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In this article, Wood reviews recent cases on the tax treatment of legal malpractice recoveries.

Yet another tax case has been decided about the tax treatment of legal malpractice recoveries. After only sparce authorities over the years, the spate of recent decisions is notable. The latest is *Holliday*,[1] and it came on the heels of several other recent cases. In *McKenny*,[2] an accounting firm was sued for allegedly bad tax advice that caused the taxpayer to pay more in taxes.[3] Joseph McKenny's recovery from his accountants was ultimately held to be taxable.

In *Blum*,[4] a woman sued her lawyer for allegedly botching her personal physical injury suit. As a practical matter, it appeared that Debra Blum was really trying to get her lawyer to pay her money that she had failed to collect for her physical injuries because of the alleged malpractice. Even so, her malpractice recovery was held to be taxable.[5] However, the adverse result might be attributed to the settlement agreement itself, arguably the most inartful one ever written.

The *Blum* settlement agreement expressly said that the settlement payment was *not* for her underlying physical injuries. The newest case, *Holliday*, is about a legal malpractice case that arose out of a divorce case. It may not be as widely read as *McKenny* or *Blum*, but in some ways, it is more important and more nuanced. And it has a similarly negative holding.

Divorce

In March 2010 Carol Holliday's spouse filed for divorce. There were legal proceedings in 2012 and a final divorce decree. Her divorce attorney filed a motion for a new trial and stated that she received $74,864 less than her equal share of the community property. A new trial was denied, and Holliday's divorce attorney said that he would appeal, but he failed to timely appeal.

Holliday sued for malpractice, asserting claims for negligence, gross negligence, breach of fiduciary duty, and so on. The suit sought damages for "pecuniary and compensatory losses," including "damages for past and future mental anguish, suffering, stress, anxiety, humiliation, and loss of ability to enjoy life" as well as punitive damages and disgorgement of the attorney's fees she paid in the divorce proceeding that resulted from the malpractice.

In 2014 Holliday and the divorce lawyer settled. The settlement agreement contained the usual no admission of fault or liability language that is common to many settlements. The payment

[1] *Holliday v. Commissioner*, T.C. Memo. 2021-69.

[2] *McKenny v. United States*, 973 F.3d 1291 (11th Cir. 2020), *aff'g in part, rev'g in part, and remanding* No. 2:16-cv-00536 (M.D. Fla. 2018).

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

[4] *Blum v. Commissioner*, T.C. Memo. 2021-18.

[5] *See* Wood, "Legal Settlement Tax Worries (Revisited)," *Tax Notes Federal*, Apr. 19, 2021, p. 443.

provision was also rather general, stating that the $175,000 was "in consideration for the mutual promises and obligations set forth in this Release." There was global release language about all damages of whatever kind or character.

Holliday received the $175,000, from which she paid her malpractice attorney's $73,500 fee. Mechanically, the malpractice attorney received the gross settlement, deducted his fee, and sent the remaining $101,500 to his client. On her 2014 tax return, Holliday listed other income of zero. She did, however, acknowledge the receipt of $101,500 through an attached Form 1099-MISC Summary and a "Line 21 Statement" on which she reported "Other Income from Box 3 of 1099-Misc" of $101,500. The Line 21 Statement then subtracted $101,500 with the description "Misclassification of Lawsuit recovery of marital assets," leaving other income of zero.

This reporting, it should be noted, was far better than what occurred in Blum's case of the malpractice settlement against her personal injury lawyer. Blum also received a Form 1099, but she ignored it, making no reference to the Form 1099 on her return. I said recently that had she reported the Form 1099 and then excluded the amount on her return, she might well have avoided an audit.[6]

However, *Holliday* proves that audits still sometimes occur despite attempts to explain a Form 1099. Holliday could have done a better job with her explanation and exclusion, but she had the basic idea down, and her heart was in the right place. Even so, the IRS eventually said that the $175,000 settlement should have been reported as gross income, with a miscellaneous itemized deduction of $73,500 for the fees.

Facing off against the IRS, Holliday claimed that the settlement proceeds were a nontaxable return of capital. The settlement compensated her for the portion of the marital estate she was entitled to but didn't receive because of her lawyer's legal malpractice. In short, it was just her own money she was getting back, she argued. That arguably should have carried the day.

After all, a property settlement in a divorce is clearly nontaxable. Moreover, this malpractice settlement was merely a substitute for it. This is an appealing argument, and one that sounds right on the substance. Yet the IRS said that the money compensated her for the alleged failings of her divorce attorney and were gross income.

Heavy Burden

Who must prove what is always a table-setting issue. Generally, the taxpayer bears the burden of proving that IRS determinations are erroneous, and the Tax Court said that applied to this fateful ruling. The legal fee issue was easy. Generally, when a plaintiff's recovery constitutes income, that includes the portion paid to the attorney as a contingent fee.[7]

But should that money replace part of divorce property settlement income in the first place? The Tax Court agreed that a recovery of capital generally isn't income, but is that what this was? Whether a settlement payment represents a recovery of capital depends on the nature of the claims. So far, so good. Indeed, the Tax Court helpfully noted that it had held that "an amount paid to a taxpayer in order to compensate the taxpayer for a loss that the taxpayer suffered because of the erroneous advice of the taxpayer's tax consultant generally is a return of capital and is not includible in the taxpayer's income."[8]

Why shouldn't that helpful ruling apply here? To determine if a settlement represents lost profit or lost value, the court noted that the origin and nature of the claims are important, as is the language of the settlement agreement. If the settlement agreement is unclear on such points, other facts that might reveal the payor's intent can be important. That might include items such as the amount paid, evidence adduced at trial, and the factual circumstances that led to the agreement.

