Malpractice Settlement Is Taxable, Not Nontaxed Capital: What Went Wrong?

by Robert W. Wood

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In this article, Wood examines the tax treatment of legal and accounting malpractice recoveries and explores lessons from the recent *McKenny* decision.

This discussion is not legal advice.

In *McKenny*, a district court in Florida and the Eleventh Circuit considered the tax treatment of an accounting malpractice recovery.[1] The courts came out differently, providing lessons for many plaintiffs hoping to save on taxes. The underlying case was also about taxes, and paying more than you arguably should. Joseph and Amy McKenny sued their accounting firm, Grant Thornton LLP, alleging that its negligence made them pay more than $2 million in taxes they would not have owed with competent planning.

The accounting firm settled the lawsuit for $800,000. Because the McKennys were just being reimbursed — and only for part of what they lost — they shouldn't have to pay tax on that reimbursement, right? That's what the McKennys thought, and the district court agreed. But the Eleventh Circuit reversed, and the McKennys ended up paying more taxes *again*. The reasons may seem complex, but there are some surprisingly simple lessons, as we will see.

Some are substantive: Which lawsuit recoveries count as basis recovery or reimbursement and so are not taxed?

Some are procedural: You must prove your claim in court, and the taxpayer nearly always has to do that, not the IRS. Even more fundamentally, consider your tax returns carefully and how related items hang together, as well as whether you are going too far. Also, always consider tax refund claims and refund lawsuits very carefully. When you sue the IRS, you are poking a bear, itching for a fight, or both.

Tale of Woe

This tale of woe started with some complex tax planning that didn't work out in the end. Joseph McKenny hired Grant Thornton to help lower taxes related to his business. Grant Thornton steered him into an S corporation and an employee stock ownership plan. They were supposed to provide big tax benefits. However, through a series of mishaps, misunderstandings, and poor implementation, the McKennys ended up in hot water with the IRS. In 2007 they settled their big tax bill.

The McKennys committed to pay the IRS for the failed ESOP transactions, ultimately remitting $2,235,429 in taxes, penalties, and interest. Then in 2008, the McKennys sued Grant Thornton, claiming that accounting malpractice was responsible for their paying the IRS more than $2 million out of pocket. In 2009 Grant Thornton paid $800,000 to settle. As nearly every legal settlement

[1] *McKenny v. United States*, No. 18-10810 (11th Cir. 2020), *aff'g in part, rev'g in part, and remanding* No. 2:16-cv-00536 (M.D. Fla. 2018).

agreement does, this one expressly denied the claims and all liability related to the tax advice.

On the McKennys' 2009 tax return, they deducted $419,490 in legal fees, and claimed an unreimbursed loss for the difference between the Grant Thornton settlement and the $2.2 million payment to the IRS. What's more, the McKennys excluded the $800,000 from their income. With the deductions and exclusions, the McKennys claimed a net operating loss, carrying it forward to 2010 and 2011.

That seemed OK on paper, until the McKennys were audited and the IRS came down hard. In September 2013 the IRS issued a notice of deficiency rejecting all the deductions and exclusions. The IRS recharacterized the legal expenses as a miscellaneous itemized deduction, not a business expense for the McKennys' business.

The IRS disallowed the loss deduction, too.

The coup de grace was the $800,000 settlement, which the IRS said was income.

As a result, the McKennys owed an additional $813,407 in taxes. Unlike the customary path of going to Tax Court once a notice of deficiency is issued, the McKennys paid the taxes due. Then, in 2016 the McKennys sued the government, seeking a refund of $586,000 — the amount of disallowed exclusions and deductions for 2009 and 2011.

The district court concluded that the legal expenses incurred in the Grant Thornton case were not deductible business expenses, because the McKennys sued Grant Thornton on their own behalf, not for their business. As for the loss, the district court said the McKennys were barred by their 2007 IRS settlement from claiming any losses related to the ESOP transactions. But regarding the $800,000 settlement, the district court agreed with the McKennys that it was a return of capital and not taxable.

