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### Recovery for Causing Tax Overpayment - Lyeth v. Hoey and Clark Revisited

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***RECOVERY FOR CAUSING TAX OVERPAYMENT – LYETH V. HOEY  
AND CLARK REVISITED***

*by*

Douglas A. Kahn\* & Jeffrey H. Kahn\*\*

**ABSTRACT**

The question has arisen in numerous cases as to the extent to which a settlement between arms' length parties is dispositive in tax cases of the claims on which the settlement is based. Another issue that often arises is whether the receipt of compensation for a tax payment that was incurred because of the negligence of the payor is excluded from gross income. While those two issues were central to the proper resolution of a recent case in the United States Court of Appeals for the Eleventh Circuit, *McKenny v. United States*, the court failed even to note one of those issues and did not resolve the other. The court's failure to deal with those two issues led it to reach an incorrect result.

The two landmark cases establishing the doctrines that should have been applied in *McKenny* are the Supreme Court's decision in *Lyeth v. Hoey* and the decision of the Board of Tax Appeals (now known as the Tax Court) in *Clark v. Commissioner*. Using *McKenny* as a springboard, this article reviews the continued misapplication and sometimes disparagement of the *Lyeth v. Hoey* and *Clark v. Commissioner* reasonings. *Clark*, in particular, has been criticized by both academics and the Service. The article reviews those criticisms and argues that they are unpersuasive. The article concludes that both doctrines are valid and should have applied to find for the taxpayer in the *McKenny* case.

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## I. INTRODUCTION AND THE *MCKENNEY* CASE

The question has arisen in numerous cases as to the extent to which a settlement between arms' length parties is dispositive in tax cases of the claims on which the settlement is based. Another issue that often arises is whether the receipt of compensation for a tax payment that was incurred because of the negligence of the payor is excluded from gross income. Those two issues were central to the proper resolution of a recent case in the United States Court of Appeals for the Eleventh Circuit, but the court failed even to note one of those issues and did not resolve the other. The case in question is *McKenny v. United States*,<sup>1</sup> and the court's failure to deal with those issues led it to reach a totally incorrect result. The *McKenny* decision is worthy of discussion as a vehicle for examining the scope and application of the doctrines that should have controlled the result in that case. The two landmark cases establishing the doctrines that should have been applied in *McKenny* are the Supreme Court's decision in *Lyeth v. Hoey*<sup>2</sup> and the decision of the Board of Tax Appeals (now known as the Tax Court) in *Clark v. Commissioner*.<sup>3</sup> The Eleventh Circuit failed to even mention *Lyeth v. Hoey* or the doctrine it established. While the court did note the *Clark* case, because the court determined that the taxpayer had failed to establish that he would have paid less tax if the payor had not been negligent, it expressly declined to pass upon whether the principle established in *Clark* is valid and whether it should have been applied to the taxpayer's recovery.

The relevant facts of *McKenny* are as follows. The taxpayer<sup>4</sup> operated a consulting business as a sole proprietor. On advice of his accountant, an S corporation was formed with the sole shareholder being an ESOP, and the sole beneficiary of the ESOP was the taxpayer. The taxpayer's consulting business was taken over by the S corporation, and the taxpayer was the sole employee of the corporation. The goal of this arrangement was to defer the recognition of income

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<sup>1</sup> --- F3d ---, 2020 WL 5167333 (11<sup>th</sup> Cir. 2020).

<sup>2</sup> 305 U.S. 188 (1938).

<sup>3</sup> 40 B.T.A. 333 (1939), Acq.

<sup>4</sup> The taxpayer's wife was included as a party to the case because she and the taxpayer filed a joint return. Throughout this article, we refer only to the husband as the taxpayer even though the wife was also a taxpayer as a result of filing a joint return with the husband.

by having the income from the consulting business pass through to the ESOP as the shareholder of the S corporation so that the income would not be taxable until dispersed from the ESOP at some future date.<sup>5</sup> The accountant created the S corporation and the ESOP. The business was conducted in that fashion from 2000 to 2005, and the taxpayer reported little taxable income in those years. Pursuant to an audit in 2005, the IRS determined that the manner in which the entities were established did not qualify the arrangement for tax deferral and that the taxpayer's taxable income in those years that was derived from the consulting business was greatly underreported.<sup>6</sup> As a result of an amendment to the Code, for years after 2004, the S Corp/ESOP arrangement on which the consulting business was being conducted was expressly prevented from obtaining the tax deferral benefits that the taxpayer hoped to have. Consequently, even if the arrangement had been carried out properly, there would have been no tax benefits for the income earned in the year 2005; but the benefits likely could have been obtained for the income in the years 2000-2004 if all of the required conditions had been satisfied.

In 2007, the taxpayer settled his tax issues with the IRS. Under the written settlement agreement, the taxpayers conceded that they were not entitled to any of the tax benefits they had claimed for the ESOP arrangement and paid over \$2,000,000 in tax liability including interest and penalties.

In 2008, the taxpayer filed suit against the accountant for malpractice. Taxpayer claimed that the accountant made numerous errors in establishing the ESOP that prevented the arrangement from successfully deferring the income, and those errors caused the taxpayers to incur greater tax liability than he would have incurred if the accountant had conducted the arrangement properly. In 2009, the parties settled the lawsuit. The settlement required the accountant to pay taxpayer \$800,000, which was substantially less than the amount of damage claimed by the taxpayer.<sup>7</sup> The taxpayer incurred legal fees of \$419,400 in the pursuit of this litigation and settlement.

The taxpayer excluded the \$800,000 settlement proceeds from his gross income on the ground that it was a return of capital. The taxpayer claimed a business expense deduction under § 162 for the \$419,400 of legal fees. The taxpayer also claimed a loss deduction for the excess of amounts he paid to the IRS over the \$800,000 settlement he received from the accountant. The IRS determined that the \$800,000 settlement was included in taxpayer's gross income, and it denied the claim for a loss deduction for the excess of the taxes paid over the \$800,000 settlement. The IRS determined that the legal fees paid in connection with the litigation were not business expenses but rather were miscellaneous itemized

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<sup>5</sup> §§ 401(a), 501(a), and 402(a).

<sup>6</sup> The audit also denied the taxpayer's treatment of income from a car dealership that was held by the taxpayer in a similar arrangement. For purposes of this article, we need not discuss that issue.

<sup>7</sup> In the settlement agreement, the accountant maintained that it was not negligent. Nevertheless, the accountant agreed to pay \$800,000 to the taxpayer on his claim.

deductions.<sup>8</sup> The taxpayer contested those determinations and filed suit for a refund in a United States District Court. In the district court, both the taxpayer and the government filed motions for Summary Judgement.

The result of the cross motions in the district court were mixed. The district court held that the \$800,000 settlement the taxpayer received from the accountant was excluded from his income. The court held that the legal fees paid to litigate with the accountant were not business expenses<sup>9</sup>, and also denied the claim for a loss deduction for the unreimbursed excess amount paid to the IRS. Both parties appealed to the Court of Appeals for the Eleventh Circuit.

The decision of the court of appeals was a complete victory for the government. The court upheld the district court's denial of a deduction for the difference between the excess amount of taxes paid to the IRS and the \$800,000 settlement on the ground that that issue was foreclosed by the written settlement agreement that the taxpayer and the IRS had executed concerning the arrangement. The court held that the legal fees incurred in litigating with the accountant were not business expenses but were deductible, subject to the 2% of adjusted gross income floor, as a miscellaneous itemized deduction.<sup>10</sup> Most importantly to the focus of this article, the court held that the \$800,000 settlement was included in the taxpayer's gross income and so reversed the district court on that issue.

