In Case You Missed It: October 2020
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Almost every day, federal and state courts issue opinions that affect taxpayers. And the IRS and state taxing authorities often publish guidance on a myriad of topics.

So, each month, this column will review a selection of recent court cases or guidance that tax professionals should know about when advising their clients and preparing tax returns.

For more extensive detail on any of these items, please feel free to reach out to the author.

McKenny v. U.S.A.
Tax impact of accountant malpractice settlement payment

In *McKenny v. U.S.A.*, the taxpayers sued their accounting firm, alleging that its negligence caused them to pay more than $2 million in federal taxes to the government. The firm, while denying liability, settled the case and paid the taxpayers $800,000.

The taxpayer was an independent consultant who hired Grant Thornton in the late 1990s to advise him on tax strategy and tax return preparation. Grant Thornton advised him to run his consulting business as an S corporation wholly owned by an employee stock ownership plan (ESOP), of which the taxpayer was to be the sole beneficiary. This was intended to allow him to defer taxation on the earnings from his consulting business until he took distributions from the ESOP.

The taxpayer decided to implement the strategy in 2000 and filed tax returns reflecting little or no federal income tax. However, Grant Thornton allegedly failed to file the S corporation election or to create the ESOP.

The taxpayers were audited in 2005, and the IRS determined that they had been underpaying their taxes since 2000.The taxpayers ultimately conceded all the tax benefits they'd previously claimed from the ESOP transactions and paid the IRS $2,235,429 in income taxes, interest, and penalties.

The taxpayers then sued Grant Thornton, alleging that the firm's accounting malpractice led to their unpaid tax liabilities. Grant Thornton denied all of the claims but ultimately settled the suit by paying the taxpayers $800,000.

The taxpayers then filed a tax return that—

- deducted $419,490 in legal fees they incurred litigating the malpractice claim
- claimed an unreimbursed loss for the $1.4 million difference between the Grant Thornton settlement payment and the amount they had to pay the IRS
- excluded the $800,000 settlement payment they received from Grant Thornton from their gross income.

The taxpayers were audited again, and the IRS disallowed all three of these deductions and exclusions. The IRS found the taxpayers liable for an additional $813,407 in taxes.

The IRC allows deductions for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" [IRC section 162(a)]. Litigation costs are deductible business expenses if the litigation itself is business in nature, not personal.

The Court concluded that the taxpayers' claim against Grant Thornton was personal in character and origin, as it concerned their personal income tax liability. Plus, the alleged malpractice was for services performed for the taxpayer in minimizing his tax liability, not for services performed for his consulting business.

The Court also disallowed the deduction for the difference between the amount the taxpayers had to pay to settle their IRS audit and the amount they recovered from Grant Thornton. The taxpayer had entered into a written closing agreement with the IRS, pursuant to IRC section 7121. As explained in section 7121(b), a closing agreement is final and conclusive, and by its terms prevented the taxpayers from taking any further deductions with respect to the ESOP adjustments.

The taxpayers thus cannot deduct any portion of the payment they made to settle with the IRS that wasn't compensated by Grant Thornton.

The final issue reviewed by the Court was whether the taxpayers could exclude from gross income Grant Thornton's $800,000 payment. IRC section 61 defines gross income as "all income from whatever source derived." In determining whether a settlement payment is income, the court looks to see what the payment was made in lieu of.

A 1939 Tax Court decision ruled that a payment made to compensate for damages caused by a third party's negligence in the preparation of a tax return is excluded from the definition of income. (See Clark v. Commissioner.) However, the Court pointed out that in the taxpayers' case, Grant Thornton's alleged malpractice wasn't in connection with the preparation of their tax return, but rather with respect to the structuring and implementation of the underlying transactions.

The taxpayers could not, and did not offer sufficient evidence to, prove that had Grant Thornton not committed malpractice, they would have had a zero-tax liability. There was no evidence that the ESOP structure would've eliminated their income tax liability even if all of the proper paperwork were drafted, signed, and filed.

Additionally, the Court pointed out that the S/ESOP strategy was disallowed as of Dec. 31, 2004, and therefore couldn't have provided the taxpayers any tax benefits in 2005. As they did not show their entitlement to an exclusion from gross income, the settlement payment was fully taxable.

So, the taxpayers lost on all three issues.

Takeaway: Settlement agreements, be they with the IRS or third parties, have numerous tax impacts that must be considered.

Franklin v. Commissioner
Remember to contemporaneously document your expenses

In *Franklin v. Commissioner*, the IRS challenged the petitioner's Schedule C deductions and loss deductions on the grounds that he failed to properly substantiate them.

Schedule C expenses

The petitioner filed a late personal income tax return for 2014, on which his Schedule C reflected gross income of $293,250 and business expenses of $141,402. He didn't ordinarily prepare or maintain records of his business expenses.

