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Are Recoveries for Losses Taxable? The Commissioner's Nonacquiescence in *Cosentino* Muddies the Waters

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The tax treatment of the recovery of losses is a common issue, as is the question of what constitutes a loss. The governing principles, not always clear to begin with, have been further muddied by the Commissioner's nonacquiescence in the 2014 Tax Court decision in Cosentino v. Commissioner, *a case involving an accounting firm's compensation of the Cosentinos for, among other things, additional federal income tax they had paid because of the firm's suspect advice. The Internal Revenue Service distinguishes* Cosentino *from the classic Board of Tax Appeals case* Clark v. Commissioner, *on which the Tax Court had relied in holding that the recovery of federal income tax paid wasn't taxable. This article discusses the tax treatment of losses and loss recoveries generally and examines both* Clark *and* Cosentino *in detail. The conclusion: The distinctions that the Service sees between those two cases are plausible in some respects, but not satisfying.*

Introduction

How the recovery of a loss is treated for tax purposes depends on the nature of the loss and the nature of the recovery. No general rule can apply in all situations. Life isn't simple.

Even within particular categories of losses and recoveries, the law can be unsettled in important respects. That's certainly true after the Commissioner's nonacquiescence in *Cosentino v. Commissioner*,[1] a 2014 Tax Court decision reported on in an earlier issue of the *Journal*.[2]

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[1] TC Memo. 2014-86, 2014 RIA TC Memo ¶ 2014-186. The announcement of the nonacquiescence is at 2016-16 IRB 581. The explanation for the nonacquiescence can be found in AOD (Action on Decision) 2016-01 (Apr. 18, 2016), available at 2016 TNT 65-18 (Apr. 5, 2016).

[2] See "Short Takes: Recent Developments of Interest to Investors," 32(3) J. Tax'n Invs. 67, 72–74 (Spring 2015).

The Cosentinos were compensated by an accounting firm for, among other things, their federal income tax liability arising from the disposition of a commercial rental property. The disposition was structured in a way that had been recommended by the firm but that was later determined to be an abusive tax shelter. Expecting a largely tax-free result from the transaction, the Cosentinos instead wound up with a big tax bill. They sued the accounting firm, claiming damages of over $640,000, and a settlement of $375,000 was agreed to. It was the treatment of the $375,000 payment to the Cosentinos that was at issue in the Tax Court case.

Before the Tax Court, the Cosentinos successfully argued that, to the extent the payment compensated them for additional federal income tax they had paid, the recovery wasn't taxable. The court—relying, in part, on the classic case of *Clark v. Commissioner*[3]—agreed: because the federal tax initially paid hadn't been deductible by the Cosentinos, any recovery of that tax was in effect a nontaxable return of capital or basis.

The Tax Court's acceptance of that argument wasn't crazy, but, through the nonacquiescence, the Internal Revenue Service has signaled that it will continue to take a contrary position in subsequent, similar disputes. This is an important development, reflecting strong disagreement between the Tax Court and the Service on some basic tax principles. In form, the Service accepts *Clark*, or so it says, but it interprets that case as having very limited scope. As far as the Service is concerned, an amount that compensates a taxpayer for a previously nondeductible loss will, in many cases, still have to be included in the taxpayer's gross income.

In addition, the Service continues to disagree with the Tax Court about another potential issue in a *Cosentino*-like dispute: whether any loss was incurred in the first place. In explaining the nonacquiescence, the Service contended, as it had before the Tax Court, that the Cosentinos had simply paid the tax due on a transaction in which they had willingly participated. Viewed in that way, the payment from the accounting firm wasn't compensation for a loss because there had been no loss. Rather, the payment was a windfall, the taxability of which shouldn't have been in doubt.

This article first provides a general discussion of the tax treatment of losses and the recovery of losses, and then describes what happened in *Cosentino*, and considers why *Clark* seemed to be reasonable authority for the result in *Cosentino*, why criticisms of *Clark* a few commentators have made aren't compelling, and how *Clark* is consistent with other authority that the Tax Court also relied on in *Cosentino*. It next describes the Service's rationale for the nonacquiescence in *Cosentino*, and argues that the Service's rationale, although plausible, is suspect. Finally, the conclusion explains

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[3] 40 BTA 333 (1939), acq. 1957-2 CB 4. See infra notes 32–40, 51–57 and accompanying text.

why, in applying the law, tax professionals need to understand both *Clark*, as the Tax Court interpreted that case in *Cosentino*, and the Commissioner's nonacquiescence in *Cosentino*.

Tax Treatment of Losses and Recoveries for Losses—The Basics

To set the stage for the discussion of *Cosentino*, this section describes some of the basic principles affecting the tax consequences of losses and recoveries for losses.