The IRS appealed, and so did the McKennys. On appeal, the McKennys argued that the district court was wrong about the legal fees and their unreimbursed loss. The government said the district court was right about both, but was wrong to treat the $800,000 settlement as a return of capital.

Personal or Business?

The appeals court had an easy time with the legal fees. Whether litigation costs are a business expense depends on whether the litigation is business or personal. The McKennys argued that their lawsuit against Grant Thornton concerned their business — because that's what they hired the accounting firm for. But to be a business expense, the appeals court said, it must be one that has a business origin.[2] In *Gilmore*, the Supreme Court said huge legal bills in a divorce were personal and nondeductible, even though the husband was trying to protect his business.

Similarly, the litigation between the McKennys and Grant Thornton was personal in character and origin. According to the court, the suit concerned the McKennys' personal tax liability, not the tax liability of their business. The appeals court was no more sympathetic on the $1.4 million loss deduction. This was the difference between what the McKennys paid to the IRS and the $800,000 they received from Grant Thornton to settle their suit.

The IRS's 2007 closing agreement committed the McKennys to pay taxes they owed on the ESOP mess. The court found that the closing agreement barred them from claiming a deduction for this payment. The court also said blaming Grant Thornton for their tax troubles or arguing that they were only partially made whole by Grant Thornton didn't change that. So the McKennys lost that one, too.

Return of Capital

The notable part of the case, of course, concerns the $800,000 settlement payment. After all, the argument *seems* so appealing. If you had to pay $2.2 million, and only got $800,000 back, isn't that just a reimbursement? The district court thought so, and in many legal settlements, it can play out just fine.

Say you buy a condo for $1 million, but discover bad construction, so you collect $200,000 from your contractor. Is that income? Most people would say no, it's not income, it reduces your basis. You paid $1 million, but got $200,000 back,

[2] *United States v. Gilmore*, 372 U.S. 39, 45 (1963).

so your basis in your condo is now $800,000. If you sell it, your gain is pegged from $800,000. If you depreciate it (business or rental use), you must use that lower number, too. There are plenty of private letter rulings supporting this common-sense treatment.[3]

It can work with investments, too. Say you have a $1 million stock portfolio, but your broker inappropriately whittles it down to $500,000. You sue your broker for mismanagement (if you try to go to court, you'll almost certainly be relegated to a National Association of Securities Dealers arbitration). Eventually, if you get back $200,000, is it income? This one is trickier.

To answer, you'll need to know about basis and gain. After all, you could have a big portfolio with a very low basis, so getting any money back as basis reduction may be impossible. In short, not everything is as it seems. You have to think hard about it, run the numbers, and do some research, but there may not be income.[4]

McKenny's Appealing Appeal

How about the McKennys and their $800,000? Let's start with the obvious. Just about everything is income. The tax code's "all income from whatever source derived"[5] scoops up everything and is unforgiving. You must overcome its presumption. With legal settlements, whether the settlement constitutes taxable income depends on a few things. In lieu of what were the damages awarded?[6]

Fortunately, the McKennys found a seminal tax case from the days before there was even a Tax Court.[7] In the 1930s, Mr. Clark paid some extra tax because his tax counsel negligently failed to tell him to file a separate return, not a joint return with his wife. This negligence caused Clark to pay $20,000 more in taxes than he would have paid on a separate return.

His tax counsel paid the $20,000 to settle, and Clark included it in his income. But Clark later asked for a refund (remember, consider refund claims carefully). The IRS argued that the $20,000 paid by the tax lawyer were taxes paid by a third party, so Clark had income. But the Board of Tax Appeals (BTA) said Clark paid his *own* taxes, sustaining a loss caused by the tax lawyer's negligence. The BTA held the $20,000 was compensation/reimbursement for the loss because of the tax lawyer's negligence, not income.

It was irrelevant that the obligation was for taxes, said the BTA. That means *Clark*'s reach should be broader than tax malpractice. The BTA went on to say that a recovery on account of a loss is not income. As long as Clark did not (and could not) take a deduction in a prior year for the loss to offset his income for the prior year, his recovery was not includable in his gross income. That "did not and could not" standard suggests a tough tax benefit theory.