For the taxpayer in *McKenney* to prevail on his claim that the \$800,000 settlement is excluded from income, he must first establish that: (1) the accountant was negligent, (2) the S Corp/ESOP arrangement would have reduced that taxpayer's tax liability if the arrangement had been handled properly, and the accountant's negligent handling of the arrangement caused the taxpayer to pay a larger amount of tax, and (3) the amount of larger tax payment incurred from the accountant's negligence was no less than \$800,000. As to the latter requirement, the amount of overpayment could not include the tax payment made for income earned in 2005 since the amendment to the Code prevented the arrangement from

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<sup>8</sup> Since the IRS determined that the \$800,000 recovery was included in taxpayer's income, the legal fees would be expenses incurred for the production of income and would be deductible as a miscellaneous itemized deduction under §212(1). The taxpayer's total amount of miscellaneous itemized deduction is deductible only to the extent that the total exceeds 2% of the taxpayer's adjusted gross income. § 67(a). Note that under the District Court's determination that the \$800,000 settlement is excluded from gross income, the legal fees would not be incurred for the production of income and so would not be deductible at all. Note also, that in 2017, the Code was amended to deny any deduction for miscellaneous itemized deductions incurred in the years 2018-2025. § 67(g).

<sup>9</sup> Since the court held that the settlement the taxpayer received was excluded from income, the legal fees were not incurred to produce income and so were not deductible at all.

<sup>10</sup> Since the court held that the \$800,000 settlement was included in taxpayer's gross income, the legal fees were deductible under § 212(1) as expenses incurred to produce income. Since the years involved were prior to 2018, the taxpayer's miscellaneous itemized deductions were deductible subject to the 2% of adjusted gross income floor. If the court had not erred in determining that the \$800,000 settlement was included in taxpayer's income, the legal fees would not be deductible at all since they would not have been incurred to produce income.

applying to the income earned in that year. In deciding *McKenney*, the court of appeals held that the taxpayer failed to provide sufficient evidence to meet his burden to prove that the arrangement would have succeeded if done correctly, and failed to prove what the amount of tax reduction taxpayer would have obtained from that arrangement. In reaching that decision, the court did not mention the doctrine established by *Lyeth v Hoey*<sup>11</sup> and failed to consider whether that doctrine satisfied the taxpayer's burden of proof. As discussed below in Part II, the authors contend that the doctrine of *Lyeth v. Hoey* is applicable to the facts of *McKenney* and does establish that the requirements described above were satisfied. Even if those requirements were satisfied, the taxpayer could not exclude the recovery from income unless the doctrine established in *Clark v. Commissioner*<sup>12</sup> is valid and is applicable to the facts of the *McKenney* case. We discuss the applicability of the *Clark* doctrine in Part III of this article.

## II. *LYETH V. HOEY*

In *Lyeth v. Hoey*,<sup>13</sup> the taxpayer was one of the grandchildren of a decedent and was one of the heirs to her estate if she had died intestate. The decedent, however, had made a will leaving small bequests to her heirs, and leaving the bulk of her estate (over \$3,000,000) to a trust to preserve the records of Mary Baker Eddy. In the probate of the decedent's estate, the grandchildren contested the will claiming that it was invalid because the testatrix lacked testamentary capacity and because of undue influence. The issue was set for trial; but before the trial took place, the parties settled the dispute dividing the estate among the heirs and the trust.

As one of the heirs, the taxpayer received a share of the estate under the settlement. The government contended that the amount received by the taxpayer was included in his gross income and was taxable. The taxpayer contended that the amount he received was an inheritance attributable to his status as an heir and so was excluded from income.<sup>14</sup>

The question of whether a settlement can override the terms of a will had arisen in a number of states primarily in cases involving inheritance tax laws. The state court decisions on that question were divided. Massachusetts, which was the state whose law applied, had held that a settlement did not override a will. The Supreme Court held that state law did not apply in determining whether the decedent's property passed to the taxpayer by inheritance. Instead, federal law controlled. The Court determined that under federal law, the settlement controlled. Since the basis of the taxpayer's claim for a share of the estate depended upon the claim that the will was invalid, the settlement was treated as resolving that question,

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<sup>11</sup> 305 U.S. 188 (1938).

<sup>12</sup> 40 BTA 333 (1939), Acq.

<sup>13</sup> 305 U.S. 188.

<sup>14</sup> § 102(a).

and the property that the taxpayer received was treated as inherited from an intestate decedent. The Court did hold that the question of who was an heir who would inherit if the decedent died intestate was determined by Massachusetts state law. In the *Lyeth v. Hoey* case, there was no dispute that the taxpayer was an heir under state law. The Court noted that if the issue had been litigated and the result reached by the judgment of a court, the court's decision would be controlling;<sup>15</sup> and the Supreme Court said that there was no reason to treat a settlement differently.

The *Lyeth v. Hoey* decision has been cited in a vast number of cases and rulings, and the holding of the case has been followed and explained in many cases. A requirement for the application of the rule is that the claim on which the settlement was made was bona fide, in good faith and has a color of merit. The settlement will not be controlling if it is merely a disguised means of instigating another transaction such as a gift or a sale or exchange. For example, if Mary died and left all of her estate to her two daughters and nothing to her son, and if her two daughters wanted their brother to have some part of the estate, they might have the son make a claim that the will was invalid even though there were no reasonable grounds for that claim and then settle with the estate for a portion thereof. The actual substance of the purported settlement would be a disguised gift from the daughters to their brother; and the transaction should be so characterized by the tax law. But, if a claim is bona fide and made in good faith and is not frivolous, a settlement will control regardless of the likelihood of its success in litigation.

In Rev. Rul. 66-139,<sup>16</sup> a decedent left his widow an interest in his estate that did not qualify for a marital deduction. The value of that interest was less than the widow would receive if she elected to take against the will and receive the commuted value of her dower interest. The widow did elect against the will, and the Executor denied her claim on the basis of an antenuptial agreement that the decedent and the widow had executed. The widow claimed that the antenuptial agreement was invalid. The widow and the Executor settled the dispute under which the widow received a dollar amount that was greater than the value of the interest bequeathed to her in the will but less than the value of her dower interest. The Commissioner held that the compromise in the settlement is to be treated the same as if the widow's election were effective and so qualified for the marital deduction.

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<sup>15</sup> *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) changed the weight to be given state court decisions in tax cases other than the decisions of a state supreme court. State lower court decisions are respected but are not necessarily conclusive. Cases and rulings subsequent to *Bosch* have continued to give conclusive effect to settlement agreements. See e.g., *Early v. Commissioner*, 445 F2d 166 (5<sup>th</sup> Cir. 1971); *Howard v. Commissioner*, n. 17, *infra*; *Shook v. United States*, 713 F2d 662 (11<sup>th</sup> Cir. 1983); and Rev. Rul. 76-199, 1976-1 Cum. Bull. 288.

<sup>16</sup> 1966-1 CB 225.

The decision of the United States Court of Appeals for the Fifth Circuit in *Howard v. Commissioner*<sup>17</sup> illustrates the scope and operation of the *Lyeth v. Hoey* rule. In that case, the taxpayer (Lucille) had been married to a man who was serving in the Army. They separated, and the husband subsequently sought to divorce her. Claiming falsely that he could not locate her, the husband sent a notice of the action for divorce to the wife at her birthplace. The taxpayer never received notice of the divorce proceeding. A court granted the divorce without the wife's appearance. The wife knew nothing about the case until she received a form from the Army notifying her that she would no longer receive support payments because there had been a divorce. She assumed that there had been a valid divorce or the Army would not have discontinued her support payments. Many years later, the husband wanted to sell real estate that he owned and entered into negotiations for a sale of the property. The buyer's lawyer looked into the prior divorce proceeding and determined that there was a strong possibility that the divorce decree was invalid because of the husband's fraudulent representations. If so, the wife would have dower rights. The buyer would not purchase the property unless the taxpayer signed the transfer of the deed to waive her dower rights. The husband needed to sell the property to avoid a foreclosure on it. The husband contacted the wife and asked her to sign the deed of transfer. The taxpayer agreed to sign and waive her dower rights but only if the husband paid her \$40,000 in exchange for her dower rights in the property. The husband agreed, and taxpayer received the \$40,000. A payment in exchange for the release of a dower interest is not included in the income of the recipient.<sup>18</sup> The taxpayer excluded the \$40,000 from her income on the ground that it was a payment for her release of her dower rights. The IRS contended that the payment was includible in her gross income.

