DAMAGE AWARD TAXATION AND DISTRIBUTIVE JUSTICE

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Damage awards are often intended to make plaintiffs whole, yet their tax treatment often undermines this goal. Plaintiffs frequently face unfavorable tax consequences that reduce the net value of their awards, leaving them worse off relative to the position they would have occupied absent the defendant's wrongful conduct. Despite their significant impact, the tax costs of damage awards remain an overlooked issue in both legal scholarship and judicial decision-making.

This Article makes several contributions to the discourse on damage award taxation. First, it develops a novel taxonomy of unfavorable tax consequences, systematically categorizing the ways in which tax liabilities can undermine "make whole" remedies. While prior scholarship has primarily focused on the effects of progressive taxation in employment discrimination claims, this Article demonstrates that unfavorable tax consequences affect a much broader range of legal claims. Next, it highlights the disproportionate impact of unfavorable tax consequences on low-income plaintiffs, who are significantly more vulnerable to progressive tax rates and the loss of critical, means-tested tax benefits.

Lastly, to address these concerns, this Article proposes an original framework for determining when unfavorable tax consequences should warrant an increased damage award, balancing the goals of plaintiff compensation with fairness to defendants. This framework is used to address the existing circuit splits regarding the recoverability of tax-based damages in Title VII employment discrimination and breach of contract claims. By providing a principled methodology for courts to assess unfavorable tax consequences, this Article advances a more equitable and coherent approach to damage award taxation, ensuring that tax consequences do not diminish the fundamental objective of "make whole" remedies.

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Introduction

Many legal remedies are normatively premised on restoration—that is, making plaintiffs whole. However, the tax consequences of the associated damage award can result in the injured party not obtaining the economic position intended by the putatively "make whole" remedy. Plaintiffs in tort claims, non-breaching parties in contract suits, and victims of wage theft, for instance, can face heightened tax liability on their damage award that results in their failure to be adequately restored.

Consider E. Jean Carroll, who sued Donald Trump for defamation and was eventually awarded $18.3 million in compensatory damages.[1] This award was intended to compensate Ms. Carroll for her mental anguish, the cost of repairing her reputation, and her lost earnings—that is, to restore her to the position she was in before Trump defamed her.[2] Although the jury intended the award to make Ms. Carroll whole, the inclusion of the award in her gross income and resulting tax liability undermined the completeness of her restoration.

Contrast this with a far less high-profile case: A victim of wage theft whose employer systematically underpaid them by $10,000 in 2022, 2023, and 2024. Suppose that prior to any judgment, the employee earned $31,000 in taxable income for all three years. If the employee successfully recovers $30,000 in damages from the employer in 2024, progressively higher rates will apply to her now $61,000 of taxable income. Though the employer has made the employee whole on a pre-tax basis, the tax burden associated with the lump sum award leaves the

1 The total judgment against Donald Trump was $83.3 million—$65 million in punitive damages and $18.3 million in compensatory damages. Benjamin Weiser et al., *Jury Orders Trump to Pay Carroll $83.3 Million After Years of Insults*, N.Y. Times (Jan. 26, 2024), https://www.nytimes.com/2024/01/26/nyregion/trump-defamation-trial-carroll-verdict.html [https://perma.cc/P2TC-QBXM].

2 Carroll v. Trump, 683 F. Supp. 3d 302, 319 (S.D.N.Y. 2023), *aff'd*, 124 F.4th 140 (2d Cir. 2024) (jury instructions stating that Ms. Carroll "would be entitled to a dollar amount to compensate her adequately and fairly for any physical injury, pain and suffering, mental anguish, [and] emotional distress").

employee with approximately $1,400 less in after-tax income relative to having been properly paid.[3] Although she "won" her case, she is left with significantly less than if her employer had simply followed the law in the first place.

This additional tax liability triggered by damage awards arises in a variety of ways: What would have been capital gain is converted to ordinary income, what would have been non-deductible losses or excluded income is received as taxable income, or, most commonly, a lump sum award made in lieu of income expected to be received over multiple tax years is subjected to progressively higher marginal tax rates.[4] This "income bunching" can also result in losing valuable means-tested tax benefits (such as the earned income tax credit) causing plaintiffs to incur more tax liability than had the harm not been suffered.[5]

These effects are particularly acute for low-income taxpayers. Plaintiffs with different incomes receiving identical damage awards can experience starkly different tax consequences. For example, if the wage theft victim in the preceding example had taxable income of $250,000 rather than $31,000, the $30,000 damage award would not be subjected to progressively higher rates.[6] Because the income tax brackets for the lower-income taxpayer are smaller in size relative to the higher-income taxpayer, the income bunching of the damage award is more likely to expose the former to higher marginal tax rates. Though both plaintiffs' harm and subsequent damage awards are identical

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[3] Taxable income of $31,000 places the employee in the 12% marginal tax bracket. Had the $10,000 in wages been paid each year as it should have been, the employee would have an extra $8,800 in after-tax income per year, for $26,400 total. If the $30,000 award is received all in 2024, the employee's taxable income will increase to $61,000. In 2024, the 22% bracket starts at $47,150, meaning that $61,000 minus $47,150 = $13,850 of the $30,000 award is taxed at 22% (22% of $13,850 = $3,047), with the balance ($16,150) taxed at 12% (12% of $16,150 = $1,938). This leaves the employee with only $25,015 in after-tax income (the 2024 taxes owed on the award = $3,047 plus $1,938 = $4,985; $30,000 minus $4,985 = $25,015). *See* Rev. Proc. 2021-45, 2021-48 I.R.B. 764 (2022 tax brackets); Rev. Proc. 2022-38, 2022-45 I.R.B. 445 (2023 tax brackets); Rev. Proc. 2023-34, 2023-48 I.R.B. 1287 (2024 tax brackets).

[4] Unless otherwise noted, references to "taxable," "income tax," and other similar terms refer to the federal income tax.

[5] "Income bunching" refers to including multiple years of income into one tax year, resulting (in a progressive tax system) in income being taxed at greater rates. Jay A. Soled & Bruce A. Wolk, *The Minimum Distribution Rules and Their Critical Role in Controlling the Floodgates of Qualified Plan Wealth*, 2000 B.Y.U. L. Rev. 587, 620 (2000).

[6] *See* Rev. Proc. 2023-34, 2023-48 I.R.B. 1287.

on a pre-tax basis, the lower-income plaintiff, due to unfavorable tax consequences, suffers a shortfall.[7]

These harmful effects on low-income plaintiffs are exacerbated by the income-based eligibility of many significant tax benefits. The thousands of dollars of benefits provided by programs such as the earned income tax credit and the child tax credit can be lost by taxpayers receiving a sudden increase in taxable income.[8] For instance, an unmarried taxpayer with one child receiving a $30,000 damage award might lose an earned income tax credit worth approximately $4,200.[9] Because higher-income taxpayers are eligible for fewer income-based tax benefits and are more likely to protect themselves with ex ante tax planning, they are less likely to suffer unfavorable tax consequences of damage awards.

Prior scholarship has not recognized the range of situations in which unfavorable tax consequences of damage awards arise, nor the extent to which low-income taxpayers are particularly affected by them. Earlier writing has focused on one category of damages—employment discrimination awards and the unfavorable tax consequences flowing from progressive rate structures—with little consideration given to questions of distributional justice.[10] Additionally, practical considerations of how to properly balance plaintiff compensation with fairness to defendants have largely been omitted from the discussion. This Article provides a normative and practical framework through which the unfavorable tax consequences of damage awards can be assessed and, when appropriate, addressed.

This analysis has immediate relevance due to the lack of authority in most jurisdictions about when the unfavorable tax consequences of damage awards should result in an increased

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7 *See infra* Part III. As described in Part III.B, a plaintiff suffers unfavorable tax consequences if the tax liability from receiving a "make whole" damage award is greater than the liability the taxpayer would have had at the point of restoration intended by the "make whole" damage award.

8 *See generally* I.R.S., Dep't of Treasury, Cat. No. 59790P, 2024 Instructions for Schedule 8812 (Nov. 14, 2024) (describing income limits on the child tax credit); I.R.S., Dep't of Treasury, Cat. No. 15173A, Publication 596: Earned Income Credit (EIC) (Oct. 24, 2024) (describing income limitations on the earned income tax credit).

9 In 2024, a taxpayer with one child filing singly obtains a $4,213 tax credit if earned income is $21,000. Increasing the taxpayer's earned income by $30,000 to $51,000 results in ineligibility for the credit. *See* I.R.S., Dep't of Treasury, Cat. No. 15173A, Publication 596: Earned Income Credit (EIC) (Oct. 24, 2024) (describing earned income tax credit amounts and eligibility).

10 *See infra* note 116 and accompanying text.

award to the plaintiff.[11] To the extent that courts have considered the issue, they have done so in limited contexts (such as employment discrimination suits) and reached conflicting conclusions.[12] Most state courts have not addressed the issue, and the federal circuits are explicitly split.[13] Thus, the approaches described in this Article clarify an area of law that is both normatively underdeveloped and analytically muddled.

This Article begins in Part I by first addressing the normative foundations of damage awards, emphasizing their core function of restoring plaintiffs to some favored economic position. It distinguishes "make whole" damages—including compensatory remedies in tort, contract, and statutory claims—from other forms of recovery, such as punitive or restitutionary damages. In tort law, compensatory damages aim to return plaintiffs to their pre-tort status, covering both economic and non-economic harms. In contract law, expectation damages and reliance damages similarly serve a restorative function, albeit with different reference points—either the position the plaintiff would have occupied had the contract been performed or the position they held before entering into the agreement. Statutory damages, while often codified for specific policy objectives, frequently share this same remedial rationale. By framing these damage awards as inherently restorative, Part I sets the stage for analyzing how taxation can interfere with "make whole" damage awards' ability to fully compensate injured parties.

Part II examines how the taxation of "make whole" damage awards can prevent plaintiffs from achieving full economic restoration by reducing the net value of an award. It makes the original observation that any assessment of unfavorable tax consequences must be made with reference to a clearly defined point of restoration and that this point in time varies across remedies. While the point of restoration (e.g., pre-tort, post-contractual performance) influences the size of the award, it should not change the fundamental question of whether the defendant should be responsible for the tax burdens that prevent full economic restoration.

Part II also argues that unfavorable tax consequences can, in principle, be recoverable damages. These tax burdens are not simply incidental costs borne by plaintiffs, but rather a direct consequence of the defendant's wrongful actions triggering

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11 *See infra* Part IV.

12 *See infra* notes 191-223 and accompanying text.

13 *See infra* Part V.B.

a taxable event. By asserting that unfavorable tax consequences can be an extension of harm rather than an unrelated expense, this section introduces a novel normative argument: The tax costs of compensation should, at least in certain cases, be treated as part of the damages for which defendants are responsible.

Part II recognizes that "make whole" awards are not absolute in their compensatory effect. Courts already accept deviations from perfect restoration—such as requiring plaintiffs to pay their own legal fees, mitigate damages, and have damages that are certain and foreseeable. By situating unfavorable tax consequences within this broader framework, the Article introduces an evaluative method for determining when tax burdens should be viewed as recoverable damages or an additional exception to the requirement that plaintiffs be made whole.

Part III provides a novel taxonomy of the unfavorable tax consequences associated with damage awards, showing that tax damages can be classified into four categories: timing, inclusion/exclusion, conversion, and loss of tax benefits. Timing issues are caused when the income associated with a damage award is recognized in a year other than the year in which the income should have been recognized. Due to income bunching and potential changes in taxpayer attributes, these timing differences can trigger increased liability. Inclusion/exclusion problems are created when the damage award requires the taxpayer to recognize income that, absent the defendant's wrongful conduct, they would not have had to recognize. Conversion occurs when what would have been capital gain is treated as ordinary income due to receiving the proceeds via a damage award rather than through a sale or exchange. Lastly, and of especial importance to low-income taxpayers, unfavorable tax consequences can occur when the damage award renders the plaintiff ineligible for income-based tax benefits.

Part IV introduces a crucial and original contribution to the discourse on damage award taxation by highlighting the distributional inequities that arise from unfavorable tax consequences. It demonstrates that low- and moderate-income plaintiffs bear a disproportionately greater tax burden due to unfavorable tax consequences compared to wealthier, more sophisticated litigants. This effect is particularly pronounced when damage awards are paid as lump sums, which are more likely to push lower-income recipients into higher tax brackets and phase them out of critical income-based tax benefits.

The discussion underscores that sophisticated parties can often mitigate tax consequences through strategic planning, indemnification clauses, and tax insurance—mechanisms largely unavailable to economically vulnerable plaintiffs. Part IV expands prior scholarship by moving beyond a singular focus on employment discrimination awards and progressive taxation, instead offering a broader view of how various tax rules exacerbate economic disparities among plaintiffs. By framing unfavorable tax consequences as an issue of distributive justice rather than merely a technical tax concern, Part IV lays the groundwork for a more equitable reconsideration of tax-based damages, an argument further developed in Part V.

Part V considers the prescriptive approaches courts should take in considering unfavorable tax consequences and outlines a generalized framework for determining when defendants should be responsible for the unfavorable tax consequences associated with a damage award. This Article argues that, as a normative matter, plaintiffs must prove that (1) the damage award results in an increase in tax liability relative to the remedy's contemplated counterfactual; (2) the damage award is given via a truly "make whole" remedy; (3) no exceptions for that area of law limit the scope of the damage award. This analysis balances plaintiffs' interest in being made whole with defendants' interest in limiting the scope of damages. Though this analytical framework would help resolve issues concerning the taxation of damage awards for all plaintiffs, the special detriment faced by low-income litigants makes the proposals described especially important from an economic justice perspective.

Part V also directly addresses the ongoing circuit splits regarding whether tax damages should be recoverable in Title VII employment discrimination claims and breach of contract suits. The proposed framework reconciles these differences by establishing clear criteria for when tax damages are appropriate—ensuring that they are granted only when plaintiffs can demonstrate actual economic harm from unfavorable tax consequences and when awarding such damages aligns with the underlying purpose of the remedial scheme. By doing so, this approach brings coherence to an area of law that remains inconsistent across jurisdictions, providing courts with a principled method to balance fairness to plaintiffs with concerns about excessive defendant liability.

This Article makes several key contributions to the discourse on damage award taxation and distributive justice. First, it develops a novel taxonomy of unfavorable tax consequences, systematically categorizing how different scenarios—such as income bunching, inclusion/exclusion mismatches, conversion from capital gain to ordinary income, and loss of tax-based benefits—can prevent plaintiffs from being fully restored. Second, it identifies that unfavorable tax consequences disproportionately harm low-income plaintiffs, who are more vulnerable to the adverse effects of progressive tax rates and the loss of means-tested tax benefits. This recognition shifts the discussion from a purely doctrinal debate to one with significant implications for economic justice. Third, the Article devises a structured framework for determining when unfavorable tax consequences should justify an increased damage award, balancing the goal of full compensation with established legal limitations on recovery. Finally, the Article applies this framework to resolve existing circuit splits on whether tax damages should be recoverable in Title VII employment discrimination cases and breach of contract claims, offering a principled approach that courts can adopt to ensure consistency and fairness. By addressing these overlooked issues, this Article advances both the theoretical and practical understanding of how tax law interacts with damage awards, with a focus on improving distributional outcomes.

I
Normative Rationales for Damage Awards

This Part discusses the normative foundations of civil litigation damage awards, which generally arise under tort law, contract law, or claims created by federal and subnational statutes.[14] "Make whole" damage awards—damage awards intending to restore injured parties to some favored point in time—are

[14] *See* John F. Coyle, *The Canons of Construction for Choice-of-Law Clauses*, 92 Wash. L. Rev. 631, 638 (2017) (categorizing claims as either tort, contract, or based in statute); Max N. Helveston, *Preemption Without Borders: The Modern Conflation of Tort and Contract Liabilities*, 48 Ga. L. Rev. 1085, 1110 (2014) (discussing tort, contract, and statutory claims as the main causes of action in the consumer protection context); Edward Sherman, *"No Injury" Plaintiffs and Standing*, 82 Geo. Wash. L. Rev. 834, 837 (2014). *See also generally* Juscelino F. Colares & Kosta Ristovski, *Pleading Patterns and the Role of Litigation as a Driver of Federal Climate Change Legislation*, 54 Jurimetrics J. 329 (2014) (analyzing state and federal filings of regulatory and statutory causes of action concerning climate change litigation). The same facts can give rise to many different claims. *See* Jeffrey M. Hirsch, *Revolution in Pragmatist Clothing: Nationalizing Workplace Law*, 61 Ala. L. Rev. 1025, 1040 (2010) ("Depending on the facts, [a fired] employee could pursue a wide variety of claims under both federal and state law, [including but not limited to] antidiscrimination laws, whistleblower laws, and [] antiretaliation provisions . . . .") (footnote omitted). For purposes of this Article, however, the basis of the claim is less relevant than the normative goal of the damage award. Claims can also arise via regulatory authority created by statute.

a specific category of compensatory damage awards that, in contrast to damage awards generally, are premised on restoration. These "make whole" remedies are a subset of remedies more generally.

A. Tort Claims

Damages in tort law are generally categorized as either compensatory, non-compensatory money damages (e.g., nominal damages, punitive damages, and restitution), or specific relief (e.g., injunctive relief).[15] As the name implies, compensatory awards are intended to compensate plaintiffs for the harm imposed by defendants.[16] When the harm to the plaintiff is economic (that is, solely financial) the damage award is intended to place the injured party in the same financial position they would have been in had the tort not occurred.[17] Though non-economic harms, such as emotional distress or bodily harm, have no easy cash equivalents, awards for these harms are still intended, by some reasonable approximation, to restore the injured party to their ex ante, pre-tort position.[18] Although these compensatory awards may not truly redress the plaintiff's suffering, that is their goal.

