Should Taxes Be Included in Damage Calculations?

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In many cases, tax results can dramatically affect a litigation award or settlement, so that one or both parties may ask that it be adjusted accordingly. This article details how tax results can affect litigation awards and analyzes pertinent cases.

The use of jury instructions on tax matters in civil litigation is becoming widespread. Either plaintiffs or defendants may initiate them. Usually, jury instructions on taxes are simple. For example, there may be an admonition that in "awarding any damages, the jury should consider the additional taxes that the plaintiff will have to pay on receiving a lump sum, which would not have been payable had the defendant not breached the contract." Conversely, the jury may be told to consider the tax benefits a plaintiff received in the past, which may reduce the plaintiff's claim for damages.

Plaintiffs or defendants may include the tax effects in their damages study,[1] even when there is no jury. Plaintiffs may ask for extra damages because the damages *themselves* will be taxable. Supplemental damages, or a tax gross-up, may be needed to put a plaintiff in the same position the plaintiff would have occupied if not for the defendant's actions.

Conversely, defendants may request a deduction from damages that would otherwise be awarded if such damages would be tax free. In such cases, the defendant is raising the tax issues. Such a defendant may argue that failing to take the tax effects into account may result in a windfall to the plaintiff.

This article explains how tax results can affect litigation awards and analyzes the case law.

Litigation and Taxes

Most plaintiffs and defendants agree that tax considerations play a vital part in a case's overall outcome. One example is the much-debated tax treatment of contingent attorneys' fees, which has accounted for voluminous articles, television exposés, Congressional hearings, etc. In some of these situations, the tax rules have resulted in successful plaintiffs actually going out-of-pocket (i.e., experiencing a net after-tax loss) on the otherwise successful conclusion of a case.[2] Recently, the Supreme Court addressed the tax treatment of attorneys' fees, in *Banks*[3]; however, even this most recent chapter in the controversy may not quell all the debate.[4]

Editor's note: Mr. Wood is the author of *Taxation of Damage Awards and Settlement Payments* (Tax Institute, 3d ed., 2005).

[1] Typically, a damages study is simply a series of calculations translating the damages suffered by the plaintiff into economic terms. The question is whether tax effects—positive or negative—should be reflected.

[2] See *Cynthia Spina v. Forest Preserve District of Cook County,* 207 FSupp2d 764 (ND IL 2002) and Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Case," *NY Times* (8/11/02), section 1, p. 18.

[3] *John W. Banks,* Sup. Ct., 1/24/05.

[4] See Wood, "Supreme Court Attorneys Fees Decision Leaves Much Unresolved," 106 *Tax Notes* 792 (2/2/05).

Example 1: *W,* married filing jointly, recovers a $1 million nonbusiness settlement. Due to particular circumstances (several successive attorneys and the case settling while on appeal), her contingent attorneys' fees total $800,000, so she nets only $200,000. Under *Banks, W* must recognize the gross amount of her $1 million recovery as income. She is entitled to a miscellaneous itemized deduction, subject to the 2% adjusted-gross-income floor, for the recovered legal fees. *W* owes $276,500 in Federal income tax on the recovery. Thus, while she won her case, she has actually lost $76,500.

This attorneys' fees tax problem is perhaps an extreme illustration of the maxim that "tax results can radically alter litigation success." The problem was partially addressed by Congress in late 2004.[5] Yet, even after legislative action and the Supreme Court's decision, pre-tax and post-tax results in litigation continue to be very different in many cases. Of course, the tax effect to plaintiffs in contingent fee cases is but a small portion of the universe of tax issues affecting litigation.

Thus, it is hardly surprising that one party in a case may bring up tax issues; sometimes, both parties do. For example, a Washington state court[6] upheld a tax offset when the plaintiffs sued for discrimination based on race and national origin. After a three-week trial, the jury awarded the plaintiffs $430,000 in front and back pay, and $120,000 in noneconomic damages. The plaintiffs' counsel sought attorneys' fees under the Washington Law Against Discrimination, calculating a lodestar amount[7] at $347,588. The trial court reduced it to $297,532. The plaintiffs requested supplemental damages to cover the verdict's adverse tax consequences; the trial court awarded $168,000 in additional damages. Yet, this amount only accounted for tax on the economic damages portion of the jury award. It did not include an offset for tax on the $120,000 of noneconomic damages. In other words, the plaintiffs only received a tax gross-up on part of their award. They appealed, arguing that the court erred when it did not grant them a tax offset for the entire award.

