

## How to Get Tax-Based Damages In Civil Litigation

By Robert W. Wood



Robert W. Wood

Robert W. Wood practices law with Wood LLP in San Francisco (<http://www.WoodLLP.com>) and is the author of *Taxation of Damage Awards and Settlement Payments* (2009 with 2012 supplement), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at

<http://www.taxinstitute.com>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Plaintiffs and defendants in civil litigation often mention the tax impact of the case. Apart from questions of how the settlement or judgment will affect their taxes, they may be concerned whether the plaintiff can get enhanced damages for the tax impact the defendant's actions caused. Wood looks at this unusual but important damages question.

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As a tax lawyer, I've heard many lawyers and clients say that a defendant in a lawsuit caused them to incur additional taxes. Can't we collect those additional taxes (perhaps even penalties and interest) as part of our damages? Unfortunately, whether a plaintiff can collect damages for adverse tax consequences is a thorny subject. Although tax consequences significantly affect just about everything, many courts have been loath to allow tax-based damages claims.

Tax-based damages can be broken into several categories. The first is the claim that the defendant's action (say, preventing a sale from closing) caused a particular tax result. Such a tax claim is part of the underlying damages and surely belongs in the plaintiff's original tally. An important recent ex-

ample is *Beim v. Hulfish*,<sup>1</sup> in which damages for wrongful death included federal estate taxes.

A second type is defensive, as when the defendant claims that tax benefits the plaintiff achieved should offset the plaintiff's damages. These defensive claims can be dangerous from a strategic viewpoint unless all the tax issues are out in the open.

The third type of claim is a requested gross-up of the plaintiff's damages by the taxes the plaintiff must pay because of the verdict itself. All are distinct issues and all are damages questions, not tax questions. Of course, they are tax based and presuppose tax calculations.

One reason courts are reluctant to take any tax damages into account is the notion that we all must pay taxes. Thus, the plaintiff would have had to pay taxes regardless of the defendant's activity. Nevertheless, if the defendant's conduct actually caused the additional taxes, it seems reasonable that a plaintiff who can prove it should be able to recover them.

### Employment and Tax Shelter Cases

A good example is *Eshelman v. Agere Systems Inc.*,<sup>2</sup> a case of first impression in the Third Circuit. Joan Eshelman sued her former employer under the Americans With Disabilities Act, and the jury awarded \$200,000 of back pay and compensatory damages. On her motion, the court added damages for additional taxes because of the lump sum nature of the award compared with how she would have been taxed on periodic wage payments. The district court awarded the tax gross-up. Affirming, the Third Circuit noted that it had discretion to fashion a remedy<sup>3</sup> and could restore the status quo to make the plaintiff whole.

However, in *Kelley v. City of Albuquerque*,<sup>4</sup> a similar employment dispute, a district court denied the plaintiff's request for a tax gross-up. Noting that the Seventh Amendment prohibits additur, the

<sup>1</sup>No. A-5947-10T4 (N.J. Super. Ct. App. Div. 2012).

<sup>2</sup>No. 05-4895 (3d Cir. 2009), *Doc 2009-2478*, 2009 TNT 23-7.

<sup>3</sup>See 42 U.S.C. section 2000e-5(G)(1). See also *Franks v. Bowman Transportation Co. Inc.*, 424 U.S. 747 (1976).

<sup>4</sup>No. CIV 03-507 (D.N.M. 2006), *Doc 2006-9776*, 2006 TNT 98-7.

court said damages were the jury's province, not the court's. Conversely, in *Sears v. Atchison*,<sup>5</sup> the Tenth Circuit allowed a gross-up of employment damages in a case that had been tried by a judge rather than a jury.<sup>6</sup> The additur question was absent in *Blaney v. International Association of Machinists and Aerospace Workers*,<sup>7</sup> because it involved a state rather than federal discrimination statute. As those cases show, the remedial scheme and even the judge versus jury point must be considered in assessing tax damages questions.

Even the Supreme Court has had trouble with damages for tax consequences. In *Randall v. Lofts-gaarden*,<sup>8</sup> the plaintiffs sued tax shelter promoters under the federal securities laws to recover their investments. The defendants claimed that tax benefits the plaintiffs received should offset their recovery, but the Supreme Court rejected that tax-based claim. It suggested that the result might be different if taxes were central to the investment.

