Taxes, Constructive Receipt, Structured Legal Fees, and Escrows

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Constructive receipt is a fundamental tax concept that can have a broad and frightening impact. According to the IRS, you have income for tax purposes when you have an unqualified, vested right to receive it. Asking for payment later doesn't change that.[1] The idea is to prevent taxpayers from deliberately manipulating their income.

The classic example is a bonus check available in December, but which the employee asks his or her employer to hold until January 1. Normal cash accounting suggests that the bonus is not income until paid. But the employer *tried* to pay in December, and made the check available. That makes it income in December, even though it is not collected until January.

Constructive receipt is an issue only for cash method taxpayers like individuals. Accrual basis taxpayers (like most large corporations) have constructive receipt built into the accrual method. The accrual method says you have income when all events occur that fix your right to receive it, if the amount can be determined with reasonable accuracy.[2]

Thus, in accrual accounting, you book income when you send out an invoice, not when you collect it.[3] But for cash method taxpayers, the IRS worries about "pay me later" shenanigans. The tax regulations state that a taxpayer has constructive receipt when income is credited to the taxpayer's account, set apart, or otherwise made available to be drawn upon.[4]

On the other hand, there is no constructive receipt if your control is subject to substantial limitations or restrictions. There is considerable discussion of what substantial limitations or restrictions prevent constructive receipt. For example, what if the employer cuts the check on December 31 but tells the employee that the employee can either drive 60 miles to pick up the check, or ask the employer to mail it?

The employer may book this as a December payment (and issue a Form W-2 or 1099 that way). But the recipient may have a legitimate position that it is not income until received. Such mismatches occur frequently, and my research did not uncover evidence of manipulation by employers and employees.

Legal Rights

Whether they know it or not, lawyers deal with constructive receipt issues all the time. Suppose a client agrees orally to settle a case in December, but specifies that the money is to be paid in January. In which year is the amount taxable? The mere fact that the client could have agreed to take the settlement in Year 1 does not mean the client has constructive receipt.

The client is free to condition his agreement (and the execution of a settlement agreement) on the payment in Year 2. The key will be what the settlement says before it is signed. If you sign the settlement agreement and condition the settlement on payment next year, there is no constructive receipt.

In much the same way, you are free to sell your house, but to insist on receiving installment payments, even though the buyer is willing to pay cash. However, if your purchase agreement specifies you are to receive cash, it is then too late to change the deal and say you want payments over time. The legal rights in the documents are important.

If a case settles and funds are paid to the plaintiff's lawyer's trust account, it is usually too late to structure the plaintiff's payments. Even though the plaintiff may not have *actually* received the money, his lawyer has. For tax purposes, a lawyer is the agent of his client, so there is constructive (if not actual) receipt.

Suppose that Larry Lawyer and Claudia Client have a contingent fee agreement calling for Larry to represent Claudia in a contract dispute. If Larry succeeds and collects, the fee agreement provides that Claudia receives two-thirds of the recovery and Larry retains one-third as his fee. Before effecting the one-third/two-thirds split, however, costs are to be deducted from the gross recovery.

Suppose that Larry and Claudia succeed in recovering $1 million in September of 2016. Before receiving that money, however, Larry and Claudia become embroiled in a dispute over the costs ($50,000) and the appropriate fee. Larry and Claudia agree that $25,000 of costs should first be deducted. However, Claudia claims that the other $25,000 in costs is unreasonable and should be borne solely by Larry.

Furthermore, Claudia asserts that a one-third fee is unreasonable, and that the most she is willing to pay as a legal fee is 20 percent. Larry and Claudia try to resolve their differences, but cannot do so by the end of 2016. In January 2017, the $1 million remains in Larry's law firm's trust account. What income must Larry and Claudia report in 2016?

Undisputed Amounts

Arguably, there is a great deal that is *not* disputed. Larry and Claudia appear to have agreed that $25,000 in costs can be recouped, and that Larry is entitled to at least a 20 percent fee. Of course, it is not yet clear if that 20 percent fee should be computed on $950,000, or on $975,000.

However, Larry is entitled to at least $25,000 in costs and to at least a $190,000 fee, for total income of $215,000. Perhaps that is undisputed. Looking at Claudia, it is not yet clear how much she will net from the case. Yet the minimum Claudia will get would be by applying the provisions in the fee agreement.

Thus, taking the $50,000 as costs, Claudia should receive two-thirds of $950,000, or $633,270. Even under Larry's reading of the fee agreement, this is the amount to which Claudia is entitled. She might receive more if her arguments prevail.

How much should Larry and Claudia report as income? You might say that you do not have enough information to make that decision, and you would probably be right. After all, you do not really know whether Larry and Claudia have agreed that partial distributions can be made, or if they are taking the position that they will not agree to *anything* unless the entire matter is resolved.

However, that does not appear to be so. Indeed, the positions of the parties seem clear that each is already entitled to *some* money. That gives rise to income, regardless of whether they actually receive the cash. If they have a legal right to the money and could withdraw it, that is constructive receipt, if not actual receipt.

