INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL, SAN JOSE, CALIFORNIA
ATTN LAURA B. BELOTE CC:LM:5:SJ

FROM: Associate Chief Counsel CC:ITA

SUBJECT: Constructive Receipt

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This Chief Counsel Advice responds to your memorandum dated April 9, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

<u>LEGEND</u>:

Industry A =
Industry B =
Crop A =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Entity A =
Entity B = .
Entity C =
B =
C =
D =
E =
F =
G =
H =

ISSUE:

Did Entity A constructively receive income upon the receipt of a promissory note from Entity B; upon the due date of the promissory note or upon receipt of a secured promissory note from Entity B.

CONCLUSION:

The present facts do not establish that constructive receipt has occurred. Much more factual development is necessary in order to evaluate whether there is any possibility of successfully establishing constructive receipt.

FACTS:

Entity A has been involved in Industry A since Date 1. The sole shareholder of the corporation is B. The facts are unclear as to which three persons serve on Entity A's Board of Directors. The Board is composed of either B, C and D or B, C, and E. During the years at issue for Entity A, the officers were B, President and Chief Financial Officer, and C, Secretary. Entity A has always used the cash method of accounting and adopted a fiscal period ending February 28th or 29th.

Entity B was incorporated less than a year after Entity A and uses the accrual method of accounting and a calendar year. During the years at issue, the stock of Entity B was held: 50% Entity A, 20% F, 15% G, 15% D. The Board of Directors and Officers are B, G and H. There is some dispute, though, whether B was either a Director or an officer.

Entity B is engaged in Industry B. During the years in issue, Entity B sold all of Crop A produced by Entity A. Petitioners, though, prefer to characterize the transaction as: Crop A is sold through Entity B, which sells Crop A for the account of Entity A and other entities. Entity B generally pays all growers within two to four weeks of receipt of Crop A, with the exception of Crop A delivered by Entity A. With respect to Entity A, Entity B records each purchase and sets up an account payable when it receives the crop. Since the beginning of their business relationship over 25 years ago, Entity B has never paid on its account payable to Entity A, except that it did pay for crops received during two of the years at issue. Entities A and B have never executed a deferral contract with respect to money owed to Entity A by Entity B, nor is there a due date for the amounts owed.

Entity A, as a cash method taxpayer, does not record its sales of Crop A to Entity B. Thus, it has not reported any income from such sales. Upon delivery of Crop A, it does deduct its cost of goods sold expenses.

Except for Entity A, Entity B does have a policy of advancing funds to other entities with whom it transacts business. At the end of one of the years at issue, Entity

B had advanced funds, and the majority of it was advanced to entities in which B had a 50% ownership interest.

On Date 2, G, a minority shareholder of Entity B, filed a lawsuit against, among others, B and Entity A. Entity A made of demand for the balance due to it by Entity B. Entity B subsequently on Date 3 issued a promissory note to Entity A which represented the full amount that Entity B owed to Entity A at that time, including interest. The note also provided that the entire principal and interest was due on Date 4.

At the same time, the parties executed a Secured Advance Agreement, securing the promissory note by the assets of Entity B. The agreement also provided that Entity A will loan and advance to Entity B, or permit Entity B to retain, in Entity A's sole discretion, an amount not to exceed $5 million at any time. The agreement is characterized as a credit arrangement between the parties. Entity A also agreed to advance funds and restrain from collecting its receivables to insure that Entity B could maintain its customary advances. Entity A could, without notice, take possession of the collateral on default of the promissory note. According to Entity B's Board minutes, the parties agreed to postpone any attempts to collect the balance due by Entity B to Entity A for two years to Date 5.

During audit, an Internal Revenue Service economist concluded that the fair market value of the promissory note equaled its face value (which was the full amount owed Entity A by Entity B).

Several years later, the parties to the lawsuit entered into a Settlement Agreement which acknowledged that the promissory note and Secured Advance Agreement were canceled, released and rescinded. The parties acknowledged that the note had no ascertainable value as it was not negotiable and could not be collected, and Entity B did and does not have the financial ability to pay the note.

Pursuant to the settlement, G sold his 15% of Entity B stock to Entity C, a corporation owned equally by C and E; Directors and Officers were B and C. Entity C purchased the stock with loans from Entity A. At the same time, Entity A sold its 50% interest in Entity B to Entity C (35%) and D (15%). Again, these shares were purchased with loans from Entity A.

Contrary to the petitions filed in this consolidated case, petitioners stated in their response to Respondent's First Requests for Admission that technically, Entity B does not "purchase" crops from Entity A or the other growers; rather, the growers sell their crops "through" Entity B, which sells the crops "for the growers' accounts."

In a previous audit of Entity A, a constructive receipt issue was conceded by Appeals due to a determination that Entity B did not have the financial ability to pay Entity A.

LAW:

Under the cash method of accounting, an item of gross income is to be recognized in the year in which it is actually or constructively received. Treas. Reg. § 1.451-1(a). Two major issues which may arise are: was the item of income in such a form that it should be recognized for tax purposes (the doctrine of cash equivalency) and whether the item of income has in fact been received (the doctrine of constructive receipt).

Cash Equivalency

Questions of cash equivalency arise primarily with intangible property, such as contract rights, accounts receivable and promissory notes. Courts have generally interpreted the applicable Code sections and regulations to exclude from income the receipt of certain intangible property which is deemed NOT the equivalent of cash. *See generally,* S. Gertzman, Federal Tax Accounting, ¶ 3.03 (2d. ed. 1993).

