PERSPECTIVES

Tax Damages in Wrongful Terminations (California)

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

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INTRODUCTION

Economy v. Sutter East Bay Hospitals

In 2019, in the case of *Economy v. Sutter East Bay Hospitals*, a doctor sued a hospital for wrongful termination. The trial court awarded the plaintiff $3,867,122 in damages, comprising $1,136,906 in lost income, $1,159,354 in future lost income, $650,910 for tax neutralization, $19,000 for the cost of a particular program, $650,000 for emotional distress, and $250,952 in prejudgment interest. The hospital appealed.

The only element of damages awarded to the plaintiff that the hospital specifically challenged was $650,910 for tax neutralization. This amount was calculated to offset the increased tax burden on the plaintiff resulting from a lump-sum award of damages, compared to the taxes if the earnings had been paid annually. The amount was based on testimony by plaintiff's expert, an economist.

In May 2019, the CA Court of Appeal, 1st District made a decision in *Economy v Sutter East Bay Hospitals* stating, "The court did not err in awarding an additional amount of damages intended to offset the tax consequences of a lump-sum award for lost earnings."

With the CA Court of Appeal's decision to uphold these tax damages and the denial of the CA Supreme Court to hear the case, this new element of damages became the law of the land in California.

WHAT IS TAX NEUTRALIZATION?

This tax-adjusted loss calculation, also known as tax neutralization, is meant to offset the additional taxes plaintiffs may pay by receiving large lump-sum awards for income lost as a result of a wrongful termination (as compared to the lower taxes the plaintiff would have paid had they received that income normally over time). The goal of a tax neutralization calculation is to provide an award amount that is enough to make the plaintiff whole after taxes have been considered.

Per IRC § 104(a)(2), damages received in employment-related matters to compensate for economic loss are not excludable from gross income unless a personal physical injury caused such loss. Due to the bracket format of income taxes, receiving a large sum in one year may result in a higher tax liability than in a situation where income was to be received over multiple years. This differential is the basis for a tax-adjustment calculation (refer to the end of this article for an example).

In many cases, the inclusion of tax neutralization damages increases total economic damages significantly. Amounts vary greatly due to the number of factors that need to be considered, but tax neutralization can add an additional 25%-50% to the total economic damages in a case. Such factors include level of income, duration of loss, offset earnings, income tax brackets in years of loss, and many more.

TAX-ADJUSTMENT CALCULATION METHODS

There is presently no universally agreed-upon method for calculating the tax-adjustments. Economists vary in their methodologies; some use historical effective tax rates as published by the IRS and State tax authority, some refer to the income tax tables and perform the calculations by hand, and others use tax software such as TurboTax to prepare their calculations.

EXAMPE TAX-ADJUSTMENT CALCULATION

Below is a step-by-step walkthrough of a simplified, hypothetical tax-adjustment calculation.

• Assume that a person who earns $20,000 in a year might pay about 12% in federal and state income taxes, or $2,400. This person finds themselves out of work for 5 years due to a wrongful termination:

  • They receive a jury award of $100,000 ($20,000 x 5 years lost) and they'll have to pay federal and state income taxes on that $100,000, which would be about 30%, or $30,000.

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- Instead of paying $2,400 x 5 years ($12,000), the plaintiff now has to pay $30,000 because they received the award money all at once. The difference between the $30,000 and the $12,000 is called the "adverse tax consequence" of receiving the lump sum award.

• The plaintiff has not yet been made whole because they will have to pay $18,000 (or $30,000-$12,000) more in taxes by receiving their lost income all at once:

- Per the *Economy* case, this adverse tax consequence of $18,000 is a reasonable element of damages and should be included in the award. The jury award then increases the award amount to $118,000.

• However, the jury cannot simply award an additional $18,000 and call the plaintiff whole. That $18,000 adverse tax consequence award is also going to be taxed and reduced, still leaving the plaintiff in an adverse position. The plaintiff needs an amount of money that, after tax, will ensure they still have their $18,000:

- For simplicity, we'll assume a marginal tax rate of 33%, so the plaintiff needs almost $27,000 [$18,000/(1-.33), rounded] in order to make sure they have enough money to cover the adverse tax consequence of $18,000 after taxes.

- *Note: We will stop here to keep this exercise short, but additional considerations need to be made if these new amounts move the plaintiff into an even higher tax bracket.*

• The jury award, which started at $100,000, has been increased to $127,000 due to our tax neutralization, an increase of 27%.

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