

Tax Consequences of Lump Sum Awards in Wrongful Termination Cases

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I. Introduction

Three papers in the literature of forensic economics deal with *how* the tax consequences of lump sum awards for back pay and front pay in wrongful termination cases should be calculated. Those papers are by Bowles and Lewis (1996), Ben-Zion (2000), and Rodgers (2003). Each paper provides methods for what is called “grossing up” an award for back pay (and front pay). The goal is to account for the extra taxes that will be owed by an award recipient in the year an award for past and future lost income is paid. Under federal and state income tax rules, all income paid in a year, including awards for past and future lost income due to a wrongful termination, will be taxed in the year paid based on tax rules for that year. Thus, under progressive income tax structures, lump sum awards mean that more income will be paid in the form of taxes than would have been the case if the termination had not occurred and income had been paid in the years in which the income was earned. In the context of wrongful termination cases the term “gross-up” refers to calculating award amounts such that the award winner will have the same after tax net income that the award winner would have had if the termination had not taken place.

This paper will not deal with the specific methods discussed in the three papers for how to calculate the appropriate “gross up” amounts, but will explain the gross-up issue itself. The gross-up issue is subject to legal controversy, though the general trend is toward allowing gross-up calculations. This paper will review case law on that question and will also consider circumstances in which a “gross down” amount based on Social Security taxes should be calculated to go with the “gross-up” calculations based on federal and state income taxes. Finally, this paper will raise a number of tax issues relating to other aspects of wrongful termination awards that have not been addressed in the currently existing papers, but which raise questions about how “gross-ups” should be calculated. These issues involve treatment of fringe benefits, separate types of compensatory

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damages, punitive damages, and medical damages. How such damage elements should be treated will be posed as questions for further research.

II. The Reason for Tax "Gross-ups" on Lump Sum Awards for Wrongful Termination

The term "gross-up" (also "grossup" or "gross up") generally describes the addition of a sufficient monetary amount to bring an award into equality with another amount that is relevant in litigation. The term "gross-up" has a more general meaning than as an adjustment for tax consequences of lump sum awards in wrongful termination cases for back and front pay. The term will be used in this paper, however, to refer to front or back pay award adjustments in wrongful termination cases for the purpose of putting an award recipient into the same after tax position as if the termination had not occurred.¹

The problem that a tax gross-up is intended to solve is created by the tax rule that all income received in a given year is taxed in that year on the basis of tax rules relating to that year. An award for front and back pay is thus subject to taxation under the tax rules of the year that the award is received. Award winners are not permitted to allocate portions of their award to the years when the lost earnings would have been received, but must pay taxes in the year of receipt. As will be discussed later in this paper, preparing calculations for tax gross-ups can become very complex if the award in a case involves anything other than calculations for front and back pay. For the simplest possible example, assume that a worker was working at \$60,000 per year before being wrongfully terminated five years ago. Assume further that almost immediately after termination the worker found new employment at \$30,000 per year. Both pre-termination and post-termination earnings were projected to remain constant over the five years since the termination so that a lump sum award for \$150,000 for the past five years of back pay is considered to be appropriate. Since the award is entirely for back pay, no discounting issues are involved. Assume further that the award was in a state with no state income tax.

Based on those assumptions, if the termination had not taken place, the worker would have earned and paid federal income taxes on \$60,000/year in each of the past five years. Since the termination did take place, the worker will have paid taxes on \$30,000/year in each of the first four years and on \$180,000 in the fifth year (equal to a \$150,000 award for back pay plus \$30,000 earned in the post-termination job). Since the federal income tax is a progressive income tax, the average tax rate paid on \$30,000 per year for four years is lower than if the worker had been paid \$60,000 in each of those years. However, the average tax rate will be much higher in the fifth year when the worker will receive \$150,000 as

a back pay award plus \$30,000 in regular yearly earnings for a total of \$180,000 in that year. The net effect over the five year period will be to increase the overall tax rate for the five year period. At the first stage of a "gross-up" calculation, an economic expert will calculate the net increases in federal and state income taxes that will result from paying taxes on \$30,000 for four years and \$180,000 instead of paying taxes on \$60,000 for five years. Assume that difference in taxes paid in this first stage of the calculation is \$10,000.

The proper calculation is more complex, however, because the \$10,000 gross-up amount will also be subject to federal income taxes. If the award was increased by only \$10,000, the after-tax value of the award would be reduced by the tax owed on the additional \$10,000. Thus, in order to compensate for the addition of \$10,000 in taxes over the five year period, more than \$10,000 must be added to the "grossed-up" award for lost back pay. In addition, there would be a tax consequence from the "gross-up" on the "gross-up," *ad infinitum*. Papers by Bowles and Lewis, Ben-Zion and Rodgers deal with calculation issues of that sort. Bowles and Lewis (1996) develop their analysis based purely on front pay award for a five year period. Ben-Zion (2000) provides calculations for five years of back pay and also five years of front pay. Ben-Zion also provides mention of some of the complicating issues discussed later in this paper. Rodgers (2003) focuses on an issue with the Alternative Minimum Tax based on how attorney fees are treated. The issue raised by Rodgers in his 2003 paper has mostly been remedied in current tax law. However, he provides calculations for a five year period of back pay that includes Social Security taxes.

