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Taxation of Attorney Fee Awards in Legal Malpractice Cases

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The recent tax law changes may impact and increase damage awards in legal malpractice cases.

In New Jersey, when a former client successfully sues a former attorney for legal malpractice, the client is entitled to recover the fees incurred for the malpractice lawsuit as part of the measure of damages. New Jersey's Supreme Court established this fee-shifting rule, which is an exception to the American Rule that provides each party pays their own attorney fees for a lawsuit, in the 1996 case *Saffer* v. *Willoughby,* 143 N.J. 256 (1996).

The court stated that attorney fees in a legal malpractice case are consequential damages and available "to put a plaintiff in as good a position as he [or she] would have been had the [attorney] kept his [or her] contract." *Id*. at 271.

Under the tax laws that expired at the end of 2017, an individual's attorney fees (whether incurred or reimbursed) were either fully excluded from income or deductible as a miscellaneous expense to the extent the attorney fees exceeded 2 percent of the individual's adjusted gross income, and the individual was not subject to the Alternative Minimum Tax.

The Tax Cuts and Jobs Act of 2017 eliminated miscellaneous expenses as a deduction from adjusted gross income, which means that attorney fee awards are now taxable in a whole category of situations not previously taxed.

If the underlying claim is for recovery of money that will be taxed (such as a claim for unpaid wages or lost profits), the award of attorney fees is not taxed. 26 U.S.C.A. §212(1). Where the claim is for non-taxable damages, the award of attorney fees is taxed. This means that, with some exceptions, a plaintiff awarded attorney fees pursuant to a statute, case or court rule must treat the recovery as income subject to taxation by the Internal Revenue Service and State of New Jersey, including the legal fees paid to plaintiffs in legal malpractice cases where the compensatory damages are not taxable.

As for exceptions, the compensatory damages in personal injury or sickness cases are not taxable whether the funds are retained by the client or paid to the attorney. 26 U.S.C.A. §104(a). Awards for damages and attorney fees in discrimination suits and whistleblower claims are not included in adjusted gross income and thus not taxable. 26 U.S.C.A. §62(a)(20) and (21). But awards of attorney fees to individuals are now taxable in all other cases not related to the collection of taxable money.

Attorney fee awards in legal malpractice cases handled on a contingency fee basis are not subject to the time spent/hourly rate lodestar, instead, courts may award the one-third contingency fee if that is the arrangement between malpractice lawyer and client. *Distefano v. Greenstone*, 357 N.J. Super. 352, 361 (App. Div. 2003). Awards can be quite high.

Whether the compensatory damages awarded in a legal malpractice case are taxable depends on the nature of the underlying claim. *United States v. Gilmore*, 372 U.S. 39, 49 (1963). If the plaintiff sues her attorney for professional negligence in her representation in a claim for an inheritance, the compensatory damages recovered in the malpractice case are not taxable because there is no federal or state inheritance tax. If the plaintiff sues the attorney for malpractice in handling a case for the recovery of unpaid wages, on the other hand, the compensatory damages are taxable because the unpaid wages would have been taxed. 26 U.S.C.A. §104(a)(1)(a). Finally, if the attorney's negligence occurred in a claim to recover the client's security deposit, the compensatory damages would not be taxed since there is no tax on the recovery of a party's capital. *Clark v. Commissioner*, 40 B.T.A. 333 (1939), acq., 1957-1 C.B. 4 and Rev. Rul. 57-47, 1957-1 C.B. 23.

In the inheritance and security deposit case, the attorney fee awards are taxed because they do not fall within an exception and the claim for compensatory damages is not taxable income.

If the measure of damages is to place the plaintiff "in as good a position" as he or she would have enjoyed had the attorney not malpracticed, then the plaintiff's obligation to treat the attorney fee award as income and pay taxes on it certainly detracts from the plaintiff being in as a good a position.

Plaintiffs now will be seeking an augmentation of any attorney fee award to recoup an amount sufficient to pay the taxes. Known as a "tax gross up," this concept is not new.

