Tax Treatment of Legal Malpractice Recoveries

By Robert W. Wood

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Although the tax treatment of litigation payments and recoveries receives significant attention, there is a paucity of authority concerning the tax aspects of legal malpractice claims. Given the importance of the tax issues and the prevalence of legal malpractice claims, I find that surprising. It is hard to think of a type of recovery that has generated fewer tax authorities and smaller learning. As a result, any review of this corner of the tax law is likely to leave the reader with an unsatisfying, meal-interrupted experience.

Legal malpractice claims arise out of wills and trusts, litigation, tax advice, real estate deals, medical malpractice, and so on. A large number of the cases involve relatively simple acts or failures to act, such as the lawyer missing a statute of limitations, or affirmatively misstepping on some issue, such as recording a lien against the wrong parcel of property.

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? Even though tax issues should bubble to the surface quickly and there seems to be no shortage of legal malpractice cases and recoveries in them, there is little authority spelling out how those recoveries are taxed.

Ironically, virtually all of the authority concerning those tax issues has arisen in tax malpractice actions, 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 inception of the case, and so there is a corresponding degree of focus on taxes at the case's conclusion. In general, those 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.

Of course, a fundamental precept of 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, I believe a recovery of amounts sought in a malpractice action that would have been excludable if recovered in the underlying personal injury case should be similarly excludable from income. However, I have yet to find a case or ruling that says exactly that, and I would feel much better if I did.

Of course, this exclusion would not apply to amounts received in the malpractice action attributable to punitive damages. For example, suppose that because of negligence by the plaintiff's attorney, punitive damages were not awarded in the underlying personal injury action and the legal malpractice recovery in effect represents a substitute for those punitive damages. If there were a punitive element in the underlying case, it may be appropriate in the resolution of the malpractice case to allocate the recovery between tax-free and taxable portions. Similarly, the exclusion would not apply to amounts the plaintiff received in the malpractice action as interest or delay damages.

Origin of the Claim and Legal Malpractice

It is a well-worn axiom that the origin of the claim controls the tax treatment of a recovery whether it is received as a result of a settlement or a judgment.[1] To determine the origin of the claim, courts and the IRS ask in lieu of what a recovery was paid.[2] A recovery should be taxed in the same manner as the item for which it is intended to substitute.[3] Despite this rule, the IRS tends to view litigation recoveries as ordinary income, until the taxpayer demonstrates otherwise.

The origin of a claim is determined by reference to the claims raised in the complaint and the claims that are litigated and resolved in a verdict or settlement.[4] The IRS generally views the complaint as the most persuasive evidence of the origin of the claim.[5] The same is true in legal malpractice cases.

The seminal case is *Clark v. Commissioner*,[6] in which the Board of Tax Appeals[7] (BTA) determined that an amount received from tax counsel as compensation for an error in preparing and filing the plaintiff's tax return was not includable in the plaintiff's gross income. The malpractice underlying *Clark* seemed open and shut. The taxpayer paid excess federal income taxes because his tax counsel negligently failed to advise him to file a separate return rather than a joint return with his wife.

This negligence caused Clark to pay approximately $20,000 more in federal income taxes than he would have paid on a separate return. Tax counsel paid the $20,000 to

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

[2]*See Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944); LTR 200108029, *Doc 2001-5469*, *2001 TNT 38-23*.

[3]*Knowland v. Commissioner*, 29 B.T.A. 618 (1933).

[4]*State Fish Corp. v. Commissioner*, 48 T.C. 465, 474 (1967).

[5]Rev. Rul. 85-98, 1985-2 C.B. 51 (1985).

[6]40 B.T.A. 333 (1939).

[7]Predecessor to the U.S. Tax Court. It is a testament to the lack of authority in this area that *Clark* is still a leading (and nearly the only!) case nearly 70 years later.

settle the case. Clark included that amount in his gross income but later sought a refund of this amount.

The IRS argued that the $20,000 paid by the defendant tax counsel constituted taxes paid by a third party, and, as such, that Clark had income. Although not expressed exactly as such, that sounds very much like a discharge of indebtedness theory. Clark argued that the payment constituted compensation for damages or loss caused by the malpractice and that he realized no income. In rejecting the IRS's argument, the BTA found that Clark had paid his own taxes.

In fact, in paying his taxes, Clark sustained a loss caused by the negligence of his tax counsel. The BTA determined that the $20,000 paid by tax counsel was compensation for the loss. The measure of that loss was the sum of money the taxpayer paid because of the tax lawyer's negligence. It was irrelevant that the obligation was for taxes, said the BTA.