Losses. Losses from trades or businesses or other transactions entered into for profit are generally deductible under Section 165(a),[4] although the character of any deduction may still be an issue.[5] Personal losses are generally not deductible, with a few exceptions,[6] and even when an exception seems to apply, the deductions are severely limited.[7]

If there is insufficient income or gain in the current year to use otherwise deductible losses, net operating losses (generally the excess of deductions from trades or businesses of the taxpayer over the taxpayer's gross income[8]) and capital losses that can't be used currently may be carried over

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[4] See IRC §§ 165(a). The rules limiting the deductibility of losses for individuals don't restrict the deductibility of losses associated with businesses or other transactions entered into for profit. See IRC § 165(c)(1), (c)(2). The term "Section" in the article text refers to the Internal Revenue Code of 1986, as amended (the "Code") and regulations thereunder, unless specified otherwise.

[5] See, e.g., IRC § 165(f) (noting that deductibility of capital losses is limited by IRC §§ 1211 and 1212).

[6] See IRC §§ 165(a) (generally permitting a deduction for losses), 165(c) (setting out the circumstances in which an individual may deduct losses, including personal losses only "if such losses arise from fire, storm, shipwreck, or other casualty, or from theft"); 166(a), (d) (permitting the deductibility of bad debts, but treating the loss from a nonbusiness bad debt, including a personal bad debt, as a short-term capital loss); 183(b)(1) (generally permitting the deductibility of a loss from an activity not engaged in for profit to the extent of the gross income from the activity). The last citation may seem strange: IRC § 183 is generally seen as a *limitation* on deductibility of hobby losses. That's true, but by permitting a deduction up to the amount of gross income from the activity, which IRC § 183(b)(1) generally does, the section actually authorizes a deduction. If it weren't for IRC § 183, no deduction at all would be available for what is by definition a personal activity—an activity not engaged in for profit.

[7] Personal casualty and theft losses are deductible only to the extent each loss exceeds $100 and, in general, the aggregate of such losses exceeds 10 percent of adjusted gross income. See IRC § 165(h)(1), (2). In addition, any deduction would be an itemized deduction, of benefit only if and to the extent the taxpayer itemizes. A deduction under IRC § 183 is also an itemized deduction, and, worse, it is a miscellaneous itemized deduction (MID). MIDs may be taken only to the extent the MIDs, in the aggregate, exceed 2 percent of a taxpayer's adjusted gross income. See IRC § 67(a). Because of this threshold, many MIDs are effectively nondeductible.

[8] See IRC § 172(c). All sorts of technical provisions modify the general definition. See IRC § l72(d).

to other taxable years pursuant to rules set out in the Code.[9] Legitimate losses shouldn't disappear from the tax system just because the generally applicable annual accounting method may concentrate income in one year and deductions in another.[10]

One grand metaphysical debate over the years has had to do with what, if anything, distinguishes a potentially deductible "loss" from a potentially deductible "expense." Often the distinction doesn't matter; for example, whether something is treated as a loss from a trade or business deductible under Section 165(a) or an ordinary and necessary business expense deductible under Section 162 generally has no tax effect.[11] In any event, I'm going to ignore the distinction in most of the following discussion, except when I discuss whether the Cosentinos incurred any "loss."[12] I will generally use "loss" as an umbrella term to encompass both categories.

Recovery of Losses. Now the next step: if a taxpayer recovers the amount of a loss previously incurred, does that taxpayer have income attributable to the recovery? Maybe; it depends on what the recovery was for.

The Service suggested in *Cosentino* that the answer is a simple yes, unless there is clear, explicit authority to exclude the recovery.[13] Clear authority for exclusion might be found, for example, in Section 111, the so-called exclusionary tax benefit rule, under which a recovery for a previously deductible loss is excluded from gross income to the extent that the prior deduction

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[9] See IRC §§ 172(a) (providing for carryover of net operating losses, as defined in subsection (c)); 1212 (providing rules for capital loss carrybacks and carryovers).

[10] As I write these words, near the end (praise the Lord!) of the 2016 presidential campaign, a number of articles have appeared in the popular (and unpopular) press characterizing the carryover of net operating losses as a "loophole" in the Code. It isn't. (This isn't a partisan, political statement.)

[11] Whether IRC § 165 or IRC § 162 is controlling might still matter, however. An installment of "Short Takes: Recent Developments of Interest to Investors," to appear in our next issue, will discuss a case in which a taxpayer who had had to disgorge insider-trading profits argued that he had a loss deductible under IRC § 165, not a business expense governed by IRC § 162. This argument was apparently made to argue, plausibly but ultimately unsuccessfully, that public policy limitations on deductibility codified in IRC § 162 don't limit deductibility under IRC § 165. See Nacchio v. U.S., 824 F3d 1370 (Fed. Cir. 2016), rev'g 115 Fed. Cl. 195 (Ct. Fed. Cl. 2014).

[12] See infra notes 47–55 and accompanying text. It's possible to have a loss even if there's been no expenditure, which presumably is why both IRC § 165 and IRC § 162 are in the Code. For example, if the value of a business asset falls and the asset is sold at a loss, it's hard to see any arguable ordinary and necessary business expense. But there ought to be a deduction for a realized loss that is unquestionably business related, and IRC § 165 provides for that result.

