

2004

## Employment Discrimination Remedies and Tax Gross Ups

Gregg Polsky

Stephen Befort

*University of Minnesota Law School*, [befor001@umn.edu](mailto:befor001@umn.edu)

Follow this and additional works at: [https://scholarship.law.umn.edu/faculty\\_articles](https://scholarship.law.umn.edu/faculty_articles)



Part of the [Law Commons](#)

---

### Recommended Citation

Gregg Polsky and Stephen Befort, *Employment Discrimination Remedies and Tax Gross Ups*, 90 IOWA LAW REVIEW 67 (2004), available at [https://scholarship.law.umn.edu/faculty\\_articles/912](https://scholarship.law.umn.edu/faculty_articles/912).

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in the Faculty Scholarship collection by an authorized administrator of the Scholarship Repository. For more information, please contact [lenzx009@umn.edu](mailto:lenzx009@umn.edu).

# Employment Discrimination Remedies and Tax Gross Ups

Gregg D. Polsky\* and Stephen F. Befort\*\*

|   |     |
|---|-----|
| INTRODUCTION .....  | 69  |
| I. ADVERSE TAX CONSEQUENCES .....   | 71  |
| A. <i>THE BUNCHING PROBLEM</i> .....  | 74  |
| B. <i>THE AMT TRAP</i> .....  | 78  |
| 1. Description of the Trap .....  | 78  |
| 2. Source of the Trap .....   | 82  |
| 3. Inclusion/Deduction vs. Exclusion.....   | 83  |
| 4. Does it Matter Whether the Fees Are Paid Pursuant to a<br>Judgment Rather than a Settlement? ..... | 88  |
| II. CASES THAT HAVE DIRECTLY ADDRESSED THE GROSS UP QUESTION .....                                    | 91  |
| A. <i>CASES ADDRESSING THE BUNCHING PROBLEM</i> .....   | 91  |
| 1. Cases in Support of Gross Ups for Bunching.....  | 91  |
| 2. Cases Against Gross Ups for Bunching.....  | 93  |
| B. <i>CASES ADDRESSING THE AMT TRAP</i> .....   | 94  |
| 1. Cases in Support of AMT Trap Gross Ups .....   | 94  |
| 2. Case Against AMT Trap Gross Ups .....  | 98  |
| III. PRIMA FACIE CASE FOR GROSS UPS.....  | 99  |
| A. <i>THE MAKE-WHOLE OBJECTIVE</i> .....  | 101 |
| B. <i>THE DETERRENCE OBJECTIVE</i> .....  | 106 |

---

\* Associate Professor of Law, University of Minnesota Law School. Thanks to Dan Farber, Francine Lipman, David Stras, and Bryan Camp for comments on an earlier draft. The authors also thank Michael Stokes Paulsen, Guy Charles, and Miranda McGowan for helpful discussions on the topic of this Article. We also thank Mychal Bruggeman for capable research assistance. Any errors or omissions are solely our responsibility.

\*\* Gray, Plant, Mooty, Mooty & Bennett Professor of Law, University of Minnesota Law School.

|  |     |
|--|-----|
| IV. ARGUMENTS AGAINST GROSS UPS .....                          | 106 |
| A. <i>NO TAX SHIFTING UNLESS SPECIFICALLY AUTHORIZED</i> ..... | 107 |
| B. <i>COURTS AWARD PRE-TAX, NOT AFTER-TAX, DOLLARS</i> .....   | 110 |
| C. <i>COMPLEXITY AND SPECULATION</i> .....                     | 113 |
| 1. <i>Bunching</i> .....                                       | 113 |
| 2. <i>AMT Trap</i> .....                                       | 114 |
| 3. <i>De Minimis Rule</i> .....                                | 116 |
| V. COMPUTING GROSS UPS IN MORE COMPLEX CASES .....             | 117 |
| CONCLUSION .....   | 119 |

## INTRODUCTION

This Article considers whether a successful employment discrimination plaintiff may be entitled, under current law, to receive an augmented award (a “gross up”) to neutralize certain adverse federal income tax consequences. The question of whether such a gross up is allowed, the resolution of which can have drastic effects on litigants, has received almost no attention from practitioners, judges, or academics. Because of the potentially enormous impact of the alternative minimum tax (AMT) on discrimination lawsuit recoveries,<sup>1</sup> the gross-up issue is now beginning to appear in reported cases.<sup>2</sup>

The three principal federal anti-discrimination statutes—Title VII of the Civil Rights Act of 1964 (“Title VII”), the Age Discrimination in Employment Act (“ADEA”), and the Americans with Disabilities Act (“ADA”)—generally confer broad equitable powers on the courts to devise remedies that will make the victims of discrimination whole in economic terms. The Internal Revenue Code (“Code”), however, sometimes operates to frustrate this make-whole objective by taxing a discrimination award more heavily than it would have taxed the components of the award had the plaintiff earned the components in due course. This excess taxation gives rise to what this Article calls “adverse tax consequences.”

A discrimination plaintiff may suffer adverse tax consequences in two distinct ways. First, the Code may subject amounts recovered to compensate for back pay and front pay losses to higher income tax rates than if the plaintiff had earned such amounts as wages in due course. This increase in tax rates is typically due to the fact that the plaintiff’s recovery is in a lump sum; as a result, a portion of the recovery may be subject to marginal rates higher than the plaintiff’s typical marginal rate.

Second, an employment discrimination recovery could implicate the AMT.<sup>3</sup> If so, the AMT may cause the recovery to be effectively taxed at rates

---

1. See discussion *infra* Part I.B (explaining the impact of the AMT on discrimination lawsuit recoveries).

2. See *Porter v. United States Agency for Int’l Dev.*, 293 F. Supp. 2d 152, 156 (D.D.C. 2003) (considering a tax gross up under Title VII); *cf. Ferrante v. Sciarretta*, No. HNT L-584-02, 2003 N.J. Super. LEXIS 408, at \*6 (N.J. Super. Ct. Law Div. Aug. 14, 2003) (considering a tax gross up under New Jersey’s Laws Against Discrimination); *Blaney v. Int’l Ass’n of Machinists & Aerospace Workers*, Dist. No. 160, 87 P.3d 757, 759 (Wash. 2004) (considering a tax gross up under the Washington Law Against Discrimination).

