Taxes as an Element of Damages

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Introduction

In a civil suit, can a plaintiff obtain damages for tax liability caused by the defendant's conduct? Put differently, should tax consequences be a component of recoverable damages? Does recovery depend on whether the defendant was aware of the plaintiff's tax position? Does recovery depend on whether plaintiff would have paid taxes in any event?

The answer to these questions is a maddening "it depends"—not only on the court and the nature of the case, but on when such tax issues are invoked and whether the case is before a judge or jury.

Whether tax benefits or burdens are considered in damage awards is primarily a remedies, rather than a tax, question. A related issue is whether an otherwise appropriate damage award may be reduced for tax benefits conferred, to avoid unjust enrichment. Cases on both sides of these issues are discussed below.

Practical Considerations

From a practical standpoint, tax effects should be evaluated in nearly every case. Asking the court to take into account the tax impact of a case will rarely have a downside, although there may occasionally be tactical reasons not to raise tax matters. For example, a defendant may choose not to argue for discounting a plaintiff's damages to take into account tax benefits that the plaintiff received from an investment that went badly. If the plaintiff has not raised tax issues, and the defendant is concerned that any benefits it might achieve from its tax argument will be outweighed by *bigger* tax issues raised by the plaintiff in response, defendant would be wise not to raise the issue.

The current trend of case law suggests that tax gross-up claims and discount requests are more favored today than they were in the past. In seeking tax damages or discounts, however, one needs to be realistic. Here are a few points to bear in mind:

- Make your claim for taxes as part of your case as early as you can. A *motion in limine* is a good place to address such matters.
- Because tax issues can be complicated, do your best to keep your tax assumptions and calculations straightforward. You are more likely to prevail if your tax arguments are credible and understandable.
- Be cognizant that in federal cases the jury will decide the tax damage claim. You are unlikely to succeed if you ask the court to gross-up the claim after the verdict.
- In state or federal cases, plaintiff bears a heavy burden of proof. To carry that burden, you will need to show that the *specific* taxes paid were caused *solely* by the defendant, and that plaintiff would not have paid them otherwise.

Courts' Views of Taxes as Damages: Pro and Con

Cases Denying Tax Damages

In *Judith K. Kelley v City of Albuquerque* (D NM 2006) 2006 US Dist Lexis 28785, the court denied damages for tax consequences. *Kelley* arose out of an employment dispute in which plaintiff alleged violations of the New Mexico Human Rights Act and Title VII of the Civil Rights Act of 1964 (42 USC §§2000e—2000e–17). Before trial, plaintiff sought to exclude testimony concerning tax benefits she derived from the losses that formed the basis of her claims. The court excluded this testimony, but allowed plaintiff to offer evidence of the tax consequences of any resulting verdict.

The jury awarded $172,174.90 for back pay and $200,000 for loss of future retirement or pension benefits. After a final judgment, plaintiff moved to amend the judgment to take into account increased federal taxes she would have to pay because of the award. Specifically, plaintiff asked the court for $37,297.49, plus an additional 10 percent of the attorney fees award, to compensate for additional federal taxes. The court denied the motion, noting that the Seventh Amendment's guarantee of the right to a jury trial generally prohibits additur. Put simply, the amount of damages was within the jury's province, not the court's.

Kelley distinguished two Tenth Circuit cases relied on by plaintiff to support her argument for an increased award. In *Sears v Atchison, Topeka & Santa Fe Ry. Co.* (10th Cir 1984) 749 F2d 1451, the court upheld a tax component paid to class members for additional tax liabilities they faced because the lump-sum award they received covered 17 years of back pay. The *Sears* court recognized that tax damages were atypical, but found special circumstances in the protracted nature of the litigation. The *Kelley* court noted that *Sears* was a bench trial, so an increase in the award to reflect tax consequences did not interfere with the jury's province. *Carter v Sedgwick Co.* (10th Cir 1954) 36 F3d 952 was also distinguishable because it was a bench trial and did not award an increased judgment for taxes.

Kelley also distinguished *Blaney v International Ass'n of Aeronautic Workers* (Wa Sup Ct 2004) 87 P3d 757, which held that Washington state's antidiscrimination statute allowed an increased award to compensate for taxes incurred by the award. Because *Blaney* was a state case, the Seventh Amendment's requirement that courts not reexamine a jury's finding on damages was inapplicable.

The final nail in the coffin of Kelley's tax claim was denial of equitable relief. The court's rationale was stated broadly (*Kelley,* 2006 US Dist Lexis 28785, 21*):

> While it may be unfortunate that a victorious plaintiff, who believes that her damages award is necessary to make her whole, has to part with as much as a tenth of her award, the payment of those taxes does not offend justice. Indeed, Kelley would likely have had to pay taxes on much, if not all, of this money even if this city had not violated the law . . .

