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Making Prevailing Plaintiffs Whole

It's not how much money they are awarded, but how much they keep that counts

More than 100 years ago the United States Supreme Court explained that “[t]he general rule is, that when a wrong has been done, and the law gives a remedy, the compensation shall be equal to the injury. The latter is the standard by which the former is to be measured. The injured party is to be placed, as near as may be, in the situation he would have occupied if the wrong had not been committed.” *Wicker v. Hoppock*, 73 U.S. 94, 99 (1867). This has come to be known as the “make whole” doctrine, and it applies to cases brought by victims of workplace discrimination under federal laws such as Title VII of the Civil Rights Act of 1964 and the New

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Jersey Law Against Discrimination. *Albemarle Paper Co., et al. v. Moody, et al.*, 422 U.S. 405, 419-20 (1975); *Terry v. Mercer County Bd. of Chosen Freeholders*, 86 N.J. 141, 148 (1981).

This article focuses on what courts have come to recognize as the “negative tax consequences” on a judgment obtained against an employer by a victim of discrimination, and how that prevailing plaintiff can be made whole to fulfill the antidiscrimination laws’ intent with expert testimony by an economist. Although courts have thankfully addressed the plaintiff’s negative tax consequences, their decisions have generally fallen short of the make-whole objective. An alternate approach is therefore advocated to avoid that result while achieving the ultimate goal of making the plaintiff whole.

Taxation of Plaintiffs’ Awards

Under the LAD, a prevailing plaintiff is entitled to recover remedies that include compensatory and punitive damages. Compensatory damages include back pay for lost wages, and front pay for future wages lost due to the employer’s misconduct. If a discrimination plaintiff prevails at trial and is awarded back and front pay, that victory may quickly sour once the plaintiff is advised of how it will be taxed.

With regard to the back pay component, the plaintiff will likely be subject to a higher tax burden on that award because its receipt as a lump sum in a single tax year instead of being earned

by the plaintiff over a period of years. The front pay portion will be reduced to present value based on the assumption that the plaintiff can invest the money and receive a yearly return equal to his or her lost wages. But the front pay award will be subject to a higher tax on the present value of the award, leaving less for the plaintiff to invest. Courts have remedied this violation of the make-whole doctrine by molding judgments with the assistance of expert economic testimony, enabling the prevailing plaintiff to arrive at an award that is not eviscerated by taxes.

Case History

The case law on this issue is far from legion; however, the leading cases that have tackled the issue have uniformly arrived at the following conclusions: (1) federal income taxation substantially reduces a damages award; (2) such a result undermines the important public policies embodied by antidiscrimination laws; and (3) expert analysis and explanation of the issue is essential for all involved.

In July 2000, the United States District Court for the Eastern District of Pennsylvania modified a plaintiff’s verdict after he won an age discrimination trial. *O’Neill v. Sears, Roebuck and Co.*, 108 F.Supp.2d 443 (E.D.Pa. 2000). The total jury award was \$412,332, which consisted of \$106,736 in back pay, \$130,596 in front pay and \$175,000 in compensatory and liquidated damages under Pennsylvania law. The court then

molded only that portion of the verdict relating to what the plaintiff would have received during his work life (i.e., back and front pay).

With the assistance of plaintiff's economic expert, the court calculated the tax bite on the plaintiff's verdict by first assessing what that rate would have been on plaintiff's earnings if employed by the defendant at the time of the verdict. That rate of 11.96 percent resulted in taxes of \$28,384.91 on the plaintiff's \$237,332 combined back and front pay award. However, the court found the plaintiff's gross income for this analysis to be the total of his back and front pay, plus his actual salary (\$24,960) and wife's income (\$11,428) for that year. This total amount of \$273,720 increased the plaintiff's tax rate to 28.3 percent, and a corresponding \$67,164.96 tax hit on the \$237,332 award. Due to these negative tax consequences, the court deducted \$28,384.91 as the amount the plaintiff would have properly paid in taxes from the exorbitant \$67,164.96 estimated tax applicable to the plaintiff's gross income. The plaintiff was awarded an additional \$38,780.05 to absorb this difference. As will be explained below, simply adding the tax difference helps the plaintiff move closer to the make-whole position, but is still inadequate.

