Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel, Small Business/Self Employed
Area 9,

from:
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)

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subject: , POSTF-125720-12

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =
Promoter =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =
State =
State Statute =
T =
U =
V =
W =
X =

Y =
Z =

ISSUES

(1) Whether a payment in Year 3 of tax liabilities, penalties, and interest for Year 1 through Year 2 in the amount of $X pursuant to a closing agreement with the Service under the GSI is deductible by Taxpayers in Year 5 in the amount of $Z.

(2) Whether a settlement payment in the amount of $Y received in Year 5 by Taxpayers from Promoter, an accounting firm accused of negligence in providing tax advice to Taxpayers, is included in their Year 5 gross income or is excluded from gross income as a return of capital.

CONCLUSIONS

(1) Taxpayers may not deduct the tax, penalties and interest they paid pursuant to a closing agreement with the Service.
(2) Taxpayers may not exclude from their Year 5 gross income as a return of capital the settlement payment received from Promoter.

FACTS

Taxpayers (H&W) are married taxpayers who used the cash receipts and disbursements method of accounting. They filed joint income tax returns for calendar Year 1 through Year 5. H operated an automobile dealership, which he reported on his Schedule C, Form 1040 as an unincorporated sole proprietorship. H's participation in an abusive management S corporation employee stock ownership plan (ESOP) during Year 1 through Year 2 resulted in his voluntary participation in the Global Settlement Initiative (GSI) to resolve federal tax liabilities, related penalties, and statutory interest.

Taxpayers executed the closing agreement under the GSI on Date 1, and made the settlement payment in the amount of $X on that same date. As set forth in the closing agreement, the total GSI payment for Year 1 through Year 2 is composed of income tax liabilities for such years in the amount of $W, penalties in the amount of $V, and statutory interest in the amount of $U. In their response to the RAR, Taxpayers state that the Year 3 payment was slightly less than $Z. The slightly different numbers, however, do not affect our conclusions as to the tax treatment.

The closing agreement was accepted on behalf of the Commissioner on Date 2. Paragraph 4 of the closing agreement under the GSI provides that Taxpayers are not entitled to any other deductions and/or losses relating to the Transactions[1] except as set forth in

[1] The Transactions are defined in the closing agreement as the abusive management S corporation ESOP transaction.

paragraph 12, subparagraph (e). No transaction deductions or losses are allowed under paragraph 12, subparagraph (e), for either H or W.

Promoter provided accounting and tax services to Taxpayers. Promoter recommended the abusive ESOP to Taxpayers. In Year 4, Taxpayers sued Promoter in a State court for accountant malpractice, breach of contract, breach of fiduciary duty, and violation of State Statute. In settlement of the lawsuit, Promoter paid a lump sum of $Y to Taxpayers in Year 5 for a general release of all claims. The agreement did not allocate the proceeds among the claims settled.

Taxpayers did not include the settlement proceeds in their Year 5 gross income. Moreover, they claimed a Schedule C deduction in the amount of $Z (consisting of the Year 3 GSI payment in the amount of $X reduced by the $Y settlement payment from Promoter.) Taxpayers claim that had Promoter prepared and filed the necessary documents with the IRS, they would have been entitled to certain deductions and exclusions on their income tax returns for taxable years beginning in Year 1 and ending in Year 2. Taxpayers assert that the basis for this claim is the opinion of a former TEGE Counsel employee. Promoter's several failures, Taxpayers argue, caused them to participate in the GSI and to pay more tax, i.e., under the closing agreement, than they would have otherwise owed.

LAW AND ANALYSIS

Issue 1 – Deductions

Taxpayers assert that they are entitled to a deduction for a loss under I.R.C. § 165. Taxpayers state that the amount of the loss is based upon their unreimbursed additional income tax liability from the failed transaction. They claim that the amount of the taxes is just a measure of the amount of the loss and the deduction for the loss is not a deduction of federal income taxes. However, Taxpayers cite to no authority permitting a deduction under section 165 for a "loss" attributable to payment of federal income taxes, penalties, and/or interest. Taxpayers' quotations from Clark v. Commissioner, 40 B.T.A. 333 (1939), acq. 1957-1 C.B. 4, are inapposite because that case did not address a loss for purposes of section 165 and did not address the nondeductibility of federal income taxes, later codified in section 275 by section 207 of the Revenue Act of 1964, Pub. L. 88-272. Furthermore, to the extent Taxpayers argue that the "loss" is related to the Transactions rather than a deduction of federal income taxes, paragraph 4 of the closing agreement precludes any such loss.[2]

In form and substance, Taxpayers paid federal income taxes, penalties, and interest, and they are attempting to deduct those federal income taxes, penalties, and interest. Under the facts of this case, any deduction for payment of federal income tax is clearly prohibited by section 275. Also, any deduction for payment of accuracy-related penalties is prohibited

[2] We note that the legal opinion dated December 22, Year 5, does not address this issue.

under sections 162(f), 212, and 165. Finally, no deduction is allowed under section 163 for payment of interest under the facts of this case.

a. Income Tax

Section 261 provides that, in computing taxable income, no deduction is allowed in respect of the items specified in part IX of subchapter B of chapter 1 of the Code. Part IX contains section 275. Section 275(a)(1) provides the general rule that no deduction is allowed for federal income taxes.[3] See also Treas. Reg. §§ 1.275-1 and 1.164-2(a); cf. I.R.C. § 164(f). Consequently, Taxpayers are not entitled to a deduction under sections 165, 162, and 212 with respect to the payment[4] of federal income taxes.

b. Penalties

Taxpayers were liable for, and paid, penalties under section 6662, but not for any applicable excise tax under section 4973. (Sections 8 and 12(f) of the closing agreement.) Section 6662 imposes an accuracy-related penalty and is part of subchapter A of chapter 68 of the Code.