The Tax Court upheld the IRS and held that the payment was income to taxpayer on two grounds. One reason was that the court determined that there was no fraud in the divorce proceeding and that the wife had waited too long to contend that the divorce was invalid and so laches would apply. The second reason was that *Lyeth v. Hoey* did not apply because there was no threat of litigation and so no actual settlement. The Fifth Circuit reversed and held that the doctrine of *Lyeth v. Hoey* did apply and that the \$40,000 payment was properly excluded from taxpayer's income.

For the payment taxpayer received to be excluded, the court would have to find that the divorce was invalid so that taxpayer possessed dower rights and that the payment was made in exchange for those dower rights. In determining that the *Lyeth v. Hoey* doctrine conclusively resolved those issues in favor of the taxpayer, the following statements from the court's opinion are informative:

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<sup>17</sup> 447 F2d 152 (5<sup>th</sup> Cir. 1971).

<sup>18</sup> See *United States v. Davis*, 370 U.S. 65 (1972); *Dotson v. United States*, 87 F3d 682 (5<sup>th</sup> Cir. 1996); Rev. Rul. 79-132, 1979-2 Cum. Bull. 29.



The Tax Court and the Commissioner on appeal find Lyeth inapplicable because the taxpayers' standing as heirs was not challenged while here petitioner's status as wife has been contested. With deference, we think that such reasoning misses the point of Lyeth. In Lyeth the Court established the doctrine that in tax matters the characterization of proceeds received should be determined according to the nature of the claims in settlement of which the proceeds were received. It is artificial to say that any particular aspect of the claim (i.e., status) must be conceded. ....

We conclude that the case is controlled by Lyeth v. Hoey and its progeny. The question that determines whether the proceeds received by Lucille are to be treated for tax purposes as property received for release of dower rights is not whether in fact Florida would recognize dower rights but whether there was a good faith compromise concerning her claim to dower rights.<sup>19</sup>

The court further said "Moreover, we are of the view that the tax character of the proceeds received under a claim should not necessarily be determined by the strength or merits of the party's claim. Rather, it should be determined on the basis of the party's good faith belief as to the merits."<sup>20</sup> For example, while the court expressly said that it could not determine whether a court would bar the taxpayer's claim for laches, it does not matter so long as the claim was brought by the taxpayer in good faith.

*Concord Instruments Corp. v. Commissioner*<sup>21</sup> provides another example of the conclusive treatment given to settlements. Taxpayer had lost a tax case against the government and chose to appeal the decision. Taxpayer's lawyer erred in failing to file an appeal on time, and so no appeal could be taken. Taxpayer sued the lawyer for malpractice for the damage it suffered in paying taxes to the IRS and paying interest to the IRS and to a bank. The suit was settled, and taxpayer received \$125,000. The government contended that the settlement was income to the taxpayer, and the taxpayer sued the Commissioner in the Tax Court. The Tax Court acknowledged that one could only speculate as to whether taxpayer would have prevailed on an appeal, but the court treated that issue as settled by the settlement. The court excluded that amount of the settlement that was paid for the tax paid to the IRS. That portion of the settlement that was paid for the interest expenses taxpayer incurred was included in its income under the tax benefit rule since taxpayer had deducted those payments.

Consider how the *Lyeth v. Hoey* doctrine applies to the *McKenney* case. The taxpayer's claim was substantial and certainly had color of merit. The taxpayer and

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<sup>19</sup> *Howard*, 447 F2d 152, 155-56.

<sup>20</sup> *Id.* at 157.

<sup>21</sup> TC Memo 1994-228 (1994).

the accountant were dealing with each other at arms' length. The accountant had no reason to pay taxpayer \$800,000 if it did not consider the claim to have merit. Theirs was not a relationship in which the payment might have been a gift or a disguised compensation for services or property. As to the question of whether the accountant was negligent and whether that negligence caused the taxpayer to incur a larger tax liability than would have applied if the arrangement had been done properly, the settlement had to have been based on the acknowledgement that a court might find for the taxpayer on those issues. As noted in the Fifth Circuit's decision in *Howard*, it does not matter how strong the merits of the taxpayer's case may be; what matters is whether the taxpayer brought the claim in good faith and it was not frivolous. As to the question of what was the amount of additional tax liability the taxpayer incurred as a result of the negligence, the accountant agreed that it was at least \$800,000 or he wouldn't have settled for that amount. The settlement conclusively establishes an excess payment of at least \$800,000, and so that amount should have been excluded from taxpayer's income. The amount paid is too large to have been a nuisance settlement, but even if it were, the *Lyeth v. Hoey* doctrine would still apply.

There is a question whether a portion of the settlement was for the taxes paid on income earned in 2005 when the Code was changed so that the ESOP arrangement would not have deferred that year's income even if the ESOP has been established correctly. As noted later in this article, if the damage claimed includes items which had previously been deducted or for which there was not an error, the amount apportioned to those items will be included in income. A court might therefore apportion part of the settlement to the 2005 income and treat that portion as includible in income since there was no overpayment in that year. It is possible, however, that no apportionment should be made in this case. The accountant knew that his error did not affect the tax payable for 2005, and so he must have considered only the tax on the income in 2000 to 2004 in arriving at the settlement. While we believe that the entire \$800,000 ought to be treated as given for the tax paid on the income earned in 2000 to 2004 and so excluded from income, we acknowledge that a court might make an apportionment and treat a portion of that amount as attributable to 2005 and so included in income.

The *Lyeth v. Hoey* doctrine is good tax policy, and that is likely why it has been accepted by the courts and the IRS. When two parties at arms' length arrive at a settlement, there is good reason for the tax law to accept the result they reached. It would be inefficient and burdensome to require a party to litigate in a tax case the issues that were negotiated and resolved with an adverse party. There is no reason to think that a court would be better able than an adverse party to judge the merits of a claim. While there likely will be some cases when a court could judge better, in total the results reached by adverse parties will be at least as reliable. Administrative convenience and minimizing the burden of proof for taxpayers are desirable objectives when they can be accomplished without distorting the

operation of the tax system. Moreover, settlements are usually compromises that reflect the parties estimates of the likelihood of prevailing in litigation. The parties are in the best position to make those estimates, and there is merit for the tax law to adhere to them. When litigating with the IRS, parties often settle on a compromise in which the estimates of likely success are taken into account, and there is merit to adhering to the compromise that private parties reach in their settlement.

The Service has taken the position that when the status of the claimant to prevail is an issue, a settlement will not control whether the claimant actually has that status.<sup>22</sup> That issue does not arise in *McKenney* since the status of the taxpayer in that case was not in dispute. Nevertheless, in our examination in this article of the *Lyeth v Hoey* doctrine, we would be remiss not to discuss whether that distinction is viable. In our view, it is not.