3. In very general terms, the AMT is an alternative tax system that was designed to ensure that the very wealthy pay more than a minimal amount of income tax. See BORRIS I. BITTKER ET AL., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 45.01, at 45-1 to 45-4 (3d ed. 2002) (discussing the purpose of the AMT). If a taxpayer’s AMT liability is greater than her regular tax liability, then the taxpayer must pay the higher amount. I.R.C. § 55(a) (2000). The AMT as it currently exists is extremely flawed. See Leonard E. Burman et al., *The AMT: Projections and Problems*, 100 TAX NOTES 105, 109 (2003). One problem with the AMT is the AMT trap for discrimination plaintiffs described in this Article. In addition, unless the AMT is repealed or substantially re-

significantly higher than the top marginal rate of 35%. In fact, in certain cases, the AMT may cause the tax on the recovery to exceed 100%—meaning that a victorious plaintiff would owe more in taxes than her recovery.<sup>4</sup> This “AMT trap” is notoriously absurd as a matter of tax policy<sup>5</sup> and “undermines the national policy of encouraging the pursuit of meritorious civil rights claims.”<sup>6</sup> Yet, the trap persists, at least in most areas of the country.<sup>7</sup>

The resolution of the gross-up issue depends ultimately on whether the federal anti-discrimination remedial provisions permit judges to shift the liability for these adverse tax consequences from the plaintiff—on whom the Code specifically imposes the liability—to the defendant—whose unlawful conduct necessitated the lawsuit that caused the adverse tax consequences. The potential vehicle for this shift is the broad equitable powers conferred upon courts to fashion relief in order to make victims of discrimination whole.

The issue of whether these broad equitable powers allow judges to shift a portion of the plaintiff’s federal income tax liability to defendants is particularly interesting since both the plaintiff’s tax liability and the defendant’s discrimination liability arise from federal statutes passed by Congress. Thus, the resolution of the issue depends on which body of statutes, the Code or the pertinent federal anti-discrimination statute, prevails over the other.

More generally, though, the issue concerns the courts’ willingness to delve into federal income tax matters in non-tax cases and focus on after-tax dollars, which are meaningful, rather than pre-tax dollars, which are meaningless.<sup>8</sup> Courts typically have been reluctant to get their hands dirty with tax law if they can avoid it. Determining after-tax income can be a painstaking process and predicting future after-tax income even more so. Nevertheless,

---

formed, this tax will soon affect a huge number of ordinary taxpayers. See *id.* at 105–06 (projecting that by 2010 one-third of all taxpayers and 92% of households with income between \$100,000 and \$500,000 will be subject to the AMT).

4. *Kenseth v. Comm’r*, 114 T.C. 399, 425–26 (2000) (Beghe, J., dissenting).

5. See Robert J. Peroni, *Reform in the Use of Phaseouts and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415, 1422–25 (2001) (criticizing the AMT trap on tax policy grounds); Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney’s Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57, 68–73 (2002) (same).

6. Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1078 (2000).

7. Due to a severe federal circuit split, the trap currently applies in some circuits but not others. See *infra* Part I.B.3 (describing the circuit split). On March 29, 2004, the Supreme Court granted certiorari with respect to the tax issue in two consolidated cases: *Commissioner v. Bunnitts*, 124 S. Ct. 1713 (2004) and *Commissioner v. Banks*, 124 S. Ct. 1712 (2004). As a result, the circuit court split will be resolved. For a more in-depth discussion of the tax issue, see *infra* Part I.B.

8. See *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490, 493–94 (1980) (recognizing that “after-tax income, rather than one’s gross income before taxes, . . . provides the only realistic measure” of lost income).

we conclude that courts have the authority to provide gross ups to discrimination plaintiffs and should exercise this authority whenever adverse tax consequences are substantial.

This Article proceeds in five parts. Part I describes the adverse tax consequences that may impact plaintiffs suing under federal anti-discrimination statutes. Part II discusses the few cases that have addressed the question of whether these statutes allow gross ups. Part III makes the *prima facie* argument that courts have the authority to provide gross ups for adverse tax consequences. Part IV sets forth and analyzes arguments against gross ups, but ultimately concludes that these counter-arguments are not fully persuasive. Finally, Part V considers the issue of gross ups in more complex discrimination lawsuits.

### I. ADVERSE TAX CONSEQUENCES

Using Title VII as an example, an employment discrimination plaintiff may recover damages for back pay and front pay losses resulting from the defendant's conduct.<sup>9</sup> In addition, a plaintiff may recover amounts that do not simply compensate the plaintiff for pecuniary losses. These non-pecuniary components, which in general are limited to an aggregate amount of no more than \$300,000,<sup>10</sup> fall into two distinct categories. "Compensatory" damages are designed to compensate the plaintiff for emotional distress and other non-pecuniary losses caused by the defendant's conduct,<sup>11</sup> while "punitive" damages serve to punish the defendant in cases where it is shown that the defendant acted with an ill motive.<sup>12</sup> In order to isolate the question of whether a gross-up award is appropriate in general from the computational issue of the proper amount of a gross up in complex cases, we start by discussing only the adverse tax consequences on pecuniary components (i.e., back-pay and front-pay awards, as adjusted for the time value of money).<sup>13</sup>

A back-pay award compensates the plaintiff for the amount of wages he had lost prior to the judgment.<sup>14</sup> Since the wages, had they been earned by the plaintiff in due course, could have been invested by the plaintiff, an interest component is generally added to the back-pay award.<sup>15</sup> On the other

---

9. 42 U.S.C. § 2000e-5(g)(1) (2000).

10. *Id.* § 1981c(b)(3).

11. *Id.*

12. *Id.* § 1981A(b)(2). See *Kolstad v. Am. Dental Ass'n*, 527 U.S. 526, 535 (1999) (holding that an award of punitive damages is appropriate under Title VII where an employer acts with malice or reckless disregard of an employee's protected rights).

13. In Part V we address these computational issues in complex cases.

14. See *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 416-17 (1975) (discussing the equitable nature of the back-pay award).

