

An Expert Witness on Taxes?

By Robert W. Wood

Everyone pays taxes, or at least they are supposed to. The annual trudge up to April 15 can be an unforgiving one, but there's always extensions, right? Yes, but extensions give you a six-month reprieve on signing and filing your return; they do not extend the time for payment. Yet even determining how much to pay in can be fraught with uncertainty.

Fundamentally, our tax system is based on self-assessment. You are supposed to determine yourself (and with your tax professionals) what taxes you owe, and to pay them. The IRS only comes around if you fail to file and pay, or if they audit your return and disagree with something. In that case, there is an orderly system in which you can dispute the IRS administratively (such as the IRS Appeals Office).

If that fails, and you still disagree with the IRS, you can continue your dispute in court, either Tax Court or District Court depending on the circumstances. At tax time and later, determining how much tax you owe or how any particular item should properly be taxed is famously complex, even byzantine. Take the tax treatment of damages, for example, and related legal fees.

I've often written that litigants and their lawyers should think about taxes before and during settlement negotiations and documentation. But how about even before then? Should plaintiffs be considering tax issues in calculating and proving their damages? Defendants will want to push back on such assertions if they are made, but should defendants ever think about taxes, even if plaintiffs do not raise the issue?

Tax law may produce groans, but we all know how severely it can impact the bottom line. Tax advice may be more valuable in litigation than you previously considered. Tax experts can be used in a wide variety of cases. The general federal rule is that an expert witness may testify where his scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue. See Federal Rule of Evidence 702.

The expert's testimony must be based upon sufficient facts or data, the testimony must be the product of reliable principles and methods, and the expert must have applied the principles and methods reliably to the facts of the case. Qualification as an expert witness depends on the type of opinion to be offered. The witness must possess an expertise that is based on knowledge, skill, training, education, or experience regarding the particular subject on which he will opine.

Once qualified, the trial court is granted broad discretion to determine whether to admit the expert's testimony. In California state court, an expert witness' testimony must be related to a subject that is sufficiently beyond common experience so that the expert will assist the trier of fact. The expert's testimony must be based upon her special knowledge, skill, training, education, and experience with respect to the matter. See California Evidence Code Section 801.

Tax experts are useful in civil disputes where their specialized knowledge may help explain tax issues central to

the case, or that are important in assessing and evaluating damage claims. The latter is especially broad, as virtually any money we pay or receive has tax consequences. The IRS seemingly gets a piece of most any payment or transaction.

Some expert testimony on tax matters is largely explanatory, to demystify the tax law and to make a complex transaction or concept more understandable for the judge or jury. Much of the tax law is complex, and even a seemingly simple transaction—say, a 1031 exchange or a stock-for-stock merger—can be confusing. When you are dealing with more complex situations and mashups of tax concepts, this demystification function can be even more important.

Then there are the cases where the tax result is central to the complaint. Take legal or accounting malpractice cases. The plaintiff may say that the defendant botched a transaction, a tax filing, or an estate plan. And as a result, more taxes are due, or perhaps they were already paid because of the defendant's alleged actions.

A tax expert can be important in such a case to explain the standard of care, how the defendant did or did not comply with it, and what the damages from the fallout are. Suppose that an investor enters into a transaction purporting to have a particular tax result. When the transaction fails or goes awry, what are the client's damages? A tax expert is usually necessary to make such determinations.

Far from merely crunching the numbers and testifying about the client's damages, the tax expert is likely to explain how the transaction was supposed to work. Given the complexity of taxes, the educational function tax experts serve can be of enormous value, even when there is no dispute about the amount of damages.

Another example where taxes are central is a malpractice case against lawyers or accountants for causing *higher* taxes. Spoiled 1031 exchanges, blown S corporation elections, faulty wills and trusts, messed up mergers or stock purchases, missed stock option exercises, and goofed tax returns all involve central tax issues.

Tax reporting is another area of frequent dispute. When is tax withholding required, and when should Forms 1099 be issued? There are hundreds of pages of Treasury Regulations about IRS Forms 1099: when they should be issued, which form should be used, how to report joint payees, lawyers, legal settlements, etc. Some of the rules overlap or are inconsistent. It can help materially to have the consequences of incorrect reporting detailed and the rules explained.

Even if tax issues are not central to your case, there is likely a tax component to it. For example, it is becoming increasingly common for plaintiffs to seek *additional* damages based on tax consequences. Conversely, defendants often ask for tax issues to be taken into account to reduce damages the plaintiff might be awarded.

Suppose that a plaintiff sues a real estate broker and title company for not completing a real estate transaction within the contractual timeframe. One consequence of that failure may be that the plaintiff incurred additional income tax on the transaction. The plaintiff may want to claim those additional taxes as part of his damages.

Another example involves employment claims. A former employee calculating damages for a wrongful termination by his employer may ask for a tax gross-up. Had the plaintiff been paid properly in the first place, she would have received wages payable over many years, which would have been more favorably taxed. The tax gross-up may compensate the plaintiff for the negative tax impact of receiving a lump sum damage award in one year.

Jurisdictions vary in how they regard tax-based damage claims. Not only is the type of claim relevant, but whether the case is to be tried before a judge or jury can have an impact. So, too, can the time at which the tax claim is asserted.

Axiomatically, when one side has an expert, the other side generally wants a rebuttal expert. But whether there is one tax expert or two, are tax experts ever *essential*? Consider the extreme case of *Baxter v. United States*, No. 1:04-CR-00371 (N.D. Illinois June 25, 2009). In this criminal case, the court vacated a two-year prison sentence given to a certified public accountant who had pled guilty to obstructing and impeding the administration of the federal tax laws.

The reason for vacating the sentence? Ineffective assistance of counsel because Baxter's lawyer *did not retain a tax expert*. This is an extreme case, to be sure, but the *Baxter* opinion gives a thorough review of constitutional standards as well as covering a good bit of tax law.

Tax issues are thorny and easy to get wrong. Many lawyers, judges, and juries have a hard time with them, as do members of the public at large. The frequent grey areas that seem ever-present in our always-changing tax law, and the major way that taxes eat into just about everything, make it a fertile subject for expert testimony.

The nature of litigation and the peculiar tax issues facing litigants can exacerbate these problems. Even in garden-variety civil disputes, the tax impact on a settlement or judgment can be tricky. There are special tax rules for punitive damages, structured settlements, employment cases, sexual harassment, physical injury cases, divorce, and many more. Even the tax treatment of attorney fees—are they deductible and if so, how?—is tricky.

Hiring a tax expert may not involve a formal expert role and expert testimony. It might consist of hiring a tax lawyer or accountant to consult or to run some numbers before a mediation session, to run some calculations about the after-tax impact of a likely resolution, or to work up a detailed damage study. If testimony is needed, it could be to explain and educate the jury about a tax-related investment or the impact of the defendant's actions, or it could be to justify or to criticize a tax gross up claim.

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