

IRS tax on legal settlement agreement?

Watch your wording.

By Robert W. Wood

How legal settlements are taxed often surprises people, including many plaintiffs. Most things are taxed, but there is often flexibility, and what you say matters. Even legal malpractice settlements are usually taxed, and there has been a spate of recent tax cases. The latest is *Carol Holliday v. Commissioner*, T.C. Memo. 2021-69 on the heels of several other recent cases. In *McKenny v. United States*, No. 18-10810 (11th Cir. 2020), *aff'g in part, rev'g in part*, and remanding No. 2:16-cv-00536 (M.D. Fla. 2018), an accounting firm was sued for allegedly bad tax advice that caused the taxpayer to pay more in taxes. McKenny's recovery from his accountants was held to be taxable.

In *Blum v. Commissioner*, T.C. Memo. 2021-18, a woman sued her lawyer for botching her personal physical injury suit. Ms. Blum was really trying to get her lawyer to pay money that she had failed to collect for her physical injuries because of the malpractice. Even so, her malpractice recovery was held to be taxable. However, the adverse result might be attributed to the badly written settlement agreement.

The newest case, *Holliday*, is about a legal malpractice case that arose out of a divorce.

After a divorce decree, Ms. Holliday's divorce attorney filed a motion for a new trial trying to get her the \$74,864 she was shorted in the community property. A new trial was denied, and Ms. Holliday's divorce attorney said that he would appeal, but he failed to timely appeal.

Ms. Holliday sued for malpractice, and it settled. The settlement agreement contained the usual no admission of fault, and the payment language was neutral, for all claims.

Ms. Holliday's lawyer received \$175,000, with which he paid himself his \$73,500 fee, sending her \$101,500. She didn't report it as income, but she did disclose the net settlement on her return, trying to explain away the Form 1099 she received.

The IRS said the entire \$175,000 settlement was income, with a itemized deduction of \$73,500 for the fees. Ms. Holliday claimed that the settlement proceeds were a nontaxable return of capital she should have gotten in the divorce. It was just her own money she was getting back, she argued. After all, a property settlement in a divorce is clearly nontaxable. This malpractice settlement was merely a substitute for it.

Generally, the taxpayer bears the burden of proving that IRS determinations are wrong, and the Tax Court applied that tough standard. When a plaintiff's recovery is income, that includes the contingent legal fees. See *Commissioner v. Banks*, 543 U.S. 426, 430 (2005). But should this money to replace a part of a divorce property settlement income in the first place?

Whether a settlement payment represents a recovery of capital depends on the nature of the claims. Yet the settlement agreement *itself* is often the most important factor. Ms. Holliday's settlement agreement said that the settlement proceeds were in lieu of damages for legal malpractice. But she could not convince the Tax Court that this settlement was a

substitute for money that would not have been taxed. The court pointed to the wording of the settlement agreement for release of all claims.

In fact, the IRS and the Tax Court myopically focused on the settlement agreement itself. Settlement agreement wording cannot make a silk purse out of a sow's ear. But *Holliday* serves as another painful reminder that settlement agreement wording is *terribly* important, perhaps more important than anything else. The wording in *Holliday* said the settlement money was for claims for legal malpractice.

On the *Holliday* facts, the wording ideally would have been: "the settlement amount is paid to reimburse Holliday for additional nontaxable property settlement she would have received in the underlying divorce case." When a plaintiff cannot get the settlement agreement wording that he, she, or it wants, what is to be done?

There is no easy answer. Not all plaintiffs are able to get tax advice when their case is settling. Their lawyers and the other side may be pushing them relentlessly to sign the settlement agreement. Plaintiffs do not have guns to their heads, but they may sometimes feel as though they do. 'You can sort out the taxes later,' is a common refrain.

Even if there is a tax adviser on the scene, not every defendant rolls over and give plaintiffs the language they want. The defendant may perceive that the plaintiff wants wording that will help on taxes, and the defendant may not agree out of spite. Alternatively, the defendant may have principled objections to the requested language, thinking it does not fairly represent the claims or is flat wrong.

The defendant may fear tax risks, including Form 1099 reporting penalties, failure to withhold liability, etc. Even before the settlement agreement is signed, the defendant may say it is too late to raise tax issues. For example, suppose that a term sheet for the settlement is signed at mediation that calls for a more comprehensive settlement agreement within two weeks.

The term sheet may say that in the event a more fulsome settlement agreement is not signed, the term sheet itself is binding. That can give the defendant a trump card if the plaintiff and defendant cannot agree on tax wording in a comprehensive settlement agreement. Of course, many plaintiffs do not ask for good tax language, and even if they do, they may not be able to get it.

It is not always possible for a plaintiff to hold out forever. Some settlement agreements—many in fact—are not going to be terribly helpful in fixing the tax treatment. That means tax advice post settlement, and many of those circumstances can work out fine, despite the grim result in the *Holliday* case. However, when you have the chance, don't pass up an opportunity to try to optimize the tax language in every settlement agreement.