taxanalysts tax practice

# Damages for Tax Consequences

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In a civil suit, can you obtain damages for additional taxes the defendant's conduct caused you to pay? Put differently, should tax consequences be a part of the damages you recover? Does it depend on whether the defendant was aware of your tax position? Does it depend on whether you would have paid taxes in any event?

The answer to those questions is a maddening ''it depends,'' not only on the court and the nature of the case, but on the point during the case at which you invoke the tax issues, whether the case is before a judge or jury, and so on. The variables make enunciating any guidelines difficult.

Whether tax benefits or tax burdens should be taken into account in damage awards is not a tax question, at least not predominantly. The question whether additional taxes can be recovered as an item of damages is primarily a remedies question. The corollary question is whether an otherwise appropriate damage award should be reduced for tax benefits conferred on the plaintiff, since such a reduction may be necessary to avoid unjust enrichment.

A good example of how broad the reach of this problem can be is *Randall v. Loftsgaarden*,[1] a case that reached the Supreme Court. The plaintiffs were limited partners in a motel marketed as a tax shelter to provide tax losses offsetting other income. The plaintiffs sued to recover their investment, alleging violations of federal securities laws. The 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, concluding that no tax adjustment was needed, but it failed to enunciate a general rule about tax-based damages. The Court actually suggested 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.

[1]478 U.S 647 (1986).

### Hit-and-Miss Authority

The case law has continued to bumble along, and whether a plaintiff can obtain tax damages is often unclear. A recent offering on those issues is *Judith K. Kelley v. City of Albuquerque*.[2] That case arose out of an employment dispute in which Kelley alleged violations of the New Mexico Human Rights Act and Title VII of the Civil Rights Act of 1964. Before trial, Kelley sought to exclude testimony concerning tax benefits she derived from the losses that formed the basis of her claims. The court excluded that testimony but allowed Kelley 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, Kelley moved to amend the judgment to take into account increased federal taxes she would have to pay because of the award. Specifically, Kelley asked the court for $37,297.49, plus an additional 10 percent of the attorney fee award, all to compensate for additional federal tax effects.

The court denied the motion, noting that the Seventh Amendment to the U.S. Constitution generally prohibits additur. Put simply, the amount of damages was the jury's province, not the court's. Nevertheless, the court had to deal with several tax gross-up cases Kelley cited. The first was *Sears v. Atchison, Topeka and SFR Co.*,[3] in which the Tenth Circuit had upheld a tax component paid to class members for additional tax liabilities they faced because the lump sum covered 17 years of back pay.

The Tenth Circuit recognized that tax components of damages may be atypical, but it found special circumstances because of the protracted nature of this particular litigation. Notably, the *Sears v. Atchison* case was tried before a judge rather than a jury, so an increase in the award to reflect the tax consequences did not interfere with the jury's province. Kelley also cited *Carter v. Sedgwick Co.*,[4] another bench trial. More pertinent was *Blaney v. International Association of Aerospace Workers*,[5] which held that Washington state's antidiscrimination statute allowed an increased award to compensate for taxes incurred by the award.

Yet, *Blaney* was a Washington state case, so the Seventh Amendment was inapplicable. Besides, it was also a

[2]*Doc 2006-9776*, *2006 TNT 98-7* (D. N.M. 2006).
[3]749 F.2d 1451 (10th Cir. 1984).
[4]36 F.3d 952 (10th Cir. 1954).
[5]87th P.3d 757 (2004).

bench trial, so there was no jury to overstep. The last nail in Kelley's tax claim coffin came with a denial of equitable relief. The court's broad rationale probably could be stated in many similar cases:

> 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.

### Other Tax Gross-Ups

Employment cases represent fertile ground for plaintiff employees to argue for tax gross-ups, particularly given the 1996 amendments to require physical injury or physical sickness for excludability under section 104. Yet plainly, that is not the only venue in which this tax-as-damages issue arises. A plaintiff may assert damages arising out of an increased tax liability resulting from the defendant's conduct in many situations. Often, however, courts are unsympathetic to such attempts.

Indeed, that's even true when the nature of the dispute itself revolves around tax issues. In *Gaslow v. KPMG, LLP*,[6] 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 the IRS later attacked. The premise seems to be that the plaintiff would have paid taxes anyway. This dividing line is also suggested by *Eckert Cold Storage Inc. v. Behl*.[7] Although a claim for tax damages was permitted in that case, the court admonished the plaintiffs that they would have 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.

