Deal Closings, Forms 1099 and Constructive Receipt

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Do Forms 1099 get issued in error or in ways that are at odds from the economic details of the transaction? The question sounds rhetorical. We know that sometimes there are mistakes.

Sometimes one can prevail and fix them, either before filing or as part of (and on) one's tax return. The issuer and recipient of the Forms 1099 may be at odds and may well disagree. After all, in corporate transactions, whether large or small, stock or assets or reorganization, there are likely to be some adverse parties.

Although there are almost certainly some tax effects in a transaction, there are also economics to be observed. In that sense, one could argue that the least desirable tax treatment is the unexpected one or one in which the tax impact is at odds with the economic impact. Put simply, you do not want to be surprised or taxed any earlier than you think you should.

And that brings us to constructive receipt, a fundamental tax concept. It can have an impact across a miscellany of tax fields. Under the constructive receipt doctrine, a taxpayer has income when he or she has an unqualified, vested right to receive immediate payment. That sounds easy, right?

Constructing Constructive Receipt

At its heart, the constructive receipt doctrine prevents a taxpayer from deliberately disregarding income. Thus, when one has an unfettered right to receive something, its actual receipt will be assumed. This is so even if the taxpayer does not actually collect it until later.

Constructive receipt therefore trumps actual receipt. The classic example is the bonus check the employer makes available in December, but which the employee asks to have held until January 1. Cash accounting would suggest that the bonus is not income until actually paid.

However, we know intuitively that this "pay me later" may not work. 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.

The regulations say that the income attaches when all events have occurred fixing the right to receive the income, when its amount can be determined with reasonable accuracy. [Reg. §§ 1.446-1(c)(1)(ii), 1.451-1(a).] 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. [Rev. Rul. 84-31, 1984-1 CB 127.]

Accrual-method taxpayers must accrue income when they have a legal right to income regardless of when they receive it. Under accrual accounting, you normally book income when you send out an invoice, not when you later collect it. For taxpayers on the cash method (the vast majority of individuals and many small businesses), the risk of manipulation is too great for the tax law to ignore.

Thus, Code Sec. 451 codifies constructive receipt. The regulations 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 upon it if notice is given. [See Reg. § 1.451-2.] Nevertheless, 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. There is much discussion of what the IRS means by "substantial limitations or restrictions." There can be 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 he'll mail it? Many such transactions occur. And reporting mechanics must also be considered.

The employer may book a December payment (and issue a Form W-2 or Form 1099 in that way). However, the recipient may have a legitimate position that it is not income until received. Such mismatches occur frequently, and there's little to suggest there's manipulation going on.

Yet sometimes there is, or at least the IRS *thinks* there is. And sometimes the taxpayer gets taxed before he has actual receipt, as occurred in the recent case of *Santangelo* [(CA-5, December 27, 2014) 114 AFTR 2d ¶ 2014-5572].

Stock Sale Receipt

Natalie Santangelo, like most individuals, reported on the cash basis. She owned 21,534 shares of common stock in HCA, Inc. The stock was divided into two certificates, one for 7,178 shares and another for 14,356 shares.

Natalie was old-school too. She actually had physical possession of the stock certificates, rather than turning them over to a broker, transfer agent or bank. In November 2006, HCA merged with another corporation. As part of the merger agreement, all common stock holders were set to receive $51 per share.

As often happens, they would receive the cash, and their stock would be cancelled. Pursuant to the merger agreement, HCA deposited the funds with a paying agent on November 20, 2006. Natalie was therefore eligible to receive her cash consideration of $1,098,234 (21,534 x $51) as of that date.

To collect, she was required to surrender the physical stock certificates or follow the steps outlined in the merger agreement for stockholders who had misplaced their certificates. But here is where the facts took an unfortunate turn. Despite the funds being available in November 2006, neither Natalie nor her daughter Rita, who had power of attorney, took any action to obtain the proceeds before her death on March 29, 2007.

In November 2007, the stock certificate for 7,178 shares was located and redeemed. That produced cash, and these proceeds were deposited in the estate account on January 8, 2008. The second stock certificate for 14,356 shares was never found.

The estate therefore followed the steps outlined for a lost share certificate. Eventually, that culminated in a final payment on October 19, 2009. But as you might expect, that was not the end of the story.

My Kingdom For a Form 1099

Reporting mismatches can be pervasive and seem permanent. Indeed, some measure of the result in this case was attributable to this nettlesome reality. HCA issued a Form 1099 indicating that Natalie received taxable proceeds in the full amount in 2006.

The IRS argued that Natalie had income from the sale in 2006. Natalie's estate took the position that the income should not have been claimed in 2006 because it was not actually received in 2006. In district court, the estate's co-executors argued that the constructive-receipt theory had no application for two reasons.

They first contended that the three-year delay in obtaining the funds negated this theory. Specifically, they argued that constructive receipt had not taken place because of the length of time it took for the taxpayers to ultimately obtain the redemption proceeds. That argument had a certain practical appeal.

Nevertheless, the court rejected this argument stating that no legal authority was cited to it supporting that notion. In any event, the court noted that the Fifth Circuit, to which this case was appealable, had applied constructive receipt to even longer delays. Time alone did not mean there was not a right to the immediate payment.

But the estate also claimed that constructive receipt did not apply because HCA was actively resisting the payment of the redemption proceeds. This was an arm's-length transaction, and although there was no litigation, it was not entirely friendly either.

Thus, the co-executors claimed, the funds were still subject to substantial limitations or restrictions. The court rejected this argument because it found no evidence in the record to support it. In short, the district court found that IRS properly assessed the tax in 2006.

Final Answer

Undaunted, Natalie appealed to the Fifth Circuit. The Fifth Circuit agreed that the taxpayer did not show a substantial limitation on receipt of the stock proceeds when they first became available in 2006. That meant there was income from the stock sale on the merger in 2006.

This was so even though neither the taxpayer nor her daughter (holding a power of attorney) took the required steps to surrender the stock certificates and to obtain the monies before her death the next year.

1099 Wars?

It does not happen often, but occasionally the recipient of a Form 1099 sues the issuer over the issuance of the form. These are generally in the consumer arena. For example, a plaintiff might claim that a discharge of debt reported on a Form 1099-C should not be taxed.

The payment of lawsuit settlements can be fraught with such problems too. A plaintiff who claims he had personal physical injuries or physical sickness from the defendant's actions may say that no Form 1099-MISC should have been issued. The defendant may agree that if the payment was really for such damages, no Form 1099 would have been appropriate. But the defendant may defend that those are not the facts.

Most lawsuits over Forms 1099 get dismissed or settled. And the tax and reporting rules themselves have many nuances so it is typically possible for issuers of the forms to justify their actions as just complying with the law. Not surprisingly, the IRS prefers to have taxpayers err on the side of reporting.

Equally unsurprising, the IRS will not join in private taxpayer litigation, even though one might say that the IRS arguably has a stake in the case. And, as frustrating as it may be for taxpayers who receive a Form 1099 with which they disagree, there is usually not much they can do about it except to address the subject of the Form 1099 on their return.