Constructive Receipt

The Doctrine of Constructive Receipt requires that a taxpayer include as income during a taxable year income over which the taxpayer has “unfettered control” or dominion. The constructive receipt rules apply even where the taxpayer either declines to receive such amounts in the current taxable year or directs payment of such income to another taxpayer. Examples of such income include:

- salary (outside of IRS recognized deferred compensation plans)
- bonuses
- commissions
- prizes, and other accessions to wealth

Even though the taxpayer has yet to reduce the amounts to income, the amounts are considered income in the current taxable year because the taxpayer had “unfettered control” or dominion over the funds.

“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.” (U.S. Treasury Regulations Section 1.451-2)

What does this mean, and why do we care?

From the perspective of the Internal Revenue Service (IRS) and for purposes of computing a tax obligation, employees are deemed to receive income when it is available to them, regardless of whether they actually take possession of it. The doctrine of constructive receipt applies whenever a cash-basis taxpayer is entitled to money, the money is immediately available to him, and his failure to receive it is due entirely to his own volition.
Departmental compensation plans that have an incentive compensation component that give faculty the option – at the time of payment of the incentive – of (1) receiving incentive bonuses as compensation or (2) placing that money in an unrestricted account, create “constructive receipt” for the faculty member. If the faculty member elects to place the money in an unrestricted account, his/her failure to receive the income is “due entirely to his/her own volition,” and the amount is deemed taxable gross income to the faculty member in the taxable year in which the income was available to him/her.

To avoid constructive receipt of funds placed in an unrestricted account, departments can give faculty the option before the beginning of the fiscal year. The faculty member would be required to elect at the beginning of the year whether to receive the incentive component of his/her salary as income or place the bonus in a University account. Once the election is made it is irrevocable. The election document must stipulate if the choice applies to the entire amount of the incentive compensation generated that year, or if a stated percentage will go to a University account and a stated percentage will be paid to the individual faculty member as bonus compensation. Again, once the choice is made the faculty member could not change the distribution.

In providing this choice, a department must abide by certain administrative requirements. Departments will need to retain appropriate records to document each faculty member’s yearly election. If funds are paid to a departmental account, they would not be available to pay a faculty member’s salary or incentive bonus in subsequent years. Further, the University would retain these funds in the event the faculty member leaves or retires. The funds would be governed by University policies regarding oversight and appropriate use of University monies (e.g. University policies regarding travel, entertainment, and purchases would be followed).

Similarly, faculty who are entitled to retain income from consulting engagements, expert witness activities, etc. must receive those payments as personal income and incur the obligation for the income tax associated with those payments. The Faculty Handbook outlines appropriate ancillary non-academic employment activities, generally limited to one day per seven-day week. If the agreement to provide such services is with the individual faculty member and not the University, the dollars are due the individual. If the faculty member elects to gift the post-tax income to Yale, he or she is certainly entitled to make a donation. However, relieving the personal income tax obligation on these funds by having the company make the check payable directly to Yale is precluded by the constructive receipt doctrine because the faculty member is entitled to the income; the money is available to him/her; and failure to receive it is due entirely to the faculty member’s own volition.