Other authorities continue *Clark*'s thread. In Rev. Rul. 57-47, 1957-1 C.B. 23, a tax consultant made an error in preparing and filing a taxpayer's return. The error caused the taxpayer to pay additional tax. By the time the error was discovered, the statute of limitations had expired. To settle it, the tax consultant reimbursed the taxpayer for the additional tax. The IRS ruled that the reimbursement was not income, but the excess recovery (interest) was taxable.

The IRS acquiesced in *Clark*,[8] but later tried to limit its breadth in a series of private letter rulings. In LTR 9743035, a CPA firm's negligence caused a fund not to qualify as a regulated investment company, triggering additional tax. The IRS said this was different from *Clark* and Rev. Rul. 57-47. However, the distinction has proven difficult to apply.

In *Clark* and Rev. Rul. 57-47, the IRS said the preparer's errors in filing returns caused the taxpayers to pay more than the "proper" federal income tax. In LTR 9743035, the CPA firm's error altered the underlying entity status of the fund, which had to file as a C corporation during the period it did not qualify as a RIC. That led the IRS to conclude that the CPA firm's reimbursement to the fund was not made to compensate it for the

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[3] *See, e.g.*, LTR 9041072. *See also* Rev. Rul. 70-510, 1970-2 C.B. 159.

[4] *See Commissioner v. Pennroad Corp.*, 228 F.2d 329 (3d Cir. 1955).

[5] Section 61.

[6] *See Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944).

[7] *See Clark v. Commissioner*, 40 B.T.A. 333, 335 (1939).

[8] *See* Rev. Rul. 57-47.

excess tax liability the fund suffered because of the CPA firm's negligence.

Instead, the IRS characterized the reimbursement as a payment of the fund's proper tax liability (as a C corporation). Thus, the reimbursement of taxes, interest, and penalties was gross income. Whether a focus on proper tax versus erroneous tax makes sense can be debated, but the IRS has continued it.

In LTR 9728052, the taxpayer executed an agreement to pay alimony to his former spouse. His attorney said the payments were deductible, but the IRS disallowed the deductions because they clearly did not qualify as deductible alimony. The taxpayer negotiated with his attorney's malpractice insurer, which eventually settled.

The settlement included payment for the additional taxes, interest, and penalties, plus the additional federal income taxes he expected to pay over the term of the alimony agreement because of their nondeductibility. The IRS ruled that the reimbursement was income, although arguably this was precisely the kind of reimbursement that occurred in *Clark*.

Not so, said the IRS. Here, the attorney's error related to the underlying transaction and the terms of the agreement. As a result of the error, the payments were not deductible, as alimony should have been. Unlike *Clark*, the IRS reasoned, this taxpayer was *not* paying more than his minimum proper federal income tax liability.

One wonders whether giving lip service to the IRS terminology and reasoning would matter in how the IRS sees it. For example, would it matter if one recited in a malpractice settlement agreement that a settlement payment was reimbursement for the excess (tax, penalties, and interest) the plaintiff had to pay, not the proper tax? Settlement agreement wording does not bind the IRS. Maybe it is window dressing, but in the real world, many an audit is influenced by such simple steps, sometimes pivotally.

In another private letter ruling, LTR 9833007, the taxpayer won the state lottery and consulted attorneys for tax preparation advice. That advice missed deductible expenses, so the lottery winner paid more federal income tax than required. His attorney's malpractice insurer reimbursed him for the additional taxes. Again, the IRS distinguished the situation from *Clark*.

This reimbursement was not traceable to an error made by the attorney on the return itself, the IRS reasoned. The offending act was an omission to provide advice that would have reduced the taxpayer's tax liability. Unlike in *Clark*, this taxpayer did not pay more than his minimum proper federal income tax liability. As such, the amount he received was gross income.

However, sometimes the IRS is willing to come out the other way. In LTR 200328033, the IRS ruled that a settlement was excludable when the defendant was responsible for an error causing the taxpayer to overpay his taxes. The taxpayer was a city employee who retired under full disability related to his duties. As such, the retirement pay should have been tax-free, not income. When the clear error was discovered, it was too late to amend the returns, so the tax adviser reimbursed the retiree.

