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Claim for Bad Tax Advice Results in Nontaxable Recovery

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Where a transaction is planned and implemented or a tax return is filed on the basis of advice from a tax professional that turns out to have been faulty, resulting in the payment of more tax than would otherwise have been paid, the taxpayer may have a claim against the tax professional for the additional tax cost and related expenses such as interest and legal fees. Is a recovery on such a claim itself income subject to tax?

Cosentino v. Commissioner,¹ a recent memorandum decision of the Tax Court, concludes that such a recovery is generally nontaxable as a “replacement of capital” except to the extent it represents a recoupment of amounts previously deducted for income tax purposes by the taxpayer. Although no corporate tax issue was implicated, similar issues often arise in corporate contexts, and this decision and authority on which it relies are therefore discussed below.

Facts in *Cosentino*

The description of facts in *Cosentino* is quite limited. It appears, however, that G.A.C. Investments, a limited liability company classified as a partnership for tax purposes (GAC), owned commercial rental property. GAC was owned by two individuals filing joint tax returns who were the petitioners before the Tax Court (the Cosentinos).

GAC and the Cosentinos entered into a plan on the advice of their accounting

firm pursuant to which certain transactions (not otherwise described) were executed in 2002 in an effort to increase the tax basis of GAC in its property. GAC then disposed of the property in 2003 in a like-kind exchange with “boot”—that is, cash or other property the receipt of which generally results in the recognition of gain notwithstanding the general nonrecognition rule of Internal Revenue Code (Code) section 1031.

The tax basis step-up was apparently intended to reduce or eliminate the gain that would otherwise ordinarily be recognized by reason of the receipt of boot, and a relatively small gain of less than \$200,000 was reported by reason of the disposition of the property.

In 2005, the Cosentinos learned that the plan implemented to dispose of the property constituted an abusive tax shelter. Thereafter, they: filed and caused GAC to file amended tax returns that disclaimed the intended benefits of the plan; reported on those returns additional gain of \$1,800,000 from the disposition of the property; and paid additional federal and state income tax in 2002 and 2003.

In 2006 the Cosentinos filed a lawsuit against the accounting firm that provided the tax advice on which they relied and against certain accountants at that firm. The complaint asserted claims for damages on account of various losses resulting from the advice received from the accountants.

The largest component of the claimed damages was for income taxes paid “including lost opportunity to use legitimate tax deferral methods under Section 1031.” Other components of the claimed damages included fees paid to the accounting firm

for its advice, and estimated penalties and interest allegedly payable to the tax authorities.

So far as appears from the decision, the core of the Cosentinos’ claim against the accountants was not that the Cosentinos paid more tax than they should have based on the transactions effected by them, but rather that, had the Cosentinos been properly advised, they or their controlled entity would have instead disposed of the property in a like-kind exchange without boot (for example, by exchanging that property for more valuable real property but no cash or other boot), as had previously been done by the Cosentinos with respect to other property.

The total of the damages alleged in the complaint was \$641,000, of which approximately \$450,000 was attributable to additional federal and state income taxes stipulated (in the Tax Court proceeding) to have been paid in 2002 and 2003. The lawsuit against the accountants was settled in 2007 for a payment to the Cosentinos of \$375,000. So far as appears from the decision, the settlement agreement did not specify any allocation of the payment between the categories of damages claimed.

No part of the \$375,000 payment was included in the income of the Cosentinos on their tax returns for 2007. Subsequently, the IRS issued notices of deficiency alleging, among other adjustments, that the full amount of the settlement payment was required to be included in the taxable income of the Cosentinos in 2007, and imposing an accuracy-related penalty under Code section 6662. The assertion of a penalty was withdrawn and other issues were resolved

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by stipulation, such that the only issue before the Tax Court was whether the \$375,000 amount was includible in the income of the Cosentinos.

Discussion

The legal analysis in *Cosentino* starts with the noncontroversial principle, established by cases including those cited in the decision, that the taxability of a settlement payment or judgment received in resolution of a lawsuit depends on the nature of the claims made and the basis on which a recovery was attained.