Another recent case in which the court declined to award tax damages to a prevailing plaintiff is *Porter v United States Agency for Int'l Dev.* (DC Dist 2003) 293 F Supp 2d 152. Plaintiff Porter was awarded $30,000 by a jury on his employment discrimination claims, and was also to receive over $200,000 in attorney fees and litigation expenses. Plaintiff requested indemnity against any tax consequences from the fees award, or, in the alternative, that the court "gross-up" the attorney fees to cover the tax liability. Although the court did not grant the plaintiff's petition for indemnification or a supplemental award for the tax liability, the plaintiff was not ultimately responsible for the tax liability associated with the attorney fees. Instead, the court took a proactive approach, attempting to insulate the plaintiff from tax liability on the attorney fees by making the fee award payable directly to counsel, and by explaining the nature of the award clearly so the plaintiff and his tax advisor could refer to the explanation when preparing income tax returns. Presumably, the court also hoped that the IRS would consider the explanation before attempting to impose a tax on the plaintiff for the attorney fees award.

Employment cases such as *Kelley* and *Porter* present fertile ground for employee-plaintiffs to argue for tax gross-ups, particularly given the 1996 amendments to IRC §104 that require physical injury or physical sickness for a damage award to be excluded from taxable income. Yet that is not the only situation in which the tax-as-damages issue arises. A plaintiff may assert a claim for tax damages resulting from the defendant's conduct in various situations. Courts are, however, usually unsympathetic to such claims.

This is true even when the nature of the dispute itself revolves around tax issues. For example, in *Gaslow v KPMG, LLP* (NY Sup Ct 2005) 797 NYS2d 472, the plaintiff could not recover taxes and interest in a suit against his accounting firm, even though the defendant allegedly induced the plaintiff to make the tax shelter investments that the IRS later attacked. The basis for this decision appears to be that the plaintiff would have paid taxes anyway. This rationale is also suggested in *Eckert Cold Storage Inc. v Behl* (9th Cir 1996) 943 F2d 1230. In *Eckert Cold Storage,* the court permitted a claim for tax damages but admonished the plaintiffs that they would need to establish with reasonable certainty that other investments available at the time would have shielded the same tax dollars, and that they would have made those alternative investments.

Plaintiffs making claims for tax damages must meet a difficult burden of proof, and face what seems to be a fairly high degree of prejudice against such claims. For example, in *DCD Programs, Ltd. v Leighton* (9th Cir 1996) 90 F3d 1442, the court denied a claim for tax damages, noting that everyone must pay taxes, and that taxes are imposed by the Internal Revenue Code, not by the wrongful conduct of the defendant. The same reasoning appears in *Thomas v Cleary* (Alaska Sup Ct 1989) 768 P2d 1090, in which the court noted that plaintiffs are "under a legal duty to pay taxes." See also *Alpert v Shea Gould Climenko & Casey* (NY Sup Ct 1990) 559 NYS2d 312 (investors were not allowed to recover taxes paid to IRS after deductions attributable to their investment were disallowed).

When taxes would be payable by the plaintiff irrespective of the defendant's conduct, a tax claim against the defendant may seem spurious. However, it is often not clear whether taxes would be payable (and, if so, in what amount) if not for the defendant's conduct. This can lead to complex calculations and alternative positions, which some courts have viewed as speculative.

Oddly, many of the authorities dealing with taxes as an item of damages arise in tax malpractice cases, in which the plaintiff is suing a tax lawyer or tax accountant for malpractice. For example, in *Pytka v Gadsby Hannah, LLP* (Mass Sup Ct 2002) 15 Mass L Rep 451, plaintiff sued his attorney for malpractice, claiming the defendant's actions caused him to pay an extra $284,468 in federal and state income tax because certain stock sales subjected him to short-term capital gains instead of the long-term capital gains treatment he sought. However, because the damages to reimburse him for the $284,468 in taxes would *also* be taxable, he sought a gross-up of $222,605 *on top* of the tax reimbursement. The Massachusetts court denied the gross-up even though plaintiff had an expert who testified that he would be taxed on the judgment and would need a tax gross-up to make him whole.