Thus, the burden of proof is high and most plaintiffs cannot meet it. In *Lewin v. Miller, Wagner and Co.*,[8] the court disallowed a claim for taxes, calling the claim speculative. In fact, plaintiffs making claims for tax damages face what seems to be a fairly high degree of prejudice against such claims.

For example, in *DCD Programs Ltd v. Leighton*,[9] the court denied a claim for tax damages, noting that everyone has to pay taxes and that they are imposed by the Internal Revenue Code, not by the wrongful conduct of the defendant. The same thread appears in *Thomas v. Cleary*[10] (a case noting that plaintiffs are under a legal duty to pay taxes).[11] When taxes are payable in any event, a tax claim against the defendant may seem spurious. But it is often not so clear whether taxes would be payable (and if so, to the same magnitude) if not for the defendant's conduct.

That 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 damage are tax malpractice cases in which the plaintiff is suing a tax lawyer or tax accountant for malpractice. In *Pytka v. Hannah*,[12] for example, the plaintiff sued his attorney for malpractice, arguing that he paid tax on short-term gains from sales of stock.

Pytka claimed the defendant's actions caused him to pay an extra $284,468 in federal and state income because the stock sales were not long-term capital gains. 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. Although Pytka had an expert testify that he would be taxed on the judgment and would need a tax gross-up to make him whole, the Massachusetts court denied the gross-up.

Sometimes both parties raise tax consequences, seeking offsets. For example, in *Pham v. Seattle*,[13] the plaintiffs sued for discrimination based on race and national origin. The jury awarded the plaintiffs $430,000 in front and back pay, and $120,000 in noneconomic damages. Plaintiffs' counsel sought attorney fees under the Washington Law Against Discrimination, calculating a lodestar amount of $347,588. The trial court reduced that to $297,532.

The plaintiffs requested supplemental damages to cover the adverse tax consequences of the verdict. The trial court awarded $168,000 in additional damages on account of adverse tax consequences. Notably, that amount accounted only for tax on the economic damages portion of the jury award and did not include an offset for tax on the $120,000 of noneconomic damages.

Thus, the plaintiffs received a tax gross-up on only part of their award. They appealed, arguing for a tax offset on *all* of their award. Citing *Blaney v. International Association of Machinists and Aerospace Workers*,[14] in which the Washington Supreme Court determined that damages for adverse federal income tax consequences could be awarded under a general statute allowing ''other appropriate remedies,'' the court of appeals agreed.

Many courts continue to scrutinize the gross-up of damage awards due to adverse tax consequences. The court in *O'Neill v. Sears, Roebuck and Company*[15] addressed damages for front and back pay and compensatory and liquidated damages under the Age Discrimination in Employment Act (ADEA). The court stated that the ADEA was designed to make the claimant whole. Receiving front and back pay in a lump sum produced higher taxes, so the court allowed a supplemental award for taxes on the front and back pay components.

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[6] 797 N.Y.S.2d 472 (App. Div. 1st Dept. 2005).
[7] 943 F.2d 1230 (D.C. Cal. 1996).
[8] 725 P.2d 736 (Ariz. Ct. of App. 1986).
[9] 90 F.3d 1442, *Doc 96-22189, 96 TNT 153-32* (9th Cir. 1996).
[10] 768 P.2d 1090 (Ak. 1989).
[11] *See also Alpert v. Shea Gould Climenko and Casey*, 559 N.Y.S.2d 312 (App. Div. 1st Dept. 1990) (investors were not allowed to recover taxes paid to the IRS after deductions attributable to their investment were disallowed).
[12] 15 *Massachusetts Law Reporter* 451 (Mass. Sup. Ct. 2002).
[13] Wash. Ct. of App. No. 52356-2-I (2004).
[14] 87 P.3d 757, 93 FEP Cases 1529 (Wash. 2004).
[15] 108 F. Supp.2d 443 (E.D. Pa. 2000).

To be made whole, he was entitled to an award for the negative tax consequences. However, the compensatory and liquidated damages received by the plaintiff were only a product of the lawsuit. The plaintiff would not have received those amounts but for the defendant's discriminatory actions, and the court said that allowing the plaintiff to recover increased taxes on those amounts would give the plaintiff a windfall.