The IRS determined that this tax indemnity payment was identical to *Clark.* The reimbursing payer in LTR 200328033 was the same entity responsible for the error that led the retiree to overpay his taxes. When the retiree overpaid his taxes in the earlier years, he suffered a loss of capital, and that loss of capital is what the payer was reimbursing, said the IRS.

Finally, consider ILM 201306018, which appears to describe the facts in the *McKenny* case, foreshadowing the result the Eleventh Circuit would ultimately reach. The long series of IRS rulings are important tea leaves to read. Of course, like other private letter rulings, they are technically not authority.

The IRS intimates that *Clark* can only (rarely) help a narrow class of taxpayers in cases of settlement or indemnification for negligent tax advice. However, *Clark*'s reasoning should arguably apply to a much broader class of settlements and reimbursements. When the IRS has declined to follow *Clark*, it relied on the underlying nature of the transaction that created the problem. And despite the IRS focus on proper tax versus excess tax, the reasoning does not seem wholly convincing.

Notably, *Clark* was followed by several Tax Court decisions. In *Concord Instruments*,[9] there

[9] *Concord Instruments v. Commissioner*, T.C. Memo. 1994-248.

were many tax issues, and a relatively minor one was a $125,000 legal malpractice settlement over a lawyer's failing to timely file a notice of appeal. Relying on *Clark*, the Tax Court held that it was not income, except for the part based on amounts previously deducted as interest.

Concord Instruments claimed that the lawyer's error caused it to pay more taxes than it should have. Over the IRS's objection, the Tax Court said that, as in *Clark*, this was a recovery of capital. A recovery of capital, the court said, "includes amounts paid to a taxpayer to compensate for a loss suffered because of erroneous advice from his tax counsel."

Clark Redux

Then, in *Cosentino*,[10] the Tax Court reprised *Clark* after 75 years. This sympathetic taxpayer had a disabled daughter, and, trying to save for her future, he wanted to save taxes and accumulate wealth for her care. His tax adviser sold him on a variant of a basis inflation shelter to offset gain on real estate. When Cosentino discovered that the shelter was listed as abusive, he immediately amended his returns and paid the tax.

He then sought damages from the adviser, arguing that he could easily have done a safer 1031 exchange, not the shelter. The IRS made all the predictable arguments we saw in its raft of private letter rulings. However, the Tax Court liked the "I would have done a 1031" argument. After all, Cosentino had previously done numerous 1031 exchanges to defer taxes.

The IRS countered that section 1031 was only about deferral, not eliminating taxes forever. However, Cosentino said he planned to keep doing 1031 exchanges until he died, when his real estate would get a stepped-up basis for income tax purposes. The Tax Court liked this, and ultimately concluded that the malpractice settlement paid to Cosentino was not includable in his income.

In 2016 the IRS announced its nonacquiescence in *Cosentino*,[11] elaborating on its position with the familiar proper tax rationale:

> The taxpayers in this case paid the correct amount of Federal income tax based on the transaction they entered into. In this transaction, the taxpayers received taxable boot as part of their consideration upon the disposition of the rental property. When the artificially inflated basis was disregarded, the boot resulted in gain recognition from the exchange and the imposition of tax on that gain. Once this transaction was completed, no choices were available to the taxpayers to reduce this taxable gain. It was the facts of the transaction, and not a failure to make an election or a failure to timely file an appeal, that caused the taxpayers to incur additional tax.
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> In light of the underlying gain recognition transaction, the amount of tax imposed was not more than what they properly owed on that transaction and, consequently, the taxpayers did not sustain a loss. To the contrary, because the taxpayers received the boot, and because they continued to receive the benefit of both the boot and the basis in the newly acquired real property even after the abusive tax shelter transaction was disregarded, taxpayers financially were in a better (not merely restored) position after the settlement than they were in before entering the transaction.