Take for example the facts of the *Howard* case. One question was whether the taxpayer in that case was a married woman so that she had dower rights. The IRS maintained that that question was not resolved by *Lyeth v. Hoey* because it related to her status to have dower rights. The Fifth Circuit rightly rejected that contention and held that the taxpayer's status is no different from other issues and is resolved by the settlement. The basis of the Service's contention is that status of the taxpayer in the *Lyeth v. Hoey* case as an heir was not disputed. It is true that the Supreme Court stated that state law and not federal law determined whether the taxpayer was an heir. All that that statement meant is that the standards for determining whether someone is an heir is determined by state law; it did not mean that a settlement could not establish that those standards were met. A crucial issue in *Lyeth v. Hoey* was whether the decedent's will was valid; the heirs had no right to the decedent's property unless the will was invalid and the decedent died intestate. The validity of a will is determined by state law, not by federal law, Nevertheless, the Supreme Court held that the settlement conclusively established that the taxpayer received the settlement as the heir of an intestate.

### III. THE CLARK DOCTRINE

When a taxpayer's property is damaged or destroyed, payments received by the taxpayer to compensate for the loss he suffered are excluded from income to the extent of the taxpayer's basis in the damaged property. Consider the following examples.

Ex. (1). Helen has an adjusted basis of \$300,000 in her home. Helen's home is damaged by a fire caused by the negligence of Ralph. As a consequence of the damage caused by the fire, the value of Helen's home is reduced by \$25,000. Ralph pays Helen \$25,000

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<sup>22</sup> See TAM 7505140090 and the publication of that advice as a revenue ruling in Rev. Rul. 76-155, 1976-1 Cum. Bull. 286.

to compensate her for the loss he caused. Helen's receipt of the \$25,000 is treated as a return of the capital she had invested in the home and so is excluded from income. Helen reduces her basis in the home to \$275,000.

Ex. (2). In Year One, Paula had adjusted gross income of \$50,000, Paula had an automobile with a fair market value of \$4,000 that she had for personal use. Paula had an adjusted basis of \$10,000 in the automobile. In Year One, the automobile was destroyed when a tree fell on it during a storm. Paula had no other personal casualty losses or personal casualty gains. While Paula suffered a loss of \$4,000 (the lesser of her basis and the car's fair market value), she would not be allowed to deduct that loss because a net personal casualty loss is deductible only to the extent that the loss exceeds 10% of the taxpayer's adjusted gross income. Since 10% of Paula's adjusted gross income is \$5,000, she did not qualify for a deduction. However, Paula had insured the automobile, and the insurer paid her \$4,000 for her loss. Since the \$4,000 she received does not exceed her adjusted basis in the car, it is excluded from her gross income.

*Clark v. Commissioner*<sup>23</sup> is the landmark case concerning the tax treatment of the reimbursement of a taxpayer for the additional amount of tax paid because of an error of the payor. The facts of *Clark* are as follows.

In 1932, taxpayer was married and living with his wife. On advice of his tax counsel, taxpayer and his wife filed a joint federal income tax return for that year. In 1934, taxpayer was audited by the government who imposed a deficiency for the taxes paid for 1932. Taxpayer's tax counsel then realized that if he had advised the taxpayer and his wife to file separate returns, their tax liability would have been \$19,441.10 less than the amount they actually had to pay.<sup>24</sup> The tax counsel had advised the parties to file a joint return because of a mistake the tax counsel made in claiming a deduction to which they were not entitled. Recognizing that his error caused the taxpayer to pay a larger tax, the tax counsel paid taxpayer \$19,441.10 to compensate him for the excess amount of tax he caused taxpayer to pay. The government contended that the amount paid to the taxpayer was includible in his income, and the taxpayer chose to litigate that issue in the Board of Tax Appeals (now the Tax Court). For convenience, hereafter we will refer to that court as the Tax Court.

The Tax Court held that the payment to the taxpayer was a return of capital and so was excluded from his gross income. The tax counsel's negligence caused the taxpayer to pay a larger tax than he would have paid if he had been advised

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<sup>23</sup> 40 BTA 333 (1939), Acq.

<sup>24</sup> The taxpayers were not permitted to file amended separate returns for the year 1932 to cure the defect.

correctly. The tax counsel was liable to taxpayer for the amount of damage he caused by his negligence. The payment to the taxpayer was compensation for the extra amount of dollars he paid to the government. Just as a payment for causing damage to property is treated as return of the capital invested in the property, the reimbursement of dollars lost is a return of those dollars. Basis in property is just a reflection of the dollars deemed to be invested in the property, and the damages received for an injury to property is a replacement of the dollars deemed to be invested in the property. In the *Clark* situation, it is the loss of actual dollars that is being recovered, and that is no different from the recovery of dollars invested in property.

While the government initially nonacquiesced in the *Clark* decision,<sup>25</sup> it subsequently acquiesced<sup>26</sup> in it and published a revenue ruling adopting the *Clark* approach.<sup>27</sup> However, the *Clark* case has been subjected to a significant amount of discussion by tax experts, some of whom disagree with the result and some of whom are uneasy with the result.<sup>28</sup> We will discuss the issues raised concerning the *Clark* decision and will show that they are without merit.

One issue raised is that the Tax Court in *Clark* mentioned that the amount received by the taxpayer was not gain derived from capital or from labor or from both combined. That language was used by the Supreme Court in its 1920 decision in *Eisner v. Macomber*<sup>29</sup> as a definition of what constitutes income for federal income tax purposes. That definition became the standard used by the courts from that date until the Supreme Court repudiated it in 1955 in *Commissioner v. Glenshaw Glass*.<sup>30</sup> After *Glenshaw Glass* was decided, that definition was no longer used. The decision in *Clark* was criticized for using a definition of income that was subsequently repudiated. However, the basis of the decision in *Clark* does not rest on that defunct definition. Instead, the decision rests on the normal tax treatment of compensatory damages, and that treatment is as valid today as it was in 1939. The reference to the *Eisner v. Macomber* definition was understandable since it was in good standing at that time, but the decision would be the same if that definition had been ignored.

There have been three issues raised in questioning the validity of the *Clark* decision. We will examine each of them.

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<sup>25</sup> 1939-2 C.B. 45

<sup>26</sup> 1957-1 C.B. 4

<sup>27</sup> Rev. Rul. 57-47, 1957-1 Cum. Bul. 23.

<sup>28</sup> For a thorough discussion of the principles adopted in the *Clark* case, see Jeffrey H. Kahn, *Hedging the IRS—A Policy Justification for Excluding Liability and Tax Insurance Proceeds*, 26 Yale J. on Reg. 1 (2009) and Lawrence Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income*, 46 Tax L. Rev. 381 (1991).

<sup>29</sup> 252 U.S. 189 (1920)

<sup>30</sup> 348 U.S. 426 (1955)

(a) *Old Colony Trust*

In *Old Colony Trust Co. v. Commissioner*,<sup>31</sup> the taxpayer had an arrangement with his employer under which the employer paid the income tax liability the taxpayer incurred for the taxes on his salary. Accordingly, the employer paid the taxpayer's taxes. The government contended that the payments of those taxes was additional compensation to the taxpayer and are included in taxpayer's gross income. The Supreme Court agreed with the government and held that the payments were taxable income to the taxpayer. The Court reasoned that the payment to a third party of a debt of a taxpayer is the same as a payment made directly to that taxpayer. The Court held that the payment was not a gift but was additional compensation for taxpayer's services.

Some tax commentators have contended that the case stands for the proposition that if someone pays the tax liability of a taxpayer, the payment is always income to the taxpayer. Since the tax counsel in *Clark* effectively reimbursed taxpayer for part of the income tax he paid, that was said to be equivalent to the counsel's paying his tax; and the contention was made that therefore the payment is income to taxpayer under *Old Colony*. Indeed, the government relied on *Old Colony* in asserting that the taxpayer in *Clark* recognized income.