[13] *Cosentino*, 2014 RIA TC Memo at 1311 (quoting notice of deficiency: "All awards received are taxable unless specifically excluded by law.").

didn't reduce tax liability.[14] Implicit in Section 111 is the idea that a recovery for a previously deductible loss or other item that *did* create a tax benefit—which did, that is, reduce taxable income and therefore tax due—is taxable.[15]

But it seems as though, even if there is no specific statutory provision on point, a recovery of what might be characterized as basis or capital—compensation for previously nondeductible losses or expenditures—generally ought to be tax-free as well. That was the result of the Board of Tax Appeals' decision in *Clark*.[16] I'll return to that point later in the article.[17]

Some situations are easy to analyze. A recovery for lost profits, which could include lost compensation for services, is generally taxable.[18] There's no arguable recovery of basis if the lost profits weren't already reflected in income. The recovery takes the place of income that would have been taxed anyway, and a taxpayer shouldn't have better tax results than would have been the case had no injury occurred.[19] One important exception to that generally applicable rule is found in Section 104(a)(2). In the case of a recovery attributable to a "personal physical injury or sickness," the full amount of the recovery (with two exceptions to this exception) is excluded from gross income,[20] and that includes any lost-income component of the recovery.

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[14] In general a reduction in tax liability results if the taxable income of the taxpayer is lowered because of the deduction. (The lower the taxable income, the less the tax due—hence the tax benefit.) If a deduction doesn't in fact reduce tax liability because, say, the taxpayer is already in a loss position, the deduction is still treated as having created a benefit if it contributes to a larger net operating (or other) loss that can be carried over to another year. See IRC § 111(c).

[15] The recovery would fit, that is, within the broad definition of "gross income" under IRC § 61(a), and no exclusion from gross income would apply.

[16] Supra note 3.

[17] See infra notes 30–45 and accompanying text.

[18] Cf. Comm'r v. Glenshaw Glass Co. v. Comm'r, 348 U.S. 426 (1955) (implicitly accepting the proposition that compensation for lost profits is taxable unless there is explicit statutory authority to the contrary).

[19] If you lose $100,000 of what would have been taxable income, and you recover the $100,000 but aren't taxed on the recovery, you would be better off, from a tax standpoint, than if no injury had occurred to begin with. (That statement is admittedly a bit over the top in that it ignores the psychic damage from the injury and the costs of recovering the amount of the loss.)

[20] IRC § 104(a)(2) provides that "gross income does not include . . . the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness." Punitive damages aren't eligible for the exclusion presumably because they're not compensatory. IRC § 104(a) also excepts from the exclusion "amounts attributable to (and not in excess of) deductions allowed under [S]ection 213 . . . for any prior taxable year." That is, a recovery of amounts that were deducted as medical expenses in an earlier year (taking into account the high threshold for deductibility under IRC § 213), and that reduced taxable income in that year, is included in income under the inclusionary tax benefit rule.

Congress has broad authority to determine what is taxable, and, as it has done in Section 104(a)(2), it can exclude from gross income amounts that would otherwise clearly be taxable. But the special treatment of lost income under that section is an exception, not the norm.[21]

Similarly, a windfall—a payment that, by definition, doesn't compensate for anything—should be treated as taxable, unless the transfer might be characterized as a gift excludable under Section 102 or as something else covered by a specific exclusion in the Code. No section excludes punitive (and other, similar damages) from gross income, however, and such damages are taxable to the recipient, regardless of the nature of the underlying claim.[22]

Except for the very long footnote below, I'm putting aside treatment of compensation for the involuntary conversion of property. Suffice it to say that the recovery, if it exceeds the taxpayer's basis in the property, will lead to a possible taxable gain, with relief available if certain steps are taken. If the recovery doesn't exceed basis, there's no gain and therefore nothing to be taxed. A loss on an involuntary conversion could arise, if at all, only to the extent the compensation is less than the basis of the converted property.[23]

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[21] A few other special sections exclude recoveries of lost profits, or what might be conceptualized as recoveries of lost profits, from gross income, but the interpretive rule here is clear: A recovery for lost profits is taxable unless Congress has specifically provided otherwise.

[22] That was a conclusion of *Glenshaw Glass*, supra note 18, and no Code section provides an exception to that principle. Punitive damages recovered in connection with a personal physical injury are specifically ineligible for exclusion despite the broad scope of IRC § 104(a)(2). See supra note 20.

[23] Suppose your property is involuntarily converted, and you're compensated for the conversion by an insurance company or a tortfeasor. If the amount of the compensation exceeds your basis in the converted property, you have realized gain—even though something has happened that you didn't intend to happen, and even if the amount of your compensation is less than the value of the converted property. (The appropriate comparison in determining whether gain is realized is between compensation and basis, not compensation and value.) If the amount of compensation is less than the value of the converted property, there's no potentially deductible loss unless the compensation is less than the basis of the property. For example, if your property is worth $50,000, but you receive only $40,000 on the conversion of the property, there's a loss for tax purposes only if the basis of the property is more than $40,000. If the basis is $35,000, gain has been realized even though the compensation is $10,000 less than value. See IRC § 1033(a)(2) (characterizing conversion of property into money as a generally taxable event). If, however, within a statutorily prescribed period you reinvest an amount at least equal to the proceeds from the conversion in property similar or related in service or use to the converted property, IRC 1033(a)(2) permits the taxpayer to elect to defer any realized gain. (The gain is deferred through a basis in the replacement property that is as many dollars less than cost as the unrecognized gain on the involuntary conversion. See IRC § 1033(b)(2).)

