Mercer Law Review

Volume 72
Number 4 *Eleventh Circuit Survey*

Article 11

7-2021

Federal Income Taxation

Nikolai Karetnyi

Ruoxi Zhang

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by Nikolai Karetnyi [*]

and Ruoxi Zhang [**]

In the year 2020, the federal courts within the United States Court of Appeals for the Eleventh Circuit handed down several notable opinions on federal tax issues.[1] This Article surveys two of those opinions involving the taxation of conservation easements and the receipt of settlement payments.

I. PINE MOUNTAIN PRESERVE V. COMMISSIONER[2]

A conservation easement is a unique mechanism that carefully balances private property ownership rights with the public good inherent in conserving land. Under a typical conservation easement arrangement, a real property owner enters into a contractual arrangement with a land trust or government agency that creates permanent restrictions on the use of that real property, while still allowing the owner to hold certain rights over that real property. These permanent restrictions are meant to curtail certain uses of land or other real property that would hinder its conservation value. For example, a large piece of scenic land with delicate ecological systems could be protected through a conservation easement restricting natural resource exploration. Similarly, a conservation easement could also protect a historic building with an original façade from encroaching real estate redevelopment. Conservation easements incentivize property owners to recognize the public utility of privately owned spaces, whether it be natural beauty or historical significance, and

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[*] Associate, Weil, Gotshal & Manges, New York, New York. Georgetown University (B.A., 2009); University of Michigan Law School (J.D., 2013); New York University School of Law (LL.M., 2015). Member, State Bar of New York.

[**] Associate, King & Spalding, New York, New York. Cornell University (B.A., 2015); New York University School of Law (J.D., 2019). Member, State Bar of New York.

[1] For an analysis of federal income taxation during the prior survey period, see Nikolai Karetnyi & Ruoxi Zhang, *Federal Income Taxation, 11th Circuit Survey*, 71 MERCER L. REV. 1037 (2020).

[2] 978 F.3d 1200 (11th Cir. 2020).

to take necessary actions to harness such utility. In *Pine Mountain Preserve v. Commissioner*, the Eleventh Circuit navigated the balance between land conservation rights granted to a donee charitable organization and land development rights retained by a private donor with respect to a contribution of a conservation easement and assessed whether this arrangement would allow the private donor to claim a charitable deduction for the donation of the conservation easement. The Eleventh Circuit ultimately reversed in part and affirmed in part the Tax Court's determination of these issues.[3]

Section 170 of the Internal Revenue Code (the Code)[4] works to further incentivize private property owners to enter into conservation easements by offering tax benefits. Essentially, Section 170 recasts the conservation easement arrangement as a deductible charitable contribution of certain property rights by a property owner. Generally, no charitable contribution deduction is allowed for a contribution of a partial interest in property, where the interest consists of anything less than the owner's entire interest in a property.[5] However, through an exception to this general rule, a taxpayer may still retain property rights and be entitled to a charitable contribution deduction for grants of real property that qualify as a "qualified conservation contribution."[6] A qualified conservation contribution is a contribution of a "qualified real property interest" to a "qualified organization" that is made exclusively for conservation purposes.[7]

A qualified real property interest includes an entire interest in real property (other than mineral rights);[8] a remainder interest in real property;[9] or a restriction on the use of the real property that is granted in perpetuity.[10] For the purpose of these rules, "the terms easement, conservation restriction, and perpetual conservation restriction have the same meaning."[11]

The "in perpetuity" requirement is enforceable in three ways, in that a restriction must be granted,[12] protected,[13] and enforceable in

[3] *Id.* at 1202.
[4] 26 U.S.C. § 170 (2020).
[5] 26 U.S.C. § 170(f)(3).
[6] 26 U.S.C. §§ 170(h)(1), (f)(3)(B)(iii).
[7] 26 U.S.C. § 170(h)(1).
[8] 26 U.S.C. § 170(b)(2).
[9] 26 U.S.C. § 170(h)(2).
[10] 26 U.S.C. § 170(f).
[11] Treas. Reg. § 1.170A-14(b)(2) (1986).
[12] 26 U.S.C. § 170(h)(2).
[13] Treas. Reg. § 1.170A-14(a) (1986).

perpetuity.[14] First, for a restriction to be granted in perpetuity, a restriction must attach to property and cannot expire at a designated time (the "granted in perpetuity" requirement).[15] If at the time of the contribution, the restriction is contingent upon a remote future act or an event ("if on the date of the gift it appears that the possibility [of] such an act or event" is negligible), then such contingency does not prevent that restriction from being granted in perpetuity.[16]

Second, a restriction is not "exclusively for conservation purposes" (and thus fails the third prong of the qualified conservation contribution test) if the conservation purpose itself is not protected in perpetuity (the "protected in perpetuity" requirement).[17] Finally, the donor of the real property must maintain a perpetual right to enforce the restriction upon the property (such as through deed recordation) to prevent the use of the property in a manner "inconsistent with the conservation purposes of the donation" (the "enforceable in perpetuity" requirement).[18]

For these purposes, a "qualified organization" is either a public charity (or an organization controlled by a public charity) or a governmental unit (or an organization that "receives a substantial part of its support" from a governmental unit).[19] A public charity is an organization that is exempt from tax under Code Section 501(c)(3)[20] that receives more than one-third of its support for each of its taxable years from gifts, grants, contributions, membership fees, or gross receipts from activities that do not constitute an unrelated trade or business generally from unrelated

[14] Treas. Reg. § 1.170A-14(g)(1) (1986).