Section 165 allows, subject to certain limitations, a deduction for a loss sustained during the taxable year and not compensated for by insurance or otherwise. However, a deduction is not allowed under section 165 when it would frustrate a sharply defined public policy. Rev. Rul. 77-126, 1977-1 C.B. 47. The reach of the public policy exception under section 165 is at least co-extensive, and in our opinion, broader than the reach of section 162(f). Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990). It is well settled that section 162(f) applies to civil penalties imposed under chapter 68 of the Code. Treas. Reg. § 1.162-21(b)(1)(ii); Reid v. Commissioner, T.C. Memo. 1981-677; see also Medeiros v. Commissioner, 77 T.C. 1255 (1981).[5] Taxpayers are not entitled to a deduction under sections 165, 162, and 212 with respect to the payment of accuracy-related penalties.

c. Interest

Section 163(a) provides the general rule that a deduction is allowed for all interest paid or accrued within the taxable year on indebtedness. Section 163(h)(1) provides that, in the case of a taxpayer other than a corporation, no deduction is allowed for personal interest paid or accrued during the taxable year. Section 163(h)(2) defines the term "personal interest." It is well settled that interest paid on individual tax liabilities relating to income

[3] Because it is not critical to the outcome in this case, we are not addressing the effect, if any, of section 6665(a)(2) (penalties included in references to "tax") and section 6601(e)(1) (interest included in references to "tax") on the scope of section 275.

[4] With respect to a deduction other than under section 165, taxpayers would need to show that they paid a deductible amount during the tax year at issue because they use the cash receipts and disbursements method of accounting. Section 461(a) and Treas. Reg. § 1.461-1(a)(1).

[5] Similarly, no deduction is allowed under section 212. Treas. Reg. § 1.212-1(p).

from a sole proprietorship is treated as nondeductible personal interest. Treas. Reg. § 1.163-9T(b)(2)(i)(A); Powerstein v. Commissioner, T.C. Memo. 2011-271, and the cases cited therein. Taxpayers are not entitled to a deduction for the payment of interest.

Issue 2 -- Return of Capital Theory

Except as otherwise provided in the Internal Revenue Code, a taxpayer must include in gross income "all income from whatever source derived." Section 61(a). The Supreme Court has long recognized that the definition of gross income sweeps broadly and reflects Congress' intent to exert the full measure of its taxing power and to bring within the definition of gross income "any accession to wealth." Commissioner v. Schleier, 515 U.S. 323, 327 (1995); United States v. Burke, 504 U.S. 229, 233 (1992). Accordingly, any receipt of funds by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the exclusions created by other sections of the Code. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

Whether the proceeds recovered in a lawsuit or settlement thereof constitute an item of gross income under section 61 depends on the nature of the claim and the actual basis for settlement. Rev. Rul. 81-277, 1981-2 C.B. 14. If the recovery represents damages for lost profits, it is taxed as ordinary income; if the recovery constitutes a replacement of lost capital, it is treated as a non-taxable return of capital. Id., citing Clark v. Commissioner, 40 B.T.A. 333 (1939), acq., 1957-1 C.B. 4, and Rev. Rul. 57-47, 1957-1 C.B. 23.

In Clark, the taxpayers, on the advice of their return preparer, made an irrevocable election to file a joint federal income tax return rather than separate returns. The Service subsequently determined a deficiency against taxpayers because the return preparer claimed a larger than permissible deduction for capital losses. Had the taxpayers filed separate returns, their combined tax liability would have been significantly less than the amount paid with their joint return. As recompense for his error, the tax return preparer indemnified the taxpayers for the difference.

The Service included the indemnification payment in the taxpayers' gross income under the theory that it constituted payment of taxpayers' taxes. See Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). The Board rejected the Service's treatment stating that the taxpayer paid his own taxes and that the indemnification payment was not qua taxes but compensation for taxpayer's loss.

In the present case, Taxpayers assert that damages recovered for improper tax advice constitute a return of capital under Clark and Rev. Rul. 57-47.

The damages recovered by Taxpayers here are distinguishable from the indemnity payments in Clark and Rev. Rul. 57-47 where the tax return preparer's error caused the taxpayers to pay more than their minimum proper federal income tax liabilities on the underlying transactions. The additional federal income tax paid pursuant to the closing agreement was not due to an error made by Promoter on Taxpayers' income tax return but

on an alleged failure to provide accounting and tax advice that may have reduced Taxpayers' federal income tax liability. Accordingly, the damage recovery does not constitute a non-taxable return of capital and must be included in Taxpayers' gross income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We note that the Year 5 Schedule C for H includes a deduction of $T on line 17, legal and professional services. This could be for legal fees related to the litigation against Promoter. If so, such amounts are not deductible on Schedule C, but are deductible on Schedule A because they are not ordinary and necessary expenses of the taxpayer's trade or business. See generally sections 162 and 212; Green v. Commissioner, 507 F.3d 857, 870 (5th Cir. 2007), aff'g T.C. Memo. 2005-250; cf. section 62(a)(20). Such amounts are related to the income arising from the $Y payment from Promoter, which is reportable on line 21 of Form 1040, not on Schedule C.

Please call (202) 622-4920 if you have any further questions.