More on Interest in Tax Malpractice Cases

To the Editor:

I'm writing (belatedly) to comment on the article by Burgess J.W. Raby and William L. Raby, ''Interest as Damages in Tax Malpractice,'' *Tax Notes*, Nov. 13, 2006, p. 651, *Doc 2006-22290, 2006 TNT 219- 52*. As is customary with their articles, it is thought provoking and insightful. However, my point of view is slightly different than theirs, so I offer a few observations.

The Rabys approach this topic primarily from the perspective of a tax practitioner who is understandably interested in avoiding professional malpractice liability, or if facing the unfortunate event of liability, understandably wishes to limit it. Hence, their focus is on whether a client should be able to recover interest as an item of damages from an accountant (or perhaps from a tax lawyer) who missteps. The Rabys note sagely that whether interest can be recovered by the plaintiff:

> matters a great deal to the tax practitioner facing a claim for malpractice or planning to minimize the likelihood or severity of those claims. The interest (or lost opportunity damages) being sought will usually be a greater amount than the tax. *Id*. at 651.

I agree that the topic is interesting, and the cases the Rabys collect that speak to the issue are worth saving. I, too, would want to avoid paying interest as an item of damages.

However, a topic I find even more interesting is the tax treatment of that interest if it is paid, as it may be in at least some cases. The Rabys begin their article with

Concord Instruments Corp. v. Commissioner, T.C. Memo. 1994-248, *Doc 94-5229, 94 TNT 105-12,* and its predecessor, *Clark v. Commissioner*, 40 BTA 333 (1939). Those cases suggest that damages to reimburse the client for taxes (that is, to make the client whole via the payment of taxes in a tax malpractice case) should be nontaxable. Notably, though, those cases suggest that the interest element of the recovery should be taxed no matter what.

If one posits a case in which the client recovers 100 percent of the tax attributable to the error and an extra $10,000 of interest, that may make perfect sense. I am not convinced that it makes any sense, however, when (as would more likely occur in the real rough and tumble world) the client recovers only a portion of the tax and a portion of the interest sought. That was the situation in *Concord Instruments*, in which the Tax Court applied a ratio to the recovery, treating 160/466ths as attributable to Concord's recovery of excludable tax malpractice damages and the rest as attributable to taxable interest.

The Rabys' point about that case is that the interest element of a malpractice suit can often far exceed the other potential elements of the claim. My read is that *Concord Instruments* artificially pumps up the value of interest, using Judge Colvin's formulaic approach. In fact, although such a formulaic approach may appear to be fair (putting the interest on a par with the underlying malpractice damages) it hardly achieves equilibrium. If the Rabys are right that the interest elements of tax malpractice cases are likely to involve larger numbers than the underlying damages (and they do appear to be right about that), any fraction such as the one applied by Judge Colvin in *Concord Instruments* is going to artificially skew the numbers.

The malpractice case in *Concord Instruments* settled for just $125,000, which was considerably less than the tax deficiency of $160,020 that Concord sought to recover, let alone the interest of $306,014 that Concord also claimed as an additional item of damages in the underlying malpractice case. Ultimately, the Tax Court used its ratio approach to find that only $42,920.70 of the $125,000 settlement was attributable to a recovery of capital, with the balance of $82,079.30 treated as taxable interest. That was a raw deal.

For one thing, it did not reflect the fact that the interest — from everything the Rabys prove — is a lot harder for a plaintiff to recover than the principal. Of course, anything labeled as interest gets taxed. It is hard enough to come within the *Clark* rationale, given that the IRS has done much to try to winnow its logic in a series of private letter rulings. The IRS has made no secret of the fact that, despite *Clark*, it generally considers tax indemnity payments to be fully taxable. Typically, the IRS cites to reg. section 1.61-14(a), stating that the payment of another person's income tax, either directly or indirectly, results in gross income, unless otherwise excluded by law. See LTRs 9833007, *Doc 98-25747*, *98 TNT 158-12*; 9743035, *Doc 97-29235, 97 TNT 207-11*; 9743034, *Doc 97-29234, 97 TNT 207-10*; 9728052, *Doc 97-20252, 97 TNT 134-27*; and 9226033 (June 26, 1992).

Perhaps *Concord Instruments* can be explained by the theory that the settlement of $125,000 was not explicitly set forth in the settlement agreement as solely attributable to the tax-free recovery of basis. Yet one wonders whether the Tax Court would have accepted such language if it had been present. In any event, what happened was the application of a rigid formula that really makes no sense in a case settling before trial.

If the formulaic approach — applied rigidly pro rata — comparing what is requested in the complaint with what is recovered in settlement is correct, then, by a parity of reasoning, if a plaintiff asks for punitive damages in the complaint, a settlement of the case before trial should also involve an amount allocated to punitives. Yet, given the large number of hurdles that must be cleared for a plaintiff to recover any punitive damages, and the primarily *in terrorem* effect for which punitive damages requests are often made, that makes no sense. For discussion, see Robert Wood, ''Will Courts Import Punitive Characterization?'' *Tax Notes*, Mar. 3, 1997, p. 1200, *Doc 97-5998*, *97 TNT 41-84*.

It's one thing when a case settles on appeal. In that context, it's often considerably easier to understand why a court would look askance at the notion that no interest is being paid. For example, in *Rozpad v. Commissioner*, 154 F.3d 1, *Doc 98-26496, 98 TNT 166-4* (1st Cir. 1998), the court treated a portion of an unsegregated settlement amount as attributable to interest. By the way, that reminds me of a venerable piece by the senior Raby, ''When Interest is Not Interest,'' *Tax Notes*, Oct. 10, 1994, p. 229. In *Rozpad*, the court clearly found it unconvincing that there was a stipulation that no interest was being paid.

Similarly, in *Woods v. Commissioner*, T.C. Memo. 1998-435, *Doc 98-36347, 98 TNT 238-9*, a medical malpractice case settled on appeal, and the Tax Court applied a ratio to treat a portion of the settlement proceeds as taxable prejudgment interest. *Forest v. Commissioner*, T.C. Memo. 1995-377, *aff'd without published opinion*, 104 F.3d 348 (1st Cir. 1996) is to the same effect. Arguably, a partial explanation for all those cases is a lack of attention to the issue at settlement time. Although a ''no interest'' statement may not be respected, straight percentage formulas based on the amount sought in the case (as in *Concord Instruments*) or, in cases settling on appeal, based on amounts awarded at trial seem rigid. Apart from their rigidity, they are generally going to be unfavorable.

In fact, the First Circuit's statements in *Forest* almost read as an admonition to advisers to take the tax bull by the horns and to attempt to plan around what the First Circuit seems implicitly to acknowledge is an unfortunate result. The First Circuit seems to invite express disclaimers or waivers of prejudgment interest, presumably in exchange for a payment of a larger portion of the compensatory damages.

In any case, if the Rabys are right that in a tax malpractice case the magnitude of the interest liability will far exceed the magnitude of the tax reimbursement damages, it adds insult to injury that when the plaintiff recovers that interest it will almost invariably be unfavorably taxed.

Very truly yours,

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