[15] 26 U.S.C. § 170(h)(2)(C).

[16] Treas. Reg. § 1.170A-14(g)(3) (1986) ("For example, a state's statutory requirement that use restrictions must be rerecorded every 30 years to remain enforceable shall not, by itself, render an easement nonperpetual.").

[17] 26 U.S.C. § 170(h)(5)(A).

[18] Treas. Reg. § 1.170A-14(g)(1).

[19] 26 U.S.C. § 170(b)(1)(A); *see* 26 U.S.C. § 170(h)(3)(A) (1986) (citing 26 U.S.C. § 170(b)(1)(A)).

[20] 26 U.S.C. § 501(c)(3). A Section 501(c)(3) exempt organization is an entity that is

> organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Id.

third parties.[21] A public charity cannot "receive more than one-third of its support in each taxable year from" gross investment income and the excess of its income from unrelated trades or business over the tax imposed on such income.[22]

Permitted conservation purposes include the preservation of land areas for outdoor recreation or for the education of the public, the protection of natural habitats and ecosystems, preservation of open spaces for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental mandate, or the preservation of a historically important land area or structure.[23] A donation is expected to satisfy one or more of these permitted conservation purposes.[24] For a donation to be "exclusively for conservation purposes," the conservation purpose must be protected in perpetuity, as discussed above.[25] In other words, the donor's retained interest in the contributed property must be subject to legally enforceable restrictions that will prevent uses of the property inconsistent with the permitted conservation purposes.[26] Often, this is accomplished through the recordation of a deed of easement that sets forth the conservation purpose(s), restrictions, and permissible uses of the contributed property.

The general rules applicable to the deductibility of charitable contributions also govern qualified conservation contributions. A qualified conservation contribution must be made with charitable intent and without receipt of adequate consideration.[27] *Quid pro quo* contributions are prohibited as the donor cannot make the contribution with the expectation of direct or indirect benefits.[28] The amount of deductions which an individual may take for its charitable contributions of capital gain property is limited to 30% of the individual's contribution

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[21] With certain exemptions, an "unrelated trade or business" is

> any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501 . . . .

26 U.S.C. § 513(a).

[22] 26 U.S.C. § 509(a)(2)–(3).

[23] 26 U.S.C. § 170(h)(4)(A). Special rules apply to contributions of façade easements of buildings in registered historic districts. The discussion of these rules is outside of the scope of this article. *See* 26 U.S.C. § 170(h)(4)(B).

[24] I.R.S. Priv. Ltr. Rul. 507.04-00 (Aug. 25, 2006) (citing 26 U.S.C. § 507(b)(1)(B)(i) for requiring compliance with 26 U.S.C. § 509(a)).

[25] 26 U.S.C. § 170(h)(5)(A).

[26] Treas. Reg. § 1.170A-14(g)(1).

[27] Treas. Reg. § 1.170A-1(h)(1) (as amended in 1975).

[28] *Id.*

base (which is generally the individual's adjusted gross income).[29] However, a qualified conservation easement contribution is subject to a higher cap of 50% of the individual's contribution base.[30] Additionally, while individual and corporate taxpayers may carryover unused charitable contributions for five years,[31] the carryover period for conservation easement contributions is fifteen years.[32]

Pine Mountain, LLLP (Pine Mountain) owned 6,224 acres of contiguous unimproved land near Birmingham, Alabama. "In each of 2005, 2006, and 2007, Pine Mountain granted the North American Land Trust (NALT)" conservation easements representing 559, 499, and 224 acres of land respectively.[33] Under the easements, Pine Mountain conceded broad land development rights and granted to NALT land preservation rights.[34] In each case, NALT was granted a "perpetual easement in gross" over a specified conservation area "for the purpose of preserving and protecting defined conservation purposes."[35] In line with the Code, the easements memorialized the conservation purposes as protecting natural habitats and open areas that provide scenic enjoyment to the public and yield a significant public benefit. NALT was empowered to enforce the litany of covenants and restrictions in the easements in order to prevent Pine Mountain from developing the property for commercial and residential use.[36] Pine Mountain became subject to covenants including prohibitions "on building structures, roads and driveways, collecting ground or surface water, removing trees, posting signs, mining, dumping, modifying topography and water courses, introducing non-native plant species, and subdividing the land."[37]

In each of the easements, Pine Mountain retained a discrete set of certain rights. In the 2005 easement, Pine Mountain retained the right to build a single-family home on each of ten delineated one-acre plots (designated as "Building Areas"), along with a barn within 1,000 feet of each Building Area. Further, Pine Mountain was authorized to modify the location of a Building Area so long as the total cumulative acreage of all Building Areas remained unchanged and NALT did not conclude that

[29] 26 U.S.C. §§ 170(b)(1)(B), (G).

