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McKenny v. U.S.,126 AFTR 2d 2020-5943(11th Cir.)

The Eleventh Circuit Court of Appeals reversed a lower court decision and held that taxpayers must include in the income, a malpractice claim settlement award received from an accounting firm. The court agreed with the lower court's holding concerning the denial of legal expense deductions and losses the taxpayer claimed related to transactions involving the accounting firm. A summary of the *McKenny* case follows.

Basics of Deductible Business Expense versus Non-Business Expense

IRC §162 allows a deduction for "all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business." To be deductible under IRC §162(a) an expense must have a business origin. The characterization of legal cost as business or personal depends on the origin and character of the event that led to the expense.

Basics of Gross Income

Gross income is defined broadly at IRC §61 as "all income from whatever source derived." It is the total of the amount received from various sources unless expressly excluded under the tax law. When a taxpayer receives a settlement award after a claim, its treatment of inclusion or exclusion from gross income depends on the reason for which the settlement for damages was awarded.

Background of the Case

Mr. and Mrs. McKenny were residents of Missouri in the late 1990s. The husband (H) worked as an independent consultant, providing advisory services for a car - dealership business. He hired accounting firm, Grant Thornton for tax planning advice.

Grant Thornton suggested that H form his consulting business as an S corporation for tax purposes. This suggestion also included that the S corporation be owned by an employee stock ownership plan (ESOP), with H as the sole beneficiary of the ESOP. This plan would enable H to accumulate tax-free income in the ESOP until distributions were made to him. Following this plan, H could also defer tax on his income from the consulting business. The income earned from the company would pass through the S corporation without being subject to corporate income tax.

In 2000, Grant Thornton's advice was implemented, and Joseph McKenny Inc. ESOP was formed, with McKenny as its sole beneficiary. Following the firm's direction in the same year, H also acquired a 25 percent stake in a GMC car dealership in Florida, with this stake held in a separate S corporation. This S corporation was wholly owned by Joseph McKenny Inc. ESOP. For tax purposes, Grant Thornton suggested H characterize the dealership's payments to the S corporation as management fees instead of partnership profit share. For numerous years, they paid little or no federal income taxes.

The IRS audited the McKenny's tax returns in 2005 and determined underpayment in their federal income taxes between 2000 and 2005. The IRS alleged that tax planning concerning the ESOP was an abusive tax shelter. The dealership's payments were improperly characterized as business expenses for tax purposes. The McKennys settled with the IRS and paid over $2.2 million in taxes, interest, and penalties. They entered into a closing agreement, which states that no amount would be allowed as an ordinary loss for the years at issue. The McKennys were not entitled to any deductions or business losses relating to the ESOP and accepted that they owed unpaid taxes.

The McKennys subsequently sued Grant Thornton. They alleged that their accounting firm was negligent and committed malpractice and held the firm responsible for their unpaid tax liabilities for the years at issue. The firm provided complex tax planning, which did not work well, and that is why the McKennys had to pay a large tax bill. In 2009, the accounting firm settled the lawsuit by paying $800,000 to the McKennys but denied any wrongdoing.

Over the consecutive three years (2009-2011), the McKennys filed tax returns with several deductions and exclusions related to their lawsuit against Grant Thornton. For the 2009 tax return, the McKennys claimed a deduction for legal fees of $419,490, which they paid to litigate the malpractice claim. They excluded the $800,000 settlement payment from gross income. They claimed an unreimbursed loss of approximately $1.4 million which was the difference between the amount they paid to the IRS ($2,235,429) and the amount they received from accounting firm as a settlement payment of $800,000. The McKennys claimed a net operating loss based on deductions and exclusions, and it was carried forward to 2010 and 2011 to reduce their tax liabilities.

After the IRS issued a notice of deficiency in 2013, the McKennys ended up paying an additional $813,407 in taxes. The notice stated that all the deductions and exclusions claimed were disallowed. The IRS recharacterized the legal expenses as a miscellaneous itemized deduction (rather than as a business deduction), subject to the two percent of adjusted gross income limitation. After the IRS denied all deductions and exclusions, the McKennys filed a lawsuit in the District Court of Florida.

