

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