One way or the other, the controlling question in evaluating the tax treatment of any of these situations must be: What's the recovery for?[24] That's another way of asking the often controlling question in taxation: What's really going on?

Cosentino and Its Reliance on *Clark*

***Cosentino* in a Nutshell.** In *Cosentino,* the Tax Court concluded that amounts received by a couple in settlement of a claim against an accounting firm—arising from losses arguably attributable to the firm's advice to participate in what turned out to be an abusive tax shelter—were generally excludable from the couple's gross income. The exclusion wouldn't apply to the extent the settlement compensated for losses that the couple had deducted earlier (when the *inclusionary* tax benefit rule would apply[25]) and to the extent the amounts received didn't compensate for losses at all (if the settlement was a windfall). But otherwise, to the extent the recovery compensated the Cosentinos for what had been a nondeductible loss—and the payment of federal income taxes doesn't generate a deduction—the recovery wasn't taxable.[26]

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[24] Many old cases and rulings concluded that recoveries for particular nonphysical injuries weren't taxable because the recoveries weren't income at all. *Clark*, supra note 3, discussed later in the article, is such a case, involving what might be characterized as a recovery for legal malpractice. See infra notes 32–40, 51–57, and accompanying text. Other authority to that effect can be found, for example, governing recoveries for invasion of privacy or alienation of affections. In Rev. Rul. 74-77, 1974-1 CB 33, for example, dealing with a recovery for alienation of affections, the Service concluded that there was no income. Although IRC § 104(a)(2) at that time provided an exclusion for recoveries for all personal injuries, whether physical or nonphysical, the Service didn't seem to base its conclusion on the statute. There was just no income. That ruling became embarrassing to the government when, after the amendment to IRC § 104(a)(2) limited the exclusion to recoveries for *physical* injuries or sickness, the Service was litigating high-profile cases involving the taxability of recoveries for nonphysical injuries. The best known case involved a recovery by a whistleblower, with a D.C. Circuit panel reversing, on its own motion, an initial decision that the recovery was not income within the meaning of the Sixteenth Amendment. See Murphy v. IRS, 493 F3d 170 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008). See also Erik M. Jensen, "*Murphy v. Internal Revenue Service*, the Meaning of 'Income,' and Sky-Is-Falling Tax Commentary," 60 Case W. Res. L. Rev. 751 (2010) (describing the tangled history of *Murphy* and arguing that, despite the almost uniformly critical commentary, the D.C. Circuit panel may have been right the first time). Rev. Rul. 98-37, 1998-2 CB 133, rendered Rev. Rul. 74-77 obsolete, although no statutory or other change seemed to have undercut the rationale for that ruling. But the underlying issue remains in evaluating a recovery: Is the recovery even potentially gross income? If not, IRC § 104(a)(2), limiting the exclusion for recoveries to personal physical injuries, and all other exclusions from gross income are irrelevant. Exclusions are irrelevant if there's no income to begin with.

[25] See supra note 20 and accompanying text.

[26] The Tax Court apportioned the recovery, $375,000, across the various damages claimed by the Cosentinos, the total of which was $640,000. *Cosentino*, 2014 RIA TC Memo at 1317. As a result, only part of the recovery was deemed to have been attributable to the federal taxes paid.

The transaction recommended by the accounting firm, which was expected to be largely tax-free, involved two steps: increasing the basis in the Cosentinos' rental property in a tax-free way—largely through a basis-shifting strategy, the details of which aren't relevant to this discussion—and then exchanging the property, with its newly heightened basis, in a like-kind exchange with boot to be received.[27] In a like-kind exchange, any gain must be recognized to the extent of the boot.[28] But, if this transaction had worked, little gain would have been realized, and therefore recognized, because of the increased basis in the relinquished property.

That sounds terrific, maybe too good to be true, and the Service determined that the steps, when viewed together, constituted an abusive tax shelter. As a result, the basis in the relinquished property wasn't increased, the receipt of boot led to the recognition of a great deal of taxable gain, and the Cosentinos had a large, unexpected tax bill. They claimed, and the Tax Court accepted their claim, that had they known the transaction might be treated as an abusive tax shelter, they would have disposed of the property in a like-kind exchange without boot.[29]

The Holding in *Clark*. The Commissioner had argued in *Cosentino* that "all awards are taxable unless specifically excluded by law"[30]—an argument that is way too broad[31]—and that no specific exclusion applied to this recovery. (Certainly there was no plausible argument that the recovery was for a personal *physical* injury excludable under Section 104(a)(2) or a gift excludable under Section 102.)