Upon learning he was being audited, he created a travel log from memory, which he subsequently supplemented with his credit card statements, bank account statements, and receipts. He didn't provide any evidence as to how these expenses related to his business.

The petitioner also created a meal log, including meals at restaurants both foreign and domestic. He stated that the meals with his former spouse and his current spouse were to discuss real estate opportunities. He provided no other explanation or evidence as to how these expenses related to his business.

The IRS disallowed his Schedule C deductions for travel expenses and meal and entertainment expenses.

IRC section 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." A taxpayer has the burden of proof to establish both that the expenses were actually incurred and that they were ordinary and necessary. Further substantiation requirements to deduct expenses for travel, meals, and entertainment are imposed by IRC section 274(d), which requires "adequate records."

Treasury Regulations section 1.274-5T explains that in determining whether a taxpayer has "adequate records," written evidence has more probative value than oral evidence, and that the probative value of the written evidence increases the closer in time it was created with respect to the expenditure. While it doesn't have to be contemporaneous, it'll be given more weight if the record was prepared at or near the time of the expenditure, as opposed to being composed after an audit begins.

The court found that neither the petitioner's travel log nor testimony was credible. The petitioner argued he was entitled to deduct his travel expenses as long as they were motivated by business purposes, but he provided no evidence to establish any such business purposes for the trips. The court held similarly with respect to his personal meal expenses and denied his deductions.

Loss deductions

The petitioner also reported losses of $86,640 on his 2014 Form 4797. This was a combination of worthless loans, loss of software, and an abandoned timeshare. The IRS disallowed all of these losses as well.

Worthless loans

In 2011 and 2012, the petitioner made two loans to a Delaware corporation. The petitioner had the option, which he never exercised, to convert this debt into equity. He deducted the loans as worthless on his 2014 Form 4797. His argument for the worthlessness of the loans was that the borrower's business was struggling and was on a path to failure. The petitioner provided no evidence that he ever attempted to collect on the note before or during 2014.

The petitioner also claimed additional worthless losses on another note that he had made during 2014 that was due on Feb. 8, 2015. This note was also convertible into equity. He claimed a loss based on his belief that the loans were worthless, even though he had no personal knowledge of the debtor's financial position. The petitioner did not contact the debtor about potential collection of the loan until Feb. 13, 2015.

IRC section 166(a)(1) provides "[t]here shall be allowed as a deduction any debt which becomes worthless within the taxable year." In order to qualify for this deduction, the debt must have become wholly worthless during the tax year at issue.

It is long established that a taxpayer cannot take a deduction for worthlessness without requesting payment and attempting to collect the debt or to ascertain its worthlessness (*Ellisberg v. Commissioner*). The petitioner made no attempt to collect his debts during 2014 or establish their worthlessness, and thus the court denied the losses he had claimed on both sets of loans.

Loss of software

The petitioner's loss deduction also included a claim for software used in his real estate consulting business. He'd acquired it in 2012 but lost it after a computer crash in 2014. He provided no evidence regarding his initial cost basis in the software or the method of depreciation used for the period prior to the computer crash.

IRC section 165 allows a deduction for losses sustained during the tax year that aren't compensated by insurance or otherwise. Computer software that's readily available for purchase by the general public may be depreciated using the straight-line method and a useful life of 36 months under IRC section 167. If such an asset is disposed of prior to the end of its useful life, the loss recognized will be the adjusted basis less any salvage value.

Because the petitioner offered no documentary evidence or credible testimony supporting his cost basis or depreciation deductions, the court disallowed any deduction for the loss of software.

Loss on timeshare

The final piece of the petitioner's loss deduction included on his Form 4797 was with respect to his timeshare property. As he provided no evidence other than some inconsistent testimony that he even used the timeshare in his trade or business, and no evidence whatsoever that the timeshare was worthless in 2014, this final part of the loss deduction was disallowed as well.

Penalties

The IRS asserted accuracy penalties under IRC section 6662 for the petitioner's underpayment of tax on the theory that it was attributable to "negligence" or "disregard" of rules or regulations or a substantial understatement of income tax.

IRC section 6662(c) defines negligence as "any failure to make a reasonable attempt to comply with the provisions of" the IRC and defines disregard as "any careless, reckless, or intentional disregard." IRC section 6662(d)(1) states that an understatement of income tax is substantial if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000.

As this column has explained previously, an exception to the IRC section 6662(a) penalties exists if the taxpayer can show that there was reasonable cause for the underpayment and the taxpayer acted in good faith, per IRC section 6664. The petitioner made no argument during the trial that he was entitled to the reasonable cause exception and the court therefore sustained the IRS's determination that he was liable for the accuracy-related penalty.

Takeaway: Remember to make sure your clients have the necessary documents to support their deductions and claimed losses.

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