This statement suggests that if this aging BTA decision is still good law — a point discussed below — its reach may be considerably broader than the context of tax malpractice actions. Given the paucity of authority on the tax aspects of malpractice recoveries, that is an intriguing possibility.

The BTA in *Clark* went on to say that a recovery on account of loss is not income, because it is not derived from capital, labor, or from both combined. As long as Clark did not (and could not) take a deduction in a prior year for the loss in such a way as to offset his income for the prior year, his recovery was not includable in his gross income. That ''did not and could not'' standard suggests that a tough tax benefit theory should apply to such analyses. It suggests that there is a requirement that the plaintiff not only not have *claimed* a tax deduction for the loss, but also that he not have been *able* to do so.

Once again, that point suggests that *Clark's* meaning today goes far beyond recoveries in tax malpractice actions and should apply to many types of legal malpractice awards. The tax benefit rule, of course, is one of general application, applying to far more than merely tax payments.

Other authorities beyond *Clark* continue this thread. In Rev. Rul. 57-47,[8] a tax consultant made an error in preparing and filing a taxpayer's individual income tax return. The error caused the taxpayer to pay additional tax. By the time the error was discovered, the statute of limitations for recovery of the overpayment had expired. To settle the matter, the tax consultant reimbursed the taxpayer for the additional tax. The IRS determined that the reimbursement was not income, but that the excess recovery (representing interest) was includable in her gross income.

IRS Private Letter Rulings

Although *Clark*'s theory suggests that many malpractice recoveries even outside the tax arena might be tax-free, the IRS has tried to limit the breadth of the *Clark* holding in a series of private letter rulings involving malpractice in tax preparation. In LTR 9743035, *Doc 97-29235*, *97 TNT 207-11*, a CPA firm's negligence caused a fund not to qualify as a regulated investment company, resulting in additional tax. The IRS drew a distinction between the payment the fund received as reimbursement for additional taxes, penalties, and interest arising from the CPA firm's negligence and the indemnity payments in *Clark* and Rev. Rul. 57-47. However, the distinction has proven difficult to apply.

In *Clark* and Rev. Rul. 57-47, the IRS said, the preparer's errors in filing returns caused the taxpayers to pay more than the ''proper'' federal income tax. In LTR 9743035, the CPA firm's error altered the underlying entity status of the fund, which had to file as a C corporation during the period it did not qualify as a RIC. That led the IRS to conclude that the CPA firm's reimbursement to the fund was not made to compensate it for excess tax liability the fund suffered because of the CPA firm's negligence.

Instead, the IRS characterized the reimbursement as a payment of the fund's *proper* tax liability (as a C corporation). Thus, the reimbursement of taxes, interest, and penalties represented gross income. Whether or not that focus on proper tax vs. erroneous tax makes any sense, or is equivalent to a glass half empty vs. glass half full debate, the IRS has continued it.

In LTR 9728052, *Doc 97-20252*, *97 TNT 134-27*, the taxpayer executed an agreement to pay alimony to his former spouse. His attorney advised him the payments would be deductible. The IRS disallowed the alimony deduction because the alimony agreement provided that payment would be made to the former spouse's estate if the former spouse died during the term set forth in the alimony agreement.

The taxpayer negotiated with his attorney's malpractice insurer. Eventually, he received payment for the additional taxes, interest, and penalties he paid, plus the additional federal income taxes he *expected* to pay over the term of the alimony agreement because of the nondeductibility of the payments.

The IRS determined that the reimbursement to the taxpayer was income. This is puzzling, for the reimbursement seems to be precisely the kind of reimbursement that occurred in *Clark*. Not so, said the IRS. Here, the error of the attorney related to the underlying transaction and the terms of the agreement. As a result of the error, the taxpayer's payments were not deductible, as alimony should have been. Unlike *Clark*, the IRS reasoned, this taxpayer was not paying more than his minimum proper federal income tax liability for the tax years to which the reimbursement related.

In another private letter ruling, LTR 9833007, *Doc 98-25747*, *98 TNT 158-12*, the taxpayer won the state lottery and consulted attorneys for tax preparation advice. The taxpayer was not advised as to specific deductible expenses, so he paid more federal income tax than he otherwise would have been required to pay. He negotiated with his attorney's malpractice insurer, which reimbursed him for the additional taxes.