Cases Awarding Tax Gross-Up

Some courts have permitted tax offsets in employment cases. For example, in *Pham v Seattle City Light* (Wa Sup Ct 2007) 151 P3d 976, the plaintiffs sued for discrimination based on race and national origin. The jury awarded the plaintiffs approximately $430,000 in front and back pay, and $120,000 in noneconomic damages. The plaintiffs requested supplemental damages to cover the adverse tax consequences of the verdict. The trial court awarded the plaintiffs $168,000 in additional damages for adverse tax consequences related to the economic damages portion of the jury award; no offset was awarded for tax on the $120,000 noneconomic damages award. The Washington Supreme Court reversed the court of appeal and affirmed the trial court's decision to decline to award a tax offset for noneconomic damages.

Many courts continue to scrutinize grossing-up damage awards due to adverse tax consequences. In *O'Neill v Sears, Roebuck & Co.* (ED Pa 2000) 108 F Supp 2d 443, the court addressed an award of damages for front and back pay and compensatory and liquidated damages under the Age Discrimination in Employment Act (ADEA). The *O'Neill* court concluded that because receiving front and back pay in a lump sum produced higher taxes, and in light of the "make whole" objective of the ADEA, the plaintiff was entitled to a supplemental award for these negative tax consequences. However, the court concluded that the compensatory and liquidated damages awarded to the plaintiff were only a product of the lawsuit; allowing the plaintiff to recover increased taxes on these amounts would be a windfall.

In *LaSalle Talman Bank, F.S.B. v U.S.* (2005) 64 Fed Cl 90, aff'd (Fed Cir 2006) 462 F3d 1331, the Court of Federal Claims considered the appropriateness of a tax gross-up in a complicated breach of contract case against the U.S. government. The plaintiff argued that to be put back in the position it would have been in had there been no breach of contract, damages had to be calculated on a pretax basis. Alternatively, the plaintiff argued that its damages should be grossed-up for future taxation. See *Centex Corp. v U.S.* (2003) 55 Fed Cl 381. The *LaSalle* court recognized that it was likely the award would be taxed, and concluded that it should be adjusted to account for subsequent taxation. The court cited its decision in *Home Sav., F.S.B. v U.S.* (2003) 57 Fed Cl 694, in which damages were awarded based on the cost of replacement capital, and the award was adjusted assuming it would be taxable.

In considering the appropriateness of a tax gross-up, the *LaSalle* court stated: "Clearly, if we make the adjustment [for taxes], plaintiff would be estopped from disputing the tax-ability of the award." *LaSalle,* 64 Fed Cl at 114. This statement suggests that plaintiffs who receive tax gross-ups will report and pay tax on the full measure of damages they receive. Alternatively, it may reflect a lack of perception about the parties and the dynamics of the tax issues involved. The taxing agencies will by definition not be parties to the case, and both the plaintiff and the defendant will presumably develop their tax reporting positions based on the best information they have available at the time. The tax reporting positions they take may be entirely inconsistent with the tax postures they took during litigation.

Indeed, in my experience, plaintiffs commonly ask for a tax gross-up based on one set of assumptions, but take a different tax-return reporting position. For example, a plaintiff's damage study may calculate taxes based on the entire verdict being taxed at ordinary income rates. That same plaintiff may take the position on his tax return that the recovery is capital gain or even a recovery of basis.

This may sound duplicitous, but the way in which a verdict will be taxed is often complex and may involve difficult factual and legal judgments. A plaintiff may make pessimistic tax assumptions about how the verdict will be taxed. Nine months or a year later, the same plaintiff may take a more aggressive tax return posture. Even if such a dual-pronged approach is contemplated when the plaintiff asks the court for a tax gross-up, it seems appropriate for the plaintiff to assume the worst tax result when seeking damages.

It is also inevitable that a court facing claims for taxes as an item of damages will need to determine what taxes are payable, or, if they have already been paid, whether the payor took appropriate tax positions. This can be complicated and may account for the frustration courts express when they discuss tax issues.

For example, the court in *LaSalle Talman Bank, F.S.B. v U.S., supra,* expounded a lengthy analysis, referencing expert testimony, on whether the award to the plaintiff should be considered a return on capital. Ultimately, the court concluded that "[w]e have no reason to believe that the Internal Revenue Service would treat the reimbursement of this cost item as a replacement of a capital asset." *LaSalle,* 64 Fed Cl at 116. The court then concluded that justice required increasing the plaintiff's award for tax consequences. Recognizing that there may be some doubt on the tax assumptions, the court stated (*LaSalle,* 64 Fed Cl at 116):

> It is only a possibility, and not a high one in our view, that the award will not be taxed. We cannot ignore the fact that, as a general proposition, amounts received as damages in litigation are taxable as income.

This is a telling comment, recognizing that tax rules are often about probability, and that black-and-white answers are not usually available.

