Keepin' It **Legal**

Are Tax Gross-up Damages Getting Easier?

by Robert W. Wood, Esq.

Taxes and legal settlements and judgments go hand in hand. Most awards are taxable income to someone, and that can sometimes inject tax issues into the equation even before a case is resolved. Can plaintiffs in litigation successfully seek damages for additional taxes they owe because of the defendant's actions?

Historically, some courts have been reluctant to "gross up" a plaintiff's damages by the taxes the plaintiff must pay. One reason to deny tax damages is a lack of precision in tax calculations. Another commonly stated reason is that we all have to pay taxes.

Thus, the plaintiff must pay taxes in any event, regardless of the activity of the defendant. Sometimes, though, the lump-sum nature of a jury verdict or settlement itself causes the tax problem. That problem would not have existed if payments should have been made over time but were not.

In such a case, shouldn't a plaintiff who can prove that but-for link be able to recover for such an item of damage? It would seem so, and the Ninth Circuit in *Arthur Clemens, Jr. v. CenturyLink Inc. and Qwest Corporation*, 2017 WL 5013661 (9th Cir. 2017) recently said yes, at least in Title VII employment cases. The case started when Arthur Clemens Jr., sued his employer (Qwest) for Title VII violations.

A jury awarded him damages for back pay, emotional distress and punitive damages. Clemens also asked for extra damages for taxes. He claimed that a lump sum would cost him more in taxes than if Qwest had paid him over time, as it should have. But the trial court denied his request for a tax enhancement. Accordingly, Clemens appealed to the Ninth Circuit.

Recently, the Ninth Circuit said that Clemens was right, and reversed the district court. The district court explained that there is a split in the circuit courts on this issue, and that the Ninth Circuit had not ruled on it. Now that it has, taxes as an element of damages may be easier to recover, at least in Title VII cases.

Yet the impact could be broader still. In Title VII cases, the courts are supposed to have full equitable powers to make a plaintiff whole. Back-pay awards are taxable, but a lump-sum award can push a plaintiff into a higher tax bracket than if he had received his pay over several years.

Clemens argued that this extra tax hit denied him what Title VII promises—full relief that puts Clemens where he would have been if the unlawful employment discrimination had never occurred. Some other courts have considered this question. The Third, Seventh and Tenth Circuits have all held that district courts have the discretion to "gross up" an award to account for income-tax consequences [see *Eshelman v. Agere Sys., Inc.*, 554 F.3d 426, 440–43 (3d Cir. 2009); *EEOC v. N. Star Hosp., Inc.*, 777 F.3d 898, 903–04 (7th Cir. 2015); *Sears v. Atchison, Topeka & Santa Fe Ry., Co.*, 749 F.2d 1451, 1456–57 (10th Cir. 1984)].

In contrast, the D.C. Circuit has ruled against such gross ups. In a per curiam opinion, it rejected gross ups [see *Rann v. Chao*, 346 F.3d 192, 197–98 (D.C. Cir. 2003)]. Although the Ninth Circuit joins the majority view, it made clear that there is no automatic tax gross up. As the Third Circuit put it, "we do not suggest that a prevailing plaintiff in discrimination cases is presumptively entitled to an additional award to offset tax consequences. … The nature and amount of relief needed to make an aggrieved party whole necessarily varies from case to case." *Eshelman*, 554 F.3d at 443, (quoting *Albemarle*, 422 U.S. at 424, 95 S.Ct. 2362).

The party seeking relief bears the burden of showing an income-tax disparity and justifying any adjustment. In this case, Qwest had unsuccessfully argued that only a jury can award a back-pay tax adjustment. Qwest also argued that the district court already exercised its discretion in refusing Clemens a tax gross up.

On that point, the Ninth Circuit agreed that the district court's ruling was somewhat opaque. However, the court found that the district court had declined to consider a gross up in part because the Ninth Circuit had never authorized one. The Ninth Circuit has now remedied that.