The court of appeals agreed, citing a Washington supreme court decision[8] holding that damages for adverse Federal income tax consequences could be awarded under a general statute allowing "other appropriate remedies." This general equitable remedy feature was sufficient to cause the court of appeals to determine that a full tax offset was appropriate.

Grossing-up Awards

Tax gross-up authorities are becoming more common and are certainly not limited to employment cases. Recently, in *LaSalle Talman Bank, F.S.B.,*[9] 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 case arose out of the savings and loan industry and the government's interpretation of various capital maintenance requirements. The plaintiff argued that to be restored to the position it would have been in had there been no breach of contract, damages had to be calculated on a pre-tax basis. Alternatively, it argued that its dam-

[5] See Wood, "Jobs Act Attorney Fee Provision: Is it Enough?" 105 *Tax Notes* 961 (11/15/04).

[6] *Chuong Van Pham v. City of Seattle,* WA Ct. of Apps., No. 52356-2-I, 12/20/04.

[7] A lodestar amount is the sum of the attorneys' fees determined under a certain formula. To calculate attorneys' fees using the lodestar method, one multiplies the number of hours reasonably expended in the litigation by the lawyer's reasonable hourly rate of compensation. The hourly rate depends on a variety of factors, including the novelty or complexities of the issues, the time spent on unsuccessful claims or unproductive time, and the counterpart nature and quality of the representation.

[8] *Linda Blaney v. Int'l Assoc. of Machinists and Aerospace Workers,* 87 P3d 757 (WA 2004).

[9] *LaSalle Talman Bank, F.S.B.,* Ct. Fed. Cl., 2/8/05.

EXECUTIVE SUMMARY

- **Plaintiffs may seek a gross-up of an award, or additional damages, when all or part of the award is taxable.**
- **Defendants may request a deduction from damages when the damages are tax free or result in tax benefits (such as tax credits and depreciation).**
- **Many cases support the notion that tax benefits should not be considered in computing economic-loss damages.**

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ages should be grossed up to account for future taxation.[10]

These alternatives are two sides of the same coin. Indeed, the court acknowledged that either a pre-tax damage calculation or a tax gross-up is consistent with the holding in *Home Savings*[11] that damages are foreseeable if they follow from a breach of contract in the ordinary course of events. Taxes are clearly foreseeable. Specifically, if one party injures another, it is foreseeable that money damages may not put the plaintiff in the same position, because of tax issues. In *Home Savings,* damages were awarded based on the cost of replacement capital; the award was adjusted on the assumption that it would be taxable. In *LaSalle Talman Bank,* the court noted that dividends were paid from after-tax net earnings. The government argued that the award would not be subject to tax. Thus, the court had to decide whether the award would be taxed.

Interestingly, in considering the appropriateness of a tax gross-up on the award, the *LaSalle* court stated: "clearly, if we make the adjustment, plaintiff would be estopped from disputing the taxability of the award." This suggests that plaintiffs who receive tax gross-ups are going to report and pay tax on the full measure they receive. However, plaintiffs commonly ask for a tax gross-up based on one set of assumptions, but take a different (more aggressive) return reporting position.

Inconsistent Positions?

A return position reveals only what a taxpayer anticipates a tax liability will be, which may not ultimately be clear until the statute of limitations (SOL) has run on the return. For example, a plaintiff may calculate tax in a damages study based on the entire verdict being taxed at ordinary income rates. Yet, the plaintiff may take the position on his or her return that the recovery is capital gain.

This may sound duplicitous, but frequently, complex determinations comprise the analysis of how a verdict will be taxed. Plaintiffs may be well-advised to make pessimistic assumptions, but be persuaded by their tax advisers (nine months or even a year later, at return filing time) to try a more aggressive posture on their return.

Even if such a dual-pronged approach is contemplated when a plaintiff asks the court for a tax gross-up, it seems perfectly appropriate to assume the worst tax result (i.e., to make conservative tax assumptions). Ultimately, even if plaintiffs take a less conservative position on their return later, it will be unclear for at least three years thereafter whether the IRS accepts it. In fact, although the normal Federal tax return SOL is three years, a six-year SOL applies to any understatement of income (or overstatement of deductions) of 25% or more, under Sec. 6501(e)(1).

Thus, in many cases, a plaintiff's return will be open to examination for up to six years. Even when plaintiffs think they have figured out the tax liability, the IRS may recompute it at any time during the next three (and often six) years.

Difficult Tax Analysis

The court in *LaSalle* needed to face this complexity when it considered whether the award would be a return of capital. It referred to testimony from the defendant's expert, and expressly acknowledged that he did not venture a legal opinion on whether the award would be taxed. Yet, the court found his testimony on tax accounting matters to be quite relevant and quoted extensively from it as to the tax and accounting treatment of dividends and other items.

