McKenny v. United States: Eleventh Circuit Clarifies the Deductibility of Litigation Fees and the Exclusion of an Unreimbursed Loss in a Federal Tax Return

Kate Belyayeva[*]

In *McKenny v. United States*, the U.S. Court of Appeals for the Eleventh Circuit addressed a question of first impression: whether the taxpayers' settlement with their accounting firm, whose negligence allegedly led to a $2 million overpayment in federal taxes to the government, constitutes taxable income.[1] The court also discussed whether the corresponding litigation fees and the difference between the settlements with the law firm and the IRS are deductible.[2] As to the issue of first impression, the court held that the taxpayers failed to meet their burden to prove that the settlement was excludable.[3] Further, although the firm's advice touched upon the structuring of the taxpayers' business, the income tax liability was personal in nature and origin.[4] Thus, the taxpayers could not deduct the litigation expenses as ordinary and necessary business expenses.[5] Finally, the taxpayers' settlement with the IRS barred any deduction of the unreimbursed loss.[6]

This case involved two taxpayers, Joseph and Amy McKenny, who sued their accounting firm.[7] Mr. McKenny, an independent consultant for car dealerships, hired Grant Thornton, an accounting firm, to assist him with tax strategy and preparation.[8] Grant Thornton advised Mr. McKenny to restructure his consulting business as an S corporation, where any income from the business would pass through to Mr. McKenny and thus avoid taxation at the corporate level.[9]

In 2000, following the firm's recommendation, Mr. McKenny became the sole owner of Joseph M. McKenny, Inc. ("JMM"), a newly structured S corporation, owned by an Employee Stock Ownership Plan

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[*] Junior Editor, *Cumberland Law Review,* Candidate for Juris Doctor, May 2022, Cumberland School of Law; B.S. Accounting, May 2019, Troy University.

[1] McKenny v. United States, 973 F.3d 1291 (11th Cir. 2020).

[2] *Id.*

[3] *Id.* at 1300.

[4] *Id.* at 1298.

[5] *Id.* at 1297–98.

[6] *Id.* at 1298.

[7] *McKenny*, 973 F.3d at 1293.

[8] *Id.*

[9] *Id.*; *see* 26 U.S.C. §§ 1362, 1366.

(“ESOP”).[10] Mr. McKenny was the sole beneficiary of JMM ESOP.[11] This structure would benefit Mr. McKenny because ESOPs are tax-exempt employee retirement plans, and, as a sole beneficiary, Mr. McKenny would be taxed on his contributions only when plan benefits are distributed.[12] As a result, any income from the consulting business “would pass through the S corporation without being subject to corporate income tax,” accumulating tax-free in the ESOP until it was distributed to Mr. McKenny.[13] Initially, the McKennys alleged that Grant Thornton improperly filed the S corporation election with the IRS and that the ESOP was not created or approved by the IRS as the parties discussed.[14] During the same year, the McKennys acquired a twenty-five percent interest in a Florida GMC dealership.[15] Just as Grant Thornton advised, this newly acquired stake was held in another S corporation that was also owned by JMM ESOP.[16] According to Grant Thornton, any payments the couple received from the dealership would be “characterized as management fees rather than a share of profits.”[17]

The McKennys paid little to no federal income tax on their joint tax returns after Grant Thornton’s strategy was implemented in 2000.[18] However, during a tax audit in 2005, the IRS discovered that the McKennys underpaid their federal income taxes between 2000 and 2005 and also had unpaid liabilities regarding the consulting business.[19] The IRS characterized the GMC scheme as an “unlawful and abusive tax shelter.”[20]

In 2007, the McKennys settled the dispute with the IRS.[21] Pursuant to the settlement agreement, the taxpayers agreed to pay the full amount of the ESOP liabilities and admitted to the unpaid taxes resulting from the