Deducting Tax Benefits From Damages

Much of the authority suggests that tax benefits should not be considered in computing economic loss damages.

In *Randall v Loftsgaarden* (1986) 478 US 647, 92 L Ed 2d 525, 106 S Ct 3143, plaintiffs were limited partners in a motel that was marketed as a tax shelter that would provide tax losses to offset other income. The plaintiffs sued to recover their investment, alleging violations of the federal securities laws. The United States Supreme Court held that the tax benefits the plaintiffs received should not be offset against their recovery. The Court analyzed the specific language of the securities laws and concluded that no tax adjustment was needed, but did not enunciate a general rule about tax-based damages. However, the Court suggested in dicta that if taxes were central to the investment, a different result might apply. Such waffling about the ability to obtain tax-based damages seems to be the norm.

In *Danzig v Jack Grynberg & Assocs.* (1990) 161 CA3d 1128, 208 CR 336, the defendant argued that damages in a class action for fraud should be reduced by the claimed tax benefits to class members arising from their investments. The court rejected this contention, concluding that tax benefits were irrelevant to the amount of restitution to be awarded. See also *Kalman v Berlyn Corp.* (Fed Cir 1990) 914 F2d 1473.

Similarly, in *DePalma v Westland Software House* (1990) 225 CA3d 1534, 276 CR 214, a buyer of computer equipment and software sued the seller for breach of contract. The seller tried to reduce the damage award by arguing that the buyer had received tax benefits such as investment tax credits and depreciation, and that this should reduce his damages. The court excluded evidence of tax benefits, finding that tax consequences realized by a nonbreaching plaintiff should not be considered as a mitigating factor and used as an offset against a defendant's liability for compensatory damages.

In *Coty v Ramsey Assocs.* (Vt Sup Ct 1988) 546 A2d 196, in which plaintiff sued a neighboring pig farm on a nuisance theory, the court also found tax benefits to the plaintiff to be irrelevant. One of plaintiff's damage claims was for air conditioners that were installed to mitigate the noxious odor from the farm. The defendant argued that the cost of the air conditioners should be reduced by depreciation tax benefits. The court disagreed, finding no error "in disregarding this extraneous issue."

Another tax argument to reduce a plaintiff's award is presented by *Hanover Shoe, Inc. v United Shore Machinery Corp.* (1968) 392 US 481, 20 L Ed 2d 1231, 88 S Ct 2224, an antitrust case in which the plaintiff sued for lost profits. The defendant argued that the plaintiff should only recover damages after deducting taxes it would have had to pay absent the violation. In other words, the defendant argued that the lost profits had to be computed *after tax.* Had the antitrust violation not occurred, the defendant argued, the plaintiff would have received profits and those profits would have been taxable. Although this argument may seem vapid (after all, the damage award would *also* be taxable when received, thus making the plaintiff worse off), the court of appeals agreed.

In reversing the court of appeals, the Supreme Court held that the award should not be reduced for taxes. The Court reasoned that because the plaintiff would be taxed when it recovered damages, reducing the damages by the amount of the taxes it would have paid would be deducting tax twice. Yet, the Court also made a more sophisticated observation (392 US at 503):

> It is true that accounting for taxes in the year when damages are received rather than the year when profits were lost can change the amount of taxes the revenue service collects.

The Court noted that the statute of limitations often bars the IRS from recomputing tax due in earlier years, and the "rough result" of not taking account of taxes for the year of injury, but taxing the recovery when it is received, seems the most satisfactory outcome.

The *Hanover Shoe* approach, that there should not be a double deduction of taxes, has been followed in many cases. See, *e.g., Orchard Container Corp. v Orchard* (Miss App 1990) 601 SW2d 299.

However, underlying *Hanover Shoe* is the notion that considerable uncertainties in our tax rules are part of the reason *not* to deal with this tax subject. The Supreme Court noted that the proper amount of tax liability ultimately depends on a plethora of factors. Tax determinations under our system are hardly simple, and are one of the main reasons that courts are often unwilling to reflect tax consequences in their awards.

Some courts have said that when current tax rates are higher than the prevailing tax rates for the year in which the losses occurred, that also should be disregarded. See *McLaughlin v Union-Leader Corp.* (NH Sup Ct 1956) 127 A2d 269.

Conclusion

Whether a party has his or her version of the tax impact of a judgment adopted by a court, thereby potentially increasing or decreasing damages for tax effects, varies substantially depending on the jurisdiction, venue, and applicable law. Because tax issues can be central to the overall outcome for your client, practitioners are well-advised to consider these matters carefully.