[30] 26 U.S.C. § 170(b)(1)(E)(i).

[31] 26 U.S.C. § 170(d)(1)(A)–(B).

[32] 26 U.S.C. § 170(b)(1)(E)(ii).

[33] *Pine Mountain*, 978 F.3d at 1203–04. All parties agreed that NALT was a "qualified organization" pursuant to 26 U.S.C. § 170(h)(3). *Id.* at 1203.

[34] *Id.* at 1203.

[35] *Id.*

[36] *Id.* at 1203–04.

[37] *Id.* at 1204.

such modification would be materially adverse to the conservation purposes of the easement. Subject to NALT's approval, Pine Mountain also reserved rights to build an additional barn, two scenic overlooks with ancillary structures, five ponds, and an unspecified amount of hunting blinds. The 2006 easement also granted Pine Mountain the right to build a single-family home on each of six Building Areas, although unlike the 2005 easement, these Building Areas were not clearly marked on a plan. However, Pine Mountain was obligated to notify NALT in advance of where it planned to place these six Building Areas, and any such construction was subject to NALT's ultimate approval. Similarly, NALT held advance approval rights over additional buildings that Pine Mountain could build on the property pursuant to the 2006 easement. The 2007 easement did not allow for the construction of single-family homes, but it did allow Pine Mountain to build a water tower on a site subject to NALT's approval. Additionally, each grant also included language permitting the parties to bilaterally amend the easement's terms, provided that the amendment would be "not inconsistent" with the easement's conservation purposes. This provision also expressly forbade NALT from agreeing to an amendment that would result in the easement failing to qualify as a conservation easement under Section 170(h).[38]

Pine Mountain claimed deductions of $16,550,00, $12,726,000, and $4,100,00 in 2005, 2006, and 2007, respectively, for its contributions of the conservation easements. Following an audit, the Internal Revenue Service (IRS) denied these deductions in their entirety. Pine Mountain responded to the IRS denials by petitioning the Tax Court, ultimately leading to a trial.[39]

The Tax Court disallowed the deductions for the 2005 and 2006 easements while allowing the deduction for the 2007 easement (albeit at an adjusted valuation).[40] Specifically, the Tax Court held that (1) Pine Mountain's rights to build residential units and other structures on the property under the 2005 and 2006 easements disqualified these easements from being granted in perpetuity; (2) Pine Mountain's ability to build a water tower on the property under the 2007 easement did not prevent the easement from being granted in perpetuity; and (3) the amendment clause contained in all three easements did not violate the requirement that the conservation purpose must be protected in perpetuity. The parties disputed the valuation of the 2007 easement,

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[38] *Id.* at 1204.

[39] *Id.* at 1204–05.

[40] *Pine Mountain Preserve, LLLP v. Comm'r*, 151 T.C. 247, 274–82 (2018); *see Pine Mountain Preserve, LLLP v. Comm'r*, T.C. Memo 2018-214 (2018).

with Pine Mountain claiming an estimated valuation of $9,110,000 and the Commissioner countering with an estimated valuation of $449,000. The Tax Court considered both sides' experts and arrived at a valuation of $4,779,500, almost exactly the numerical mean of both sides' estimates.[41]

Pine Mountain appealed the Tax Court's disallowance of deductions for the 2005 and 2006 easements based on their violation of the granted in perpetuity requirement to the Eleventh Circuit. The Commissioner cross-appealed the Tax Court's decision to allow deductions for the 2007 easement and its valuation of the 2007 easement.[42]

The Eleventh Circuit first assessed the Tax Court's decision to disallow deduction for the 2005 and 2006 easements.[43] The Tax Court's decision held that these easements were not granted in perpetuity because Pine Mountain retained rights to develop the Building Areas. In the Tax Court's view, these development rights were not restricted by the conservation easements in "any meaningful sense."[44] To illustrate its point, the Tax Court deployed a "Swiss Cheese" metaphor where the Building Areas represented holes in the total conservation area, so that the easement's restrictions did not attach to a "defined parcel of property."[45]

On this point, the Eleventh Circuit overturned the Tax Court and held that the 2005 and 2006 easements indeed satisfied the "granted-in-perpetuity" requirement.[46] First, the Eleventh Circuit looked to the statutory language and determined that the 2005 and 2006 easements sufficiently burdened Pine Mountain's absolute discretion over the property.[47] Although narrow exceptions remained to allow for limited development of the land, the broad limitation against development of the land as a whole was sufficient to satisfy the statutory test.[48] Additionally, because nothing in the grant envisioned the reversion of the easement interest to Pine Mountain, its heirs, or its assigns, the restrictions in the 2005 and 2006 easements were granted in perpetuity.[49]

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[41] *Pine Mountain*, 978 F.3d at 1205.