Tort law also countenances, under certain situations, non-compensatory awards. The normative foundation of these remedies is not to make whole, on a cash basis, the injured party.[19] An action for replevin, for instance, seeks to recover personal property in possession of the tortfeasor.[20] This non-monetary award returns to the injured party property that is rightfully theirs and provides no additional compensation, even if the property has decreased in value.[21] Similarly, tort

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15 RESTATEMENT (THIRD) OF TORTS: REMEDIES, §§ 1–3 (A.L.I., Tentative Draft No. 1, 2022).

16 Alexander Tabarrok & Eric Helland, *Court Politics: The Political Economy of Tort Awards*, 42 J.L. & ECON. 157, 173 (1999).

17 RESTATEMENT (SECOND) OF TORTS § 903 (A.L.I. 1979).

18 *See id.* cmt. a (conceding only a "rough correspondence" between the amount awarded as damages and extent of suffering).

19 1 DAN B. DOBBS, LAW OF REMEDIES: DAMAGES—EQUITY—RESTITUTION § 1.1 (West 2d ed. 1993).

20 *See, e.g.*, Patricia Youngblood Reyhan, *A Chaotic Palette: Conflict of Laws in Litigation Between Original Owners and Good-Faith Purchasers of Stolen Art*, 50 DUKE L.J. 955, 965–66 (2001) ("Replevin is an action at law, normally treated as sounding in tort, through which the owner seeks to recover personal property.") (footnote omitted).

21 *See, e.g.*, Marks v. Willis, 58 P. 526, 526 (Or. 1899) (return of goods under claim of replevin fully satisfying judgment).

remedies based on restitution are premised on disgorging the tortfeasor's unjust enrichment rather than on restoring the injured party to their pre-tort position.[22] To be sure, recovering property and disgorging unjust enrichment compensate injured parties, but not by reference to making them whole, on a cash basis, relative to some normatively favored point in time.

Both punitive and nominal damage awards can also be contrasted with compensatory damages since they are not intended to confer benefits onto the injured party. Though punitive damages are received by plaintiffs and are often significant, they exist to punish the defendant and deter future bad acts rather than to compensate.[23] Similarly, nominal damage awards, which express liability but have limited economic consequence, exist to publicly demonstrate the defendant's culpability.[24]

To summarize, "make whole" damage awards in tort law attempt to compensate injured parties for the harm they have suffered from the tort. "Make whole" awards are a subset of tort awards more generally and are used to restore both economic, pecuniary harms (financial harm, such as lost wages) and non-economic, non-pecuniary harms (e.g., emotional distress) via cash payments of damages.

B. Contract Claims

The default remedy for breaches of contract is expectation damages, which aspire to restore the non-breaching party to the position they would have been in had there been no breach.[25] In contrast to the default remedy in tort, which compensates the injured party to their position prior to the tortious conduct, expectation damages compensate the non-breaching party as if the contract was completed.[26] Although there are

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22 *See* Dobbs, *supra* note 19, § 1.1.

23 Margaret Meriwether Cordray, *The Limits of State Sovereignty and the Issue of Multiple Punitive Damages Awards*, 78 Or. L. Rev. 275, 277 (1999).

24 *See* Sadie Blanchard, *Nominal Damages as Vindication*, 30 Geo. Mason L. Rev. 227, 250 (2022) (arguing that nominal damages vindicate rights via the public provision of facts and/or legal determinations that can assist with "reputation-based private ordering"); *see also* Uzuegbunam v. Preczewski, 141 S. Ct. 792, 800–01 (2021) (discussing rationales behind nominal damages).

25 Restatement (Second) of Contracts § 344 cmt. a (A.L.I. 1981) (A plaintiff's expectation interest is their interest in having the benefit of his bargain by being put in "as good a position as [they] would have been in had the contract been performed . . . .").

26 Richard A. Glaser & Leslee M. Lewis, *Redefining the Professional: The Policies and Unregulated Development of Consultant Malpractice Liability*, 72 U. Det.

several common law principles that can functionally prevent the non-breaching party from obtaining the true benefit of the bargain, the stated goal of expectation damages is to make the plaintiff whole.[27]

If expectation damages are difficult to determine, plaintiffs in contract disputes might be awarded alternative remedies, such as reliance damages.[28] Rather than obtaining damages equivalent to contractual performance, reliance damages compensate the plaintiff for expenses incurred in reasonable reliance on the defendant's promise.[29] Similar to expectation damages, reliance damages are premised on the notion of restoration but to a point *prior* to contract formation (or putative contract formation, in the case of promissory estoppel) rather than ex post contractual performance.[30] Rather than giving the injured party the benefit of the bargain, reliance damage awards aim to undo the relationship between the parties.

Other contractual remedies, however, are not premised on economic restoration. For awards of specific performance, defendants are obligated to perform rather than pay money damages.[31] Instead of restoring the plaintiff to some normatively favored point in time via money damages, specific performance gives the plaintiff exactly what they were expecting from a fully

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MERCY L. REV. 563, 567 (1995).

27 RESTATEMENT (SECOND) OF CONTRACTS § 347 (A.L.I. 1981) (stating that the non-breaching party has a right to expectation damages "measured by [] the loss in the value to him of the other party's performance caused by its failure or deficiency, plus [] any other loss, including incidental or consequential loss, caused by the breach, less [] any cost or other loss that he has avoided by not having to perform.").

28 Reliance damages can be awarded if expectation damages are difficult to measure or if the injured party cannot establish a breach of contract claim but *can* argue a successful promissory estoppel claim. *See* Edward Yorio & Steve Thel, *The Promissory Basis of Section 90*, 101 YALE L.J. 111, 131 (1991) (discussing reliance interest awards rather than expectation interest when "there was no promise" (i.e., a promissory estoppel claim) or if "expectation damages were difficult to prove").

29 *See* RESTATEMENT (SECOND) OF CONTRACTS § 90 (A.L.I. 1981) ("A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise.").

30 W. David Slawson, *The Role of Reliance in Contract Damages*, 76 CORN. L. REV. 197, 198 (1990) ("The reliance measure puts the injured party in as good a position as if the contract had never been made.").

31 *See* RESTATEMENT (SECOND) OF CONTRACTS § 357 cmt. a (A.L.I. 1981) ("An order of specific performance is intended to produce as nearly as is practicable the same effect that the performance due under a contract would have produced.").

executed contract—not in dollar terms, but in substance.[32] How the plaintiff values this performance is irrelevant since the completed performance is assumed to be fully compensatory.[33]

Similarly, restitution awards in contract claims, similar to their use in tort suits, disgorge any unjust enrichment conferred upon defendants.[34] The normative basis of restitution is to strip benefits away from the defendant rather than to compensate the plaintiff.[35] Although the plaintiff receives the disgorged benefit, this remuneration does not necessarily provide the plaintiff with either the benefit of the bargain or make them whole relative to their position prior to entering the contract.[36] Restitution awards are therefore not intended to be "make whole" awards.

Liquidated damage clauses award the non-breaching party a stated dollar amount if a breach occurs.[37] Although a wide divergence between the estimated harm at the time of

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32 Ted Sichelman, *Innovation Factors for Reasonable Royalties*, 25 TEX. INTELL. PROP. L.J. 277, 322–23 (2018) ("In essence, this shift would be from a make-whole expectation damages regime to an incentive-focused, reliance damages regime."). *But see* Jon W. Burd, Note, *Where the Rabbit Hole Ends: A Working Model for Measuring* Winstar*-Type Damages in the Federal Circuit*, 13 FED. CIR. BAR J. 657, 686 (2005) (describing use of reliance damages as a form of "make whole" damages); George N. Stepaniuk, *The Statute of Frauds as a Bar to an Action in Tort for Fraud*, 53 FORDHAM L. REV. 1231, 1250 (1985) (discussing how reliance damages in the fraud context can constitute a make whole award).

33 If a non-breaching party values the completed performance less than the free market does, they will likely argue for expectation damages rather than specific performance.

34 *See* RESTATEMENT (SECOND) OF CONTRACTS § 371 cmt. a (A.L.I. 1981).

35 *See* RESTATEMENT (SECOND) OF CONTRACTS ch. 16, topic 4, intro. note (A.L.I. 1981) ("[Restitution] has as its objective not the enforcement of contracts through the protection of a party's expectation or reliance interests but the prevention of unjust enrichment through the protection of his restitution interest.").

36 In addition to, say, giving the defendant a deposit (the unjust enrichment) a plaintiff might also have incurred expenses that did not benefit the defendant.

37 Liquidated damages can be characterized as either compensatory or punitive, depending on the legal claim pursued. *See, e.g.*, Overnight Motor Transp. Co. v. Missel, 316 U.S. 572, 583 (1942) ("The liquidated damages for failure to pay the minimum wages . . . are compensation, not a penalty or punishment . . . ."); Trans World Airlines, Inc. v. Thurston, 469 U.S. 111, 125 (1985) ("The legislative history of the ADEA indicates that Congress intended for liquidated damages to be punitive in nature."). In contract law, most jurisdictions require liquidated damage terms to bear some resemblance to the estimated damage in the event of breach with punitive liquidated damage awards deemed unenforceable. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (A.L.I. 1981) ("Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach."). Some scholars, however, treat liquidated damages as distinct from compensatory damages. *See, e.g.*, Craig Robert Senn, *Proposing A Uniform Remedial Approach for Undocumented Workers Under Federal Employment Discrimination Law*, 77 FORDHAM L.

contract formation and the stated amount of liquidated damages can render the liquidated damages term unenforceable, the liquidated damages term need not match the actual harm suffered by the injured party.[38] The normative basis of liquidated damages clauses is definiteness with respect to damage awards rather than precision with respect to making plaintiffs whole.[39]

Of the various contractual remedies available to non-breaching parties, only expectation damages and reliance damages are premised on making the injured party whole. Though they are both "make whole" remedies, the desired point of restoration for these two remedies differ significantly—expectation damages aim to give the plaintiff the benefit of the bargain (that is, after the contract has been performed), whereas reliance damages restore the plaintiff to a point prior to entering into the contract.[40]

C. Statutory Claims

Countless federal and state statutory claims exist outside of the common law domains of tort and contract law. Even when limited to the relatively common scenario of employee termination, for instance, the fired employee's possible state claims include laws prohibiting discrimination and whistleblower retaliation.[41] Relevant federal claims include Title VII of the Civil Rights Act (which prohibits employment discrimination based on race, color, religion, sex and national origin), the Americans with Disabilities Act, the Age Discrimination in Employment Act, the Family and Medical Leave Act, the Fair Labor Standards Act, the Employee Retirement Income Security Act, and the Occupational Safety and Health Act.[42]

REV. 113, 113 (2008) (listing compensatory damages and liquidated damages as distinct remedies).

38 RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (A.L.I. 1981). States vary in whether actual damages (as opposed to anticipated damages at the time of contract formation) can render a liquidated damages clause unenforceable. *See generally* Trey Qualls, Note, *Take A Second-Look at Liquidated Damages in Texas (Regardless of What the Texas Supreme Court Says)*, 67 BAYLOR L. REV. 666, 671 (2015).

39 *See* V. L. Nicholson Co. v. Transcon Inv. & Fin. Ltd., Inc., 595 S.W.2d 474, 484 (Tenn. 1980) ("The reason for allowing parties to stipulate the amount of damages is to create certainty where damages are likely to be uncertain and not easily proven.").

40 *See* Slawson, *supra* note 30, at 198.

41 Hirsch, *supra* note 14, at 1040.

42 *Id.* at 1027, 1040.

Given the number of statutory claims available, the normative foundations for these statutory causes of action vary and are not always obvious. Federal employment discrimination claims under Title VII, for instance, allow for compensatory awards plus "other equitable relief" to make plaintiffs whole as well as punitive awards to deter future bad conduct.[43] Title VII's definition of compensatory damages excludes back pay and front pay for lost wages while explicitly including emotional distress.[44] Instead, back pay and front pay can be awarded as "other equitable relief." Additionally, the compensatory damages a plaintiff can seek are capped by the number of employees of the employer.[45] Although the front and back pay components of the Title VII damage award scheme can be interpreted as restoring the plaintiff for the economic harm associated with lost wages, back pay damages are limited to the prior two years.[46] Rather than fully restoring all losses of Title VII's claimants, Title VII's damage award structure is better described as providing restoration of lost wages, subject to a temporal limitation, and restoration of other harms, potentially subject to a cap on size of the employer.

Other statutory claims are premised on providing easy-to-calculate damage awards that are not determined with reference to the plaintiff's actual losses. For instance, most states' workers compensation laws for permanent total disability provide a compensation schedule determined as a function of worker wage.[47] For permanent partial disability, North

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[43] 42 U.S.C. § 2000e–5(e)(3)(B), (g)(1); 42 U.S.C. § 1981a(a)(1), (b); Marc Schachter, *Individualizing Back Pay Relief in Title VII Class Actions*, 19 N.Y.U. Rev. L. & Soc. Change 617, 620–21 (1992).

[44] 42 U.S.C. § 1981a(b). The Supreme Court established that front pay awards are not within the scope of § 1981a(b)(3)'s definition of compensatory damages. Pollard v. E.I. du Pont de Nemours & Co., 532 U.S. 843, 852 (2001) ("When § 1981a is read as a whole, the better interpretation is that front pay is not within the meaning of compensatory damages in § 1981a(b)(3), and thus front pay is excluded from the statutory cap.").

[45] 42 U.S.C. § 1981a(b)(3); *see also* Rebecca Hollander-Blumoff & Matthew T. Bodie, *The Effects of Jury Ignorance About Damage Caps: The Case of the 1991 Civil Rights Act*, 90 Iowa L. Rev. 1361, 1366 (2005) (discussing damage caps). These damage caps are not in place for plaintiffs making race-based discrimination claims under 42 U.S.C. § 1981. Sandra Sperino, *The New Calculus of Punitive Damages for Employment Discrimination Cases*, 62 Okla. L. Rev. 701, 709 (2010).

[46] 42 U.S.C. § 2000e-5(g)(1); Charles A. Sullivan, *Raising the Dead?: The Lilly Ledbetter Fair Pay Act*, 84 Tul. L. Rev. 499, 524 (2010).

[47] Chandler Sessums, Comment, *Able but Unwilling to Work: Why the Current State of Workers' Compensation Law in Mississippi Deters Workers from Returning to Work as Soon as They Are Physically Able*, 40 Miss. Coll. L. Rev. 315, 318 (2022).

Carolina's Workers' Compensation Act, for example, provides qualifying workers who suffer the loss of a big toe two-thirds of their average weekly wage for thirty-five weeks.[48] Similar to liquidated damages awards for contract claims, these awards are based on calculational ease rather than precisely ascertaining (and redressing) the exact level of harm experienced by plaintiffs.

In contrast, Washington's Law Against Discrimination ("WLAD"), a state statute providing broad protection against employment discrimination, entitles the plaintiff to any appropriate remedy authorized by Washington law, the U.S. Civil Rights Act of 1964, or the U.S. Fair Housing Amendments Act of 1988.[49] As interpreted by the Washington Supreme Court, WLAD incorporates Title VII's goal of making injured parties whole in any manner deemed appropriate by the court.[50] Thus, WLAD is properly construed as a make whole remedy intended to restore the injured party to their pre-injury position.

It is not necessary for our current purposes to catalog, for the plethora of state and federal statutory claims available to plaintiffs, which remedies aspire to make the plaintiff whole and which remedies serve to only partially compensate and/or punish. The same is true for the other legal remedies previously discussed. Though this Article argues that an affirmative answer to that inquiry is necessary (but not sufficient) to determine that a plaintiff is entitled to an increased damage award due to unfavorable tax consequences, the preceding sections simply demonstrate that legal remedies have a range of normatively desired outcomes.[51] However, the subset of remedies that are premised on restoration can, because of unfavorable tax consequences, fail to accomplish their goal of making injured parties whole.

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Part I discussed the normative foundations of civil litigation damage awards, which generally arise under tort law, contract law, or statutory claims. It highlighted that "make whole" damage awards—a subset of damage awards more generally—are

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48 N.C. Gen. Stat. § 97-31(8) (2025).

49 Wash. Rev. Code § 49.60.030(2) (2024).

50 *See* Blaney v. Int'l Ass'n of Machinists & Aerospace Workers, 87 P.3d 757, 762–63 (Wash. 2004).

51 *See infra* Part V (discussing when defendants should be liable for increased damage awards).

uniquely premised on restoring plaintiffs to some favored point in time. Thus, the unfavorable tax consequences associated with "make whole" damage awards can potentially undermine the damage awards' normative goals.

II
Unfavorable Tax Consequences of Make Whole Damage Awards

As discussed previously, "make whole" remedies are a subset of compensatory awards and exist for tort, contract, and statutory claims.[52] For instance, damage awards in tort law compensating for both economic and non-economic harms are, by default, intended to restore the plaintiff's losses and put them in a position prior to the tortfeasor's wrongful conduct.[53] For contract claims, the remedies of expectation damages and reliance damages aim to make plaintiffs whole by giving them the benefit of the bargain and restoring their precontractual position, respectively.[54] Lastly, various statutory claims are premised on making parties whole, either explicitly in the operative statute or as interpreted by judicial opinion.[55]

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52 *See infra* Section II.C. Compensatory damage awards are the most common form of damages awarded. *See* Restatement (Third) of Torts: Remedies § 1 (A.L.I., Tentative Draft No. 1, 2022) ("The most common tort remedy is compensatory damages . . . ."); *see* Amy J. Schmitz, *Confronting ADR Agreements' Contract/No-Contract Conundrum with Good Faith*, 56 DePaul L. Rev. 55, 95 (2006) ("Compensatory damages are the preferred remedy for breach of contract because damages generally compensate parties for losses . . . ."); *see, e.g.*, Channon v. United Parcel Serv., Inc., 629 N.W.2d 835, 849–50 (Iowa 2001) (discussing compensatory damages under both Iowa Civil Rights Act and the Federal Civil Rights Act of 1991). The Article's focus is on the normative goal of "make whole" damage awards (which arise across different claims of action) rather than on any one specific cause of action.