Again, the IRS distinguished the situation from *Clark*. The IRS determined that the payment of additional federal income taxes was not an error made by the attorney on the return itself. Instead, the offending act was an omission to provide advice that would have

[8] 1957-1 C.B. 23.

reduced the taxpayer's federal income tax liability. Unlike the taxpayer in *Clark*, this man did not pay more than his minimum proper federal income tax liability. As such, the amount he received was gross income.

In LTR 200328033, *Doc 2003-16433*, *2003 TNT 134-9*, the IRS determined that a settlement was excludable when the defendant was responsible for an error that led to the taxpayer overpaying his taxes. The taxpayer was a city employee who retired under full disability related to his duties. As such, the retirement pay should not have been taxable.

The settlement called for a reimbursement when amended returns were barred by the running of the statute of limitations. The IRS determined that the tax indemnity payment the taxpayer received was indistinguishable from those received by the taxpayer in *Clark*. The reimbursing payer in LTR 200328033 was the same entity responsible for the error that led the taxpayer to overpay his taxes. When the taxpayer overpaid his taxes in the earlier years, he suffered a loss of capital, and it was that loss for which the payer was compensating.

Based on the IRS's position post-*Clark*, the view that legal malpractice is nontaxable as a recovery of capital appears to be quite narrow. At least one reading of the "authority" following *Clark* (bearing in mind that private letter rulings do not constitute authority) is that it is limited to indemnification for negligent tax advice. I believe that reading is too narrow.

Still, the rulings say what they say, and extend tax relief only when the claimant paid more than his "proper" minimum federal income tax liability, and when the nature of the indemnification is related to the underlying claim. When the IRS has declined to follow *Clark*, its determination was based on the underlying nature of the transaction giving rise to the discrepancy. Of course, given the thinness of the authority, it bears frequent mention that these are merely private letter rulings and that they obviously attempt to limit the holding in *Clark*.

Untested Waters: Hypothetical Scenarios

Against the sketchy authority on tax malpractice recoveries, how do other malpractice cases come out? It isn't clear. A partial explanation for the one cluster of existing authority all arising in tax reimbursements may lie in the axiom that tax practitioners are more likely to identify tax issues related to a recovery. Yet, that self-proving explanation is hardly satisfying. Nontax malpractice recoveries occur all the time. They occur in medical malpractice cases, personal injury cases, intellectual property cases, and so on.

In the absence of a body of authority, I believe the recoveries in those situations should be based on the item the plaintiff would have received but for the attorney's malpractice. That, after all, is the *sine qua non* of the origin of the claim doctrine. In the absence of real-life cases, I hope a series of hypotheticals will shed some light on how (I think) malpractice recoveries should be treated.

Case One: Personal Physical Injury

Paula Plaintiff is injured in a car accident and retains Alan Ambulance-Chaser to represent her against the driver and his insurance company. The court finds for Paula and she recovers $400,000 in damages for her personal physical injuries. Section 104(a) excludes from gross income the amount of any damages received on account of personal physical injuries or physical sickness. So, Paula's entire recovery of $400,000 is excludable.

However, instead of prevailing in the initial lawsuit, let's assume Paula loses her personal injury case because Alan fails to introduce critical evidence, carelessly misses an important court deadline, misses the statute of limitations, or commits some other grievous error. Assume that Alan's error was the *only* reason Paula failed to recover.

As a result, Paula files a legal malpractice action against Alan and settles for the amount she would have received had Alan not erred. Instead of receiving $400,000 from the defendant for personal physical injuries, she receives $400,000 from Alan or his insurance carrier.

Should Paula include the recovery in income because it stems from a malpractice claim rather than a personal physical injury? Or can she properly exclude the recovery under section 104? Requiring Paula to include the $400,000 in her gross income merely because the payer is the negligent attorney rather than the party who caused the physical damage in the first place seems inequitable.

Is the origin of Paula's claim the malpractice or the underlying personal injury? Despite the fact that the complaint alleges malpractice, the malpractice relates solely to her failure to recover for personal physical injuries. One should look through the malpractice claim to determine the proper tax treatment. The $400,000 payment makes Paula "whole" again. It is not punitive against the negligent attorney, but is compensation Paula should have received for her injuries, and *would have* received from the driver of the car but for the negligence of the lawyer.

I find the argument that the recovery should be excluded under section 104(a) to be compelling. I also do not think it should matter whether the claim for malpractice sounds in tort or contract under state law, although I admit that *Commissioner v. Erich Schleier*[9] may suggest that a tort cause of action is always required for a section 104 exclusion.