Next, the court addressed the defendant's position that there should be no income tax, arguing that the recovery should be treated as a replacement of capital. Here, the court relied on the testimony of another witness, who testified how the plaintiff and its affiliated entities pay taxes. The court discussed the testimony at length and how it fit into the likely tax effect of the payment. It grappled with multiple experts and technical concepts. Ultimately, it concluded, "we 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." Yet, the court also concluded that the defendant's argument about nontaxability was at odds with its holding that the plaintiff was entitled to reimbursement for dividend costs only to the extent they were not a return of capital. Thus, the court found that, by definition, the plaintiff's award was not intended to make up for a loss of capital.

Solving Tax Equations without the IRS

The Service is not a party to private litigation and, in fact, will always refuse to be joined as one. Sometimes, it is almost painful to see civil judges (who rarely are tax specialists) slogging through plaintiffs' and defendants' tax arguments. Still, the IRS will not step in to help, even on request.

This leaves private parties in litigation to solve tax issues by themselves. Often, it results in civil judges with little or no tax experience having to decipher likely tax effects. Ultimately, the Court of Federal Claims in *LaSalle* concluded that it would be unjust not to adjust the plaintiff's award to take tax consequences into account. Recognizing that there may be some doubt on the tax assumptions, the court stated:

> It is only a possibility, and not a high one in our view, that the award will not be

[10] See *Centex Corp.,* 55 Fed. Cl. 381 (2003).

[11] *Home Savings of America, F.S.B.,* 57 Fed. Cl. 694 (2003).

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. It expressly recognizes that the tax rules in issue are about probability. After reaching this watershed decision, the court goes on to discuss applicable tax rates, consolidated groups, regular tax rates, state tax rates and even the effect of paying the corporate alternative minimum tax. There is also analysis of the relevance of the plaintiff's parent company paying no income tax in one particular year, and how to evaluate this issue.

All in all, *LaSalle* is an extraordinarily detailed opinion. At bottom line, it supports the notion that a foreseeable element of a contract breach is tax on top of damages. Put simply, an appropriate measure of damages must not only include lost payments, but also the tax effects.

Plaintiffs commonly ask for a tax gross-up based on one position, but take a different return reporting position.

Remedies

The question whether tax benefits or burdens should be taken into account in damage awards is not actually a tax question (at least not predominantly). It is primarily a remedies question: can one of the items of damages constitute additional taxes? Conversely, should an otherwise appropriate damage award be reduced for a tax benefit being conferred, the reduction in damages being needed to avoid unjustly enriching the plaintiff?

The answers to these questions are often influenced (or even controlled) by local law. These issues emerge with surprising frequency. As in *LaSalle,* such questions force courts to cope not only with the equitable or legal question of whether damages should be measured in a certain way, but also with substantive tax law. After all, in these kinds of situations, questions nearly always arise as to how the tax law would be applied to a particular settlement or damage award.

A good example of just how broad this problem can be is *Randall v. Loftsgaarden*.[12] The plaintiffs were limited partner investors in a motel. The investment was marketed as a tax shelter to provide tax losses offsetting other income. The plaintiffs sued to recover their investments, alleging violations of the Federal securities laws. The Supreme Court held that the tax benefits achieved by the plaintiffs should not be offset against their recovery. However, this case was decided based on Federal securities laws, not on general principles, so it does not necessarily have universal application.

The Supreme Court analyzed the specific language of the pertinent securities laws (including sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 ('34 Act)). Even in this context, however, the opinion in this seminal case does not provide a general rule about tax-based damages. In fact, the Supreme Court expressly stated that it was not considering whether courts could refuse to allow a rescissory recovery under Section 10b of the '34 Act when the premium for expected tax benefits represented a large portion of the purchase price. The Court noted that in such event, an out-of-pocket measure of damages might yield a significantly smaller recovery. Thus, the Court's suggestion is that if taxes are central to an investment, a different result might apply.

Litigation Trends

It is difficult to summarize the case law. However, there is a surprising amount of authority, and much of it is negative, on the prospect of recovering damages for tax effects. As a general proposition, many cases stand for the notion that tax benefits should not be considered in computing economic-loss damages.[13]

For example, in one case,[14] 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 to the plaintiffs were irrelevant to the amount of restitution to be awarded.