53 *See* Restatement (Second) of Torts § 903 cmt. a (A.L.I. 1979) ("[C]ompensatory damages are designed to place [the injured party] in a position substantially equivalent in a pecuniary way to that which [they] would have occupied had no tort been committed.").

54 *See* Restatement (Second) of Contracts § 344(a)–(b) (A.L.I. 1981) (stating that a plaintiff's expectation interest is their "interest in having the benefit of his bargain by being put in as good a position as [they] would have been in had the contract been performed" and that a plaintiff's reliance interest is their "interest in being reimbursed for loss caused by reliance on the contract by being put in as good a position as [they] would have been in had the contract not been made"); *see* Marco J. Jimenez, *The Many Faces of Promissory Estoppel: An Empirical Analysis Under the Restatement (Second) of Contracts*, 57 UCLA L. Rev. 669, 711 (2010) (discussing courts awarding reliance damages in promissory estoppel claims).

55 *See, e.g.*, Albemarle Paper Co. v. Moody, 422 U.S. 405, 418 (1975) ("It is also the purpose of Title VII to make persons whole for injuries suffered on

But the tax consequences of putatively "make whole" damage awards can undermine the stated goal of the remedy. Consider a writer who successfully sues a politician in tort for defamation. The jury awards the writer $10 million intending to fully compensate her for the reputational harm suffered. However, because of taxes owed, the net award to the writer is only $6 million.[56] As a result, the supposedly "make whole" damage award fails in its objective.[57]

A. Temporal Considerations of Unfavorable Tax Consequences

Importantly, the specific point in time for which the damage award intends to make the plaintiff whole is irrelevant in determining whether, as a normative matter, the defendant should be liable for the unfavorable tax consequences (if any exist) of the damage award. Although there might be objections about what the proper point of restoration should be, those protests do not concern the defendant's responsibility for unfavorable tax consequences. That is, the point of restoration associated with the remedy once the remedy has been established as "make whole" might affect the size of the award, but not whether the unfavorable tax consequences are owed by the defendant. For instance, reasonable objections against awarding reliance damages over, say, specific performance could be lodged in some given scenario. But once reliance damages have been established as the remedy, the proper inquiry is only about whether failing to address the unfavorable tax consequences is inconsistent with reliance damages' "make whole" aspirations.

To be sure, the point of restoration favored by the "make whole" remedy has a role in determining whether the tax

account of unlawful employment discrimination."); *Blaney*, 87 P.3d at 762–63 (holding that Washington's Law Against Discrimination intended for remedies to make claimants whole); Ricco v. Potter, 377 F.3d 599, 605–06 (6th Cir. 2004) (applying "make whole" remedy for violation of Family Medical Leave Act).

56 *Cf.* Robert W. Wood, *The Federal Income Taxation of Contingent Attorneys' Fees: Patchwork by Congress and Supreme Court Creates Uncertainty*, 67 MONT. L. REV. 1, 9 (2006) (discussing taxation of defamation damage awards). To the extent attorney's fees are also owed, the net award to the writer can be significantly less. *Id.* The non-deductibility of attorneys' fees can further undermine the award's "make whole" objective. *See* Gregg D. Polsky, *Taxing Litigation: Federal Tax Concerns of Personal Injury Plaintiffs and Their Lawyers*, 22 FLA. TAX REV. 120, 133–35 (2018) (describing when non-deductibility of attorneys' fees results in phantom income to plaintiff).

57 Other examples of unfavorable tax consequences arising from "make whole" damage awards are described in Part III.

consequences of the damage award are indeed unfavorable. Consider a hypothetical student incurring $1,000 of non-deductible moving expenses to intern at a company where the expected compensation will be $1,000 of taxable wages.[58] If the company breaches the employment agreement after the student has incurred the expenses but prior to getting paid, a reliance damages award and an expectation damages award would both yield $1,000.[59] If the $1,000 award is characterized as reliance damages, the point of restoration is prior to entering into the contract; if characterized as expectation damages, the point of restoration is after the contract has been completed (i.e., after the wages have been paid).[60] If in both instances the award is taxable income, only the reliance damage award results in unfavorable tax consequences—on a pre-tax basis the student is fully compensated for their moving expenses and restored to their economic position prior to entering into the contract. However, the non-deductibility of the moving expenses combined with the taxation of the award means that the student would *not* be fully restored on an after-tax basis.[61]

In contrast, an expectation damages award would not, though equivalent in dollar terms to a reliance damages award, result in the student facing an additional tax burden relative to the point of restoration contemplated by the remedy. Expectation damages restore non-breaching parties to the economic position they would have been in had there been no breach. In this instance, had the company not breached and fully performed, the student would have obtained $1,000 of taxable wages—the same tax result as including the $1,000 damage award in gross income. If both damage awards are treated as taxable income, only the reliance damage award results in unfavorable tax consequences.

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58 *See* I.R.C. § 217(k) (eliminating the moving expense deduction for tax years 2018–2025). Though the student will have no net profit, they might enter into such an arrangement in order to obtain work experience.

59 The student has incurred $1,000 in expenses in reliance on contract (the reliance award) and expected to receive $1,000 in wages in compensation (the expectation interest). This assumes that the value of the experience is not a compensable component of the expectation damage award.

60 RESTATEMENT (SECOND) OF CONTRACTS § 344 (A.L.I. 1981).

61 This assumes that the $1,000 of commuting expenses are non-deductible, and that the $1,000 in reliance damages are included in gross income (that is, not treated as a non-taxable return of capital). This also assumes that the student has no other unfavorable tax consequences associated with the award (e.g., from income bunching or loss of tax benefits).

To generalize, the goal of "make whole" damage awards is to restore the plaintiff to some point in time (e.g., before the tort occurred, after the contract was performed, or before they were discriminated against) with a better economic position which the defendant's actions have prevented them from achieving. Because "make whole" damage awards are premised on restoration, if the tax consequences of the damage award cause the injured party to not be restored to the desired position, the damage award has arguably fallen short of its normative objective.[62] Thus, as used in this Article, the term "unfavorable tax consequences" has a specific meaning: A plaintiff suffers unfavorable tax consequences if the tax liability from receiving a "make whole" damage award is greater than the liability the taxpayer would have had at the point of restoration intended by the "make whole" damage award.

B. Unfavorable Tax Consequences as Recoverable Damage

Only "make whole" damage awards result in a defendant's potential liability for unfavorable tax consequences. Unfavorable tax consequences arise when the tax liability from receiving a damage award exceeds the liability the taxpayer would have incurred had the defendant not acted wrongly.[63] Unfavorable tax consequences do *not* arise simply because the damage award is taxed; rather, "unfavorable" refers to the difference in tax liability triggered by the award and the tax liability of the counterfactual in which the defendant's actions do not give rise to a legal claim.

For example, unfavorable tax consequences in a breach of contract claim would be determined by comparing the taxes owed on the expectation damage award to the liability the non-breaching party would have faced had there been no breach. In the tort context, the tax liability of an award for emotional distress would be compared to the liability incurred (typically zero) had the tortfeasor not committed the tort. For a Title VII claim, the taxes owed on the employment discrimination award are compared to the liability incurred had the employee been paid as expected.

At first blush, unfavorable tax consequences may not seem to be within the scope of a defendant's liability, regardless of

62 Examples of situations where tax consequences for certain awards prevent plaintiffs from being made whole can be found in Part III.

63 "Wrongly" is used here to encompass a defendant's tortious conduct, breach of contract, and other actions giving rise to a cause of action by a plaintiff.

the legal claim pursued. Damages traditionally flow from the defendant's wrongful action: the commission of a tort, the breach of a contract, the violation of a civil right, and so on. The tax costs of the award appear not to arise from the actions giving rise to the legal claim, but from the plaintiff's specific financial situation. However, tax costs of damage awards constitute harm for which defendants can (as a matter of positive law) and should (as a normative matter, this Article argues) be found liable. The defendant's wrongful conduct gives rise to not only the plaintiff's legal claim but also the defendant's obligation to pay damages, which triggers the subsequent tax costs. The wrongful actions and the obligation to pay damages are sufficiently related (in certain circumstances) to also obligate the defendant to compensate the plaintiff for the additional tax burden.[64]

C. "Make Whole" Damage Award Exceptions

Even damage awards premised on a normative foundation of making parties whole have exceptions that often prevent parties' complete restoration. Some (non-exhaustive) examples follow. Litigants in the United States are (in general) responsible for paying their own attorneys' fees, despite the fact that lawyers' fees may represent a significant cost.[65] Plaintiffs of both tort and contract claims are required to mitigate damages and take reasonable steps to minimize harm; failure to do so can result in damage awards that fail to fully restore.[66] Additionally, plaintiffs' damages are typically measured objectively rather than subjectively, meaning that injured parties with idiosyncratic preferences will often be undercompensated (or,

64 *See infra* Part V.A, establishing a framework for defendant liability.

65 *American Rule*, BLACK'S LAW DICTIONARY (11th ed. 2019) (defining the "American rule" as "[t]he general policy that all litigants, even the prevailing one, must bear their own attorney's fees"); *see also generally* Peter Karsten & Oliver Bateman, *Detecting Good Public Policy Rationales for the American Rule: A Response to the Ill-Conceived Calls for "Loser Pays" Rules*, 66 DUKE L.J. 729 (2016) (examining the origins of, rationales given for, and impact of the American Rule). Statutory exceptions to this general rule exist. *See, e.g.*, 42 U.S.C. § 2000e-5(k) (providing a reasonable attorney's fee to the winning litigant in Title VII claims).

66 Tortfeasors are not responsible for any harm that the "plaintiff could have avoided . . . by reasonable effort or expenditure and without undue risk, difficulty, or embarrassment." RESTATEMENT (THIRD) OF TORTS: REMEDIES § 8(a) (A.L.I., Tentative Draft No. 1, 2022). Non-breaching parties cannot recover "for loss that the injured party could have avoided without undue risk, burden or humiliation." RESTATEMENT (SECOND) OF CONTRACTS § 350 (A.L.I. 1981).

potentially, overcompensated).[67] In tort law, emotional distress associated with torts causing economic harm is not necessarily recoverable, though clearly imparting harm upon the injured party.[68] In contract law, non-breaching parties cannot recover damages that are unforeseeable or uncertain, despite their significant potential cost.[69] Statutory claims can have damage caps that limit the plaintiff's recovery.[70] Precluding recovery for these occurrences undermines the ability of plaintiffs to truly be made whole.

Whether a damage award is considered a "make whole" damage award may not always be a binary determination. Instead, characterization could exist along a spectrum, depending on the goals and limitations of the remedy in question. For instance, as described previously, Title VII includes statutory caps on compensatory and punitive damages based on the size of the employer, which may prevent plaintiffs from being fully restored to their pre-injury position.[71] Thus, damage awards, though often intending to restore plaintiffs to a certain degree, may not fully make injured parties whole.

Supposedly "make whole" damage awards can also make injured parties *better* off relative to the damage not occurring.[72] For example, if an injured party is compensated by a third party prior to the judgment against a tortfeasor, the tortfeasor's judgment is generally not reduced.[73] Rather than making the plaintiff whole, the tortious conduct (and associated damage award) confers a windfall. Relatedly, a plaintiff's damage award might also overcompensate if the damage award replaces a taxable item of income (such as wages) but is itself excluded from tax.[74] In the contract law context, an expectation damage

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67 Yehonatan Shiman, *Perverting Incentives When the Priceless Is Not Compensable: Victims' Subjective Value in Negligence*, 122 W. Va. L. Rev. 447, 452 (2019) ("[S]entimental value is not typically recognized as a compensable loss.").

68 *See, e.g.*, Jonathan G. Lester, Note, *The True Benefit of the Bargain: How Emotional Distress Damages Make Fraud Victims Whole*, 62 B.C. L. Rev. 703, 704–05 (2021) (discussing divide in courts' willingness to award emotional damages for victims of fraud).

69 Robert A. Hillman, *Contract Lore*, 27 J. Corp. L. 505, 508 (2002).

70 *See infra* note 158 and accompanying text; *see also supra* note 45 and accompanying text.

71 *See supra* note 45 and accompanying text.

72 *See infra* note 193 and accompanying text.

73 Maximilian Atchity, Comment, *Is Universal Healthcare Really the Death of Medical Expense Awards? The Current and Future State of the Collateral Source Rule*, 73 Baylor L. Rev. 642, 645 (2021).

74 Damage awards received in lieu of wages are excluded from federal income tax if flowing from a physical injury or physical sickness. I.R.C. § 104(a)(2).

award measured by cost of performance might be significantly higher than if measured by the economic harm suffered by the non-breaching party.[75] If the goal of the remedy is to make the plaintiff whole (and only whole, as opposed to at *least* whole) in these situations, the "make whole" remedy has arguably failed its objective by overcompensating the injured party.

There are policy arguments for (and against) these recognized deviations from the baseline goal of making injured parties whole.[76] This Article does not revisit these fundamental debates but instead considers in what circumstances these established departures from otherwise "make whole" remedies should also apply to the unfavorable tax consequences of damage awards. By so doing, a framework through which the unfavorable tax consequences arising from damage awards can be assessed. As discussed in Part V, this provides a method to determine whether the unfavorable tax consequences of "make whole" damage awards constitute harm for which the defendant should pay increased damages or are, like the examples discussed above, an acceptable deviation from the goal of making injured parties whole and thus properly borne by the award recipient.

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Part II discussed how the unfavorable tax consequences of "make whole" damage awards can undermine their intended purpose of fully restoring plaintiffs to the economic position desired by the remedy. In these situations, defendants should potentially be liable for the incremental tax burdens their actions

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75 *See* Melvin A. Eisenberg, *Impossibility, Impracticability, and Frustration*, 1 J. LEGAL ANALYSIS 207, 238–39 (2009) (noting that absent judicial relief, the classic measure of expectation damages via cost of performance can give buyers a windfall). Similarly, if the non-breaching party does not value the completed performance as much as it costs, a payment of money damages overcompensates the non-breaching party.

76 These justifications include preventing unexpected liability for the defendant (for requiring foreseeability in contract damages), administrative ease (for requiring certainty in contract damages), and not wanting to disincentivize socially beneficial behavior (e.g., if the victim of a tort had insurance or good employment benefits). Scholars have debated the merits of all of these exceptions. *See* Peter Lee, *Distinguishing Damages Paid from Compensation Received: A Thought Experiment*, Symposium, 26 TEX. INTELL. PROP. L.J. 231, 234 (2017) ("If a court awards make-whole damages, those damages may overcompensate patentees. However, awarding damages that only cover invention and commercialization costs (and a reasonable profit) may encourage widespread infringement and incur concomitant social costs.") (citation omitted).

cause. However, recognizing that "make whole" damage awards often contain inherent limitations—such as duties to mitigate and statutory caps—Part II also acknowledged that such deviations might justify excluding unfavorable tax consequences from recoverable damages.

III
Taxonomy of Unfavorable Tax Consequences

Part III categorizes the several ways in which damage awards can give rise to unfavorable tax consequences. Prior writing has largely focused on the progressive rates to which lump sum damage awards are subjected.[77] Not only do lump-sum awards have other adverse effects, such as loss of tax-based benefits, but these issues also arise in contexts outside of lump-sum awards.

Unfavorable tax consequences are a comparative assessment. It is not necessarily problematic that the damage award is taxed; rather, it is the additional, incremental liability incurred that might be objectionable.[78] The liability of the damage award is compared to the liability that would have resulted at the counterfactual point of restoration contemplated by the "make whole" remedy. For example, if a damage award of $10,000 paid (and taxed) this year to replace wages that should have been paid (and taxed) last year is subjected to this year's higher marginal tax rates, unfavorable tax consequences ensue. In contrast, if this year's damage award of $10,000 is taxed identically to last year's hypothetical wages, no unfavorable tax consequences have resulted.[79]

Part III therefore begins with an overview of how damage awards are generally taxed and concludes by classifying

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77 *See infra* note 116 and accompanying text.

78 As a result, damage awards that are excluded from tax will, in general, preclude the plaintiff's claim for an enhanced damage award. However, there are some extenuating circumstances in which income excluded from tax could give rise to an increased tax burden. For example, tax-exempt interest is excluded from income tax but counts towards investment income for purposes of eligibility for the earned income tax credit. I.R.C. § 32(i)(2)(B). Therefore, significant amounts of tax-exempt interest could result in a higher tax liability via losing the earned income tax credit.

79 Adjusting for the time-value of the damage is not a tax damage issue and is often awarded in the form of pre-judgment interest. Robert J. Sergesketter, Comment, *Interesting Inequities: Bringing Symmetry and Certainty to Prejudgment Interest Law in Texas*, 32 Hous. L. Rev. 231, 237 (1995) ("[P]rejudgment interest has become recognized as an integral element of the law of damages.").

unfavorable tax consequences into four non-exclusive categories: timing, inclusion/exclusion, conversion, and loss of tax benefits.

A. How Damage Awards Are Taxed

Absent specific authority,[80] the federal tax treatment of a damage award is not determined by the remedy used to calculate the award or the area of law giving rise to the claim; rather, the general rule is that damage awards are taxed based on how the underlying interest they replace *would* have been taxed.[81] As described below, this "origin of the claim" rule has statutory exceptions but is the starting point for determining how damage awards are taxed.[82]

1. *Tort*

As per Internal Revenue Code Section 104(a)(2), compensatory damage awards sounding in tort are excludable from gross income if arising from a physical injury or physical sickness.[83] This exclusion holds even when the damage award replaces a payment that would have been taxable if received via the expected pathway. For example, a compensatory damage award in a personal physical injury lawsuit is entirely excludable even if some portion of the award is given to replace lost wages, which would otherwise be treated as taxable income.[84]

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80 *See, e.g.*, I.R.C. § 139F (excluding damages obtained by wrongfully incarcerated plaintiffs); *id.* § 104(a)(1) (excluding workmen's compensation damages); *see also infra* Part III.A.1 (discussing § 104(a)(2)).