By definition, every legal malpractice claim must be based on an underlying claim, cause of action, or transaction. But for the underlying matter, the plaintiff would not need the attorney's services in the first place. In this personal injury hypothetical, Paula's claim is rooted in the personal physical injuries she sustained. What is Paula being compensated for? I say, for personal physical injuries.

Admittedly, the analysis becomes more complicated if Paula recovers punitive damages in addition to the $400,000 malpractice recovery. If Paula receives the $400,000, plus $150,000 in punitive damages, what is the proper tax result? Rev. Rul. 57-47 suggests that the $150,000 is taxable. That amount is not rooted in the personal physical injury claim. Of course, *O'Gilvie v.*

[9]515 U.S. 323, *Doc 95-5972*, *95 TNT 116-8* (1995).

United States[10] holds that punitive damages are always taxable, and that was confirmed in the 1996 statutory change to section 104.

Case Two: Medical Malpractice

Legal malpractice is not the only type of malpractice in which taxpayers recover for negligent actions. Medical malpractice recoveries are prevalent. Assume Iris Inspired was a patient of Doctor Defendant. Iris was supposed to undergo a simple medical procedure performed by Doctor Defendant. During the course of the procedure, Doctor Defendant negligently failed to correct Iris's malady, and in fact caused her further personal physical injuries.

Iris sues Doctor Defendant for malpractice. Doctor Defendant's malpractice insurer settles with Iris by paying her $500,000. Should this $500,000 be taxable to Paula? Is there any difference between this situation and that posed in Case One above?

In medical malpractice cases, the plaintiff will almost always recover based on an underlying personal physical injury. In these situations, section 104 should provide the taxpayer with an exclusion. As in the previous example, the $500,000 here should be excludable from Iris's income because the malpractice recovery is rooted in her personal physical injury, and she is recovering on account of that injury.

There is no reason the result should change if instead of pursuing Doctor Defendant, Iris is forced to pursue her own lawyer for the money. Suppose her ironclad case against Doctor Defendant is blown by her careless lawyer, whom Iris then sues. Iris would have received the $500,000 from Doctor Defendant but for the lawyer's flub. Again, I believe it should not matter whether the legal malpractice action sounds in tort or in contract.

Case Three: Divorce

Divorce and its aftermath raise interesting tax issues. In *Graham v. Harlin, Parker, & Rudloff*,[11] the taxpayer was barred from bringing a malpractice suit against her former divorce attorney because the statute of limitations had run. Regardless, the facts present an interesting scenario. 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." That monthly payment was intended by both parties as child support.

The IRS later audited Mrs. Graham and asserted that the $500 monthly payments were alimony. Of course, alimony would be income to the recipient and deductible by the payer. To eliminate the confusion and avoid tax assessments, the parties to the divorce received a court order amending the original divorce decree so that the $500 monthly payments were "for child support of the infant children."

Unfortunately, the U.S. Tax Court held that the amendment to the dissolution decree was contrary to state law and therefore would not be recognized retroactively for federal income tax purposes. It found the payments to be alimony, taxable to Mrs. Graham. Had the payments been respected as child support, they would not have been taxable.

Mrs. Graham sued her attorney for negligence, claiming that he failed to advise her of the tax consequences of the original decree and that he failed to correct the wording, thus causing her additional tax on the monthly payments. The court found that her malpractice suit was barred by the statute of limitations. It did not address what result might have occurred had Mrs. Graham not been barred by the statute, nor did it address whether a recovery would have been taxable.

However, this fact pattern raises an interesting question. Had she timely sued and recovered from the attorney, what would be the tax treatment of her recovery?

Based on the series of private letter rulings issued in the 1990s, the recovery probably would be taxable. 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. Here, Mrs. Graham would have paid her proper minimum federal tax liability based on the fact that the $500 monthly payments were characterized as alimony.

LTR 9728052 found that a taxpayer's alimony payments were not deductible even though the payments were intended to constitute deductible alimony. In that ruling, the taxpayer received an indemnification payment from his tax adviser's malpractice insurer. The adviser's error related to the underlying transaction (and the terms of the divorce agreement) under which the payments were not deductible.

The taxpayer in Mrs. Graham's situation would probably have to include the malpractice recovery in income, even though the payments were intended to be child support instead of alimony payments.

Case Four: Will Contest

While all legal disciplines are subject to malpractice actions, estate planning and drafting presents unique issues. Malpractice claims against estate planning attorneys 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 from a bequest or may cause him to pay tax on an asset received from the estate.

