Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:MIA:TL-N-5933-00
TSMoraviaIsrael

date: APR 24 2001

to: Jerry Rocco, Case Manager - Group 1207 (LM:FSH)

from: Associate Area Counsel (Miami), CC:LM:RFP:MIA

---

subject: [redacted]
Taxable periods [redacted] through [redacted]

This memorandum responds to your request for assistance. This memorandum should not be cited as precedent.

This issue was coordinated with Industry Counsel Joseph Grant (LMSB) IC Change-of-Accounting-Method.

FACTS

The Service is currently conducting an audit of [redacted][1] (hereinafter referred to as "[redacted]"), for taxable periods ending [redacted] through [redacted].[2] During the years [redacted] through [redacted][3], [redacted] deferred and/or partially reported the income earned from advisory fees.

---

[1] Prior to [redacted], it was [redacted] that conducted business with [redacted]. [redacted]' general partners were [redacted], [redacted] and [redacted]. Taxpayer claims that [redacted] could no longer be used because it was an accrual basis taxpayer.

[2] Taxable period ending [redacted] is open due to taxpayer's omission from gross income ". . . an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return. . . ." I.R.C. § 6501(e).

[3] For taxable period ending [redacted], taxpayer elected to report, rather than defer, the income earned from the advisory fees, in accordance with certain deferred compensation agreements. There is therefore no issue as to deferred income for this year.

[redacted] is a Nevada general partnership formed in [redacted] as a cash basis tax reporting entity. [redacted] is registered with the Commodities Futures and Trading Commission (CFTC) as a commodity pool operator (CPO) and Commodity Trading Advisor (CTA), but it is not registered with the Securities and Exchange Commission (SEC) as an investment advisor.

For the years at issue, as per the advisory agreements (See attached sample of the [redacted] advisory agreement as **Composite Exhibit "A"**), [redacted] bought and sold financial instruments, including those of the U.S. and foreign governments, corporate securities, and other financial instruments for the following funds: [redacted] (hereinafter referred to as "[redacted]"), [redacted]. (hereinafter referred to as "[redacted]"), [redacted]. (hereinafter referred to as "[redacted]"), [redacted], (hereinafter referred to as "[redacted]") and [redacted] (hereinafter referred to as "[redacted]"), which manage approximately $[redacted] of client and propriety capital. All of the above funds are [redacted] companies. The advisory agreements between [redacted] and the Funds extend through [redacted].

[redacted]'s general partners are the following [redacted] Corporations:

Partners	Shareholders	Owners
[redacted]		

[redacted] deferred the advisory fees earned from [redacted] through [redacted] based on three separate "deferred compensation agreements" (hereinafter referred to as "DCAs") entered into with [redacted], [redacted] and [redacted] on [redacted], [redacted] and [redacted], respectively. (See attached as **Composite Exhibit "B"**).

According to the financial statements for [redacted], [redacted], and [redacted], for the year ending [redacted], the advisory fees earned by [redacted] were $[redacted] $[redacted] and $[redacted]. The income reported on its federal income tax return for taxable period ending [redacted] was $[redacted]. The difference of $[redacted]

constitutes the deferred income in [redacted]. Exam is currently attempting to determine the amount of deferred (advisory fees) income for the years [redacted], and [redacted]. It should be noted that any earnings such as dividends or capital gain distributions payable to [redacted] as shareholders in these Funds, via their deferred fees investment, have also gone unreported. Exam is investigating these unreported amounts as well.

As of [redacted], [redacted] had [redacted] investors, [redacted] had [redacted] investors, [redacted] had [redacted] investors, and [redacted] had [redacted] investors. The Funds are administered by [redacted]

LEGAL ANALYSIS

I.R.C. § 446(c) lists four general categories of permissible methods of accounting, which the regulations refer to as "overall methods." Treas. Reg. § 1.446-1(a)(1). The cash method is one of these methods.