81 *See* I.R.S. Field Serv. Advisory, TL-N-6674-92 (July 27, 1992) (describing how taxation of damage award depends on what the award substitutes). The remedy used, however, might imply what the award is intended to replace. For example, in the earlier example the $1,000 reliance damages award implies a reimbursement of expenses whereas the $1,000 expectation damages award implies a replacement of wages.

82 Settlements are also taxed by determining what they are intended to replace. The IRS often defers to the parties' intent with respect to allocation of settlement agreements. *See Tax Implications of Settlements and Judgments*, I.R.S., https://www.irs.gov/government-entities/tax-implications-of-settlements-and-judgments [https://perma.cc/U9Y4-WPXD] ("In some cases, a tax provision in the settlement agreement characterizing the payment can result in their exclusion from taxable income. The IRS is reluctant to override the intent of the parties.").

83 I.R.C. § 104(a)(2); *see also* Reg. § 1.104-1(c)(1) (defining damages as "an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.").

84 Compensation for services is generally included in the earner's gross income. I.R.C. § 61(a)(1).

Because they are not taxed, recipients of "make whole" damage awards excluded under Section 104(a)(2) do not suffer from unfavorable tax consequences.

In contrast, punitive damages, with limited exceptions, are included in a taxpayer's gross income. This inclusion occurs even if the punitive damages are received on account of physical injury.[85] Because punitive damage awards are not "make whole" damage awards, any taxing of punitive damages does not result in unfavorable tax consequences.[86]

Compensatory damage awards that do not arise from physical injury or physical sickness do not qualify for Section 104(a)(2)'s exclusion.[87] These awards are excluded only if they are a substitute for proceeds that would have otherwise been received tax-free. Under this origin of the claim rule, damage awards received in lieu of lost profits are taxed as ordinary income, and awards received to replace expended capital are non-taxable returns of capital.[88] For instance, a damage award obtained by an heir to recover a lost inheritance would be excluded, since inheritances, if received, are excluded.[89]

Compensatory damage awards not arising from physical injury that compensate for non-deductible losses, such as awards for emotional distress, malpractice, defamation, and slander, are included in recipients' gross income.[90] To the extent that these awards intend to fully restore the injured party to their pre-tort position, this inclusion in gross income gives rise to unfavorable tax consequences.[91] Because the injury for

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85 *Tax Implications of Settlements and Judgments*, *supra* note 82 ("Punitive damages are not excludable from gross income [except for those flowing from a wrongful death]."). If, however, punitive damages are received as part of a wrongful death lawsuit, with the relevant state law allowing only for punitive damages, these punitive damages are excluded from gross income. I.R.C. § 104(c). This exception has been interpreted narrowly. Benavides v. United States, 497 F.3d 526, 530 (5th Cir. 2007).

86 *See supra* Part II.B for this Article's definition of "unfavorable tax consequences."

87 Robert S. Barnett, *Discrimination Settlements—Income Tax Considerations*, 133 J. TAX'N, 5, 8 (2020).

88 Kelsey Moran, Note, *Sausage, Specificity, and Settlement Payments: The Erroneous Elevation of Form over Substance in* Freda v. Commissioner, 68 TAX LAW. 263, 264 (2015).

89 I.R.C. § 102(a). Any unfavorable tax consequences arising from these awards are not due to inclusion, but from timing or loss of tax benefits. *See infra* Part III.B.

90 *See* I.R.C. § 104(a) (stating that emotional distress shall not be treated as a physical injury or physical sickness).

91 Other unfavorable tax consequences, such as loss of tax benefits, can follow from inclusion. *See infra* Part III.B. Note that this assumes that the court is

which the award is compensating is typically a non-deductible personal loss, the injured party must include an amount in gross income without obtaining an offsetting deduction.[92]

2. *Contract*

Application of the "origin of the claim" test to contract damage awards requires identifying what payment the award is replacing.[93] The breach of an employment contract, for instance, in which expectation damages are paid in lieu of wages, would result in taxable income. A damage award of reliance damages to compensate for non-deductible capital expenditure, in contrast, would likely be treated as a non-taxable return of capital. In contrast, damage awards to replace *deductible* expenditures would properly be included in income, since the taxpayer, by receiving the initial deduction, has no basis to offset against the damage award.[94]

Awards of specific performance do not need specific rules for determining tax treatment of the award since the remedy is simply the performance contemplated by the contract. Obligating the breaching seller in a real estate contract to sell the property in question results in the tax consequences associated with the forced sale. Since specific performance is not a "make whole" damage award, any tax consequences of the damage award are properly borne by the recipient.

Damage awards for breaches involving property transactions are not given capital gain treatment since a sale or exchange is a prerequisite for capital treatment.[95] Damage awards compensating the non-breaching party for value lost due to the counterparty's breach will generally be treated as ordinary income included in the injured party's gross income. This conversion from what would have been capital gain to ordinary income constitutes unfavorable tax consequences.

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determining the value of the award on a pre-tax (rather than after-tax) basis.

92 *See* Murphy v. I.R.S., 493 F.3d 170, 178, 185–86 (D.C. Cir. 2007) (holding that damages for emotional distress and loss of reputation are fully taxable without any offsetting loss).

93 *See* I.R.S., Priv. Ltr. Rul. 8923052 (June 9, 1989) (using the origin of the claim test to determine taxability of indemnification).

94 The tax benefit rule exists to ensure that if a taxpayer takes a deduction for an expenditure in a prior tax year and that amount is recovered in a subsequent year, the taxpayer must recognize income in the year of recovery. *See* Am. Mut. Life Ins. Co. & Subsidiaries v. United States, 267 F.3d 1344, 1346 (Fed. Cir. 2001) (describing tax benefit rule); I.R.C. § 111.

95 *See infra* note 105 and accompanying text.

3. *Statutory Claims*

The Internal Revenue Code does not specifically address the taxation of statutory claims, instead defaulting to the same origin of the claim test used for tort and contract claims. Discrimination-based lawsuits, which constitute the bulk of statutory claims, have been specifically addressed by the IRS, which states that "discrimination suits for age, race, gender, religion, or disability can generate compensatory, contractual and punitive awards, none of which are excludible under IRC Section 104(a)(2)."[96] Thus, damage awards for statutory claims can give rise to unfavorable tax consequences, most usually due to timing and the loss of tax benefits.

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Part III.A's discussion is not intended to be a comprehensive summary of how damage awards are taxed; rather, the overview highlights key tax issues that arise when damages are awarded.[97] Although different rules governing the taxation of damage awards could address the problems associated with unfavorable tax consequences, that inquiry is beyond this Article's scope.[98] Instead, this Article takes the current tax treatment of these awards as a baseline for analysis, to the extent that such treatment can be determined.

B. Types of Unfavorable Tax Consequences

Unfavorable tax consequences, the incremental tax liability from receiving a "make whole" damage award relative to the liability the taxpayer *would* have had if the defendant had not acted wrongly, arise in more situations than scholars have previously considered. Although lump sum damage awards commonly trigger unfavorable tax consequences, previous writing has largely focused on the progressive rates to which these awards are subjected.[99] Not only do lump sum awards have other adverse effects, such as loss of tax-based benefits, but these consequences also arise in contexts outside of lump sum awards. Unfavorable tax consequences can more generally be

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96 *Tax Implications of Settlements and Judgments*, *supra* note 82.

97 Indeed, given judicial and administrative inconsistency in how damage awards are treated, a definitive summary would be difficult to provide.

98 If, for instance, the Internal Revenue Code excluded all damage awards from gross income, unfavorable tax consequences would cease to exist.

99 *See infra* note 116 and accompanying text.

classified into four non-exclusive categories: timing, inclusion/exclusion, conversion, and loss of tax benefits.

1. *Timing*

Receipt of damage awards in years other than the year (or years) in which the original payment was expected can create unfavorable tax consequences due to differences in timing. Lump sum damage awards are potentially problematic because they bunch multiple years of income into one taxable year. Because of the U.S.'s progressive income tax structure, this aggregation can subject bunched income to higher rates. This increased liability flows from the mismatch in timing between the actual payment (via the damage award) and the expected payments.

Timing consequences can also create unfavorable tax consequences outside of the lump sum context. A taxpayer may receive a damage award identical to the expected payment, but in a different tax year. If the tax rates in the year of receipt are different than the tax rates for the year of *expected* receipt, this difference can give rise to unfavorable tax consequences even without bunching multiple years of income into one year. These tax rate differences could arise from legislative changes or from changes in taxpayer attributes.[100] A taxpayer's divorce could, for example, subject any damage award received to tax brackets smaller in size since brackets for single filers are generally smaller than brackets for married filers.[101]

2. *Inclusion/Exclusion*

Taxable damage awards received in lieu of proceeds that would have been excluded from tax also give rise to unfavorable tax consequences. Although in many circumstances a damage award meant to replace tax-free proceeds will itself be excluded from tax,[102] this result does not hold in all situations. Consider an investor that enters into an agreement with a developer to

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100 For instance, the Tax Cuts and Jobs Act generally decreased tax rates but also decreased after-tax income for a cohort of taxpayers with certain attributes. *See* Isabel V. Sawhill and Christopher Pulliam, *The Middle Class Needs a Tax Cut: Trump Didn't Give It to Them*, BROOKINGS INST. COMMENT. (Oct. 16, 2018), https://www.brookings.edu/articles/the-middle-class-needs-a-tax-cut-trump-didnt-give-it-to-them/ [https://perma.cc/7WY7-XL7L].

101 *See* I.R.C. § 1 (providing income tax rate schedules).

102 Eric Fishman, *Tax Consequences of Contract Breach: Proposed Relief for the Forced Realization of Income*, 11 VA. TAX REV. 915, 917 (1992); *see also* United States v. Gilmore, 372 U.S. 39, 49 (1963) (describing origin of the claim test).

participate in a Low-Income Housing Tax Credit ("LIHTC") project expecting to receive a tax credit worth $2,000.[103] The tax credits, which reduce tax liability, are expected to be obtained on an after-tax basis.[104] If the developer's breach results in the project's ineligibility for the tax credits, the subsequent damage award of $2,000 would be included in the investor's gross income and would thus face unfavorable tax consequences.

In the example above, tax-free proceeds were expected but not received. A related but distinct inclusion/exclusion problem arises when proceeds are expected to be tax-free but are, contrary to the defendant's assurances, taxable income to the plaintiff. For instance, consider a city promising that the interest on its municipal bonds will qualify as tax-exempt under Internal Revenue Code Section 103.[105] If the city pays the interest but fails to comply with Section 103's statutory requirements, the interest will be taxable to the bondholder. Here, the damage award would be the tax liability owed by the bondholder on the interest, and the unfavorable tax consequences would be the additional tax liability (if any) owed on the damage award.

3. *Conversion*

Even a damage award obtained in the same year as the defendant's wrongful conduct and nominally equal to the harm imposed could result in unfavorable tax consequences due to the conversion of what would have been capital gain into ordinary income. Consider a seller contracting with an agent who, in exchange for a fee, agrees to use best efforts to market the seller's capital asset. If the agent's breach by failing to use best efforts results in a missed opportunity to sell the asset for $1,000 when now the asset can only be sold for $700, the seller's expectation damage award from the agent would be $300—what the seller would have obtained had the agent not breached the agreement. However, the lack of a sale or exchange associated with the damage award would convert what would have been $300 of capital gain (assuming the asset's

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103 *See* I.R.C. § 42 (providing transferrable credits for investors in low-income housing projects).

104 The investor values the tax credits on an after-tax basis because tax credits, by default, reduce tax liability dollar-for-dollar. Richard Stephenson McEwan, *State Workarounds to the IRC's SALT Cap: The Past, the Present, and Building for the Future*, 98 Ind. L.J. 667, 675 (2023).

105 I.R.C. § 103 (excluding interest obtained from certain municipal bonds from gross income).

basis is $700) taxed at preferential rates into $300 of ordinary income.[106]

Conversion to ordinary income from capital gain can occur even if the non-breaching seller sells the asset. If after the agent's breach (but before the damage award is paid) the seller sells the asset for $700, the seller will recognize no gain or loss.[107] The subsequent expectation damage award of $300 would still result in $300 of ordinary income to the seller since this damage award is not associated with a sale or exchange and therefore cannot be characterized as capital gain.[108] This conversion from capital gain to ordinary income creates unfavorable tax consequences for the seller.

4. *Loss of Tax Benefits*

If a taxpayer is forced to recognize income that they otherwise would not have, they might lose eligibility for valuable tax benefits. This additional income recognition can arise from any of the three forms of unfavorable tax consequences discussed previously. That is, timing, inclusion/exclusion, and conversion issues can all increase a taxpayer's adjusted gross income ("AGI"), which is the eligibility determinant for many tax-based benefits.[109] As AGI increases, phaseout provisions proportionately reduce the value of many tax benefits.[110] For example,

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106 *See* I.R.C. § 1222(9) (defining capital gain net income as the "excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges").

107 Gain equals amount realized minus basis, which is $700 minus $700, which equals zero.

108 *See* Nat'l-Standard Co. v. Comm'r of Internal Revenue, 749 F.2d 369, 371 (6th Cir. 1984) ("[W]here one party to the transaction receives neither property nor money or its equivalent, there is no 'sale or exchange'" and therefore no capital gain). *See also* I.R.C. § 1234A (providing capital gain treatment for "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . [certain] right[s] or obligation[s] . . . ."). The IRS has stated that Section 1234A would result in capital gain for certain contractual termination fees. I.R.S., Chief Couns. Advisory 201642035 (Oct. 14, 2016); I.R.S., Chief Couns. Advisory 202224010 (June 17, 2022).

109 Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 722 (2003) ("The Code contains nearly twenty provisions that serve to limit tax benefits to taxpayers with certain income levels."). Most commonly, the "income" metric is adjusted gross income, or AGI, but other similar measures are also used, such as modified adjusted gross income; *see* John R. Brooks, *The Definitions of Income*, 71 TAX L. REV. 253, 253 (2018) ("[W]ithin the Code, there are several different measures of income for different purposes.").

110 There are a number of phaseouts/income limits in the Internal Revenue Code. *See, e.g.*, I.R.C. § 25E (used electric vehicle credit; income limitation of $75,000 for single filers); *Id.* § 86 (taxing social security benefits preferentially up

above certain income thresholds, the earned income tax credit decreases by thirty-four cents for every additional dollar of adjusted gross income.[111]

The loss of these tax benefits can be greater than the size of the award itself. In 2020, only taxpayers with household incomes of less than 400 percent of the federal poverty level could obtain the Premium Tax Credit, a refundable credit subsidizing the cost of health insurance purchased through the federal Health Insurance Marketplace.[112] A single taxpayer with a pre-damage award AGI of $50,000—just less than the 2020 threshold of $51,040—would receive a credit equal to approximately $10,000 if the benchmark health care plan had an annual cost of $15,000.[113] A damage award of $1,000 would, in 2020, reduce this taxpayer's PTC to zero.[114]

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These categories of unfavorable tax consequences are not mutually exclusive. For example, the breach of a contract for

to a modified adjusted gross income of $25,000); *Id.* § 6433 (saver's match eliminated for all filers at adjusted gross incomes of $71,000); *Id.* § 135 (exclusion for savings bond interest phased out starting at AGI of $40,000), § 85 (unemployment compensation excluded up to AGIs of $150,000); *Id.* § 25A (American Opportunity and Lifetime Learning Credits phased out starting at AGI of $80,000); *Id.* § 221 (student loan interest deductibility phased out at MAGI of $50,000, indexed for inflation); *Id.* § 137 (adoption assistance exclusion phased out starting at AGI of $150,000); *Id.* § 36B (as first enacted, limited subsidy to taxpayers with AGI below 400% of the federal poverty level); *Id.* § 32 (earned income tax credit, limiting credit by both income and investment income); *Id.* § 6428 (recovery rebates); *Id.* § 74 (prizes and awards); *Id.* § 30D (clean vehicle credit); *Id.* § 24 (child tax credit); *Id.* § 213 (medical expenses); *Id.* § 408A (Roth IRA contributions); *Id.* § 22 (credit for the elderly); *Id.* § 165 (losses only allowed if they exceed 10% of AGI); *Id.* § 469 (passive activity losses); *Id.* § 163 (mortgage insurance premiums treated as interest for AGIs less than $100,000).

111 *See* I.R.C. § 32.

112 The precise eligibility metric used for PTC eligibility is modified AGI, which is defined as AGI plus excluded foreign income, excluded Social Security benefits, and tax-exempt interest. I.R.C. § 36B(d)(2)(B). For most eligible taxpayers, this is simply AGI. For simplicity, modified AGI is assumed to equal AGI. *See also* I.R.S., *The Premium Tax Credit - The Basics*, https://www.irs.gov/affordable-care-act/individuals-and-families/the-premium-tax-credit-the-basics [https://perma.cc/6HSK-CV2H].

113 The taxpayer's contribution would be approximately 9.5% of AGI, or $4,750.

114 Subsequent legislation has eliminated this cliff effect for years 2021-2025, but not for subsequent years. *See* Jaime S. King, Katherine L. Gudiksen & Erin C. Fuse Brown, *Are State Public Option Health Plans Worth It?*, 59 HARV. J. ON LEGIS. 145, 158 (2022); CONG. RSCH. SERV., R48290, ENHANCED PREMIUM TAX CREDIT EXPIRATION: FREQUENTLY ASKED QUESTIONS 2 (2024).

an installment sale, which permits sellers to recognize gross income ratably over a multiyear payment schedule, could result in a lump sum damage award. This lump sum damage award could potentially create unfavorable tax consequences with respect to timing, conversion, and loss of tax benefits.

