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Tax Aspects of Lost Wages Claims

Posted date: **April 27, 2022** In: **Litigation Consulting**, **QuickRead Top Story**

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Many engagements to determine or rebut a lost wages claim include many elements established by the expert. This article focuses on the tax aspects of an award, specifically, how should the plaintiff receive a tax component award and, if so, how should this award be calculated.

Many engagements to determine or rebut a lost wages claim (in an alleged wrongful termination, improper denial of promotion, wrongful death, or other such litigated dispute involving individuals) have the following elements established by the expert:

- Establishing the chronology of events;
- An assumption of the defendant's liability;
- Analyzing lost earnings and/or lost earning capacity;
- Establishing the earnings base;
- Comparing "but for" and actual/mitigating earnings;
- Considering the existence and dollar amount of lost fringe benefits;
- Calculating the value of household services, if any;
- Adding together past medical and/or rehabilitation costs;
- Calculating the present value of lost future medical and/or rehabilitation costs;
- Offsetting the loss for personal consumption and/or personal maintenance;

- Estimating the remaining work life expectancy and remaining life expectancy;
- Discounting future lost earnings to current cash value; and
- Considering tax issues.[1]

Consider for now, only the tax issues—of which there are many.

“The taxation of damages awards varies, depending on why the damages were awarded. Damages for loss of business profits generally represent taxable income to the recipient because they compensate or reimburse for amounts that would have been taxable. Amounts recovered for property damages are generally treated as taxable proceeds with taxable gain or loss measured by comparison of these proceeds to the adjusted basis of the property.” “The test is not whether the action was one in tort or contract but rather the question to be asked is, in lieu of what were the damages awarded?”[2]

“Damages awarded for injuries or sickness may be excluded from income. Internal Revenue Code (IRC) section 104(a)(2) provides that gross income does not include: The amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or physical sickness.”[3]

There are other potential tax complications. For example, the treatment of punitive damages, deductions from awards for attorney’s fees, reimbursement of medical expenses, payments of awards over time, payroll taxes, and more. This article addresses none of those issues. Depending on the type of damages being awarded, the tax treatment differs.[4]

This article addresses only the following two-part question:

Should a successful plaintiff receive an additional award (“a tax component award”) granted to make that successful plaintiff whole by easing the tax burden that arises from receipt of a lump sum award … and how should that tax component award be calculated?

A recent case is informative.[5]

In 2013, Lydia Vega (“Vega”), a Hispanic woman, brought 12 claims against the Chicago Park District (“Park District”) all related to its investigation and termination of her employment for allegedly falsifying her timesheets. Vega countersued for discrimination and retaliation. After the filing of extended pretrial motions, the District Court allowed Vega’s discrimination and retaliation claims to proceed to trial.

The jury returned a verdict for Vega on some but not all her claims and awarded her damages. The Park District moved for remittitur[6] and for judgment as a matter of law on the discrimination claims. The District Court granted some claims in whole and some in part and reduced the final damages award.

The District Court ordered the Park District to reinstate Vega in her position, pay her back pay, provide her with the cash value of lost benefits, pay prejudgment interest, and pay her a tax component award—an award granted to make a plaintiff whole by easing the tax burden from a lump sum award.

The Park District appealed every decision it lost at trial and Vega cross-appealed the District Court’s ruling on some of her claims. The Appellate Court affirmed all the District Court’s rulings except for the tax component award, which it held was not explained sufficiently for meaningful appellate review.

The Appellate Court held that the District Court did not abuse its discretion in calculating the tax component award because it had ample, uncontradicted evidence to employ the methodology described in *Washington v. Office of the State Appellate Defender* (“the Washington Methodology”), but it did not sufficiently show its workings.[7]

The District Court based the tax component award on redacted tax records that Vega provided from 2013 to 2019, showing no actual tax liability for each year from 2013 to 2017 and a specific dollar amount of tax liability for 2018; her testimony that, had she remained employed with the Park District from 2012 to 2017, she would not have paid any federal income tax (based on her zero tax liability while employed with the Park District from 2010 to 2012); her testimony that she would have paid a specific dollar amount of federal income tax in 2018 if employed with the Park District; and a calculation of the award, following the Washington Methodology.

The Appellate Court noted that when employing the Washington Methodology, the District Court calculated Vega's total income for the current tax year by adding together the back pay award and the compensatory damages award. It used this total to calculate Vega's effective tax rate. The District Court then applied that effective tax rate to the back pay award (but not to the compensatory damages) to arrive at the tax component award. In doing so, the District Court rejected the Park District's argument that the compensatory damages award should not be used to calculate Vega's effective tax rate.

On appeal, the Park District took issue with the District Court's calculation of the tax component award. The Appellate Court reviewed the District Court's grant of a tax component award for abuse of discretion and found that the District Court had used the Washington Methodology to calculate the award. Application of the Washington Methodology comprises the following steps (paraphrased):

(1) Subtract the plaintiff's actual tax burden during the back pay period from the tax burden she would have borne during the same period had she remained employed by the defendant,

(2) Subtract the plaintiff's expected tax burden in the year of the decision, absent any lump sum back pay award, from the expected tax burden that would be borne if the back pay award were paid in a lump sum payment in the same tax year, and

(3) Subtract the result of (1) from the result of (2).[8]
Following these steps in detail, the District Court had arrived at its calculation of a tax component award. The Park District did not object to the Washington Methodology. Rather, it maintained that the District Court abused its discretion for two reasons:

(1) Portions of Vega's tax returns from 2013 to 2017 were redacted—Vega's adjusted gross income, itemized deductions, and taxable income—which made it impossible for the District Court to accurately calculate Vega's hypothetical tax liability had she remained employed with the Park District for those years; and

(2) The District Court erred when it included the compensatory damages award to calculate Vega's effective tax rate.