In particular, the court observed, damages for lost profits or to replace other items of ordinary income are taxable, generally, as ordinary income. Conversely, if a recovery represents a replacement of capital, such a recovery generally does not result in taxable income to the recipient to the extent the recovery does not exceed the basis of the destroyed or damaged property.²

The decision discusses prior case law and a published ruling cited by the Cosentinos concerning the treatment of damages received in settlement of claims arising from erroneous tax advice or other negligence relating to tax matters. In *Edward H. Clark v. Commissioner*,³ a married individual was advised by tax counsel to file a joint return with his spouse, but doing so resulted in an overall federal tax liability greater than what would have been incurred if they filed separately. The payment later made to Mr. Clark by his tax counsel, equal to the amount of tax that could have been avoided by filing separately, was ultimately determined to be excludible from income as compensation for a loss that impaired the capital of Mr. Clark and did not give rise to any deduction for him.

Revenue Ruling 57-47 described a fact pattern, similar to that of *Clark*, involving a payment as compensation for an error made by a tax consultant in preparation of an individual's income tax return. The taxpayer received in settlement from her tax consultant not only the additional federal tax due by reason of an error in preparation of a tax return, but also a return of the fee paid to the consultant to prepare the tax return—which fee had previously been deducted under Code section 212.

The ruling concluded that the amount paid on account of the additional tax was excludible from income, citing *Clark* (and

noting that the prior IRS non-acquiescence in that case had been withdrawn). Because the return preparation fee had previously been deducted, the ruling further concluded that the return of that fee to her must be included in income.

*Concord Instruments Corporation v. Commissioner*⁴ involved a situation in which the Tax Court had previously upheld a tax assessment against a predecessor of a corporation relating to the disallowance of depreciation deductions that were attributable to a prior acquisition. The corporation desired to appeal the adverse determination of the court but failed to timely file a notice of appeal.

The corporation made a claim against its counsel based on the failure to file a timely appeal, and the resulting payment from counsel's professional liability insurance company was treated by the corporation as nontaxable. The Tax Court in *Concord* upheld that treatment in reliance on the recovery of capital principle and the *Clark* case in particular, notwithstanding that in *Concord* it was not at all clear whether and to what extent the corporation was injured by its counsel's failure to timely file an appeal (it being entirely plausible that the initial decision of the Tax Court concerning the underlying tax assessment would have been upheld).

The Tax Court in *Cosentino* found the government efforts to distinguish *Clark*, *Concord*, and Rev. Rul. 57-47 to be unconvincing, and concluded that the amount received by the Cosentinos was properly excluded from their income to the extent attributable to the additional tax they would allegedly have avoided, but for the faulty tax advice, by pursuing a nontaxable like-kind exchange.

The court noted, however, that the settlement payment also appeared to be attributable in part to (i) claims for estimated tax penalties that were not ultimately required to be paid, and (ii) expenditures for state income tax that had previously been deducted for federal tax purposes. The court concluded that the aggregated settlement amount of \$375,000 must be apportioned ratably among the components of damages that had been alleged in the complaint, and that the portions of the overall settlement amount so apportioned to estimated damages that were not in fact incurred, and to expenditures that were previously deducted, must be included in income.

Conclusions

The decision in *Cosentino* may prove to be controversial, taking into account that, unlike *Clark* and possibly unlike *Concord*, there is no indication in this decision that the Cosentinos paid any more tax than the tax that should have been due based on the transactions they actually effected.

On its face, however, the decision seems helpful in supporting the view that individuals and business entities who receive payments in respect of tax malpractice claims and other claims of a similar nature may not be required to include such amounts in income, thereby perhaps making such claims easier to resolve.

The decision also underscores the potential for the manner in which claims are set forth in a complaint or other pleadings to affect the taxability of a settlement of the claims. The petitioners were ultimately required to include a portion of the settlement payment in their income because certain amounts of damages alleged in the complaint on an estimated basis were not ultimately paid and because the lawsuit-related documents apparently did not otherwise provide assistance to the court in making an apportionment of the settlement payment other than pro rata to the damages as initially claimed. It is conceivable that a different allocation of the settlement payment, if set forth in the settlement agreement, might have produced a better tax result for the petitioners without adversely affecting the other parties to the settlement.

¹ *Garey A. Cosentino et ux. v. Commissioner*, TC Memo 2014-186.

² *See Sager Glove Corp. v. Commissioner*, 36 T.C. 1173 (1961), *affirmed*, 311 F.2d 210 (7th Cir. 1962) (setting forth this rule but holding against the taxpayer, in respect of proceeds received in settlement of antitrust claims, on the basis of circumstances strongly suggesting that the award was determined on the basis of lost profits); *see also* Treasury Reg. §§ 1.165-7, -8 (addressing consequences of the receipt of insurance proceeds by reason of theft or casualty, in determining allowable loss deductions).

³ 40 B.T.A. 333 (1939).

⁴ TC Memo 1994-248.

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