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When Plaintiffs Get, and Defendants Pay, Tax Gross-Up Damages

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In this article, Wood and Brown survey cases in which courts have addressed awarding additional damages for tax consequences, and they explain the rudiments of tax gross-ups and some significant tactical issues.

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Some plaintiffs are surprised to learn that their lawsuit recoveries generate a tax bill. Income tax is supposed to be incurred on income, something that *increases* your wealth.[1] In lawsuits, compensatory damages are intended to make the plaintiffs whole, to compensate for their actual damages.[2] Plaintiffs may feel they have not been made wealthier if they are only being restored to their prior positions or compensated for damage that the defendants caused.

How do you square these concepts? The tax law's concept of income and the general law's concept of making a plaintiff whole are fundamentally different. If someone damages you and later pays to make you whole, you are just back to even. But under the tax law you may have been made wealthier by the payment. For tax purposes, you might have not only been made whole but also profited.

Compensatory damages, unless excludable from income, usually trigger income taxes.[3] For example, a plaintiff suing a former employer for unpaid wages might expect that any front pay or back pay awarded will be taxed as wages. Plus, pre- or post-judgment interest is taxed as interest.

If a court awards a plaintiff damages of $X, and the award is subject to income tax, the plaintiff will receive less after taxes. Is the plaintiff really being made whole if he receives (net of tax) less than the court-determined award? Some plaintiffs argue that the court should award an additional amount to cover taxes so the plaintiff ends up with $X after taxes.

There is a cumulative effect of this argument. If the court awards a gross-up payment, the gross-up payment itself is also subject to income tax. Yet if the plaintiff has a bona fide claim that a tax gross-up is merited, it seems clear on principle that the gross-up should be calculated to include

[1] *See Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (defining gross income for tax purposes to include "undeniable accessions to wealth, clearly realized, over which the taxpayers have complete dominion").

[2] *See Birdsall v. Coolidge*, 93 U.S. 64 (1876).

[3] *See, e.g.*, section 104(a)(2) (excluding from gross income damages received "on account of" personal physical injuries or physical sickness).

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the income tax generated by the tax gross-up award itself.

This article explains the rudiments of tax gross-ups and describes some major contexts in which they have generally been awarded. It also explains some of the primary reasons that courts have denied such claims. The article concludes by introducing some of the significant tactical and presentation issues at play.

I. When Are Tax Gross-Up Damages Available?

Do litigants argue for these tax-based damages, and do they sometimes collect them? The answer to both questions is yes, but reactions to tax-based damage claims are decidedly mixed from lawyers and judges. The context of the case and the applicable law are key factors. Notably, whether damages should be awarded for taxes is not a question about taxes, it is a question about damages.

Federal and state laws both address the nontax question regarding when a plaintiff should be awarded damages that relate to the plaintiff's taxes. The applicable law governing the case should determine what kinds of damages are appropriate to include in a compensatory award and how to value them. Thus, the appropriateness of a tax gross-up award may vary based on the jurisdiction and underlying cause of action.[4]

Taxes are material to everyone. Nearly every transaction involving money involves taxes on one or more parties. And if you are about to receive $1 million in any context, you are likely to consider — and perhaps to complain — that taxes are going to eat up 25 percent to 50 percent of your money. That should make it obvious that a tax gross-up can have a profound effect on a compensatory damage award.

Suppose that a plaintiff receives a compensatory award of $1 million, which is subject to tax at an effective rate of 30 percent. In rough terms, the award would need to be grossed up to over $1.4 million to make up for the resulting tax. If the same $1 million were subject to tax at a combined federal and state tax rate of 55 percent, the $1 million award would need to be grossed up to $2.2 million for the plaintiff to net $1 million after tax.

In this $2.2 million hypothetical calculation, the tax gross-up damages ($1.2 million) are larger than the principal damages ($1 million). Indeed, for plaintiffs in the highest tax jurisdictions, such as California or New York City, the combined tax rates can exceed 50 percent, at least on a marginal basis. If either side in the case is looking at which item of damages is the most significant, a tax gross-up claim may be the largest single claim in the dispute. That means the parties and the court will pay attention.

The principal legal questions regarding tax gross-ups might find answers outside of tax law, but the parties and their counsel usually look to tax lawyers and accountants for guidance. That guidance can involve summarizing and interpreting the tax gross-up authorities and relating them to a specific case. It can involve making and justifying tax assumptions and running calculations. And it can involve serving as an expert witness.

