

Constructive Receipt and Assignment of Income In Payment for Services Scenarios

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Introduction and Purpose

The purpose of this Tax Management Office Guideline (TMOG) is to help identify situations at the University of Minnesota (U) that warrant further investigation to determine whether constructive receipt or assignment of income issues need to be addressed. Generally, if an individual has the right to receive compensation for services performed, the U must report the income to the individual and the Internal Revenue Service (IRS). However, there may be instances when an individual does not want to receive the income, but instead wants the compensation to be paid to the University, often into a research chartstring, or to an unrelated charity. When an individual earns the compensation but diverts the payment to another, the question of whether constructive receipt or an assignment of income has occurred must be answered to determine whether the U is required to include the amount in the individual's taxable income for IRS reporting purposes.

Constructive Receipt

The constructive receipt doctrine says that income, even when not actually within an individual's possession, is constructively received when the money is set apart for the individual, credited to the individual's chartstring, or otherwise made available so the individual may draw upon it at any time. Once the individual personally has control of the money, has a right to the money, or has a right to direct the payment of the money, it is constructively received.

Assignment of Income

The assignment of income doctrine says that income is taxed to the true earner of the income; any attempt to transfer the income to a third party will be disregarded by the IRS with the true earner taxed on the income, even when it has been transferred to a third party. Generally, a transfer between departments at the U does not trigger assignment of income since there is no third-party involved. The U is one legal entity and the performer of the services is the second-party. However, if the transfer involves a third party, assignment of income limitations should be considered.

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Example 1

A faculty member agrees to perform tasks on campus in addition to normal job duties. In this case, the faculty member agrees to speak at a conference hosted by another U department. In exchange for the speaking services, the department hosting the conference agrees to pay the faculty member \$500. Rather than receive the payment for services as a taxable augment to salary, the faculty member wants the payment to be deposited into a research chartstring where the funds can be used for research related expenses. Is there a constructive receipt or an assignment of income issue?

Constructive Receipt – Once the speaking services have been performed, the faculty member has a right to receive the payment for the services. Even if the faculty member subsequently waives all rights to the payment and the paying department deposits the payment in a research chartstring, the U will need to include the amount in the faculty member's W-2 income.

Following are two alternatives that facilitate making the payment to a U chartstring without subjecting the faculty member to income tax on money not received. Both alternatives require:

- entering into an agreement **before** the services are performed, preferably in writing, in which the faculty member waives all rights to the payment, and
- that the faculty member not have the option of using the funds deposited in the U chartstring to pay him/herself salary supplements without higher level approval.

Alternative 1: Before the services are performed, the hiring department may enter into an agreement directly with the faculty member's U department to provide the speaking services. The department, not the individual, is hired to perform the services. Rather than the faculty member earning the income, the department is the true earner of the \$500 payment. The faculty member performs the services as part of his/her U job. The department decides where to deposit the payment. If desired, the faculty member could control how the money is spent as long as it is used for appropriate U business purposes and the faculty member has no legal right to the funds at any time during employment with the U or upon termination.

Alternative 2: Before the services are performed, the faculty member may enter into an irrevocable agreement waiving all rights to the payment. It is preferred that the agreement to waive all rights be documented in writing prior to the performance of the services. However, it may be acceptable to verbally enter into the agreement before performing the services, but memorialize that agreement later. The faculty member may not have the option of directing that the payment be deposited into a particular chartstring, because if the faculty member can control the payment, it is an indication that the faculty member did not waive all rights to the payment and has constructively received the income. The paying department must retain complete control regarding whether a payment will be made, and if so, to what chartstring. However, the paying department is free to consider the preferences of the faculty member in making decisions regarding whether, and where, to make a payment. If the

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chartstring where the payment is deposited allows for salary supplements to the faculty member, higher level approval (generally by a Dean or Department Head) must be required to avoid constructive receipt.

Assignment of Income – Because this example does not involve transferring the payment to a third party, an assignment of income issue does not arise.

Example 2

The same fact pattern as Example 1, except the faculty member providing the speaking services asks that the \$500 payment for services be made to the University of Minnesota Foundation.

Constructive Receipt – See following Assignment of Income answer that prohibits this type of transfer to a third party. If the transfer was allowed, there would also be a constructive receipt issue.

Assignment of Income – These facts illustrate a classic example of assignment of income. The faculty member is the true earner of the \$500 speaking fee, yet the faculty member is directing the U to make the payment to the University of Minnesota Foundation, which is a third party. (The Regents of the University of Minnesota which employs the faculty member is a separate legal entity from the University of Minnesota Foundation.) The U is required to include the payment in the individual's income even if the U makes the payment to the Foundation.

Alternative 1: The U could make the payment directly to the faculty member and the faculty member could then make a charitable contribution to the University of Minnesota Foundation. The payment would be received and reported as income for the faculty member, but the faculty member may be able to take a charitable contribution deduction for the donation made to the Foundation.

Example 3

A faculty member is chosen to receive a \$50,000 award that will be deposited into the faculty member's research chartstring. The award letter states that the faculty member has the option of using the chartstring to pay him/her-self up to two months of supplemental summer salary. No higher level approval need be obtained to elect this option.

Constructive Receipt – Because the faculty member has the option to augment his/her salary with part of the award, the U will need to report the augmentation amount as W-2 income, whether the faculty member elects to take the salary supplement or not.

Alternative 1: If, instead, the award allowed for the salary augmentation only when approved by a higher level employee, constructive receipt would not occur; the amount would only need to be included in income if the faculty member elected to receive it as a salary supplement.

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Following is sample language that provides for this type of award without creating constructive receipt:

You will receive an award of \$50,000 which may be used over the next fiscal year and will be deposited into your research chartstring. These funds are to be used at your discretion for expenditures related solely to your research or scholarly activities, e.g. research equipment, professional travel, conferences. Additionally, with the approval of your Dean, you may use the funds to pay yourself up to two months supplemental summer salary, plus related fringe benefits.

If this type of approval is agreed upon, a process should be established to ensure that the higher level approval is actually obtained when using the funds for salary supplements.

Example 4

The U agrees to pay a sole proprietor vendor \$10,000 for specific services provided to the U. Before the services are performed, the vendor requests that half of the payment be made to a specific charity.

Assignment of Income – Under the assignment of income doctrine, the payment to the charity will be taxable to the vendor that earned it, regardless of who receives the payment. Even if the U agrees to bifurcate the payment as requested, the U will send a Form 1099-MISC to the vendor and IRS indicating the payment for services was \$10,000.

Process for Reporting Constructive Receipt or an Assignment of Income to Employee

When income needs to be reported to an employee due to constructive receipt or an assignment of income, the income is not received by the individual via normal channels, so it's not automatically reported. Please contact Payroll Services through the Office of Human Resources at 612-624-UOHR (8647) or email at payroll@umn.edu to get the income reported on the employee's W-2.

Exceptions

There is a narrow exception to including certain prizes in income when the recipient is selected without taking any action to enter the contest, the recipient isn't required to render substantial future services, and the recipient directs the U to transfer the prize award to a governmental or charitable organization. There is also an exception for an honorarium payment made to a governmental or charitable organization on behalf of a Federal Government officer or employee. Please contact the Tax Management Office about specific requirements for these exceptions.

Contact

If you have questions about whether a scenario creates constructive receipt or an assignment of income, please contact the Tax Management Office at taxhelp@umn.edu or 612-624-1053.