Part III.B's taxonomy of unfavorable tax consequences is essential for identifying the specific circumstances in which these issues arise and understanding their implications. By categorizing unfavorable tax consequences into timing, conversion, inclusion/exclusion, and loss of tax benefits, the taxonomy aids in pinpointing the mechanisms that lead to economic harm for plaintiffs. For example, it clarifies the multiple ways in which lump sum damage awards can disproportionately harm low-income individuals through timing issues or loss of means-tested tax benefits. It also provides insight into structural inequities caused by conversion of capital gains to ordinary income or the taxation of what would have otherwise been excluded. This clarity enables more targeted judicial and legislative responses to mitigate these harms and ensure that remedies fulfill their intended goal of making plaintiffs whole.

IV
Distributional Concerns of Damage Awards

Part IV discusses why the unfavorable tax consequences of damage awards are more severe for low- and moderate-income parties rather than for higher-income, sophisticated parties. Damage awards are often lump sum awards; that is, one-time payments intended to replace items of income that should have been received over multiple years.[115] Low-income plaintiffs are both more likely to have these awards taxed at rates higher than their pre-award income *and* lose valuable income-based tax benefits. Outside of the lump sum context, sophisticated parties, unlike those who are low-income, are better at anticipating the risk of unfavorable tax consequences and planning accordingly. To the extent a transaction might result in problematic tax consequences, sophisticated parties often use risk-mitigation tools such as indemnification clauses and tax insurance. The result is that unfavorable tax consequences

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115 *See* J. Martin Burke & Michael K. Friel, *Getting Physical: Excluding Personal Injury Awards Under the New Section 104(a)(2)*, 58 Mont. L. Rev. 167, 180 (1997) (stating how employment discrimination cases represent the "great majority" of recent cases reported under the prior version of I.R.C. Section 104(a)(2)).

raise previously underappreciated distributional concerns by imposing disproportionate hardships on low-income parties.

A. Lump Sum Damage Awards and Progressive Rates

Legal scholarship has extensively discussed the unfavorable tax consequences that arise from lump sum damage awards.[116] As this scholarship illustrates, recipients of lump sum damage awards often incur additional tax liability due to progressive income tax rates. Although this effect exists across all income bands other than the highest marginal tax bracket, the effect is more pronounced for low-income taxpayers since lower-income tax brackets are, in general, smaller than higher-income brackets.[117]

Consider again the employee with $31,000 of annual income that is underpaid by their employer by $10,000 in 2022, 2023, and 2024, who successfully files a wage theft claim under the federal Fair Labor Standards Act.[118] The employee obtains a $30,000 judgment which the employer pays in full in 2024. This employee faces an additional tax bill of approximately

116 This scholarship has largely focused on employment discrimination awards. *See generally*, Sheldon I. Banoff & Richard M. Lipton, *Should Lump Sum Damage Awards That 'Bunch Up' Taxable Income Be Grossed Up for Taxes?*, 126 J. Tax'n: Shop Talk 88 (2017) (considering methods for taking unfavorable tax consequences of lump sum damage awards into account); Gene A. Trevino, *Calculating Taxable Commercial Damage Awards: A Further Comment*, J. Legal Econ. (2011), at 23–27 (providing methods for calculating tax damages); Tim Canney, Comment, *Tax Gross-Ups: A Practical Guide to Arguing and Calculating Awards for Adverse Tax Consequences in Discrimination Suits*, 59 Cath. U. L. Rev. 1111, 1112 (2010) (providing approach for determining tax consequences for employment discrimination damages); Gregg D. Polsky & Stephen F. Befort, *Employment Discrimination Remedies and Tax Gross Ups*, 90 Iowa L. Rev. 67, 69-70 (2004) (considering when and how tax gross-ups in employment discrimination suits should occur); Corinne Spencer, Comment, *Authorizing Gross-Up Compensation: Making Recovering Plaintiffs Whole by Accounting for the Additional Tax Consequences that Accompany Lump-Sum Back Pay Awards*, 56 Wake Forest L. Rev. 417, 418 (2021) (arguing in favor of taking unfavorable tax consequences into account for employment discrimination claims); Shawn A. Johnson & Thomas Roney, *"Make Whole": The Need for Gross-Ups in Employment Discrimination Cases*, 17 Hous. Bus. & Tax L.J. 31 (2016) (arguing in favor of taking unfavorable tax consequences into account for employment discrimination claims); Eirik Cheverud, Note, *Increased Tax Liability Awards After* Eshelman*: A Call for Expanded Acceptance Beyond the Realm of Anti-Discrimination Statutes*, 56 N.Y.L. Sch. L. Rev. 711, 713–14 (2012) (focusing on anti-discrimination generally).

117 Corporations currently pay a flat 21% federal income tax rate on all income. See I.R.C. § 11(b). Therefore, corporations receiving lump sum damage awards do not generally have unfavorable tax consequences due to income bunching.

118 *See* Lauren K. Dasse, *Wage Theft in New York: The Wage Theft Prevention Act as a Counter to an Endemic Problem*, 16 CUNY L. Rev. 97, 107 (2012) (describing workers' rights under the Fair Labor Standards Act).

$1,400 when their $30,000 of back wages is lumped into one tax year as opposed to being spread ratably across three tax years.[119] In 2024, the 12% tax bracket only applies to a taxpayer's taxable income between about $12,000 and $47,000 (a bracket size of $35,000).[120] All subsequent tax brackets are larger than the 12% bracket, with the 35% bracket encompassing taxable incomes between about $244,000 and $609,000 (for a bracket size of approximately $366,000).[121] Thus, that same $30,000 award for a taxpayer with a pre-award taxable income of $250,000 will not span multiple tax brackets and will therefore not result in unfavorable tax consequences due to progressive rates.

This effect on low-income taxpayers is even more acute when the additional tax liability is calculated as a percent of taxable income, even for higher-income taxpayers whose damage awards *do* straddle multiple brackets. The employee in the earlier example suffered an additional tax liability of $1,385 due to $13,850 of the damage award being subjected to the 22% (rather than the 12%) tax bracket. This additional $1,385 of tax liability represents 2.3% of the taxpayer's 2024 taxable income.[122] Taxpayers in the 24, 32, 35, and 37% brackets having the same $13,850 straddling the higher bracket will have taxable incomes of $114,375, $205,800, $257,575, and $623,200, respectively.[123] For these taxpayers, the additional liability expressed as a percentage of their taxable income is 0.24%; 0.54%; 0.2%, and

119 This assumes the taxpayer is single. Because $13,850 of the damage award will be subjected to the 22% bracket rather than the 12% bracket, the taxpayer will owe an additional $1,385 ((22% minus 12%) times $13,850) equals $1,385 in taxes. *See infra* footnote 120.

120 I.R.S., Rev. Proc. 2023-34 (2023).

121 *Id.* The marginal tax rates and brackets for 2024 are as follows: for single filers, 10% for taxable incomes between zero and $11,600 ($23,200 for married filing jointly); $ 1,160 plus 12% for excess over $11,600 ($23,200 for married filing jointly); $5,426 plus 22% for excess over $47,150 ($94,300 for married filing jointly); $17,168.50 plus 24% for excess over $100,525 ($201,050 for married filing jointly); $39,110.50 plus 32% for excess over $191,950 ($383,900 for married filing jointly); $55,678.50 plus 35% for excess over $243,725 ($487,450 for married filing jointly); $183,647.25 plus 37% for excess over $609,350 ($731,200 for married couples filing jointly). *Id.*

122 $1,385/$61,000 = 2.27%.

123 I.R.S., Rev. Proc. 2023-34 (2023). A taxpayer with $13,850 of award taxed at (1) 24% has taxable income of $114,375; (2) 32% has taxable income of $205,800; (3) 35% has taxable income of $257,575; (4) 37% has taxable income of $623,200. The additional tax liability due to bracket straddling is, respectively, $277 ($13,850 times (24%-22%)); $1,108 ($13,850 times (32%-24%)); $415.50 ($13,850 times (35%-32%)); $277 ($13,850 times (37%-35%)).

0.04%, respectively.[124] Even if taxpayers in higher brackets have awards that straddle multiple brackets, the additional tax liability will, for the same size award, be smaller as a percentage of taxable income.

Higher-income taxpayers might, as an empirical matter, obtain lump sum damage awards that are larger, as a function of income, than the awards typically obtained by low-income claimants. However, the disparity in rate differentials and bracket size between low- and high-income taxpayers would likely make up for any award size differential based on income.[125] For instance, a taxpayer whose damage award pushes their marginal tax rate to 37% (from 32%) would need a damage award of at least $470,000 to suffer the same tax liability (expressed as a percentage of taxable income) as the employee in the earlier example.[126] Thus, lower-income taxpayers are more likely than higher-income taxpayers to experience unfavorable tax consequences arising from income bunching and progressive rates.

B. Lump Sum Awards and Other Tax Benefits

As discussed previously, many tax deductions and credits are means-tested via income, with income bunching triggering ineligibility.[127] Historically, most of these phaseouts provide benefits to low- and middle-income taxpayers while precluding them for high-income earners.[128] By eliminating benefits at

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124 As a percentage of taxable income, this represents 0.24%; 0.54%; 0.16%; and 0.04%.

125 I.R.S., Rev. Proc. 2023-34 (2023). The largest increase in rate between consecutive bracket occurs between the 12% and 22% brackets, for a difference of 10%. For single filers, this change occurs at taxable income of $47,150 ($94,300 for married filing jointly).

126 *Id.* A taxpayer with taxable income that would be in the 32% bracket but for the award has taxable income pre-award of at most $243,725. The incremental liability owed due to progressive rates is 3% for the next $365,625 ($609,350-$243,725) and 5% for additional income. A damage award of $470,000 would increase taxable income to $713,725 ($470,000 plus $243,725) and incrementally increase tax liability by (3% of $365,624) plus (5% of ($470,000 minus$365,624) = $16,188. $16,188 divided by $713,725 = 2.27%.

127 *See supra* notes 109-114 and accompanying text; *see also* Cong. Budget Off., *Growth in Means-Tested Programs and Tax Credits for Low-Income Households* (Feb. 11, 2013), https://www.cbo.gov/publication/43934 [https://perma.cc/R4P4-86JL] ("[D]uring the past 40 years, federal spending for 10 of the major means-tested programs and tax credits for low-income households more than tripled as a share of GDP.").

128 JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES 3 (Feb. 4, 1998) ("The majority of the

higher incomes, phaseouts enhance income-based progressivity, making additional dollars earned less valuable. This might serve a desired policy goal, but it makes income bunching especially burdensome for low-income taxpayers whose eligibility for certain deductions and credits is lost when income suddenly increases.

Consider a single taxpayer with one child with a reported earned income of $10,000 in tax years 2021 through 2024. In these four tax years, the taxpayer would have received an earned income tax credit ("EITC") of $3,400 per year, or $13,600 total.[129] If this taxpayer suffered $10,000 of wage theft over these four years, being properly paid over the years in question would increase the taxpayer's earned income to $20,000 per year. Because the additional earned income adds to the taxpayer's creditable earnings, the taxpayer's EITC for each year would increase, with a total EITC of about $15,500.[130] If instead the taxpayer receives a lump sum damage award of $40,000 in 2024, the taxpayer's total EITC over all four years decreases to $10,200.[131] The $40,000 increase in earned income precludes the taxpayer's 2024 eligibility for the EITC, resulting in a $5,300 shortfall relative to proper performance by the employer. Even though the lump sum damage award is not affected significantly by progressive rates, it has a considerable effect on the taxpayer's ultimate tax liability due to the loss of the EITC.

This result is not limited to credits. Any tax benefit, be it a credit, exclusion, or deduction, that bases eligibility on income can be lost due to an unexpected lump sum payment. The deduction for student loan interest, for example, permits taxpayers with AGIs below $80,000 to deduct up to $2,500 of student loan interest in 2024.[132] This benefit is completely

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[phaseout] provisions deny tax benefits to higher-income taxpayers, while preserving tax benefits to low-income and middle-income taxpayers.").

129 The earned income tax credit provides a subsidy to low-income workers by providing a refundable credit for earned income (34% of earned income for taxpayers with one child) subject to both a maximum credit amount and a phaseout once earned income (or adjusted gross income) exceeds a threshold amount. *See* I.R.C. § 32 (providing credit and phaseout percentages).

130 $20,000 of earned income would result in an earned income tax credit of $3,618, $3,733, $3,995, and $4,213 for 2021 through 2024, respectively. *See* I.R.S., *Earned Income and Earned Income Tax Credit (EITC) Tables*, https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/earned-income-and-earned-income-tax-credit-eitc-tables [https://perma.cc/W75J-G9QE].

131 *Id.* $10,000 of earned income in 2021, 2022, and 2023 and $50,000 of earned income in 2024 would result in EITCs of $3,400, $3,400, $3,400, and $0 for 2021 through 2024, respectively.

132 I.R.C. § 221; 26 C.F.R. § 1.221-1(d)(1).

phased out at AGIs greater than $95,000.[133] Similar to the EITC recipient above, receiving a damage award that increases AGI from below $80,000 to above $95,000 results in a total loss of the deduction.[134]

The result of this patchwork of income-based tax benefits is that low-income taxpayers' marginal tax rates are difficult to ascertain with precision. Because each tax benefit depends on income, a taxpayer's effective marginal tax rate can differ widely from their statutory rate.[135] A taxpayer with $40,000 of taxable income would, in the absence of the EITC, only experience marginal tax rates of 10, 12, and 22%. Because of the phase-in and phaseout of the EITC, that same taxpayer could possibly face (in order, as taxable income increases) marginal tax rates of negative 24, negative 22, 12, 28, 38, and 22%.[136]

Higher-income taxpayers are not subjected to income-based limitations on the tax benefits they can receive. To be sure, there are still significant tax benefits for the wealthy that function to reduce both gross income and tax liability, but these benefits often face few income restrictions.[137] Because lump sum damage awards obtained by wealthy taxpayers are not likely to push them into significantly higher brackets or cause them to lose income-based tax benefits, higher-income taxpayers are less likely than low-income taxpayers to experience unfavorable tax consequences from receiving lump sum damage awards.

C. Sophisticated Parties

Sophisticated parties regularly consider the potential unfavorable tax consequences of a transaction and plan for them accordingly. As a primary matter, the overwhelming majority of

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133 *Id.*

134 *Id.*

135 *See* Julie Roin, *The Case for (and Against) Surrogate Taxation*, 39 VA. TAX REV. 239, 272 (2019) ("[O]stensibly lower bracket taxpayers can face much higher marginal rates of tax as their income rises due to the phaseout of the earned income credit."); Manoj Viswanathan, *The Hidden Costs of Cliff Effects in the Internal Revenue Code*, 164 U. PA. L. REV. 931, 952 (2016) (stating how additional dollars of income could put taxpayers in worse post-tax economic positions).

136 During the phase-in range of the EITC, the effective marginal tax rate decreases by 34% relative to the statutory rate. During the income range when the EITC is neither phasing in or phasing out, the effective marginal tax rate is the statutory rate. During the phase-out range, the effective marginal tax rate increases by 15.98% relative to the statutory rate.

137 For instance, the ability to defer recognition of gains until a realization event is not limited by a taxpayer's income, nor is the ability to exclude the imputed rental value of owner-occupied homes. *See* I.R.C. § 1001; I.R.C. § 61.

lawsuits are settled out of court, with only a small proportion tried by a judge or jury.[138] When parties settle, the tax consequences of the damage award fall where they fall; that is, there is no subsequent liability imposed on the defendant for unexpected tax costs of a settlement. Unsophisticated plaintiffs, who often lack assistance of counsel, are more likely to settle for amounts that do not take unfavorable tax consequences into account.[139] The result is that lesser-resourced claimants will often incur unexpected tax liabilities from their settlement only after filing their taxes, or after receiving notice from the IRS.

In contrast, sophisticated parties are more likely to take potential tax consequences into account when negotiating settlements. Because the circumstances for which a plaintiff can obtain an increased award due to unfavorable tax consequences are not settled,[140] knowledgeable parties can argue that their tax costs should be included in any potential settlement. The mere possibility of a court awarding tax damages serves as a useful tactic when negotiating settlements.[141] But only parties sophisticated enough to consider not only their direct monetary damages, but also the tax damages that flow from that original award, obtain this benefit.

Moreover, even if parties do not settle and are awarded damages by a court or jury, these damage awards cannot be increased for unfavorable tax consequences unless the plaintiff specifically requests them. Parties without experience in receiving damage awards are less likely to request damage

138 Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1, 2 (1996) ("Of the hundreds of thousands of civil lawsuits that are filed each year in America, the great majority are settled; of those that are not settled, most are ultimately dismissed by the plaintiffs or by the courts; only a few percent are tried to a jury or a judge.").

139 *See* Lewis Taub, *Minimizing the Tax Consequences of Awards and Settlements for Personal Injury*, BERKOWITZ POLLACK BRANT (Feb. 14, 2022), https://www.bpbcpa.com/minimizing-the-tax-consequences-of-awards-and-settlements-for-personal-injury-by-lewis-taub-cpa/ [https://perma.cc/HZ6Y-U6DK] (stating that plaintiffs "often fail to recognize the tax implications" of damages and that such information "typically is revealed by legal counsel"); *see also* Kevin A. Palmer, *The Taxation of Damage Awards and Settlements Under the Antidiscrimination Laws*, 67 TAXES 461, 467 (1989) (noting that "[a]ttorneys embroiled in combative litigation have little time to consider and plan for the tax consequences of a successful verdict or settlement" and "[i]n the heat of litigation, tax outcomes often fall by the wayside.")

140 *See infra* Part IV.

141 *See, e.g.*, Gregg D. Polsky & Dan Markel, *Taxing Punitive Damages*, 96 VA. L. REV. 1295, 1336 (2010) ("[Tax damage awards] would increase settlement values because litigants determine these values in the shadow of what a jury would be expected to award.").

enhancements, with the additional tax costs becoming known only at some later date.[142] Even if the unfavorable tax consequences would have been recoverable from the defendant, unsophisticated plaintiffs will often fail to obtain the recovery.