Many plaintiffs believe all their claims are meritorious, and many defendants believe they should not have to pay, or at least not very much. Tax gross-up claims may be similar, but they may provoke special passion from plaintiffs and defendants. Plaintiffs might say, "You did this to me, and your actions are also causing me to pay lots of extra taxes that I would not have had to pay." Defendants might say, "I didn't cause you any harm, and even if I did, everyone has to pay taxes; I should not have to pay your taxes, too."

The authorities on these issues are hard to summarize and categorize. Even so, the cases that consider whether to award a tax gross-up reveal some broad patterns.

The case law reflects pockets of strong support for tax gross-ups largely centered on contexts or causes of action in which tax gross-up damages have been granted. Cases reinforcing the appropriateness of tax gross-ups for specific cases often jump jurisdictions, gaining a toehold in a different state or federal circuit. Sometimes that even occurs where tax gross-ups are generally looked on with suspicion.

[4] *See, e.g.*, *Pruett v. Erickson Air-Crane Co.*, 183 F.R.D. 248, 252 (D. Or. 1998) (federal court holding that whether a tax gross-up is appropriate is a question of state law), citing *Oddi v. Ayco Corp.*, 947 F.2d 257, 268 (7th Cir. 1991).

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II. Employment Discrimination Cases

Cases alleging employment discrimination are natural subjects for tax gross-up damages. The cases are usually brought under Title VII, the Americans with Disabilities Act, the Age Discrimination in Employment Act, or similar antidiscrimination legislation regarding wrongful termination, etc. One fact that seems to reassure courts about awarding gross-ups in this area (other than the many cases that can be cited in support of gross-ups in this context) is that such tax gross-ups are generally limited and easy to calculate.

Employment discrimination cases often involve claims for unpaid or underpaid wages. If the defendant had not broken the law (allegedly), the unpaid or underpaid wages may have been paid over several years and taxed over several years. However, in a typical employment discrimination case, the back pay and front pay awards are typically paid in one year, in a lump sum. As a result of receiving in one year wages that should have been paid out over several years, the recipient often sees the lump sum wage settlement payment taxed at a higher marginal rate than the same wages would have been taxed if paid over several years — as they should have been.

Therefore, in employment discrimination cases, the plaintiffs are not asking for their wage recoveries to be tax free. They are instead asking only that their wages effectively be taxed at the same rates (and that they receive the same net wages after tax) as they would have if the wages had been paid when due, divided over several tax years rather than all at once.

Conceptually, the limited-scope gross-up awards regularly granted in employment discrimination cases are straightforward to calculate. Assume that a plaintiff can show, based on previous tax reporting, that $100 of wages that were supposed to have been paid two years ago would have been taxed at 12 percent federally (producing $12 of federal income tax) had they been received two years ago. However, suppose that they are being paid as part of a large lump sum award along with wages for several other years (plus noneconomic damages and other taxable items). The result of all the income hitting in the same tax year is that the same wages are now going to be taxed at 37 percent federally.

Paying the plaintiff a principal gross-up equal to 25 percent of $100 (or $25) would leave the plaintiff effectively owing only the $12 of tax she would have owed had no suit been needed. The $25 principal gross-up payment would itself be subject to income tax (at the same 37 percent rate), so the principal gross-up award may itself be grossed up to $39.68. After paying tax (at 37 percent, or $14.68) on the $39.68 grossed-up gross-up, the taxpayer should have about $25 left to reimburse her in part for the $37 of tax she owes on her $100 lump sum wage award.

That leaves her effectively out of pocket for only the $12 of tax she would have owed if she had been paid the $100 of wages when due. It is not surprising if the experts who calculate the gross-up damages in employment discrimination cases can point out other nuances and complications that are used to refine this framework for a taxpayer's specific facts. However, that seems simple in concept and modest in scope. Thus, many courts find this basic framework easy to understand and fundamentally fair.

Moreover, particularly for back pay awards, there is little to none of the dreaded speculation that can make claims for tax gross-up damages difficult. We can know for certain the plaintiff's tax attributes for a previous tax year based on her previously filed tax returns and any other necessary records that should already exist. We also know for certain the relevant tax rates and rules for a previous tax year. Moreover, courts considering front pay awards in this context generally do not seem to be put off by having to make some reasonable assumptions about what the relevant tax brackets and rates might be for the following year or a few years into the near future.