15. This interest component is usually in the form of pre-judgment interest. See, e.g., *EEOC v. Ky. State Police Dep't*, 80 F.3d 1086, 1097-98 (6th Cir. 1996) (awarding pre-judgment interest and discussing its equitability). Courts also award post-judgment interest in appropriate

hand, a front-pay award compensates the plaintiff for future wage loss.<sup>16</sup> Since the plaintiff receives the front-pay award in one lump sum (rather than as wages periodically in the future), a court must discount the award to reflect time value of money principles.<sup>17</sup>

The tax treatment of personal injury awards is relatively straightforward, except in cases in which the AMT trap, discussed below in Part I.B, is implicated. Unless the claim arises from a physical injury, a plaintiff's entire award is taxed as ordinary income, subject to the tax rates specified in Code § 1.<sup>18</sup> With respect to pecuniary damages, this tax treatment appears consistent with the tax treatment that would have been accorded the back pay and front pay had the plaintiff earned them in due course. However, pecuniary damages may in fact be taxed more heavily than the lost wages they represent. We refer to this excess taxation as an "adverse tax consequence."

To be precise, we use the term "adverse tax consequences" to refer to the amount by which (i) the after-tax dollars recovered by a plaintiff (after proper adjustment to take into account time value of money principles) for pecuniary damages is less than (ii) the after-tax dollars the plaintiff (after proper adjustment for time value of money) would have received had no discrimination occurred and the plaintiff earned the wages represented by the pecuniary damage award in due course. Therefore, for purposes of computing the amount of adverse tax consequences, the baseline is simply the amount of money the plaintiff would have had (after taxes) absent the discrimination.

---

circumstances. *See, e.g., Skalka v. Fernald Envtl. Restoration Mgmt. Corp.*, 178 F.3d 414, 428–29 (6th Cir. 1999) (awarding post-judgment interest from the date of the initial judgment).

16. Susan K. Grebeldinger, *The Role of Workplace Hostility in Determining Prospective Remedies for Employment Discrimination: A Call for Greater Judicial Discretion in Awarding Front Pay*, 1996 U. ILL. L. REV. 319, 327–28 (1996).

17. *See, e.g., Rhodes v. Guiberson Oil Tools*, 82 F.3d 615, 622 (5th Cir. 1996) (noting the district court's use of present value principles to discount the front-pay award); *Cassino v. Reichhold Chems., Inc.*, 817 F.2d 1338, 1346 (9th Cir. 1987) (discussing a jury's competence to reduce a front-pay award to present value).

18. *Cf. I.R.C. § 104(a)(2)* (2000) (excluding damages, other than punitive damages, from gross income if such damages arise from a personal physical injury). This inconsistent tax treatment between recoveries arising from a personal *physical* injury and recoveries arising from a personal *non-physical* injury has been extensively criticized on a number of grounds. *See, e.g., Karen B. Brown, Not Color- or Gender-Neutral: New Tax Treatment of Employment Discrimination Damages*, 7 S. CAL. REV. L. & WOMEN'S STUD. 223, 227–29 (1998) (contending that the inconsistent treatment creates race and gender biases); J. Martin Burke & Michael K. Friel, *Getting Physical: Excluding Personal Injury Awards Under the New Section 104(a)(2)*, 58 MONT. L. REV. 167, 168 (1997) (contending that the inconsistent treatment violates tax policy principles and creates administrative hardships); Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax*, 35 HARV. J. ON LEGIS. 447, 449–50 (1998) (criticizing the inconsistent treatment); Mark J. Wolff, *Sex, Race, and Age: Double Discrimination in Torts and Taxes*, 78 WASH. U. L.Q. 1341, 1348 (2000) (contending that there are no policy justifications for the inconsistent treatment).

A variety of circumstances can give rise to adverse tax consequences. For example, because of the so-called "marriage penalty," an award of back pay to a married plaintiff who was single at the time the back wages would have been earned may be subjected to a higher rate because of his new marital status.<sup>19</sup> In addition, adverse tax consequences may arise when Congress raises marginal tax rates. In such a case, the pecuniary damages will be taxed at the higher new rates even though the back wages they represent would have been taxed at the lower old rates.

Many other circumstances may cause the plaintiff to suffer adverse tax consequences. Two are usually by far the most significant, however, and will be the focus of this Article. First, because the pecuniary damages are paid in one lump sum (rather than periodically), the result is a "bunching" of income that, while earned over a period of time, is received and taxed in a single tax year. This bunching may cause the damages to be taxed at a higher rate than had the plaintiff received them in due course as wages.<sup>20</sup> Similarly, the AMT trap may cause the damages to be effectively taxed at higher rates than had the plaintiff received them as wages.<sup>21</sup>

Before addressing the bunching problem and the AMT trap in depth, we should emphasize that the actual computation of the precise amount of adverse tax consequences can be highly complex. We discuss some aspects of this complexity in more detail below.<sup>22</sup> The purpose of this Article, however, is not to demonstrate how to compute the precise amount of adverse tax consequences.<sup>23</sup> Rather, the purpose of this Article is to discuss the threshold question of whether discrimination plaintiffs should be compensated (i.e., grossed-up) for adverse tax consequences. Parts I.A and I.B below provide very simple, and thereby somewhat unrealistic, examples to explain the two main causes of adverse tax consequences. Although simplistic, the examples serve their purpose—to show in general terms the two main Code imperfections that are the primary source of adverse tax consequences.

---

19. See Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1429–31 (1975) (discussing the marriage penalty); Pamela B. Gann, *Abandoning Marital Status as a Factor in Allocating Income Tax Burdens*, 59 TEX. L. REV. 1, 21–22 (1980) (same); Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63, 64 (1993) (same); Michael J. McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573, 1586 (1977) (same).

20. See *infra* Part I.A (discussing the bunching problem).

21. See *infra* Part I.B (discussing the AMT trap).

22. See *infra* Part IV.C.

23. For discussions of the computational issues, see Barry Ben-Zion, *Neutralizing the Adverse Tax Consequences of a Lump-Sum Award in Employment Cases*, 13 J. FORENSIC ECON. 233–44 (2000) and Tyler J. Bowles & W. Cris Lewis, *Taxation of Damage Awards: Current Laws and Implications*, LITIG. ECON. DIG., Fall 1996, at 73–77. These articles assume without discussion that tax gross ups are permitted under federal anti-discrimination law.