Sophisticated parties, in addition to being better advised about their potential remedies under the law, often avail themselves of other tools to mitigate the harm caused by a damage award's unfavorable tax consequences.[143] A party to a contract that anticipates the potential harm that could result from the counterparty's breach is able to factor that risk into the contract terms.[144] The result could be a liquidated damages term that anticipates costs, or a tax indemnity provision that obligates the breaching party to compensate the non-breaching party for any tax costs arising due to the party's breach.[145]

Similarly, sophisticated parties can use structured settlements, that is, payments spread over multiple years, to mitigate the unfavorable tax consequences associated with lump sum damage awards.[146] Rather than obtaining the full damage award in one taxable year, the award is spread across several years, with terms agreed upon by payor and payee.[147] Due to their complexity, unsophisticated parties are unlikely to obtain the benefits of their use.[148]

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142 Defendants paying settlements must report amounts paid on Form 1099 unless the settlement qualifies for a statutory exception. I.R.S., *supra* note 82.

143 Jennifer J. S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 762 (1988) (observing likely inequity in tax outcomes where tax treatment depends on how "well-advised" parties are in making claims or "drawing up their settlement agreement").

144 *See, e.g.*, McManaman v. First Health Grp. Corp., No. 2-10-0871, 2012 Ill. App. 2d 100871-U ¶ 1 (June 19, 2012) (describing contract terms in which plaintiff would receive payment for excise taxes owed).

145 Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 386 (2005) ("Contracting parties frequently allocate between them the responsibility for potential tax liabilities through the use of tax indemnity agreements that become an integral part of the overall transaction."); *see also* Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 HASTINGS L.J. 645, 669 (2006) (describing a non-breaching party seeking indemnity for tax burdens resulting from attorney malpractice); 2 RAYMOND T. NIMMER & DAVID OLIVEIRI, COMMERCIAL ASSET-BASED FINANCING § 14:30 (2024 ed.) (describing most common feature of tax indemnity clause as compensating non-breaching party for any change in tax consequences caused by the breaching party's non-performance).

146 *See* Henry E. Smith, *Structured Settlements as Structures of Rights*, 88 VA. L. REV. 1953, 1962 (2002).

147 *Id.* at 1953–54.

148 *Cf., e.g.*, Jeremy Babener, *Structured Settlements and Single-Claimant Qualified Settlement Funds: Regulating in Accordance with Structured Settlement*

Parties that are well-advised can also use third-party tax insurance to protect against unexpected tax consequences flowing from a transaction.[149] Under current law, the uncertainty in calculating the relative tax burdens of a lump sum award and the monies lost due to breach can preclude recovery for the unfavorable tax consequences arising from the award.[150] Similarly, a settlement by a tax advisor to reimburse a client for faulty tax advice may or may not be included in gross income.[151] By obtaining tax insurance, the damage award recipient can lessen the harm imposed if the award were indeed found to be taxable. As a practical matter, tax insurance is generally only available for well-resourced, sophisticated taxpayers.[152]

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Part IV examined the distributional concerns of damage awards, emphasizing how unfavorable tax consequences disproportionately burden low- and moderate-income plaintiffs compared to higher-income, sophisticated parties. Lump sum awards, which consolidate multiple years of income into a single tax year, often subject lower-income recipients to higher marginal tax rates and phaseouts of critical income-based tax benefits. The financial impact of these consequences is amplified because lower-income taxpayers have smaller tax brackets, making them more susceptible to income bunching and loss of deductions or credits. In contrast, sophisticated parties are better equipped to anticipate and mitigate tax consequences through strategic planning, indemnification clauses, and tax insurance, ensuring they are not unfairly disadvantaged by settlement structures.

This discussion of how low-income parties bear the brunt of the unfavorable tax consequences associated with damage awards does not imply that the unfavorable tax consequences

History, 13 N.Y.U. J. Legis. & Pub. Pol'y 1, 3 (2010) (noting that defendants obtained much of the benefit of early use of structured settlements).

149 *See* Heather M. Field, *Tax Lawyers as Tax Insurance*, 60 Wm. & Mary L. Rev. 2111, 2127 (2019) (describing range of transactions for which tax insurance is available).

150 *See, e.g.*, Sonoma Apartment Assocs. v. United States, 939 F.3d 1293, 1298 (Fed. Cir. 2019) (dismissing tax damages based on future income as too uncertain and speculative).

151 *See* Anthony E. Rebollo, *Responding to 'Gross-Up' Claims in Tax Malpractice Cases*, 104 J. Tax'n 353, 353 (2006) (noting that the taxation of malpractice reimbursement cases is muddled).

152 Logue, *supra* note 145, at 387.

borne by other parties are not worth addressing. The methodology developed in Part V to determine when defendants should, as a normative matter, be required to pay increased damage awards to compensate for this additional liability, applies to all plaintiffs regardless of financial status. However, low-income taxpayers, who currently bear a disproportionate share of unfavorable tax consequences, will have much to gain.

V
Prescriptive Approaches to Unfavorable Tax Consequences

By combining normative assumptions with existing legal rules, Part V develops a generalized framework through which determinations about defendants' responsibilities for the tax costs of plaintiffs' damage awards can be made. This Article argues that, as a normative matter, plaintiffs must prove that (1) the damage award results in an increase in tax liability relative to the remedy's contemplated counterfactual; (2) the damage award is given via a truly "make whole" remedy; and (3) no exceptions for that area of law limit the scope of the damage award. Calculational specifics and considerations of unsophisticated parties are also discussed.

This discussion takes the taxation of damage awards as a given. To the extent that this tax treatment is not based on sound policy, the plaintiff's unfavorable tax consequences could simply be cured by modifying how the damage awards are taxed. However, because existing scholarship has addressed many of those questions, this Article's focus is on the neglected question of when and how defendants' liability should (or should not) be adjusted to take unfavorable tax consequences into account.

A. Framework for Defendant Liability

1. *Ensuring a "Make Whole" Remedy*

A successful claim for tax damages first requires that the remedy used be a "make whole" remedy—that is, it must intend for the plaintiff to be fully restored (subject to the exceptions discussed later) to the counterfactual contemplated by the remedy. Although a remedy might desire to restore a plaintiff to a certain point in time, it is not always the case that the remedy intends to *fully* restore. For instance, California Government Code Section 19584 awards adversely affected employees, upon reinstatement after being improperly terminated, any lost salary and benefits.[153] Although the remedy contemplated by the statute intends to partially restore plaintiffs for their losses, the statute's restoration is limited to salary and benefits. Tax damages under this statutory claim are therefore inappropriate.[154] In contrast, California Civil Code Section 3333, generally describing tort awards, provides that the measure of damages is "the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not."[155]

Similarly, Title VII limits a defendant's compensatory damage liability based on the number of employees of the defendant.[156] As defined by statute, "compensatory damages" are statutorily limited to "future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses."[157] Specifically excluded from this definition of compensatory damages are back pay, front pay, and other forms of equitable relief.[158] Thus, to the extent tax damages are considered (uncapped) equitable relief rather than compensatory damages, they should be part of a truly "make whole" award.

Under the common law principles associated with tort awards and contract claims, restoration, if contemplated by the remedy, is generally not limited.[159] That is, a tort award intended to compensate or an expectation damage award for breach of contract is not limited by either defendant attributes or dollar value. Although specific jurisdictions may vary from these general descriptions, in general, for tort and contract claims, a "make whole" damage award is generally intended to be fully restorative.

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153 Cal. Gov't Code § 19584 (West 2026).

154 California case law accords with this normative statement. *See* Barber v. State Pers. Bd., 247 Cal. Rptr. 474, 476 (Cal. App. 4 Dist. 2019) (ruling against award for tax damages).

155 Cal. Civ. Code § 3333 (West 2026).

156 42 U.S.C. § 1981a(b)(3)(A)–(D). For defendants with between 14 and 101 employees, 101 and 201 employees, 201 and 300 employees, and more than 300 employees, compensatory damages are capped at $50,000, $100,000, $200,000, and $300,000, respectively.

157 *Id.* § 1981a(b)(3).

158 *Id.* § 1981a(b)(2); *see also* Pollard v. E.I. du Pont de Nemours & Co., 532 U.S. 843, 852 (2001) (finding front pay awards under Title VII to be equitable rather than compensatory).

159 *See* Restatement (Third) of Torts: Remedies, § 2 (A.L.I., Tentative Draft No. 1, 2022); Restatement (Second) of Contracts §§ 370–71 (A.L.I. 1981). In contrast, statutory limits to tort awards are relatively common across states. California's Medical Injury Compensation Reform Act (MICRA) limits the recovery of non-economic damages—such as pain, suffering, inconvenience, physical impairment, and disfigurement—to an annually indexed cap. Cal. Civ. Code § 3333.2 (2026 West).

2. *Establishing Tax Consequences*

Any claim for an enhanced damage award must also prove that the baseline damage award—that is, the damage award without considering tax considerations—will result in unfavorable tax consequences. This requires comparing the tax burden of the baseline damage award with the tax burden associated with the counterfactual situation where the defendant had not wrongly acted. More specifically, the comparison is to the counterfactual contemplated by the "make whole" remedy (that is, the point of restoration) to which the injured party is entitled. As discussed earlier, this counterfactual depends on the remedy used to determine damages. The relevant point in time could (non-exclusively) be, for instance, prior to the defendant's tortious act (for tort awards), prior to the plaintiff's entering into the contract (for reliance damages), after the hypothetical completion of the contract (for expectation damages), or prior to the defendant's prohibited discrimination (for Title VII claims), depending on the remedy involved.[160]

An inherent challenge in establishing unfavorable tax consequences is that a claimant's tax liability for the baseline damage award will not be fully known until they file their taxes for the year in which the award was received. Many factors—such as changes in income, deductions, credits, or even shifts in tax law—can affect the final tax impact of the award, making it difficult to precisely calculate the harm caused by income bunching, inclusion/exclusion mismatches, or loss of tax-based benefits, for example, when damages are being sought. Despite these uncertainties, claimants can use several methods to satisfy the evidentiary burden required and establish the likelihood and magnitude of unfavorable tax consequences.

a. *Prior-Year Returns*

By examining tax returns from previous years, a claimant can estimate the extent to which a current-year "make whole" damage award might result in unfavorable tax consequences. Returning to the earlier wage theft example, a worker receiving a $30,000 award in 2024 should be able to use prior year returns to create a rebuttable presumption of what their income (and other relevant tax attributes) would be in 2024. This would allow the plaintiff to argue for an enhanced damage award without needing to know precisely how the damage award affects tax liability in 2024.

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160 *See supra* Part I.

Using prior year-returns to estimate current tax effects has relevance across all categories of unfavorable tax consequences, and not just those attributable to timing. Because taxpayer liability depends not just on income, but also taxpayer attributes that may vary from year to year, plaintiffs must establish what these attributes will be for the current tax year. For instance, to prove the loss of a tax benefit such as the EITC, a taxpayer should be able to establish their earned income, marital status, and investment income.[161] Prior year returns can help resolve the burdens of proof.

Because plaintiffs are making forward-looking predictions, there is no guarantee that their current-year tax situation will ultimately align with expectations. For instance, an EITC claimant might obtain an enhanced damage award based on their status as a single filer but get married sometime during the current year. If so, the unfavorable tax consequences taken into account by the enhanced damage award might never materialize. In short, accurately forecasting tax damages can be challenging.

While uncertainty regarding a claimant's future tax situation presents a potential challenge, it does not fundamentally undermine the validity of using projected tax consequences to determine enhanced damages. This uncertainty only affects the burden of proof, not the legitimacy of the claim itself. Courts routinely assess damages based on probabilistic evidence where exact financial outcomes cannot be known at the time of judgment.[162] The key inquiry is not whether the claimant's tax consequences will be known with absolute certainty, but whether they can be established with sufficient confidence under the evidentiary standard applicable to the remedy. As long as the claimant can demonstrate that unfavorable tax consequences meet the relevant evidentiary standard, their entitlement to an enhanced damage award should not be precluded simply because their actual tax liability might later diverge from projections.[163]

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161 *See* I.R.C. § 32 (listing factors associated with earned income tax credit determination).

162 *See* Recent Case, *False Claims Act – Proof of Liability – Eastern District of Tennessee Rules that Statistical Extrapolation May Suffice to Prove Liability*, 128 HARV. L. REV. 2074, 2078 (2015) ("The Supreme Court has held that uncertain or probabilistic evidence may suffice to prove the extent of damages . . . .").

163 In situations of extreme misalignment between actual and expected damages, remittitur can result in a post-verdict adjustment of damages. *See* Irene Sann, *Remittitur Practice in the Federal Courts*, 76 COLUM. L. REV. 299, 299 (1976) ("Remittitur . . . gives a plaintiff who has received an excessively favorable jury verdict the option of accepting a specified reduction in the jury verdict or submitting to a new trial.").

b. *Tax Expert Testimony*

Using information from prior-year returns may not adequately capture the extent to which a current-year damage award might have unfavorable tax consequences. This is especially true if tax laws have recently changed or if the taxpayer's attributes are different.[164] In these situations, tax experts, such as forensic accountants or tax attorneys, can play a crucial role in establishing unfavorable tax consequences by providing courts with objective, data-driven analyses of how a damage award will impact a claimant's tax liability. These experts can prepare tax analyses that compare the counterfactual scenario in which the harm never occurred to another showing the actual tax consequences of receiving the damage award in the relevant year. Experts would be especially useful in identifying less obvious tax impacts, such as the conversion of what would have been capital gains into ordinary income, which may subject claimants to significantly higher tax rates.

Expert testimony could, of course, be useful even if a plaintiff relies solely on prior-year returns to establish unfavorable tax consequences. Any financial claim could be bolstered with the opinions of credible witnesses. But tax experts would be especially useful in situations where claimants are attempting to prove that a plaintiff's current-year tax situation *varies* from prior years, with unfavorable tax consequences then likely more difficult to establish.

c. *Conditional Adjustments Post-Tax Filing*

A conditional adjustment post-tax filing mechanism would allow courts to revisit an enhanced damage award once the claimant has filed their tax return and determined their actual tax liability. Instead of relying solely on forward-looking projections of unfavorable tax consequences, this approach would ensure that the additional tax burden caused by the damage award is accurately reflected in the final judgment. Under this model, courts could establish an initial, conservative estimate of the unfavorable tax consequences at the time of the award, but if the claimant later demonstrates that their actual tax liability exceeds a predetermined threshold, they would be entitled to a supplemental adjustment. This system could work similarly to how courts handle future medical expenses or

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164 If, for instance, the taxpayer had children or was recently married, the prior-year returns may not be adequate.

structured settlements, where awards are revisited based on evolving circumstances.[165]

However, implementing a post-tax filing adjustment system presents practical challenges, particularly regarding finality in litigation. Courts generally favor final judgments to provide certainty and closure for both plaintiffs and defendants, and allowing claimants to reopen cases based on actual tax filings could introduce administrative burdens and potential delays.[166] Additionally, defendants might argue that such a system creates prolonged financial uncertainty, as they would not know their true liability until well after the initial judgment. To address this concern, courts could establish a streamlined post-filing claims process that avoids full case reopening but allows for a modification of judgment based on IRS filings, subject to judicial review. While conditional adjustments introduce practical complexities, they might offer a fairer and more precise mechanism for determining unfavorable tax consequences associated with an award.

3. *Applying Relevant Exceptions*

Even if the remedy for which the damage award is given intends to fully restore the injured party, exceptions to the general rule of restoration can limit what plaintiffs may recover. As discussed previously, these exceptions prevent the injured party from truly being made whole and include damages that the plaintiff could have mitigated and damages that are uncertain or (for contract claims) not reasonably foreseeable.[167] There are persuasive normative justifications for these deviations away from the default goal of restoration, including preventing economic waste, fairness to the breaching party, and administrative ease.[168]

Although the unfavorable tax consequences from the damage award are, as a technical matter, distinct from the damage

165 *See* Smith, *supra* note 146, at 1954 ("In a structured settlement, the plaintiff and others decide to set up the schedule of payments . . . .").

166 *See* Ronnie Gomez, *Ethics Rules in Practice: An Analysis of Model Rule 5.6(b) and Its Impact on Finality in Mass Tort Settlements*, 32 Rev. Litig. 467, 470 (2013) ("[S]ettlements with finality add value and are attractive for all parties involved in the litigation.").

167 *See supra* Part II.C.

168 *See, e.g.*, George M. Cohen, *Finding Fault with Wonnell's "Two Contractual Wrongs"*, 38 S.D. L. Rev. 137, 159 (2001) ("Doctrines such as mitigation, foreseeability, and certainty all serve to improve promisee incentives to take precautions and mitigate losses.").

caused by the defendant's wrongful conduct, the same normative justifications precluding recovery for certain categories of plaintiff harm apply to the tax costs associated with the damage award. In other words, for purposes of determining whether the unfavorable tax costs are additional damage for which the plaintiff is responsible, this incremental liability needs to constitute additional "damage" to which a "make whole" exception should not apply. The same limitations applicable to the central damage claim should also, therefore, apply to the claim for tax-based damages.

For example, tort and contract damages are recoverable only for losses that can be determined to a degree of certainty.[169] Even if the damage award can be shown to have unfavorable tax consequences, these consequences must be quantifiable to a reasonable degree to be compensable. To the extent the unfavorable tax consequences arise from income that should have been recognized in prior tax years, certainty is more easily obtained since the plaintiff has the benefit of more easily proving the counterfactual.[170] For unfavorable tax consequences caused by shifting income (or other relevant tax events, such as a realization event) from future years to the current year, overcoming the burden of certainty is more difficult since other taxpayer attributes could change in future years. A reasonable default rule would be to presume certainty for prior year tax damages but presume a lack of certainty for tax damages related to future tax years.