In another tax shelter case, *Gaslow v. KPMG LLP*,<sup>9</sup> the plaintiff could not recover taxes and interest from his accounting firm, apparently because he would have paid taxes anyway.<sup>10</sup> The burden of proof on those tax issues is high and most plaintiffs cannot meet it.

In *Lewin v. Miller, Wagner and Co.*,<sup>11</sup> an Arizona court disallowed a claim for taxes as speculative. Similarly, in *DCD Programs Ltd v. Leighton*,<sup>12</sup> the Ninth Circuit denied a claim for tax damages, noting that everyone has to pay taxes (the common refrain). But it is often unclear whether taxes would have been payable (and of the same magnitude) if not for the defendant's conduct.

Many of the authorities arise in tax malpractice cases in which the plaintiff is suing a tax lawyer or accountant. In *Pytko v. Hannah*,<sup>13</sup> the plaintiff sued his attorney, claiming the lawyer caused him to pay an extra \$284,468 in income taxes. Because the \$284,468 in damages for taxes would be taxable, he sought an additional \$222,605. An expert testified

that he would be taxed on the judgment and would need a tax gross-up to make him whole. Despite that, the Massachusetts court denied it.

### When the Defendant's Act Triggers the Tax

Sometimes logic, causation, and a convincing expert win. The court in *Beim v. Hulfish* took additional estate taxes into account in a wrongful death case despite the volatile nature of U.S. estate tax laws. After a car accident caused the death of a 97-year-old passenger in early 2008, his estate sued the drivers and owners of the cars for wrongful death.

Regarding damages, the estate argued that if the decedent had lived until 2009, the federal estate tax would have been cut by \$626,083. Moreover, if the decedent had lived into 2010, which the estate claimed was likely, the entire \$1,196,084 of estate taxes paid in 2008 would have been avoided. In either case, but for the accident, significant taxes would not have been triggered.

However, the trial court dismissed the estate tax claim as too speculative, noting that it was not certain whether the federal estate tax would resurface in 2010. There was also uncertainty whether the decedent would have lived beyond 2010.

However, shortly after the trial court's decision, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was signed into law. It reenacted the federal estate tax for 2010, 2011, and 2012, resolving that question. The estate moved for reconsideration, noting that speculation was no longer a concern because the estate tax law was now clear. Moreover, the actuarial tables suggested that the decedent would die between 2008 and 2012.

Despite that, the trial court was not convinced and denied the claim a second time. The appellate court reversed, stating that expert tax opinions could be presented to juries without undue speculation.

Apart from *Beim v. Hulfish*, however, estate tax claims in wrongful death cases have not fared well. For example, in *Elliott v. Willis*,<sup>14</sup> a court held that premature payment of estate taxes could not be recovered in a wrongful death action. Taxes had nothing to do with what the decedent (had he lived) would have contributed to the surviving spouse and children, said the court.<sup>15</sup> Similarly, in *Lindsay v. Allstate*,<sup>16</sup> the court held that a loss of prospective

<sup>5</sup>749 F.2d 1451 (10th Cir. 1984).

<sup>6</sup>See also *Carter v. Sedgwick Co.*, 36 F.3d 952 (10th Cir. 1994), involving another bench trial.

<sup>7</sup>87 P.3d 757 (Wash. 2004).

<sup>8</sup>478 U.S. 647 (1986).

<sup>9</sup>797 N.Y.S.2d 472 (App. Div. 1st Dept. 2005).

<sup>10</sup>That dividing line is also suggested by *Eckert Cold Storage Inc. v. Behl*, 943 F.2d 1230 (D.C. Cal. 1996). Although the court allowed a claim for tax damages, it 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.

<sup>11</sup>725 P.2d 736 (Ariz. Ct. of App. 1986).

<sup>12</sup>90 F.3d 1442 (9th Cir. 1996), *Doc 96-22189*, 96 TNT 153-32.

<sup>13</sup>15 Mass. Law Rptr. 451 (Mass. Super. Ct. 2002).

<sup>14</sup>442 N.E.2d 163 (Ill. 1982).

<sup>15</sup>In *Farrar v. Brooklyn Union Gas Co.*, 537 N.Y.S.2d 26 (N.Y. 1988), the court held similarly based on a lack of express legislative authority.

<sup>16</sup>561 So.2d 427 (Fla. Dist. Ct. App. 1990).

federal estate tax credits could not be recovered under Florida's Wrongful Death Act.