In *Oddi v. Ayco Corporation,* 947 F.2d 257 (7th Cir. 1992), the court considered a negligent tax planning and advice claim in which the tax advisor made an error calculating the tax impact of a transaction for his investor client. The court awarded damages not only for the difference between the advised amount and the actual amount, but augmented the award to include an amount for the income taxes that would be incurred on the award. *Id.* at 261. The trial court's award was not disturbed on appeal.

In *Jobe v. International Insurance Company*, 933 F.Supp. 844 (D. Ariz. 1995), the court relied on *Oddi* as it outlined the damages available to a plaintiff in a tax malpractice case:

Damages in a tax malpractice case are the difference between what the plaintiff would have owed if the tax returns had been properly prepared and they owe now because of the professional's negligence, plus incidental damages. *Thomas v. Cleary,* 768 P.2d 1090, 1091–92 n. 5 (Alaska 1989). The injured plaintiff in a tax malpractice action may recover: (1) the taxes paid after audit, appeal and/or settlement attributable to the negligence; *Thomas,* 768 P.2d at 1092; (2) interest paid on those taxes; (3) prejudgment interest on taxes and interest paid, *Wynn v. Estate of Holmes,* 815 P.2d 1231, 1235–36 (Okla. Ct. App.1991); (4) professional fees incurred in defending the audit, *Thomas,* 768 P.2d at 1092; (5) all fees paid to a lawyer who acts while in a conflict situation, *Day v. Rosenthal*, 170 Cal. App.3d 1125, 217 *Cal.Rptr*. 89, 113 (Ct.App.), *cert denied,* 475 U.S. 1048, 106 S.Ct.1267, 89 L.Ed.2d 576 (1986); and (6) **additional taxes a plaintiff will incur on receipt of the damages award**. *Oddi v. Ayco Corp*, 947 F.2d 257 (7th Cir.1991).

Id. at 860 (emphasis added).

While it benefits the clients, the attorneys and the insurance company to pay taxes that the government uses for education, roads and police, most litigants see it differently—not welcoming the opportunity to pay taxes. One tax-avoidance strategy for settlement negotiations is to attribute all or as much of the settlement amount to compensatory damages that have some justification in fact. The plaintiff may be asserting $100,000 in compensatory damages but may have proof problems with $30,000 of that amount which results in the plaintiff accepting an $80,000 settlement offer. Instead of itemizing the settlement as $70,000 for compensatory damages and $10,000 for taxable attorney fees, the parties can agree to settle for $80,000 in compensatory damages with the plaintiff waiving the claim for attorney fees. The settlement number is still less than the maximum compensatory claim and the itemization is justifiable, and no part of the settlement was paid for attorney fees.

This strategy is supported by the finding of the United States Tax Court in *Concord Instruments Corp. v. C.I.R.*, 67 T.C.M. (CCH) 3036 (T.C. 1994) (1994 WL 232364). There, a taxpayer sued for compensatory damages of $466,000 arising from legal malpractice for its attorney's failure to file an appeal of a tax assessment. The $466,000 was comprised of taxes and interest paid from the taxpayer's capital. The case settled for $125,000 and the IRS wanted to tax the settlement, asserting that it was income to the taxpayer. The tax court ruled that $125,000 was paid to settle a claim in which the taxpayer sought a return of capital, and since damages for a return of capital are not taxed, the $125,000 settlement was not taxed.

The court reasoned that the nature of the settlement (whether taxable income or non-taxable return of capital) is determined by looking at the nature of the claim, not the merits of the claim. "The tax consequences of an award for damages depend on the nature of the litigation and on the origin and character of the claims adjudicated, but not the validity of such claims." *Id.*

The IRS argued that the taxpayer would never have won its appeal if the attorney had timely filed the appeal, and since the taxpayer would not have won the appeal, the payment of $125,000 must be considered income to the taxpayer. The court disagreed.

As the tax gross up issue evolves with the settlement and adjudication of legal malpractice cases in New Jersey, practitioners will likely develop more strategies for the avoidance of the payment of taxes on attorney fee awards. Creative minds are required.

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