Additionally, in both tort claims and contract claims, injured parties should not be able to recover for harm that could have been avoided through reasonable effort.[171] Unfavorable tax consequences that the plaintiff could have reasonably avoided, even if caused by the defendant's wrongful conduct, would not be recoverable. If, for instance, a developer fails to obtain the LIHTC credits contractually promised to an investor, the investor might suffer tax damages from having to include the damage award in gross income.[172] But if the investor could have easily filed paperwork to exclude the damage award from gross income, this failure to mitigate could preclude recovery for the tax-based damages.

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169 RESTATEMENT (THIRD) OF TORTS: REMEDIES § 5 (A.L.I., Tentative Draft No. 1, 2022); RESTATEMENT (SECOND) OF CONTRACTS § 352 (A.L.I. 1981).

170 *See* Polsky & Befort, *supra* note 116, at 113.

171 RESTATEMENT (THIRD) OF TORTS: REMEDIES § 8 (A.L.I., Tentative Draft No. 1, 2022); RESTATEMENT (SECOND) OF CONTRACTS § 350 (A.L.I. 1981).

172 *See supra* notes 102-103 and accompanying text.

Damages for breach of contract are recoverable only for losses that are foreseeable by the breaching party.[173] Losses are foreseeable when they occur in the ordinary course of events or result from special circumstances that the breaching party had reason to know.[174] For a lump sum damage award that creates unfavorable tax consequences via income bunching, it should, as a normative matter, be established that the additional liability caused by progressive rates either was or should have been contemplated by the breaching party.[175]

The applicability of the various "make whole" exceptions depends on the facts underlying the claim and not just on the nature of the unfavorable tax consequences. This means that the attributes of the parties are potentially relevant to establishing whether enhanced damages should be awarded. For instance, a sophisticated defendant is more likely to be aware that their breach could result in unfavorable tax consequences to the plaintiff. It is therefore less plausible for a large employer with experience settling employee claims to argue that unfavorable tax consequences caused by a lump sum damage award are unforeseeable.

These exceptions all limit the scope of tax damages to which defendants might be subjected. If, for instance, a recently divorced plaintiff obtains a settlement in 2024 for salary that should have been paid the previous year (while they were married), they might suffer unfavorable tax consequences due to their new status as a single filer.[176] But it is unlikely that the defendant could foresee that their breach could give rise to this form of unfavorable tax consequences. That is, the plaintiff's current-year divorce (absent special circumstances) and use of smaller tax brackets is likely not something the defendant could have anticipated.

Recognizing that tax damages for breaches of contract must be foreseeable does not imply that the only tax damages for which defendants should be responsible are those caused by income bunching and progressive rates. There are many tax

173 Restatement (Second) of Contracts § 351 (A.L.I. 1981).

174 *Id.* § 351(b).

175 This standard, though common, is not uniform across all jurisdictions, but is illustrative of the type of analysis that should be performed. *See, e.g.*, *Home Sav. of Am. v. United States*, 399 F.3d 1341, 1356 (Fed. Cir. 2005) (articulating, without opining on foreseeability of additional tax costs, that a tax award is appropriate if award replaces money that would not have been taxable); *Oddi v. Ayco Corp.*, 947 F.2d 257, 268 (7th Cir. 1991) (stating that foreseeability by defendant makes tax award appropriate).

176 *See* I.R.C. § 1 (providing income tax rate schedules).

benefits of which defendants could be reasonably aware. For instance, employer participation is required for taxpayers to use a dependent care flexible savings account ("FSA").[177] This tax benefit is limited by taxpayer income.[178] Thus, an employer could be deemed reasonably aware that paying a lump sum damage award would result in the loss of some portion of the dependent care FSA benefit.

This is especially important for low-income plaintiffs for whom the counterparty is sophisticated, as is the case when a large employer has significant numbers of low-wage employees.[179] As discussed previously, for these employees, the loss of tax benefits can be a significant source of harm.[180] Although employers might not know the precise tax benefits their employees receive, they are likely aware, due to knowing their employees' income, that tax benefits such as the EITC are possible. For low-income plaintiffs for whom the counterparty is sophisticated, it is more reasonable for the scope of tax damages to encompass a broader range of claims. As a result, the loss of tax benefits is reasonably within the scope of unfavorable tax consequences for which certain defendants could be responsible.[181]

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177 An employer-provided dependent care FSA permits employees to pay for certain dependent care services using pre-tax dollars. *See* I.R.C. § 129.

178 In 2024, pre-tax contributions to dependent care FSAs are limited to $3,000 for employees earning more than $150,000. Employees earning less than $150,000 can contribute $5,000. I.R.S., Dep't of Treasury, Cat. No. 29744N, Publication 15-B: Employer's Tax Guide to Fringe Benefits For use in 2024 (2024).

179 *See, e.g.*, Kathleen Dailey, *Walgreens Employees in California Secure $4.5 Million Wage Deal*, Bloomberg L. News (Nov. 25, 2020), https://news.bloomberglaw.com/daily-labor-report/walgreens-employees-in-california-secure-4-5-million-wage-deal [https://perma.cc/3B2U-K4SC] (reporting wage-theft settlement for hourly employees).

180 *See supra* Part III.B.4.

181 This implies that other non-tax, means-tested benefits (possibly provided by state and local governments) are also possibly within the scope of compensable damages. However, eligibility for many non-tax benefits is determined monthly rather than annually, which minimizes the extent that non-tax benefits might be lost. Brandon L. Greene, *Too Rich to be Poor: The Hypocrisy of Indigency Determinations*, Berkeley J. Crim. L., Fall 2019, at 12. Also, non-recurring lump sum payments are excluded. *See SHD Paraphrased Regulations – CalFresh*, Cal. Dep't of Soc. Servs. § 266-1, https://www.cdss.ca.gov/shd/res/pdf/ParaRegs-Food-Stamps-Income.pdf [https://perma.cc/E7ZV-E5DB]. A full exploration of the extent to which the loss of non-tax benefits could enhance damage awards is beyond the scope of the Article.

The purpose of this analysis is not to determine exactly which unfavorable tax consequences will be compensable under which legal claims, but rather to articulate a generalized methodology for assessing, within the existing framework of damage recovery limitations, whether a given unfavorable tax consequence constitutes harm for which the defendant should be held responsible. This discussion takes as a given the established doctrinal constraints on damage recovery across tort, contract, and statutory claims while providing a structured approach for courts to evaluate tax damages within those constraints. By considering factors such as the nature of the remedy, the foreseeability of the tax consequences, the plaintiff's duty to mitigate, and the certainty of the harm, this framework offers a principled way to determine whether tax-based damages fall within the scope of recoverable harm. The goal is to ensure that plaintiffs are compensated for tax burdens that genuinely undermine the "make whole" purpose of the damage award, while maintaining doctrinal consistency and preventing unwarranted expansions of defendant liability.

4. *Calculating Tax-Based Damages*

Determining that unfavorable tax consequences are recoverable as a matter of law still requires determining how much more the defendant should pay. Since the damage award in question will itself be taxed, the increase in damage award will need to be grossed up; that is, increased beyond the amount of the plaintiff's tax damages to account for the additional taxes owed on the larger award.[182] For claims that are purely economic (that is, reduceable to a specific dollar amount) the increased damage award should be grossed up to compensate, on an after-tax basis, for the unfavorable tax consequences incurred by the plaintiff.[183] This approach presupposes being able to calculate, with some level of specificity, the extent of the plaintiff's unfavorable tax consequences. However, given that an inability to ascertain these damages should preclude recovery (as described previously), this should not be a significant hurdle.

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182 To leave a taxpayer with *x* amount of after-tax dollars requires giving them a pre-tax amount of *x* divided by (1 minus *r*), where *r* is the applicable tax rate. This assumes a constant marginal tax rate.

183 Judges generally only approve contract damage awards for economic harms. David A. Hoffman & Alexander S. Radus, *Instructing Juries on Noneconomic Contract Damages*, 81 FORDHAM L. REV. 1221, 1253 (2012).

For non-economic harms, which include damages awarded for emotional distress and non-physical harms,[184] the damages awarded are generally based on qualitative rather than quantitative factors, leading to wide variation in the range of possible awards.[185] Unlike an award to compensate for $1,000 of lost earnings, compensating a victim for emotional distress does not lend itself to easy calculation.[186]

Given the inherent difficulty in computing restorative damage awards for non-economic harm, it is imprudent to enhance these awards post-judgment based on the tax liability they trigger. The opacity of the damage calculation process for non-economic damages means that juries might have already considered the tax consequences while formulating the award.[187] In this instance, increasing a damage award for unfavorable tax consequences would provide a windfall to the plaintiff. Rather, this Article proposes instructing juries of the tax consequences of the non-economic damage award and permitting them, in their judgment, to increase the award appropriately.[188] Though this would

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184 Non-economic damage awards include compensation awarded for physical harm, but since awards for physical harm are excluded from gross income under I.R.C. § 104(a), they cause no unfavorable tax consequences.

185 *See* Restatement (Third) of Torts: Remedies § 5 cmt. e (A.L.I., Tentative Draft No. 1, 2022) (describing non-economic damages such as pain and suffering, emotional distress, and dignitary harms as inherently imprecise and difficult to measure by reference to fair market value); *see also* Randall R. Bovbjerg, Frank A. Sloan & James F. Blumstein, *Valuing Life and Limb in Tort: Scheduling "Pain and Suffering"*, 83 Nw. U. L. Rev. 908, 912 (1989) ("Whatever the categories of non-economic damages allowed in a given jurisdiction, the law provides no objective benchmarks for valuing them.").

186 Roger Bern, *A Biblical Model for Analysis of Issues of Law and Public Policy: With Illustrative Applications to Contracts, Antitrust, Remedies and Public Policy Issues*, 6 Regent U. L. Rev. 103, 164 (1995) ("The same discrepancies and wide variations in damage awards in physical pain and suffering cases also occur in the related unmeasurable area of emotional distress . . . .").

187 States vary on whether juries are permitted to hear information on the taxability of the damage award. *See generally* Lauren Guest & David Schap, *Case Law Concerning the Treatment of Federal Income Taxes in Personal Injury and Wrongful Death Litigation in the State Courts*, 20 J. Legal Econ. 85 (2014) (describing the range of jury instructions regarding taxability of damage awards).

188 This approach extends the proposal formulated by Gregg Polsky and Dan Markel to make juries "tax aware" so that they might adjust punitive damage awards to impose the proper (post-tax) deterrence cost on defendants. Polsky & Markel, *supra* note 141, at 1307–10; *see also* Morgan L. Holcomb, *Taxing Anxiety*, 14 Fla. Tax Rev. 77, 80 (2013) ("I submit that nearly all damages, including damages received on account of physical injury, ought to be taxable, and that juries must be apprised of tax consequences so that they can make proper adjustments to take account of these tax consequences.").

require a change in practice in several jurisdictions, it would better accomplish the normative goal of fully restoring injured plaintiffs.[189]

5. *Unsophisticated Plaintiffs*

The preceding discussion of defendant liability for unfavorable tax consequences has significant implications for unsophisticated plaintiffs, particularly because most litigation does not go to trial but settles out of court. However, if courts develop clear principles for when and how unfavorable tax consequences should be compensated—such as those suggested in this Article's framework—these principles will extend beyond formal litigation and influence the broader settlement negotiation process. By providing a structured methodology for courts to assess when tax-based damages should be awarded, the framework described in this Article would help both plaintiffs who litigate and plaintiffs who settle, ensuring that tax-related harms are systematically addressed rather than left to the discretion of individual judges or opposing counsel.

The establishment of judicial precedent on unfavorable tax consequences would also provide a clearer framework for pro se litigants and other unsophisticated plaintiffs who lack access to formal legal counsel to understand their rights. Many legal services organizations currently provide informal guidance on the tax consequences of settlement payments, but this guidance typically acknowledges that seeking increased damages to offset tax liability is uncertain and rarely guaranteed.[190] If courts were to adopt the structured approach outlined in this Article, it would provide a clear legal basis for such claims, allowing legal aid organizations to provide stronger, more concrete advice to their clients. This would empower self-represented plaintiffs to advocate for fairer settlements, even without the benefit of formal legal representation. By ensuring that tax-based damages

189 Several jurisdictions have limits on non-economic damages. Heidi Li Feldman, *Harm and Money: Against the Insurance Theory of Tort Compensation*, 75 TEX. L. REV. 1567, 1567–68 (1997); RESTATEMENT (SECOND) OF TORTS § 914A cmt. d (A.L.I. 1979) ("There is no agreement among the states or even within the federal courts on how the rule that recoveries for future earnings are not taxable is implemented by instructions to the jury in a trial."). Any increase to non-economic damage awards would also be subject to that limitation.

190 *See, e.g.*, Douglas L. Stevick, *Little Shop of Tax Horrors: Tips and Tricks for Avoiding Settlement-Related Employment Tax Nightmares*, TEX. RIO GRANDE LEGAL AID (Nov. 10, 2021) [https://perma.cc/MS9M-EPY5].

are assessed consistently and predictably, the framework advanced in this Article would serve as a critical safeguard against disproportionate harm to economically vulnerable and legally inexperienced plaintiffs.

B. Current Law on Tax-Based Damages

Prior sections established that unfavorable tax consequences can fail to make damage recipients whole, undermining the restorative goal of certain "make whole" remedies, and that these burdens are more pronounced for lower-income taxpayers. Part V.B identifies the inconsistencies in how unfavorable tax consequences are treated (to the extent that they are addressed at all) across tort, contract, and statutory claims and the normative shortcomings of commonly accepted legal rules.[191] Courts that have considered how to treat unfavorable tax consequences have generally limited their holdings to the specific fact patterns before them rather than provide guidelines of general applicability. Although a comprehensive summary of approaches used is beyond the scope of this Article, this section provides an overview of existing doctrine and describes the splits in federal Circuit courts.

1. *Tort Claims*

The Restatement (Third) of the Law of Torts ("R3T"), an authoritative summary of common law tort principles across jurisdictions,[192] states that large mismatches between the tax liability incurred on the damage award and the liability that would have been incurred but for the tort can give rise to the defendant paying an increased damage award.[193] This is most relevant for inclusion/exclusion situations when the taxable damage award replaces proceeds that would have been excluded from tax.[194]

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191 *See, e.g.*, Elgee v. Ret. Bd. of Pub. Emp. Ret. Sys. of Idaho, 490 P.3d 1142, 1154 (Idaho 2021) ("We note there is considerable disagreement among courts in other jurisdictions whether such [tax-based] claims can be maintained, and if so, under what circumstances.").

192 G. Edward White, *The American Law Institute and the Triumph of Modernist Jurisprudence*, 15 L. & Hist. Rev. 1, 2–3 (1997).

193 Restatement (Third) of Torts: Remedies § 13(b)(2) (A.L.I., Tentative Draft No. 1, 2022).

194 *See* Girsch v. Hiffman, Nos. 1-21-1098, 1-22-0872, and 1-22-1473, 2024 IL App (1st) 211098, at 33–34 (Feb. 13, 2024) (approving tax gross-up to compensate for taxability of damage award received in lieu of what would have been a tax-free payment).

No tort case on records has addressed the unfavorable tax consequences arising from income bunching.[195]

The R3T also provides that increased damage awards are not appropriate if the damage award compensates for a loss that is non-deductible.[196] For example, awards for emotional distress are generally taxable, though the distress itself is a non-deductible loss. Thus, the tax consequences of an emotional distress award, though causing the injured party to not be made whole, are not, as per the R3T, proper grounds for an increased damage award. Though generally followed, some courts have questioned this rule in similar contexts.[197]

Federal courts, in contrast to most state jurisdictions, decrease a plaintiff's award for the *beneficial* tax treatment of the damage award.[198] That is, a federal tort award excluded under Section 104(a)(2) will be reduced if the award replaces income that would have been taxed, such as wages. This rule is followed only by a minority of states, with most jurisdictions treating the Section 104(a)(2) exclusion as a benefit for the injured party rather than a subsidy for the defendant.[199] If, however, the after-tax tort award will face other tax consequences, the Fifth and Ninth Circuit have approved increasing the damage award correspondingly.[200]

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195 RESTATEMENT (THIRD) OF TORTS: REMEDIES § 13 cmt. j (A.L.I., Tentative Draft No. 1, 2022) ("It does not appear so far that any common-law tort cases have addressed the effects of bunching income into the year the judgment is collected.")

196 *See id.* § 13(b)(3).

197 Chuong Van Pham v. City of Seattle, 151 P.3d 976, 984–85 (Wash. 2007) (en banc) (Sanders, J., dissenting) (approving lower court's tax gross-up for emotional damages).

198 Norfolk & W. Ry. Co. v. Liepelt, 444 U.S. 490, 493 (1980) (stating that "after-tax income, rather than [] gross income before taxes" is the relevant measure of the damage award); RESTATEMENT (THIRD) OF TORTS: REMEDIES § 13 cmt. c (A.L.I., Tentative Draft No. 1, 2022) ("In cases controlled by federal law . . . damages in personal-injury cases are calculated on the basis of net income, on the theory that plaintiff has not lost money that would have gone to governments in taxes.").

199 Guest & Schap, *supra* note 187, at 86 (summarizing state case law on the taxation of tort awards).

200 Sosa v. M/V Lago Izabal, 736 F.2d 1028, 1033–34 (5th Cir. 1984); DeLucca v. United States, 670 F.2d 843, 844 (9th Cir. 1982). In both *Sosa* and *DeLucca*, the plaintiffs' lump sum tort award that encompassed many years of lost income was excluded from gross income and calculated on an after-tax basis. 736 F.2d at 1033–34; 670 F.2d at 844. However, the awards were increased due to the expected tax liability on the future earnings of the award. *Sosa*, 736 F.2d at 1033–34; *DeLucca*, 670 F.2d at 844.

