Can you get increased taxes as damages?

by **Robert W. Wood**

In a civil suit, can you obtain damages for additional taxes the defendant's conduct caused you to pay? The corollary question is whether damages can be reduced for tax benefits conferred on the plaintiff. The answer to both questions is a maddening "it depends." It can hinge on jurisdiction and venue, timing, and even on whether the case is a jury or bench trial.

Whether taxes should be taken into account is not actually a tax question, at least not predominantly. It is primarily a remedies question. A good example of the breadth of this issue is *Randall v. Loftsgaarden*,[1] where the plaintiffs were partners in a motel sold as a tax shelter. They sued to recover their investment, alleging securities violations. The U.S. Supreme Court held that tax benefits the plaintiffs received should not be offset against their recovery. Unfortunately, the Court failed to enunciate a general rule about tax-based damages.

Hit and miss authority

The case law has bumbled along without clear guidance, and much of the authority is negative. However, sometimes tax damages are unavailable. For example, in *O'Neill v. Sears, Roebuck and Company*,[2] the court addressed damages for front and back pay and compensatory and liquidated damages under the Age Discrimination in Employment Act (ADEA). The ADEA was designed to make the claimant whole, and receiving front and back pay in a lump sum produces higher taxes. Thus, the court allowed a supplemental award for taxes on the front and back pay. It denied tax damages on the compensatory and liquidated damages.

Courts generally will not adjust an award for taxes if a jury has already ruled on damages.[3] The 7th Amendment to the U.S. Constitution generally prohibits additur. In a bench trial, a tax component is more likely to be available.[4] Of course, you don't face constitutional issues in state court. Thus, in *Blaney v. International Association of Aero. Workers*,[5] a Washington state court increased an award to compensate for taxes under Washington's anti-discrimination statute.

Often, courts are unsympathetic to tax gross-up claims.[6] Indeed, this is even true where the dispute revolves around tax issues. Thus, in *Gaslow v. KPMG, LLP*,[7] the plaintiff could not recover taxes against his accounting firm, even though the defendant allegedly induced the plaintiff to make tax shelter investments. The premise seems to be that the plaintiff would have paid taxes anyway.

The inevitability of taxes is also suggested by *Eckert Cold Storage Inc. v. Behl*.[8] The court allowed the plaintiff to make a claim for tax damages. However, the court admonished the plaintiffs that they would have to establish with reasonable certainty that other investments would have shielded the same tax dollars, and that they would actually have made those investments. The burden of proof is high, and many plaintiffs cannot meet it.[9]

Often, courts disallow claims for taxes, calling them speculative. That means plaintiffs often face an uphill battle. In denying a claim for tax damages, the court in *DCD Programs, Ltd v. Leighton*[10] noted that everyone has to pay taxes. Taxes, are imposed by the Internal Revenue Code, the court said, not by the conduct of the defendant. The same thread appears in *Thomas v. Cleary*,[11] (a case noting that plaintiffs are under a legal duty to pay taxes).[12]

Tax gross-up authorities are not limited to employment and malpractice cases. For example, *LaSalle Talman Bank FSB v. U.S.*,[13] considered the appropriateness of a tax gross-up in a complicated breach-of-contract case against the U.S. government. To be made whole, the plaintiff argued, its damages had to be calculated on a pre-tax basis. Alternatively, the plaintiff argued that its damages should be grossed-up for future taxation.[14]

The Court of Federal Claims relied on *Home Savings*,[15] a case stating that damages are foreseeable if they follow from a breach of contract in the ordinary course of events. Taxes are clearly foreseeable, and it is foreseeable that money damages may not make the plaintiff whole because of tax issues.

Much of the authority suggests that tax benefits should not be considered.[16] This seems particularly true where the defendant is seeking a reduction in damages. For example, in *Danzig v. Jack Greenberg & Associates*,[17] the defendant unsuccessfully argued that damages in a class action for fraud should be reduced by tax benefits the class members received from their investments. Similarly, in *DePalma v. Westland Software House*,[18] a buyer sued for breach of a computer contract. The seller unsuccessfully argued to reduce the damages by the buyer's investment tax credits and depreciation.