The Tax Court concluded, however, that the Cosentinos' situation was indistinguishable from that of the taxpayers in *Clark v. Commissioner,*[32] a case once known to almost all law students,[33] where the Board of Tax Appeals held in 1939 that a nearly $20,000 recovery from a tax lawyer was excludable from a couple's gross income. (The figure was actually slightly under $20,000; I'm using the rounded-up figure to make the numbers easy.) The recovery compensated for a computational mistake made by the lawyer (lawyers shouldn't

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[27] The transaction was done through the Cosentinos' partnership, but that fact is also not relevant to the discussion of the treatment of the recovery.

[28] See IRC § 1031(b)(1).

[29] *Cosentino*, 2014 RIA TC Memo at 1307.

[30] Id. at 1311.

[31] At least it's way too broad unless "specifically excluded by law" is meant to pick up situations governed by case law, when there is no Code provision precisely on point. If the argument should be understood in that way, it comes close to being a tautology.

[32] Supra note 3.

[33] It's now known only to the three or four students in each law school who are still taking the basic federal income tax course.

be relied on for calculations) that led to the couple's making the wrong decision about whether to file separately or jointly. As a result, the Clarks paid $20,000 more in nondeductible federal income taxes than should have been necessary. The honorable tax lawyer (some redundancy there) compensated the Clarks for that loss.

Most (but not all) commentators think *Clark* was rightly decided even though no specific statutory exclusion applied; indeed, most think *Clark* was *clearly* rightly decided. The Clarks had lost a full $20,000 with no tax benefit arising from the loss because federal income taxes aren't deductible in computing federal taxable income.[34] The loss was therefore 20,000 after-tax dollars. If the Clarks were to be returned to the position they would have been in had the lawyer not made a mistake—that ought to be the goal—the $20,000 of compensation shouldn't have been taxable. The Clarks, that is, should have been left with $20,000 after taxes, and that would be true only if the recovery weren't taxable.[35] Put another way, the compensation was like a refund of overpaid federal income taxes, and such refunds are tax-free.

As noted earlier, a recovery of basis or capital ought to be excludable from gross income, even if no statutory exclusion explicitly applies.[36] And, with after-tax dollars replacing lost after-tax dollars, that's what effectively happened in *Clark*.

In contrast, had the compensated loss in *Clark* been attributable to extra *state* income tax paid because of the lawyer's mistake—as is the case now, state income taxes were then deductible in computing federal taxable income[37]—not taxing the recovery would have left the Clarks better off than if the lawyer had made no mistake. (State tax refunds are taxable to the extent that the refund is for amounts that did create a tax benefit in a prior taxable year. If the prior year's deduction had the effect of reducing your taxable

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[34] See IRC § 274.

[35] Run the numbers: If a $20,000 loss is nondeductible, you're out a full $20,000. If on recovering the $20,000 you have to recognize $20,000 of income, and have to pay tax on the recovery, you won't be made whole. (If you're taxed at a 40 percent rate, the tax bill would be $8,000, leaving you with only $12,000 after taxes.)

[36] See supra notes 16–17 and accompanying text.

[37] State income taxes were made deductible by the Revenue Act of 1913, ch. 16, 38 Stat. 114, 167, § II.B, the first tax statute enacted after ratification of the Sixteenth Amendment to the Constitution. State income taxes have been deductible ever since for purposes of the regular income tax. State taxes aren't deductible for purposes of computing alternative minimum taxable income, however, see IRC § 56(b)(1)(A)(ii), so it's possible, for particular taxpayers, that state income taxes won't be deductible. (The AMT didn't exist at the time of *Clark*. The world was nicer then.) And state income tax paid would today be an itemized deduction, of benefit for regular tax purposes only if a taxpayer itemizes. (The standard deduction and the concept of itemized deductions didn't exist when *Clark* was decided.)

income, you should have to include the amount recovered in income.[38]) But that isn't what happened in *Clark*.

Criticisms of *Clark*. *Clark* has come to be understood to mean that a recovery for a previously nondeductible loss or expenditure ought to be tax-free. The recovery is a return of basis or capital.

The few who think *Clark* was wrongly decided generally point to the fact that the income tax system is based on annual accounting: we make a determination at the end of each taxable year about the consequence of events that occurred in that year. (If a particular determination turns out to have been mistaken, appropriate adjustments are made later.) A loss and a recovery of that loss are arguably distinct events, and, critics say, the Clarks' recovery should have been analyzed on its own. Viewed that way, receipt of the $20,000 was a clear accession to wealth, regardless of what had happened in earlier taxable years. Compare the Clarks' position on December 31 in the year of recovery with what it had been on January 1, and their wealth had increased.

Treating a loss and a later receipt of value as distinct events may make sense when the connection between the two occurrences is tenuous or nonexistent,[39] but that wasn't the case in *Clark.* There was no doubt about the relationship between the loss and the compensation for the loss. When the dust had settled, the Clarks should have been in the same tax position as if no loss had occurred at all, and that was the Board of Tax Appeals' conclusion.

