

Constructive Receipt and Economic Benefit:

What Settlement Planners Need to Know

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Matthew J. Meltzer
FLASTER GREENBERG P.C.



Today's Agenda

- 1. A Few Fundamentals**
- 2. The Constructive Receipt Doctrine**
- 3. The Economic Benefit Doctrine**
- 4. Implications for Settlement Planners**

Key Questions When Analyzing a Tax Issue

1. Is it income?

2. If so, to whom?

3. And when?

⇒ Is my plaintiff or attorney client taxable now, or later?

Is It Income?

- C.I.R. v. Glenshaw Glass Co., 348 U.S. 425 (1955):

“undeniable accessions to wealth,
clearly realized, and over which the
taxpayers have complete dominion”

- Payments for wages and services ⇒ Yes.
- Damages for lost profits ⇒ Yes.
- Damages for personal injury ⇒ No. An **exclusion**.
- Gifts and inheritances ⇒ No. **Another exclusion**.



“Now read me the part again where I disinherit everybody.”

Is It Income?



Assignment of Income

- Precursor to constructive receipt and economic benefit ⇨ addresses the issue of **WHO** is taxable.



Lucas v. Earl, 281 U.S. 111 (1930)

- Husband and Wife enter into a contract, providing that Wife is entitled to half of Husband's compensation.
- This was prior to "married filing jointly," so the arrangement afforded meaningful tax savings given the existing marginal tax rate structure.
- Because Husband ultimately controlled whether services were performed (and thus, whether compensation was earned), **the full amount was taxable to him.**
- No "anticipatory assignments."

Assignment of Income—Two Roles.

1. **Basic Tax Principle** – determines the proper taxpayer, based on the ability to control whether the income is received and what is done with it.
2. **Anti-Avoidance Rule** – prevents income from being shifted to another taxpayer in a lower marginal rate.

E.g., Parent gifts stock in a corporation to a child after a purchase and sale agreement has been signed but before proceeds have been transferred. Big issue with donor advised funds accepting gifts of illiquid assets.

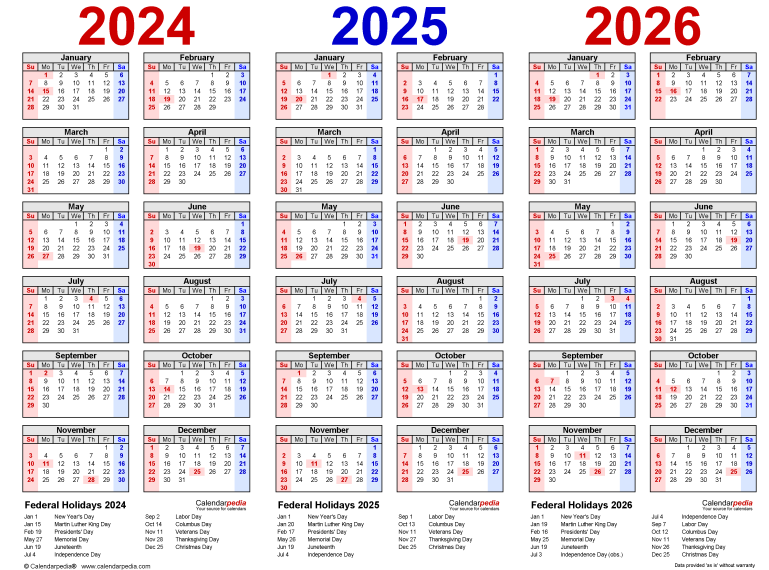
Assignment of Income $\equiv$ *A Permanent Shift*

- In order for the Assignment of Income Doctrine to apply, the Taxpayer must **avoid** recognition of the income.
- Accounting for the income in a different taxable period, on the other hand, is a different principle. A **deferral** involves a single taxpayer, but the recognition of income in a subsequent taxable period.
- This is a matter of **timing**.

Timing of Income

- In what **taxable period** is the income recognized?
 - 2024: gains
 - 2025: losses
 - **Issue**: timing payments to minimize tax.
- Individuals: cash method.
- Entities: cash method or accrual method.

In our world, we deal almost exclusively with the **cash method**.