[42] *Id.*

[43] *Id.*

[44] *Id.* at 1205 (quoting *Pine Mountain Preserve*, 151 T.C. at 277).

[45] *Id.* at 1205–06 (quoting *Pine Mountain Preserve*, 151 T.C. at 278).

[46] *Id.* at 1206.

[47] *Id.*

[48] *Id.*

[49] *Id.*

The Commissioner argued that even a limited reservation of development rights would violate the granted in perpetuity requirement because any removal, weakening, or diminishment of the overarching land use restriction would infringe on its perpetuity.[50] The Eleventh Circuit disagreed with the Commissioner's argument, viewing it as asserting that "every inch of land must be subject to the restriction in perpetuity."[51] First, the Eleventh Circuit contended that the plain meaning of the statute requires a single broad restriction over the use of the property, which the 2005 and 2006 easements provided by significantly restricting Pine Mountain's development rights over the property.[52] Second, the Eleventh Circuit looked to the common law meaning of "in perpetuity," rather than the Commissioner's formulation of that term.[53] Because Pine Mountain remained indefinitely subject to the restrictions and nothing in the grants would cause the easements to revert back to Pine Mountain, the 2005 and 2006 easements were held to be granted in perpetuity.[54]

The Eleventh Circuit further held that the Tax Court's reading of the granted in perpetuity requirement under the Swiss Cheese metaphor rendered the protected in perpetuity requirement superfluous.[55] Under the Tax Court's formulation, the entire conservation area (the slice) must be protected in perpetuity, and the landowner may not under any circumstances alter its reserved rights (the holes).[56] The Eleventh Circuit stated that this metaphor conflated the requirement to grant a restrictive easement with the requirement to protect a restrictive easement.[57] The granted in perpetuity condition requires that the landowner merely grant a restrictive easement and does not speak to whether such a restrictive easement is adequate in its protections, which is covered by the protected in perpetuity requirement.[58] To illustrate its point, the Eleventh Circuit offered its own cheese metaphor:

> We agree with Pine Mountain that the better cheese analogy is to Pepper Jack. Here, the reserved rights don't introduce holes into the conservation-easement slice, because the entire slice remains subject to "a restriction"—i.e., the conservation easement. Instead, the

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[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.* at 1207.
[56] *Id.*
[57] *Id.*
[58] *Id.*

> reserved rights are embedded pepper flakes, and, so long as they don't alter the actual boundaries of the easement, Section 170(h)(2)(C) is satisfied.[59]

Ultimately, the Eleventh Circuit ruled that the Tax Court's and Commissioner's challenges to the granted in perpetuity requirement posited whether the easement was sufficiently restrictive in offering adequate protection.[60] However, in the Eleventh Circuit's view, the question was not that of the easement's protective substance, but whether a restriction was imposed on Pine Mountain's parcel and whether that restriction was granted in perpetuity.[61]

The Eleventh Circuit also analyzed prior case law in reaching its decision.[62] In *Belk v. C.I.R.*,[63] invoked by the Commissioner, the United States Court of Appeals for the Fourth Circuit held that a restriction on real property was not perpetual because the boundaries of the conservation area could shift.[64] The Eleventh Circuit ruled *Belk* inapplicable because it concerned a scenario where a landowner could substitute land contiguous to a conservation area for an equal or lesser area of land within the conservation area.[65] This ability to transform the boundaries of a conservation area was easily distinguishable from Pine Mountain's easements that only allowed Building Areas to be moved within the fixed boundaries of the conservation area.[66] The Eleventh Circuit cited the Fifth Circuit's decision in *BC Ranch II v. C.I.R.*[67] that held that a conservation easement was granted in perpetuity even though the landowners retained rights to build homesites on select plots within the conservation easement upon receiving the donee-land trust's consent.[68] The Fifth Circuit's reasoning that relocation of buildings within an easement's boundaries that does not change the outer boundaries of the easement does not interfere with the granted in perpetuity requirement was echoed by the Eleventh Circuit in its reasoning.[69]

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[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *Id.* at 1207–08.
[63] 774 F.3d 221 (4th Cir. 2014).
[64] *Id.* at 226.
[65] *Pine Mountain*, 978 F.3d at 1207–08.
[66] *Id.*
[67] 867 F.3d 547 (5th Cir. 2017).
[68] *Pine Mountain*, 978 F.3d at 1208 (citing *BC Ranch*, 867 F.3d at 553).
[69] *Id.* (citing *BC Ranch*, 867 F.3d at 553).

