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Taxable Income But No Cash? What To Tell IRS

What items are taxable? It's easy to remember wages, since you receive a Form W-2. It's also easy to remember income reported on [Forms 1099, although if you are missing one, maybe not so much](#). Yet a variety of events can give you taxable income even though you've seen no cash. Constructive receipt requires you to pay tax when you merely have a right to payment, even though you do not actually receive it. If you have a legal right to a payment but elect not to receive it, the IRS can still tax you. The classic example 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](#).

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 2015 with the understanding that you will complete all of the services in 2015, but will not be paid until Feb. 1, 2016. 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. Say you are selling your watch collection, and a buyer offers you \$100,000, even holding out the 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 big for both sides, but especially for plaintiffs. 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 that you would rather not have.

You can also have income without cash if you have a discharge of debt. It is also called cancellation of debt or “COD” income. If a relative or the bank loans you money, you get the cash but don't have income since you have to pay back the debt. But if you are relieved of the obligation to repay? That's usually COD income. There used to be spotty reporting of COD income. But today, lenders are required to issue a Form 1099-C reporting COD income to ensure you don't skip it on your tax return. 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.

Phantom income from entities can also be a big problem. Partnerships, limited liability companies (LLCs) and S corporations are pass-through entities. They are generally not taxed themselves. Instead, 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 Forms K-1 against individual tax returns.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.