Any talk of withdrawal should invite discussion of restrictions and partial agreements. For example, what if you add to the fact pattern that, while these are the negotiating positions of Larry and Claudia, neither of them will agree to *any* distributions, treating the entire amount as disputed. Does that mean neither has any income in 2016? Does it matter what documents are prepared?

The answer to the latter question is surely yes. Good documentation always goes a long way to helping to achieve tax goals. For example, an escrow agreement acknowledging that all the money is in dispute and prohibiting any withdrawal until the parties agree, might contraindicate income.

If there is a document each party signs agreeing that they disagree and that no party can withdraw any amount until they both agree, in writing, that should be pretty convincing. Even so, one cannot be sure that it will be *positive* to the IRS. It may be hard to argue with the fact that the parties' positions speak for themselves, and that some portions of the funds are undisputed.

Besides, there is a strong sentiment that a lawyer is merely the client's agent. Presumptively, settlement monies in the hands of the lawyer are already received by the client for tax purposes. Let's also consider the defendant in this example.

The defendant paid the $1 million in 2016. Depending on the nature of the payment, it seems reasonable to assume that the defendant will deduct it in 2016. The defendant will most likely issue IRS Forms 1099 in the full amount of $1 million to both Larry and Claudia. How will Larry and Claudia treat those Forms 1099?

There may be a variety of possibilities. Assuming that both Larry and Claudia argue that the *entire* amount is in dispute, one approach might be to footnote Form 1040, line 21 (the "other income" line), showing the $1 million payment, but then to subtract the $1 million payment as disputed and in escrow and therefore not income, netting to zero on line 21. There is probably no perfect way to do this.

Escrows and Qualified Settlement Funds

This also may invite questions about the nature of the escrow itself. Is it an escrow, or could it be a qualified settlement fund (sometimes called a QSF, or a 468B trust)?

If the fund is a QSF, the defendant would be entitled to its tax deduction, and yet neither Larry nor Claudia would be taxed on the fund's earnings. The fund itself would be taxed, but only on the earnings on the $1 million, not the $1 million itself.

A QSF is typically established by a court order and remains subject to the court's continuing jurisdiction.[5] In our example, there is no court supervision, so it seems unlikely that the escrow could be a QSF. If the fund is merely an escrow, either Larry or Claudia should be taxable on the earnings in the fund, but not on the principal until the dispute is resolved and the disputed amount is distributed.

Unlike a QSF, escrow accounts are typically not separately taxable, so one of the parties must be taxable on the earnings.[6] Normally, the escrow's earnings would be liable for tax to the *beneficial owner* of the funds held in escrow.[7] Either Larry or Claudia (or both) could be viewed as a beneficial owners of the escrowed funds. Therefore, an agreement specifying who will be taxed on the disputed funds while they are held in escrow can be wise.

Structured Legal Fees Too

Contingent fee lawyers who are about to receive a contingent fee are allowed to "structure" their fees over time. But if they receive the funds in their trust account, it is too late to structure. In fact, it is too late to structure fees if the settlement agreement is signed and the fees are payable.

A lawyer who wants to structure legal fees must put the documents in place before the settlement agreement is signed. Just as in the case of the plaintiff discussed above, legal rights are at stake. In general, a contingent fee lawyer is entitled to condition his or her agreement on a payment over time.

In reality, of course, it is the client of the plaintiff's lawyer that has the legal rights and is signing the settlement agreement. That is why a lawyer wanting to structure fees must build that concept into the settlement agreement. Usually, however, legal fees are not structured as installment payments by the defendant. Rather, the settlement agreement will specify the stream of payments, and call for the contingent fee to be paid to a third party that makes those arrangements. As you might expect, it is important for each element of the legal fee structure to be done carefully, to avoid the lawyer being taxed before he or she receives installments. But the entire concept of structured legal fees must begin with being mindful of the constructive receipt doctrine.

Understandably, cash-basis taxpayers do not want to be taxed on monies before they actually receive them. However, the constructive receipt doctrine can upset this expectation. Constructive receipt can often be avoided through careful planning and proper documentation.

Qualified Settlement Funds

A QSF or a 468B trust is typically set up as a case is being resolved. The rules of constructive receipt seem to be thrown out the window when using this important and innovative settlement device. The IRS provides that a fund is a "qualified settlement fund" if it satisfies each of the following:

- It is established pursuant to an order of, or is approved by, specified governmental entities (including courts) and is subject to the continuing jurisdiction of that entity;
- It is established to resolve or satisfy one or more claims that have resulted or may result from an event that has occurred and that has given rise to at least one claim asserting certain liabilities; and
- The fund, account, or trust must be a trust under applicable state law, or its assets must otherwise be segregated from other assets of the transferor.[8]

Section 468B trusts (one structure that can be used to establish a QSF) allow defendants to pay money into the trust and be entirely released from liability in a case. Yet the plaintiffs and their counsel do not have income until the money comes out. Normally, tax law is reciprocal. The 468B trust is a kind of holding pattern, where no one is (yet) taxed on the principal, or corpus, of the trust. Even so, the defendant can deduct the payment. Any interest earned on the monies in the trust are taxed to the trust itself.