Sometimes the courts even seem to react to a party's hubris. In *Coty v. Ramsey Associates*,[19] the plaintiff sued a neighboring pig farm as a nuisance. The plaintiff claimed the cost of air conditioners it bought to mitigate the noxious odor. The defendant sought to reduce its damages by depreciation-tax benefits the plaintiff received on the air conditioners. That argument smelled, said the court.

There is a sentiment in some cases that tax issues are just too hard to pin down. In *Hanover Shoe, Inc. v. United Shore Machinery Corp*,[20] the U.S. Supreme Court concluded that taxes should not be taken into account. The Court noted that tax liabilities depend on a plethora of factors. Tax determinations are rarely simple, causing courts to be unwilling to reflect taxes in their awards. However, some courts are willing to consider taxes in determining what will make the plaintiff whole.

General rules?

Like many remedies questions, whether tax effects will

increase or decrease damages varies depending on the jurisdiction, venue and applicable law. Here are a few rules to bear in mind:

- 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 such evidentiary matters.

- Since tax issues can be complicated, do your best to keep your tax assumptions and tax calculations straightforward. You are more likely to prevail if you make it credible and understandable.

- Be cognizant that in federal cases with a jury, the jury should decide the tax-damage claim. You are unlikely to succeed if you ask the court to gross-up your claim for taxes after the fact.

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

Inconsistent tax positions?

Note that the IRS and state taxing agencies will not be parties to the case. In my experience, plaintiffs commonly ask for a tax gross-up based on one set of tax assumptions, but take a different tax position when they file their return. For example, a plaintiff's damage study may calculate taxes based on the entire verdict being ordinary income. That same plaintiff may file a tax return claiming it is capital gain.

This may sound duplicitous, but how a verdict (or settlement) will be taxed is often complex and can involve difficult factual and legal judgements. A plaintiff may make pessimistic tax assumptions during litigation. Later, the plaintiff may take a more aggressive tax-return posture.

ROBERT W. WOOD, *a member of the State Bar of Montana, practices law with Wood & Porter in San Francisco (www.woodporter.com), and is the author of "Taxation of Damage Awards & Settlement Payments" (3d Ed. Tax Institute 2005 with 2007 Update) available at www.damageawards.org.*

NOTES

1. 478 U.S 647 (1986).
2. 108 F.Supp.2d 443 (E.D. Pa. 2000).
3. See *Judith K. Kelley v. City of Albuquerque*, Tax Analysts Doc. No. 2006-9776, 2006 TNT 98-7 (D.N.M. 2006).
4. See *Sears v. Atchison, Topeka and SFR Co.* 749 F.2d 1451 (10th Cir. 1984). See also *Carter v. Sedgwick Co.*, 36 F.3d 952 (10th Cir. 1954).
5. 87th P.3d 757 (2004).
6. For example, see *Matthew F. Fogg v. Alberto Gonzales*, No. 05-5439, 2007 U.S. App. LEXIS 15484 at *1 (D.C. Cir. 2007).
7. 797 NYS 2d 472 (Appellate Division 1st Dept. 2005).
8. 943 F.2d 1230 (D.C. California 1996).
9. *Lewin v. Miller, Wagner and Co.*, 725 P.2d 736 (Az. Ct. of App. 1986).
10. xi 90 F.3d 1442 (9th Cir. 1996).
11. 768 P.2d 1090 (Alaska 1989).
12. See also *Alpert v. Shea Gould Climenko and Casey*, 559 NYS 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).
13. 2005 U.S. Claims LEXIS 32 (Ct. Cl., 2005).
14. See *Centex Corp. v. United States*, 55 Fed.Cl. 381 (2003).
15. See *Home Savings of America, FSB v. U.S.*, 57 Fed.Cl. 694 (2003).
16. See *Kalman v. Berlyn Corp.*, 914 F2d 1473 Fed. Cir. (1990). See also *DePalma v. Westland Software House*, 225 Cal. App. 3rd 1534 (1990).
17. 161 Cal. App. 3rd 1128 (1984), cert. denied 474 U.S. 819 (1985).
18. 225 Cal. App. 3rd 1534 (1990).
19. 546 Atlantic 2nd 196 (1988), cert. denied 487 U.S. 1236 (1988)
20. 392 U.S. 481 (1968).