Many courts that have granted gross-up awards in employment discrimination cases also cite the Supreme Court's opinion in *Albemarle*,[5] which discusses the broad equitable powers contained in Title VII to "make the victims of unlawful discrimination whole." *Albemarle* did not directly address tax gross-up awards in Title

[5] *Albemarle Paper Co. v. Moody*, 422 U.S. 405 (1975).

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VII cases, but many courts find the Supreme Court's affirmation of Title VII's "make-whole purpose" sufficient to justify awarding gross-ups.

Of course, it can be argued that all compensatory damages are intended to make a plaintiff whole. Moreover, *Albemarle* and its analysis is based on Title VII's specific legislative history. Therefore, it does not explain the extension of tax gross-up awards to employment discrimination cases brought under other antidiscrimination employment statutes not addressed in *Albemarle* and that did not yet exist when *Albemarle* was decided in 1975. Examples include the ADA[6] and the Age Discrimination in Employment Act.[7] In any event, plaintiffs receiving recoveries in employment discrimination suits enjoy broad support for tax gross-ups in the Third, Seventh, Ninth, and Tenth circuits.[8]

III. Calculating Future Earnings in Wrongful Death Suits

Section 104(a)(2) contains language that has changed over the years regarding exclusion from income of amounts received because of personal physical injuries or physical sickness. The most notable amendment was 1996's addition of the word "physical." However, the underlying position that recoveries for compensatory damages received on account of a physical injury or physical sickness qualify to be excluded from a taxpayer's gross income has long been a part of the tax law.

Even compensatory damages for lost future earnings based on a physical injury are excludable under section 104(a)(2) because they qualify as being "on account of" the physical injury or physical sickness.[9] However, it is common in physical injury cases for future earnings to be discounted to a present value, so they can be satisfied in a current settlement. That raises a question about whether the present-value adjustment should give rise to a tax gross-up.

The settlement payment itself may be excludable from income under section 104(a)(2). However, if the money is set aside to pay for future expenses, the investment income is taxable. Suppose that a court awards a plaintiff the present value of $1 million that he would otherwise have received in 10 years' time. Applying a present-value formula, a court may conclude that $1 million in 10 years may be worth, say, only $500,000 today, because the plaintiff can invest the $500,000 now and let it grow for 10 years.

However, once the income tax on that investment income and growth is factored in, the plaintiff may end up with less than $1 million in 10 years. To end up with $1 million in 10 years, the plaintiff may need to be awarded the present value of the $1 million plus an additional amount to cover the income taxes. At least two circuit courts in the early 1980s issued three opinions that affirmed that a court can gross-up the lump sum present value of an award for future earnings to account for the income tax the plaintiff would owe on the award while it is invested — after the award is paid and before the funds are meant to be used.[10]

There appears to be little discussion of the concept since then. The changes to section 104(a) and the addition of section 130 to the tax code in 1983 opened the market for qualified assignments of excludable personal injury recoveries.[11] Section 104(a) now confirms that amounts received "whether as lump sums or as periodic payments" are still tax free. That provides plaintiffs wanting to invest personal injury recoveries over time with a tax code-approved vehicle for doing so without taxes.

IV. When the U.S. Government Is the Defendant

In 1996, the Supreme Court issued its opinion in *Winstar*,[12] upholding the lower Federal Circuit holding that the U.S. government was liable under contract law to some financial institutions

[6] *See Eshelman v. Agere Systems Inc.*, 554 F.3d 426 (3d Cir. 2009).

[7] *See O'Neill v. Sears, Roebuck & Co.*, 108 F. Supp. 2d 443 (E.D. Pa. 2000).

[8] *See Eshelman*, 554 F.3d 426; *EEOC v. Northern Star Hospitality Inc.*, 777 F.3d 898 (7th Cir. 2015); *Clemens v. Centurylink Inc.*, 874 F.3d 1113 (9th Cir. 2017); *Sears v. Atchison, Topeka & Santa Fe Railroad Co.*, 749 F.2d 1451 (10th Cir. 1984). *See also Gelof v. Papineau*, 829 F.2d 452 (3d Cir. 1987) (employer did not dispute that it properly owed plaintiff for additional tax created solely because of lump sum nature of wage award).

