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Does Constructive Receipt Apply When a Buyer and Seller Have Agreed Upon a Sale Price for a Capital Asset, But Not Yet Received Funds?

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This article discusses how a structured sale works and its tax implications.

The questioned posed is: "Does constructive receipt apply when a Buyer and Seller have agreed upon a sale price for a capital asset, but not yet received the funds." In general, merely reaching an agreement should not trigger constructive receipt; further, if title has been transferred, rescission could allow you to renegotiate the transaction to permit a structured installment sale. Permit me to explain.

The constructive receipt doctrine prohibits taxpayers from deliberately turning their backs on income and selecting the year in which they want to receive (and report) income. Income is constructively received if it is credited to the taxpayer's account, set apart, or otherwise made available so that the taxpayer can draw upon it. Treas. Reg. § 1.451-2(a) states " 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."

Thus there is no constructive receipt if the taxpayer's control is subject to substantial limitations or restrictions. For example, if a corporation credits its employees with bonus stock, but the stock is not available until some future date, the mere crediting of the stock on the corporate books does not constitute receipt. See Letter Ruling 7927001;Commissioner v. Tyler, 28 B.T.A. 367 (1933).

The focus of the constructive receipt doctrine is whether the taxpayer has the power to lay claim to an item of income. If so, the taxpayer is treated as having exercised that power and as having actually received the item of income. The test is whether the taxpayer's power is an unfettered one or whether it is subject to substantial restrictions or limitations. The constructive receipt doctrine prevents taxpayers from deferring the timing of income inclusion by unilaterally turning their back on an item of income and electing not to exercise their current ability to take possession of income.

The constructive receipt doctrine is premised on the legal rights or entitlements the Seller has to sums of money, and here the Seller has no claim or entitlement to anything prior to the time the Sale Agreement is executed, and the Sale Agreement does not give the Seller any claim or entitlement to the lump sum amount. The Seller should be free to further negotiate for installment payments and only be taxed as and when they become due. For example, in the case of Richard's Estate v. Commissioner, 150 F.2d 837 (2d Cir. 1945) the taxpayer negotiated the settlement of a litigation claim against a defendant. In December 1936, the defendant was ready, willing, and able to settle the claim for $100,000, the amount of which was acceptable to the plaintiff. However, solely for the purpose of reducing taxes, the plaintiff and the defendant delayed execution of the settlement agreement until January 1937. The Court rejected that argument that the taxpayer was in constructive receipt of the settlement proceeds in 1936 simply because the defendant was ready, willing, and able to pay this amount at the time. Instead, the Court held that the rights of the plaintiff to the settlement proceeds came into existence when the settlement agreement was executed and not before. The fact that the taxpayer deliberately delayed

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execution of the settlement agreement solely to reduce the taxes owed was held to be "immaterial":

"The obligations of the parties under the settlement as agreed to are what count and under them nothing was credited or set apart to the petitioner which could be drawn upon in 1936. At least that much was required by the applicable regulation to constitute constructive receipt of the money Presley agreed to pay. . . . The money had to be placed unconditionally at the disposal of the petitioner before it was constructively received by her. . . . That was not done in 1936."

Numerous other courts have reached this same conclusion in similar circumstances, and this same reasoning should also apply to a sale transaction. See e.g., Cowden v. Comm'r, 289 F.2d 20, 24-25 (5th Cir. 1961); Schniers v. Comm'r, 69 T.C. 511, 518 (1977);Oliver v. U.S., 193 F. Supp. 930, 933 (E.D. Ark. 1961); Amend v. Comm'r, 13 T.C. 178, 183 (1949), acq., 1950-1 C.B. 1. See generally Boris I. Bittker & Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶105.5.3, at 105-53 (1992) (In general, the date specified for payment by a contract is controlling, and the payment is not constructively received before that, even if the obligor would have agreed at the outset to an earlier contract date or would have paid before the due date on request." Note, that in the compensation context, when an employee elects to defer compensation, that elective deferral, if done in a timely manner, is generally effective and no constructive receipt occurs, even though the employer may have been ready, willing and able to pay the compensation immediately. See, e.g., Robinson v. Comm'r, 44 T.C. 20, 35-36 (1965).

Thus, that the fact that the Buyer is ready, willing and able to pay the full Sale price in cash should not cause the Seller should be treated as in constructive receipt of the lump sum amount and not be able to negotiate or bargain for installment payments. For constructive receipt purposes it is irrelevant that the parties agree on a sales price, which the Buyer may actually offer to pay to the Seller, since the issue is one of legal entitlement. Indeed, most contracts for the sale of property have some period of delay before title passes in order for the parties to deal with additional details, complete paperwork and address any contingencies, material or otherwise. Parties will use this escrow period to finalize details, including the use of installment payments.

If title has passed and there are no contingencies, it may still be possible to use rescission in order to avoid a constructive receipt problem. The primary IRS authority dealing with rescission is Rev. Rul. 80-58, enunciating the Service's position on rescission and its tax consequences. Rescission can undo the tax effects of a transaction if two requirements are met by the initial transaction: the rescission must occur in the same tax year; and as a result of the rescission, both parties to the original transaction must be returned to the same positions they occupied before the original transaction — that is, they must be returned to the status quo ante.

A rescission may be achieved by the parties' mutual agreement, by one party declaring a rescission without the other's consent, but with sufficient grounds to make that declaration; or by applying to the court for a decree of rescission.

Rev. Rul. 80-58 considered two situations involving the sale of land. In the first, all events occurred during one tax year. In the second, the transaction occurred in one year but the rescission occurred in the next. In the first case, the transaction and its rescission are essentially treated as tax nonevents, so no gain or loss is recognized. In the latter case, while the money was repaid and the transaction was unwound, the IRS refused to disregard the annual accounting concept. Thus, the original seller in the transaction had to report the sale in year 1, even though he reacquired the property in year 2. He would take a new cost basis in the property in year 2 equal to the price paid to the buyer for the reconveyance. Rev. Rul. 80-58 relied heavily on a 1940 Fourth Circuit opinion, Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940). In Penn, the Fourth Circuit held that income should be determined at the end of each tax year without regard to subsequent events.

In Hope v. Commissioner, 55 T.C. 1020 (1971), aff'd, 471 F.2d 738 (3d Cir. 1973) the Tax Court rejected a seller's attempt to postpone the recognition of gain even though he had sued to rescind the transaction in the year of the sale. Hope had still received the purchase price in 1960. Moreover, he had an unrestricted right to use the money as he pleased despite the filing of the lawsuit.

While rescission is a remedy, the proper format, as laid out in Rev. Rul. 80-58, must be followed. This is for your information and parties to a transaction should seek their

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