The district court ruled in favor of the government on the legal fees and unreimbursed loss. It concluded that they were not deductible as business expenses because the McKennys sued the accounting firm on their personal behalf rather than the consulting business bringing the suit.

The court also mentioned that their 2007 settlement with the IRS barred McKennys from claiming any losses related to the ESOP transactions. They held in favor of McKennys that the settlement payment of $800,000 was a return of capital rather than income. Both the IRS and McKennys were not convinced with the district court's decision, and they sought reversal in the U.S. Court of Appeals for the Eleventh Circuit.

The Eleventh Circuit's Decision

The Eleventh Circuit partially reversed the lower court's decision on the settlement payment of $800,000 to be excluded from the income. It held that the settlement payment received by the McKenny's was not a return of capital but was taxable income. The Eleventh Circuit sided with lower court's decision that the legal fees were personal expenses only deductible to the extent they exceeded two percent of AGI along with the McKenny's other miscellaneous deductions.

Explanation of the 11th Circuit's Holding

Exclusion of settlement payment

The McKenny's argument was based on *Clark,* 40 BTA 333 (1939). A settlement payment received in *Clark* was due to the tax adviser's error in preparing and filing the married couples tax return. The adviser recommended the Clarks file jointly but later discovered he should have suggested filing separately. This negligence caused the Clarks to pay almost $20,000 more in taxes. Because the law does not allow an amended return to change this filing status, the Clarks ended up paying more than the minimum amount of tax owed.

The Board of Tax Appeals held that the payment received was reimbursement which constituted "compensation for a loss which impaired petitioner's capital," and was not taxable. The IRS acquiesced to the *Clark* case in Revenue Ruling 57-47.

After a discussion of the "very difficult questions" presented by Clark and similar situations and questioning if the *Clark* case was correctly decided, the appeals court found that the McKenny's situation was not the same as that of the Clarks. The settlement received by the McKennys related to taxes they truly owed on the "structuring of an underlying transaction." . The court also noted that the McKennys failed to "sustain their burden of demonstrating that the $800,000 settlement was excludable."

Treatment of Legal Fees

The McKennys contended that their legal fees were deductible as a business expense under IRC §162 because they related to McKenny's business. This argument though is not the correct one for legal fees. As addressed by the lower court, for legal fees to be a business deduction, they must have a "business origin." This is the *origin of the claim doctrine* laid out by the U.S. Supreme Court in *United States v. Gilmore*, 372 US 39 (1963). In the Gilmore case, legal fees were incurred by Mr. Gilmore to protect his business interests, but the origin for why the legal action existed was a divorce. Thus, the origin was personal rather than business making his legal fees personal. For the McKennys, the accountants had an agreement with the McKennys, not their businesses. The appeals court therefore affirmed the district court decision on the legal expenses not being deductible as a business expense.

Unreimbursed Loss Deduction

The McKennys contended that their $1.4 million loss claimed was not related to ESOP transactions due to the accountants "failure to reimburse" them fully in the lawsuit. This deduction was denied by the IRS because their audit closing agreement clearly stated that McKennys agreed to pay tax attributable to the disallowance of any of the ESOP transactions. The Eleventh Circuit noted that it was "a distinction without a difference." The court mentioned that the McKennys did not have a position to dispute that their $2.2 million tax payment to the IRS was not related to ESOP transactions. Their settlement agreement with the IRS as per IRC §7121 blocked them from claiming any deduction based on this payment. IRC §7121(b) does not allow them to reopen matters that are agreed upon and treated as final and conclusive under the Code. Therefore, the court affirmed the lower court's decision barring the $1.4 million loss.

Lessons Learned

As *Clark* is still valid authority, it helps taxpayers decide the tax malpractice settlement award issue. The holding in *McKenny*, on the other hand, has clarified the taxability issue. As a result, taxpayers facing these issues should refer to both cases and be careful in determining whether a payment from a preparer must be included in gross income.

In addition, the McKenny case reminds us of the origin of the claim test as still applicable to determine if legal fees are personal or business for tax purposes.