[9] *See Commissioner v. Schleier*, 515 U.S. 323 (1995).

[10] *See, e.g., Hollinger v. United States*, 651 F.2d 636 (9th Cir. 1981); *DeLucca v. United States*, 670 F.2d 843 (9th Cir. 1982); *Sosa v. M/V Lago Izabel*, 736 F.2d 1028 (5th Cir. 1984).

[11] P.L. 97-473, Title I, section 101, 97th Cong. (1983).

[12] *United States v. Winstar Corp.*, 518 U.S. 839 (1996).

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involved in the 1980s savings and loan crisis. When that crisis hit, the Federal Savings and Loan Insurance Corp. realized that it lacked the liquid resources to rescue the failing thrifts. Thus, the government recruited healthy financial institutions to rescue the failing thrifts by merging with them or buying them.

Financial institutions asked to come to the rescue were concerned that the purchases and mergers with the failing institutions would cause the healthy institutions to fall out of compliance with the federal capital reserve requirements. The government assured them that their professional goodwill as healthy financial institutions could be counted as capital for the capital reserve requirements. After being induced to rescue the failing thrifts in reliance on the government's assurances, Congress materially changed the law in 1989. The new law prohibits goodwill from being considered capital for the purposes of the capital reserve requirements.

That put the financial institutions that came to the government's aid at risk for compliance and potential penalties. Some institutions suffered greatly. The *Winstar* case held that under those facts, the United States was liable for breach of contract and related claims to the financial institutions that rescued the failing thrifts in reliance on the government's assurances. The *Winstar* case and its progeny ultimately resulted in the government's paying out more than $1 billion in damages to financial institutions.

The *Winstar* cases were essentially breach-of-contract cases brought against the U.S. government. They originated in the Court of Federal Claims and are appealable to the Federal Circuit. One notable feature of the *Winstar* cases is that the U.S. government was both the defendant and the party receiving the plaintiff's federal income tax liability. Therefore, the payment of U.S. income tax on the plaintiff's award effectively represents a partial refund to the government of its damage payments, a discount on its own liability.

If a financial institution plaintiff's effective federal tax rate was 40 percent, then the government was effectively paying out only 60 percent of the value of the damages it caused. The plaintiff's payment back to the U.S. government of 40 percent as tax was factored in. Moreover, economically, a gross-up may be seen as effectively free to the government in those cases. In the short term, the government may have had to pay out more to a plaintiff as a tax gross-up. However, the additional gross-up (at least to the extent calculated for federal tax) should be paid back to the government in tax by the plaintiff.

Depending on how often the financial institution plaintiff remits its estimated tax deposits, the tax gross-up in a *Winstar* context may be little more economically than a short-term interest-free loan that is repaid to the government in a matter of months. Of course, the government is still effectively losing the tax it would have gotten on the plaintiff's principal compensatory damages — the 40 percent that would have been taken out of the principal award. Because that tax represents a discount on the government's liability to the plaintiff, the Court of Federal Claims and Federal Circuit did not seem bothered. In this context, it is unsurprising that the *Winstar* cases became a pocket of positive authorities in which gross-ups have been liberally granted.[13]

Other cases against the U.S. government for breach of contract have received more liberal awards of tax gross-up damages, perhaps as a spillover effect of the *Winstar* gross-up cases.[14] Nevertheless, the possibility of gross-up damages is not the same as an absolute right, as discussed below.

V. Reasons Courts Deny Tax Gross-Ups

Following are some reasons a court might give for denying a tax gross-up claim.

A. Lack of Legal Basis

Some courts or jurisdictions choose to keep the lid of Pandora's box closed on the issue of tax gross-up awards. Rather than dipping even a toe into the minutia of how taxes apply to an award — and how to determine when tax gross-up damages may be appropriate — these cases pass on the idea outright. Some opinions contain

[13] *See Home Savings of America FSB v. United States*, 399 F.3d 1341 (2005); *LaSalle Talman Bank FSB v. United States*, 462 F.3d 1331 (Fed. Cir. 2006); *First Nationwide Bank v. United States*, 56 Fed. Cl. 438 (2003).

[14] *See, e.g., Sonoma Apartment Associates v. United States*, 127 Fed. Cl. 721 (2016).