That contention reads *Old Colony* far too broadly. The case does not hold that any payment of a taxpayer's tax liability is income to the taxpayer. Rather, it holds that a payment of a taxpayer's tax liability (or indeed of any other liability of the taxpayer) is treated as a payment made directly to the taxpayer and characterized the same as a direct payment would have been. In its opinion, the Court held that the payment was not a gift to the taxpayer; thereby inferring that if it had been a gift, it would not be included in taxpayer's income. Surely, that is correct. If a father makes a gift to his son by paying the son's income taxes, that would not be taxable income to the son. In *Old Colony*, the payment of the taxes was made as compensation for services; and therefore was properly included in the taxpayer's income.

Consider the situation where Robert, a consultant to businesses, advises Alice to incur certain nondeductible expenses that Robert assures her will prove profitable. Alice incurs the expenses, and they turn out to be of no benefit to her business at all. Robert acknowledges that he gave bad advice and reimburses Alice for the expenses she incurred. That reimbursement should be excluded from income as a return of Alice's capital. Alice's situation is identical to the taxpayer in *Clark* except that the expenditures in the *Clark* case were tax payments. There is no reason why a tax expenditure is different from any other expenditure that was not deducted.

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<sup>31</sup> 279 U.S. 716 (1929).

Treas. Reg. § 1.61-14(a) states that another person's payment of a taxpayer's income tax is income to the taxpayer "unless excluded by law." The regulation explicitly acknowledges that the payment of a taxpayer's income tax is not income to the taxpayer when exclusionary tax principles or provisions are applicable.

(b) Annual Accounting.

Another issue that has been raised is whether the Supreme Court's decision in *Burnet v. Sanford & Brooks Co.*<sup>32</sup> requires the inclusion of the reimbursement in Clark's income. The contention is that the annual accounting concept prevents the examination of past events to characterize the recovery that the taxpayer received in *Clark*. The short answer to that question is that the *Sanford & Brooks* case was badly decided and clearly would not be decided that way if it arose today.<sup>33</sup> The case misapplied the annual accounting concept.

In *Sanford & Brooks*, the taxpayer carried out a contract for the United States government from the years 1913 to 1915. In conducting that contract, the taxpayer incurred and deducted expenses that exceeded its income for those years by \$176,271.88.<sup>34</sup> In 1916, taxpayer sued the government for breach of warranty and obtained a judgment for \$192,577.59 compensatory damages that included an amount for the \$176,271.88 of its excess expenses over its income. The taxpayer also received interest on its award. The Supreme Court held that all of the amounts received by the tax payer were included in its income. The Court relied on the annual accounting requirement that income be reported on an annual basis. The Court stressed that if income instead were reported on a transactional basis, the tax law would be difficult to administer in that the characterization of current events could not be made until a transaction was completed perhaps some years in the future. The case is often cited for the general proposition that income is to be reported annually, but it is not cited for the holding on the facts that were present in that case. The annual accounting concept means that a taxpayer cannot take into account events that occur in the future to characterize the treatment of events in the current year. It does not mean that events in the past cannot be taken into account in characterizing current events. There is no administrative difficulty in looking to the past. It is only the problems that would be caused by having to wait for future events to occur that is prevented by annual accounting.

It is quite common for the tax law to look at past events to characterize current events. The use of basis in determining gain or loss or depreciation deductions is an example of examining past events to characterize what occurs in the present. The tax benefit rule is another example of referring to past events.

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<sup>32</sup> 282 U.S. 359 (1931).

<sup>33</sup> See the thorough discussion of that case in Lawrence Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income*, 46 TAX L. REV 381 (1991).

<sup>34</sup> The taxpayer was not able to carryover those losses to a profitable year.

Section 108(e)(5) is another example. Section 111(a) excludes from income a recovery of past expenses that had been deducted without providing a tax benefit. That provision is a codification of what came to be the common law rule.<sup>35</sup> It is noteworthy that if the facts of the *Sanford & Brooks* case arose today, § 111(a) would exclude the recovery of the prior expenses that were deducted without a tax benefit.

(c) Non-parallel Treatment

If no compensation had been obtained in *Clark*, the taxpayer would not have been allowed a deduction for the additional tax he paid.<sup>36</sup> Yet, the reimbursement of that additional tax is excluded from income. We refer to this situation as a non-parallel treatment. Excluding a receipt from income has the same tax consequence as including it in income and allowing a full deduction for the amount. The apparent inconsistency in disallowing a deduction for a “loss” while excluding a reimbursement of that loss from income might seem to violate the principle of horizontal equity<sup>37</sup> and has troubled some commentators. To the contrary, however, several commentators<sup>38</sup> have demonstrated that there is no inconsistency in having non-parallel treatment. In some situations, it would be inappropriate, and in some it would be correct.

While a non-taxed reimbursement of an expenditure bears some similarity to allowing a deduction for the expenditure, they are not the same. A reimbursement provides the taxpayer with the same net worth that he would have had if he had not made the reimbursed expenditure. Granting a deduction for an unreimbursed expenditure does not provide the same net worth position for the taxpayer. The benefit derived from the deduction depends upon the taxpayer’s marginal tax rate; but regardless of the rate, the benefit will be less than 100% of the expenditure. While the two situations are not identical, the question remains as to whether different tax treatments are warranted. As explained below, we conclude that different treatment is appropriate in some circumstances including the events of the *Clark* case.

It is difficult to understand why some commentators have been troubled by the non-parallel aspect of the *Clark* situation. There is nothing unusual about that treatment. There are numerous provisions in the tax law in which that occurs, especially in the case of a recovery of damages; and it is odd for there to be angst over the situation when the subject of the reimbursement is tax payments and not when it is something else. For example, if John is injured by Mildred’s negligence

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<sup>35</sup> See *Dobson v. Commissioner*, 320 U.S. 489 (1943).

<sup>36</sup> § 275(a)(1).

<sup>37</sup> Horizontal equity dictates that people who are in equivalent circumstances should be taxed the same.

<sup>38</sup> See Lawrence Zelenak, n. 33, *supra*, and Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 HASTINGS L.J. 645 (2006).



and loses his arm as a result of the accident, and if he does not recover damages for his injury, John is not allowed any deduction for his loss. But, if John recovers \$1,000,000 from Mildred as compensatory damages for his personal physical injury, the amount he received is excluded from his gross income by § 104(a)(2).

Another example is where property that is held for personal use is damaged or destroyed. An uncompensated personal casualty loss is deductible only to the extent that the taxpayer's net casualty loss exceeds 10% of the taxpayer's adjusted gross income.<sup>39</sup> If the casualty loss is less than that floor, none of it is deductible. However, if the taxpayer is reimbursed for that loss by the tortfeasor or by an insurance company, the reimbursement is excluded from his income to the extent of his basis in the property and the payment merely reduces the basis of the damaged property. In that regard, consider Ex. (2) set forth in Part II of this article.

A similar example is where a taxpayer has medical expenses that do not exceed the percentage of adjusted gross income floor for that deduction and so are not deductible.<sup>40</sup> A reimbursement of those expenses by a medical insurer is excluded from gross income by § 104(a)(3).

In an article written in 1991, Professor Zelenak stated that the question of whether the reimbursement of a nondeductible expenditure (or the payment of a taxpayer's liability the payment of which would not be deductible) should be excluded from the taxpayer's income depends upon the reason that Congress made the expenditure (or the payment of the liability) nondeductible.<sup>41</sup> Professor Zelenak suggested that if an exclusion from income would contravene the purpose of denying a deduction, the item should be included in income. If an exclusion from income does not contravene the purpose of not allowing a deduction, the item can be excluded from income. Professor Zelenak set forth two examples to illustrate reimbursements that do not contravene the purpose of nondeductibility, and one of those examples was the *Clark* case itself. Those examples are instructive, and we have set them forth below.