## A. THE BUNCHING PROBLEM

Assume that from 1993 through 2002 an unmarried plaintiff earned \$40,000 per year in wages, had an amount of other income to offset exactly his standard deduction and personal exemption deduction, and always took the standard deduction.<sup>24</sup> In 2003, a court determines that, but for unlawful discrimination, the plaintiff would have earned \$65,000 per year, rather than \$40,000, for the past ten years.<sup>25</sup> In addition, the court determines that, even though for the next four years (2003 through 2006) it is expected that the plaintiff will continue to earn \$40,000 per year in substitute employment, the plaintiff would have earned \$65,000 per year had the discrimination not occurred. As a result, the court awards the plaintiff pecuniary damages of \$350,000 (\$250,000 of back pay and \$100,000 of front pay), and the defendant pays that amount in one lump sum to the plaintiff in 2003.

Under the tax law, the plaintiff will include the entire \$350,000 in gross income in 2003 when he receives the money.<sup>26</sup> This is so even though the \$350,000 represents an amount that the plaintiff earned (or with regard to the front pay, would have earned) over a fourteen-year time period (from 1993 through 2006).<sup>27</sup>

As a result, in 2003 the plaintiff will have taxable income equal to \$390,000, the sum of the \$40,000 in regular wages and the \$350,000 in pecuniary damages. This \$390,000 would be applied to the plaintiff's 2003 tax rates. As a result, the first \$7,000 would be taxed at 10%, the next \$21,400 at 15%, the next \$40,400 at 25%, the next \$174,600 at 28%, the next \$168,450

---

24. In order to provide a simple example to show the effects of bunching, it is assumed that the plaintiff lives in a world without a time value of money and that the 2003 tax rates apply to all prior and past years. Of course, in the real world there exists a time value of money, so the back-pay amounts would have to be augmented to take into account lost interest, and the front-pay amounts would have to be discounted to present value. Furthermore, due to the time value of money, the plaintiff's salary itself would increase over time, as would the amount of front pay lost, and tax brackets would be adjusted for inflation. It is also assumed for purposes of this example that the plaintiff incurs and pays no attorney's fees in connection with the litigation. If the plaintiff did incur and pay such fees, it might trigger the AMT trap discussed *infra* Part I.B.

25. Although Title VII states that "[b]ack pay liability shall not accrue from a date more than two years prior to the filing of a charge" of discrimination with the Equal Employment Opportunity Commission ("EEOC"), 42 U.S.C. § 2000e-5(g) (2000), the litigation life of a complicated employment discrimination case may result in a back-pay award covering a substantially longer period of time. *See, e.g.,* *Sears v. Atchison, Topeka & Santa Fe Ry. Co.*, 749 F.2d 1451, 1456 (10th Cir. 1984) (awarding seventeen years of back pay).

26. *See* Treas. Reg. § 1.446-1(c)(1)(i) (2004) (providing that cash method taxpayers include an item of gross income only when the item is actually or constructively received).

27. *See id.* (same).

at 33%, and the remaining \$78,050 at 35%.<sup>28</sup> This would yield a tax liability of \$117,832.<sup>29</sup>

Had the plaintiff not received the award in 2003, he would have had only \$40,000 of taxable income, of which \$7,000 would be taxed at 10%, the next \$21,400 at 15%, and the remaining \$11,600 at 25%, yielding a tax liability of \$6,810.<sup>30</sup> Because of the award, therefore, the plaintiff's tax liability increased by \$111,022, the excess of the \$117,832 actual tax liability over this \$6,810 hypothetical tax liability. The plaintiff's effective tax rate on the \$350,000 is thus 31.72%, the ratio of \$111,022 to \$350,000.<sup>31</sup>

Compare these tax consequences with those that would have resulted had the taxpayer not suffered from discrimination and received an extra \$25,000 in wages each year over the fourteen-year period. In such a case, the taxpayer would have had \$65,000 of gross income instead of \$40,000 in each of those fourteen years. The first \$7,000 would have been taxed at 10%, the next \$21,400 at 15%, and the remaining \$36,000 (\$25,000 of which represents the amount of extra wages received) at 25%.<sup>32</sup> Accordingly, the extra

28. See I.R.C. § 1(c) (West Supp. 2003) (providing tax rates for single taxpayers).

29. This Article discusses only federal income tax consequences. There may also be different state, local, or employment tax consequences when a plaintiff receives wages as one lump sum rather than as being paid over time.

30. See I.R.C. § 1(c) (providing tax rates for single taxpayers).

31. It might appear that the plaintiff receives a tax deferral benefit with respect to the back-pay portion that may absorb part or all of the adverse tax consequences caused by bunching. There would be no deferral benefit if the interest rate used to determine the amount of lost interest with respect to the back pay (i.e., pre-judgment interest) is an *after-tax* interest rate. For example, assume that a plaintiff recovers \$100,000 of wages, representing \$10,000 of lost wages for each of the past ten years. Assume further that the appropriate pre-tax interest rate is 10% and that the plaintiff's marginal tax rate is a constant 30%. Had the plaintiff received the \$10,000 in wages in due course, paid taxes on the wages, and invested the after-tax amount, the plaintiff would end up with \$96,715, the future value after ten years of \$7,000 annual payments invested at an after-tax rate of 7%. If, in the litigation, the plaintiff were awarded the future value after ten years of the \$10,000 annual lost wages invested at a *pre-tax* rate of 10%, the plaintiff would receive \$159,374 pre-tax, leaving him with \$111,562 after paying 30% in tax, resulting in a \$14,847 windfall. In such a case, the plaintiff is overcompensated because he was able to defer the tax on the lost wages and the interest on the wages until settlement. However, if the award were computed using an *after-tax* discount rate (i.e., 7%), the plaintiff would receive the appropriate amount. Thus, if the plaintiff were awarded the future value after ten years of the \$10,000 annual lost wages invested at an *after-tax* rate of 7%, the plaintiff would receive \$138,164 pre-tax, leaving him with \$96,715 after paying 30% in tax, the same amount as if the wages had been earned and invested in due course. Therefore, if an after-tax interest rate is used in computing pre-judgment interest, the plaintiff would receive no deferral benefit, and the adverse tax consequences attributable to bunching would be felt by the plaintiff in their entirety. However, if a pre-tax interest rate is used, the plaintiff would receive a deferral benefit, and if gross ups were allowed, the defendant should be able to argue that this deferral benefit be considered as an offset in determining the proper amount of the gross up.