An example of this unique twist on malpractice claims is *Getty v. Commissioner*.[12] Here, a third-party beneficiary sued to recover amounts he thought were owed to him under his father's estate plan. Although the 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, the remainderman and largest beneficiary of the J. Paul Getty estate. The suit sought additional inheritance Ronald believed was due

[10] 519 U.S. 79, *Doc 96-31894*, *96 TNT 240-1* (1996).

[11] 664 S.W.2d 945 (Ky. Ct. App. 1984), *overruled by Alagia, Day, Trautwein & Smith v. Broadbent*, 882 S.W.2d 121 (Ky. 1994).

[12] 913 F.2d 1486 (9th Cir. 1990).

him as intended by his father. In exchange for dismissing the lawsuit, the museum paid Ronald $10 million. The issue before the Ninth Circuit was whether the $10 million settlement was taxable income to Ronald or could be excluded under section 102(a). Section 102(a) excludes from gross income the value of property acquired by gift, bequest, devise, or inheritance.

Ronald's mother was J. Paul's third wife. The marriage lasted only four years. J. Paul remarried and had two additional children. Because of bad relations with his third wife, J. Paul executed a codicil to his will reducing Ronald's inheritance.

About the time he executed the codicil, J. Paul 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 over his lifetime, and then to his children over their lifetimes. The trust was to terminate on the death of J. Paul's last surviving child, with the trust's corpus being distributed per stirpes to his grandchildren. 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 that was necessary to ensure that the corpus would not be included in the grandmother's estate on her death. The grandmother's attorneys drafted a letter to J. Paul 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 litem, J. Paul's third wife found out about the unequal treatment of her son. J. Paul assured his third wife that the inequality would be cured if she signed the requisite documents. J. Paul reiterated his intent to equalize the income allocations several years later in conversations he had with Ronald, then an adult.

J. Paul had promised his mother (the cograntor of the trust) that he would equalize the income bequest to Ronald through his will so that they did not have to revoke the trust. That promise also prevented J. Paul's mother from making a more generous bequest to Ronald in her will to compensate for the income shortfall to Ronald in the trust, an action she would have taken but for J. Paul's promise to equalize Ronald in his will.

J. Paul died in 1976, leaving an estate valued at approximately $760 million. J. Paul left each of his children an inheritance, but left the residue of his estate to the trustees of the museum as part of its endowment fund. At the time of J. Paul's death, the trust held assets valued at approximately $1.3 billion (consisting of about 32 million shares of Getty Oil), which generated millions of dollars of dividends each year. After J. Paul's death, all of the income from the trust was distributed among the children; however, Ronald received a disproportionately small amount.

As a result, he filed suit seeking to impose a constructive trust on the assets the museum received from J. Paul's estate and on income derived therefrom. Ronald alleged that J. Paul had promised to cure the inequality in his estate plan by providing additional income to Ronald under his will to equal the amount going to J. Paul's other children.

In 1980 the trustees of the museum and Ronald settled for $10 million. Ronald excluded the $10 million from his income, and the IRS disagreed. The IRS argued that the $10 million should be included in Ronald's gross income because the exclusion provided by section 102(a) does not apply when a gift, bequest, devise, or inheritance is income from property (essentially, when it is an income stream from the property itself).

In evaluating whether the $10 million should be included in Ronald's gross income, the Ninth Circuit looked to the origin of the claim. The court treated the proceeds received by Ronald as if they had been received from J. Paul in satisfaction of his promise to equalize the income allocations. The complaint is the best source for determining what Ronald sought and how it should be treated for tax purposes. In his complaint, Ronald alleged that J. Paul promised to provide in his will for "income" to Ronald in an amount equal to that received by J. Paul's other children. The IRS argued that the bequest should be treated as income from property, which is includable in gross income under section 102(b)(2).

The Ninth Circuit took a broader view, noting that the prayer for relief should be read as a claim by Ronald for a judicial declaration that the trustees of the museum hold assets in constructive trust in an amount equal to the "amount of income received by or credited to each of J. Paul Getty's other children." The court distinguished its view from the IRS's by finding that Ronald did not seek income per se, but instead sought equalization with J. Paul's other children.

The Tax Court had found that J. Paul would have satisfied his promise to equalize Ronald's inheritance to that of his other children with a bequest of property, but stated that Ronald could not prove it. Because of the lack of proof, the Tax Court found that Ronald was not entitled to exclude the $10 million settlement from his income. The Ninth Circuit reversed.