Another common criticism of *Clark* depends on a comparison of three hypothetical taxpayers: one who, as in *Clark*, is compensated for a nondeductible loss of $20,000 (call him Able); one who incurs the loss but isn't compensated and is thus out a full $20,000 (Baker); and one who has no loss to begin with (Charlie).[40] Given the result in *Clark*, Able, who is fully compensated and thus winds up in the same position as if no loss had been incurred, is treated the same as Charlie, who had no loss at all. That makes sense—indeed, it makes perfect sense—if Able and Charlie are the appropriate comparables. But if the appropriate comparison is to Baker, who incurred a real, nondeductible loss of $20,000, Able is $20,000 richer. If that's the right comparison, Able has had a significant accession to wealth. Why shouldn't it be taxed?

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[38] To that extent, the exclusionary tax benefit rule of IRC § 111(a) wouldn't apply, and no other theory for exclusion is relevant. Any taxable recovery would be taxed at the appropriate rate for the year of recovery, regardless of the tax rate applicable in the year of deduction.

[39] Put another way: If you ask what the "recovery" is for, and you don't have a good answer to that question, the receipt of value should be treated as a straightforward accession to wealth.

[40] With names and numbers changed, this example comes from Joseph Bankman et al., *Federal Income Taxation* 125 (16th ed. 2012).

That theoretical conundrum exists, but I'm not sure what to do about it. It's impossible, I think, to treat Able, Baker, and Charlie in ways that are consistent and intellectually satisfying. We must choose who should be compared to whom, and the argument that the decision in *Clark* restored the taxpayers to the status quo strikes me as reasonable. The result—that the recovery of what was a nondeductible loss shouldn't be taxed—is, if not obviously right, at least strongly defensible.

Other *Clark*-Like Authority. The *Clark* result—that recoveries for losses that weren't deductible are effectively returns of capital—didn't stand alone. As the Tax Court noted in *Cosentino*, accepting an argument advanced by the taxpayers, the result was supported by the 1994 decision in *Concord Instruments Corp. v. Commissioner.*[41] In *Concord Instruments*, the Tax Court concluded that a recovery from an attorney who failed to file a timely appeal on his client's behalf from an unfavorable Tax Court decision was excludable to the extent it didn't exceed the extra federal income tax the client wound up paying (i.e., the tax that wouldn't have been owed had a *successful* appeal taken place).[42]

The Tax Court in *Cosentino* also noted the existence of Revenue Ruling 57-47,[43] which held, on a set of hypothetical facts like those in *Clark*, that "no taxable income is derived from that part of the recovery received by the taxpayer which does not exceed the amount of [federal income] tax which she was required to pay because of the error made by her tax consultant, but that the remainder of the recovery must be included in gross income in computing her taxable income."[44] This revenue ruling probably shouldn't be treated as additional authority; basically the Service was announcing that, on *Clark*-like facts, it would accept the *Clark* result. And with the issuance of the 1957 revenue ruling, the Commissioner withdrew his nonacquiescence in *Clark*, which had been on the books for 18 years.[45]

The 18-year period made it clear the Service wasn't happy with *Clark*, and that unhappiness has continued. The Service routinely has tried to limit *Clark* to its particular facts. That is, if you have a set of facts exactly like those in *Clark*, the Service will leave you alone. But the Service seldom agrees that a new set of facts is sufficiently close to those of *Clark* to make a recovery nontaxable.

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[41] TC Memo. 1994-248, discussed in *Cosentino*, 2014 RIA TC Memo at 1313.

[42] The decision that was not appealed, but should have been, was *Concord Control, Inc., v. Comm'r*, 78 TC 742 (1982). The details are unnecessary for present purposes. All you need to know is that there was a plausible case to be made on appeal.

[43] 1957-1 CB 23, discussed in *Cosentino*, 2014 RIA TC Memo at 1313–1314.

[44] 1957-1 CB at 24.

[45] See 1957-1 CB 4. (The original nonacquiescence can be found at 1939-2 CB 45.)

Lest we forget, however, the Commissioner did acquiesce, albeit reluctantly, in *Clark*. The scope of that decision may be uncertain, but something arising from *Clark* is the law.

The Nonacquiescence in *Cosentino*

The Commissioner filed his nonacquiescence in *Cosentino*, and, in AOD (Action on Decision) 2016-01,[46] the Service provided reasons for the nonacquiescence. The Service is continuing the effort to cabin *Clark*, and the AOD stated that the Tax Court's reliance in *Cosentino* on *Clark* and *Concord Instruments* was misplaced.

As it had unsuccessfully argued in *Cosentino*, the Service said that, in *Clark* and *Concord Instruments*, taxpayers were reimbursed for federal income tax liability they shouldn't and wouldn't have incurred except for the mistakes of their tax advisors. In contrast, the Cosentinos had paid the proper amount of federal income tax attributable to transactions in which they had participated. Because the Cosentinos had suffered no loss, to the extent the accounting firm's payment was for federal taxes they legitimately owed, it was income. It was a clear accession to wealth, falling within the broad definition of gross income in Section 61, and to which no exclusion from gross income applied.[47]

The Cosentinos had said that, had they been well advised by the accounting firm, they would have entered into a different, non-abusive, tax-free transaction (or transactions—basically a series of tax-free like-kind exchanges over time,[48] deferring gain on each exchange until an ultimate, tax-free step-up in basis would occur under Section 1014 when the property then held was transferred as a result of death). Had they participated in an initial like-kind exchange without boot, there would have been no federal income tax liability.[49] The additional tax liability attributable to characterizing the actual transaction as an abusive tax shelter was thus a loss, the Cosentinos

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[46] Supra note 1.