Approximately two years later, a court of appeals in Washington emphatically held that "adverse federal income consequences triggered by payment of a judgment for violation" of that state's law against discrimination were "actual damages" to be awarded a prevailing plaintiff. *Blaney v. Int'l Assoc. of Machinists and Aerospace Workers*, 55 P.3d 1208, 1216-17 (Ct.App.Wash. 2002). *Blaney* was a gender discrimination case resulting in a judgment of \$638,764 following a verdict in plaintiff's favor. A further judgment for plaintiff was entered by the court, pursuant to the statute's fee-shifting provisions, in the amount of \$235,625.38 for prejudgment interest, attorney and expert fees, and costs. The trial court denied plaintiff's motion for a supplemental judgment to compensate her for the negative tax consequences applicable to the judgment, but the appellate

court reversed and remanded on that issue.

The overarching issue addressed by the appellate court was whether or not "actual damages" under Washington's law against discrimination included compensation for the negative tax consequences. In a detailed and passionate opinion, the court answered this question in the affirmative, finding the federal income tax reduction of compensatory damages to present the very real "risk of having the entire benefit of a judgment eliminated plus incurring a substantial tax liability to the Internal Revenue Service." *Id.* at 1217. That plaintiff consequently lost every penny of her award and ended up owing the IRS an additional \$99,000.

The "net effect" of this tax impact would be that Blaney would not receive the full benefit of her award, and therefore not be made whole consistent with Washington's antidiscrimination laws. The matter was remanded on this strictly legal issue for a determination to be aided by expert opinion. *Id.* at 1218. This precise issue was addressed in a case of first impression before a New Jersey trial court last year.

The plaintiff in *Ferrante v. Borough of Bernardsville* prevailed in a case of hostile work environment sexual harassment. 365 N.J. Super. 601, 603 (Law Div. 2003). The resulting award to her consisted of \$340,659 in economic damages, \$26,250 in emotional distress, prejudgment interest of \$72,298.16, and attorneys' fees and costs totaling \$895,025.77. Plaintiff moved post-judgment for an award reflecting the negative tax consequences on her lump-sum award for economic damages. *Id.*

The issue before the court, similar to the issue in *Blaney*, was whether negative tax consequences to a prevailing plaintiff constituted "such damages" under the LAD. Applying the "logic of *O'Neill* and *Blaney*," Judge Bernhard concluded that, pursuant to the make whole policies of the LAD, the defendants would be "required to compensate plaintiff for the negative tax consequences of receiving the lump sum award." *Id.* at 607. Based on the un rebutted report and testimony of plain-

tiff's expert, the court awarded the plaintiff an additional \$107,000 to reflect the negative tax impact on the jury award. *Id.* at 608-10.

As the foregoing cases demonstrate, prevailing plaintiffs in antidiscrimination lawsuits should be made whole in order to avoid federal taxation diminishing their significant result. For a practical tip, we suggest that the issue be placed into the case as early as possible, such as pleading it as an element of damages in the complaint's WHEREFORE clause. Expert testimony will then be necessary to explain to the court how to make the plaintiff whole.

Expert Analysis Is Required

Each of the decisions discussed in this article arrived at the same point on a critical issue: expert analysis and explanation is required for the court to understand and decide exactly what are the negative tax consequences applicable to a plaintiff's award. *O'Neill* relied upon the plaintiff's expert, finding that the proffer of such an opinion with corresponding calculations set it apart from prior cases denying this form of relief where no expert analysis was offered to determine the plaintiff's speculative tax liability. 108 F.Supp.2d at 447. The remand instructions in *Blaney* specifically provided that "[e]xpert opinion regarding the income tax consequences shall be required." 55 P.3d at 1218. Finally, in *Ferrante*, Judge Bernhard found that the negative tax consequences of a jury award is a legal issue with calculations that "require expert analysis." 365 N.J. Super. at 607-08. Although each decision supplemented, or molded, the judgment to reflect the impact of taxation on the plaintiff's award, the end result of those decisions did not fully relieve the plaintiff of the corresponding adverse tax bite. A more refined and accurate approach to that utilized by the courts is needed, as explained in the following section.