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statements to the effect that, "everyone pays taxes, period." Why should courts get involved? Asking the defendant to pay your taxes is like asking for a personal exemption from the tax law. There are many examples.

In 1994, the D.C. Circuit in *Dashnaw* rejected outright the idea of awarding a tax gross-up award, "given the complete lack of support in existing case law for tax gross-ups."[15] This case involved grossing up a back pay award in an employment discrimination case, which, as discussed, is the context in which courts seem most likely to grant a limited tax gross-up award. Nevertheless, in 2007, when the D.C. Circuit had an opportunity to reconsider its bright-line rejection, it stood firm in blanket rejection of tax gross-ups in another employment discrimination case, *Fogg*,[16] reaffirming *Dashnaw* as "binding circuit precedent."

In *Union-Leader*, the New Hampshire Supreme Court held that a plaintiff's additional tax liability that resulted from compensatory damages "is not a loss within the meaning of the term as used in the law of damages." Though acknowledging this can produce an unfair result to plaintiffs, the court noted that "the answer seems to us to be that this situation results primarily from the provisions of the federal income tax statute which sometimes produce inequities. We believe the remedy should be sought at the source — in federal [tax] legislation."[17]

In *Stopford*,[18] the New Jersey Supreme Court stopped short of rejecting tax gross-up awards as a rule, declining "to attempt to lay down a rule of general application for all breach of contract cases." Nevertheless, the court denied the gross-up in that case, holding that the plaintiff "should be obliged to abide by . . . the tax consequences" of his choice to pursue a lump-sum recovery over a recovery paid over time.

At least one intermediate appellate court in New Jersey has subsequently refused to award tax gross-ups categorically because "there is no statutory or other legal basis for an enhanced award for negative tax consequences of non-economic damages" and "absent clear direction from our Supreme Court, we . . . reverse the award of additional tax-offset sums" to the plaintiff.[19] It is somewhat ironic that the New Jersey Supreme Court's express desire not to create a bright-line rule was later used to support why there should be a bright-line rule against tax gross-ups.

In *Ehly*,[20] the Supreme Court of Montana addressed and dismissed the tax gross-up question in a single paragraph, reversing the awarding of a gross-up payment by the lower courts:

> We appreciate the concern of Ehly's counsel that his client be made whole. We also realize that the damages for breach of contract will potentially be considered taxable income. However, we know of no authority, nor has counsel provided us with any, whereby an award for [compensatory damages] may be ballooned in anticipation of additional taxation. We decline to create such a precedent in this case. The additional monetary relief was erroneously granted.[21]

In *Arneson*,[22] the Eighth Circuit considered a Title VII employment discrimination recovery in which the defendant was the federal government, not a private employer. The federal government defendant implicated sovereign immunity questions that are not implicated by Title VII suits against nongovernment employers. The Eighth Circuit concluded that Title VII had not expressly waived the government's immunity against awards for tax gross-up damages, and the court was not willing to infer a waiver of sovereign immunity for tax gross-up damages against a government defendant.

B. Causation

Lawsuits in myriad contexts often wrestle with the appropriate scope of damages. Many

[15] *Dashnaw v. Pena*, 12 F.3d 1112, 1116 (D.C. Cir. 1994).

[16] *Fogg v. Gonzales*, 492 F.3d 447, 456 (D.C. Cir. 2007).

[17] *McLaughlin v. Union-Leader Corp.*, 100 N.H. 367, 371-72 (1956), *cert. denied* 353 U.S. 909 (1957), *reh'g denied*, 353 U.S. 943 (1957).

[18] *Stopford v. Boonton Molding Co.*, 56 N.J. 169, 195 (1970).

[19] *Besler v. Board of Education*, 2008 WL 3890499 (N.J. App. Ct. 2008).

[20] *Ehly v. Cady*, 212 Mont. 82, 687 P.2d 687 (1984).

[21] *Id.* at 98.

[22] *Arneson v. Callahan*, 128 F.3d 1243 (8th Cir. 1997).

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jurisdictions use "but-for causation," "substantial factor" tests, and "proximate cause" in setting limits on the scope of the damages and losses for which a defendant can be considered responsible. Those concepts generally require the plaintiff to show that the defendant has some requisite relationship or causal connection to the injury.

Courts deny claims for tax gross-ups when the defendant does not have a sufficient causal relationship to the tax at stake. It may be debatable whether the damages would be subject to income tax at all. It also may appear that the tax would have been payable regardless of the defendant's alleged misconduct.