III. Legal Decisions Regarding Whether and When Gross-Ups Should be Made

The federal circuits are not in agreement with respect to whether or not "gross-up" tax adjustments should be made. The 3rd (*Eshelman v. Agere Systems, Inc*, 2009) and 10th (*Sears v. The Atchison, Topeka & Santa Fe Railway Company*, 1984) Circuits and one district court in the 11th Circuit (*E.E.O.C. v. Joe's Stone Crab*, 1998) have held that gross-ups should be made. The D.C. Circuit (*Dashnaw v. Pena*, 1994) has stated in very definite terms that gross-ups should not be made. However, a subsequent district court decision in the D.C. Circuit (*Fogg v. Gonzales*, 2005) held that gross-ups should be allowed if litigation is protracted. Other federal circuits have not spoken to this issue. To resolve the differences between the Circuits on this question, it is reasonably likely that the U.S. Supreme Court will someday take up a case on this issue and make a definitive ruling. The appendix to this note provides descriptions

of five legal decisions dealing this question. *O'Neill v. Sears, Roebuck and Company* (2000) is included as an earlier district court decision in the 3rd Circuit. The appendix also includes a decision in favor of gross-ups by the Supreme Court of the state of Washington in *Blaney v. International Association of Machinists* (2004). Other decisions bearing on this question also appear in Appendix I.

A closely related question is when “gross-up” analysis should be presented and to whom it should be presented. Bowles and Lewis (1996), Ben-Zion (2000), and Rodgers (2003) all appear to have assumed that the necessary “gross-up” amounts should be included in the analysis of damages presented to a jury. Such presentations were made to juries in some of the legal decisions cited in the appendices of this paper. However, it can also be argued that gross-up amounts should be presented in post-trial hearings before a judge who may be better equipped to deal with the complexities of the relevant calculations.

IV. Gross-Downs for Social Security Taxes

The focus of the three papers and five legal decisions mentioned thus far has been on federal and state income tax consequences. None of the decisions provided guidance with respect to Social Security and Medicare payroll taxes which are also taxed in the year of an award and are not based on the years when the back pay would have been earned. At one time, tax rules for Social Security taxes were different from those for federal and state income taxes. In *Social Security Board v. Nierotko* (1946), the United States Supreme Court held that Social Security taxes should be based on amounts of tax for which an individual would have been liable in the years awarded rather than in the year of the award. Subsequently, however, the IRS changed its position after a change in tax law and began basing both Social Security and Medicare payroll taxes on amounts earned in each year in the same fashion as with federal income tax. The United States Supreme Court in *United States v. Cleveland Indians Baseball Company* (2001) indicated that the IRS had the power to make this change in policy. These decisions and another important decision regarding taxes that will be discussed below are described in Appendix II.

Both Social Security and Medicare taxes must be paid on the amount of an award for back pay. Medicare taxes raise no special problem because employees have paid 1.45% on all earnings since the early 1990s. As such, if the amount of the award makes an individual whole, the total amount of Medicare taxes on *lost money wages* would be the same regardless of which year to which earnings were allocated and taxed. (Note, however, that any conversion of non-taxable job-related fringe

benefits into money wage equivalents can result in an increase in even Medicare payroll taxes. For example, if \$3,000 per year in employer contributions to retirement benefits that were not subject to Medicare or Social Security payroll taxes were converted to \$3,000 in back pay or front pay, the award recipient would have to pay payroll taxes on that \$3,000. (This issue will be discussed in a more general context below.)

Social Security taxes work in an opposite direction from progressive income taxes, and a small offsetting "gross down" based strictly on money wages may be appropriate. Social Security taxes currently apply only up to a maximum amount of income (in the range of \$106,000 as of 2010). Effectively, this makes the Social Security payroll tax a regressive tax on active income. A worker pays 6.2% on income within the first bracket, currently about \$106,000, and 0% on income above that level. The maximum income level subject to the tax increases each year is based on the Consumer Price Index. In the example used to illustrate the basis for a gross-up, the Social Security tax structure is such that the worker would have paid 6.2% on all \$60,000 of earnings in each of the five years since termination. This would have meant paying $\$300,000 \times 0.062 = \$18,600$ in Social Security taxes over that period. Given that the worker actually earned \$30,000 per year over the first four years of that five year period, the worker only paid $\$120,000 \times 0.062 = \$7,440$ over the first four years. In the fifth year, the worker would receive total earnings of \$180,000, but would only have to pay Social Security taxes on the first \$106,000 of that amount, or $\$106,000 \times 0.062 = \$6,572$. Thus, the total paid in Social Security tax over the five year period would be $\$7,440$ plus $\$6,572 = \$14,012$ instead of the \$18,600 he would have paid if he had earnings of \$60,000 in each of the five years. This is a tax savings of $\$18,600$ minus $\$14,012 = \$4,588$ compared to what the worker would have paid if he had not been terminated.

Therefore, by the logic that suggests one should gross-up an award for taxes based on federal and state income taxes, one should "gross-down" an award for the net decrease in Social Security taxes by \$4,588. In this example, however, there is no problem of gross-downs on gross-downs since reducing the award by \$4,588 keeps the total amount of the award well above the maximum income level upon which the Social Security payroll tax is paid. Implicitly, Rodgers calculated the gross-down for Security taxes without pointing out that he had done so by applying the Social Security tax to the right amounts of income in his analysis of the tax impact of the lump sum in his 2003 paper.

