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Tax Treatment of Damages for Accountant Malpractice: 'McKenny v. United States'

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A taxpayer suffers a loss by reason of errors made by a tax advisor, and the tax advisor makes a payment to compensate the taxpayer for the loss. May the payment be excluded from the taxpayer's income subject to tax? The courts and the IRS have, in some circumstances, found such payments to be non-taxable returns of capital. In *McKenny v. United States*, a recent decision of the Court of Appeals for the 11th Circuit (126 AFTR 2d 2020-5943), however, the court concluded that the taxpayers before it could not exclude the payment at issue from income.

Background in *McKenny*

Mr. McKenny (McKenny) was an independent consultant providing advice to car dealerships. He engaged an accounting firm (the Accountant) to advise him on matters including tax strategy.

The Accountant recommended that McKenny conduct his advisory business through an S corporation wholly owned by an employee stock ownership plan (ESOP), of which McKenny would be the sole beneficiary. McKenny implemented that strategy in 2000 and, also at the recommendation of the Accountant, caused another S corporation owned by the ESOP to acquire an interest in a car dealership.

The underlying strategy became clearly impermissible as a result of changes to the Internal Revenue Code that took effect in 2005. Also in 2005, the IRS commenced an audit of McKenny and his spouse that ultimately asserted the ESOP strategy was ineffective even for pre-2005 years and that the McKenneys owed deficiencies for those years. The audit was resolved through a settlement agreement with the IRS in 2007. Under the agreement, the McKennys conceded all claimed benefits from the ESOP/S corporation strategy for years 2000 through 2005, paid more than $2 million in taxes, interest, and penalties, and were barred from claiming any other deductions or losses relating to the ESOP transactions.

In 2008, the McKennys sued the Accountant, alleging that the Accountant had committed malpractice in the assistance it provided for implementation of the ESOP/S corporation strategy which had resulted in additional tax obligations. The suit, seeking compensatory and punitive damages, was settled in 2009, when the Accountant paid $800,000 under a settlement agreement, but denied the claims against it by the McKennys and all liability.

The McKennys filed tax returns in which they deducted the legal fees they paid to pursue the malpractice claim, claimed a loss for the excess of the payments made by them to the IRS on account of the ESOP transactions over the amount received by them from the Accountant, and excluded the $800,000 settlement payment from their income. These positions resulted in a net operating loss for 2009 that was then carried forward to reduce their tax liabilities for 2010 and 2011.

The IRS rejected all these positions and asserted deficiencies in excess of $800,000, which the McKennys paid. They then filed refund claims and ultimately sued the government in a U.S. District Court in Florida to further pursue those claims.

Analysis

The district court (121 AFTR 2d 2018-337) denied the deduction for legal fees, on the basis that the claims against the Accountant were made by the McKennys personally and that the related legal fees were personal obligations of the McKennys, rather than expenses of McKenny's business deductible as business expenses; and denied any deduction for the additional taxes paid and not recouped from the Accountant, because the settlement agreement with the IRS stated that the McKennys would not claim any deduction for these amounts. (The court's decision does not address whether any deduction would have been allowable for such amounts even if the settlement agreement had been silent on that point.)

With respect to whether the $800,000 settlement payment was excludable from income, the court found that the circumstances established that the payment was made as compensatory, rather than punitive, damages, even though punitive damages (generally includible in income) were claimed as well. The court also rejected the government's argument that, because the McKennys had failed to show that the ESOP would have been effective to reduce their tax obligations but for errors by the Accountant relating to implementation, the settlement payment could not be considered a nontaxable return of capital.

To the contrary, the court concluded that the McKennys had established that their losses were attributable to the failure of the Accountant to "properly follow through with the ESOP strategy" and that the settlement payment from the Accountant was therefore excludable from income as a return of capital, citing *Clark v. Commissioner* (40 B.T.A. 333 (1939)). In *Clark*, a payment by a taxpayer's tax return preparer to the taxpayer for additional tax owed by reason of negligence in the preparation of the taxpayer's tax return was determined to be excludible from income as compensation for a loss that impaired the taxpayer's capital. It was also noted that the IRS has indicated its agreement with *Clark* in similar circumstances (see Rev. Rul. 57-47, 1957-1 C.B. 23).

Both the McKennys and the government appealed. The Court of Appeals affirmed the trial court's determinations that the McKennys' legal fees were not deductible and that the additional taxes not recouped from the Accountant could not be deducted either, but also agreed with the government that the $800,000 payment must be included in the McKennys' income (reversing the district court on this point).

The Court of Appeals decision noted that the IRS in private letter rulings had concluded that the return of capital rationale applied in *Clark* could be limited to situations in which the manner of preparation of a tax return was the cause of the loss, and the decision questioned whether the rationale should be applied more broadly to situations where poor advice in the planning or implementation of a transaction increased the taxpayer's tax obligations, as reflected on a properly prepared tax return, in relation to what could have been achieved with better planning and implementation.

The Court of Appeals declined to resolve the question of the scope of *Clark* and concluded that, even if *Clark*'s rationale should also apply where malpractice related to structuring of an underlying transaction, the payment received from the Accountant could not be excluded from income in this case. The taxpayers had neither provided evidence, beyond mere conclusory assertions, regarding, nor addressed in their briefs how, the ESOP/S corporation structure would have reduced their tax liabilities if properly implemented, and they had not substantiated the amount of tax reduction that would have been achieved.

The appellate court also noted that the McKennys did not offer the testimony of a tax expert as to how the ESOP strategy would have worked. The opinion states, in a footnote, that the court was not suggesting that taxpayers must employ an expert in order to prevail in a case of this nature, but that testimony of a tax expert might have been one means of providing evidence as to how the ESOP/S corporation strategy would have worked. Absent such evidence, the court concluded that the McKennys did not meet their burden of proof to exclude the settlement amount from income.

Observations

Although the equities may have favored the exclusion from income of the settlement payment (taking into account the other adverse consequences imposed on the taxpayers), the reversal by the Court of Appeals of the district court on this issue is not very surprising, taking into account enduring uncertainties as to the scope of *Clark* and the apparent lack of specific and uncontroverted information in the record as to what mistakes were made and by whom, and the reasonably anticipated consequences of the ESOP/S corporation structure as initially contemplated and as implemented.

The Court of Appeals decision does not, however, provide much by way of clear guidance for taxpayers who may find themselves in similar circumstances as to what needs to be done to maximize the likelihood of an exclusion from income of a compensatory payment from their tax adviser. Perhaps the best that can be said is that scrutiny by tax authorities of the exclusion of such payment from income should be anticipated and that, especially in more complicated situations, substantial efforts should be made to preserve and document the intended effect of a particular transaction or structure and how errors in planning, implementation or reporting (or some combination thereof) led to adverse tax results.

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