32. As noted in note 24, *supra*, for purposes of this example, it is assumed that the taxpayer lives in a world without time value of money. The 2003 tax rate tables are used as the baseline so that those tables are assumed to be appropriate for all years during the relevant period, including the pre-award years.

wages, had they been earned in due course, would have been subject to a marginal tax rate of 25%, yielding a total tax liability of \$87,500 (\$6,250 of tax<sup>33</sup> per year over fourteen years). This yields an effective tax rate on the extra wages of 25%.

In this example, the lump sum award caused the plaintiff to suffer adverse tax consequences in the amount of \$23,522,<sup>34</sup> the excess of (i) \$111,022—the plaintiff's actual tax liability attributable to the \$350,000 award, over (ii) \$87,500—the plaintiff's hypothetical tax liability resulting from the hypothetical annual \$25,000 increase in wages during the fourteen-year period. The \$23,522 increased tax liability is due to the fact that the entire award is bunched into a single tax year (2003) instead of being spread out over the fourteen-year period. Because of this bunching, only \$28,800 of the \$350,000 award is subject to a 25% rate, with the remainder being subject to higher rates.<sup>35</sup> If the plaintiff had received the \$350,000 ratably over the fourteen-year period, the entire award would have been subject to a 25% rate.<sup>36</sup>

This bunching problem is a byproduct of two of the most durable features of the federal income tax: the annual accounting system and progres-

---

33. This is the product of (i) the \$25,000 of extra wages earned each year during the period, and (ii) the 25% marginal tax rate applicable to those wages.

34. Even though the plaintiff suffers adverse tax consequences in the amount of \$23,522, because a gross up itself would be taxable, see *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929) (holding that payment of an employee's taxes by the employer results in further taxable income for the employee); *Ben-Zion*, *supra* note 23, at 233, the gross up would have to be higher in order to leave the plaintiff with the \$23,522 after paying taxes on the entire gross up. The appropriate gross up equals:  $x/(1-t)$ , where  $x$  equals the amount of the adverse tax consequences and  $t$  equals the tax rate applied to the gross up. Under the facts in the hypothetical, since the plaintiff's marginal tax rate is 35%, the gross up award would have to equal \$36,187, leaving the plaintiff with \$23,522 after paying tax on the gross up award. This \$23,522 after-tax amount would then absorb the adverse tax consequences suffered by the plaintiff as a result of bunching. In *Ehly v. Cady*, 687 P.2d 687, 695 (Mont. 1984), the Montana Supreme Court inexplicably denied the plaintiff's request for an additional gross up to offset the taxes the plaintiff would incur as a result of the court's award of an initial gross up for adverse tax consequences caused by the defendant's contractual breach. This decision has been rightly criticized. See *Oddi v. Ayco Corp.*, 947 F.2d 257, 268 (7th Cir. 1991) ("To award a plaintiff damages for what would have been a nontaxable return on his investment yet to award nothing for a tax he would not have incurred but for the defendant's breach strikes us as unprincipled."). For a discussion of whether this "gross up upon a gross up" calculation can be criticized on the ground that it is unduly costly to employers, see discussion in note 278 *infra*.

35. Compare *supra* text accompanying note 28 (concluding that \$40,400 of plaintiff's actual 2003 income would be taxed at 25%) with *supra* text accompanying note 30 (concluding that, absent the discrimination recovery, only \$11,600 of plaintiff's 2003 income would have been taxed at 25%).

36. As noted in note 24, *supra*, this simple example did not take into account time value of money principles. If those principles are considered, then the plaintiff will receive a "lost interest" component in the back-pay award to take into account the fact that the plaintiff would have been able to invest back wages. As a result, the lump-sum award also bunches together this lost interest, which would have been earned periodically, into one payment, causing the interest component to be excessively taxed.

sive tax rates.<sup>37</sup> Because taxes are assessed on an annual basis, the progressive rate structure results in a greater lifetime tax liability for a taxpayer whose income significantly fluctuates year to year compared to a taxpayer whose income is stable, even if the two taxpayers earn the same amount of lifetime income.<sup>38</sup> However, if taxes were assessed on a lifetime basis, or if income was subject to a single flat rate of tax, these two taxpayers would owe the same amount of tax.<sup>39</sup>

From 1964 to 1986 the Code contained "income-averaging" provisions that alleviated the bunching problem to some extent.<sup>40</sup> These provisions allowed taxpayers whose taxable income was extraordinarily high in a given year to apply a lower marginal rate to that income.<sup>41</sup> In order to be eligible for the relief, the taxpayer's taxable income in such a year had to be 40% higher than his average taxable income for the prior three years.<sup>42</sup> Since the plaintiff in our example received a huge award relative to his typical income, had Congress not repealed these income-averaging provisions, the plaintiff would have been able to apply a lower rate to his award.<sup>43</sup> This result would have put the plaintiff closer to the economic position that he would have occupied had he earned the wages in due course.

Congress, however, repealed this income-averaging rule in the Tax Reform Act of 1986.<sup>44</sup> That Act significantly flattened the tax rate structure, reducing the top rate from 50% to 28%.<sup>45</sup> Because of the flattening of rates, the Act substantially reduced the potential adverse consequences caused by bunching. As result, Congress apparently believed that the complexity of in-

---

37. Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509, 509-10.

38. In other words, an "individual with a lifetime income of 50x [is taxed] more heavily if his income pattern consists of alternating years of zero income and 2x income than if his income were x in each year." *Id.* at 509.

39. One of the most common examples of bunching concerns the gain from the sale of long-held property. See Nohel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 328 (1993) (using stock transactions to show the effect of bunching). The gain may represent accretions that occurred over the property's holding period, yet the entire gain is reported in a single year when it is realized. *Id.* at 329-30. Alleviation of this bunching problem is sometimes cited as a justification for a having a lower tax on capital gains. *Id.* at 330. But this capital gains preference does not apply to pecuniary damage recoveries. See I.R.C. § 1222(3) (2000) (requiring that, in order to have a gain characterized as a long-term capital gain, the gain must be the result of the "sale or exchange of a capital asset").