The IRS even pushed back on *Cosentino*'s lifetime plan theory:

> In reaching its holding, the court considered the taxpayers' plan to use a lifetime series of tax-free exchanges, followed by a step up in basis at death, to permanently avoid paying taxes on the gain from these transactions. We disagree with the court's reliance on these facts. The taxpayers' ability to execute that tax planning strategy was purely speculative, and a change in the taxpayer's circumstances, or even a change to the provisions of the Internal Revenue Code, could have altered the strategy at any time.

[10] *Cosentino v. Commissioner*, T.C. Memo. 2014-186.

[11] AOD 2016-01.

The Court of Claims addressed *Clark* in several decisions.[12] In *Centex*, it held that unlike in *Clark*, the taxpayer was not ultimately paying more in federal income tax than it otherwise would have, but for the negligence of another. Hence, the Court of Claims said the tax indemnity payment was taxable, citing the private rulings.

No Capital or No Proof?

The Eleventh Circuit in *McKenny* called it remarkable that (apart from the *McKinney* case in district court), "no Article III federal court has addressed or applied *Clark* in the 80 years it has been on the books." But the court seemed to have an easy time holding for the government on the $800,000 payment. The district court had said the ESOP strategy was legal at the time, and would have saved the McKennys nicely. But the district court seemed to assume all the tough facts in the McKennys' favor.

For example, the district court assumed that Grant Thornton did not properly file for S status, but IRS records clearly said otherwise. On burden of proof grounds, the appeals court had an easy time saying that the McKennys essentially made a bald assertion, devoid of specifics. They claimed they overpaid taxes and might have owed nothing had Grant Thornton followed through on its S corporation and ESOP strategy.

An expert witness might have carried the day, or at least provided enough smoke and mirrors to get the district court affirmed. But the Eleventh Circuit reversed and held for the government that the $800,000 settlement was income. Besides, the government in *McKenny* had another argument to distinguish *Clark*: A third party's payment of a taxpayer's tax liability is generally taxable.[13] That principle has often caused tax-related malpractice cases to be handled as reimbursements, not as direct payments.

As the Eleventh Circuit noted, the McKennys cited me for the proposition that a return of capital should not be income.[14] It seems hard to argue with that principle if the injury is to a capital asset. But it is less clear with a payment (of taxes, legal fees, anything else?) you paid and did not deduct, but later get back from the wrongdoer. The Eleventh Circuit simply did not see this as a recovery of capital, not one that was proven in any event.

Does *Clark* only apply if a tax adviser makes a mistake in preparing a tax return, or in advising how to prepare it? The government in *McKenny* argued that *Clark* does not apply to settlements based on claims of malpractice in giving advice about, structuring, or implementing a transaction. And that issue, as in *Cosentino*, seems likely to come up again.

Lessons Learned

For tax malpractice recoveries, *Clark* is still valid authority, and still helps taxpayers, as *Cosentino* clearly shows. But the IRS has whittled it down as much as it can. As a result, anyone facing these issues should get some advice and be careful. *Clark*'s theory suggests that many malpractice recoveries even outside the tax arena might be tax-free.

The IRS has arguably fomented the use of its own magic words, at least in tax malpractice settlements. Surely saying in a settlement agreement that a payment is a reimbursement of excess (tax, penalties, and interest) the plaintiff had to pay can't hurt. Similarly, saying that this settlement is not a reimbursement of the plaintiff's proper tax seems wise. Sometimes, if you say something enough, it might come true.

Clark can be read as applying only to tax malpractice actions, or it can be read more broadly. How about a case against a corporate lawyer for botching a merger? What about suing a litigator who doesn't file suit before the statute of limitations has run? These and other big questions merit a separate article. ■

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[12] *See Local Oklahoma Bank NA v. United States*, 59 Fed. Cl. 713, 720-721 (Ct. Cl. 2004); *Centex Corp. v. United States*, 55 Fed. Cl. 381, 389 (Ct. Cl. 2003).

[13] *See Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

[14] "Where a recovery compensates a plaintiff for injuries to a capital asset, the recovery constitutes a tax-free return of capital to the extent of the taxpayer's basis in the injured asset." *See* Robert W. Wood, "Tax Treatment of Business Litigation Recoveries — Capital Gain vs. Ordinary Income," 99 *J. Tax'n* 27, 28 (2003).