Legal Settlement Tax Worries (Revisited)

by Robert W. Wood

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In this article, Wood reprises his recent article about the tax treatment of legal malpractice recoveries to address the Tax Court's even more recent decision in *Blum.*

I recently wrote several articles about the tax treatment of accounting and legal malpractice recoveries. First, I wrote about the much-discussed decision in *McKenny.*[1] The *McKenny* case involved an accounting firm sued for allegedly bad tax advice. The district court held the settlement proceeds to be tax free, but the Eleventh Circuit reversed, holding that damages for additional taxes were taxable. Whether the court got it wrong is still being discussed.

More recently, I wrote about legal malpractice recoveries in general, with a series of examples involving various types of malpractice claims. I noted the paucity of tax authority on those points, but described how I thought a series of fact patterns should be analyzed.[2] My timing could not have been worse. Within days of that article's publication, the Tax Court decided *Blum*.[3] *Blum* seems to contradict a lot of what I said.

Could the tax law have changed in a week? More bluntly, *Blum*'s harsh holding suggests that I may have been wrong in one or two of my examples about how legal malpractice recoveries should be taxed. I think *Blum*'s extreme facts and my views can be reconciled, but I also think *Blum* contains enormously useful lessons, a kind of boot camp for tax lawyers and litigants alike.

Even better, I do not believe *Blum*'s lessons are limited to the tax treatment of legal malpractice recoveries. I did not use "malpractice" in the title of this article for that reason, as I think the lessons of this case are universal. *Blum* is relevant to how *any* lawsuit recovery is taxed. I will not try to retread the ground I covered (rightly or wrongly) in my earlier articles. Instead, I want to first describe *Blum*, and then explain why I think it is important.

Perfect Storm

Debra Jean Blum received a $125,000 settlement from a lawyer who botched her personal (physical) injury suit. She did not report it, and the IRS said it was taxable. The Tax Court agreed despite the genesis of her claim.

Does that mean that a legal malpractice recovery for a botched personal (physical) injury lawsuit cannot be tax free? Hardly. Does it mean that most such recoveries should not be tax free? Again, clearly not. But as with everything else, care is needed.

In 2007 Blum was admitted to the hospital for a knee replacement. While she was there, she was injured in a wheelchair accident. She hired a lawyer and sued the hospital for negligence. Her lawyer retired, his handoff to another lawyer went

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

[2] *See* Wood, "Legal Malpractice Settlement Tax Worries," *Tax Notes Federal*, Feb. 8, 2021, p. 963.

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

poorly, and her negligence case against the hospital was dismissed.

Malpractice Settlement

Blum sued her lawyers for malpractice. There was little doubt that she was trying to get the money that she *would have* collected in her hospital negligence case were it not for the alleged malpractice. The parties settled in June 2015, with Blum agreeing to drop all claims against her former attorneys "related to or arising out of [their] representation of Blum in" her claim against the hospital in exchange for $125,000.

The settlement agreement "stated that it was 'entered into by the Parties for the purpose of compromising and settling the dispute between them,' which the agreement described as a 'malpractice claim.'" The court went on to note that the settlement agreement provided that:

> "Blum maintains, and . . . [her former attorneys] do not dispute, that Blum did *not* sustain any physical injuries as a result of the alleged negligence of either . . . [of her former attorneys]," and that "Blum's physical injuries are . . . alleged to have resulted from the . . . [hospital] incident, which did *not* occur as a result of any fault or negligence by . . . [her former attorneys]."[4]

Settlement agreement wording is important. In fact, I would argue that it is essential if you want to avoid trouble. Such wording does not bind the IRS or the states, but it can still go a long way. Conversely, inartful wording can hurt the tax treatment of a settlement a great deal, as it did here. Of course, many a tax lawyer must occasionally contend with a settlement agreement that describes a settlement payment for "pain and suffering."

Does the pain and suffering canard mean that such a settlement must be taxable? Of course not. How about money paid under a general release that simply says the settlement is for any and all claims? If a plaintiff is badly or even catastrophically hurt in an accident, does a general release make the settlement taxable?

[4]*Blum*, T.C. Memo. 2021-18 at 4-5.

Again, of course not. If the case is a catastrophic injury case (with no punitive damages and no interest, settled before trial), there should be no problem.

