PERSPECTIVE

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The ins and outs of taxing legal malpractice settlements

By Robert W. Wood

Legal malpractice claims arise out of accident and medical malpractice cases, wills and trusts, divorce, litigation, tax advice, real estate deals, and many other types of legal matters. In fact, the list seems almost endless. Some cases involve simple acts or failures to act. Consider a lawyer who misses a statute of limitations or who missteps on some issue, such as recording a lien against the wrong parcel of property.

Whatever the circumstance, when a legal malpractice case settles, there are bound to be tax issues. Is the recovery taxable? If so, as ordinary income, capital gain, basis recovery, or some combination of those? There seem to be no shortage of legal malpractice cases and recoveries, but there is little authority how they are taxed. Convincing the IRS and the courts *not* to tax payments can be difficult. Here are a few examples of malpractice recoveries with how I think they should be taxed.

Example 1. Paula Plaintiff is injured in a car accident and retains Alan Ambulance Chaser to represent her against the 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. Paula was physically injured, but in the end, Paula recovers from her lawyer, not from the person who injured her.

Section 104(a) of the tax code 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 tax free. It should not matter whether the claim for malpractice sounds in tort or contract.

It should also not matter who pays Paula, the driver, the driver's insurer, Larry, or Larry's malpractice insurer. Third parties get roped in and pay (or contribute to paying) settlements or judgements in any number of contexts. The analysis becomes more complex if Paula recovers punitive damages, since punitive damages are always taxable.

Example 2. 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.

The tax 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.

Example 3. 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 in the divorce. Instead, Tanya ends up with half the stock in the startup. Tim sues Larry and eventually recovers. This one arguably ought not to be taxable provided that Tim had sufficient basis in his startup stock to absorb the settlement from Larry.

In that event, much like in a construction defect or investment loss case, Tim might be able to reduce his basis by the amount of the recovery from Larry. That is better than having to take it into income. However, if Tim has negligible basis—and in my experience that is usually the case—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 it is argue it is capital gain. If the stock was qualified small business stock, could Tim argue this was a sale? Perhaps, since he is getting proceeds, albeit from someone who really didn't end up with the stock.

Qualified Small Business Stock (QSBS) is still in the federal tax law. If you qualify, up to $10 million in sales proceeds can be tax free when you sell your stock. There are numerous requirements of course, but it is a whopper of a benefit. Not that California tax law does not conform, so it is fully taxed by the Franchise Tax Board. Well, unless you move out of state before you sell.

Example 4. 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 in the documents 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.

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 may cause him to pay tax on an asset received from the estate. If the beneficiary is being placed in the same position that he would have been in but for the negligence of the attorney, a settlement payment should arguably not be income.

Example 5. Suppose that Larry 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. This is a big topic, one that is hard to summarize, and the facts will obviously matter. Some recoveries of this sort will be ordinary income, some will be capital gain, and some will be basis recovery that might escape current tax.

Example 6. What if 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. The origin of the claim doctrine tries to address this, and it should still do it in the follow-on malpractice case that makes up for a legal flub. Still, there is no question that everything is more attenuated.

Despite my glib and seemingly definitive answers in this column, it is difficult to predict the tax treatment of legal malpractice recoveries. There is surprisingly little authority, so one is often arguing from other contexts. Not only that, but what authority there is seems to involve only tax matters, and then to do so in a way that is hardly consistent or satisfying. In the authority that does exist, the IRS is predictably usually arguing that something is taxable.

The origin of the claim doctrine should be the center of analysis for the tax treatment of malpractice recoveries. A

cleverly crafted complaint might help, and that is true with the wording of settlement agreements too. In some cases, however, magic language may not be enough to change an unfortunate outcome. Taxpayers and their advisers facing significant tax issues in malpractice recoveries should consider these issues carefully, hopefully long before it is time to sign a tax return under penalties of perjury.

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