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CONSTRUCTIVE RECEIPT OF INCOME

— by Neil E. Harl*

The doctrine of constructive receipt of income is repeatedly litigated in large part because there is no bright line test for when the concept applies.[1] Yet the doctrine is immensely important to farmers and ranchers on the cash method of accounting.[2]

Basic rules

The regulations have long made it clear that income is constructively received when it is (1) credited to the taxpayer's account, (2) set apart for the taxpayer, (3) made available so the taxpayer could have drawn on it, or (4) could have been drawn upon if notice of intent to withdraw had been given.[3]

It is also clear that income is not constructively received if the taxpayer's control or receipt is subject to substantial limitations or restrictions.[4]

Problems with checks

A substantial part of the disputes over constructive receipt between taxpayers and the Internal Revenue Service has involved checks. In a 1987 case, a taxpayer did not have constructive receipt of income as to a check which could not have been cashed until January 1 of the following year.[5] A case in 1988 held that a taxpayer did not have constructive receipt of a tax refund check where the estranged spouse took possession of the check without informing the taxpayer.[6] A 1991 case focused on the issue of constructive receipt as to a check where the bank had placed a hold on withdrawals until the check had cleared.[7] The court pointed out that steps could have been taken to obtain the proceeds before year end. Therefore, the funds were considered to have been constructively received.[8]

A 1996 private letter ruling involved a fairly common practice with checks written and mailed at the end of the year but not received until the following year.[9] In the facts of that ruling, amounts were paid by check (and deducted) late in one year but received (and reported) by the recipient the following year. The payment included severance pay and settlement of an age discrimination claim. The employer filed a Form W-2 showing payment in the earlier year. Apparently fearing constructive receipt, the taxpayer's attorney requested that the checks be reissued to reflect payment in the later year. The ruling held that the amounts were not deemed constructively received in the earlier year. The ruling noted that the mere fact that a check is issued in one year and received in another does not make the check taxable in the year issued. Moreover, checks sent through the mail are generally not constructively received in advance of actual receipt unless the amounts were made available to the taxpayer in the earlier year.[10]

For deferrals of compensation, it appears that constructive receipt does not apply unless the funds were made available to the taxpayer, the payor was ready and willing to pay, the right to receive payments was not restricted and the failure to receive payments resulted from the individual's own choice.[11] In a 1996 case, there was no constructive receipt for future annuity payments in a structured settlement agreement for attorney's fees.[12]

Constructive receipt for farmers

A major area of constructive receipt litigation for several years in the 1940s and 1950s involved deferred payment sales of grain and livestock[13] In 1958, the Internal Revenue Service issued a revenue ruling[14] permitting the use of deferred payment contracts for crops. Other than for a letter ruling in 1979 holding that deferred payment contracts that were transferable at year end had to be reported into income as of the end of the year, deferred payment contracts (and, since 1980, installment sale contracts for grain and livestock)[15] have been effective for deferral of income for regular income tax purposes. The problem, more recently, has been with deferral for alternative minimum tax purposes[16]

However, IRS has continued to maintain that payments under federal farm programs where an option was provided to the recipient to accept payment in the year of sign-up for the program or to defer payment to the following year are includible in income in the earlier of the year of actual payment or the year made available to the taxpayer.[17]

FOOTNOTES

1 See generally 4 Harl, *Agricultural Law* § 25.03[2](1996); Harl, *Agricultural Law Manual* § 4.01[1][b] (1996).

2 See, e.g., Rev. Rul. 68-44, 1968-1 C.B. 191 (federal farm program payments constructively received; funds available to taxpayer).