However, what if the defendant or defendant's insurance carrier issues the plaintiff a Form 1099 for the settlement? It happens more frequently than you might think. Does that flip the switch and make section 104 irrelevant? Plainly no, but the Form 1099 must be considered. If the Form 1099 is allowed to stand, rather than reversed via a corrected Form 1099 from the payer, it must be addressed on the tax return.

Quite apart from the truly terrible settlement agreement wording in *Blum* — I'm not sure I've ever seen worse — there were other problems, too. The Tax Court seemed to fixate on the fact that Blum's malpractice complaint failed to allege that she had suffered physical injuries for which the attorneys should be responsible. She also failed to seek compensation for any physical injuries.

Form 1099

The (terrible) language in the settlement agreement was not the only thing that did Blum in. It was also the Form 1099 that she had evidently ignored. That was the first domino to fall. A Form 1099 does not mean that a payment is always income, of course. But it usually does, and the IRS will rightly assume it is.

The real killer is if the Form 1099 is issued but the taxpayer does not address it on her tax return. Perhaps the form gets lost in the mail, the taxpayer moves, or she unwittingly ignores the form. In any event, once you get crossways in the system, you will need to do better than saying "everyone knows this is physical injury money excludable from income." If the IRS computer spits out a tax return that fails to account for a Form 1099, you should respond with care.

I have resolved many cases of that sort in which the facts and documents are strong. Resolving things might be easy in the catastrophic injury example above, when despite the errant Form 1099, the nature of the entirely excludable payment is arguably clear. However, easy fixes are not always possible. Weak settlement agreement wording and failure to report a Form 1099 can be tall mountains to climb. The result can depend on the facts, documents, handling, and even luck.

If you can fairly put on your return that the amount shown on a Form 1099 is excludable from income in whole or in part, you must say that. There are different ways to do it, and differing levels of detail and disclosure depending on the circumstances. You might not be claiming that a payment is excludable under section 104.

You might instead be saying that some or all of it is long-term capital gain. You might be claiming that it is basis recovery rather than gross income. All of these require facts, planning, and thought. In a twisted way, you can look at a Form 1099 as a blessing in disguise: It means you do not have a choice about addressing it on your return in some fashion.

If, like Blum, you have an argument that your recovery should not be taxed (yes, despite the *terrible* settlement agreement), the Form 1099 makes you consider it and makes you disclose it. Disclosure is one of those underrated pleasures, I think. Even if no Form 1099 is issued, if you have a strong case, disclosure may have no real downside. Admittedly, for most people, disclosure can have a negative connotation.

Disclosure

Without knowing exactly why, most people do not want to "disclose" unless they must. Discretion and privacy sound better. Disclosure sounds like extra work and extra risk, and extra attention is the last thing anyone wants. Disclosure is an extra explanation, but how much extra varies considerably.

There are almost infinite circumstances in which disclosure could be required. The IRS generally wants disclosure if you do not have at least substantial authority for your tax position. Technically, you do not *have to* disclose even then, but disclosing is a way to get out of penalties, and it can also make the usual three-year limitations period for assessment of income tax firmer.

If you omit more than 25 percent of the gross income from your tax return, the normal IRS three-year statute of limitations is extended to six years. However, in determining whether you omitted income from your return, disclosure is relevant. There is also a penalty for a substantial understatement of income tax, which disclosure may obviate. So you may help yourself by disclosing.

How do you disclose a tax position? In many cases, there is nothing wrong with a white paper disclosure that lists and addresses the Form 1099 or the settlement amount even if no Form 1099 was issued. If it is clear about the position being claimed and the amounts, there are good arguments that a white paper disclosure is adequate and gives you protection. A white paper disclosure often worries clients less than the more formal disclosure forms.

If you want more certainty about the adequacy of your disclosure, there are always the forms the IRS prefers. There are two disclosure forms — Form 8275, "Disclosure Statement"; and Form 8275-R, "Regulation Disclosure Statement." We can dispense with Form 8275-R because that form is for positions that contradict the law. If you must file a Form 8275-R, get some professional advice, possibly from more than one source.