V. Distinguishing between Front Pay and Lost Earning Capacity

At this point, the paper shifts from explaining the meanings of simple gross-up and gross-down calculations to describing additional complications that can arise in the calculations of gross-ups for federal and state income taxes. The first such distinction is between front pay and loss of future earning capacity. Many forensic economists are unaware of a distinction made in wrongful termination law between front pay and loss of earning capacity, both of which involve awards that are based on expected future rates of earnings. The difference, which is well explained in Bowles (2008), is that front pay is an equitable remedy, while lost future earning capacity is a compensatory damage. In *Pollard v. E.I. du Pont de Nemours & Company* (2001), the U.S. Supreme Court held that front pay is not a compensatory damage and thus not subject to a limit on the amount of an award that could be made for compensatory damages, saying:

Although courts have defined “front pay” in numerous ways, front pay is simply money awarded for lost compensation during the period between judgement and reinstatement or in lieu of reinstatement. For instance, when an appropriate position for the plaintiff is not immediately available without displacing an incumbent employee, courts have ordered reinstatement upon the opening of such a position and have ordered front pay to be paid until reinstatement occurs. . . . In cases in which reinstatement is not viable because of continuing hostility between the plaintiff and the employer or its workers as a result of the discrimination, courts have ordered front pay as a substitute for reinstatement.

Bowles also relies strongly on *Williams v. Pharmacia* (1998) to make the distinction between front pay and lost earning capacity. In that decision, the 7th Circuit said:

Pharmacia argues that the front pay award and the lost future earnings award are duplicative and therefore overcompensatory. . . . [T]he two awards compensate the plaintiff for different injuries. Front pay in this case compensated Williams for the immediate effects of Pharmacia’s unlawful termination of her employment. The front pay award approximated the benefit Williams would have received had she been able to return to her old job. The

district court appropriately limited the duration of Williams's front pay award to one year because she would have lost her position by that time because of the merger with Upjohn.

The lost future earnings award, in contrast, compensates Williams for a lifetime of diminished earnings resulting from the reputational harms she suffered as a result of Pharmacia's discrimination. Even if reinstatement had been feasible in this case, Williams would have been entitled to compensation for her lost future earnings. . .

Front pay gives the employee the earnings she would have received had she been reinstated to her old job. But since the employee has a duty to mitigate damages, she may have taken another job in the interim (or be expected to find another job soon). . . Giving the employee the earnings from her old job without taking account of her earnings from her new (or expected) job would result in overcompensation. Thus, the front pay award gives the employee the present value of the earnings from her old job less earnings from her new (or expected) job. . .

Damages for lost future earnings, in contrast, are not limited in duration in the same way. The reputational or other injury that causes the diminution in expected earnings can stay with the employee indefinitely. Thus, the calculation of front pay differs significantly from the calculation of lost future earnings. Whereas front pay compensates the plaintiff for the lost earnings from her old job as long as she may have been expected to hold it, a lost future earnings award compensates the plaintiff for the diminution of expected earnings in all of her future jobs for as long as the reputational or other injury may be expected to affect her prospects.

Before 1996, another distinction was made between front pay and lost future earning capacity when awarded in the same case. In *Johnston v. Harris County Flood Control District* (1989), the 5th Circuit held that a front pay award was subject to income and payroll taxes, while an award for lost future earning capacity was not subject to taxation. The 5th Circuit explained that wrongful termination, while technically a contract violation, can involve harms with tort-like character. Loss of future earning capacity resulting from a bad reputation caused by a wrongful termination can be much like personal injury damages resulting from libelous statements made about an individual. The 5th Circuit therefore argued that damages,

such as loss of earning capacity, which is a tort-like damage, should be treated for tax purposes as a tort-like damage. In 1996, however, the IRS amended Section 104(a)(2) of the Tax Code, which governs taxation of awards. That section now limits tax exclusion for damages from litigation to:

[T]he amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as to lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

Thus, after 1996, the distinction between taxation of back and front pay on the one hand and non-taxation of loss of earning capacity disappeared. With the Tax Code amendment, tort-like damages for loss of future earning capacity caused by reputational effects of a termination no longer constitute a "physical injury" from the perspective of exemption from federal, state, and payroll tax liability. The same limitation holds for earnings losses caused by libel or slander that did not lead to wrongful termination. As a result, non-physical personal injuries of that type are be subject to "gross-ups" and "gross-downs" described in this paper to account for the impact of combining losses into a single lump sum or converting earnings into periodic payments for purposes of taxation.

VI. Fringe Benefits and Gross-ups

Ben-Zion (2000) pointed out the "gross-up" issue involved with lost job-related fringe benefits, but did not include it in his sample calculations. A wrongfully terminated worker is entitled to recover for the value of lost job-related fringe benefits. However, recovery for benefits can convert those benefits from tax-exempt benefits into a wage form that is subject to income tax. For example, suppose that an employer was providing 401k matching up to 5% of money earnings sheltered by an employee. Assume that the worker had averaged putting 10% into her 401(k) plan. The implication of the 10% put into a 401(k) or equivalent plan will be discussed first, followed by a discussion of the 5% matching provided by the employer.