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10 *McKenny*, 973 F.3d at 1294.
11 *Id.*
12 *Id.*; *see* 26 U.S.C. § 402(a).
13 *McKenny*, 973 F.3d at 1294.
14 *Id.* The IRS admitted that Grant Thornton filed an S corporation election but stated that there was no admissible evidence as to the improper formation of the ESOP. *Id.* at 1294 n.1. The court found the parties’ dispute on this issue to be immaterial in the appeal. *Id.*
15 *Id.* at 1294.
16 *Id.*
17 *McKenny*, 973 F.3d at 1294.
18 *Id.*
19 *Id.*
20 *Id.* The McKennys claimed that the tax strategy “could have been lawful for at least some of the relevant period” if Grant Thornton had properly established the ESOP. *Id.* at 1294 n.2. The government did not dispute that this strategy could be lawful only until 2004 when federal legislation made it unlawful. *Id.* (citing Econ. Growth & Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 656 (2001)).
21 *McKenny*, 973 F.3d at 1295.

consulting business and the GMC dealership.[22] Ultimately, they paid $2,235,429 in income taxes, interest, and penalties.[23] In 2008, the McKennys sued Grant Thornton in state court on multiple claims for the unpaid tax liabilities during the five years in question.[24] A year later, although Grant Thornton denied all claims, the firm settled the suit and paid $800,000 to the McKennys.[25]

On their 2009 federal tax return, the McKennys deducted $419,490 in legal fees as to the malpractice litigation, claimed an unreimbursed loss reflecting the difference between the settlement figures with Grant Thornton and the IRS, and excluded the $800,000 settlement with Grant Thornton from their taxable income.[26] These deductions and exclusions led to net operating losses, which they carried forward in 2010 and 2011.[27] According to the IRS's deficiency notice, the legal fees were a miscellaneous itemized deduction rather than a business deduction.[28] In addition, the IRS disallowed the loss deduction and denied the exclusion of the settlement payment.[29] The proposed adjustments amounted to $813,407 in taxes.[30] The McKennys filed a refund claim for the entire amount.[31]

The IRS denied the 2009 claim, mistakenly issued a refund for the 2010 claim, and did not respond to the 2011 claim at the time of the suit.[32] In 2016, the McKennys sued the government for $586,000, the combined amount of the 2009 and 2011 disallowed exclusions and deductions.[33] Both parties filed cross–motions for summary judgment, which the district court granted in part and denied in part for both parties.[34] The United States District Court for the Middle District of Florida agreed with the IRS's conclusion that the legal fees were not deductible because the taxpayers sued the accounting

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[22] *Id.*
[23] *Id.*
[24] *Id.* The claims included accounting malpractice, breach of contract, breach of fiduciary duty, and violations of the Missouri Merchandising Practices Act. *Id.* at 1295 n.3.
[25] *Id.* at 1295.
[26] *McKenny*, 973 F.3d at 1295.
[27] *Id.*
[28] *Id.* This recharacterization of the legal fees meant that the expenses "were deductible only to the extent that they exceeded two percent of the McKennys' adjusted gross income." *Id.* *See also* 26 U.S.C. § 67.
[29] *McKenny*, 973 F.3d at 1295.
[30] *Id.* at 1295–96.
[31] *Id.* at 1296.
[32] *Id.*; *see also id.* at 1296 n.4.
[33] *Id.* at 1296.
[34] McKenny v. United States, Civ. No. 2:16-536-FtM-PAM-MRM, 2018 WL 481867, at *1 (M.D. Fla. Jan. 2, 2018).

firm in their individual capacity, not as business representatives.[35] Further, the district court found the deductibility of any ESOP losses to be barred by the 2007 settlement with the IRS.[36] The district court, however, sided with the McKennys on the third issue and held that the $800,000 settlement with Grant Thornton was a return of capital and thus not taxable income.[37] Neither party found the district court's decision satisfactory and appealed to the Eleventh Circuit.[38]

Reviewing the district court's findings *de novo*, the Eleventh Circuit reconsidered all three disputed deductions and exclusions.[39] The court acknowledged that "determinations in a notice of deficiency are entitled to a presumption of correctness, and as a result[,] the burden is on the taxpayer to prove by a preponderance of the evidence that they are incorrect."[40] In addition, the taxpayer has the burden to prove the amount of refund he is entitled to receive.[41]