**Income: Capital vs. Ordinary, etc.**

Tax gross-up authorities are not limited to employment cases. The Court of Federal Claims in *LaSalle Talman Bank F.S.B. v. United States.*[16] 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.[17]

The court relied on *Home Savings*,[18] in which it concluded that damages are foreseeable if they follow from a breach of contract in the ordinary course of events. Taxes are clearly foreseeable. Plus, if one injures another, it is foreseeable that money damages may not make the plaintiff whole, because of tax issues.

In *Home Savings,* damages were awarded based on the cost of replacement capital, and the award was adjusted assuming it would be taxable. In *LaSalle Talman Bank,* the court noted that dividends were paid from net earnings after taxes. The government argued that the award would not be subject to tax, so the court had to address that. Considering the appropriateness of a tax gross-up, the court stated: ''Clearly, if we make the adjustment, plaintiff would be estopped from disputing the taxability of the award.''[19]

That statement suggests that plaintiffs who receive tax gross-ups are going to 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 tax issues involved. The taxing agencies will by definition not be parties to the case, and both plaintiff and defendant will presumably develop their tax reporting positions based on the best information they have available at the time. The tax reporting position they take may be entirely inconsistent with the tax posture they have described in seeking damages.

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.

That may sound duplicitous, but how a verdict will be taxed is often complex and involves 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-prong 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.

**Substantive Tax Analysis**

It seems almost inevitable that a court facing claims for taxes as an item of damages must determine what taxes are payable, or if they have already been paid, whether the payer took appropriate tax positions. That is sticky, and it may account for some part of the frustration courts seem to express when they discuss tax issues. For example, the court in *LaSalle Talman Bank* had to consider whether the award would be considered a return of capital. The court referenced testimony from several expert witnesses.

Ultimately, the court concluded that it had ''no reason to believe that the Internal Revenue Service would treat the reimbursement of this cost item as a replacement of a capital asset.''[20] The Claims 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 that:

> 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.[21]

That is a telling comment, recognizing that tax rules are often about probability and that black-and-white answers are often not available. After reaching that watershed decision, the court discussed applicable tax rates, consolidated groups, state tax rates, and the impact of paying the corporate alternative minimum tax. There was even discussion of the relevance of the plaintiff's parent company paying no income tax and how that issue should be evaluated.

While *LaSalle Talman Bank* supports the notion that a foreseeable element of a contract breach is tax on top of damages, many plaintiffs fail to win tax damages. An example is *Porter v. U.S. Agency for International Development*.[22] After a jury award in his employment discrimination action, the plaintiff filed a petition for equitable relief seeking a supplemental award to recover any tax liabilities associated with attorney fees. The plaintiff was awarded $30,000 as a result of the discrimination but

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[16]2005 U.S. Claims LEXIS 32, *Doc 2005-2944, 2005 TNT 29-10* (Fed. Cl. 2005).

[17]*See Centex Corp. v. United States*, 55 Fed. Cl. 381, *Doc 2003-17565, 2003 TNT 153-3* (2003).

[18]*See Home Savings of America, FSB v. United States*, 57 Fed. Cl. 694 (2003).

[19]*LaSalle Talman Bank F.S.B. v. United States*, 2005 U.S. Claims LEXIS 32 (Fed. Cl. 2005).

[20]*Id.*

[21]*Id.*

[22]D.D.C. Civ. Act. No. 00-1954 (JR), 2003 U.S. Dist. LEXIS 21358 (2003).

generated $200,000 in attorney fees and litigation expenses, for which the plaintiff was also to receive an award.

The plaintiff requested indemnity against any tax consequences from the attorney fee award or, in the alternative, that the court should ''gross up'' the attorney fee award 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 attorney fees. Indeed, the court took a proactive tack, trying 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 adviser could refer to the explanation when preparing income tax returns. Presumably, the court also hoped the IRS would consider the explanation before attempting to impose a tax on the plaintiff for the attorney fee award.

## General Rules?

It is hard to summarize the case law. Much of the authority suggests that tax benefits should not be considered in computing economic loss damages.[23] For example, in *Danzig v. Jack Greenberg & Associates*,[24] 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 that contention, concluding that tax benefits were irrelevant to the amount of restitution to be awarded.

To the same effect is *DePalma v. Westland Software House*,[25] in which a buyer sued for breach of contract for computer equipment and software. The seller tried to reduce the damage award by arguing that the buyer had received investment tax credits and depreciation and that that should reduce his damages. Excluding the evidence, the court found it was inappropriate to mitigate the amount of damages awarded by such tax benefits.