Similarly, in another case,[15] a buyer sued for breach of contract for computer equipment and software. The seller tried to reduce the damage award, arguing that the buyer had received investment tax credits and depreciation, which should reduce the amount of any damages. The court excluded the evidence, finding that it was inappropriate to mitigate the damages awarded by such tax benefits.

A similar argument was made in a Vermont case.[16] The plaintiff sued a neighboring pig farm on a nuisance theory; one of the damage claims

[12] *William C. Randall v. B.J. Loftsgaarden,* 478 US 647 (1986).

[13] See *Peter Gabor Kalman,* 914 F2d 1473 (Fed. Cir. 1990); see also *John R. DePalma v. Westland Software House,* 225 Cal.App.3d 1534 (1990).

[14] *Paul Danzig v. Jack Greenberg & Assoc.,* 161 Cal.App.3d 1128 (1984), *cert.* den.

[15] *DePalma,* note 13 supra.

[16] *Victor Coty v. Ramsey Associates, Inc.,* 546 A2d 196 (VT 1988), *cert.* den.

was for 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 benefits. The court disagreed, finding the tax consequences to be irrelevant.

The answers to damage computation questions are often influenced or controlled by local law.

Hanover Shoe

Another classic argument in this context is presented by *Hanover Shoe, Inc.,*[17] an antitrust case. The defendant argued that the plaintiff should recover damages only after deducting taxes that it would have had to pay absent the violation. In other words, the plaintiff was suing for lost profits; 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 that 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 lower court agreed with the defendant.

The Supreme Court reversed, holding that the award should not be reduced for taxes. The Court stated the obvious proposition that because the plaintiff would be taxed when it recovered damages, reducing the actual damages for taxes would be deducting tax twice. Yet, it also made a more sophisticated observation: "[i]t 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 also noted that the SOL often bars the IRS from recomputing tax in earlier years. Besides, said the Court, the "rough result" of not taking taxes into account for the year of injury, but taxing the recovery when it is received, seems the most satisfactory outcome.

Example 2: Plaintiff *A* wins an antitrust suit against *D* and is awarded $1 million. *D* argues on appeal that because the $1 million represents *A*'s lost profits, the award should actually be $650,000 (the after-tax profits *A* would have after paying $350,000 in tax).

Under *Hanover Shoe,* a court should reject *D*'s argument. Because the damage award is taxable, awarding only $650,000 to *A* would be, in essence, double-taxing him. For *A* to obtain $650,000 after tax, he must receive $1 million pre-tax. If the tax effect were built into the award, as *D* suggests, and the award is taxable, *A* would again be double-taxed and end up with a mere $422,500 ($650,000 × 65%) after tax.

The approach laid down in *Hanover Shoe* seems to be followed in the vast majority of cases.[18] The *Hanover Shoe* theory is that there should not be a double deduction of taxes, and that the plaintiff needs to be restored to the position it *would* have occupied prior to the suit. However, underlying *Hanover Shoe* is the notion that the considerable uncertainties in the tax rules are part of the reason *not* to deal with this subject. The Supreme Court noted that the proper tax liability ultimately depends on a plethora of factors. Tax determinations under the system are hardly simple.

Some courts have said that the fact that current tax rates are higher than the prevailing tax rates for the year in which the losses occurred, should be disregarded.[19] However, it is questionable whether this authority is applicable today, in light of the cases discussed above. The recent cases suggest that there is a kind of tax damages rebirth afoot. The tax effect of a case is important; some courts seem increasingly willing to consider taxes in determining how to make a plaintiff whole.

Conclusion

Like many remedies questions, whether a plaintiff or defendant will be successful in having its version of the tax effect adopted by a court is likely to vary substantially depending on the jurisdiction, venue and applicable law. At a minimum, these tax effects should be evaluated in every case, because the tax questions represent a central economic issue.

Of course, there may occasionally be tactical reasons not to raise such matters. For example, a defendant may forgo arguing for discounting a plaintiff's damages to take into account tax benefits that the plaintiff received from a bad investment, if the plaintiff has not raised tax issues; the defendant may be worried that the benefits to be achieved from the tax argument will be more than outweighed by the risk that the plaintiff will raise bigger tax issues in response. In effect, the defendant may not want to "open the door" to such issues.

But such circumstances aside, asking a court to take into account the realities of the tax effect on the case will rarely be detrimental.

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[17] *Hanover Shoe, Inc.,* 392 US 481 (1968).

[18] See, e.g., *Orchard Container Corp. v. Edgar L. Orchard,* 601 SW2d 299 (MO 1990).

[19] See, e.g., *McLaughlin v. Union–Leader Corp.,* 127 A2d 269 (1956), *cert.* den.