40. Civil Rights Act of 1964, Pub. L. No. 88-272, § 232, 78 Stat. 19, 105-12 (codifying I.R.C. §§ 1301-1305). These income-averaging provisions were repealed in the Tax Reform Act of 1986, Pub. L. No. 99-514, § 141, 100 Stat. 2085, 2117.

41. See Schmalbeck, *supra* note 37, at 512-23 (describing the income-averaging provisions).

42. I.R.C. § 1302(a)(1) (1986).

43. See *id.*

44. § 141, 100 Stat. at 2117.

45. § 101, 100 Stat. at 2096-99.

come averaging now outweighed its fairness benefits.<sup>46</sup> And, even though tax rates have become more progressive since 1986, with a current top rate of 35%,<sup>47</sup> there have been no attempts to reinstate income averaging.

## B. THE AMT TRAP

### 1. Description of the Trap

Take the same example, except now the plaintiff, after winning the \$350,000 judgment, petitions the court for statutory attorney's fees pursuant to the fee-shifting provisions in the anti-discrimination statutes.<sup>48</sup> The court grants the petition and awards \$650,000 in fees to the plaintiff. The plaintiff then, pursuant to his fee agreement, pays the attorney the \$650,000 of court-awarded fees.<sup>49</sup> The tax consequences to the plaintiff with regard to this payment under current law are unclear and complicated.<sup>50</sup>

In some jurisdictions, the plaintiff must include the entire award, including the attorney fee portion of the award, in his gross income and take a deduction for the attorney fee portion.<sup>51</sup> We refer to this treatment as the inclusion/deduction method. In other jurisdictions, the plaintiff is required to include only his net recovery of \$350,000 in his gross income.<sup>52</sup> We refer to this treatment as the exclusion method. If the Code allowed the plaintiff a full and unimpaired deduction for the attorney fee portion, there would be no effective difference between the two methods because the plaintiff would always ultimately be taxed only on his \$350,000 net recovery.

However, the Code does in fact significantly impair the plaintiff's attorney fee deduction under the inclusion/deduction method. The most signifi-

---

46. One is forced to speculate as to why the income-averaging provisions were repealed since there is no explanation in the legislative history of the Tax Reform Act of 1986.

47. I.R.C. § 1 (2000).

48. *See, e.g.*, ADEA, 29 U.S.C. § 626(b) (2000) (incorporating § 16 of the FLSA, which authorizes an award of attorney fees); Title VII, 42 U.S.C. § 2000e-5(k) (2000) (authorizing an award of attorney fees); ADA, 42 U.S.C. § 12117 (2000) (adopting the remedies and enforcement procedures of Title VII).

49. A typical contingent fee agreement provides that the client will pay the attorney the greater of (a) some percentage of the client's total recovery (sometimes including statutory attorney's fees), or (b) the amount of statutory attorney's fees. In this case, the amount of statutory fees would exceed the agreed-upon percentage.

50. *See generally* Polsky, *supra* note 5 (discussing the tax treatment of attorney's fees).

51. *See, e.g.*, *Campbell v. Comm'r*, 274 F.3d 1312, 1314 (10th Cir. 2001) (requiring the plaintiff to include the attorney fee portion of the award in gross income, but then allowing the plaintiff to take a deduction for the fees); *Young v. Comm'r*, 240 F.3d 369, 377 (4th Cir. 2001) (same); *Alexander v. I.R.S.*, 72 F.3d 938, 944 (1st Cir. 1995) (same); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962) (same), *aff'd*, 319 F.2d 532 (3d Cir. 1963).

52. *See, e.g.*, *Banks v. Comm'r*, 345 F.3d 373, 386 (6th Cir. 2003) (excluding the attorney fee portion of the award from the plaintiff's gross income); *Srivastava v. Comm'r*, 220 F.3d 353, 364 (5th Cir. 2000) (same).

cant impairment is that, under the AMT, the deduction is disallowed.<sup>53</sup> Enacted by Congress in 1969 in an attempt to ensure that extremely wealthy taxpayers do not escape their fair share of taxation through excessive use of exclusions, deductions, and credits, the AMT is a separate tax regime that applies to every individual taxpayer.<sup>54</sup> In very general terms, the AMT operates by disallowing certain exclusions, deductions, and credits and then applying a lower, flatter rate structure to the taxpayer's resulting alternative minimum taxable income.<sup>55</sup> Each taxpayer is then effectively required to pay the greater of (i) his liability under the AMT, or (ii) his tax liability under the regular income tax system.<sup>56</sup>

Because the plaintiff's attorney fee deduction is one of the deductions disallowed under the AMT, the plaintiff's net recovery may be taxed at rates significantly in excess of the top marginal rate of 35%<sup>57</sup> and, in certain cases, may even be taxed at rates exceeding 100%.<sup>58</sup> In these latter cases, the AMT trap turns an apparent pre-tax "winner" into an after-tax "loser" because the plaintiff is forced to pay out of pocket some of the taxes incident to the recovery.

For example, under the inclusion/deduction method, the hypothetical plaintiff will include \$1,040,000 in gross income in 2003.<sup>59</sup> Although he will be able to deduct the \$650,000 amount of attorney's fees paid under the

---

53. See I.R.C. § 56(b)(1)(A)(i) (2000) (disallowing a deduction for miscellaneous itemized deductions). Even if the AMT is not triggered, the deduction will be limited in other ways. See Polsky, *supra* note 5, at 63–67 (describing these other impairments). However, the deduction disallowance under the AMT is generally most significant for plaintiffs. Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 531, 532 (2000); Sager & Cohen, *supra* note 6, at 1077.

54. See BORIS BITTKER & MARTIN J. MCMAHON, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 45.1, at 45-1 to 45-2 (3d ed. 2002) (discussing the purpose of the AMT). Although beyond the scope of this Article, because of very serious structural flaws, primarily Congress's failure to index its exemption amounts and rate brackets for inflation, the AMT will soon affect an astounding number of middle class taxpayers. See Burman et al., *supra* note 3, at 105 (estimating that by 2010 the AMT will affect 33 million taxpayers, half of whom have income of less than \$100,000).

55. See BITTKER & MCMAHON, *supra* note 54, ¶ 45.1, at 45-1 to 45-2 (discussing the operation of the AMT).

56. See *id.* (same). Technically, taxpayers are required to add to their tax liability—as computed under the regular income tax—the excess, if any, of (i) the amount of their liability as computed under the AMT, over (ii) their tax liability as computed under the regular income tax. I.R.C. § 55(a).

