Legal Malpractice Settlement Tax Worries

by Robert W. Wood

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In this article, Wood uses tax malpractice cases as a jumping-off point to examine a broader class of legal malpractice recoveries.

This discussion is not legal advice.

Every plaintiff thinks about taxes. Most defendants do too, although they worry far less about them than most plaintiffs do. Ideally, of course, plaintiffs hope to pay no taxes on their recoveries. At most, many plaintiffs are (grudgingly) willing to pay taxes on their *net* recoveries, after legal fees and costs. However, no plaintiff is willing to pay taxes on their gross recovery, even though changes made by the Tax Cuts and Jobs Act can make deducting attorney fees seem next to impossible in some cases. On that point, I bet there are going to be some interesting cases in the coming years about the tax treatment of legal fees.

For decades, the tax treatment of legal settlements and judgments has generated volumes of authority. There are very few tax code sections at play, but there are plenty of tax cases. That can make for rather *ad hoc* resolutions of these issues, and there are frequent tax disputes. That is especially true with the section 104 exclusion for personal physical injury damages. However, there are many other bones of contention, including capital versus ordinary income disputes.

Settlement agreement wording is terribly important, although it does not tell the whole story, nor does it bind the IRS. Despite a treasure trove of tax cases dealing with these issues, there are not many tidbits about the tax treatment of legal malpractice recoveries. One notable exception relates to tax malpractice cases (malpractice by tax lawyers, accountants, and tax return preparers), a point addressed later.

In any event, there was an important recent case in this area — *McKenney*.[1] I recently wrote about its effect on tax malpractice cases,[2] and I will not repeat that discussion here. Instead, I want to use it as a jumping-off point for a broader class of legal malpractice recoveries, even if there is very little authority to go on.

Compared with 10 or 15 years ago, today's tax treatment of litigation payments and recoveries receives significant attention. Even so, there is a paucity of authority concerning the tax aspects of legal malpractice recoveries. Given the importance of the tax issues and the prevalence of legal malpractice claims, I find this surprising. Indeed, it is hard to think of a type of legal recovery that has generated less authority and guidance.

When a legal malpractice case settles or proceeds to judgment, there are inevitably tax issues, however infrequently they may be discussed in the tax literature. Is the recovery taxable? If so, is it ordinary income, capital gain, basis recovery, or some combination of these? Although the tax issues should bubble to the

[1] *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).

[2] *See* Robert W. Wood, "Malpractice Settlement Is Taxable, Not Nontaxed Capital: What Went Wrong?" *Tax Notes Federal*, Oct. 5, 2020, p. 103.

surface quickly, and there seems to be no shortage of legal malpractice cases and recoveries, there is little authority spelling out how those recoveries are taxed.

As noted, virtually all the authority concerning these tax issues has arisen in *tax* malpractice actions. These are cases in which a plaintiff recovers against his attorney or accountant for poor tax advice. Perhaps in tax malpractice cases there is understandably more focus on tax issues from the start of the case, and so there is a corresponding degree of focus on taxes at the case's conclusion.

In general, these authorities suggest that when the plaintiff has not been enriched, but has merely been put back in the position he would have occupied were it not for the malpractice, there may be no income to the plaintiff. However, that is probably an overly broad statement, and one that is often disproven in practice. Indeed, as the *McKenney*[3] case shows, getting to a no-tax tax result is the exception rather than the rule. Persuading the IRS and the courts *not* to tax payments can be difficult, and planning that you *will* be taxed on any recovery would be a safer assumption.

I. Origin of the Claim

A fundamental precept of the tax law is that recoveries in litigation are taxed according to the origin and nature of the underlying claim. Thus, if an underlying recovery in litigation would be excludable from income under section 104 (for personal physical injuries or physical sickness), a legal malpractice recovery based on that underlying cause of action should arguably also be excludable.

Under the origin of the claim doctrine, a recovery of amounts sought in a malpractice action that would have been excludable if recovered in the underlying personal injury case should arguably be similarly excludable from income. However, I have yet to find a case or ruling that says exactly this. Of course, this exclusion would not apply to amounts received in the same malpractice action that are attributable to punitive damages.

[3] *McKenney*, No. 18-10810, discussed in Wood, *id*.

For example, suppose that, because of negligence by the plaintiff's attorney, punitive damages were not awarded in the underlying personal injury action, and a legal malpractice recovery in effect represents a substitute for those punitive damages.

If there was a punitive element in the underlying case, the IRS may argue that a resolution of the malpractice case should have tax-free and taxable portions.