The 10% of earnings put into a 401(k) account by the employee would have been subject to payroll taxes, but not federal and state income taxes. To the best of this author's knowledge an award winner cannot put a portion of an award for back and front pay into a 401(k) account and avoid current tax on that portion of the award. Therefore the fact that earnings are paid in the form of an award precludes the award winner from sheltering any of the income in a 401k account (or equivalent) that would

have been available before termination. Precluding an individual from partial tax-sheltering via a 401k account, however, is a double edged sword. Money put into a 401k account is not free of tax, but is taxed when taken out of the 401k account. Thus, while there is a tax advantage with a 401k account the advantage comes with a future partial disadvantage. The money will be taxed in the future, just not in the present. Thus, while it would be appropriate to gross-up an individual's award to account for loss of 401k (or equivalent) tax-sheltering, the calculation must also take into account the fact that the tax increase in the present will be partially offset by a decrease in taxes that will be paid by the worker in the future. Higher taxes in the present will result from a portion of income not being put into a 401(k). However, since that income was not put into a 401(k), there will be no future taxes on that income when the terminated person would have taken that portion of income out of the 401k in the future. Thus, the current higher taxes resulting from the lost chance to shelter part of income are associated with lower taxes in the future on that portion of income. The tax consequence is equal to the difference between higher taxes in the present and the present value of higher taxes in the future if the income had been able to be sheltered in a 401(k) (or equivalent) account. Higher taxes in the present will imply lower taxes in the future, but there is still a net tax loss due to increased taxation of the portion of income that would have been sheltered if the termination had not taken place."

The 5% of money earnings that the employer matched by investing that amount in the employee's 401(k) account would also become subject to income tax in the year of the award. Again, a fringe benefit that would not have been taxable if the termination had not taken place is converted into taxable income because of the relevant tax codes. The difference between the 10% that the employee put into the 401(k) account and the 5% matched by the employer is that the 5% matched by the employer would not have been subject to Social Security and Medicare payroll taxes. This increases the necessary amount to be grossed-up by the amount of those payroll taxes. However some offset should be made for the fact the money taken out of the 401(k) account in the future would have been subject to federal and state income taxes (but not payroll taxes). In this instance the conversion of employer matching, which would not have been subject to payroll taxes, into a lump sum that is subject to payroll taxes (at least the Medicare portion), does not generate a future offset.

One exception to the general rule that fringe benefits are often converted from a non taxable form of income to taxable income may exist with respect to medical expenses. If an individual seeks counseling in the aftermath of a wrongful termination, the costs of treatment can be claimed as a damage in addition to loss of earnings. This exemption is covered in Section 104(a)(2) of the IRS code. Because this reimbursement does not

constitute an award of lost earnings, it would not be subject to taxes applied to earnings. For that reason, reimbursement of costs of counseling would not be subject to income taxation. Going a step further, suppose that John Jones was wrongfully terminated. In the aftermath of the wrongful termination, John Jones has lost his medical insurance. As a result, John Jones has had out-of-pocket expenses of \$50,000 for an injury to his son Billy Jones. A claim might be made for recovery of the \$50,000 in medical expenses that John Jones would not have had to pay if he had not been terminated. If such a claim was made successfully and \$50,000 was awarded to compensate John Jones for his out-of-pocket expenses, it is possible under Section 104(a)(2) that the \$50,000 would not be subject to income taxation and should not be included when calculating an appropriate gross-up (or gross-down). An economic expert would need to consult with a retaining attorney about how such a situation should be handled.

VII. The Tax Impact of Spousal Income and other Family Income on Lump Sum Awards

If one assumes that the plaintiff was married, spousal income has an impact on the correct amount of the gross-up. Assume that the plaintiff's spouse earned \$50,000/year and that the plaintiff received a wrongful termination award of \$200,000 and earned no mitigation income. In calculating the correct amount for the tax gross-up, the impact of the spouse's earnings must be taken into account, as must any other source of family income. The more income the family is assumed to have from sources other than the plaintiff's award and mitigation earnings, the larger the amount must be to prevent the plaintiff from suffering from the negative tax consequences of a lump sum award. This is because of the nature of progressive income taxation. Assume that two persons each receive an award for back and front pay of \$200,000. Assume that they each now earn \$30,000 per year. The spouse of the first person earned \$60,000 in the year of the award. The spouse of the second person had no earnings. Other factors such as the number of children are the same. The first person's family will pay taxes on \$200,000 plus \$30,000 plus \$60,000 = \$290,000. The second person's family will pay taxes on \$230,000. The marginal tax rate could be higher for the second person, meaning that the amount of gross-up needed to make the first person whole would be greater than the amount of gross-up needed to make the second person whole.

VIII. Punitive Damages

If an award is made for punitive damages in addition to back pay, front pay, and perhaps future loss of earning capacity, the monetary value of punitive damages will be subject to tax in the year of an award. Since punitive damages are not based on earnings loss, but on egregious behavior of the employer, there is no argument for a gross-up based on the timing of the award and taxes. For similar reasons, payroll taxes would not have to be paid on punitive damages. However, the amount of punitive damages would still affect the marginal rate of taxation in the year of the award. This, however, raises the question of the order in which particular types of income have to be counted for purposes of determining the tax impact of a lump sum award.