Yet the settlement agreement *itself* is often the most important factor. In *Holliday* as in *Blum*, the settlement agreement was unhelpful. In fact, Holliday's settlement agreement said that the settlement proceeds were in lieu of damages for legal malpractice. Holliday argued that the settlement proceeds directly related to the marital

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[6] *Id.*

[7] *Commissioner v. Banks*, 543 U.S. 426, 430 (2005).

[8] *Cosentino v. Commissioner*, T.C. Memo. 2014-186, at *31; *see also Clark v. Commissioner*, 40 B.T.A. 333, 335 (1939); and *Concord Instruments Corp. v. Commissioner*, T.C. Memo. 1994-248, at *24-*25.

estate. Indeed, they represent compensation for lost value or capital that she rightfully should have received from her divorce as her share of the marital estate.

That sounded appealing and seemed to match the facts nicely. But one could say the same thing about the malpractice claim in *Blum*. Many an observer after the *Blum* case noted that the facts seemed to dictate that the ensuing legal malpractice recovery should be tax free. However, in *Holliday* as in *Blum*, the Tax Court wasn't persuaded.

To be sure, the wording of the settlement agreement in *Holliday* wasn't as big a disaster as was the wording in *Blum*. In *Blum*, the settlement agreement expressly said that the settlement was for alleged malpractice and then went on to say expressly that the money was *not* for personal physical injuries. But the settlement agreement wording in *Holliday* was still enough to tip the scales in favor of the IRS.

Holliday was unable to persuade the Tax Court that this settlement money was purely a substitute for money that would not have been taxed. The court pointed to the wording of the settlement agreement. The settlement proceeds were for the release of all claims against the lawyers in the malpractice case. Holliday sensibly pointed to the major claim she had — that the lawyer failed to file the appeal that would have netted her additional property claim dollars.

But the Tax Court declined to look beyond the plain terms of the settlement agreement.

The IRS and the Tax Court myopically focused on the settlement agreement itself. That surely doesn't mean that a settlement agreement in an antitrust case could successfully attribute the damages to personal physical injuries. 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. When a plaintiff cannot get the settlement agreement wording that they want, what is to be done? There is no easy answer. The most troublesome result is *damaging* language. That was clearly the problem in *Blum*, in which the settlement agreement expressly said that the payment was *not* for the underlying physical injuries that caused Blum to hire a malpractice lawyer.

The wording in *Holliday* wasn't as bad, but saying that the settlement money was for the claims for legal malpractice wasn't enough to carry the day. The cases suggest that perhaps the only thing the Tax Court would find compelling would be something like this on the *Blum* facts: "The settlement amount is paid on account of Blum's alleged personal physical injuries and physical sickness." 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."

It is no coincidence that the Tax Court in *Holliday* grouped together its holdings in the two cases. In *Blum*, the court said it focused on the text of the settlement agreement, which specified that it was entered into "for the purpose of compromising and settling the disputes." In *Holliday*, the court was similarly not persuaded that the settlement proceeds were meant only to replace her marital property. Instead, the court said the proceeds were generally to release the malpractice defendants from the various claims and types of damages listed in her malpractice case.

The court said that even if it had been persuaded that *some* of the settlement proceeds were meant to replace Holliday's loss of marital property and that the loss was a nontaxable recovery of capital, there was the question of how much. The court said that Holliday failed to provide a basis that would allow the court to allocate the settlement proceeds between any nontaxable recovery and other taxable amounts. The settlement agreement didn't allocate any of the settlement proceeds toward any of the various claims or types of damages.

The court cited cases for the proposition that it could make its own allocation between taxable income and nontaxable return of capital in appropriate cases when the record provides a basis for such an allocation.[9] However, the court

[9] *See Estate of Taracido v. Commissioner*, 72 T.C. 1014, 1026 (1979).

said it simply didn't have that on the facts presented.

Last Words

Reading about the *Blum* and *Holliday* cases could be downright depressing if you are a plaintiff. Not all plaintiffs are able to get tax advice when their cases are settling. Their lawyers and the other side may be pushing them relentlessly to sign settlement agreements. Plaintiffs don't 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 from litigators.

Even if there is a tax adviser on the scene, not every defendant is going to roll 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. The defendant may believe that the requested tax characterization doesn't fairly represent the claims.

Then, too, the defendant may fear tax risks from the language, including Form 1099 reporting penalties and failure-to-withhold liability. 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 the ensuing weeks.

Usually, such term sheets say that in the event a more fulsome settlement agreement isn't 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 for a comprehensive settlement agreement. Of course, many plaintiffs don't ask for well-considered tax language. The plaintiff may not know what wording would be best for the settlement agreement.

Even if the plaintiff has asked for perfect wording, the plaintiff might be unable to get it. Whatever the dynamics, it isn't always possible for a plaintiff to hold out forever. Some settlement agreements — many, in fact — aren't going to be terribly helpful in fixing the tax treatment. As *Blum* and *Holliday* illustrate, the tax dangers may be especially acute in legal malpractice cases. However, the precise wording of the settlement agreement can be important in every settlement in every type of case. ■