First, the court affirmed the district court's judgment as to the deduction of legal fees from the Grant Thornton lawsuit.[42] The Tax Code allows deductions for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[43] To be deductible, expenses must be of "'business origin.'"[44] The classification of litigation expenses as personal or business depends on "'whether . . . the claim arises in connection with the taxpayer's profit-seeking activities.'"[45] Although the court considered Grant Thornton's advice to be "at least indirectly related" to Mr. McKenny's business, mere relation is not enough.[46] Citing the Eleventh Circuit's prior holdings regarding litigation expenses, the court emphasized that "the inquiry concerns 'the *character* of the claim and its *origin*'" rather than whether business considerations caused the litigation.[47] In this case, the litigation between the taxpayers and the accounting firm was "personal in its character and origin" because the lawsuit

[35] *Id.* at *2.
[36] *Id.* at *3.
[37] *Id.*
[38] *McKenny*, 973 F.3d at 1296.
[39] *Id.*
[40] *Id.* (citation omitted).
[41] *Id.*
[42] *Id.* at 1298.
[43] *Id.* at 1297.
[44] *McKenny*, 973 F.3d at 1297 (quoting United States v. Gilmore, 372 U.S. 39, 45 (1963)).
[45] *Id.* (quoting *Gilmore*, 372 U.S. at 48).
[46] *Id.*
[47] *Id.* (citing *In re* Collins, 26 F.3d 116, 118 (11th Cir. 1994)).

was regarding the McKennys' personal tax liability, not business tax liability.[48]

Second, addressing the approximately $1.4 million difference in the settlements with Grant Thornton and the IRS, the court agreed with the district court again and upheld the bar on the deductibility of any losses from the ESOP transactions.[49] The IRS is authorized to enter into written settlement agreements that are "'final and conclusive'" and are "'binding on the parties who enter into them.'"[50] In 2007, the McKennys entered into an agreement with the IRS, which specifically barred them from claiming "any other deductions and/or losses relating to" the ESOP transactions.[51] The court denied the McKennys' argument that the $1.4 million loss was not related to the ESOP transactions because "th[is] payment was made to settle the tax liability resulting from those transactions."[52] Subsequently, the court held that the settlement barred the McKennys from deducting the $2.2 million settlement itself or any fraction thereof.[53]

Third, the court reversed the district court's finding as to the $800,000 Grant Thornton settlement because the McKennys failed to meet their burden to prove that the settlement was excludable from their gross income.[54] The Tax Code states that "gross income" is a broad definition encompassing "'all income from whatever source derived.'"[55] To determine whether a settlement of a taxpayer's claim is taxable income, courts must consider "[i]n lieu of what were the damages awarded?"[56] The McKennys cited *Clark v. Commissioner* for the premise that compensation for damages "caused by a third party's negligence in the preparation of a tax return" was not to be included in gross income and maintained that the settlement was a return of capital.[57] Even though the IRS and a few Tax Court decisions "acquiesced in the *Clark* ruling,"[58] such acquiescence is not equivalent to the IRS's unequivocal acceptance of the rule in all future cases.[59] The IRS countered

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[48] *Id.* at 1298.
[49] *Id.*
[50] *McKenny,* 973 F.3d at 1298 (quoting 26 U.S.C. § 7121(b); Ellinger v. United States, 470 F.3d 1325, 1336 (11th Cir. 2006)).
[51] *Id.* (citation omitted).
[52] *Id.*
[53] *Id.*
[54] *Id.* at 1300.
[55] *Id.* at 1299 (quoting 26 U.S.C. § 61).
[56] *McKenny*, 973 F.2d at 1299 (citations omitted).
[57] *Id.* (citing Clark v. Commissioner, 40 B.T.A. 333, 335 (1939)).
[58] *Id.*
[59] *Id.* at 1299 n.5.