The Ninth Circuit stated that even though Ronald did not prove that J. Paul would have "necessarily" remedied the inequality with a bequest of property, he did show that J. Paul "probably" would have done so with a bequest of property rather than an income stream. Thus, the Ninth Circuit softened the taxpayer's burden of proof. Interestingly, the Ninth Circuit and the Tax Court both found the law to be clear. If Ronald was treated as receiving property, the $10 million could be excluded from gross income under section 102(a). If, however, he was treated as receiving an income stream, the $10 million would be includable in gross income under section 102(b)(2). The law was clear; it was the facts that could be subject to varying interpretations.

Although the $10 million was ultimately transferred to Ronald and the underlying will contest case was resolved in his favor, it is easy to imagine a beneficiary bringing a malpractice action against the drafting attorney. The malpractice case could yield a less favorable tax result. For instance, assume that J. Paul 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 then dies.

A beneficiary in Ronald's position could assert a malpractice claim against the drafting attorney alleging that the attorney was negligent in drafting the estate plan even though 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?

Put differently, would the Ninth Circuit's decision change if the $10 million recovered was from a malpractice action rather than from the estate itself? The starting point for such an analysis is the origin of the claim. As *Getty v. Commissioner* demonstrates, what the plaintiff alleges in the complaint can affect the outcome. The Ninth Circuit's finding that Ronald sought ''equalization'' instead of income appeared to make a significant difference in its holding. Had Ronald sought relief in the form of income from specific securities, the IRS would have argued (and the court might have agreed) that section 102(b)(2) applied, and the $10 million Ronald received in lieu of inheritance would probably have been includable in his income.

When the intended beneficiary alleges malpractice, one should scrutinize the claim underlying the malpractice action. Of course, one could debate whether it should make any difference if the amount comes from a bequest of a specific asset or from the income produced by that specific asset (for example, dividends from stock).

As long as the beneficiary is being placed in the position he would have been in but for the negligence of the attorney, it should arguably not matter. 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 to the federal income tax treatment whether the recovery makes up for a stream of income or an asset, even though the asset might in turn produce a stream of income. The ultimate determination would likely hinge on several factors, one of which is the actual wording in the complaint.

Case Five: Like-Kind Exchange

Section 1031 provides a mechanism for excluding gain from gross income, deferring the gain on a like-kind exchange of property. To obtain tax-deferred treatment, a taxpayer must comply with several requirements relating to the type of property received in the exchange, the taxpayer's intent (with respect to either holding or disposing of the property), and statutory time periods.

Taxpayers often rely on the advice of accountants and attorneys in attempting to achieve tax deferral under section 1031. Often, despite a good-faith attempt to meet the necessary requirements, taxpayers come up short. When the taxpayer relies on the advice of an accountant or attorney and fails to qualify for section 1031 treatment, the taxpayer may have a malpractice claim against his adviser.

In *Mills v. Garlow*,[13] the taxpayers brought a malpractice suit against their former accountant, who counseled them on a real estate transaction that failed to get section 1031 treatment. The accountant believed the transaction would meet the requirements and qualify for deferral, and he prepared the taxpayers' return reporting a good section 1031 exchange. A few years later, the accountant and taxpayers severed their business relationship, and the taxpayers obtained a new accountant.

A year later, the taxpayers were audited on the section 1031 exchange. Involving both the new and old accountants, the taxpayers protested the deficiency asserted by the IRS. The new accountant thought the taxpayers owed tax, while the former accountant found grounds for protesting the deficiency. The taxpayers ultimately lost their case and were billed for additional taxes and interest.

The taxpayers filed a malpractice suit against their former accountant. The issue in *Mills* was not the taxability of a malpractice award, or even the merits of the malpractice case itself, but merely whether the statute of limitations for filing an action against their former accountant had run. The court determined that the statute of limitations had not run when the taxpayers filed suit. The case centered on whether the statute of limitations should begin to run on the taxpayer's discovery of the error (that is, when they were notified of a possible tax adjustment), or when the error became more formal and certain.

Although the case is silent about how the accountant improperly advised the taxpayers and the result of the ensuing malpractice action, the fact pattern raises an interesting scenario. The IRS collected approximately $6,600 plus interest from the taxpayers as a result of the audit. It is fair to assume that the taxpayers could collect that amount from their former attorney in their malpractice action. If they do, should the $6,600 malpractice recovery constitute gross income?

The private letter rulings suggest that an exclusion from income is appropriate only when the taxpayer pays more than his ''proper'' minimum federal income tax liability based on the underlying transaction. But in this failed section 1031 exchange fact pattern, the taxpayers are not paying more than their proper minimum federal income tax. The tax they paid was proper because the underlying transaction did not qualify for deferral under section 1031.