Ex. (3). In year One, Hilda pays a fine of \$4,000 to a government. Hilda is not allowed a deduction for the payment of the fine. Section 162(f) denies a tax deduction for the payment of a fine. In Year Three, it is determined that Hilda was innocent of the violation, and the government returned the \$4,000 to her. The purpose of prohibiting a deduction for the payment of a fine is that allowing the deduction would mitigate the sanction sought to be imposed, and so no deduction is allowed in order to maintain the level of sanction chosen for the violation. Returning the fine to the taxpayer when it

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<sup>39</sup> § 165(h)(2).

<sup>40</sup> Currently, the floor is 7.5% of adjusted gross income, but in 2021, the floor is scheduled to return to 10% of adjusted gross income. § 213(a) and (f).

<sup>41</sup> Zelenak, n. 33, *supra*.

is determined that there was no violation does not contravene the purpose of the nondeductibility provision since there was no reason to penalize the taxpayer who was innocent.

Ex. (4). Consider the facts of the *Clark* case. Professor Zelenak gave the following argument for allowing the exclusion. The reason that the payment of a federal income tax is not deductible is because Congress chose to have the income tax be tax-inclusive, and to allow a deduction would make it tax-exclusive.<sup>42</sup> The exclusion of the reimbursement does not affect the tax-inclusive characterization of the amount that taxpayer would have paid if all had been done properly. The only effect of excluding the reimbursement from income is to relieve the taxpayer of the burden of an overpayment of his taxes.

But, the fact is that the taxpayer chose to file a joint return, and consequently he did owe the larger tax amount to the government. While it is far from clear, excluding the reimbursement could be deemed to conflict with the goal of having the entire tax liability be tax-inclusive. If so, can the exclusion still be justified? We explain below that it can.

While we agree with Professor Zelenak, that if a reimbursement does not contravene the purposes for which the expenditure was made nondeductible, it can be excluded from income, we do not agree that contravening the purposes of nondeductibility necessarily requires that the reimbursement be included in income. In the latter circumstance, there can be a separate and independent purpose for excluding the reimbursement, and the question can then be as to which purpose should be given priority – the purpose for exclusion or the purpose for denying a deduction. In some cases, it may well be reasonable to give priority to the purpose for excluding the reimbursement.

Consider the *Clark* case as illustrated in Ex. (4) above. The exclusion of the reimbursement allows the taxpayer to be made whole –i.e., effectively, he bears no more tax liability than the amount that he would have paid if he had not suffered from the negligence of the tax counsel. Excluding the compensatory payment from income facilitates the effort to keep him from suffering harm from the tax counsel's negligence. That humane and equitable goal is entitled to considerable weight. Comparing the goal of eliminating the harm that the taxpayer suffered with the goal of having a tax-inclusive tax system, it is not unreasonable to give priority to facilitating the former. Even if the exclusion of the reimbursement were deemed to conflict with the purpose for nondeductibility, there still is a good reason to exclude the reimbursement from income.

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<sup>42</sup> A tax-inclusive tax is one in which taxes are paid on the income that is used to pay the tax. A tax-exclusive tax is one in which tax is not paid on the income that is used to pay the tax,

Another objection that has been made to non-parallel treatment is that it violates horizontal and vertical equity.<sup>43</sup> A number of commentators have made that point. The nature of the situation and the reason that it is not actually a problem is illustrated in the following Example.

Ex. (5). A, B, and C are three individuals each of whom has \$100,000 of actual taxable income if their taxable incomes were determined correctly. All three individuals have their returns prepared by an accountant. A's accountant correctly determines his income, and so A pays tax on \$100,000 of taxable income. B's accountant negligently errs in determining B's taxable income, and so B pays tax on \$120,000 of reported income. On discovery of the error, B's accountant reimburses B for the additional tax that B paid. The reimbursement is excluded from B's gross income.

As a result of that recovery and exclusion, B has the identical increase in net worth as A whose taxable income was determined properly; and A and B would pay the same tax. That treatment conforms with horizontal equity. Now assume that C's accountant also makes an error, and causes C to pay tax on \$120,000 of taxable income. C's accountant is judgment proof, and so C does not recover any of the additional tax he paid. Since C cannot deduct the additional tax he paid as a loss, C pays a greater tax than either A or B even though all three had the same net income. That difference of tax treatment would seem to violate the principle of horizontal equity.

Taxing B on the receipt of damages from the accountant would still result in a violation of horizontal equity. B would pay a greater tax than A even though they had the same net income. Indeed, B would have less of an increase in net worth than A because of the tax B would pay on the receipt of the reimbursement. C would pay a larger tax than either B or A even though all three had the same net income.

The result is that once a deduction is denied for the excess payment, there will be a conflict with horizontal and vertical equity regardless of how a reimbursement is treated by the tax law. Consequently, equity considerations have no role to play in determining how the reimbursement should be treated.

The reason that there is conflict with horizontal equity in the above situation is not because of the exclusion of B's recovery but rather because of the denial of a deduction to C. Whenever a deduction is denied for a loss, it will create an inequity in the tax treatment of that taxpayer when compared to the treatment of a taxpayer who had the same income but did not suffer a loss. For example, F and G each earned \$100,000 net income. G lost \$10,000 when it was stolen from him,

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<sup>43</sup> For the meaning of horizontal equity, see n. 37, *supra*. Vertical equity dictates that persons having disparate amounts of income should pay different amounts of tax that reasonably relate to the difference in their incomes.

and G could not deduct that loss because of the 10% of adjusted gross income floor. While G's increase in net worth is less than F's, G pays the same amount of tax that F pays. That is contrary to the vertical equity principle, but it is an inevitable aspect of denying the deduction.<sup>44</sup>

Horizontal and vertical equity are one general goal of the tax law, but there are many other goals that often take priority over them. Moreover, the determination of what constitutes a departure from equity is murky at best.<sup>45</sup> The tax laws are replete with provisions that conflict with horizontal and vertical equity, and equity principles have been ignored more than followed.

#### IV. PURPORTED DISTINCTION OF *CLARK*

Even if it is agreed that the principle of the *Clark* case is correct as we have concluded, the case for the taxpayer in *McKenney* has another hurdle to overcome. In *Clark*, the error made by the tax counsel was the advice he gave about how the parties should file their tax return. The accountant's error in *McKenney* did not involve the taxpayer's tax return. Rather, it was the accountant's failure to take the required steps to qualify the ESOP so that the taxpayer would obtain the tax deferral benefits he sought. The question is whether the *Clark* doctrine applies only to reimbursements for errors made in preparing or filing the return?

After the IRS came to accept the validity of the *Clark* decision, it had to rule on a number of circumstances in which the reimbursement was made for external errors that failed to qualify the taxpayers for tax relief rather than on the preparation of a tax return. Initially, the IRS concluded that the *Clark* doctrine applied in those situations as well. After a few years, however, the IRS changed its position and ruled that the doctrine was limited to return errors and did not apply to remedies for payment of a larger tax because of external errors. The rationale for making that distinction is that when a return error is made, the taxpayer paid a greater tax than the correct amount. In contrast, when an external error failed to qualify a taxpayer for tax relief, the tax that he paid was equal to the tax that he actually owed. Since the reimbursement of the taxpayer's larger payment is a reimbursement of a tax that he actually owed, the IRS maintains that it is included in income under Treas. Reg. § 1.61-14(a). As we will show below, we contend that the current position of the IRS is incorrect and that there is no principled basis for not applying *Clark* to external errors. Before discussing the merits of the IRS's position, we will note several of the rulings on this issue.

In PLR 8447076, the taxpayer wished to make a gift to his son of the maximum amount he could give without incurring any gift tax liability. He sought advice from his attorney as to what that amount would be. The attorney erred in arriving at a figure that was larger than the minimum amount. Consequently, the

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<sup>44</sup> *Id.*

<sup>45</sup> See Jeffrey H. Kahn, n. 38, *supra*.

taxpayer incurred gift tax liability. Taxpayer claimed that attorney should reimburse him for the gift tax. A negotiated settlement provided a recovery for taxpayer. The Service ruled that the payment to taxpayer was excluded from income under the *Clark* doctrine.