In some cases, even <u>after</u> receipt of settlement proceeds, if a person satisfies the rules, they can elect <u>after the fact</u> to have QSF treatment. This extraordinary rule allows you to retroactively designate a bank account as a QSF if you meet two tests:

- The attorney's fund, account, or trust is a trust under the law of the state where the attorney established the account (usually it is); or the account's assets are otherwise segregated from other assets of the defendant (usually they are); and
- The attorney's trust or account is established to resolve or satisfy one or more claims that have resulted, or may result, from the litigation settlement (again, not difficult).

Usually, an attorney's client trust account will satisfy the requirement of being a trust account under state law. However, it is important for the attorney to segregate the client's recovery from other funds. Fortunately, this is the general practice of many plaintiffs' counsel.

When these tests are met, you should be able to petition any court to create and approve a trust. This relation-back election can give everyone more time to determine whether one or more structured payments would be a better alternative than cash. In many (if not most) cases, a structure *will* be preferable as a means of achieving tax savings, retirement goals, investment returns, and even asset protection.

Although the requirements for a relation-back election are relatively easy to meet, obtaining the defendant's signature can be difficult. After all, the defendant may not be thrilled about losing the litigation. However, many defendants can be won over to sign (signing one or more documents after settlement can be innocuous) by a good explanation of the plaintiff's tax planning opportunities. Moreover, sometimes a judge may be helpful in persuading the defendant to help.

Discretionary Relief

There is rarely a second chance when it comes to tax issues. For plaintiffs mired in the process of litigation and the crush of issues addressed at settlement time, the relation-back election provides a second chance to address tax issues. And even the relation-back procedure is not rigid. The IRS Commissioner has discretion, with good cause shown, to grant a reasonable extension of time to make the election if the plaintiff:

- Requests relief before the failure to resolve the defect is discovered by the IRS;
- Failed to make the election because of intervening events beyond his control;
- Failed to make the election because, after exercising due diligence, the plaintiff was unaware of the necessity for the election;
- Reasonably relied on the written advice of the Service; or
- Reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the election.[9]

The "or" at the end of this list is important. The key point here is that the plaintiff must satisfy only <u>one</u> of the above tests for relief. Private letter rulings suggest that the IRS is pretty helpful on this issue, when asked.[10] Although an IRS private letter ruling cannot be cited as precedent, it does provide an indication of the position of the IRS in connection with such an issue.

Conclusion

Constructive receipt is a fundamental tax concept that is intended to prevent taxpayers from manipulating their income. The rules of constructive receipt, however, seem to be thrown out of the window when parties use QSFs. Increasingly, plaintiffs, defendants, and their counsel are finding that QSFs can provide tax efficiency and allow the time needed to evaluate structured settlement alternatives. This is in addition to their most classic purpose, helping co-plaintiffs to resolve their own disputes about who gets what following a defendant's settlement. A 468B trust allows the defendant to pay its money and obtain a court-approved release, so the defendant is entirely out of the litigation even if the trust holds the money for months or years before distributing it to the plaintiffs and their counsel. Not coincidentally, the defendant also is entitled to a tax deduction when the money first goes into the trust.

Ideally, a QSF should be set up before the settlement agreement is signed and before the money is paid. A week or two is usually enough time to do everything. Sometimes, though, for whatever reason, the plaintiff's attorney will end up with a signed settlement agreement and money in the bank before realizing that the clients want to structure their recoveries and/or that an attorneys' fee structure for the lawyers would be advantageous. In that case, the plaintiff's attorney should consider the relation-back option.

Endnotes

1 Childs v. Comm'r, 103 T.C. 634, 654 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996).

2 Treas. Reg. §§ 1.446-1(c)(1)(ii), 1.451-1(a).

3 Rev. Rul. 84-31, 1984-1 C.B. 127.

4 *See* Treas. Reg. § 1.451-2.

5 Treas. Reg. § 1.468B-1(c)(1).

6 *See* Treas. Reg. §§ 1.468B-6, 1.468B-7.

7 Rev. Rul. 77-85, 1977-1 C.B. 12 (I.R.B. 1977), *modified on other grounds*, I.R.S. Announcement 77-102 (1977).

8 Treas. Reg. § 1.468B-1(c).

9 Treas. Reg. § 301.9100-1(a).

10 *See* I.R.S. Priv. Ltr. Rul. 01-40-031 (Oct. 5, 2001); I.R.S. Priv. Ltr. Rul. 99-04-009 (Jan. 29, 1999); I.R.S. Priv. Ltr. Rul. 95-50-010 (Dec. 15, 1995).