Constructive Receipt

Constructive Receipt

- Technical component:



Income although not actually reduced to a taxpayer's possession is **constructively received** by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to **substantial limitations or restrictions**.

Treasury Regulations Section 1.451-2(a).

Constructive Receipt



- Anti-abuse component:

“prevents a taxpayer from deferring income when earlier **receipt is prevented solely by taxpayer’s own will**” (Field Service Advice no. 200151003 (Jul. 5, 2001)).

“The purpose of the constructive receipt doctrine is to prevent a taxpayer from **turning his back on income** he has a right to receive and thereby **select in which year** he will report it. **The doctrine is sparingly used and is invoked only when it is clear that the taxpayer has an unrestricted right to receive payment and his failure to do so is attributable to exercise of his own choice.**” Evans v. C.I.R., T.C. Memo. 1988-288, at *7; see also Lacy Contracting Co. v. C.I.R., 56 T.C. 464, 469 (1971) (“the doctrine must be **sparingly used**” and “Its application presents a **factual question.**”).

Constructive Receipt—Examples.

- Taxpayer refuses to accept a payment due to him under an installment note, which payment was placed into a savings account under an agent's name and then paid over to the taxpayer in the following year.
- Taxpayers sell property to a controlled corporation in exchange for an installment note. The corporation had sufficient cash to make the payment, but “defaulted.”
- Funds placed in trust for a taxpayer which was overseen by a “pliable trustee.”

No Constructive Receipt—Examples.

- Distribution of cash and stock from an estate to a beneficiary was disputed by the estate's residual legatees. The executor did not pay the amounts over until the year after the decedent's death. Amounts were taxable in year of receipt, not in the year of death, because the beneficiary lacked “unfettered command” over the bequest until it was released.
- Funds from a stock sale placed in escrow and payable only if no claims for breach of the purchase and sale agreement not constructively received in year of the sale.
- **Some motivation on the taxpayer's part for deferral is okay:** “So long as the redemption proceeds are in fact restricted and subject to conditions that are **definite, real, and not dependent in any way upon petitioner's whim or caprice**, we are **not concerned with his motives for accepting those restrictions** in the redemption agreement.” Stiles v. C.I.R., 69 T.C. 558 (1978), acquiescence by C.I.R. 1978-2 C.B. 3 (1978).

Economic Benefit

Economic Benefit

- IRS General Counsel Mem. 337333 (Nov. 21, 1966):

Pursuant to the [economic benefit doctrine] the creation by an obligor or a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A 'fund' is created when an amount is **irrevocably placed with a third party**, and a taxpayer's interest in such fund is 'vested' if it is **nonforfeitable**.

- Nonforfeitable includes not subject to the claims of **someone else's creditors**.



Sproull v. C.I.R., 16 T.C. 244 (1951), aff'd 194 F.2d 541 (6th Cir. 1952)

- Board of directors placed funds in a trust for its president (who was also president of the board) for prior services rendered.
- President's family owned 25.1% of the corporation's stock.
- Trust restricted distribution of funds until the succeeding tax year.
- Amount was beyond the reach of the corporation's creditors.
- President was taxable on the amount in the year it was placed into the trust, not when subsequently distributed.
- The objective is preventing **self-impoundment**.

Escrow Arrangements

- *Bona fide* three-party commercial escrow arrangements generally do not result in immediate taxation.
 - Three parties: buyer; seller; escrow agent.
 - An Escrow Agreement restricts the parties rights to access or benefit from the funds.
 - Joint written instructions required to release funds to a party.
- **But**: Where the escrow agent is controlled by the recipient of the funds, or the escrow agent is the recipient's **agent as a matter of law**, the recipient is immediately taxable. See Tarpey v. U.S., 78 F.4th 1119, 1131 (9th Cir. 2023).

Final Thoughts

- These rules have funny names and they sound like two ways of saying the same thing.
- Be on the lookout for:
 - Recipient has too much control over when the amounts are received.
 - The restrictions on the recipient are self-imposed.
 - Only the recipient's creditors can access the amount.



Thank You!



Matthew J. Meltzer

FLASTER GREENBERG P.C.

(215) 279-9384

Matthew.Meltzer@flastergreenberg.com

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