If a plaintiff received a lump sum award that included (by assumption) \$80,000 for back pay, \$70,000 for front pay, \$350,000 for loss of future earning capacity, and \$200,000 in punitive damages, the total amount for the award would be \$700,000. Assume for simplicity that the plaintiff was single and had \$0 in mitigation earnings. The plaintiff's income on which the plaintiff would have to pay federal and state income tax would be \$700,000. The plaintiff's income on which payroll taxes would have to be paid is \$500,000. However, of the \$700,000 in income subject to federal and state income taxes, only \$500,000 should be the basis for a tax gross-up. Taxes on the \$200,000 in punitive damages would not be eligible for a gross-up. The amount of the gross-up on the \$500,000 depend on whether the \$200,000 for punitive damages are treated as the first \$200,000 of the individual's income in the year of the award or the last \$200,000. If the portion of the award for punitive damages is the first \$200,000 of the award, the tax on that amount will be lower than if the award for punitive damages is the treated as the last part of income. Correspondingly, this will have an effect on the proper amount for the gross-up.

This is a simple consequence of progressive income taxes. First income to be counted is generally taxed at lower marginal tax rates than last income to be counted. This is not normally considered by taxpayers filing tax returns because the issue for a tax payer is the total amount of the tax to be paid. However, since the logical basis for a gross-up only applies to a portion of the award, a forensic economist has to determine the tax on the \$500,000 portion of the award that was for loss of earnings. The amount of that tax depends on whether the \$200,000 or the \$500,000 is treated as the first or last portions of the award to be taxed. The Internal Revenue Service probably has rules governing how this should be done, but it is still another complicating issue an economist who is calculating the amount of a gross-up must consider.

IX. Conclusion

When all of these complexities are considered, any calculation for a gross-up is likely to be a “rough and ready” calculation. The argument that gross-ups should be considered is straight forward and logical. The method that would need to be used to do so correctly becomes increasingly complicated as each additional element of damages or tax complexity is added. A forensic economist would be wise to make such calculations only under close direction from an employing attorney.

Endnote

1. In a LEXIS search on the keywords “gross up” and “gross-up” this author found 307 case citations. The majority of those citations had to do with “gross-up” increases to equalize after-tax amounts in commercial litigation contexts. Others had to do with increases made to account for dividend payments. Only three of the cases out of the 307 cases found had to do with tax grossups relating to wrongful termination of individual workers. Since the 307 case citations did not include many of the papers discussed in this paper or covered in the appendices of this paper, the search did not capture all and probably not even most legal decisions in which the term “gross-up” appears.

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- United States v. Cleveland Indians Baseball Company*, 532 U.S. 200; 121 S. Ct. 1433 (2001).

Appendix I: Legal Decisions Impacting Tax Consequences of an Award for Wrongful Termination

(1) *Pollard v. E. I. Du Pont De Nemours & Company*, 532 U.S. 843; 121 S. Ct. 1946 (2001). This decision of the United States Supreme Court held that front pay is not a compensatory damage in a wrongful termination case, but is an equitable remedy that serves in lieu of reinstatement in the job from which an individual was wrongfully terminated. This ruling was relevant to the size of a plaintiff's award in that compensatory damages were subject to a statutory cap on compensatory damages. The Court defined front pay as follows: "[F]ront pay is simply money awarded for lost compensation during the period between judgment and reinstatement or in lieu of reinstatement. For instance, when an appropriate position for the plaintiff is not immediately available without displacing an incumbent employee, courts have ordered reinstatement upon the opening of such a position and have ordered front pay until reinstatement occurs."

(2) *Tesser v. Board of Education*, 2004 U.S. App. LEXIS 10450 (2nd Cir. 2004). This decision involved the issue of gross-ups to take account of tax consequences of a lump sum award for back pay in a wrongful discrimination case. The trial court judge ruled that tax returns of the Plaintiff could be admitted to impeach the testimony of a witness who "opens the door" to the subject. In this case, the argument that the award should be "grossed up" to account for higher taxes on a lump sum was treated by the trial court judge as opening the door to showing that the Plaintiff and her husband were already in the highest marginal tax bracket so that such consequences did not exist. The Plaintiff appealed on the basis that there was nothing in the tax returns that showed that she and her husband were in the highest tax bracket, so that the tax returns were not "actually" inconsistent with the Plaintiff's testimony. The 2nd Circuit did not resolve the differences between the parties, holding that the admission of tax returns was harmless error if it was error. There is substantial discussion in the decision about the definition of "harmless error."

(3) *Eshelman v. Agere Systems, Inc.*, 554 F. 3d 426 (3rd Cir. 2009). The 3rd Circuit held that it was not an abuse of the trial court's discretion to have provided an additional monetary award to offset the negative tax consequences of the plaintiff's back pay award. The Court said: "A chief remedial purpose of employment discrimination statutes such as the ADA is 'to make persons whole for injuries suffered on account of unlawful employment discrimination. . . . Congress armed the courts with broad equitable powers to effectuate this 'make whole' remedy. . . District courts

are granted wide discretion to 'locate a just result' regarding the parameters of the relief granted in the circumstances in each case." The Court added: "[E]mployees may be subject to higher taxes if they receive a lump sum back pay award in a given year, meaning the employee would have a greater tax burden than if he or she were to have received the same pay in the normal course. This is the origin of Enshelman's argument that she should receive an additional sum of money to compensate for her added tax burden." The decision further explained that Enshelman had: "submitted an affidavit from an economic expert who calculated the amount of tax-effect damages based on the back pay award, the applicable tax rates, and Enshelman's tax returns for the appropriate years. . . Having reviewed the record, we hold that the District Court did not abuse its discretion in awarding Enshelman \$6,893 as compensation for the negative tax consequences of receiving her lump sum back pay award."