Form 8275 (without the R) is another matter. This is a commonly filed form. Most tax returns attaching Form 8275 are not audited, so the form does not automatically trigger an audit. But how much detail to provide is another matter. In the many Forms 8275 I have reviewed, rarely have I not whittled down what the taxpayer or tax return preparer proposes to say.

Some people go on for pages on Form 8275, and even send attachments. Some proposed Forms 8275 are long-winded arguments about the law, sometimes all in capital letters, citing many legal authorities. In my view, that is not appropriate material for a disclosure, nor are attachments. I have even seen proposed Forms 8275 that attach full legal agreements. If the IRS wants your legal settlement agreement or purchase contract, the IRS will ask for it.

In short, going overboard in a disclosure seems unwise. You are required to disclose enough detail to tell the IRS what you are doing, but keep it short and succinct.

Presumptions and Burdens

As big a disaster as the *Blum* settlement agreement was, it would be easy to skip over the parts of the Tax Court's opinion that are devoted to what might be regarded as boilerplate. But even those are worth examining. The Tax Court noted — and perhaps this helps to further explain the outcome of the case — that the commissioner's determinations in a notice of deficiency are generally presumed to be correct, and that the taxpayer bears the burden of proving those determinations erroneous.[5]

In cases involving failure to report income, the court noted that the commissioner must establish some evidentiary foundation linking the taxpayer to an alleged income-producing activity before the presumption of correctness attaches to the deficiency determination.[6] Once the commissioner has established this foundation, the burden of proof shifts to the taxpayer to prove that she is entitled to an exclusion.[7]

Remember, the definition of gross income is as big as all outdoors, and exclusions are narrowly construed. Regarding section 104, the Tax Court once said that "for a taxpayer to fall within this exclusion, he must show that there is 'a direct causal link between the damages and the personal injuries sustained.'"[8] When damages are received under a settlement agreement, the nature of the claim that was the actual basis for the settlement controls whether the damages are excludable under section 104(a)(2).[9] The nature of the claim is typically determined by reference to the terms of the agreement.[10]

First, the court looks to the settlement agreement. Does it expressly state that the damages are paid on account of personal physical injuries or physical sickness under section 104(a)(2)? If not, the court looks primarily to the intent of the payer.[11] The intent of the payer may be determined by considering the amount paid, the factual circumstances leading to the settlement, the allegations in the injured party's complaint, and so on.[12]

Fatal Language

This sentence in the *Blum* opinion says it all: "We need look no further than the parties' settlement agreement to conclude that the settlement payment is not excludable under section 104(a)(2)." The agreement identified the suit as a malpractice claim and specified that they entered into the agreement to compromise that dispute. Not only that, but the agreement also expressly *negated* what would have been helpful.

The agreement said the settlement did *not* compensate for any physical injuries. To the contrary, it recited that "Blum maintains, and . . . [her former attorneys] do not dispute, that Blum did *not* sustain any physical injuries as a result of the alleged negligence of either" of her former attorneys. And it stated that "Blum's physical injuries are . . . alleged to have resulted from the . . . [hospital] incident, which did *not* occur as a result of any fault or negligence by" her former attorneys.

The settlement agreement said the payment was in lieu of damages for legal malpractice, *not* on account of personal physical injuries or physical sickness. Blum valiantly made "but for" arguments, which I find persuasive, but the court said a taxpayer "must show that there is 'a direct causal link between the damages and the personal injuries sustained.'"[13] The language of the settlement agreement put that to rest.

Blum also argued that her former attorneys actually intended to compensate her for the physical injuries she allegedly sustained at the hospital. The court's response: "The settlement agreement dooms her contention."

Loss of Capital

In a last-ditch argument, Blum argued loss of capital. This settlement just reimbursed her, replacing her capital. The Tax Court disposed of that too, citing the tax reimbursement cases

[5] *See* Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Merkel v. Commissioner*, 192 F.3d 844, 852 (9th Cir. 1999), *aff'g* 109 T.C. 463 (1997).

[6] *Weimerskirch v. Commissioner*, 596 F.2d 358, 361-362 (9th Cir. 1979), *rev'g* 67 T.C. 672 (1977).

[7] *See Simpson v. Commissioner*, 141 T.C. 331, 338-339 (2013), *aff'd*, 668 F. App'x 241 (9th Cir. 2016).