Next, the Eleventh Circuit analyzed the Commissioner's contention that the 2007 easement violated the protected in perpetuity requirement due to the amendment clause.[70] The Commissioner argued that the amendment clause gave the parties an inordinate amount of discretion to change the terms of the easement, such that the conservation purposes of the easement were insufficiently protected.[71] Here, the Eleventh Circuit agreed with the Tax Court.[72] First, the Eleventh Circuit wholly rejected the Commissioner's equation of "'perpetuity' with inalienability, unreleasability, or unamendability" and re-iterated its earlier common law interpretation of "perpetuity" as a safeguard against reversion.[73] Second, the Eleventh Circuit drew on common law principles and the Uniform Conservation Easement Act[74] to argue that parties are always free to bilaterally amend contracts after the fact.[75] Under the Eleventh Circuit's formulation, "[i]f the possibility of amendment were a deal-killer, then there could be no such thing as a tax-deductible conservation easement."[76]

The final issue at hand was the Tax Court's valuation of the 2007 easement. In reconciling the parties' "wildly divergent" estimates of the 2007 easement's value, the Tax Court "split the baby" and arrived at a valuation that was almost the mathematical mean of the estimates.[77] The Eleventh Circuit disagreed with this approach, citing Treasury Regulations prescribing the valuation methodology for conservation easements.[78] Generally, the value of a conservation easement is its fair market value at the time of the contribution.[79] These Treasury Regulations determine the fair market value of a conservation easement by first looking to the sales price of comparable easements.[80] If no such comparable sales exist, then the Treasury Regulations adopt a "with or without" approach where the value of the easements is the difference between the value of the unencumbered property prior to the granting of the easement to the value of the encumbered property after the granting of the easement.[81] The Tax Court declined to use either of these

[70] *Id.* at 1209.

[71] *Id.*

[72] *Id.* at 1210.

[73] *Id.* at 1209.

[74] Ala. Code § 35-18-2 (1997).

[75] *Pine Mountain*, 978 F.3d at 1209–10.

[76] *Id.* at 1209.

[77] *Id.* at 1210.

[78] *Id.* at 1210–11 (quoting Treas. Reg. § 1.170A-14(h)(3)(i) (as amended in 1988).

[79] Treas. Reg. § 1.170A-14(h)(3)(i).

[80] *Pine Mountain*, 978 F.3d at 1211 (citing Treas. Reg. § 1.170A-14(h)(3)(i)).

[81] Treas. Reg. § 1.170A-14(h)(3)(i).

methodologies and instead justified its valuation by holding that the errors committed by each party's expert in over- and undervaluing the easement offset each other.[82] The Eleventh Circuit rejected the Tax Court's mathematical approach as inconsistent with the methodologies prescribed by the Treasury Regulations and remanded this portion of the analysis to the Tax Court for evaluation in line with the Treasury Regulations.[83]

The divergence between the Tax Court and the Eleventh Circuit's views of the granted in perpetuity requirement and the valuation methodologies applicable to contributions of conservation easements demonstrate that uncertainties still surround the gating statutory framework of the conservation easement regime. Given the delicate balance between the property rights surrendered and retained by property owners and the inherent difficulty of valuing intangible rights, the conservation easement arena is ripe for IRS attention and all parties understandably remain on high alert. While the court in *Pine Mountain* adopted a statutory approach in determining how conservation easements are granted and protected, new questions are likely to emerge as the field evolves to take into account landowners' development goals and the corresponding new formulations of retained rights. Perhaps next time, the applicable metaphor will be a funky Camembert rather than Swiss cheese.

II. MCKENNY V. UNITED STATES[84]

In *McKenny v. United States*, the Eleventh Circuit partially reversed a district court opinion and held that the appellants were not entitled to exclude from income the settlement payment they received from an accounting firm that advised them in a tax strategy that led to a $2.2 million tax liability.[85] The court also affirmed the district court's decision that taxpayers were not entitled to deductions for legal expenses or for the taxes they paid.[86]

Joseph McKenny, the appellant, worked as an independent consultant providing advisory services to car dealerships and hired Grant Thornton, an accounting firm, in the late 1990s to advise him on tax strategies. Grant Thornton recommended that McKenny structure his consulting business as an S corporation that would be wholly owned by an Employee Stock Ownership Plan (ESOP) with McKenny as the sole beneficiary. In

[82] *Pine Mountain*, 978 F.3d at 1211.
[83] *Id.* at 1211–12.
[84] 973 F.3d 1291 (11th Cir. 2020).
[85] *Id.* at 1303.
[86] *Id.* at 1298.

