IRB No. 2016-16
April 18, 2016

ACTION ON DECISION

Subject: Cosentino v. Commissioner, T.C. Memo. 2014-186

Issue: Whether an amount the taxpayers received from an accounting firm, to settle a claim that the taxpayers incurred additional income tax liability because of the firm's advice that they enter into an abusive tax shelter, is excludible from their gross income as a restoration of lost capital.

Discussion: The taxpayers, husband and wife, each had a 50% direct interest in a partnership that received rental income from real estate rentals. In 2002, the taxpayers wanted to dispose of a rental property held by the partnership through a like-kind exchange and sought advice from an accounting firm. The accounting firm advised the taxpayers to enter into an abusive tax shelter in an attempt to artificially increase the partnership's basis in the property. In 2003, the partnership disposed of the property in a like-kind exchange with boot. On its 2003 partnership return, the partnership reported a small amount in recognized gain and no deferred gain on the like-kind exchange. Had it not relied on the abusive tax shelter to report an improperly inflated adjusted basis in the relinquished property, the partnership would have reported realized gain of almost $2.4 million, of which almost $2 million would be recognized for 2003. In 2005, upon learning that the transaction was abusive, the taxpayers filed amended returns for 2002 and 2003 to report the correct gain from the like-kind exchange and pay the correct Federal and state income taxes on the recognized gain, as well as interest and penalties. The taxpayers also disclosed their participation in the abusive tax shelter.

In 2006, the taxpayers filed suit against the accounting firm, seeking to recover $640,749.80 in fees, in losses from the transaction, and in income tax deficiencies, interest, and penalties paid to Federal and state tax authorities. In 2007, a settlement was reached in which the accounting firm paid the taxpayers $375,000. The taxpayers did not include any of the settlement proceeds on their 2007 Federal income tax return. In a notice of deficiency, the Service rejected the taxpayer's exclusion of the settlement proceeds.

The Tax Court held that, except for those portions to which the tax benefit rule applies or to which no actual loss on the taxpayers' part was attributable, the settlement proceeds were excludible from gross income because they represented a return of lost capital. The court noted that the taxpayers did not know the transaction advised by the accounting firm was abusive and their intent was to defer gain recognition on the disposition of the rental property through a like-kind exchange. Relying on two cases that the court found similar to this case, and which involved settlement payments in malpractice lawsuits, the court concluded that the taxpayers paid Federal and state income taxes and other expenses they would not have paid had they not relied on the accounting firm's erroneous advice.

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The Service disagrees with the Tax Court's holding.

Gross income includes "all income from whatever source derived" unless subtitle A of the Internal Revenue Code provides otherwise. Sec. 61(a).

"When a claim is resolved by settlement, the relevant question for the tax treatment of a settlement award is: 'In lieu of what were the damages awarded?'" Milenbach v. Commissioner, 318 F.3d 924, 932 (9th Cir. 2003) (quoting Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944)). The payments are includible in gross income if they are to replace lost profits, and are excludible from gross income as a return of capital if they are to compensate for the loss or destruction of capital. See Milenbach, 318 F.3d at 933; Raytheon, 144 F.2d at 113.

In Clark v. Commissioner, 40 B.T.A. 333 (1939), acq. 1957-1 C.B. 4, the Board of Tax Appeals held that the taxpayers, a husband and a wife, could exclude an amount they received from their tax counsel to compensate for additional income tax the taxpayers had to pay because of the tax counsel's error in return preparation. The tax counsel had prepared the taxpayers' joint return. The joint return brought them a less favorable tax outcome than separate returns would have. The Board concluded that the payment was compensation for the taxpayers' "loss which impaired [their] capital," or a return of the lost capital, and was "not income since it was not 'derived from capital, from labor or from both combined.'" Clark at 335 (citations omitted).

In Rev. Rul. 57-47, 1957-1 C.B. 23, the Service analyzed the nearly same facts as in Clark. The Service held (1) that no taxable income is derived from that portion of the settlement proceeds that does not exceed the amount of tax that the taxpayer was required to pay because of the return preparer's error; and (2) that the remainder of the proceeds that represented interest on the overpaid tax and the fees that the taxpayer paid to the preparer and deducted must be included in gross income.

In Concord Instruments v. Commissioner, T.C. Memo. 1994-248, a taxpayer received $125,000 in settlement of a malpractice claim against an attorney who failed to file a notice of appeal from a Tax Court decision against the taxpayer. The taxpayer was seeking compensation for additional costs incurred (including the deficiency it paid) because of the attorney's failure. Relying heavily on Clark and Rev. Rul. 57-47, the Tax Court held that the portion of the $125,000 settlement attributable to the Federal income tax deficiency was excluded from gross income as a restoration of capital.

The Tax Court's reliance on Clark and Concord Instruments is misplaced. In Clark, the taxpayers sustained a loss of capital when they paid the additional tax due to the tax counsel's error. The Clark taxpayers could have paid less tax without any change in the facts of their situation if their tax counsel had advised them to file separate returns. The filing of a joint return, not the underlying facts, caused the Clark taxpayers' loss by leading them to pay more than the minimum amount of tax they owed based on the transactional facts.

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In Concord Instruments, the taxpayer's claim against the attorney was that it paid taxes over and above the minimum amount it owed because the attorney failed to file a timely notice of appeal. The court looked to the nature of the taxpayer's claim to characterize the settlement amount the taxpayer received, and found that the amount was to compensate for the loss sustained due to the attorney's negligence that resulted in the taxpayer losing the ability to challenge the merits of the underlying tax liability.

Unlike the taxpayers in Clark and Concord Instruments, 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.

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.[1]

Accordingly, the settlement amount the taxpayers received is not a restoration of lost capital, but is instead compensation by the accounting firm for a portion of the Federal income tax the taxpayers properly owed, and therefore should be included in the taxpayers' gross income as an accession to wealth.

[1] 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 taxpayers' circumstances, or even a change to the provisions of the Internal Revenue Code, could have altered the strategy at any time.

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Recommendation: Nonacquiescence.

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