[47] The Service might have cited, but didn't, the classic Supreme Court case *Old Colony Trust Co. v. Comm'r*, 279 U.S. 216 (1929), which held that an employer's payment of federal income taxes due on an employee's salary and commissions was itself income to the employee. *Old Colony* isn't exactly on point, in that Mr. Wood, the employee, clearly had income associated with the federal income taxes paid on the wages and commissions earned from his employer, American Woolen Co. The federal taxes paid constituted additional compensation for services. In *Cosentino*, in contrast, it would be difficult, if not impossible, to characterize the reimbursement of federal taxes as compensation for services.

[48] Governed by IRC § 1031(a)(1).

[49] In contrast, in *Old Colony Trust*, supra note 47, American Woolen Co. had paid the taxes due on wages and commissions that Mr. Wood had unquestionably earned. There was no doubt, that is, that federal tax dollars were due.

argued, a nondeductible loss attributable to bad advice from the firm. Recovery of such a loss should be tax-free, just as had been true in *Clark*.

The Service in effect rejected this "we would have done things differently" defense of the Cosentinos.[50] Said the Service, we don't know for sure what the Cosentinos would have done had events unfolded differently—how could we?—and, in any event, what's relevant is what actually happened. The tax liability was the Cosentinos', and someone else satisfied it. In *Clark*, in contrast, it was only because of the lawyer's mistake that the Clarks incurred additional federal income tax liability. And implicitly the Service accepted the idea that *Concord Instruments* presented a similar situation: it was only because of the lawyer's mistake, the failure to file a timely appeal, that the additional income tax liability arose for which compensation was later received.

As the AOD put it:

> When the artificially inflated basis was disregarded, the boot resulted in gain recognition from the exchange and the imposition of tax on that gain. Once this transaction was completed, no choices were available to the taxpayers to reduce this taxable gain. It was the facts of the transaction, and not a failure to make an election [as in *Clark*] or a failure to timely file an appeal [as in *Concord Instruments*], that caused the taxpayers to incur additional tax.
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> In light of the underlying gain recognition transaction, the amount of tax imposed was not more than what they properly owed on that transaction and, consequently, the taxpayers did not suffer a loss. To the contrary, because the taxpayers received the boot, and because they continued to receive the benefit of both the boot and the basis in the newly acquired real property even after the abusive tax shelter transaction was disregarded, taxpayers financially were in a better (not merely restored) position after the settlement than they were in before entering the transaction.

Why the Service's Position in the AOD Is Suspect

The Service's explanation of the nonacquiescence isn't mindless, but several points are worth making.[51]

For one thing, it's not clear the AOD properly characterized what happened in *Concord Instruments.* That case doesn't stand for the proposition that the taxpayer necessarily would have had a lower federal income tax liability if the advisor hadn't messed up (as had been true in *Clark*). Because of

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[50] The Service had earlier rejected such a claim in ILM 201307005 (Jan. 14, 2003).

[51] Whether *you* think the points are worth it is another question. Valuation is always a serious question in taxation.

the missed appeal, Concord Instruments lost the opportunity to get a definitive conclusion about the merits of its case. It might have won on appeal, it might have lost. We don't know for sure (although there is reason to think the company would have lost[52]), just as we don't know for sure what the Cosentinos would have done in different circumstances.

The compensation to Concord Instruments was for federal income tax liability that *might* not have arisen had no mistake been made. Whether or not Concord Instruments would have prevailed on appeal, however, the recovery was determined to have compensated the company for a tax payment that wasn't deductible. Recovery of basis or capital was the point of the case, and it was the point in *Clark* as well.

Of course *Cosentino* and *Clark* aren't identical. If you look hard enough, you can always find factual differences between two situations. The question, however, is whether the differences should matter for legal purposes. In both cases there were losses of after-tax dollars because no deduction was available, and to make the taxpayers whole the recovery had to be in after-tax dollars.[53] In *Cosentino*, the taxpayers paid extra federal income tax attributable to a transaction in which they wouldn't have participated if the advice had been good, or so they plausibly said, and they were compensated for those nondeductible taxes. And there was a settlement because the accounting firm effectively conceded that some significant damage, including unexpected federal income tax liability, resulted from the bad advice.

If you're making economic calculations to determine whether a possible transaction is worth doing and, because of poor advice, your assumptions about the nature of that transaction are mistaken, those mistaken assumptions are going to affect your analysis. If the mistakes are big enough, your decision will almost certainly be affected. That's Economics 101. Of course we can't be sure that the Cosentinos' decision would have changed if they had known the recommended transaction was an abusive tax shelter, but certainty isn't the standard. And it's hard, maybe even impossible, to imagine that sort of information wouldn't have affected the calculus in important ways.