2. *Breach-of-Contract Claims*

There is little precedential authority on how the tax consequences of breach of contract claims should factor into calculating damage awards, with the Restatement (Second) of the Law of Contracts not addressing the issue.[201] Although some states have recognized the possibility that unfavorable tax consequences could lead to increased awards, these decisions have generally shown a reluctance to provide them.[202] Although state courts have awarded damages for plaintiffs losing tax benefits due to a defendant's breach, that issue is distinct from increasing damage awards due to the tax consequences of the damage award itself.[203] In the former, the lost tax benefits are the very harm for which the plaintiff is seeking redress; in the latter, the tax harm arises from the defendant's payment to satisfy the plaintiff's original claim.

Federal courts have considered the matter more explicitly but have not reached a consensus. For breaches of contract, the Second Circuit has indicated skepticism that taxpayers can overcome the evidentiary burdens required to successfully prove tax damages.[204] The Seventh Circuit has stated that "[a]s a general matter, a court will not increase an award of damages to compensate for the expected tax liability on the damage award" but has also indicated that exceptions to this general rule exist; notably, when taxable damage awards replace proceeds that would have been obtained tax-free.[205] The Federal and Tenth Circuits have also indicated their willingness to increase damage awards when they replace tax-free proceeds.[206] This rule

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201 *See generally*, RESTATEMENT (SECOND) OF CONTRACTS (A.L.I. 1981).

202 *See* McGuire v. City of Jersey City, 593 A.2d 309, 316 (N.J. 1991) (considering tax damages to be too speculative); DeSantis v. Oakmont LLC, No. A128220, 2012 WL 6094145, at *17, 21 (Cal. Ct. App. Dec. 7, 2012) (noting evidentiary hurdles to increasing damage awards because of tax consequences); André Nieuwenhuizen, *The Impact of Taxes on Damage Awards and Settlements*, 19 COLO. LAW. 2453, 2455 (1990) ("The majority of cases on the subject reflect that income tax seldom has been a factor in assessing damages for breach of contract.").

203 *See, e.g.*, Walker v. Signal Companies, Inc., 149 Cal. Rptr. 119, 124 (Cal. Ct. App. 1978) (awarding damages because defendant's breach prevented plaintiff from obtaining capital gain treatment from sale of house).

204 *See* Paris v. Remington Rand, Inc., 101 F.2d 64, 68 (2d Cir. 1939) ("Such variation of tax is not a consequential damage flowing from the breach of contract").

205 Medcom Holding Co. v. Baxter Travenol Lab'ys, Inc., 106 F.3d 1388, 1404 (7th Cir. 1997) (citing Oddi v. Ayco Corp., 947 F.2d 257, 267 (7th Cir. 1991)).

206 *See* Home Sav. of Am. v. United States, 399 F.3d 1341, 1356 (Fed. Cir. 2005) (deeming award gross-up appropriate); O'Toole v. Northrop Grumman Corp., 499 F.3d 1218, 1223 (10th Cir. 2007) (remanding to district court to determine whether contractual proceeds would have been obtained tax-free).

demonstrates a willingness in some circuits to remedy unfavorable tax consequences arising due to inclusion/exclusion but not those arising in other more general situations.

Most recently, a three-judge panel of the Court of Appeals for the Federal Circuit denied an increased breach-of-contract damage award that had been approved by the lower court.[207] The case involved a lump sum payment for rental income that the defendant's breach prevented the plaintiff from obtaining.[208] The lump sum award consisted of both prior-year and forward-looking rental payments aggregated into one damage payment.[209] Although the Federal Circuit noted that tax-based recovery might have been possible, it rejected the damages because of uncertainty due to the plaintiff's request for tax damages on both the prior-year and future-year rental streams.[210] Even though the prior-year tax rates to which the plaintiffs were subjected were already known, the future-year uncertainty, in the court's view, tainted the entire claim for tax damages.[211]

Other circuits have not addressed unfavorable tax consequences arising from breaches of contract.[212] Although not explicitly addressing the issue, the D.C. and Sixth Circuits have expressed a strong reluctance to avoid tax damages in other contexts; it is likely that they would also reject tax damages for breaches of contract.[213]

3. *Statutory Claims*

A comprehensive survey of how all statutory claims are taxed is beyond the scope of this Article. However, the most widely discussed statutory claim, by far, concerns back pay awards in Title VII employment discrimination lawsuits. The federal circuits are explicitly split as to whether the unfavorable consequences arising from lump sum damage awards constitute additional damage for which the defendant is responsible.[214] The D.C. and Eighth Circuits (for claims against

[207] Sonoma Apartment Assocs. v. United States, 939 F.3d 1293, 1298–1300 (Fed. Cir. 2019).

[208] *Id.* at 1296.

[209] *Id.* at 1296–98.

[210] *Id.* at 1298–1301.

[211] *Id.*

[212] *See id.* at 1298 ("Nor have any of our sister circuits addressed this issue.").

[213] *See infra* note 215-217 and accompanying text.

[214] Spencer, *supra* note 116, at 425.

the federal government) deny damage award increases,[215] while the Third, Seventh, Eighth, Ninth, and Tenth Circuits permit it under certain circumstances.[216] Additionally, the Sixth Circuit seems opposed to awarding tax-based damages in any context.[217]

In the administrative realm, Section 10(c) of the National Labor Relations Act gives the National Labor Relations Board ("NLRB") the power to require reinstatement of an employee that has suffered an unfair labor practice.[218] This reinstatement can come with an award of the back pay lost because of the unfair labor practice, with the ultimate goal of restoring the injured party to the position they would have been in had no unfair labor practice occurred.[219] The NLRB has taken the position that injured parties should also be compensated for the excess taxes incurred when backpay is paid in a lump sum.[220]

There are limited state decisions addressing tax-based damage awards. In 2019, while awarding a tax neutralization payment for lump sum tax costs, a California appellate court noted that "there are no reported decisions in California on the concept of tax neutralization."[221] A 2021 Idaho Supreme Court decision similarly stated that the topic was one of first

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215 Dashnaw v. Peña, 12 F.3d 1112, 1116 (D.C. Cir. 1994) ("Given the complete lack of support in existing case law for tax gross-ups, we decline so to extend the law in this case."); Arneson v. Callahan, 128 F.3d 1243, 1247 (8th Cir. 1997) (denying tax damages award where defendant was the federal government); *see also* Hukkanen v. Int'l Union of Operating Eng'rs, Hoisting & Portable Loc. No. 101, 3 F.3d 281, 287 (8th Cir. 1993) ("The district court denied Hukkanen's request because she failed to present evidence of the enhancement's amount or a convenient way for the court to calculate the amount at the time the court announced its judgment.").

216 Eshelman v. Agere Sys., Inc., 554 F.3d 426, 441–42 (3rd Cir. 2009); EEOC v. N. Star Hosp., Inc., 777 F.3d 898, 904 (7th Cir. 2015); Monohon v. BNSF Ry. Co., 623 F. Supp. 3d 990, 1002 (S.D. Iowa 2022) ("This Court concludes authority for tax gross-ups exists in light of the make-whole remedy under the FRSA and similar anti-discrimination statutes . . . ."); Clemens v. CenturyLink, Inc., 874 F.3d 1113, 1117 (9th Cir. 2017); Sears v. Atchison, Topeka & Santa Fe Ry., Co., 749 F.2d 1451, 1456 (10th Cir. 1984).

217 Messing v. Provident Life & Accident Ins. Co., No. 1:20-cv-351, 2023 WL 5497946, at *8 (W.D. Mich. Aug. 25, 2023) ("[T]he concept of tax-neutralization has not been adopted in the Sixth Circuit.").

218 National Labor Relations Act § 10(c), 29 U.S.C. § 160(c).

219 *Id.*; Don Chavas, 361 NLRB 101, 102 (2014).

220 NLRB, CASEHANDLING MANUAL: PART THREE: COMPLIANCE PROCEEDINGS, SEC. 10556 (Oct. 2020).

221 Econ. v. Sutter E. Bay Hosps., 43 Cal. Rptr. 3d 495, 508 (Cal. Ct. App. 2019).

impression.[222] States with anti-discrimination statutes similar to Title VII, such as Washington and New Jersey, have held that unfavorable tax consequences can be offset by increased damage awards.[223]

C. Clarifying Existing Doctrine in Tax Damage Awards

The judicial treatment of tax-based damages remains inconsistent, with courts divided over whether and when plaintiffs should receive compensation for the unfavorable tax consequences of their damage awards. While some jurisdictions recognize tax-enhanced damages as necessary to fulfill the "make whole" principle, others reject them outright or apply inconsistent standards. This section applies the framework developed in this Article to resolve these doctrinal uncertainties, providing a principled approach for courts to assess when tax damages are appropriate. By offering clear criteria for evaluating unfavorable tax consequences, this analysis brings coherence to an area of law that is unsettled and analytically fragmented.

1. *Title VII Employment Discrimination Claims*

Circuit courts are split on whether the unfavorable tax consequences of lump sum damage awards associated with Title VII employment discrimination claims constitute damage for which defendants should be responsible.[224] The D.C. Circuit has, without elaboration, rejected such awards, while the Third, Seventh, and Tenth Circuits have upheld their validity.[225] Other circuits, including the Eighth and Ninth, have approved such awards in principle but rejected them for evidentiary reasons. Thus, even if recovery for tax damages is theoretically possible, no consensus exists on the standards to

222 Elgee v. Ret. Bd. of Pub. Employee Ret. Sys. of Idaho, 490 P.3d 1142, 1154 (Idaho 2021) (finding that the relevant statute precluded "tax loss claims").

223 Blaney v. International Ass'n of Machinists & Aerospace Workers, 87 P.3d 757, 762–63 (Wash. 2004); Mallon v. Hudson Sav. Bank, No. A-4438-16T1, 2019 WL 3297393, at *18 (N.J. Super. Ct. App. Div. July 23, 2019) (holding that a trial court may issue an award to successful plaintiffs under the New Jersey Law Against Discrimination to offset the negative tax consequences from lump sum awards).

224 *See supra* Part V.B.3.

225 *See* Clemens v. Centurylink, Inc., 874 F.3d 1113, 1116 (9th Cir. 2017) (noting that "The Third, Seventh, and Tenth Circuits have all held that district courts have the discretion to "gross up" an award to account for income-tax consequences" and that "[t]he D.C. Circuit, however, does not permit such gross ups").

apply for determining which unfavorable tax consequences are compensable. Applying the framework developed earlier provides clarity to both issues.

As described in Part V, Title VII's remediation scheme includes both compensatory and equitable relief; the former is capped by dollar amount (and thus not purely intended to make plaintiffs whole) based on number of the defendant's employees, while the latter is unlimited by statute.[226] Thus, for the unfavorable tax consequences of Title VII employment discrimination awards to be compensable requires either that the tax damages be considered equitable (as concluded by the Third, Seventh, Ninth, and Tenth Circuits) or compensatory and under the statutory cap.[227] Since Title VII limits compensatory damages to specific categories, and broadly defines equitable relief, the former interpretation is most sound.[228]

Title VII plaintiffs must, in general, prove their damages by a preponderance of the evidence.[229] As such, unfavorable tax consequences should only be compensable if the plaintiff is able to establish their existence according to this same standard. Unfavorable tax consequences associated with back pay awards would likely be easier to prove since they necessarily involve tax years for which other taxpayer attributes are fully known. However, there should be no per se bar against compensating plaintiffs for the unfavorable tax consequences associated with front pay awards. Although proving that the tax consequences of the lump sum damage award would indeed be unfavorable relative to receiving a future stream of payments might be challenging, that inquiry is distinct from the threshold question of whether the unfavorable tax consequences are a permissible item of recovery.

Title VII permits defendants to prove that the plaintiff failed to mitigate their damage after the plaintiff meets their burden of proof.[230] As described earlier, tax damages should be

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226 *See supra* Part V.A.1.

227 *See, e.g.*, *Clemens* 874 F.3d at 1117 (noting that under Title VII precedent, tax damages are equitable relief rather than legal relief.).

228 *See* Eshelman v. Agere Sys., Inc., 554 F.3d 426, 442 (3d Cir. 2009) (characterizing tax damages as equitable relief consistent with Title VII's "make whole" intent).

229 Tex. Dep't of Cmty. Affs. v. Burdine, 450 U.S. 252–53, (1981) ("[T]he plaintiff has the burden of proving by the preponderance of the evidence a prima facie case of discrimination.").

230 *See* 42 U.S.C. § 2000e–5(g)(1) ("Interim earnings or amounts earnable with reasonable diligence by the person or persons discriminated against shall operate to reduce the back pay otherwise allowable.").

subjected to the same exceptions associated with the damage award more generally.[231] As a result, employers should also be allowed to demonstrate that the plaintiff failed to mitigate the unfavorable tax consequences associated with their damage award. Precisely what mitigation in this context entails would be a fact-specific inquiry, but one that would strike the correct balance between the remedial aims of Title VII and the limits of defendant liability as envisioned by Congress.

Thus, resolving the existing circuit split with regard to unfavorable tax consequences arising from Title VII damage awards can be distilled into three distinct issues. First, confirming that unfavorable tax consequences are either equitable relief or compensatory damages under the statutory cap with a normative goal of making plaintiffs whole; second, determining that plaintiffs have proven, by a preponderance of the evidence, the unfavorable tax consequences to which they will be subjected; and third, ensuring that plaintiffs have not failed to mitigate the tax consequences of payments made in lieu of back pay awards.

2. *Tort Claims*

This Article's framework for defendant liability disagrees with the R3T's stance on certain claims for tax damages. Although allowing for tax damages in situations where the award is taxed at a higher rate than the money it is intended to replace (a taxable award replacing tax-free proceeds, for instance), the R3T, in its comment k, explicitly rejects compensating for tax mismatches in cases where damages are taxable but the underlying harm was a non-deductible loss, such as emotional distress.[232] The result is an undermining of the "make whole" principle that the R3T concedes is fundamental to tort damages in an effort to promote administrative ease.[233]

Rather than dismiss all tax damage claims when an award replaces non-deductible losses, this Article's framework recommends first ensuring a "make whole" remedy is in place. For

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231 *See supra* Part V.A.3.

232 *See supra* notes 196–197 and accompanying text; *see also* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 13 cmts. J, k (A.L.I., Tentative Draft No. 1, 2022). Comment k states "Neither . . . compensation for emotional distress, nor compensation for any other loss unconnected to tax consequences, should be inflated on the ground that the judgment will be taxable." *Id.* cmt. k.

233 *See* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 13 cmt. j (A.L.I., Tentative Draft No. 1, 2022) ("[O]f course, the make-whole principle is also fundamental to tort damages.").

punitive damages, for instance, which aim to punish rather than restore, comment k correctly rejects any increase in award due to unfavorable tax consequences. But for harms such as defamation, invasion of privacy, and other non-physical injuries where the award intends to restore the plaintiff, tax damages should potentially be recoverable.[234]

The extent to which plaintiffs can obtain tax damages in tort claims is still limited by the "make whole" exceptions discussed earlier.[235] That is, the unfavorable tax consequences must still meet the standards of foreseeability and certainty required to obtain tort damages more generally. Additionally, plaintiffs must prove their damages, tax and otherwise, by the relevant evidentiary standard. Rather than open the floodgates to a deluge of tax-related tort claims, the Article's framework tailors a workable solution to balance plaintiff restoration (the goal of the remedy) with fairness to defendants.

3. *Contract Claims*

Circuit courts are also split on whether breaches of contract can give rise to tax damage claims.[236] This split reflects two key areas of disagreement: first, whether tax damages should ever be recoverable in contract claims, and second, if they are, how courts should assess the foreseeability and certainty of tax-related harm.

As a threshold matter, only expectation damages and reliance damages are contractual remedies that are premised in restoration. Expectation damages restore the plaintiff to the financial position they would have occupied had the contract been fully performed, while reliance damages compensate for costs incurred in preparation for or in reliance on the agreement. In contrast, remedies like specific performance enforce the original terms of the contract rather than compensating for losses, and liquidated damages function as pre-determined penalties or estimates of harm, neither of which inherently involve tax consequences that should be shifted to the breaching party.

Some circuits have awarded tax damage awards only if the taxable award is replacing what would have been tax-free proceeds.[237] This narrow reading of tax damages only recognizes

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[234] For damages flowing from physical injuries, tort damages are excluded from tax, severely curtailing possible unfavorable tax consequences. I.R.C. § 104.

[235] *See supra* Part II.C.

[236] *See supra* Part V.B.2.

[237] *Id.*

the inclusion/exclusion category of unfavorable tax consequences.[238] The other categories of unfavorable tax consequences are no less burdensome to affected plaintiffs and should also potentially be recoverable.

Just as tort awards are subject to various legal limitations, so too should contract-based tax damages be assessed within the traditional constraints of contract remedies. Contract damages must be foreseeable, reasonably certain, and not avoidable through mitigation, and these same doctrines should apply to tax damages, ensuring that claims for additional compensation remain within the well-established principles of contract law. A defendant should not be liable for tax damages that were unforeseeable at the time of contracting, nor should plaintiffs recover tax-related damages that could have been mitigated through reasonable tax planning. By applying these existing limitations, courts can integrate tax damages into contract law without expanding defendant liability beyond its traditional boundaries.

However, these limitations on contract (and tort) claims should be applied to each separate unfavorable tax consequence, rather than to the plaintiff's unfavorable tax consequences in the aggregate. That is, even though some of the plaintiff's tax damages might be more difficult to prove than others, the more tenuous claims should not taint the validity of the unfavorable tax consequences that *do* satisfy the required standard. In contrast to the Federal Circuit's holding in *Sonoma*, uncertainty about future unfavorable tax consequences should not preclude a plaintiff's recovery for demonstrably more certain *past* unfavorable tax consequences.[239]

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238 *See supra* Part II.B.2.

239 *See supra* notes 207–211 and accompanying text.