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Escrows—An Often Overlooked Tax Planning Tool

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An escrow arrangement can serve many non-tax purposes; however, an escrow can also be a very handy tax planning tool. To understand the tax advantage of an escrow, some understanding of tax accounting is necessary. Generally, with respect to the timing of inclusion of income for a taxpayer, Treasury Regulation Section 1.451-1 provides that if the liability for the payment to a taxpayer of a specific amount of income is fixed, if the amount thereof can be determined with reasonable accuracy, and if such taxpayer is an accrual method taxpayer, the requirement for income inclusion has been met, regardless of whether the payment has been received. The critical point is that once an accrual method taxpayer has a right to receive income there is no real opportunity to defer taxation. If a taxpayer is a cash method taxpayer, then such person generally includes an item in income when it is actually or constructively received.

Treasury Regulation Section 1.451-2 states the "constructively received" issue thusly:

> (a) General Rule. 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.

Case law has narrowly interpreted the constructive receipt doctrine. Suffice it to say that the concept of "constructive receipt" of income is a very fact specific concept and is a fertile field of debate between the IRS and the taxpayer.

Suppose a taxpayer anticipates the settlement of an insurance claim. Since insurance proceeds constitute income unless excluded by a Code provision the timing of the receipt of such proceeds can be very important for a taxpayer. For example, the taxpayer may wish to defer receipt to a year in which the receipt can be used to offset an expenditure.

As explained above, the general rule is that when an accrual method taxpayer has obtained the right to receive income, that amount must be included in such taxpayer's gross income. It does not matter whether the taxpayer actually receives this income in that specific tax year.

There is another side to this coin, which is the tax consequences to the accrual method taxpayer when it is the payor rather than the recipient. The accrual method taxpayer in this situation may generally take a deduction for a payment when a) the liability for such payment has been fixed, b) the amount of the liability can be determined with reasonable accuracy and c) "economic performance has occurred with respect to the liability." Treas. Reg. § 1.461-1(a)(2)(i).

Using the insurance example, when dealing with an insurance settlement situation, it is not unusual for a taxpayer who has incurred an unknown amount of liability to a third party to settle with an insurance company in advance of paying the third party. In fact, several years may elapse between receipt of the insurance proceeds and payment to the injured party. If the funds are an advance reimbursement by the insurer, then the receipt is almost certainly includible in the taxpayer's current income. The problem with this recognition of income is that the taxpayer may not have available a corresponding deduction (for example, the payment to the third parties or other expenses) for a number of years.

This situation can be a tremendous tax problem, particularly for an accrual method taxpayer. However, under the constructive receipt doctrine, the taxpayer has some latitude to agree to defer income, provided an absolute right to the income has not yet come into existence.

Often, during the course of a settlement of insurance litigation, the parties will contract to form an escrow account which will contain the funds from the insurance company which will be used to pay third parties for damages. If the parties to a dispute, including an insurer, wait until *after* a settlement or other resolution to form an escrow account for the recipient of the settlement, then the recipient must include the entire amount deposited in the escrow as income. To avoid this result, the escrow account must be formed *before* a final settlement is reached or final liability adjudicated. Additionally, the escrow arrangement must be such that the ultimate beneficiary (the taxpayer) does not have any independent dominion and control over the escrowed amounts. Income is not constructively received if the taxpayer's control over its receipt is subject to substantial limitations or restrictions. This principle assumes a "bona-fide arms length agreement prior to the right to receive the income. An escrow cannot defer income where it is self imposed by the taxpayer." (*See Reed v. CIR*, 723 F.2d. 138 (1st Cir. 1983)). If the recipient's right to the income is clear, and he has control over the income prior to the formation of the escrow account, then inclusion in gross income is required.

The tax accounting rules for contested liabilities are contained in Code Section 461(f). These rules provide that a payor may take a deduction with respect to a disputed liability, even before the final conclusion of the legal proceedings, if the payor actually makes payment on the contested liability and the money is thereafter beyond his influence or control. An escrow can be quite useful for a taxpayer seeking a deduction in such context.

There are, of course, other tax issues involving an escrow arrangement (an escrow can itself be a taxpayer, for example); however, taxpayers should consider escrows as part of their tax planning when appropriate and as part of a bargaining process whenever timing for a tax deduction or income inclusion is an important issue. ■

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