

# Court OKs Award To Neutralize Tax Liabilities On Lump-Sum Payment

By Robert W. Wood

Most legal settlements and judgments are taxable. Even worse, starting in 2018, it can be tough — or even impossible in some cases — for plaintiffs to deduct their legal fees. Yes, that can actually mean paying taxes on 100 percent of the money, even though a contingent fee lawyer takes 40 percent or more off the top as legal fees.

However, since many tax rules are not black and white, there is often considerable tax planning at settlement time to try to address these rules. Sometimes, what looks taxable might not be, depending on the details. And even if it is taxable, as what? Ordinary income or capital gain?

Then there are timing issues, installments or structured settlements that pay over time, even though the defendant is paying all cash. There can also be tax issues in the equation even before a case is resolved. For example, can plaintiffs get damages for additional taxes they will owe because of the defendant's actions?

Is a tax gross up or tax neutralization fair game? Predictably, defendants, say no. But increasingly, the courts seem to be siding with plaintiffs. Historically, many courts were reluctant to gross up a plaintiff's damages by the taxes the plaintiff must pay.

One reason was a lack of precision in tax calculations. Another reason is that we all have to pay taxes. The plaintiff must pay taxes in any event, regardless of the activity of the defendant, say some courts. Yet what if the lump sum nature of a verdict or settlement *itself* causes the tax problem?

The plaintiff would not have faced those extra taxes if payments were made over time as they should have. In such a case, shouldn't a plaintiff who can prove this but-for link recover the extra taxes too? In 2017, the 9th Circuit said yes in *Arthur Clemens, Jr. v. CenturyLink Inc. and Qwest Corporation*, 874 F.3d 1113 (9th Cir. 2017). The case was limited to tax gross ups in Title VII employment cases, but may have application to many types of cases.

Then, in 2019, a California Court of Appeal gave an even broader reading, upholding a tax neutralization in a wrongful termination case involving state law. In *Economy v. Sutter East Bay Hospitals*, 2019 DJDAR 1049 (Cal. Ct. App. Feb. 4, 2019), a doctor sued a hospital for wrongful termination. The trial court awarded him \$3,867,122 in damages, comprised of \$1,136,906 in lost income, \$1,159,354 in future lost income, \$650,910 for tax neutralization, \$19,000 for the cost of a particular program, \$650,000 for emotional distress and \$250,952 in prejudgment interest.

The hospital appealed. The only element of damages awarded the plaintiff that the hospital specifically challenged was the \$650,910 for tax neutralization. This amount was calculated to offset the increased tax burden on plaintiff resulting from a lump sum award of damages, compared to the taxes if the earnings had been paid annually. The amount was based on testimony by plaintiff's expert, an economist.

Prior to trial, the hospital made a motion in limine to exclude the expert's testimony. The hospital said it did not meet the requirements of the *Kelly-Frye* test for admissibility of scientific evidence. See *People v. Kelly*, 17 Cal. 3d 24 (1976); *Frye v. United States*, 293 F. 1013, 1013 (D.C. Cir. 1923). The hospital said it also did not comply with Evidence Code Sections 801 and 802, claiming that it was highly speculative, and based on information not reasonably relied upon by experts.

But the court denied the hospital's motion and allowed the evidence. On appeal, the hospital again argued that it the expert testimony was based on speculative assumptions about future tax rates, etc. The appellate court admitted that there were no reported decisions in California on the concept of tax neutralization. But many federal appellate courts allow such tax gross ups. See *Equal Employment Opportunity Commission v. Northern Star Hospitality, Inc.*, 777 F.3d 898 (7th Cir. 2015); *Eshelman v. Agere Systems, Inc.*, 554 F.3d 426 (3d Cir. 2009); *Sears v. Atchison, Topeka & Santa Fe*, 749 F.2d 1451 (10th Cir. 1984); *Clemens v. CenturyLink Inc.* 874 F.3d 1113, 1117 (9th Cir. 2017).

The appellate court said that compensating a plaintiff for additional tax liabilities on a lump-sum payment is consistent with Civil Code Section 3333. The idea is to make the measure of damages the amount which will compensate for all the detriment proximately caused by the wrongful conduct. The federal authorities allow the trial court to adjust a lump-sum back-pay award to account for the corresponding increase in tax liability. *Clemens*, 874 F.3d at 1114-15.

A lump-sum award may push a plaintiff into a higher tax bracket. Not considering the taxes might effectively deny the plaintiff the full relief to put him in the position had the unlawful employment discrimination never occurred. An award to compensate for an income tax disparity for lost *future* wages would be inherently speculative, said the court. Any award for lost future income might be too.

However, here, we were talking about *back* pay. The court said there was no reason why tax neutralization on *back* pay could not be established with sufficient certainty. This expert provided detailed testimony regarding his calculations of plaintiff's total tax liability if he had not been terminated. He figured the taxes plaintiff would have paid. And to make up for receiving a lump sum, he figured the amount needed to offset the adverse tax consequence.

The hospital argued that a number of cases suggested that income tax figures were inappropriate to consider. However, the appeals court distinguished the authority the hospital cited, noting that it was concerned with *reducing* the amount of damages to account for income taxes that might otherwise have been paid in the future. That was entirely different.

In contrast, the purpose of the award to Dr. Economy was to ensure that he was fully compensated for his losses. His expert laid a sufficient foundation to establish the probability and reasonableness of his tax neutrality projections to justify reliance on them.

**Robert W. Wood** is a tax lawyer with [www.WoodLLP.com](http://www.WoodLLP.com), and the author of "Taxation of Damage Awards & Settlement Payments" ([www.TaxInstitute.com](http://www.TaxInstitute.com)). This is not legal advice.