McKenny's understanding, this strategy would enable him to avoid corporate income tax as the income earned from the business would pass through the S corporation to the ESOP and to defer the taxes on proceeds from his consulting business. McKenny implemented the strategy in 2000 and filed joint tax returns with his wife, Ann McKenny, reflecting this treatment. For several years, the McKennys paid little or no federal income tax. In a 2005 audit, however, the Internal Revenue Service (IRS) determined that the McKennys underpaid their taxes, as the strategy was an unlawful and abusive tax shelter. In 2007, the McKennys settled their unpaid liabilities with the IRS, conceding all claimed tax benefits from the ESOP transactions and acknowledging that they owed unpaid taxes. They ultimately paid the full amount of the liabilities from the ESOP transactions, plus interest and penalties, in an aggregate of over $2.2 million. In 2008, they sued Grant Thornton for accounting malpractice in advising the ESOP transactions and for damages in the amount of their tax liabilities paid to the IRS. In 2009, Grant Thornton settled the suit for $800,000 but expressly denied all liability related to the tax advice it provided to the McKennys.[87]

Over the following three years, the McKennys deducted the legal fees paid in connection with the lawsuit against Grant Thornton, claimed an unreimbursed loss representing the difference between the settlement payment they received from Grant Thornton and the payment they made to the IRS, and excluded the Grant Thornton settlement payment from their gross income. In 2013, the IRS issued a notice of deficiency rejecting all these claimed deductions and exclusions. Specifically, the IRS recharacterized the legal expenses as a miscellaneous itemized deduction rather than a business deduction, disallowed the loss deduction, and denied the exclusion of the settlement payment. As a result, the McKennys owed additional taxes of over $800,000. They filed a refund claim against the government, and the district court ruled that the legal expenses were not deductible business expenses and that the McKennys could not claim unreimbursed loss from their settlement with the IRS because it was barred under the settlement agreement with the IRS. However, the district court found for the McKennys on the exclusion of settlement payment, deciding that the payment from Grant Thorton was a return of capital and therefore was excludible from gross income.[88]

On appeal, the relevant issues for the Eleventh Circuit's review were the same three issues presented before the district court: (1) whether the settlement payment to the IRS was deductible as unreimbursed loss; (2) whether the legal fees in the Grant Thornton litigation was deductible as

[87] *Id.* at 1293–95.
[88] *Id.* at 1295–96.

business expense; and (3) whether the settlement payment from Grant Thornton was excludible from the McKennys' gross income.[89] The first issue was relatively straightforward, as the IRS's closing agreements are typically interpreted under general principles of contract law and are binding on the parties.[90] The settlement agreement between the McKennys and the IRS made clear that the settlement payments were attributable to the disallowance of certain transactions, including "whatever actions . . . taken to attempt to establish an [ESOP] and a management S corporation," and it explicitly barred the McKennys from claiming "any other deductions and/or losses relating to the[se] [t]ransactions."[91] The Eleventh Circuit affirmed the district court's ruling and explained that it was indisputable that the McKennys' $2.2 million settlement payment to the IRS was related to the ESOP transactions.[92] It did not matter whether the $1.4 million loss[93] was due to Grant Thornton's failure to reimburse them, as the McKennys claimed.[94] Therefore, the settlement barred the McKennys' claimed deduction of this payment.[95]

On the second issue, as IRS determinations in a notice of deficiency are typically afforded a presumption of correctness, the McKennys had the burden to prove by a preponderance of evidence that the IRS was incorrect.[96] However, they failed to prove that the IRS's characterization of the litigation expense as a miscellaneous itemized deduction was wrong.[97] At the outset, it is important to note the difference between itemized deductions and business expense deductions. On the most basic terms, business expenses are "above the line" deductions, which means they are used to reduce one's gross income to arrive at the "adjusted gross income," whereas itemized deductions are "below the line" deductions

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[89] *Id.* at 1296.

[90] Ellinger v. United States, 470 F.3d 1325, 1336 (11th Cir. 2006) (citing United States v. Nat'l Steel Corp., 75 F.3d 1146, 1150 (7th Cir. 1996) (explaining that federal common law contract principles apply)).

[91] *McKenny*, 973 F.3d at 1298.

[92] *Id.*

[93] $1.4 million was the difference between the $2.2 million tax liability and the $800,000 settlement the McKennys received from the settlement with Grant Thornton. *Id.*

[94] *Id.*

[95] *Id.*

[96] *See* Welch v. Helvering, 290 U.S. 111, 115 (1933) ("[The IRS Commissioner's] ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong."); Carson v. United States, 560 F.2d 693, 695–96 (5th Cir. 1977) ("The burden and the presumption, which are for the most part but the opposite sides of a single coin, combine to require the taxpayer always to prove by a preponderance of the evidence that the Commissioner's determination was erroneous . . . .").