When a plaintiff is being asked to be compensated for taxes he does not actually owe, or to be compensated for taxes he would have owed regardless, it is easy for a court to deny the requested gross-up payment as a windfall that overshoots the mark on making the plaintiff whole. In cases that fall into this pattern, the court may acknowledge the theoretical possibility of a tax gross-up, while declining to grant the gross-up in the immediate case, as shown in the examples that follow.

In *Erickson Air-Crane*, a federal district court, applying Oregon state law, noted that "in the event that defendants can demonstrate that plaintiffs would have paid capital gains or other taxes even absent defendants' breach (for example, upon sale of the aircraft), then plaintiffs will not be compensated for capital gains imposed upon a judgment award."[23]

In *O'Toole*, the Tenth Circuit remanded a case to require the plaintiff to establish whether a requested gross-up award would compensate him for tax he would still have owed regardless of the defendant's malfeasance.[24]

In *Doumani*,[25] the Federal Circuit, which had affirmed a tax gross-up award in another case just two years prior,[26] affirmed the denial of a tax gross-up award by the Court of Federal Claims in part on the basis that it was not clearly established whether the compensatory recovery would be taxable to the plaintiff. *Doumani* is notable because it is a *Winstar* case, so tax gross-ups are generally easier to obtain.

In the same year, the Federal Circuit also denied a tax gross-up award when the tax at issue would have been owed regardless of the defendant's malfeasance, in *Carabetta Enterprises*.[27] Although not a *Winstar* case, it is nevertheless a case with the U.S. government as the defendant, so *Winstar*-like principles could have applied if not for the issue of causation.[28] The Court of Federal Claims (whose opinions are appealed to the Federal Circuit) has also denied tax gross-ups on the basis that the compensatory damages at issue there may not be subject to tax in the first place, including *Centex*,[29] another *Winstar* case.

C. Damages That Are Too Speculative

The cases that fall into this group reject tax gross-ups under general principles of burden of proof and specificity. Generally, plaintiffs bear the burden of proof to demonstrate the amount of their damages. Many jurisdictions appear to allow some wiggle room for the valuation of damages, particularly for noneconomic damages and damages whose value depends on future or uncertain events.

However, there often comes a time when a plaintiff's asserted damages seem untethered from demonstrable proof, or too reliant on unknown future events. At some point, the court may consider them to be mere speculation.

To return to a hypothetical $1 million award, the plaintiff's effective tax rate can have a monumental difference on the value of an appropriate gross-up. A taxpayer with an ETR of 15 percent would need only an extra $10,101 to gross-up her $1 million compensatory award. However, a taxpayer with a 55 percent ETR would need a gross-up of more than $1.22 million for the same $1 million compensatory award. It is

[23] *Erickson Air-Crane*, 183 F.R.D. 248.

[24] *O'Toole v. Northrop Grumman Corp.*, 499 F.3d 1218 (10th Cir. 2007).

[25] *Bank of America FSB v. Doumani v. United States*, 495 F.3d 1366 (Fed. Cir. 2007).

[26] *See Home Savings*, 399 F.3d 1341 (a *Winstar* case, discussed below).

[27] *Carabetta Enterprises Inc. v. United States*, 482 F.3d 1360, 1367, and n.2 (Fed. Cir. 2007) ("Because, as Carabetta admits, investment income from tax-free money is taxable, Carabetta's lost income would have been taxable and thus Carabetta is not entitled to a tax gross-up.").

[28] A more thorough discussion of *Winstar* cases can be found earlier in this article.

[29] *Centex Corp. v. United States*, 55 Fed. Cl. 381 (2003).

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common for taxpayers to have combined federal and state marginal income tax rates on large legal recoveries nearing or exceeding 50 percent. A gross-up of that taxpayer's recovery is far different from the gross-up of a taxpayer's award whose federal marginal tax rate is only 22 percent, and who lives in a state with no income tax.

Many courts considering tax gross-up damages put the responsibility on the plaintiff to prove how much tax she would owe. If the plaintiff fails to precisely prove the appropriate amount of the gross-up award, the court can decide that the plaintiff failed to meet her burden of proof and that gross-up damages are too speculative to award. To know her ETR when tax returns are filed the following year, a plaintiff might need to know about other income she would receive, the portion of her recovery that would be taxable, and other deductions and credits she can claim to offset her income. The last may depend on expenditures that have not yet been made.