In *Pham v. Seattle*,<sup>17</sup> the plaintiffs sued for discrimination based on race and national origin, winning \$430,000 in front and back pay and \$120,000 in noneconomic damages. The trial court added \$168,000 in additional damages for taxes on the front and back pay. Because that amount did not cover taxes on the \$120,000 of noneconomic damages, the plaintiffs appealed, arguing for taxes on their entire award. The court agreed, awarding broad tax damages in a fashion similar to the Third Circuit's decision in *Eshelman*.

### Tax Damages and Estoppel

Tax-based damages may even be thought to influence the tax positions the litigants ultimately take on tax returns. For example, in *LaSalle Talman Bank FSB v. United States*,<sup>18</sup> the Court of Federal Claims considered the appropriateness of a tax gross-up in a breach of contract case against the U.S. government. The plaintiff argued that damages had to be calculated on a pretax basis or grossed-up to cover future taxation.

The court relied on *Home Savings of America FSB v. United States*,<sup>19</sup> holding that damages are foreseeable if they follow from a breach of contract in the ordinary course of events. Plainly, it is foreseeable that after an injury, money damages may not make the plaintiff whole because of tax issues. Yet in *LaSalle Talman Bank*, the government claimed that the award would not be subject to tax.

That substantive tax debate caused the court to state, "Clearly, if we make the adjustment, plaintiff would be estopped from disputing the taxability of the award."<sup>20</sup> In reality, of course, the plaintiff may not know what its tax reporting position will ultimately be. The taxing agencies will not be parties to the case. The parties will presumably develop their tax reporting positions based on the information they have available long after the settlement is achieved or the verdict is paid.

The tax reporting position they take may be entirely inconsistent with the tax posture they have described in seeking damages. In fact, plaintiffs may ask for a tax gross-up based on one set of assumptions but take a different tax return reporting position. A plaintiff's damage study may calculate taxes based on a verdict being taxed at ordinary income rates.

The same plaintiff may later take the return position that the recovery is capital gain. In seeking damages, a plaintiff may make pessimistic tax assumptions about how the verdict will be taxed and may assume the worst tax result when seeking damages. Nine months or a year later, however, the same plaintiff may take a more aggressive tax return posture.

### How and When to Ask for Tax-Based Damages

Many courts do not apply the "speculative" moniker, but courts are still reluctant to nail down tax issues. Whether a particular plaintiff or particular defendant will have its version of the tax effect adopted by a court (increasing or decreasing damages because of tax effects) is likely to vary substantially depending on the jurisdiction, venue, applicable law, and other variables. That is so with many remedies questions.

Although tax effects should be evaluated in every case, there may be tactical reasons not to raise tax matters. A defendant may choose not to argue for discounting a plaintiff's damages to take into account tax benefits the plaintiff received. If the plaintiff has not raised tax issues, the defendant may worry that the benefits it might achieve will be outweighed by larger tax claims it may face.

In general, however, asking a court to take into account the tax effect on the case will rarely have a downside. Yet tax issues may get lost on the cutting room floor, and predicting how a court will respond is not easy. Fortunately, the case law suggests that tax gross-up claims are more favored today than in the past. Here are a few suggestions:

- The burden of proof is high. Many of the cases suggest that everyone pays taxes. You may need to show by clear and convincing evidence that the *specific* taxes were *caused* solely by the defendant and that you would not have paid them otherwise.
- Tax issues can be complicated, so try to keep tax assumptions and tax calculations straightforward. You are more likely to prevail if your argument is understandable. An expert witness on taxes, damages, or both can spell the difference between success and failure.
- Consider making your claim for taxes part of your case as early as you can. A motion in limine is a good place to address the issue. As many of the jury cases indicate, post-trial motions suffer from many disadvantages.
- The particular court's (and even the particular judge's) track record on such claims may be important. In federal cases with a jury, the jury will have to decide the tax damage claim.

<sup>17</sup>Wash. Ct. of App. No. 52356-2-I (2004).

<sup>18</sup>64 Fed. Cl. 90 (2005), *Doc* 2005-2944, 2005 TNT 29-10.

<sup>19</sup>57 Fed. Cl. 694 (2003).

<sup>20</sup>*LaSalle Talman Bank*, 64 Fed. Cl. 90.