57. See Polsky, *supra* note 5, at 64–67 (giving an example of how this might happen).

58. *Kenseth v. Comm'r*, 114 T.C. 399, 425–26 (2000) (Behge, J., dissenting); see also Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, § 1, at 18 (describing case of a discrimination plaintiff who, despite obtaining a \$1,250,000 judgment, ended up with after-tax loss of \$99,000).

59. Recall that in the original hypothetical it is assumed that plaintiff will have other income to offset exactly the amount of her standard deduction and personal exemption, which are not allowed under the AMT. Therefore, technically plaintiff has more gross income; however, this additional gross income is de minimis and is ignored for purposes of the AMT computations.

regular income tax,<sup>60</sup> this deduction is disallowed under the AMT.<sup>61</sup> This disallowance will trigger the AMT,<sup>62</sup> and as a result, the plaintiff's 2003 tax liability will equal \$287,700 under this method.<sup>63</sup> Had the taxpayer just earned his regular salary of \$40,000, his tax liability would have been \$6,810.<sup>64</sup> As a result, his tax liability attributable to the recovery is \$280,890, the excess of his \$287,700 actual tax liability less the \$6,810 hypothetical tax liability.

Under the exclusion method, however, the plaintiff will include only \$350,000, the amount of his recovery net of attorney's fees. As a result, the AMT will not be triggered.<sup>65</sup> Plaintiff's gross income will equal \$390,000, and as computed previously, his tax liability will equal \$117,832.<sup>66</sup> Accordingly, under this method, his tax liability attributable to the recovery is \$111,022, the excess of his \$117,832 actual tax liability less his \$6,810 hypothetical tax liability.

Therefore, under the inclusion/deduction method, the plaintiff owes \$169,868 more in taxes than he would under the exclusion method and \$193,390 more in taxes than he would if he would have earned the wages in due course. We summarize these results in the table below.

---

60. See I.R.C. § 162(a) (2000) (allowing a deduction for certain trade or business expenses); *Alexander v. I.R.S.*, 72 F.3d 938, 944–47 (1st Cir. 1995) (holding that employee's legal fees incurred in connection with employment-related lawsuit are deductible under § 162(a)). However, even under the regular income tax, the plaintiff's attorney fee deduction would be impaired to some extent. See I.R.C. §§ 67–68 (setting a floor on miscellaneous itemized deductions and an overall limitation on itemized deductions). For a discussion of these impairments under the regular income tax and their interaction with the AMT's disallowance, see Polsky, *supra* note 5, at 65–67.

61. See I.R.C. § 56(b)(1)(A)(i) (disallowing miscellaneous itemized deductions).

62. When we say that the disallowance will "trigger" the AMT, we mean that, because the plaintiff's very large attorney fee deduction is disallowed under the AMT, the plaintiff's AMT liability will be greater than her regular tax liability. As a result, the plaintiff will be required to pay the greater AMT liability.

63. See I.R.C. § 55.

64. See *id.* §§ 1, 63.

65. The AMT will not be triggered here because, unlike under the inclusion/deduction method, the plaintiff does not lose any deductions when computing her AMT liability, and as a result her AMT liability will be less than her regular tax liability. Accordingly, the plaintiff will only be required to pay her regular tax liability.

66. See *supra* text accompanying notes 28–29 for the computation.

TABLE 1: COMPARISON OF TAX LIABILITY

|  | EARNED IN<br>DUE COURSE | EXCLUSION<br>METHOD | INCLUSION/DEDUCTION<br>METHOD |
|--|-------------------------|---------------------|-------------------------------|
| NET RECOVERY BEFORE<br>TAXES                       | \$350,000               | \$350,000           | \$350,000                     |
| TAX LIABILITY ATTRIBUTED<br>TO RECOVERY            | \$87,500                | \$111,022           | \$280,890                     |
| NET RECOVERY AFTER TAXES                           | \$262,500               | \$238,978           | \$69,110                      |
| EFFECTIVE TAX RATE ON NET<br>RECOVERY BEFORE TAXES | 25%                     | 31.72%              | 80.25%                        |
| ADVERSE TAX<br>CONSEQUENCES <sup>67</sup>          | 0                       | \$23,522            | \$193,390                     |

Thus, under the inclusion/deduction method, the taxpayer's effective tax rate on his recovery exceeds 80%, and his after-tax recovery is almost \$200,000 less than if he had earned the back pay and front pay in due course.

This AMT trap is simply awful policy for a number of reasons. The trap violates fundamental tax policy because by disallowing a deduction for attorney's fees, it effectively taxes the plaintiff on the cost of producing the (taxable) recovery.<sup>68</sup> It is axiomatic that under an income tax the expenses incurred in producing income must be excluded from the taxpayer's taxable income.<sup>69</sup> In addition, by excessively taxing discrimination and other civil rights plaintiffs, the trap "undermines the national policy of encouraging the pursuit of meritorious civil rights claims."<sup>70</sup>

The AMT trap is avoided under the exclusion method, which effectively allows a full deduction by simply excluding the attorney fee portion of the recovery from gross income. Therefore, the exclusion method achieves the correct policy result. However, as described below, the inclusion/deduction

67. As noted in note 34, *supra*, a gross up award itself would be taxable; therefore, an appropriate gross up would have to be computed using the following formula: gross up =  $x / (1-t)$ , where  $x$  is the amount of adverse tax consequences and  $t$  is the tax rate applicable to the gross up.

68. Peroni, *supra* note 5, at 1423; Polsky, *supra* note 5, at 68-73; James Serven, *Oral Argument in Hukkanen-Campbell: Taxpayer's Last Stand?*, 93 TAX NOTES 854, 859 n.39 (2001); Robert W. Wood, *Even Tax Court Itself Divided on Attorneys' Fee Issue!*, 88 TAX NOTES 573, 573 (2000).

69. *Hantzis v. Comm'r*, 638 F.2d 248, 249 (1st Cir. 1981).