Similarly, in *Coty v. Ramsey Associates*,[26] the plaintiff sued a neighboring pig farm on a nuisance theory. One of the plaintiff's damage claims was air conditioners the plaintiff installed to try to mitigate the noxious odor. The defendant replied that the cost of the air conditioners had to be reduced by depreciation tax benefits. The court disagreed, finding tax consequences irrelevant.

Another tax argument is presented by *Hanover Shoe, Inc. v. United Shore Machinery Corp.*,[27] an antitrust case in which the plaintiff sued for lost profits. The defendant argued that the plaintiff should recover damages only 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 the 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.

Reversing the court of appeals, however, the Supreme Court held that the award should not be reduced for taxes. Since the plaintiff would be taxed when it recovered damages, reducing the damages by taxes would be deducting tax twice, said the Court. Yet, the Supreme Court also made a more sophisticated observation: ''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.''[28]

The Court noted that the statute of limitations often bars the IRS from recomputing tax due in earlier years. The ''rough result'' of not taking account of taxes for the year of injury, but taxing the recovery when it is received, said the Supreme Court, seems the most satisfactory outcome. The approach laid down in *Hanover Shoe* seems to be followed in many cases:[29] There should not be a double deduction of taxes, and the plaintiff needs to be put in the position it *would* have occupied before the suit.

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. That is one of the main reasons this entire tax damages area often causes courts to refuse 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.[30] However, recent cases suggest that there may be a type of tax damages renaissance brewing and that it is easier for plaintiffs today to recover such damages. The tax impact of a case is important, and some courts are willing to consider taxes in determining what will make the plaintiff whole.

## Conclusions

Like many remedies questions, whether a particular plaintiff or a particular defendant will have its version of the tax impact adopted by a court (increasing or decreasing damages because of tax effects) is likely to vary substantially depending on the jurisdiction, venue, and applicable law. It is not overstatement to suggest that tax effects should be evaluated in every case, since tax issues are often central to the overall outcome.

Yet, that does not mean one will always ask for tax damages. There may occasionally be tactical reasons not to raise tax matters. For example, a defendant may

[23]*See Kalman v. Berlyn Corp.*, 914 F.2d 1473 (Fed. Cir. 1990). *See also DePalma v. Westland Software House*, 225 Cal. App.3d 1534 (1990).

[24]161 Cal. App.3d 1128 (1984), *cert. denied*, 474 U.S. 819 (1985).

[25]225 Cal. App.3d 1534 (1990).

[26]149 Vt. 451, 546 A.2d 196 (1988), *cert. denied*, 487 U.S. 1236 (1988).

[27]392 U.S. 481 (1968).

[28]*See Hanover Shoe, Inc. v. United Shore Machinery Corp.*, 392 U.S. 481 (1968).

[29]*See Orchard Container Corp. v. Orchard*, 601 S.W.2d 299 (Mo. App. 1990).

[30]*See McLaughlin v. Union-Leader Corp.*, 127 A.2d 269 (1956), *cert. denied*, 353 U.S. 909 (1957).

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 bad. A defendant might make that tactical decision when the plaintiff has not raised tax issues, and when the defendant is worried that the benefits it might achieve from its tax argument will be outweighed by the risk that the plaintiff will raise *bigger* tax issues in response. The defendant may not want to open the door to those issues.

Those circumstances aside, however, asking the court to take into account the tax impact on the case will rarely have a downside. Predicting how the court will respond is not easy. The most traditional answer is that tax issues get lost on the cutting room floor. That does not mean one can never get tax damages, but one needs to be realistic. The more modern trend of the case law suggests that tax gross-up claims are more favored today than in the past. Here are a few rules to bear in mind:

1. 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 the issue.

2. Because tax issues can be complicated, do your best to keep the tax assumptions and tax calculations you are making straightforward. You are more likely to prevail if you make your argument credible and understandable.

3. Be cognizant that in federal cases, the jury is going to have to decide the tax damage claim. You are unlikely to succeed if you ask the court to gross up the claim after the fact.

4. In state or federal cases, you must carry a significant burden of proof. Many of the cases suggest that everyone pays taxes. You'll need to carry a tough burden to show that those *specific* taxes were caused *solely* by the defendant, and that you would not have paid them otherwise.