

# Recovering Taxes Paid in Malpractice Actions: A New Look in New York

BY JAMES S. O'BRIEN JR.

When a tax advisor's negligence causes the client to pay additional taxes, interest, and penalties, the majority view in the United States is that the client may recover those payments as damages in a malpractice action. Not necessarily so in New York. In *Alpert v. Shea Gould Climenko & Casey*, 559 N.Y.S.2d (1st Dept. 1990) the First Department held that a taxpayer could not recover from his lawyer back taxes arising from a failed tax shelter because the client, who chose to enter into the tax shelter relying on the allegedly faulty advice, was not entitled to be restored to a position as if the transaction successfully avoided the tax because that would place him in a better position than if he never had invested in the tax shelter in the first place. *Alpert* was a fraud

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case. Although negligence actions involve a different measure of damages, subsequent New York courts have applied the *Alpert* holding in malpractice (i.e., *negligence*) cases without analyzing that difference. As a result, New York courts routinely hold that additional taxes occasioned by negligent advice are not recoverable as damages in malpractice actions.

In *Bloostein v. Morrison Cohen* (S. Ct., NY Cty 651242/2012), plaintiffs

sued Morrison Cohen for legal malpractice in a transaction that resulted in plaintiffs' having to pay the very taxes that the transaction was structured to avoid. Morrison Cohen moved for summary judgment, arguing the *Alpert* proscription against the recovery of taxes. The court (Borrok, J.) denied summary judgment. This article will examine the disconnect between the *Alpert* analysis and negligence (malpractice) cases, the *Bloostein*

result, and how plaintiffs may obtain the additional taxes that they had to pay due to their advisor's negligence.

### 'Alpert'

*Alpert* was a fraud action involving a tax shelter that offered the immediate deduction of future royalty payments for the right to mine coal in the future. The tax shelter sponsor obtained a tax opinion from one of the defendant law firms suggesting that the advance minimum royalty payment was deductible when made. Shortly before the plaintiffs invested, the Income Tax Regulations were amended to *disallow* an immediate deduction for such advance royalty payments, and the IRS issued a Revenue Ruling stating that such payments could be deducted only over the time period that they covered. The original law firm then withdrew its opinion. The tax shelter sponsors then obtained a second opinion from defendant Shea, Gould, Climenko and Casey suggesting that the deduction might still be valid. Plaintiffs invested in the tax shelter and the IRS disallowed the deductions, assessing substantial interest charges. Plaintiffs sued for fraudulent misrepresentation claiming as damages lost profits and the tax benefits that they would have obtained had they not relied upon defendants' opinions and had instead invested in a viable tax shelter.

The First Department noted that the recovery of consequential damages flowing from a fraud is limited to those necessary to restore a party to its position before the fraud. The court held that to allow plaintiffs to recover the back taxes paid would place them in a better position than had they never invested in the tax shelter (had plaintiffs not invested, they would have owed the taxes). Additionally, the *Alpert* court held that plaintiffs could not recover the interest they had to pay because, the court reasoned, such interest did not constitute damages but, rather, was a payment to the IRS for their use of

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the money during the period of time when they were not entitled to it. As such, the *Alpert* holding was an unremarkable application of New York's established case law concerning fraud damages.

### Post-'Alpert'

Damages in negligence actions are determined differently than in

fraud actions. The recovery available to a negligence plaintiff is the difference between what was obtained by the plaintiff and *what would have been obtained with non-negligent performance*. See *Campagnola v. Mulholland, Minion & Roe*, 76 N.Y.2d 38 (1990). See generally Prof. Jacob L. Todres, *New York's Law of Tax Malpractice Damages: Balanced or Biased?*, 86 St. John's Law Review (2012). Negligence damages are sometimes referred to as "benefit of the bargain" or "expectancy" damages, which are much broader than the "out-of-pocket" damages available in fraud actions. Thus, the benefit of the bargain should include recoupment of taxes paid due to the advisor's negligence, since the "bargain" was for the client not to incur the taxes.

Despite the fact that negligence damages are different from fraud damages, New York courts have applied the holding of *Alpert* in negligence cases without any discussion of that difference. For example, *Menard M. Gertler, M.D., P.C. v. Sol Masch & Co.*, 835 N.Y.S.2d 178 (1st Dept. 2007) involved an accountant's malpractice that resulted in plaintiff's having to pay taxes and interest. Fraud was never mentioned in the opinion, yet the court cited only *Alpert* and stated flatly, without any analysis, that "taxes and tax interest are not recoverable under

New York law.” *Id.* at 179. The same was true in *Chen v. Huang*, 43 Misc.3d 1207(A), 2014 N.Y. Misc. LEXIS 1495 (S.Ct. Kings Cty 2014), in which the court correctly observed that damages in a legal malpractice case are designed to make the injured client whole, but then inexplicably cited to *Alpert* and *Gertler* and stated that “taxes paid are generally not recoverable as damages under New York law.” See also *Solin v. Domino*, 2009 U.S. Dist. LEXIS 51405 (2d Cir. 2009), at \*7-8 (“*Solin*’s claim for malpractice damages fails because it falls within New York’s proscription on the recovery of tax liability,” citing *Gertler*).

