Legal Decisions Dealing with the Tax Consequences of Lump Sum Awards for Back and Front Pay in Wrongful Termination Cases

Thomas R. Ireland 2/28/09

There are three papers in the literature of forensic economics that deal with *how* the tax consequences of a lump sum award for back pay in a wrongful termination case should be calculated. Those papers were by Bowles and Lewis (1996), Ben-Zion (2000) and Rodgers (2003). Each of those papers provides methods for what is called "grossing up" an award for back pay (and front pay) to account for the extra taxes that will be owed by an award recipient because the award will be taxed in the year the award is paid and not in the years during which the pay would otherwise have been received. This note will explain the "gross-up" issue, but will not deal with the methods discussed in the three papers or how they differ. This note will also deal with two separate questions. The first question is the legal question about whether tax consequences of a lump sum award should be taken into account at all. The second question is about whether or not there are circumstances in which a "gross-down" amount should be used to offset the "gross-up" amount, however the "gross-up" amount is calculated.

What is a gross-up?

For simplicity, assume that a worker was working at $60,000 per year before being wrongfully terminated five years ago. Assume further that when the worker was terminated, she almost immediately found new employment at $30,000 per year and that the $30,000 differential between pre and post termination pay is estimated to have remained at $30,000 per year so that a back pay lump sum award of $150,000 has been made at the end of the 5th year. Throughout this note, this example will be continued. Since the award is entirely for back pay, no discounting issues are involved. It is very likely that both pre and post injury pay would have increased over the five year period and this could easily be taken into account by making the example slightly more complex, but assume that both pre and post termination pay are assumed to have remained constant over the five year period. Thus, if the termination had not taken place, the worker would have earned and paid 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 $180,000 in the fifth year. Since we have a progressive income tax, the percentage of taxes paid on $30,000 will be lower in the first four years than if the wrongful termination had not taken place, and much higher in the fifth year, given that taxes will be paid in the fifth year on $180,000 instead of $60,000. At the first stage of a "gross-up," an economic expert will calculate the net increases in federal and state income taxes that will result from paying taxes on $60,000 for five years and paying taxes on $30,000 for four years and $180,000. For simplicity, let's assume that the additional taxes paid over the five year period are calculated to be $15,000.

The proper calculation is more complex, however, because the $15,000 gross-up will also be subject to federal and state income taxes so that there must be a gross-up on the gross-up if the

worker is to be "made whole" by the award. In addition, there would be a tax consequence from the "gross-up" on the "gross-up,"*ad infinitem*. Papers by Bowles and Lewis, Ben-Zion and Rodgers deal with calculation issues of this sort and those issues will not be considered here.

Legal Decisions Regarding Whether Gross-Ups Should be Made

The federal circuits are not in agreement with whether or not "gross-up" tax adjustments should be made. The 3rd and 10th Circuits and one district court in the 11th Circuit have held that gross-ups should be made. The D.C. Circuit has stated in very definite terms that gross-ups should not be made. 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 some day take up a case on this issue and make a definitive ruling. The appendix to this note provides descriptions of five legal decisions on this question (including an earlier district court decision in the 3rd Circuit), but forensic economists should obtain legal guidance before preparing calculations for gross-ups.

Should Gross-Downs Be Made for Social Security Taxes?

The focus of the three papers and five legal decisions mentioned thus has been on federal and state income tax consequences of back pay awards. The decision in *O'Neill v. Sears, Roebuck and Company* (2000) also included front pay, but none of the decisions provided guidance with respect to Social Security (FICA) and Medicare (FUTA) payroll taxes which are also taxed in the year of an award and not based on the years when the back pay would ordinarily have been earned. This was made clear by the Unites States Supreme Court in *United States v. Cleveland Indians Baseball Company*, 532 U.S. 200; 121 S. Ct. 1433 (2001). A description of that decision is not included in the appendix because that decision did not deal directly with the issue of gross-ups, but it overruled a previous 1946 decision that had held that FICA and FUTA taxes should be based on the years for which the award of back pay was made. Both FICA and FUTA taxes must be paid on the amount of an award for back pay. Medicare taxes (FUTA) raise no special problem because employees have paid 1.45% on all earnings since the early 1990's. As such, if the amount of the award makes an individual whole, the total amount of FUTA taxes would be the same regardless of which year to which earnings were allocated and taxed. Social Security taxes, however, work in an opposite direction and a small offsetting "gross down" may be appropriate.

Social Security taxes currently apply only up to a maximum amount of income. While progressive element in the distribution of benefits more than offset the regressive impact of the Social Security payroll tax, it is a two bracket regressive tax. A worker pays 6.2% on income within the first bracket, which is currently up to about $106,000. The maximum income level subject to the tax increases each year based on the Consumer Price Index. In the previous example this means that the worker will have a tax savings as result of the lump sum award. In each of the five year, the worker would have earned $60,000/year, all of which would have been subject to the 6.2% Social Security tax. This would have amounted to $3720 per year and a total

of $18,600 over the five year period. In the post termination case, the worker would have paid 6.2% of $30,000 for each of the first four years, or $1860 per year. Over the first four years, the total Social Security tax paid would be $7,440. In the fifth year, the worker would have reported earnings of $180,000, of which the 6.2% would apply only to the first $106,000 and the tax would be $6572. Thus the total paid over all five years would be $14,012, a tax savings of $4,588 from the $18,600 the worker would have paid if not terminated. Therefore, by the logic that suggests one should gross-up taxes based on federal and state income taxes, one should "gross-down" Social Security taxes by $4,588. In this case, 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 in the example well above the maximum income level upon which the Social Security payroll tax is paid. If, on the other hand, the reduction reduced an award to an amount below the maximum, there might be some argument for a gross-down on the gross-down.

Article References

Bowles, Tyler J., and W. Chris Lewis. 1996. Taxation of Damage Awards: Current Law and Implications, *Litigation Economics Digest*, 2(1):73-78.

Ben-Zion, Barry. 2000. Neutralizing the Adverse Tax Consequences of a Lump-Sum Award in Employment Cases, *Journal of Forensic Economics*, 13(3):233-244.

Rodgers, James D. 2003. Handling Taxes in Employment Law Cases, *Journal of Forensic Economics*, 16(2):225-256.

Case References

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

Eshelman v. Agere Systems, Inc., 2009 U.S. App. LEXIS 1947 (3rd Cir. 2009).

Dashnaw v. Pena, 304 U.S. App. D.C. 247; 12 F.3d 1112 (D.C. Cir. 1994).

Sears v. The Atchison, Topeka & Santa Fe Railway Company, 749 F.2d 1451 (10th Cir. 1984)

O'Neill v. Sears, Roebuck and Company, 108 F. Supp. 443 (E.D. Pa. 2000).

E.E.O.C. v. Joe's Stone Crab, 15 F. Supp. 2d 1364 (S.D. Fla 1998).

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

Eshelman v. Agere Systems, Inc., 2009 U.S. App. LEXIS 1947 (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 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."

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 becaus 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 backpay 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.

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."

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.”

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.”