[97] *McKenny*, 973 F.3d at 1297–98.

and are subtracted from one's adjusted gross income.[98] Most itemized deductions are miscellaneous itemized deductions.[99] The key difference between the two types of deductions is that miscellaneous itemized deductions generally are subject to a "two-percent floor," meaning that a taxpayer may not take the deductions unless the aggregate of such deductions exceeds two percent of such taxpayer's adjusted gross income.[100] Business deductions include all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,"[101] which generally are not subject to the two-percent floor.[102]

As the Eleventh Circuit pointed out, for an expense to be deductible as a business expense, it must have a business origin and, in this case, whether litigation costs are deductible as a business expense depends on whether the claims in the litigation "arises in connection with the taxpayer's profit-seeking activities."[103] The McKennys argued that the legal fees are deductible as business expenses because their lawsuit against Grant Thornton was related to McKenny's business.[104] However, it is not enough for a legal claim to just be "related to" a business; the determinative factor is "the origin and character of the claim with respect to which an expense was incurred."[105] The circuit court did not dispute that the lawsuit against Grant Thornton was related to McKenny's business but emphasized that the inquiry concerned the character of the claim and its origin; it did not matter whether business considerations were a cause or even the proximate cause of the litigation.[106] Both the district court and the circuit court found that the litigation was personal in character and origin, as the lawsuit concerned the McKennys' personal tax liability, that is, the liability the McKennys had to pay to the IRS, allegedly as a result of Grant Thornton's failure to help them reduce their

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[98] *See generally* 26 U.S.C. §§ 62, 63, 161–224.

[99] *See* 26 U.S.C. § 67(b) for specific exceptions.

[100] 26 U.S.C. § 67(a).

[101] 26 U.S.C. § 162(a).

[102] *See* 26 U.S.C. §§ 62(a)(1), (a)(2), and 162.

[103] *McKenny*, 973 F.3d at 1297 (quoting United States v. Gilmore, 372 U.S. 39, 48 (1963)).

[104] *Id.*

[105] *Id.* (quoting *Gilmore*, 372 U.S. at 49) (emphasis omitted).

[106] *Id.* (citing In re Collins, 26 F.3d 116, 118–19 (11th Cir. 1994) (denying the taxpayer's deductions for legal expenses for litigation over the assets of a trust in which the taxpayer had no interest)); *see also* Jack's Maint. Contractors, Inc. v. Comm'r, 703 F.2d 154, 157 (5th Cir. 1987) (denying deduction for a corporation's payment of its sole shareholder's legal fees in a tax evasion case).

personal liability, not the tax liability of their income-producing activities.[107]

Finally, on the exclusion of the settlement payment, the McKennys also had the burden of proving both their entitlement to the exclusion and the amount of that exclusion by a preponderance of the evidence.[108] This is the issue over which the district court and circuit court disagreed.[109] The district court agreed with the McKennys and ruled that the settlement payment from Grant Thornton should be treated as a contribution to capital and therefore may be excluded from gross income.[110] The term "gross income" is broadly defined under the Code, which includes "all income from whatever source derived."[111] The McKennys relied on a 1939 Tax Court case, *Clark v. Commissioner*,[112] which held that a payment received from negligence of tax counsel constituted compensation for damages or loss caused by the error of tax counsel and was not includible in the taxpayer's gross income.[113] The McKennys believed that their situation was analogous to *Clark*, and therefore the settlement payment they received from Grant Thornton constituted a return of their capital that they lost due to Grant Thornton's malpractice.[114] This argument is also supported by certain academic articles.[115] The government, on the other hand, rejected this line of argument and instead relied on a different case, *Old Colony Trust Co. v. Commissioner*,[116] in which the Supreme Court of the United States held that a third party's payment of a taxpayer's tax liability is generally includible in the taxpayer's income.[117] The government argued that the present case more closely resembled *Old Colony Trust Co.* than *Clark*, reasoning that *Clark*: (1) was limited to situations where an accountant made a mistake in preparing a tax return or in advising the taxpayer on how to prepare the tax return; and (2) did not apply to settlements based

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[107] *Id.* at 1298.

[108] *Id.* at 1298–99.

[109] *Id.* at 1303.

[110] *Id.* at 1296.

[111] 26 U.S.C. § 61(a).

[112] 40 B.T.A. 333 (1939).

[113] *Id.* at 335.

[114] *McKenny*, 973 F.3d at 1299.

[115] *See generally* Robert W. Wood, *Tax Treatment of Business Litigation Recoveries – Capital Gain vs. Ordinary Income*, 99 J. TAX'N 27, 28 (2003) ("Where a recovery compensates a plaintiff for injuries to a capital asset, the recovery constitutes a tax-free return of capital to the extent of the taxpayer's basis in the injured asset.").

[116] 279 U.S. 716 (1929).