In any event, the Tax Court in *Cosentino* found, as a matter of fact, that the Cosentinos would have disposed of the property in a tax-free way—basically through an initial like-kind exchange without boot—had they been well advised. They had disposed of other properties in similar ways in the past, and the tax consequences of the abusive tax shelter wasn't at all what they wanted.[54]

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[52] Given the tendency of federal appellate courts to defer to the Internal Revenue Service's interpretation of revenue statutes, and to defer to Tax Court decisions as well, the likelihood that the Commissioner would have prevailed on appeal is substantial.

[53] See supra note 35.

[54] *Cosentino*, 2014 RIA TC Memo at 1307, 1314–1315.

In a footnote in the AOD, the Service stated:

> In reaching its holding, the court considered the taxpayers' plan to use a lifetime series of tax-free exchanges, followed by a step up in basis at death, to permanently avoid paying taxes on the gain from these transactions. We disagree with the court's reliance on these facts. The taxpayers' ability to execute that tax planning strategy was purely speculative, and a change in the taxpayers' circumstances, or even a change to the provisions of the Internal Revenue Code, could have altered the strategy at any time.

That passage is incoherent. If those were the "facts," of course the Tax Court should have relied on them. What the Service must have meant is that those really weren't facts, that the Tax Court misunderstood what underlay its result in *Cosentino*.

The nonacquiescence thus depends for its force on a rejection of a factual finding made by the Tax Court, the trial court, a *specialized* court.[55] The Service is entitled to its own opinions; it's not entitled to its own facts. Of course we don't know for sure that any particular person will make good economic choices, but it's hard to imagine that the Cosentinos—or anyone else—wouldn't have been affected by tax advice from an accounting firm.

In *Clark*, the Clarks could have ignored the tax lawyer's advice too, I suppose. There was no choice about paying the extra $20,000 in taxes once the mistake had been made, but perhaps they could have caught the mistake on their own and avoided the loss. Should the $20,000 recovery therefore have been treated as a windfall? Not to my mind.

One final point is worth making in evaluating the nonacquiescence. In *Cosentino*, the Service emphasized that nothing in the Code specifically provided for an exclusion from gross income in *Cosentino*.[56] But no specific statutory exclusion applied in *Clark* or *Concord Instruments* either. By its terms, the exclusionary tax benefit rule of Section 111 wouldn't have applied in any of these cases. Section 111 says there's no income on the "recovery . . . of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter."[57] In *Clark* and *Concord Instruments*, however, as in *Cosentino*, there was no previously deductible amount because federal income taxes aren't deductible in computing federal taxable income. Section 111 is, by its terms, no more relevant to those cases than it is in *Cosentino*.

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[55] Of course, we don't know whether the law and circumstances might change in the future, but the critical issue should be whether an initial like-kind exchange would have been tax-free, and, with IRC § 1031 on the books, it would have been. What would happen in later years would be governed by the law in effect during those years.

[56] See supra note 30 and accompanying text.

[57] IRC § 111(a).

But surely Section 111 stands for a broader principle: recovery of a loss that, for whatever reason, didn't generate a tax benefit should be excludable from gross income. We don't need to be able to find a specific statutory exclusion from gross income if there's no gross income—no accession to wealth—to begin with. And that was true in *Cosentino,* just as it was in *Clark*: after-tax dollars should have replaced lost after-tax dollars.

Maybe we shouldn't characterize what happened to the Cosentinos as a loss—the Service has said we shouldn't—but it certainly seems like a loss to me. Call it what you will, the recovery was intended to compensate for a previously nondeductible expenditure. We shouldn't let a cramped definition of "loss" trump good sense, and *Cosentino* is grounded in good tax doctrine.

Conclusion

The argument in this article is that the result in *Cosentino* was correct, or at least strongly defensible, and that the Service got things wrong in AOD 2016-01. Whether or not I'm right about that, however, it's important to know the Service's position. The Service continues to take the position that *Clark* should be read narrowly—to have little or no application to situations that go beyond the case's particular facts. And the Service considers the facts in *Cosentino* to have been different, in a legally significant way, from those in *Clark*.

But it's also important to remember that, as much as the Commissioner might grumble, the Tax Court decided *Cosentino* as it did. So what's the law governing a situation like that in *Cosentino*? In a very important respect, it's *both* the nonacquiescence (as explained in the AOD) and the result in the case itself, as inconsistent as those two positions are. Both conclusions can't be "right" in any ultimate way, of course—intellectual purity is under challenge here—but, if and until the contradiction is eliminated, both constitute legal authority.[58]

We tax professionals understand this, even if we don't like it. We have to deal with many legal issues in which there is a conflict among circuit courts or, as is the case here, the Commissioner has filed his nonacquiescence in a judicial decision. When that happens, there is no generally applicable rule to be discerned from the case law. The law is sometimes, even often, messy. We have to live with it.

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[58] Unless the Internal Revenue Service is willing to budge, the contradiction isn't going to go away in the foreseeable future. Congress isn't going to act on a matter like this, and, given how much the justices hate tax law, the Supreme Court isn't going to agree to hear a case of this sort.