The IRS would presumably argue that the situation is similar to LTRs 9743035 and 9728052, so the recovery is taxable. The malpractice recovery of $6,600 in this situation would arguably compensate the taxpayers for *additional* taxes they had to pay, even though those additional taxes were based on the accountant's error. Of course, 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. That is arguably not a question of whether the taxpayer owed the correct amount of tax, but whether the transaction is taxable at all. Yet this argument may not carry the day.

[13]768 P.2d 554 (Wyo. 1989).

As can be seen in *Getty*, a creatively and properly worded complaint can affect whether the amount received is determined to be excludable from gross income. Of course, few litigants are thinking about tax issues when they write their complaints. The facts surrounding the dispute obviously have a lot to do with how the complaint will be (or *can* be) drafted.

For example, if the property transaction could have qualified under section 1031, the taxpayer might have a better chance of arguing for exclusion when the accountant erred in advising about one of the basic requirements. However, a taxpayer would presumably have a more difficult time arguing for exclusion when the transaction was never really eligible for section 1031 treatment, despite the accountant's representation that it would qualify.

Case Six: Patent Infringement

Whether a malpractice recovery represents gross income is something each victorious malpractice plaintiff needs to address. Once it is determined that the plaintiff is likely to be taxed on the malpractice recovery, the character of the income must be determined. Unless the taxpayer can show otherwise, the IRS will view the malpractice settlement or judgment as ordinary income.

In some cases, it may be possible for the plaintiff to pay tax at capital gains rates. The scenario presented below provides an example. First, a little background on the principles of patent law.

The U.S. Patent and Trademark Office grants patents and publishes those patents in its official documents. The holder of the patent is either the inventor or developer of the technology being patented, or another party, such as the inventor's employer. The owner of the patent has the right to exclusive exploitation of the technology secured by the patent for 20 years, at which time the patent expires. Thus, the holder of the patent may preclude individuals, companies, and other entities from exploiting the invention or technology protected by the patent.

If another party uses that technology without license or the permission of the patent holder, the patent holder may take action against the unauthorized user. Initially, the patent holder usually notifies the exploiting party of patent infringement by sending it a notice. The two parties then typically engage in discussions and negotiations.

Often, the two parties resolve the dispute and the patent holder issues the user a license. If the parties are unable to reach an agreement and they litigate the alleged infringement, the allegedly infringing party often will question the validity of the patent. If the patent can be shown to be invalid, the defendant has not infringed on any protected technology and therefore should not be liable for damages.

The patent holder (or its representatives) must also administer the patent. Administration of the patent includes the payment of the issuing fee on the initial grant of the patent and payment of consecutive maintenance fees every four years. The amounts of the issuing fee and maintenance fees vary depending on the size of the patent holder. For instance, if the patent holder is a company employing 500 or more people, it is considered a ''large entity'' and must pay more than a ''small entity,'' defined as an individual or an entity employing fewer than 500 people.

With those patent law principles in mind, consider the following fact pattern: Developer works for and owns Company A, a consulting company. Company B hires Company A to perform services in connection with developing a specific technology. Anything developed by Company A in the course of its services for Company B belongs exclusively to Company B. Company B employs fewer than 500 people.

In 1981, Developer invents technology in the course of his performance of services for Company B. Company B hires Pat Patent Attorney to prepare the patent application and administer the fees. Company B also negotiates licenses with several companies during the pendency of the patent. As a result of licensing the technology, Company B qualifies as a large entity, thereby requiring a higher issuance fee and higher maintenance fees. The patent is granted in 1982, and, despite Pat Patent Attorney's knowledge of the licenses, Pat pays small-entity issuance fees on behalf of Company B. Pat repeats the error again when paying maintenance fees in 1986 and 1990.

In 1986, Company B suffers financial difficulties and ceases operations. The creditors secure most of Company B's assets, but not its patents. In 1992, Developer and Company A become aware that several other companies might be infringing on the patent. Although Company B is defunct, it still owns the patent. Also, Developer discovers the incorrect payment of the initial issuance fee and maintenance fees by Pat. Company A (owned by Developer) acquires the patent and secures its ownership of the patent through judicial means. Company A then hires Pat — the same patent attorney — to perform legal services. Specifically, Company A asks Pat to cure the previous errors related to the issuance and maintenance fees. The patent attorney requests the U.S. Patent and Trademark Office to forgive the error in fees and to accept the correct payment from Company A.