(4) *Gelof v. Papineau*, 829 F.2d 452 (3rd Cir. 1987). This decision reaffirmed that unemployment compensation cannot be used to offset an award for back pay, even if the unemployment compensation came from the state of Delaware, the defendant's employer. The decision also dealt with the tax consequences of the lump sum award for back pay in a wrongful discrimination case. The Court pointed out that both parties had agreed that adjustment for tax consequences was relevant, so the legitimacy of such an adjustment was not a question before the court. The plaintiff economic expert had projected the amount to be added to the award for tax consequences was \$85,031. However the amount was calculated on the basis of a back pay award \$23,331 higher than actually awarded and was based on 1986 tax rates instead of 1987 tax rates when the award was made. There was also an issue about whether the part of the award for prejudgment interest should have been included in the tax adjustment calculation. The Court pointed out that it was unable to determine from the District Court's finding the precise basis for the plaintiff's economic experts tax consequence calculation of \$85,031. The Court therefore vacated the \$85,031 and remanded for further findings of the district court on that issue.

(5) *Williams v. Pharmacia*, 137 F.3d 944 (7th Cir. 1998). This decision held that it was appropriate for a judge to have awarded front pay and a jury to have awarded lost future earnings in an employment discrimination case. The Court provided clear definitions for the two types of awards in reaching its conclusions. The Court argued that the legitimacy of the trial court judge's award of front pay came from the authorization in Title VII of reinstatement as an equitable remedy saying that "front pay is the functional equivalent of reinstatement because it is a

substitute remedy that affords the plaintiff the same benefit (or as close an approximation as possible) as the plaintiff would have received had she been reinstated. . . Thus, the district court did not err in awarding front pay after it concluded that Williams could not be reinstated to her old position.” With respect to the jury award for lost future earnings, the court said: “To recover for lost earning capacity, a plaintiff must produce ‘competent evidence suggesting that his injuries have narrowed the range of economic opportunities available to him . . . [A] plaintiff must show that his injury has caused a diminution of his ability to earn a living’ (citations omitted). Williams’s expert witness testified that the poor evaluations Williams received and Pharmacia’s eventual termination of her employment taint Williams’s employment record. The jury was entitled to rely on this testimony in finding that Pharmacia’s acts of discrimination diminish Williams’ future earning capacity in the same way that a physical injury may diminish the earning capacity of a manual laborer.” The court then considered the possible overlap between front pay and lost earnings. Front pay, the court argued, is for the limited duration of the period until the plaintiff finds new employment. Lost future earnings take over at that point based on differences between the old and new rates of pay.

(6) *Arneson v. Callahan*, 128 F.3d 1243 (8th Circuit, 1997). This decision deals with three issues: (1) Whether the Back Pay Act, 5 U.S.C.S. § 5596, allowed prejudgment interest to be awarded against the United States; (2) whether the Back Pay Act, 5 U.S.C.S. § 5596, allowed tax enhancement damages based on a lump sum award for back pay to be awarded against the United States; and (3) whether the United States could claim disability awards as an offset to back pay lost earnings. The 8th Circuit held that the Back Pay Act does not allow for either prejudgment interest or tax enhancement damages (grossup) to be awarded against the United States, but that the United States could not claim disability benefits as an offset to lost earnings.

(7) *Sears v. The Atchison, Topeka & Santa Fe Railway Company*, 749 F.2d 1451 (10th Cir. 1984). The 10th Circuit held that adding amounts (gross-up) to an award for back pay based on higher tax rates applicable to a lump sum payment was within the discretion of the trial court. The Court said: [W]e hold that the district court did not abuse its discretion when it included a tax component in the back pay award to compensate class members for their additional tax liability as a result of receiving over seventeen years of back pay in one lump sum.”

(8) *Dashnaw v. Pena*, 304 U.S. App. D.C. 247; 12 F.3d 1112 (D.C. Cir. 1994). The D.C. Circuit rejected grossing up an award to account for

tax effects. The Court said: "Dashnaw . . . argues that the District Court should have granted him additional compensation to help cover the higher taxes he will have to pay because he will receive his backpay in a lump sum rather than as a salary paid out over a period of years. Absent an arrangement by voluntary settlement of the parties, the general rule that victims of discrimination should be made whole does not support "gross-ups" of back pay to cover tax liability. We know of no authority for such relief, and appellee points to none. Given the complete lack of support in existing case law for tax gross-ups, we decline so to extend the law in this case. We therefore reject Dashnaw's request for additional compensation to cover his tax liability."