An important and often cited case on this issue is Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961). The issue was the proper time for recognizing income evidenced by contractual rights to receive payments of cash in the future.

> A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the marketplace. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation. Id. at 24.

Thus, to the Cowden court if any of the noted conditions is not present, income should not be recognized; the fact that an item has a fair market value does not mean that it is the equivalent of cash. Gertzman, supra at 3-17. *See also* Mellinger v. United States, 21 F. Supp. 964, 967 (1938) (A note may be received as security or evidence of indebtedness, not as a payment; in the absence of agreement or consent to receive it as such, a promissory note, though accepted by the creditor, does not in itself constitute payment.) But when a negotiable promissory note is received as payment for services rendered, the FMV of the note is income upon receipt. Rev. Rul. 76-135, 1976-1 C.B. 114. See also Barnsley v. Commissioner, 31 T.C. 1260 (1959) (negotiable promissory note of solvent debtor is cash equivalent and includible in income to extent of FMV).

Constructive Receipt

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. Treas. Reg. § 1.451-2(a).

Thus, taxable income of a cash basis taxpayer is money or other property that is subject to taxpayer's unfettered will and control; that the taxpayer is free to enjoy at his own option; that exists and is available to taxpayer; and that except for taxpayer's own volition, can immediately be reduced to his possession. The doctrine prevents a taxpayer from deferring income when earlier receipt is prevented solely by taxpayer's own will. Gertzman, supra at 3-22. On the other hand, where attorneys entered into a structured settlement which called for deferred payments of their fee, and the settlement was entered into prior to obtaining an unconditional right to compensation for their legal services, the court held that they had not constructively received income upon the purchase of the annuity contracts meant to provide payment for the legal services fee. Childs v. Commissioner, 103 T.C. 634 (1994). See also Reed v. Commissioner, 723 F.2d 138 (1st Cir. (1983) (Sale proceeds deposited into escrow account; seller did not constructively receive income where the account set up by agreement between parties entered into before seller had any right to the funds; and seller was not entitled to any economic benefits prior to scheduled disbursement.)

These cases demonstrate that if the income is not unqualifiedly subject to the taxpayer's demand, it has not been constructively received. Furthermore, with respect to the issue of restrictions or limitations, precluding taxpayer from obtaining income through his own free will, any restriction or limitation must exist prior to the time the right to receive the income occurs. Courts have identified numerous factors that must be evaluated to determine whether any restrictions or limitations preclude application of the constructive receipt doctrine. Such factors include: consistent policies of the obligor, Lacy Contracting Co. v. Commissioner, 56 T.C. 464 (1971), oral or informal understandings among the parties concerning under what circumstances amounts due a taxpayer may be withdrawn or received, Evans v. Commissioner, 55 T.C.M. 902 (1988), and the fact that the consent of another is required before a taxpayer may obtain funds. Wolder v. Commissioner, 493 F.2d 608 (2d Cir. 1974), cert.denied, 419

U.S. 828 (1974). Where a countersignature is required to obtain funds, the courts do not find constructive receipt, even where the taxpayer is the majority stockholder and could have exercised such power to obtain the funds. Evans, supra; Gertzman, supra at 3-23 to 3-25.

Lastly, constructive receipt is never appropriate where the obligor does not have the financial ability to pay what is owed. For example, unsecured promissory notes received as compensation for personal services from a corporation in a bad financial condition, were found to have no fair market value. Board v. Commissioner, 18 B.T.A. 650 (1930). Constructive receipt always requires the obligor to have the financial ability to pay the amounts in question. Basila v. Commissioner, 36 T.C. 111 (1961), acq. 1962-1 C.B. 3. Also, a controversy between the principals of a company or the particular history and nature of their relationship may preclude authorized amounts from being paid or constructively received. Radom & Neidorff, Inc. v. United States, 281 F.2d 461 (Ct. Cl. 1960), cert. denied, 365 U.S. 815 (1961).

ANALYSIS:

The facts indicate that the settlement agreement entered into by the parties states that the promissory note had no ascertainable value as it was not negotiable. In addition, the settlement agreement states that Entity B does not have the financial ability to pay the note. Assuming these facts are true, Entity A cannot be charged with constructive receipt of the promissory note. Cowden, supra; Barnsley, supra; Basila, supra. Furthermore, the parties characterized the Secured Advance Agreement as a credit arrangement. This characterization would be of no import **if** the promissory note was, in fact, negotiable and Entity B was solvent. But in light of the circumstances surrounding the issuance of the promissory note and the execution of the Secured Advanced Agreement, the characterization by the parties of the Secured Advance Agreement as a credit arrangement seems credible. If Entity B required the assurances provided to it by Entity A in the Secured Advance Agreement in order to maintain grower advances, it is doubtful that it would have been in a financial position to satisfy the promissory note and hence the note is worthless for purposes of constructive receipt.

With respect to Entity A's ability through its own will and control to access any money or property of Entity B's to cover the amount owed to it by Entity B, the facts do not show any such ability on Entity A's part. Owning 50% of Entity B as Entity A did for a period of time, is insufficient evidence of an ability to access funds. Evans, supra. Furthermore, courts have specifically identified two factors in existence here as specifically precluding constructive receipt: consistent policies of the obligor, Lacy, supra, (25 years of nonpayment of Entity A by Entity B) and oral or informal understandings among the parties concerning under what circumstances amounts due a taxpayer may be withdrawn or received, Evans, supra, (again the 25 year history of the business practices between Entities A and B).

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