A taxpayer using the cash method of accounting recognizes income upon the receipt of cash, property, or services. A cash basis taxpayer generally becomes entitled to a deduction upon payment.[4]

Because of the principle that a taxpayer cannot turn his back on income that is otherwise available to him, a cash basis taxpayer is also taxable upon the constructive receipt of income. "Constructive receipt" occurs when cash or property is unqualifiedly available upon the taxpayer's demand, without "substantial limitations or restrictions." Treas. Reg. § 1.451-2(a).

A cash basis taxpayer is taxable upon the receipt or constructive receipt of money, services, or property. Actual receipt presents few complex issues. However, determining when a taxpayer is in "constructive receipt" of income is more difficult. "Constructive receipt" requires a matured right. "Vested rights"

---

[4] However, an expense cannot be deducted if the expenditure created an asset "having a useful life which extends substantially beyond the close of the taxable year." Treas. Reg. § 1.461-1(a)(1).

are not sufficient; the taxpayer must be entitled to present possession. In considering whether a taxpayer's rights are matured, it is important to remember that a taxpayer cannot waive a present right to receive. Ordinarily, a cash basis taxpayer is entitled to negotiate to defer receipt of income before it is earned, even with a controlled entity, and this will prevent constructive receipt. However, the taxpayer may not "turn his back" upon income that is already earned.

"Receipt" occurs when there is a transfer to the taxpayer or to another party at the taxpayer's direction or for his benefit. Henritze v. Commissioner, 41 B.T.A. 505 (1940) (rent paid to assignee under agreement with creditors); Merritt v. Commissioner, 23 T.C.M. 960 (1964) (accumulated interest on tax overpayment taxable when taxpayer directed it be applied against a deficiency asserted against her husband's estate); Rev. Rul. 74-32, 1974-1 C.B. 22; Rev. Rul. 57-481, 1957-2 C.B. 48.

In addition to the right to receive, constructive receipt requires the power to collect, corresponding to the requirement in the regulations that an amount be "set apart or otherwise made available" for the taxpayer. A formal book entry is not necessary; the issue is the taxpayer's power as a practical matter to collect upon demand.

In order to establish constructive receipt, something more is needed than the taxpayer's possession of a simple matured right. The Regulations provide that constructive receipt occurs when income is "credited to [the taxpayer's] account, set apart for him, or otherwise made available so that he may draw upon it at any time [and] the taxpayer's control of its receipt is [not] subject to substantial limitations or restrictions." Treas. Reg. § 1.451-2(a). In addition to the right to receive, constructive receipt requires the power to collect.

If the money or property is already under the taxpayer's control, constructive receipt will occur as soon as the taxpayer becomes entitled to payment. Thus, in Miele v. Commissioner, 72 T.C. 284 (1979), a law firm was held taxable on the funds in its trustee account as it performed services, because it could exercise its administrative powers to transfer the amounts to its general account, even though the amounts were not actually transferred until later.

Lastly, the taxpayer must have the right to receive without "substantial limitations or restrictions." This issue is implicit in the determination of whether the taxpayer's rights are mature

and subject to the present ability to collect. However, it is clear that if collection would require the taxpayer to compromise a claim or otherwise forfeit a valuable right, there is no constructive receipt.

A "substantial limitation" can arise by agreement, providing that it is made before the "receipt" occurs. Nangle v. U.S., 145 F. Supp. 900 (Ct. Cl. 1956) (no constructive receipt when taxpayer "received" a check from an estate which he then immediately returned by prearrangement with the administrator); Williamson Est. v. Commissioner, 29 T.C. 52, 59-60 (1957), acq., 1958-2 C.B. 8 (no constructive receipt of proceeds of sale of stock when taxpayer was required under agreement with buyer to "loan" the proceeds to the corporation).