[8] *Doyle v. Commissioner*, T.C. Memo. 2019-8 at *11 (quoting *Rivera v. Baker West Inc.*, 430 F.3d 1253, 1257 (9th Cir. 2005)).

[9] *See Burke*, 504 U.S. at 237.

[10] *See Rivera*, 430 F.3d at 1257.

[11] *See Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), *aff'g* T.C. Memo. 1964-33.

[12] *See Green v. Commissioner*, 507 F.3d 857, 868 (5th Cir. 2007), *aff'g* T.C. Memo. 2005-250.

[13] *Doyle*, T.C. Memo. 2019-8 at *11 (quoting *Rivera*, 430 F.3d at 1257).

including *Cosentino*[14] and *Clark*.[15] Was there a loss here at all? The purported loss was the amount Blum might have received from winning her suit against the hospital. The court called that a highly speculative proposition. Besides, Blum failed to convince the court that the settlement was meant to replace it. The settlement agreement was detailed and expressly said otherwise.

Big Lessons

Was *Blum* wrongly decided? Some people say it was, but I am not sure. My guess is that the judge felt hamstrung by a settlement agreement that was hard to ignore. It might have been awfully tempting for the Tax Court to recognize that Blum was trying to get money from her lawyers that *would have* been tax free had she collected from the hospital.

Indeed, I personally think the court would have ruled differently if the settlement agreement had expressly tied the legal malpractice recovery to her physical injuries. I do not imagine that the legal malpractice complaint alone would have been damning, even if it had failed to say that she was physically injured. I think the extraordinarily bad settlement agreement was fatal.

I also wonder if the case would have become a case at all with even modestly better handling. Ideally, of course, not only would the settlement agreement have been better, but it would have negated a Form 1099. Many physical injury settlements expressly negate a Form 1099. It is worth fighting about the Form 1099 when negotiating a settlement agreement. The only bargaining power the plaintiff has is before the settlement agreement is signed, and you don't want to be surprised in January when Forms 1099 arrive.

The IRS instructions for Form 1099-MISC expressly say that there should be no Form 1099 for damages for physical injuries or physical sickness. The law firm in the malpractice case might have insisted on issuing a Form 1099, but it is always worth trying not to get one. Even if the defendant would not agree and issued the Form 1099, the *Blum* case would probably not have become a case with more care taken on the tax return.

One could have addressed the Form 1099 and disclosed that the recovery for legal malpractice was for an underlying physical injury claim. Claiming the section 104 exclusion on the tax return would have been easy, and most of those claims do not provoke an IRS query. Even with a poorly drafted settlement agreement, proper handling of the Form 1099 on the return could well have saved the day, at least as a practical matter.

In the end, this case had very little going for it, and is a kind of playbook for missed tax opportunities. For me, the case is a poignant reminder that settlement agreement wording is *really* important, an opportunity you should never let slip by. It is worth saying this over and over again. In IRS audits or queries, the IRS may well be satisfied with the settlement agreement, so word it carefully.

The case also reminds us that Forms 1099 should be addressed explicitly whenever possible. And whatever kind of agreement you do or do not get about Forms 1099, any Form 1099 that is issued should not be ignored. On the latter point, be sure that you know about all Forms 1099. Getting an IRS transcript can be a useful cross-check. Because the IRS system is often slow to be updated, putting your return on extension just to keep checking your transcript can be a useful precaution.

These are basic lessons, and they are certainly not limited to the exclusion from income for physical injuries and physical sickness. They apply across the board, to *any* kind of case. Just contrast the numerous failures in *Blum* with the true home run in *NCA Argyle*.[16] That case was a veritable playbook for how to do everything right to position a business recovery as capital gain.[17] *Blum* shows how letting your guard down can end up.

Be careful out there. ■

[14] *Cosentino v. Commissioner*, T.C. Memo. 2014-186.

[15] *Clark v. Commissioner*, 40 B.T.A. 333, 335 (1939).

[16] *NCA Argyle LP v. Commissioner*, T.C. Memo. 2020-56.

[17] For discussion, see Wood, "Legal Settlements as Capital Gain: A Playbook to Avoid Ordinary Income," *Tax Notes Federal*, Sept. 28, 2020, p. 2407.