(9) *Pappas v. Watson Wyatt & Company*, 2008 U.S. Dist. LEXIS 34 (D. Conn. 2008). This decision cited *Sears v. Atchison, Topeka & Santa Fe Ry*, 749 F.2d 1451, 1456 (10th Cir. 1984) and other cases allowing tax grossups in requesting a tax adjustment based on adverse tax consequences apparently arising from her attorney fees. The court held that the cited decisions did not apply because: "Unlike the plaintiffs in cases that she cites, nowhere does she express any concern that a lump sum damage award would place her in a higher tax bracket. Instead, the Plaintiff is effectively asking the Court to review the tax code and fashion a remedy where the provisions of the tax code fail [t]o allow her to deduct her damages from her gross income."

(10) *Fogg v. Gonzales*, 407 F. Supp. 2d 79 (D.D.C. 2005). This decision related to protracted litigation involving employment discrimination that had begun in 1995. The District Court reached this decision on remand from the D.C. Circuit. Thus the back pay award in this case was for a ten year period. The Court said: "Fogg requests that any back pay award be grossed up by 14 percent to reflect the adverse tax consequences of a lump sum award. Similarly, Fogg acknowledges that the amount of worker's compensation payments deducted from the award should be increased by 30% to reflect the tax free nature of those payments. . . Considering that inclusion of a tax component in a back pay award may be appropriate where, as here, the litigation is protracted . . . the court finds it appropriate to adjust both the back pay award and the deduction for workers' compensation payments received, in accordance with Fogg's request."

(11) *O'Neill v. Sears, Roebuck and Company*, 108 F. Supp. 443 (E.D. Pa. 2000). This decision held that negative tax consequences of a lump sum payment of back and front pay should be taken into account (by a gross-up) in a wrongful termination case. However, the Court held that

negative tax consequences were limited to the part of the award for back and front pay, not “the compensatory and liquidated damages, which the Court held “are only a product of this lawsuit.” Economist Andrew Verzilli provided calculations of the necessary amount to offset tax consequences of a large lump sum payment for all damages, so that the Court had to divide Verzilli’s calculated tax consequence into a portion relevant to back and front pay and a portion relevant to compensatory and liquidated damages. The Court said: “According to Mr. Verzilli (and the defendant presented no evidence contrary to Mr. Verzilli’s calculations), the O’Neills’ gross earnings this year would have been approximately \$55,843, had Mr. O’Neill continued working at Sears. . . Using the O’Neills’ deductions of approximately \$12,000 yields a tax rate of 11.96%. At that tax rate, Mr. O’Neill would owe \$28,384.91 in taxes on the \$237,332 he has received in front and backpay. However, because he is receiving this money all at once, together with his present salary of \$24,960 and Mrs. O’Neill’s salary of \$11,428, his gross income this year, exclusive of compensatory and liquidated damages, will be \$273,730. Using the same deductions, the tax rate jumps to 28.3%. Applying this rate to plaintiff’s front and backpay recovery of \$237,332 shows a tax bite of \$67,164.96. This amount is \$38,780.05 more in taxes than plaintiff would owe on this money had he received it over time as annual wages. The court will, therefore, mold the verdict to include an award of \$38,780.05 for these negative tax consequences.”

(12) *Shovlin v. Timemed Labeling Sys., Inc.*, 1997 U.S. Dist. LEXIS 2350; 1997 WL 10253 (E.D. Pa. 1997). This judicial order denies plaintiff’s motion to have negative tax consequences of a lump sum award based on age discrimination taken into account. The plaintiff had cited the case of *Gelof v. Papineau*, 829 F.2d 452 (3rd Cir. 1987) as authority, but the Court rejected that argument based on a footnote indicating that this had not been an issue in *Gelof* because the defense in that case had conceded that the award should take negative tax consequences into account and the *Gelof* Court had therefore not addressed the question of whether this should have been done or not, a point made clear in a footnote to that decision. The reason for the denial to take negative tax consequences in *Shovlin* was that: “[A]t the trial in this case there was no testimony by a tax expert calculating the ‘negative tax consequences’ to the Plaintiff in the future in connection with an award of back pay and front pay and this court is not inclined to engage in the speculative task of determining the Plaintiff’s future tax liability.”

(13) *E.E.O.C. v. Joe’s Stone Crab*, 15 F. Supp. 2d 1364 (S.D. Fla. 1998). This decision in a wrongful discrimination case did not award front pay because the Court determined that each of the claimants would have

voluntarily terminated employment prior to the entry of judgment. Back pay was determined through the period when claimants were have been likely to work for Joe's Stone Crab. The decision went on to say that it would have been appropriate to take into account negative tax consequences of lump sum payments for back pay. However, the Court also pointed out that the E.E.O.C. failed to provide the Court with "sufficient competent foundation evidence" to make appropriate calculations. Therefore, the Court declined "to award money damages to offset whatever tax liability a claimant will experience by receiving a lump sum."

(14) *Wade v. Wash. Metro. Area Transit Auth.*, 2006 U.S. Dist. LEXIS 16447 (D.D.C. 2006). "WMATA seeks to preclude testimony by Plaintiff's economist and rehabilitation expert on the issues of front pay and back pay, arguing that because those remedies are equitable, the jury may not award them, and any evidence of them would only serve to distract and prejudice the jury. Because front and back pay is a bench issue, Plaintiff's experts will be precluded from testifying on that issue. Plaintiff's economist and vocational rehabilitation expert may still testify at trial regarding Plaintiff's compensatory damages claim. The Court will hear the evidence of front and back pay at a later hearing on equitable relief, should a verdict be returned in Plaintiff's favor."