Pat then prepares a verification statement, but fails to recognize two of the four technology licenses held by large entities. Those licenses were issued to the users by Company B before it ceased operations. Developer raises this issue with Pat, but Pat assures Developer that proper procedures will be followed and that any problems will be resolved favorably. On submission and acceptance of the verification statement, the U.S. Patent and Trademark Office grants Company A a certificate of correction. On receipt, Pat assures Company A and Developer that Company A owns the patent and can enforce it against users of the technology.

At this point, Company A pursues infringement actions against several targets who are using the technology but have not entered into license agreements with Company A or Company B. Company A successfully negotiates licenses with each technology user, securing a higher license fee with each subsequent settlement. However, the largest user of the patented technology (and the final target of Company A) decides to litigate the infringement allegation instead of entering into a license agreement. In the course of discovery, the unauthorized user deposes Pat and discovers that he failed to recognize all of the licensees in the verification statement. As a result, the unauthorized technology user alleges that the patent is invalid and unenforceable because the proper maintenance fees have not been paid. Had the patent attorney recognized all outstanding licenses, as he was obligated to do, higher maintenance fees would have been due.

Ruling on a summary judgment motion, the court holds that the patent attorney engaged in inequitable conduct before the U.S. Patent and Trademark Office, which renders the patent unenforceable. That causes the patent to become worthless. Company A later sues the patent attorney for malpractice, alleging inequitable conduct (for example, failure to disclose material facts, making false statements, and payment of improper fees) before the U.S. Patent and Trademark Office.

The malpractice complaint against Pat alleges damage to Company A and Developer from destruction of the patent. While the amount of damages caused to Company A and the Developer may be measured by the loss of future royalties, the damages sought in this lawsuit are clearly distinguishable from the damages sought in the patent infringement lawsuit against the unauthorized technology user. In addition to damages for loss of the patent, Company A and Developer seek punitive damages. The availability of punitive damages suggests that the malpractice action is a tort action for money, not a patent infringement action in which the damages are to compensate for the loss of income from royalties.

The malpractice action (based on negligence and breach of duty) seeks damages for the loss of the patent asset, not royalties or lost profits. The patent was a capital asset in Company A and Developer's hands that would have continued to generate income but for Pat's negligence, which resulted in the destruction of the patent. What is the tax result?

One way to help capital gain characterization may be to allege in the complaint and additional pleadings that the malpractice action is based on the loss of the patent as an asset, rather than on the loss of royalty income. An action based on damages related to royalties would likely result in taxation of those damages at ordinary income rates, since royalty income is taxed at ordinary income rates. If a recovery in a patent case may be taxed either as ordinary income or as capital, presumably the same should be true of a legal malpractice recovery that relates to the patent attorney's malpractice.

Of course, that's a dreadful oversimplification of the law, particularly inasmuch as section 1235 provides by statute for some recoveries in this area to be capital, despite their arguable origin in a stream of royalty payments. Thus, some recoveries that may not, on the surface, appear to be capital gain may be. Here, given the legal malpractice action for the loss of a patent due to the lawyer's mistake, the recovery should arguably be capital.

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. Even then, the authority is hardly consistent or satisfying. Those tax-centric cases and rulings seem to turn on artificial distinctions rather than on basic principles.

At the same time, the origin of the claim doctrine nowhere seems to be cast aside, either explicitly or implicitly. Thus, I believe the origin of the claim doctrine should be the center of any analysis of the tax treatment of a malpractice recovery. If nothing else, perhaps the hypothetical examples presented in this article help to prove two things.

First, they show that there is no tried and true method for excluding malpractice recoveries from gross income. The origin of the claim underlying the malpractice is likely to have a significant impact on the ultimate determination, but even then, there is little comfort in the authorities. Second, the wording of the complaint in the underlying or initial case may either hurt or help the taxpayer-plaintiff. A cleverly drafted complaint might make all the difference (which may have proven true had *Getty* been a malpractice action). In some cases, however, it appears that no magic language may be enough to change an unfortunate outcome.

Although *Clark* is still a favorable and valid authority, the IRS has sought to limit its application through several private letter rulings. Even though those rulings appear to be limited to malpractice in tax matters, the general principles the IRS enunciates in those rulings could conceivably be extended to malpractice recoveries in other legal disciplines. With the conspicuous lack of guidance on those issues, that should cause taxpayers and advisers facing significant tax issues in malpractice recoveries to do so carefully.