Thus, many courts have held that the plaintiff failed to establish the appropriate value of her gross-up claim. Many cases follow this pattern.

In 1939, the Second Circuit's *Remington Rand* opinion rejected a tax gross-up award because it would be highly speculative, noting that "such variation of tax is not a consequential damage flowing from the breach of contract."[30]

In *Oddi*,[31] the Seventh Circuit indicated a theoretical openness to tax gross-up damages while noting that the plaintiff bears the "burden of presenting evidence that shows that he will be liable for the prescribed amount of taxes."[32] Nevertheless, when the Seventh Circuit reviewed the denial of a tax gross-up award just a few years later in *Medcom*, it affirmed the district court's denial of the gross-up award for being inappropriate and speculative under the abuse-of-discretion standard.[33]

In *Erickson Air-Crane*,[34] a federal district court, applying Oregon state law in a motion for summary judgment context, noted that "plaintiffs bear the burden of proving their expected tax consequences, and the court will deny recovery if plaintiff's claims are speculative. . . . These are all questions for trial."

In *Doumani*, discussed previously in the context of causation, the Federal Circuit also affirmed the Court of Federal Claim's denial of the gross-up award because the plaintiff's historic tax rate had been highly variable.[35] The claims court has also denied tax gross-ups for being too speculative under the facts of those cases in several opinions that were not appealed to the Federal Circuit, including *Citizens Bank*, another *Winstar* case.[36]

In *McKinney*,[37] a district court in the D.C. Circuit denied a gross-up award to a large class of plaintiffs because "the court finds that any award of tax gross-ups would be speculative and highly imprecise, as it would depend on the expected future incomes of each of the approximately three thousand class members." *McKinney* cites an earlier D.C. Circuit case in which the district court denied a gross-up on similar grounds, *Porter*.[38] Nevertheless, as discussed, the D.C. Circuit has been categorically hostile to tax gross-ups at least since its *Dashnaw* opinion in 1994.[39] Therefore, even if the tax calculations weren't as speculative as the district court held, it is questionable whether a gross-up award by a district court in the D.C. Circuit would have survived on appeal.

In *Joe's Stone Crab*,[40] a district court in the Eleventh Circuit acknowledged that a limited tax gross-up was an appropriate component of a Title VII employment discrimination recovery, but still denied the plaintiff the gross-up because "the EEOC failed to provide sufficient competent

[30] *Paris v. Remington Rand*, 101 F.2d 64, 68 (2d Cir. 1939).

[31] *Oddi*, 947 F.2d 257 (amended 1992).

[32] *Id.* at 268.

[33] *Medcom Holding Co. v. Baxter Travenol Labs*, 106 F.3d 1388 (7th Cir. 1997).

[34] *Erickson Air-Crane*, 183 F.R.D. 248.

[35] *Doumani*, 495 F.3d 1366.

[36] *Citizens Federal Bank FSB v. United States*, 59 Fed. Cl. 507 (2004).

[37] *McKinney v. United States Postal Service*, 2015 WL 1368071 (D.D.C. 2015).

[38] *Porter v. U.S. Agency for International Development*, 293 F. Supp. 2d 152, 156 (D.D.C. 2003).

[39] *Dashnaw*, 12 F.3d 1112.

[40] *EEOC v. Joe's Stone Crab Inc.*, 15 F. Supp. 2d 1364, 1380 (S.D. Fla. 1998).

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foundation evidence to permit the court to make [the necessary] calculations." Even in Title VII employment discrimination recoveries, the burden of proof for valuing damages remains on the plaintiff.

Similarly, the Eighth Circuit denied a limited tax gross-up in a Title VII employment discrimination suit when the plaintiff failed to provide the district court with sufficient information to calculate the appropriate gross-up amount.[41]

VI. Tactical Considerations and Conclusions

There is no easy way to know what it means to make a plaintiff whole. An award that makes a plaintiff whole, even in part, may still be a profit or income for income tax purposes. When an award for taxes is addressed, it becomes more difficult still, and different courts and jurisdictions have taken different approaches.

Some courts, like the D.C. Circuit, appear less receptive to tax gross-up awards, perhaps in any context. But in many circuits, tax gross-ups are sometimes awarded, sometimes not. The same can be said about many state courts.