II. Range of Legal Malpractice

Lawyers do many different things. Therefore, the potential scope of legal malpractice cases is about as big as legal practice itself. Legal malpractice claims arise out of wills and trusts, litigation, intellectual property, corporate transactions, real estate deals, the legal handling of medical malpractice claims, and many other situations. In fact, the list is almost endless.

Some cases involve relatively simple acts or failures to act, such as the lawyer missing a statute of limitations, or an affirmative misstep on some issue, such as the lawyer recording a lien against the wrong parcel of property. Although tax issues must come up for every successful plaintiff, there is little authority spelling out how legal malpractice recoveries are taxed. Most of the authority has arisen in tax malpractice actions, in which a plaintiff recovers against his attorney or accountant for poor tax advice.

Fortunately for lawyers, of course, malpractice claims do not happen every day. That means that legal recoveries arising out of malpractice cases do not either, nor do the ensuing tax questions about those recoveries. Still, tax questions do come up, and more frequently than one might assume, especially in a few specific cases. I will doubtless omit some likely candidates here, but I want to posit some examples and suggest how I think they should be taxed.

III. Examples

A. Personal Physical Injuries

Paula Plaintiff is injured in a car accident and retains Alan Ambulance Chaser to represent her against the other driver and his insurance company. Alan fails to file suit before the statute of limitations runs, so Paula pursues him instead and recovers for legal malpractice.

B. Medical Malpractice

Mary goes in for a routine medical procedure, but the doctor botches it, leaving Mary physically injured and emotionally distressed. Mary goes to Larry Lawyer, who fails to file suit before the statute of limitations runs. Eventually Mary recovers from Larry for legal malpractice.

C. Divorce

Tim and Tanya get divorced, and Tim's lawyer Larry assures Tim that his interest in his startup is his separate property and safe from division. Instead, Tanya ends up with half the stock. Tim sues Larry and eventually recovers.

D. Estate Planning

Victor and Vera go to Larry Lawyer for estate planning. Larry prepares and helps them execute a will and trust, which are later ruled to be defective. As a result, their estate must be probated, which costs more, takes more time, and is public. Or perhaps a defect means that Victor and Vera's intended beneficiaries do not inherit, and they sue Larry. There are many variations of estate planning problems, and it is hard to even list them all, much less consider their tax treatment.

E. Corporate, Real Estate, and IP

Larry Lawyer fouls up a real estate transaction, corporate transaction, patent filing, etc. Clive Client sues to recover what he should have gotten with a competent corporate, real estate, or patent lawyer.

F. General Litigation

Perry Plaintiff hires Larry Lawyer to sue for something, and Perry would have recovered but for Larry Lawyer's malpractice. Perry sues Larry and eventually recovers.

G. Others

There are doubtless many other instances of legal malpractice, but I will use this short sampling to consider the tax treatment of recoveries.

IV. Origin of the Claim

The origin of a plaintiff's claim controls the tax treatment of a recovery.[4] To determine the origin of the claim, courts and the IRS ask in lieu of what a recovery was paid.[5] Not surprisingly, the IRS views settlements and judgments as ordinary income, unless the taxpayer carries the burden of proving otherwise. The IRS generally views the complaint as the most persuasive evidence of the origin of the claim.

That overriding rule suggests that the plaintiff recoveries in these situations should be taxed according to the item the plaintiff *would have* received but for the attorney's malpractice. That, after all, is what the origin of the claim doctrine is all about. It is just a little bit more attenuated in a legal malpractice case, but the same principles should apply.

V. Personal Physical Injuries

Paula's case may be the easiest to resolve. She was physically injured in a car accident, but her lawyer drops the ball. In the end, Paula recovers from her lawyer, not from the person who injured her. Section 104(a) excludes from gross income compensatory damages received on account of personal physical injuries or physical sickness.

Thus, if Paula does not receive any interest or punitive damages, her entire recovery should be excludable. Is the origin of Paula's claim the malpractice or the underlying personal injury? Surely one should look through the malpractice claim to determine the proper tax treatment. The lawyer's payment makes Paula whole again — it is compensation Paula should and would have received for her injuries from the driver of the car but for the negligence of the lawyer.

[4] *See United States v. Gilmore*, 372 U.S. 39, 49 (1963); and *Hort v. Commissioner*, 313 U.S. 28 (1941).

[5] *See Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944); and LTR 200108029.

It should not matter whether the claim for malpractice sounds in tort or contract under state law.[6] It also should not matter who is paying Paula — the driver, the driver's insurer, Larry, or Larry's malpractice insurer. Third parties get roped in and pay (or contribute to paying) in any number of contexts.