Now that the Ninth Circuit allows tax gross ups, will this spill over into other cases beyond Title VII? As a legal matter, one might assume that the answer is no, or that there will be no impact. However, there may well be a practical impact, an expansion of the concept generally.

Tax gross ups are often hard to obtain, in any context. Yet they can be both appropriate and available in a variety of types of cases. In another recent case, *Sonoma Apartment Associates v. United States*, 2017 WL 5078032 (Court of Federal Claims, Nov. 3, 2017), the plaintiff in a complex suit against the federal government sought various damages.

Among the damage claims and calculations considered in a more than 40,000 word opinion from the court, was a tax neutralization payment. The plaintiff asked for an additional $2,136,681, representing compensation for the increased federal and state income taxes the plaintiff's partners would owe. Not unlike in a Title VII case, the plaintiff said that it (and its partners) was receiving a lump-sum damage award in lieu of a 24-year-long stream of market-rate rental income.

That meant more taxes on the lump sum, just like Clemens argued in his Ninth Circuit Title VII case. In *Sonoma Apartment Associates*, the plaintiff's plans for receiving many years of market rents were spoiled by the federal government. The federal government admitted liability. So, the only question was the extent and calculation of damages. The plaintiff sought to gross-up its damages to offset its partners' purported increased tax burden.

For plaintiffs at least, there are probably some lessons in both of these cases, and in their predecessors. One point is to consider claims for taxes as early as you can. Some people consider it as early as preparing a complaint. Others consider it during the discovery process. Others prepare to address it in a motion *in limine*.

On the other hand, some lawyers and claimants like to wait. Some successful plaintiffs (at least in Title VII cases) may

continued on page 5

continued from page 4
make a motion for taxes post-verdict. Some experts like to address such points post-verdict, where calculations can probably be run with considerably greater certainty. In any event, when a tax claim might be appropriate should be considered in virtually any context.

An expert witness on tax issues and/or damage calculations is often appropriate, if not a downright necessity. A plaintiff may need to show by clear and convincing evidence that these specific taxes were caused by the defendant, and that the plaintiff would not have paid them otherwise. Tax positions taken on later tax returns may or may not bear this out.

For example, a plaintiff's damage calculations may compute taxes based on the entire verdict being taxed at ordinary income rates. That may be the perfectly appropriate and conservative view of the matter. That same plaintiff may later take the position on his tax return that the recovery is capital gain, or even a recovery of basis.

This may sound duplicitous. However, how a verdict will be taxed is often complex and can involve difficult factual and legal judgments. It seems appropriate for the plaintiff to assume the worst tax result when seeking damages. Defendants can be expected to do the reverse.

This is one of many reasons that expert witnesses can be invaluable. Sometimes, tax rules are about probability, and black and white answers may not be available. The U.S. Supreme Court made this clear in *Hanover Shoe, Inc. v. United Shoe Machinery Corp*, 392 U.S. 481 (1968).

The plaintiff in this antitrust case sued for lost profits. The defendant argued that the plaintiff's damages should be reduced for taxes the plaintiff would have had to pay absent the antitrust violation. Had the antitrust violation not occurred, the defendant argued, the plaintiff would have received profits, and those profits would have been taxable.

Defendants trying to mitigate their damages with tax arguments, as in *Hanover Shoe*, may face an even higher burden. Reversing the Court of Appeals, the Supreme Court held that the award should not be reduced for taxes. Underlying *Hanover Shoe* is the notion that there are considerable uncertainties in our tax rules.

For some courts, these uncertainties represent a good reason not to deal with this tax subject. Fortunately, many courts do not apply the throw-up-your-hands "speculative" moniker. And recent case law suggests that getting tax-based damages in appropriate cases may become even easier.

Robert W. Wood *is a tax lawyer with WoodLLP (www.WoodLLP.com) and author of numerous tax books, including* Taxation of Damage Awards & Settlement Payments *(www.TaxInstitute.com). This discussion is not intended as legal advice.*