Proper Calculation Needed

Although judges in the cases cited above either molded the jury award or

remanded for further calculation, a misconception persists about the additional compensation needed to relieve the plaintiff of the excess tax bite. For example, in the *O'Neill* ruling, the difference in the tax liabilities (\$38,780) was awarded to the plaintiff in an attempt to make up for the extra tax liability. Unfortunately, when the plaintiff reports the award combined with the additional compensation, authorities will levy taxes on the entire amount, including the additional amount awarded for excess taxes. Consequently, the additional award turns out to be inadequate since it, too, would be taxed at a relatively high tax rate.

The *O'Neill* court needed to take an extra step before arriving at the proper additional amount to compensate for the adverse tax bite. What the court did, with the aid of an economist, was to determine the tax rate on the plaintiff's regular income, and then the tax rate that would be imposed on total income including the lump-sum award. Then the court took the difference between the two to represent the additional tax burden and awarded that amount to the plaintiff. In contrast, the appropriate award (A) should have been calculated by application of the following formula:

$$A = \text{lump sum award} - \text{plaintiff's normal tax liability}$$

$$1 - \text{tax rate on lump sum award}$$

The formula essentially recognizes that the additional award for excess taxes is itself being taxed as part of tax-

ing authority's calculation, and thereby recalculates the correct amount to make the plaintiff whole. The formula was first published by Tyler J. Bowles, and W. Cris Lewis, "Taxation of Damage Awards: Current Law and Implications," *Litigation Economic Digest*, Fall 1996, Volume 2, Number 1, pp. 73-77.

We illustrate the effect of using the proper calculation method by applying the formula to the *O'Neill* case. Recall that the combined back and front pay award totaled \$237,332 and that income tax rate on those earnings would have average 11.96 percent. (In jurisdictions with state and local income tax liabilities, the combined federal/local tax rate would have to be calculated and used in the formula.) The corresponding tax liability was \$28,385. Finally, the economist estimated that a 28.3 percent tax rate would be paid on plaintiff's earnings combined with the lump-sum award. We now have all the information we need to calculate the proper amount (A) of the molded award, as follows:

$$A = (\$237,332 - \$28,385) / (1 - 0.283)$$

$$A = \$208,947 / 0.717 = \$291,418$$

Now, when we subtract the initial award amount of \$237,332 from the calculated proper award of \$291,418, we obtain \$54,086, which represents the additional compensation needed to pay the adverse tax effects imposed on the plaintiff. When compared with the

actual amount granted by the court in molding the award, which was \$38,780, we realize that the correct amount is nearly 40 percent higher than that calculated by the court. Plaintiff *O'Neill* was still short-changed by the adverse tax consequence, despite the court's best intentions to make him whole. The reason is that the court simply subtracted the two different tax liabilities instead of applying the formula we have given here. Alternatively, the expert economist could have been asked to do the calculations for the court.

Conclusion

As we have demonstrated, it is important to take steps to make plaintiffs whole who have won court awards in discrimination and other employment matters. A number of courts have attempted to do just that, recognizing that the lump-sum awards are subject to full income taxation which can severely reduce the amount intended to be awarded plaintiffs by the trier of fact. Fortunately, methods are available by which courts can properly calculate the additional amount that should be awarded to compensate plaintiffs for the adverse tax consequences they face. Forensic economists can be used both to make estimates of the tax bite on jury awards and to calculate the appropriate value of the award that incorporates the added amount to truly make the awardee whole. ■