The Appellate Court found that both arguments fell flat. As for the first argument, Vega presented evidence of her actual tax burden ($0) for each year from 2013 to 2017 and testified to what she would have owed in taxes if employed by the Park District during that period. That testimony was based on Vega's actual tax burden while employed with the Park District from 2010 to 2012. The District Court reasonably credited this evidence. The Park District presented nothing to contradict it, even though the Park District—as her former employer—could have deduced a hypothetical tax liability based on what it would have paid Vega.

The Appellate Court held that because the District Court had ample, uncontradicted evidence to employ the Washington Methodology, it did not abuse its discretion when doing so. Moreover, the

Park District did not identify any case requiring certain information (here, unredacted tax returns) to calculate the hypothetical tax liability.

The Appellate Court held that the Park District's second argument sought to hold, as a matter of law, that including compensatory damages to calculate Vega's effective tax rate was an error, but the Appellate Court saw no reason to impose that requirement either. The Appellate Court noted that no other Circuit had placed such a limit on the District Court's-wide discretion to make a plaintiff whole through a tax component award.

The Appellate Court noted that the applicable law offered a court-wide latitude to fashion an award that fits the "circumstances peculiar to the case"—in other words, the plaintiff's own personal circumstances. The applicable law allowed courts in these circumstances to award, among other things, "any other equitable relief as the court deems appropriate". Some District Courts have considered compensatory damages when calculating a plaintiff's hypothetical tax liability in exercising their discretion, others have not. The Appellate Court found that the Park District had not articulated any sufficient basis—statutory or otherwise—upon which to limit a District Court's-wide discretion in computing a tax component award.

A few more thoughts before concluding. It may be possible to estimate whether a tax component award is or is not material by comparing the tax rates in the tax brackets plaintiff historically paid to the tax rates in the tax bracket the plaintiff might pay in the year of the award. The tax component award itself might be taxable, leading to a theoretical circuitous simultaneous equation loop. Some of the award may be taxable for federal purposes but not for state tax purposes. Plaintiff's tax status may have changed between the years with lost compensation and the year of the award. All these, I submit, are resolved on a facts and circumstances basis.

In conclusion, here are some "take aways" for readers:

- Whether or not a complaint includes the phrase: "any other equitable relief as the court deems appropriate," economic damages experts computing a lost wages claim may wish to discuss with retaining counsel the need to include a tax component award;
- There is a generally accepted methodology for computing such an award—the Washington Methodology—that involves determination of a tax component award using a "with and without" method for each affected tax year:
    - Step 1: compare the defendant's tax liability for each tax year if she had remained employed to the actual tax liability she incurred for the applicable years without being employed;
    - Step 2: compare the expected tax liability in the year of the lump sum award without taking into account the award to the amount the tax liability is expected to be in the year of the lump sum award including adding the award to taxable income for that year; and
    - Step 3: subtract the amount determined in step 1 from step 2 to arrive at the tax component award.

[1] These topics are individual chapters within the AICPA publication entitled, *Measuring Damages Involving Individuals: a CPA's Litigation Service Guide With Case Studies* by Holly Sharp, CPA, CFP, CFE.
[2] Measuring Damages Involving Individuals: a CPA's Litigation Service Guide With Case Studies by Holly Sharp, CPA, CFP, CFE, Chapter 10, quoting Raytheon Products Corp. v. Commissioner, 144 F2d 110,113 [1st Cir. 1944].
[3] Measuring Damages Involving Individuals: a CPA's Litigation Service Guide With Case Studies by Holly Sharp, CPA, CFP, CFE, Chapter 10.

[4] However, in personal injury cases, Internal Revenue Code Section 104(a)(2) applies. According to that code section: “Damages awarded for injuries or sickness may be excluded from income. Internal Revenue Code (IRC) section 104(a)(2) provides that gross income does not include: The amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or physical sickness.”(Measuring Damages Involving Individuals: a CPA’s Litigation Service Guide With Case Studies by Holly Sharp, CPA, CFP, CFE, Chapter 10.)
[5] LYDIA E. VEGA, Plaintiff-Appellee, v. CHICAGO PARK DISTRICT, Defendant-Appellant. United States Court of Appeals for the Seventh Circuit May 27, 2021, Argued; September 1, 2021, Decided No. 20-3492.
[6] The process by which a court requires either that the case be retried, or that the damages awarded be reduced.
[7] Washington v. Office of the State Appellate Defender, No. 12 C 8533, 2016 U.S. Dist. LEXIS 70817, 2016 WL 3058377 (N.D. Ill. May 31, 2016).
[8] See Washington, 2016 U.S. Dist. LEXIS 129918, 2016 WL 5233563, at *4.

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