In a private letter ruling in 1992, the IRS applied the *Clark* doctrine to exclude from income an accountant's reimbursement of a client's payment of a larger tax because of the accountant's failure to qualify the client as a regulated investment company (RIC).<sup>46</sup> Since, because of the accountant's error, the client did not qualify as an RIC, the tax it paid was equal to the tax that it owed. Five years later, the IRS revoked the 1992 ruling and held instead that the reimbursement was included in the client's taxable income.<sup>47</sup>

In 1997, the Service ruled on this issue and showed that it had changed its position. In PLR 9728052, the taxpayer had agreed to pay alimony to his divorced wife for a period of years with the payments to be made to her estate if she died within that time frame. Taxpayer agreed to this arrangement on the advice of his lawyer that the payments would be deductible. The lawyer erred, and the payments were not deductible thereby causing the taxpayer to pay a larger income tax than he expected. Taxpayer then entered into negotiations with the attorney for additional taxes paid, plus interest and penalties incurred. The Service ruled that any damages he received would be included in his gross income because the error that the attorney made was external. The Service did not apply *Clark* because the amount of tax paid was the amount that was owed.

In 1998, the IRS again ruled on this issue in PLR 9833007. The facts of that ruling are as follows. After winning a state lottery, a taxpayer consulted an attorney for advice as to how to treat his winnings. The taxpayer could have reduced his federal income tax liability for that year by paying his state income tax in the year in which he received his winnings so that he could deduct that amount from income that would otherwise be taxed at a high tax rate. If he had done so, the taxpayer's federal income tax liability would have been significantly lower. The lawyer failed to advise the taxpayer to take that step, and so the taxpayer bore a higher tax liability than he would have if the attorney had not erred. The taxpayer requested a ruling as to how any recovery he might obtain from the lawyer for his failure to give good tax advice would be taxed. The recovery he sought would be for the difference between the amount of federal income tax paid and the amount that would have been owed if taxpayer had been advised to pay the state tax early. The IRS ruled that since the taxpayer actually owed the tax he paid, any recovery he received would be a payment of part of his correct tax liability by a third party and so would be taxable to him.

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<sup>46</sup> PLR 9211029.

<sup>47</sup> PLR 9743034.

In our view, the Service's current position is incorrect. In those rulings and in *McKenney*, the advisor's negligence caused the taxpayer to incur a greater liability than he would have incurred if the advisor had not erred. The advisor's negligence requires him to replace the funds that he caused the client to spend in order to place the client in the same position that he would have occupied if all had been done properly. In determining the net amount of additional cost that the client incurred, the difference in tax liabilities should be offset by any additional costs the client would have incurred to achieve the reduced tax. Where the advisor's liability is settled, as was the case in *McKenney*, the amount of the settlement at which the parties arrived will reflect any mitigating costs that reduce the client's actual loss.

The Service does not dispute that when a person's negligence causes a taxpayer to expend more dollars than would have been expended if no error had been made, the replacement of those dollars is a return of capital and is excluded from income. That concession is reflected in the Service's approval of the *Clark* decision. But the Service seeks to treat the taxpayer differently when the dollars that were expended were used to pay federal income taxes. The loss of dollars is the same to the taxpayer regardless of whether they were expended on taxes or on some other liability. Consider the following example.

Ex. (6), Mildred has an idea for a profit motivated venture that does not constitute a trade or business. Consequently, the expenses of producing income from that venture are miscellaneous itemized deductions that currently are not deductible. She seeks the advice of a lawyer as to how best to handle the expenditures to conduct the venture. The lawyer proposes a plan that will reduce her expenditures, and she approves it. The lawyer then negligently fails to implement the plan correctly so that Mildred incurs greater expenditures than she would have had under the plan. The lawyer pays Mildred an amount equal to the additional expenditures that his negligence caused. Because the plan was not implemented correctly, Mildred did in fact owe the amount of expenditures she paid. Nevertheless, there is no dispute that the payment Mildred received is a return of her capital and is excluded from her income. There is no reason to treat the replacement of those dollars differently when the expenditure is the payment of a tax. The payment to Mildred is designed to make her whole from the excess costs she incurred because of the lawyer's malpractice. Similarly, in *McKenney*, the settlement was designed to make the taxpayer whole from the injury he suffered from the accountant's negligence.

The Service seeks to distinguish *Clark* on the ground that the amount of tax the taxpayers paid in those other situations was equal to the actual amount of tax they owed whereas the Service claims that the taxpayer in *Clark* paid more than his

actual tax liability. But, that is not true. Clark filed a joint income tax return, and he was not permitted to change that election. Consequently, Clark did actually owe the tax that he paid. The payment that he received from the counsel was to replace the additional tax he actually incurred over what he would have incurred if he had received proper advice.

The Service's attempt to treat tax payments differently from other expenditures is unwarranted. It is true that an error in preparing a tax return is different factually from an external error. But, there are always factual differences between a precedent and a new case. For example, the names of the taxpayers can be different. It is not sufficient to point out a factual difference; it is necessary to provide a principled justification for treating the parties differently because of that factual difference. The Service's claimed justification is that the compensatory payment effectively is a payment of the taxpayer's actual tax liability and that is taxable under *Old Colony* and Treas. Reg. § 1.61-14. But that ignores why that case and the regulation characterized a payment of another's tax as income unless the law provides otherwise. It was because the payment satisfied a liability of the taxpayer; it did not matter whether the liability was a tax obligation or some other obligation. The point of the case and the regulation is that the payment of another person's debt is equivalent to making a direct payment to the debtor and should be treated the same. The Service's effort to treat a tax debt differently than other debts makes the tax a kind of shibboleth.

There are several cases in which damages received for paying higher taxes due to external errors by an advisor have been excluded from income. The courts did not accept the Service's contention that the external distinction from the facts of *Clark* requires a different result.

In *Cosentino v. Commissioner*,<sup>48</sup> the Tax Court rejected the claim that an external error is distinguishable from *Clark*. In that case, an accountant advised the taxpayer to adopt a plan for the disposition of realty. The taxpayer carried out the plan, and it was held to be an abusive tax shelter. The taxpayer incurred a large amount of tax and interest and penalties. If the taxpayer had known that the plan was abusive, he would have exchanged the realty for realty of like kind in a § 1031 nonrecognition exchange. Taxpayer sued the accountant, and they settled. The accountant paid taxpayer \$375,000. The settlement did not allocate that amount among the several losses that the taxpayer claimed. Some of the items claimed by the taxpayer were expenses that taxpayer had deducted and from which he had received a tax benefit. One of the items was a claim for a loss in an amount that was greater than the actual amount of the loss. The court held that the settlement had to be apportioned among the several items claimed. The amount apportioned to the payment of higher taxes was excluded from taxpayer's income. The court held that the *Clark* doctrine applied to external errors. The amount apportioned to

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<sup>48</sup> TC Memo 2014-286 (2014).

the deducted expenses was included in income under the tax benefit doctrine. The amount apportioned to the claim for a loss that did not exist was also included in income.

We discussed *Concord Instruments Corp. v. Commissioner*<sup>49</sup> in Part II. In that case, the taxpayer's lawyer failed to file a timely appeal from an adverse judgment on a tax issue. The taxpayer sued the lawyer for malpractice claiming damages for the taxes he paid that would not have been due if he had won the appeal plus interest that he paid to the IRS and to a bank. Taxpayer had deducted the interest payments. The suit was settled under which the attorney paid taxpayer \$125,000. The settlement did not apportion the amount among the several claims that the taxpayer made. The Tax Court held that the settlement had to be apportioned among the several claims, and the court made that apportionment according to the percentage of each item in the taxpayer's complaint. The amount allocated to the payment of taxes was excluded from taxpayer's gross income under the *Clark* doctrine. The court did not treat an external error differently from a return error. The amount allocated to interest payments was included in income under the tax benefit rule.

