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Can You Claim Higher Tax Bills As Lawsuit Damages?

Can plaintiffs get damages for *additional taxes* they will owe because of the defendant's actions? Increasingly, the courts seem to be siding with plaintiffs and allowing these tax-based damages. This is a bright spot in this tough area. After all, most legal settlements and judgments are taxable. Even worse, starting in 2018, [it can be tough for plaintiffs to deduct their legal fees](#). That can mean paying taxes on 100% of the money, even though a contingent fee lawyer takes 40% off the top. Fortunately, there is often [considerable tax planning at settlement time to address these rules](#). But with tax-based damages, there can be tax issues at play long before a case is resolved.

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 is that we all have to pay taxes. Yet what if the lump sum nature of a verdict or settlement *itself* causes the tax problem? Let's say the plaintiff would not have faced those extra taxes if payments were made over time as they should have been paid? Shouldn't a plaintiff who can prove this recover the extra taxes too? In 2017, the Ninth Circuit said yes in [Arthur Clemens, Jr. v. CenturyLink Inc. and Qwest Corporation](#). The case was limited to tax gross ups in Title VII employment cases. Even so, it may have application to many types of cases.

Then, in 2019, a California Appeals Court gave an even broader reading, upholding tax neutralization in a wrongful termination case involving state law. In [Economy v. Sutter East Bay Hospitals](#), 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 which the hospital specifically challenged was \$650,910 for tax neutralization. This amount was calculated to offset the increased tax burden on the 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 to exclude the expert's testimony. The hospital said it did not meet the requirements for admissibility of scientific evidence. See [*People v. Kelly*](#) and [*Frye v. United States*](#). 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 the expert testimony was based on speculative assumptions about future tax rates, etc. The appeals 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.*](#); [*Eshelman v. Agere Systems, Inc.*](#); [*Sears v. Atchison, Topeka & Santa Fe*](#); and [*Clemens v. CenturyLink Inc.*](#)

A lump-sum award may push a plaintiff into a higher tax bracket. In fact, failing to consider taxes might effectively deny the plaintiff full relief. The court said there was no reason why tax neutralization on back pay could not be established with sufficient certainty. The 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 tax expert laid a sufficient foundation to establish the probability and reasonableness of his tax neutrality projections.

This is not legal advice. For tax alerts or tax advice, email me at Wood@WoodLLP.com.