The analysis becomes more complex if Paula recovers punitive damages on top of compensatory damages. *O'Gilvie*[7] holds that punitive damages are always taxable, and this was confirmed in the 1996 statutory change to section 104. Thus, if there are punitive damages, they should be taxable. Interest may be an issue too.

Say Paula would have been paid $100,000 by the driver but sues Larry for missing the statute of limitations. Paula later collects $100,000 from Larry, plus $20,000 for several years' delay. The IRS would say the latter is taxable.

VI. Medical Malpractice

The result for Mary should be the same as for Paula. The medical malpractice case is merely another kind of personal physical injury action. When Mary recovers, it may be for legal malpractice, but it is really for the underlying medical malpractice. A different party pays, but that should not matter to the tax result.

VII. Divorce

As with estate planning matters, divorce malpractice cases can be varied and messy. In the example, Tim and Tanya get divorced, and Tim's lawyer Larry assures Tim that his interest in his startup is his separate property and safe from division. Instead, Tanya ends up with half the stock. Tim sues Larry and eventually recovers.

This one arguably ought not to be taxable if Tim had sufficient basis in his startup stock to absorb the settlement from Larry. As a practical matter, that "if" is unlikely, and Tim's basis in his startup shares may even be zero. Much like in a construction defect or investment loss case, Tim might reduce his basis by the amount of the recovery from Larry. That is better than having to take it into income.

Assuming that Tim has a negligible basis, the settlement money is taxable. Indeed, even if Tim has a sufficient basis in his shares, isn't what has happened a sale or exchange? Tim started out with a block of stock and ended up with only half of it. Then he receives money from his lawyer to compensate him for the stock.

That sounds taxable, although Tim can argue it is capital gain. If the stock is qualified small business stock, could Tim argue this was a sale?[8] Perhaps, because he is getting proceeds, albeit from someone who really didn't end up with the stock. As these ruminations show, it is complex.

Divorce tax rules changed fundamentally in 2019, after the one-year delay in the effect of the TCJA provisions. Under current tax law, one cannot argue that the alimony in a divorce was supposed to be tax deductible by the payor. But there are some past cases on this very issue. In *Harlin, Parker, & Rudloff*,[9] the taxpayer was barred from bringing a malpractice suit against her former divorce attorney because the statute of limitations had run.

However, the facts present an interesting issue. Mrs. Graham hired an attorney to represent her in her divorce. Her attorney drafted the divorce decree to state that the former husband would pay "$500 per month toward the support of the family." This monthly payment was intended by both parties as child support, although the language used in the decree (that is, "support of the family") was determined to be ambiguous between alimony and child support. The IRS later audited Mrs. Graham and said the $500 monthly payments were alimony.

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[6] *See* reg. section 1.104-1(c)(1) (Jan. 23, 2012) (eliminating the phrase "tort or tort type rights"); *see also* reg. section 1.104-1(c)(1) comment ("The tort-type rights test was intended to distinguish damages for personal injuries from, for example, damages for breach of contract. Since that time, however, *Commissioner v. Schleier*, 515 U.S. 323 (1995), has interpreted the statutory 'on account of' test to exclude only damages directly linked to 'personal injuries or sickness.' Further, under the 1996 Act, only damages for personal physical injuries or physical sickness are excludable. These legislative and judicial developments have eliminated the need to base the section 104(a)(2) exclusion on tort cause of action and remedy concepts.").

[7] *O'Gilvie v. United States*, 519 U.S. 79 (1996).

[8] *See* Wood, "Can Founder Legal Settlements Be Tax Free or Tax Deferred?" *Tax Notes*, Oct. 17, 2016, p. 451.

[9] *Graham v. Harlin, Parker, & Rudloff*, 664 S.W.2d 945 (Ky. Ct. App. 1984), *overruled by Alagia, Day, Trautwein & Smith v. Broadbent*, 882 S.W.2d 121 (Ky. 1994).

At the time, alimony was income to the recipient and deductible by the payor. Trying to avoid tax assessments, the parties to the divorce received a court order amending the divorce decree so that the $500 monthly payments were "for child support of the infant children." However, the Tax Court held the payments to be alimony, taxable to Mrs. Graham. Mrs. Graham sued her attorney, claiming that his ambiguous drafting caused her additional tax on the monthly payments.

The court found that her malpractice suit was barred, so she did not recover. However, if she had won, her recovery would probably have been taxable. As discussed in my recent article on tax malpractice[10] and *McKenney*, the IRS attempted to limit nontaxable recoveries to cases in which taxpayers pay more than their proper minimum federal income tax liability based on the underlying transaction.