the *Clark* rule with a holding in *Old Colony Trust Co. v. Commissioner*, which states that "a third party's payment of a taxpayer's tax liability is generally included in gross income, regardless of the form of th[e] payment."[60] The government asserted that *Clark* did not apply to the facts and circumstances in this case.[61]

Next, the court questioned the correctness of the *Clark* decision and acknowledged the difficulty of this rule's application to this case.[62] Citing a myriad of Private Letter Rulings,[63] the court refused to decide "these difficult questions" and went on to assume that *Clark* was correctly decided.[64] Thus, the court applied the *Clark* ruling to the case at hand and determined that the McKennys failed to sustain their burden and that the $800,000 was excludable.[65] The McKennys "listed a number of steps" that the accounting firm allegedly failed to take and included "numerous factual and legal assumptions . . . ."[66] Whereas the district court accepted all the allegations as true, the Eleventh Circuit found that the unfounded assertions failed to meet the taxpayers' burden to "prove their refund claim by a preponderance of the evidence . . . ."[67]

Although there is no bright-line rule as to necessary or sufficient evidence, the court viewed the claim about the legality of ESOPs until 2004 as insufficient.[68] In addition, the court agreed with the government that the McKennys' summary judgment assertions were not supported by any admissible or probative evidence, and, "absent a stipulation or agreement, unsupported factual statements in a memorandum of law do not constitute evidence under Rule 56."[69] Furthermore, Mr. McKenny's own declaration was insufficient, and his conclusory interrogatory response contradicted the taxpayers' motion for summary judgment.[70] The court was unable to pinpoint

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[60] *Id.* at 1299 (citing Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929)).
[61] *Id.*
[62] *McKenny*, 973 F.3d at 1300 ("[T]he literature on *Clark*, though generally supportive of its holding, raises a number of complex questions of tax law (including issues about the equal treatment of taxpayers and questions about tax policy).").
[63] "Private letter rulings do not have the force of law and are not binding." *Id.* at 1299 n.6.
[64] *Id.* at 1300.
[65] *Id.*
[66] *Id.* at 1301.
[67] *Id.*
[68] *McKenny*, 973 F.3d at 1301. The S/ESOP strategy was disallowed on December 31, 2004; thus, it could not have provided the McKennys any tax benefits in 2005. *Id.* at 1302.
[69] *Id.* at 1302.
[70] *Id.* at 1302–03. In his declaration, Mr. McKenny stated that he was unable to explain how the ESOP structure worked. *Id.* at 1302. The interrogatory response stated that the McKennys would have paid taxes in 2003–2005. *Id.* at 1303. Yet, in the motion for

any evidence showing how "the [ESOP] strategy would have actually operated on the ground,"[71] nor did they provide an expert opinion on the matter.[72] As such, the McKennys failed to "meet their twin burdens of showing their entitlement to the exclusion and the amount of that exclusion."[73]

In conclusion, the Eleventh Circuit affirmed the district court's summary judgment in favor of the government on the litigation fees and the $1.4 million deduction issues and reversed the district court's holding as to the $800,000 settlement exclusion from the taxable income.[74] Taxpayers are likely to see *McKenny* as the baseline for determining the business or personal nature of litigation expenses as well as the deductibility of a settlement with the IRS. Overall, this decision will help taxpayers assess their own tax liability in subsequent taxable periods. Although the Eleventh Circuit refused to create a binding decision regarding the issues raised in *Clark*, the opinion's discussion of the dilemmas associated with this case may be a foreshadowing of decisions to come that could result in additional guidance should the court decide to distinguish *Clark* in the future.

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summary judgment, the McKennys claimed that "no taxes would have been due had Grant Thornton implemented the S/ESOP strategy." *McKenny*, 973 F.3d at 1303.

[71] *Id.*

[72] *Id.* The court urged that it made no suggestion that taxpayers must employ an expert in a refund case but rather sought to point out the absence of such evidence in this case. *Id.* at 1303 n.7.

[73] *Id.* at 1303.

[74] *Id.*