The critical factor is whether immediate collection will entail any additional cost. In Patterson v. Commissioner, 510 F.2d 48 (9th Cir. 1975), the Ninth Circuit held that a substantial limitation existed when potato farmers were required to insure their crop in favor of the purchasers to receive an advance payment against the proceeds, because "a condition precedent to earlier payments [was] arranging for earlier and longer-term insurance." Id. at 51. On the other hand, in Shelton v. Commissioner, 612 F.2d 1276 (10th Cir.), cert. denied, 449 U.S. 873 (1980), the Tenth Circuit held that the requirement of posting "a normal fiduciary bond in a probate proceeding" before receiving income was not a substantial limitation, distinguishing Patterson on the grounds that "[t]he fees for such bonds are standard and modest, and would not be different in amount whenever obtained." Further, the regulations provide that interest on bank deposits may be constructively received despite a requirement that the taxpayer withdraw the principal in order to receive the interest, or forfeit the right to earn a higher rate of interest on the principal, unless the penalty for early withdrawal meets certain standards. Treas. Reg. § 1.451-2(a)(3)-(3). For example, forfeiture of three months' interest on a time deposit of one year or less is a "substantial limitation or restriction" which will prevent constructive receipt. Treas. Reg. § 1.451-2(a)(2).[5]

---

[5] The regulation has since been amended, but the principle remains the same.

A taxpayer has the right to agree to defer income, **so long as the income is not yet earned.** (Emphasis added). This applies even if the deferral is tax-motivated and the taxpayer receives no additional consideration for the deferral, as long as there is a bona fide agreement between the parties that is effective to prevent vesting of the taxpayer's rights.

> [U]nder the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it . . . Nor may a taxpayer, by a private agreement, postpone receipt of income from one taxable year to another . . . However, the statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment . . . Consequently, it seems clear that in each case involving a deferral of compensation a determination of whether the doctrine of a constructive receipt is applicable must be made upon the basis of the specific factual situation involved.
> Rev. Rul. 60-31, 1960-1 C.B. 174, 178.

Once an amount is due, a taxpayer cannot further defer payment. This type of election between value now and value later triggers constructive receipt. Sainte Claire Corporation v. Commissioner, T.C. Memo 1997-171 (where S corporation had the ability to collect the principal amount of a note in the year it became due, the income was constructively received in that year even though the corporation extended the time for payment, since the agreement to defer was not made until the corporation's right to the income became vested). For example, in Zeltzerman v. Commissioner, 34 T.C. 73 (1960), aff'd per curiam, 283 F.2d 514 (1st Cir.1960), the taxpayer, a radiologist, was compensated by hospitals on the basis of a percentage of billings. The hospitals agreed in principle with the taxpayer to defer some compensation and apply the amounts deferred toward the purchase of annuities, but the terms of the deferral were vague and there was no written agreement. Both hospitals accumulated the amounts due and periodically bought annuities. The court held that there was no effective modification of the compensation agreements and that "in effect" the hospitals were acting at the taxpayer's direction in purchasing the annuities; the taxpayer was in constructive receipt of the full amount of compensation. Denver & Rio Grande Western Railroad v. U.S., 318 F.2d 922 (Ct. Cl. 1963) (notes payable either currently in sleeping cars or later in cash were taxable upon receipt to the extent of the fair market value of the sleeping cars); Penn v. Glenn, 265 F.2d 911 (6th Cir. 1959) (per curiam)

(tobacco grower taxable upon sale to warehouse when no enforceable contract existed to defer receipt); Hineman v. Brodrick, 99 F. Supp. 582(D. Kan. 1951) (farmer taxable on sale of wheat when he apparently requested deferral at time of delivery, when payment would otherwise have been immediately due); Romine v. Commissioner, 25 T.C. 859, 873-75 (1956), acq. on other issues, 1956-1 C.B. 5 (farmer taxable on December 31 sale when he could have obtained proceeds by going into town; he "obviously controlled completely the time of collection of the matured right to income which he could have obtained upon request"); Rev. Rul. 80-157, 1980-1 C.B. 186 (same); TAM 9336001 (amounts used to purchase annuities for taxpayer as compensation for taxpayer's legal services were constructively received by taxpayer because taxpayer performed substantially all the services owed to his client and client was ready, willing, and able to pay taxpayer his fees in cash).