That is, *McKenney* distinguished between several kinds of errors. First, there were pure reporting errors that cause taxpayers to report owing more than they would have owed if their reporting had been prepared correctly. Then, there were errors with structuring and documenting transactions in a tax inefficient manner — errors that result in the taxpayer legitimately owing more tax.

Here, Mrs. Graham would have paid her proper minimum federal tax liability, because the $500 monthly payments were characterized as alimony. Because the malpractice recovery would have compensated her for tax she legitimately owed based on the underlying transaction and its documentation (rather than mere errors in reporting), she might have to include the malpractice recovery in income even though the payments were intended to be child support.

VIII. Will Contests

Although all legal disciplines are subject to malpractice actions, estate planning presents unique issues. Malpractice claims against estate planners often come from a beneficiary instead of the client or the client's estate. An error by the attorney may cause a third-party beneficiary to be excluded or cause him to pay tax on an asset received from the estate.

An example of this unique twist on malpractice claims, and the leading case on will contest recoveries, is *Getty*.[11] Here, a third-party beneficiary sued to recover amounts he thought were owed to him under his father's estate plan. Although this case discusses the tax treatment of the settlement between the third-party beneficiary and the remainderman of the estate, it presents a basis for discussing malpractice issues.

Ronald Getty, one of J. Paul Getty's sons, sued the trustees of the J. Paul Getty Museum, which was the largest beneficiary of the estate. The suit sought additional inheritance that Ronald believed was due him, and the museum settled for $10 million. The tax issue was whether the $10 million settlement was taxable income to Ronald or could be excluded under section 102(a) as a gift, bequest, devise, or inheritance.

Ronald's mother was J. Paul Getty's third wife. The marriage lasted only four years. J. Paul Getty remarried and had two additional children. Because of bad relations with his third wife, J. Paul Getty executed a codicil to his will reducing Ronald's inheritance. About the time he executed the codicil, J. Paul Getty and his mother (Ronald's grandmother) established a trust to which each contributed significant assets. The trust instrument provided that income from the trust would be paid to J. Paul Getty over his lifetime, and then to his children over their lifetimes.

The trust was to terminate upon the death of J. Paul Getty's last surviving child. However, the allocation of income to his children was set up so that Ronald received significantly less than his half-siblings. Six years after the trust was established, it was discovered that the trust did not contain irrevocability language, which was necessary to ensure that the corpus would not be included in the grandmother's estate upon her death.

The grandmother's attorneys drafted a letter to J. Paul Getty stating that it had been her intention for the trust to be irrevocable. A legal proceeding was brought to modify the trust. In representing her son (Ronald) as guardian ad

[10] *See* Wood, *supra* note 2.

[11] *Getty v. Commissioner*, 913 F.2d 1486 (9th Cir. 1990).

litem, J. Paul Getty's third wife found out about the unequal treatment of her son. J. Paul Getty assured his third wife that the inequality would be cured if she signed the requisite documents. J. Paul Getty reiterated his intent to equalize the income allocations several years later in conversations he had with Ronald, who was then an adult.

J. Paul Getty died in 1976, leaving an estate valued at approximately $760 million. He left amounts to each of his children, but the residue to the trustees of the museum. At his death, the trust held $1.3 billion (32 million shares of Getty Oil), which generated millions in dividends each year. After his death, all the income was distributed among the children, but Ronald received a disproportionately small amount.

Ronald sued, seeking to impose a constructive trust on the assets the museum received and on income derived therefrom. In 1980 the museum and Ronald settled for $10 million, which Ronald excluded from his income. The IRS argued that the $10 million should be treated as income from property, taxable under section 102(b)(2). However, the Ninth Circuit found that Ronald did not seek income, but instead sought equalization with the other children, so the payment was excludable.

A malpractice case could yield a less favorable tax result. Assume that J. Paul Getty wanted to amend the trust agreement (or his will) to eliminate the inequality. Also, assume that his intent was clearly established in the record, but that for some reason, the estate planning attorney did not make the necessary changes, so the inequality was not eliminated. J. Paul Getty then dies.

A beneficiary in Ronald's position could assert a malpractice claim against the drafting attorney alleging that the attorney was negligent and the testator's intent was clear. As a result of the malpractice, an intended beneficiary could be prevented from receiving a significant portion of an inheritance he was intended to receive. If the intended beneficiary prevails in the malpractice action and collects $10 million — the amount he would have received had the estate plan been correctly drafted — should the recovery be included in the beneficiary's gross income?