[117] *Id.* at 729 (explaining that the discharge of a taxpayer's tax obligation is equivalent to receipt of such payment by the taxpayer).

on claims that an accountant has committed malpractice advising on structuring transactions. In the government's view, the settlement payment would be regarded as a payment by Grant Thornton into the McKenny's tax liability, thus *Old Colony Trust Co.* should apply.[118]

It should be noted that although the IRS acquiesced to the *Clark* holding,[119] it has limited the application of *Clark* over the years. For example, through a series of private letter rulings in the 1990s, the IRS ruled that *Clark* does not apply to accountants committing malpractice or negligence with respect to advice for an underlying economic transaction that results in additional tax liability.[120] However, the Eleventh Circuit simply assumed that *Clark* applied to the present case and discussed only whether the McKennys met their burden to prove that the IRS was incorrect in its determination (which is given the presumption of correctness) and that the settlement payment was excludable from gross income.[121]

To prove that the settlement payment was excludable under *Clark*, the McKennys needed to show by a preponderance of evidence that the payment was compensation for damages or loss caused by Grant Thornton's accounting malpractice.[122] However, as the government argued, the McKennys merely listed a number of steps that Grant Thornton allegedly failed to take, but offered no "admissible evidence or credible means" to demonstrate that they were entitled to the benefits of the ESOP transactions, nor did they proffer any expert witness who could testify that the McKennys would have received those benefits had Grant Thornton performed differently.[123] The district court rejected the government's argument, explaining that the ESOP strategy was legal at the time Grant Thornton recommended it to McKenny, the government did not offer any basis for its argument that it might have denied approval for the ESOP strategy, and the McKennys suffered a loss as a result of the missed opportunity of properly implemented ESOP

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[118] *McKenny*, 973 F.3d at 1299–1300.

[119] *See* Rev. Rul. 57-47, 1957-1 C.B. 23.

[120] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 98-33-007 (May 13, 1998); I.R.S. Priv. Ltr. Rul. 97-43-035 (Jul. 28, 1997); I.R.S. Priv. Ltr. Rul. 97-43-034 (Oct. 24, 1997). *See also* Chief Counsel Advisory 201306018, 2013 WL 474551 (Feb. 8, 2013) (deciding that if accounting malpractice is "an alleged failure to provide accounting and tax advice that may have reduced" a taxpayer's tax liability, payment of damages by the accountant "does not constitute a non-taxable return of capital" and must be included in the taxpayer's gross income).

[121] *McKenny*, 973 F.3d at 1300.

[122] *Id.* at 1299.

[123] *Id.* at 1300–01.

strategy.[124] Thus, the settlement payment may be seen as an award of damages for such loss. However, this reasoning was disputed by the government and eventually rejected by the Eleventh Circuit on appeal; as they both pointed out, the district court accepted certain assumptions in the McKennys' favor.[125] For instance, the district court assumed that Grant Thornton did not properly file the documents necessary to register the company as an S corporation, but the IRS exam report showed that the S corporation elections were filed and accepted by the IRS, and the McKennys did not provide additional details as to how Grant Thornton failed to implement the tax strategy as they had advised or how a successfully implemented S corporation and ESOP strategies would have actually resulted in the McKennys paying no federal income taxes.[126]

Furthermore, as the Eleventh Circuit observed, the McKennys did not present any evidence concerning how the ESOP strategy would have operated.[127] In fact, as an interrogatory response showed, McKenny was unable to explain how the S corporation/ESOP structure worked, simply stating that had Grant Thornton performed its obligations, neither the McKennys, the S corporation, nor the ESOP would have incurred any federal income tax on the income earned by the S corporation.[128] The statement itself was conclusory, containing no explanation or details as to how the McKennys "arrived at their respective tax liability numbers" for the years at issue that were ultimately challenged by the IRS,[129] and lacked probative value.[130] In addition, because the McKennys did not submit or explain anything about how the ESOP would have or should have been structured, or the tax benefits the strategy would have provided, or showing that the Grant Thornton's failure to perform its obligations was the proximate cause of their tax liability, the McKennys did not meet their burden and overcome the presumption of the correctness of the IRS notice of deficiency.[131]

Even though the case was resolved without much fuss, the circuit court punted on an important question: was *Clark* correctly decided? The excludability of the settlement payment heavily revolves around the applicability of *Clark* holding, and the literature on *Clark*, albeit

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[124] *Id.* at 1301.

[125] *Id.*

[126] *Id.*

[127] *Id.* at 1303.

[128] *Id.* at 1302–03.

[129] *Id.*

[130] *Id.* at 1303; *see also* Evers v. General Motors Corp., 770 F.2d 984, 986–87 (11th Cir. 1985).

[131] *Id.*

generally supportive of the holding, has raised complex questions of tax law, such as "the equal treatment of taxpayers and questions about tax policy."[132] The Eleventh Circuit determined not to engage in these discussions, and it may be a while before we see another court addressing any of these issues. After all, other than the district court decision before it came before the Eleventh Circuit, "no Article III federal court ha[d] addressed or applied *Clark* in the [eighty-plus] years that it has been on the books."[133]

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[132] *Id.* at 1300; *see also, e.g.*, Lawrent Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income*, 46 TAX. L. REV. 381, 385–402 (1991); Jeffrey Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 HASTINGS L.J. 645, 665–76 (2006).

[133] *Id.*