A consistent theme in the malpractice cases disallowing taxes is that to allow a plaintiff to recover taxes incurred because of the malpractice would bestow a “windfall.” That was true in *Alpert* where, according to a traditional fraud calculation of damages, restoring plaintiffs to their position before the fraud meant that they owed the taxes in any event. But that concept of a windfall does not work under a negligence standard, the purpose of which is to give plaintiff the *benefit of its bargain*. Under that standard, there is no windfall in recovering taxes actually caused by the malpractice, such as missing a deadline, improperly drafting a document, giving bad

advice to take a deduction in a later year that causes the loss of the deduction in the proper year, or miscalculating the necessary holding period causing the loss of favorable capital gain treatment.

Yet, that was the case in *Chen*, where the plaintiff’s attorney improperly transferred sales proceeds that invalidated an otherwise proper IRC §1031 like-kind exchange, triggering taxes that would not have arisen but for the attorney’s negligence. The same was true in *Solin*, where plaintiff surrendered an annuity based on improper tax advice from his accountant that caused plaintiff to incur excessive capital gains taxes. Likewise, in *Fownes Bros. & Co. v. JPMorgan Chase & Co.*, 2012 NY Slip Op 01356, plaintiff switched from one employee benefit plan to another based on improper advice. In each case, the court held that the tax liability did not flow from the negligence of the tax advisor, but from the taxable event created when plaintiff entered into the transaction. The courts did not explain how recovering taxes that would not exist but for the advisor’s negligence would constitute a windfall. In *Bloostein*, the court parted company with that view.

### ‘Bloostein’

*Bloostein* involved an Internal Revenue Code §1042(c)(4)

transfer of ESOP proceeds. The *Bloostein* plaintiffs were business owners who had sold a portion of their companies to their employees in ESOP transactions. Section 1042 allows such a seller to use the ESOP proceeds to purchase qualified replacement property (QRP), which defers any capital gains taxes as long as the QRP is held. Plaintiffs purchased 30-year utility company bonds with their ESOP proceeds for their QRP. They then pledged that QRP to Nomura International Ltd. in exchange for loans in the approximate amount of their QRP. The maturities of the loans were tied to those of the bonds, 30 years in the future, at which time the plaintiffs would be deceased, according to government actuarial tables. Their heirs would receive a “stepped up” tax basis and no capital gains on the ESOP proceeds would be due. Thus, plaintiffs would have the use of their ESOP proceeds for the remainder of their lives and no tax would be due. In the event that plaintiffs outlived the bonds’ maturities, any taxes would only come due 30 years in the future.

Days before the Nomura transaction closed, a change was made by another law firm to a default provision in the loan documents that fundamentally altered the risk profile of the transaction. Morrison Cohen attorneys noticed the change—which had

not been requested, negotiated, or discussed—and flagged it with a question. The question went unanswered and the improper change remained in the subsequent drafts and in the execution copy. Morrison Cohen neither questioned it again nor advised plaintiffs about the change. When the financial crisis hit, Nomura declared a default relying upon the improperly changed default language and sold the bonds to cover the loans, resulting in massive capital gains taxes to plaintiff. Had the improper change to the default trigger been corrected, no default would have occurred.

Morrison Cohen argued New York’s proscription against recovering taxes paid as damages, claiming that plaintiff’s taxes did not flow from any malpractice, but from the underlying ESOP transaction. It argued that the tax liability existed independently of anything Morrison Cohen did; allowing recovery of the taxes would thus represent a windfall for plaintiffs.

Justice Borrok noted that “damages in a legal malpractice action are designed to make the injured client whole.” He addressed directly the theme that recovery of the taxes paid would constitute a windfall to plaintiffs, and took issue with the argument that the tax liability was caused not by Morrison Cohen’s malpractice, but by the tax liability stemming

from the underlying ESOP transaction. He stated that the tax loss did not merely stem from Morrison Cohen’s failure to correct the improper change to the default trigger; “it also emanated from the change in inherent business risks of default between the Original Rating Event of Default Provision and the Revised Rating Event of Default Provision which revision, most significantly, was not discussed with plaintiffs.”

Justice Borrok observed that—as was the case in *Chen, Solin, Fownes* and other cases disallowing the recoverability of taxes—“if the provision had not been changed ... there would not have been a default under the Nomura indenture agreement.” Unlike other New York courts, however, Justice Borrok applied a classic negligence analysis of the tax damages, holding that “recovery of the capital gains tax paid by the plaintiffs ... places the plaintiffs in the exact position they would have been but for the alleged malpractice. Simply put, this recovery was not disallowed under *Alpert*.”

### Conclusion

*Bloostein* represents a new look at recovering taxes paid in malpractice actions. It was the first court to hold that additional taxes paid due to a tax advisor’s negligence may be recovered where the tax would not have arisen but

for the advisor’s negligence. As such, it is the first court to employ a negligence analysis in a malpractice action to hold that plaintiffs are entitled to benefit of the bargain damages and, at least in some cases, the recovery of additional taxes occasioned by the bad advice does not constitute a windfall. Morrison Cohen argued that “the policy interest behind *Alpert* and its progeny recognizes that a tax advisor/attorney is not his or her client’s insurer against tax liability.” There is no legal basis for such a protectionist policy under New York’s negligence standard, and plaintiffs should be allowed to recover additional taxes paid if they can demonstrate that there would have been no such taxes but for their advisor’s negligence.