As long as the beneficiary is being placed in the same position he would have been in but for the negligence of the attorney, it should not be income. Yet *Getty* suggests that in a will contest setting, or in a legal malpractice action arising out of a bungled estate plan, it will matter whether the recovery makes up for a stream of income or an asset. When the recovery is for a stream of income, being put in the same position you would have been might also include paying the income tax you would have owed on the income stream.

IX. Corporate, Real Estate, IP

This is a big group, one that is hard to summarize, and the facts will obviously matter. Some recoveries in cases in this arena will be ordinary income, some will be capital gain, and perhaps some will be basis recovery. Some will fall into the familiar territory of tax malpractice discussed in my recent article about *McKenney*. For example, *Garlow*[12] considers a suit for bad advice about a section 1031 exchange. It is not a tax case, but provides fodder for discussion.

Once again, IRS private letter rulings suggest that a malpractice recovery would be taxed. Yet the taxpayer could argue that but for the accountant's error, the property transaction would have qualified under section 1031 and would have been nontaxable. As *Getty* shows, a creatively and properly worded complaint can affect whether the amount received is determined to be excludable from gross income. Yet few litigants are thinking about tax issues when they draft their complaint.

X. Patent Infringement

Getting capital gain treatment for intellectual property recoveries is possible in some cases. That issue can feed into malpractice cases too. It could help the capital gain point to allege that the malpractice action is based on the loss of the patent as an asset, rather than the loss of royalty income. An action based on damages regarding royalties would likely result in ordinary income. Of course, the plaintiff is unlikely to be thinking about taxes until much later.

[12] *Mills v. Garlow*, 768 P.2d 554 (Wyo. 1989).

However, some recoveries are capital despite their arguable origin in a stream of royalty payments. A stream of royalties may just be a measuring device, and the value of the patent itself may really be what is at stake. That argument worked in the taxpayer's favor recently in *NCA Argyle LP*.[13] If a recovery in a patent case may be taxed either as ordinary income or capital gain, the same should be true of a legal malpractice recovery for a patent attorney's malpractice.

XI. General Litigation

People sue each other for all manner of things. Perhaps that is one reason the number of tax cases about how recoveries ought to be taxed is so large. The origin of the claim doctrine tries to address that, and it should still do it in the follow-on malpractice case that makes up for a flub. Still, there is no question that everything is more attenuated.

In direct litigation, you want helpful settlement agreement wording that assists your tax position. In resolving malpractice litigation, you want the same thing, but one step removed. Therefore, language and intent of the payor issues are going to make you more uneasy.

I wonder how the *McKenney* distinction might be applied to errors in drafting settlement agreements, or to complaints in general litigation malpractice suits. For example, suppose that a plaintiff has reasonable claims for physical injuries, but the litigating attorney does not emphasize them in the complaint, instead emphasizing taxable recoveries such as emotional distress or lost profits. Those taxable claims might be easier to quantify or win, so the lawyer does not pursue the physical injury claims in court.

Then at settlement time, the lawyer drafts the settlement agreement with language that implies that the recovery should be primarily or entirely allocated to taxable recoveries. What happens if the plaintiff sues the attorney for not doing enough to produce a more tax-efficient recovery? *McKenney* suggests that any malpractice recovery would be taxable — that is, the error here is not in the tax reporting itself, but in the underlying structure and documents.

A plaintiff in this situation arguably paid the tax they actually owed based on the claims pursued in the complaint and in litigation and based on the language in the settlement agreement. As *McKenney* re-enunciates, being compensated for tax you actually owe is generally taxable income, even if you could have owed less with better advice and documentation.

XII. Conclusions

It is difficult to predict the tax treatment of legal malpractice recoveries. Very little authority exists. Not only that, but what authority there is seems to involve only tax matters, in a way that is hardly consistent or satisfying. These tax-centric cases and rulings seem to turn on artificial distinctions rather than basic principles.

The origin of the claim doctrine should be the center of analysis for the tax treatment of malpractice recoveries. A cleverly crafted complaint might make all the difference, as might have proven true had the *Getty* case been a malpractice action. In some cases, however, magic language may not be enough to change an unfortunate outcome. As I said recently while discussing *McKenny*, *Clark* is still a valid authority, but the IRS cuts back its reach every chance it has. That should cause taxpayers and advisers facing significant tax issues in malpractice recoveries to do so carefully. ■

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[13] *NCA Argyle LP v. Commissioner*, T.C. Memo. 2020-56. For discussion, see Wood, "Legal Settlements as Capital Gain: A Playbook to Avoid Ordinary Income," *Tax Notes Federal*, Sept. 28, 2020, p. 2407.