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[3] Treas. Reg. § 1.451-2(a).
[4] See, e.g., Duffy v. Comm'r, T.C. Memo. 1996-556 (taxpayer not in constructive receipt for wages withheld to cover excess travel advances where taxpayer disputed liability for excess advances).
[5] Baxter v. Comm'r, 816 F.2d 493 (9th Cir. 1987), *rev'g on this issue*, T.C. Memo. 1985-378.
[6] John Single, Jr. v. Comm'r, T.C. Memo. 1988-549.
[7] Bright v. United States, 91-1 U.S. Tax Cas. (CCH) ¶ 50,142 (5th Cir. 1991).
[8] *Id*.
[9] Ltr. Rul. 9651020, Sept. 19, 1996.
[10] *Id*.
[11] Rev. Rul. 60-31, 1960-1 C.B. 174.
[12] Childs v. Comm'r, 96-2 U.S. Tax Cas. (CCH)¶ 50,504 (11th Cir. 1996).
[13] See, e.g., Romine v. Comm'r, 25 T.C. 859 (1956) (constructive receipt as to livestock sold and delivered one year with proceeds received early the following year).
[14] Rev. Rul. 58-162, 1958-1 C.B. 234.
[15] See I.R.C. § 453(b)(2)(B).
[16] Harl, "Installment Sales of Commodities and AMT," 7 *Agric. L. Dig.* 93 (1996); Harl, "More on Installment Sales of Commodities and AMT," 7 *Agric. L. Dig.* 173 (1996).
[17] Rev. Rul. 68-44, 1968-1 C.B. 191. Compare Rev. Rul. 60-32, 1960-1 C.B. 29 (payments under Soil Bank Act as income from "the normal use of the land devoted to the program" were income in year received).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

PRESCRIPTIVE EASEMENT. The plaintiffs owned land which surrounded the land owned by the defendants such that the only access to the defendants' land was over routes crossing the plaintiffs' land. The plaintiffs brought an action to quiet title to prohibit the defendants from crossing the plaintiffs' land. The trial court ruled that the defendants had acquired a prescriptive easement to one route over the plaintiffs' land. The plaintiffs argued on appeal that the defendants' use of that route was permissive and not adverse to the plaintiffs' ownership. This argument was based on the actions of the plaintiffs' predecessors in interest who had prohibited the defendants from using one route and had allowed the defendants to use the route for which the prescriptive easement was found. The court held that the evidence showed that the predecessors in interest had warned the defendants not to use any route and had posted "no trespassing" signs on the route used by the defendants. The court held that the defendants' continued use of the route after these actions demonstrated that the use was adverse and not permissive. The plaintiff also claimed that there was evidence that the defendants consulted with the predecessors in interest about improving the road and building a bridge on the route. The court held that the trial court had the discretion whether to find this evidence credible and that finding was not appealable. **Rafanelli v. Dale, 924 P.2d 242 (Mont. 1996)**.

ANIMALS

HORSES. The plaintiff was a three-year-old child who was visiting, with the plaintiff's family, a neighbor of the defendant. While the plaintiff was playing in the neighbor's yard, the plaintiff wandered into a horse pasture on the defendant's property where the plaintiff was injured when a horse kicked the plaintiff. The plaintiff filed an action in negligence and attractive nuisance. The pasture was enclosed by a wire electric fence but the electricity was not turned on at the time of the accident. The neighbor had been specifically warned not to enter the pasture. The plaintiff argued that the defendant was negligent because the fence was insufficient to keep the child out of the pasture. The court found that the horse involved was not known to be aggressive and the fence was shown to be in good repair. The court concluded that there was no evidence that the defendant had not exercised reasonable care in fencing in the horse. The plaintiff also argued that, because the defendant had erected an electric fence, the defendant was negligent in failing to have the electricity on at the time of the accident. The plaintiff cited Section 324A Restatement (Second) of Torts for the theory that the erection of the electric fence was an undertaking and the failure to electrify the fence was negligence in that undertaking. The court held that Section 324A was applicable only where the defendant undertook to perform a service for the injured party. The court upheld the jury verdict for the defendant. The plaintiff had also argued that the attractive nuisance doctrine should be implemented in Vermont but the court refused, holding that the attractive nuisance doctrine merely provided a lesser standard of negligence in certain circumstances, a basis of action already allowed in Vermont under the general negligence cause of action. **Zukatis by Zukatis v. Perry, 682 A.2d 964 (Vt. 1996)**.

BANKRUPTCY

FEDERAL TAXATION-*ALM* § 13.03[7].*

ASSESSMENT. The debtors filed for Chapter 13 and objected to claims for taxes filed by the IRS, arguing that the debtors were not taxpayers or subject to the federal income tax laws (a form of tax protester argument). The court rejected the argument as frivolous. The debtors also argued that the assessment was not valid because the notice was merely a computer printed form without a signature from an agent. The court also rejected this argument, holding that the statute and regulations do not require a signature on an assessment notice. See *In re Hopkins, 192*