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Tax Treatment When Estate Satisfies Transaction-Related Claims

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Disputes often follow the sale of the stock of a corporation. The buyer, creditors of the corporation, or others in some manner adversely affected by the transaction may assert claims against the seller. If the seller makes a payment to resolve such claims, upon either a settlement or an adverse judgment, issues often arise as to the tax treatment of that payment; if the seller dies before resolution of the dispute, and payment is made not by the seller, but by the seller's estate, the complexity of those tax issues is multiplied.

Background

Under *Arrowsmith*[1] and other cases, the tax treatment of a payment made in settlement of a dispute is generally determined by reference to the tax treatment of the underlying transaction from which the claim arose. For example, if the underlying transaction was a sale of the stock of a corporation and resulted in capital gain (or loss) to the seller, a payment later made by the seller to the buyer, in satisfaction of claims arising from the sale, will generally result in a capital loss deductible, if at all, under Internal Revenue Code ("IRC") section 165. Ordinary tax accounting rules, including the economic performance requirement of IRC section 461(h), will often not permit such a loss to be deducted in any taxable year before that of payment.

This deferral of a deduction until the year of payment can have an adverse impact on the tax treatment of the seller. Under IRC sections 165(f) and 1211, a capital loss can generally be used only to offset capital gain.[2] Although capital losses can be carried forward (for five years by corporate taxpayers, and for an unlimited number of years by noncorporate taxpayers), so that they may provide some tax benefit if the taxpayer recognizes capital gains in later years, noncorporate taxpayers cannot carry capital losses back to any earlier years, and corporate taxpayers can carry them back for only three years.[3] Thus, if payment by a stock seller occurs in a year later than the year in which the gain from the stock sale was reported, and the seller does not have other material capital gains during that later year, the resulting capital loss may not be allowed in the year of payment, even if it is sufficient to offset only in part gain from the stock sale that was previously reported.

This harsh result is consistent with the "annual accounting principle" that is generally governs the computation of income tax, and it cannot generally be avoided by amending the seller's income tax return or otherwise claiming a refund for the earlier year of the sale.[4] However, the "readjustment" provision of IRC section 1341 may offer relief in this situation, as well as in other contexts where, by reason of changes in tax rates or otherwise, a current deduction attributable to the satisfaction of a claim from an earlier transaction would result in a lesser tax benefit than the tax burden that was attributable to the receipt of an equal portion of the previously taxed consideration.

Section 1341 has three basic requirements. First, an amount must have been included in gross income for a prior year because it appeared that the taxpayer had an unrestricted right to the amount. Second, it must be established in a later taxable year that the taxpayer did not in fact have an unrestricted right to all or a portion of that amount, and, consequently, that the taxpayer is entitled to a deduction in the current taxable year with respect to an obligation to restore the disputed amount to the payor. Third, the amount of that deduction must exceed $3,000.

If all of these requirements are met, the taxpayer may—in lieu of applying normal tax accounting and computation rules for the year of payment, including the IRC section 1211 limitations on the deductibility of capital losses—compute his tax for the year of payment without regard to any deduction for making the payment, *but* reducing that tax by the amount that the taxpayer's tax for the year of the original transaction would have been reduced if an amount equal to the payment had been excluded from the taxpayer's gross income in the prior year.

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Let us try to make this confusing articulation somewhat more concrete. Assume, for example, that a taxpayer reported $100x of capital gain in the year of a stock sale and paid tax of $20x on that gain, in a later year is required to return to the buyer $5x and thereby incurs a capital loss of $5x (and, for ease of illustration, has no other income in either year), and otherwise meets the requirements of section 1341. Rather than being left with a "useless" capital loss deduction in the later year, section 1341 will generally entitle the taxpayer to a tax refund for the later year equal to whatever tax reduction would have resulted if the gain reported in the year of sale had been only $95x ($100x - $5x), rather than $100x.

Batchelor-Robjohns v. United States,[5] however, a recent decision of the Court of Appeals for the Eleventh Circuit, illustrates that the income tax relief promised by section 1341 may be limited or unattainable if a claim survives the death of an individual seller and is resolved only by the seller's estate.

Facts in Batchelor-Robjohns

During 1999, George Batchelor ("Batchelor") sold all the stock of his aviation business, IAL, for cash and other consideration totaling $502,000,000. His basis in the stock was minimal, such that his gain was close to the same amount, and the full gain was reported as a capital gain in the year of sale and the following year.

Claims related to the sale and associated transactions were made thereafter against Batchelor by the United States (for unpaid taxes), the purchaser, IAL itself (which filed for bankruptcy in 2002), and by others, which in turn led to multiple proceedings.