(15) *Ferrante v. Sciaretta*, 365 N.J.Super. 601; 839 A.2d 993 (N.J. Super. 2003). This decision of the New Jersey Superior Court held that a plaintiff was entitled to an addition to her award based on both front and back pay for the negative tax consequences of a lump sum award. The Court cited the fact that the economic expert for the plaintiff, Donald Welsch, had provided defendants with a calculation of tax consequences before the jury's verdict and a revised calculation based on the actual verdict. The Court also said: [D]efendants never sought or conducted the deposition or any document production of Donald Welsch's earlier reports, opinions and supporting documents. Nor did defendants ever identify a rebuttal expert on economic damages or negative tax consequences. As a result, this court concludes that defendants have no standing to assert a net opinion objection to Donald Welsch's conclusion that plaintiff's negative tax impact as the result of the jury award was \$107,000. The Order of Judgment of May 22, 2003 will be modified to award this sum.

(16) *Blaney v. International Association of Machinists*, 151 Wn.2d 203; 87 P.3d 757 (Wash. 2004). The Washington Supreme court held that the plaintiff was entitled to an "offset" for additional federal income tax

consequences of a wrongful termination award and for attorney fees as falling under the “any other appropriate remedy authorized by . . . the United States Civil Rights Act of 1964, as amended.” Blaney had won her discrimination suit, which increased her tax liability in the year of the award and triggered the Alternative Minimum Tax (AMT). The court awarded her additional amounts to offset the increases in taxes compared with what her taxes would have been if she had remained in her job. She was also awarded attorney fees, but there is no discussion of taxes specific to the award of attorney fees. The Washington Supreme Court reached the conclusion that the Washington Court of Appeals had ruled correctly on this issue, but for the wrong reason. The dissent in this decision by Justice Richard B. Sanders discusses the role of economic expert Dr. Lowell Basset, who projected front pay to ages 63 and 65 in this matter.

(17) *Pham v. City of Seattle*, 2007 Wash. LEXIS 123 (WA 2007). The Washington Supreme Court held that the plaintiffs in an employment discrimination case were not entitled to a supplemental award to compensate for the additional income tax consequences attributable to noneconomic damages. The trial court had awarded a supplemental award to compensate for the additional tax consequences of receiving front and back pay in a single lump sum, but declined to do so with respect to noneconomic damages. The Court of Appeals held that it was in error to deny a supplemental award for tax consequences of noneconomic damages. The Supreme Court reversed the Court of Appeals and affirmed the trial court’s decision.

Appendix II – Decisions Relating to Social Security Tax Consequences of Back Pay Awards

(1) *Social Security Board v. Nierotko*, 327 U.S. 358; 66 S. Ct. 637 (1946). This decision held that a worker was entitled to include quarters for which pay was received in the form of back pay as quarters to be counted toward the 40 quarters needed for Social Security eligibility. This means that a forensic economic expert does not have to calculate the number of quarters as a possible source of loss to the plaintiff. It also held that the IRS rule then in place that Social Security taxes should be based on earnings for years awarded back pay. This has since been changed to the year in which an award is received, as also upheld by the Supreme Court in *United States v. English*, 532 U.S. 200; 121 S. Ct 1433 (2001).

(2) *United States v. Cleveland Indians Baseball Company*, 532 U.S. 200; 121 S. Ct 1433 (2001). This decision held that for FICA (Social Security and Medicare) tax purposes, back wages should be attributed to the year in which they are actually paid, reversing a decision of the 6th Circuit on this issue.” In other words, all back pay received in a current year is taxable under FICA in the current year. This is parallel to how other income taxes are applied to back pay awards. The Court also said (quoting a brief from the “Company”): “Social security tax ‘contributions,’ unlike private pension contributions, do not create a property right to benefits against the government, and wages rather than [tax] contributions are the statutory basis for calculating an individual’s benefits.

(3) *Johnston v. Harris County Flood Control District*, 869 F.2d 1565 (5th Circuit 1989). This decision involved a plaintiff who won an jury award under Title VII of the Civil Rights Act and 42 U.S.C.S. Section § 1983 for wrongful termination. The decision includes extensive discussion that would assist a forensic economist in understanding the nature of awards in wrongful termination cases. The 5th Circuit held that the decision about whether or not to treat Social Security disability benefits as a deductible offset from an award for back pay was within the discretion of the trial court judge. It held that the plaintiff by ceasing to search for new employment had failed in his duty to mitigate damages, requiring offset for that purpose. It also discussed the difference between back pay and past earnings loss that is “personal-injury-like” in character in that the former are subject to federal income taxes and the latter are not. This suggests that front and back pay can be coupled into the same decision with past and future earnings loss and that tax treatment of front and back pay is subject to tax while past and future earnings loss are not. The court

also held that a plaintiff is liable for the Social Security taxes that would have accrued in the year the wages were due. This latter holding was subsequently overruled by *United States v. Cleveland Indians Baseball Company*, 532 U.S. 200; 121 S. Ct 1433 (2001). Based on that decision Social Security taxes are currently based on the year in which back pay is received.