The DCAs between [redacted] and the Funds read very similarly. For example, according to the deferred compensation agreement entered into between [redacted] and [redacted], [redacted] can defer receipt of all or part of the incentive fees payable to it by [redacted]. In order to defer the fees, [redacted] must file an election before the first day of the calendar year to which the election applies. The election document specifies the amount of incentive fee which is to be deferred. The DCA, paragraph 2, under the section entitled Election to Participate, states the following:

> An election under this paragraph to defer compensation under the Agreement for any calendar year, once made, may not be changed or revoked by the Participant during a calendar year.

This section of the DCA is meant to reflect taxpayer's position that "[redacted] is not in 'constructive receipt' of the fees deferred pursuant to the deferred compensation agreements because [redacted]'s control over the such deferred fees is subject to substantial limitations and restrictions as described in Treas. Reg. § 1.451-2(a)." (See IDR response by taxpayer number [redacted], dated [redacted] attached as **Exhibit "C"**).

Taxpayer's own documentation clearly demonstrates that the irrevocable yearly election in the DCA, paragraph 2, under the section entitled Election to Participate and the reasoning above in response to Exam's IDR are not substantial limitations or restrictions over [redacted]'s control over the deferred fees. For example, a letter dated [redacted] from [redacted] to [redacted], revokes [redacted]'s election during the normally

irrevocable period as per the DCA, paragraph 2, under the section entitled Election to Participate. (See letter attached as **Exhibit "D"**).

Another letter dated [redacted], from [redacted] to [redacted] revokes the election for the incentive fees to be earned for the [redacted]. (See letter attached as **Exhibit "E"**). The letter goes on to say, "[T]his revocation does not Impact any other [redacted] Incentive Fees." Again, on [redacted], another letter revokes the election for the incentive fees to be earned for the fourth quarter of [redacted]. (See letter attached as **Exhibit "F"**). The letter goes on to say, "[T]his revocation does not impact any other [redacted] Incentive Fees."

In addition, as per the DCA, paragraph 9, under the section entitled Termination of the Agreement, [redacted] may, with [redacted]'s consent terminate the DCA at any time.

Taxpayer performed advisory services for the Funds. Once these advisory services were performed, taxpayer was considered to be in receipt of the income, had the power to collect the income, and had the right to receive said income without substantial limitations or restrictions. The analysis above clearly reflects that the substantial limitations and restrictions taxpayer claims to be subject to are clearly superficial.

CONCLUSION

In this case, the taxpayer cannot defer the income. The taxpayer is in "constructive receipt" of the income as it has already been earned. Any substantial limitations and restrictions taxpayer claims to be subject to are clearly superficial. The analysis above is applicable to both the fees earned, as well as any earnings belonging to the taxpayer as a shareholder in the Funds, via their deferred fees investment. This advisory opinion is being sent to the National Office for a ten (10) day Non-Significant Advice Review. If you have any questions regarding the foregoing, please contact Tamara S. Moravia-Israel at (305)982-5319. We are closing our case file on this matter.[6]

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.

Associate Area Counsel (LMSB)
DAVID R. SMITH

By: _____
TAMARA S. MORAVIA-ISRAEL
Attorney

Enclosures

CC: James C. Lanning (LMSB), Area Counsel, Area 3
Harmon Dow (LMSB), Associate Area Counsel, (Industry Programs) Area 3
Barbara Franklin, Senior Legal Counsel, Area 3
Joseph Grant (LMSB) IC Change-of-Accounting-Method
TSS4510, Attn: Associate Chief Counsel (IT&A)

---

[6] Attached as **Exhibit "G"** is a bullet point paper listing Counsel's view of possible theories for this case. Said paper was presented to Exam on [redacted] prior to complete development of the facts.