The issue relating to the potential application of section 1341 arose from the settlement of four civil lawsuits brought against Batchelor and, after his death in July 2002, against his estate. The civil lawsuits were resolved through payments by his estate totaling $41,000,000 from 2002 through 2004. As permitted by IRC section 2053 for Federal estate tax purposes, all but $1,000,000 of the aggregate amount paid was deducted for purposes of determining Batchelor's taxable estate, and the estate tax deduction was not at issue in the district court proceedings below or on appeal.

The estate also claimed a credit of $8,300,000 on its income tax return for 2005 by reason of the civil lawsuit payments, pursuant to IRC section 1341, and sought a refund of taxes arising from the credit. This credit represented the amount by which Batchelor's income taxes for 1999 and 2000 would have been reduced if the proceeds from the sale of the IAL stock had been $41,000,000 less than the amount that Batchelor had originally reported.

The IRS disallowed the income tax refund sought by the estate, and the estate pursued the refund claim by bringing an action in a U.S. district court in Florida. The estate's claim was disallowed in a lengthy opinion by the trial court,[6] and the Court of Appeals for the 11th Circuit recently affirmed.

Analysis

The courts agreed with the government that IRC section 1341 cannot apply unless some other provision of the IRC would allow the taxpayer—in this case, Batchelor's estate—to claim a deduction, but for the section 1211 limitation.[7] As the payments resolved claims from a sale of stock that resulted in a capital gain, under case law cited in the opinions (and above), any deduction resulting from the payments would be a capital loss, presumably allowable under IRC section 165 (and other provisions referenced therein), rather than (as argued by the estate) a trade or business expense deductible under IRC section 162 or an expense associated with property held for the production of income deductible under IRC section 212.

The fact that section 165, rather than section 162 or section 212, applied was fatal to the estate's income tax refund claim because of a special rule relating to expenditures—such as these payments by the estate—that might otherwise be claimed as estate tax deductions (in determining the taxable estate) and also as income tax deductions on an income tax return of the estate. Under IRC section 642(g), any amount allowed as a deduction under IRC section 2053 in determining the taxable estate of a decedent generally is not allowable to the estate as a deduction for income tax purposes.

While the notion that the same amount cannot be claimed twice as a deduction, once for estate tax purposes and then again for income tax purposes, has a certain visceral appeal, there are in fact some significant exceptions. Indeed, IRC section 691(b) specifically permits certain estate tax deductions to be claimed again, for income tax purposes, as "deductions in respect of a decedent." The deductions allowable under section 691(b), however, are limited to those described in IRC sections 162, 212, 163 (interest), 164 (certain taxes), and 611 (depletion of oil and gas and other natural resources); section 165 losses do not qualify for this special treatment.

Since the payments made by the estate in settlement of the four civil lawsuits were not within the scope of any of those provisions listed in section 691(b), and were allowable as estate tax deductions, the payments were not allowable to the estate as income tax deductions for the years in which they were made. It followed that no income tax benefit could be derived by the estate from these payments pursuant to IRC section 1341 by reference to taxes paid by the decedent for earlier taxable periods. The Court of Appeals did not have to determine whether or how section 1341 would have applied if no estate tax deduction had been allowable or claimed and if IRC section 642(g)'s explicit prohibition against the claiming of a loss deduction by the estate had not applied.

Observations

The reasoning of the courts in *Batchelor-Robjohns* on the section 1341 issue seems sound, and the result is not surprising given the relevant statutory provisions and the estate tax benefit that was obtained. It is conceivable that a better overall tax result could have been achieved if or to the extent that the civil lawsuit claims could have been settled before Batchelor's death. Under those circumstances, relief under IRC section 1341 would more likely have been available if needed to secure the income tax benefit, and amounts paid by him during his lifetime would not have been includible in his estate subject to estate tax. However, two of the civil lawsuits involved were not even initiated until after his death, and a material acceleration of the settlement process as to any of the claims might not have been feasible or practical for any number of reasons.

More generally, *Batchelor-Robjohns* is yet another reminder of the numerous potential pitfalls that can frustrate an attempt to obtain relief under section 1341 from the harsh income tax results otherwise often attributable to the annual tax accounting principle that is a foundation of income tax accounting.

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1 *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

2 Section 1211(b) does provide a de minimis annual allowance to noncorporate taxpayers of up to $3,000 of capital losses in excess of capital gains.

3 IRC section 1212. Special rules apply to regulated investment companies and real estate investment trusts.

4 *See generally United States v. Lewis*, 340 U.S. 590 (1951).

5 115 AFTR 2d 2015-____ (11th Cir., June 5, 2015).

6 *Batchelor-Robjohns v. United States*, 112 AFTR 2d 2013-5960 (S.D. Fla.). The District Court followed the earlier report and recommendation of a magistrate judge on this issue (113 AFTR 2d 2014-1392 (2013)). The District Court and Court of Appeals decisions also addressed other issues not discussed below.

7 Treasury Regulation section 1.1341-1(c) negates the application of the section 1211 limitation for certain purposes under section 1341; in the absence of such a rule, the utility of section 1341 would be severely limited.