Whether a gross-up should be awarded or is inappropriate may require at least two levels of consideration. First is whether there is precedent of tax gross-ups being awarded or whether gross-ups otherwise seem compelling. Second, even if your case is similar to others in which gross-up damages have been awarded, you must show causation and compute your tax-based damages.

Pay careful attention to presenting the gross-up in a way that makes it clear that the tax you ask to be grossed up is (1) tax that you *would* owe on your recovery, and (2) tax that you would *not* owe had the defendant not committed its alleged breach. When possible, present your calculations for the gross-up in a way that suggests little uncertainty or that indicates speculation is needed to determine the appropriate amount. Observe local laws and precedent for the relevant jurisdiction and court.

If you are a defendant asking the court to reject a plaintiff's tax gross-up claim, the obvious starting point is to emphasize the same factors that have been historically successful. These include arguments about lack of legal basis, causation, and undue speculation. These positions can be underscored by considering related issues.

For example, is the taxability of the plaintiff's recovery the result of a previous tax election or a structure or transaction that the plaintiff put in place to obtain tax benefits? In tax planning, there is frequently a trade-off of costs and benefits. Some structures, tax elections, and tax deductions can provide tax savings up front, but create the possibility of additional taxes owed later. For example, some choices that taxpayers make in their estate planning can provide estate tax savings. However, that may be at the cost of more income taxes, or vice versa.

If the plaintiff's income tax on his recovery results from his own actions, in whole or in part, the defendant should bring it up. It may be unfair or a windfall to allow a plaintiff to pass along all the income tax costs to a defendant that the plaintiff may have caused by prioritizing estate tax savings. A natural context for this kind of trade-off tax discussion to occur is estate planning. But there are myriad other contexts, too, in which a defendant may want to raise such criticisms to rebut or reduce tax gross-up claims.

S corporation elections, accelerated depreciation, 1031 exchanges, and numerous varieties of tax deferral strategies are appropriate considerations for defendants facing tax gross-up claims. Plaintiffs facing such arguments are likely to emphasize causation, authorities saying that you take your plaintiff as you find him, etc. Expert witnesses on tax gross-up issues are almost a given to summarize the authorities and to make and present the necessary computations.

It can be a delicate matter to raise, but it should not be surprising that the plaintiff's description of the taxes he would owe may not match the way the plaintiff ends up reporting his recovery on the tax returns he files a year after the recovery. Plaintiffs requesting gross-ups typically present the taxes they will owe as high as possible and assume that the IRS and state will do their worst. For example, they might assume that they would pay ordinary income tax (and even employment taxes) on 100 percent of their gross

[41] *Hukkanen v. International Union of Operating Engineers*, 3 F.3d 281 (8th Cir. 1993).

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recovery. Unless a deduction for legal fees is assured, they might assume they cannot claim it.

When tax time comes, they may claim deductions for their legal fees, claim capital gains treatment, or any one of many other more tax-saving positions that did not feature in their tax gross-up claims. If their gross-up claims assumed they would owe tax because section 104's physical injury exclusion does not apply, they may feel differently on their tax returns. This kind of positioning should not be surprising and can arise naturally as part of the defendant's rebuttal to a tax gross-up claim.

The plaintiff's tax situation may not be as dire as she represents. These issues may touch on causation and speculation. A defendant may be able to defeat a gross-up claim by showing the math to be complex and speculative. For plaintiffs seeking tax gross-ups, clear and concrete calculations are best, while complex and expansive formulas are best avoided when possible.

The goal for a defendant in rebutting a tax gross-up claim may be to point out as many offsets, doubts, nuances, inconsistencies, and speculation as possible. Apart from the question of precedent, if the determination of the gross-up is nuanced and difficult, it will be easier for the court to deny it. Even so, the mix of available authorities provides opportunities for both sides to make their cases for or against tax gross-ups.

Finally, there are other tax-based damage issues that we have not touched on in this already lengthy article. For example, should a defendant ever bring up tax issues if the plaintiff has not? It can backfire, but the answer is still yes. Can defendants bring up tax benefits the plaintiff is likely to receive as a way of reducing their damage exposure? Those and other tax-based damage issues are also worth investigating. They show, as we all know, that taxes bear in some fashion on just about everything. ■

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