We have made significant references to an excellent article by Professor Zelenak on this topic.<sup>50</sup> In that article, Professor Zelenak concluded that the *Clark* case was correctly decided. However, he also concluded that the Service's distinction between external errors and errors in preparing a tax return is correct.<sup>51</sup> As noted above, we have come to the opposite conclusion. And the several courts that have passed on that issue have rejected that distinction. In support of his conclusion, Professor Zelenak set forth an example that he believed demonstrated that the Service's distinction is appropriate. At first blush, it might appear that his example demonstrates that he is correct, but a careful examination shows that he is not. The substance of his example is set forth below.

Ex. (7). X Corporation issues a bond to Joan for \$100. The bond pays 10% interest (\$10 per year). X falsely represents to Joan that the interest payable on the bond is exempt from federal income tax under § 103. Upon discovering that she had been misled, Joan

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<sup>49</sup> TC Memo 1994-228 (1994). See text accompanying note 21, *supra*.

<sup>50</sup> See Zelenak, n. 33, *supra*.

<sup>51</sup> Some insurance companies offer a policy to insure a taxpayer that a proposed transaction will receive the tax treatment the taxpayer wishes. If the transaction is not so treated so that the insurer is required to pay the taxpayer an amount equal to the additional tax incurred, the question arises whether those payments by the insurer are taxable to the taxpayer. In a footnote in his 1991 article, Professor Zelenak states that it is clear that the payment is taxable. Zelenak, n. 33, *supra*, at 398, n. 81. While that issue is related to the topic of this article, and we disagree with Professor Zelenak's statement, we do not choose to discuss it in this article. We note however that one of the authors of this article has written an article contending that the insurance proceeds are not taxable. See Jeffrey H. Kahn, *Hedging the IRS – A Policy Justification for Excluding Liability and Tax Insurance Proceeds*, 26 YALE J. ON REG. 1 (2009).



complains, and X is required to pay Joan the amount necessary to put her in the same position she would occupy if the bond's interest were tax exempt. Assume that Joan is in the 20% marginal tax bracket. So, the tax on the \$10 of interest she receives each year would be \$2, and Joan would retain \$8 per year after tax. X will pay Joan an amount each year to provide her with \$10. If the payment made to Joan is excluded from income, X will pay her \$2 each year. If, however, the payment to Joan is subject to tax (at a 20% marginal rate). X will have to pay her \$2.50 for her to have \$10 after tax. In effect, if the payment to Joan is not taxable, X can be seen as paying interest at a 12% rate, but if it is taxable, X will be paying interest at a 12.5% rate. The result is that X would have had to pay Joan 12.5% interest to give her the promised 10% after-tax return, but if the compensatory payment is excluded from income, X will have to pay only 12% interest.

We should note that the problem raised by the example does not exist in the *McKenny* case. First, in the example, there was not an error that prevented Joan from having a desired tax benefit that she would have enjoyed if the error had not been made as was the case in *McKenny*. Joan would not have been entitled to tax exempt interest in any event. Joan's complaint is that she was misled as to what the tax consequences of her arrangement would be, not that she was prevented by negligence from obtaining those benefits. Second, the compensatory payment in *McKenny* was not made by the obligor of the debt in question so it did not affect the arrangement between the debtor (the taxpayer) and the obligor (the government). Thirdly, there is no risk of collusion or fraud in *McKenny* since neither party benefitted from the error.

The accountant's payment in *McKenny* did not reduce the revenue the government received from taxpayer for the income the taxpayer earned on the bond. If, as we maintain, the accountant's payment is excluded from income, the government will not collect any additional revenue from that payment. The reason is that the government has chosen generally not to tax compensatory payments. Congress could tax compensatory payments if it chose to do so, but it has not. There is nothing unusual about not taxing the compensatory payments that were made in *McKenny* or in similar cases.

As to the factual situation posed in Ex. (7), the payments made by X to Joan are not actually interest payments. They are compensation for an injury she suffered, and the amount of her injury is measured by the amount of tax she incurred. Instead of the proposed characterization of the payments as additional interest on the bond, they might better be characterized as a reduction of Joan's cost in purchasing the bond. As such, they would reduce her basis in the bond. In that regard, consider the comparable treatment of a cancellation of a debt in § 108(e)(5),

which is a codification of the common law treatment of such cancellations. If a purchase money debt is cancelled in what would normally be treated as income to the debtor, instead it is treated as a reduction of the cost of the purchased item.

In any event, as noted above, the principal concerns that Professor Zelenak has are the possibility of collusion and the obtaining of unauthorized tax treatment by arranging for compensatory payments to be made. As noted above, there is no prospect for collusion in the *McKenney* situation or in comparable cases. Even in the situation described in the Example, the requirement that the arrangement be bona fide and that a settlement be bona fide, in good faith and having the color of merit would seem to be sufficient to prevent an abuse.

## V. Allocation

If a claim for damages for malpractice includes a claim for expenses incurred in addition to a claim for compensation for payment of higher taxes, and if the claims are settled by payment of a lump sum amount which is not apportioned in the settlement agreement, the courts will apportion the settlement amount among the several claimed items. There is no established manner for making that allocation, but typically the courts and the Service have allocated according to the percentage each item represents in the complaint or claim.

If a settlement includes an allocation, the courts generally will accept it if the “agreement is entered into by the parties in an adversarial context at arm’s length and in good faith.”<sup>52</sup> It is surprising that so many settlements fail to make an apportionment.

## VI. Conclusion

The decision of the Eleventh Circuit in *McKenny* failed to take into account the *Lyeth v. Hoey* doctrine that a bona fide, arm’s length settlement is conclusive of the matters settled by that agreement. The court’s decision for the government rested on its determination that the taxpayer failed to provide proof of items that were settled in the written agreement between the taxpayer and the accountant. We have shown that the *Lyeth v. Hoey* doctrine does apply to the case and should have been treated as conclusive of those issues.

Because the court determined that the taxpayer had failed to prove crucial elements of the case, the court expressly declined to examine the question of whether a payment to compensate a taxpayer for paying a larger tax because of an external error of the payor should be excluded from income. This issue raises the questions of whether the Tax Court’s decision in *Clark* is valid and, if so, as to the scope of that doctrine. We have examined the *Clark* doctrine in the light of objections raised by some commentators and found that the doctrine is valid. We

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<sup>52</sup> *Robinson v. Commissioner*, 102 T.C. 116 (1994), aff’d on that issue, 70 F.3d 34 (5<sup>th</sup> Cir. 1995).

have discussed the issues of whether the *Old Colony* and the *Sanford & Brooks* cases invalidate the *Clark* doctrine and concluded that they do not. We examined the issue as to whether non-parallel treatment violates horizontal and vertical equity principles and shown that equity cannot be obtained in the *Clark* situation because no matter whether the compensatory payment is excluded or taxed, there will be a conflict with horizontal or vertical equity. Consequently, the principle of horizontal and vertical equity has no role to play in determining how to treat those compensatory payments.

While the Service has accepted the validity of the *Clark* decision, it maintains that it is limited to errors made concerning the preparation of a tax return and does not apply to external errors that caused a taxpayer to incur a larger tax obligation. We have shown that there is no justification for treating compensatory payments to an injured party because of external errors differently from compensatory payments for errors in preparing a tax return. The purpose of generally not taxing compensatory payments is to facilitate the making whole of an injured party, and the injury caused by increasing a victim's tax liability is as harmful as any other pecuniary injury and should be treated the same.