70. Sager & Cohen, *supra* note 6, at 1078. Furthermore, the trap may "create[] very significant ethical, fiduciary duty, and malpractice issues for lawyers handling [employment discrimination and civil rights] claims." Gregg D. Polsky, *The Contingent Attorney's Fee Tax Trap: Ethical, Fiduciary Duty, and Malpractice Implications*, 23 VA. TAX REV. 615, 637 (2004).



method is the one followed by a majority of the federal circuits that have considered the issue.<sup>71</sup>

## 2. Source of the Trap

The AMT trap results from the characterization of the plaintiff's attorney's fees as "miscellaneous itemized deductions" under § 67 of the Code.<sup>72</sup> Section 67(b) defines this term in the negative, treating all itemized deductions as miscellaneous itemized deductions unless specifically listed in § 67(b)(1) through (12).<sup>73</sup> Attorney's fees paid by discrimination plaintiffs do not fit within any of the listed exceptions.<sup>74</sup> As a result, the deductions for these fees are disallowed for AMT purposes.<sup>75</sup>

It is clear that Congress did not make a deliberate decision to impair these fee deductions in this way.<sup>76</sup> Rather, the AMT trap is the result of mere inadvertence—a classic case of unintended consequences. Prior to 1992, it was generally assumed that discrimination awards were, like other personal injury recoveries, excluded from gross income under Code § 104(a)(2), and as a result, attorney's fees paid to recover these nontaxable awards were nondeductible.<sup>77</sup> Accordingly, prior to 1992, no one gave much thought to the taxation of attorney's fees in discrimination cases.<sup>78</sup>

However, in the 1992 case of *United States v. Burke*, the Supreme Court held that the personal injury exclusion did not apply to an award of back pay under Title VII.<sup>79</sup> In 1995, the Court likewise held that an award of back pay and liquidated damages under the ADEA did not qualify for the personal injury exclusion.<sup>80</sup> Shortly thereafter, Congress amended the § 104(a)(2) to

---

71. The Supreme Court recently granted certiorari on the tax issue underlying the AMT trap in *Commissioner v. Banaitis*, 124 S. Ct. 1713 (2004) and *Commissioner v. Banks*, 124 S. Ct. 1712 (2004). As discussed *infra* notes 287–96 and accompanying text, the likely (but not the only possible) outcome is that the Court will decide that either the inclusion/deduction method or the exclusion method applies universally.

72. See *Biehl v. Comm'r*, 351 F.3d 982, 987–88 (9th Cir. 2003) (holding that employee's legal fees incurred in connection with litigation arising out of employee's employment constitute unreimbursed employee business expenses subject to § 67); *Alexander v. I.R.S.*, 72 F.3d 938, 944–47 (1st Cir. 1995) (same). But see *Sager & Cohen*, *supra* note 6, at 1096–97 (arguing that these legal fees should be treated as reimbursed employee business expenses and therefore taken into account in computing adjusted gross income under § 62(a)).

73. I.R.C. § 67(b) (2000).

74. *Id.*

75. See *id.* § 56(b)(1)(A)(i) (disallowing miscellaneous itemized deductions).

76. See *Sinyard v. Comm'r*, 268 F.3d 756, 759 (9th Cir. 2001) (acknowledging that the "anomalous result[s] under the AMT trap were] . . . no doubt unintended").

77. See *Sager & Cohen*, *supra* note 18, at 452–73.

78. See *id.*

79. 504 U.S. 229, 242 (1992).

80. *Comm'r v. Schleier*, 515 U.S. 323, 336 (1995).

allow exclusion only in cases arising out of a personal *physical* injury.<sup>81</sup> Consequently, after 1996 it was clear that discrimination awards were fully taxable.<sup>82</sup> Because the awards were now taxable, attorney's fees expended in pursuit of the awards were now deductible, and as a result, the classification of this fee deduction was for the first time vitally important.<sup>83</sup> As noted above, the Code classifies the fee deduction as a miscellaneous itemized deduction, and this classification is the trigger for the AMT trap. It is clear that the AMT trap is merely an unintended consequence of this evolving tax treatment of employment discrimination recoveries. Despite repeated calls for reform,<sup>84</sup> Congress has not yet seen fit to amend the Code to fix the AMT trap by allowing plaintiffs to deduct attorney's fees without impairment.<sup>85</sup>

### 3. Inclusion/Deduction vs. Exclusion

There has been a tremendous amount of litigation regarding the issue of which method (inclusion/deduction or exclusion) applies.<sup>86</sup> A massive federal circuit court split has resulted, with seven circuits following the inclusion/deduction method and three circuits following the exclusion method.<sup>87</sup> Courts using the inclusion/deduction method acknowledge that the method leads to an unfair result, but determine that the Code requires

---

81. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838-39 (amending § 104(a)(2) to require a "physical" injury). As noted *supra* note 18, the inconsistent treatment of personal injury awards arising from physical versus nonphysical injury has been widely criticized by commentators.

82. See Julia K. Brazelton, *The Income Tax Treatment of Damage Awards*, 75 TAXES 562, 570-71 (1997) (discussing the effect of the 1996 change).

83. Sager & Cohen, *supra* note 6, at 1079.

84. See 2002 IRS ANN. REP. TO CONG. 169 [hereinafter NATIONAL TAXPAYER ADVOCATE REPORT] (advocating that § 62 be amended to add these deductions to those which are taken into account in computing the taxpayer's adjusted gross income); see also Polsky, *supra* note 5, at 120 (same). Another possible solution would be to amend § 104(a)(2) to exclude discrimination recoveries from gross income. See, e.g., Civil Rights Tax Relief Act of 2003, S. 557, 108th Cong. (exemplifying a Senate bill that would exclude discrimination awards from gross income, but was not enacted). Many commentators have argued that, as a general policy matter, these damages should be excluded. See, e.g., Karen B. Brown, *supra* note 18 (contending that the current treatment creates gender and race bias); Burke & Friel, *supra* note 18 (highlighting many policy reasons for excluding the damages); Sager & Cohen, *supra* note 18 (contending that the inclusion of damages is discriminatory); Wolff, *supra* note 18 (contending that there is no policy reason for including discrimination damages in gross income). If these damages were entirely excluded, the AMT trap would no longer affect discrimination plaintiffs; however, the AMT trap would persist for plaintiffs filing employment-related claims not involving discrimination, as well as consumer fraud claims, defamation claims, claims for intentional infliction of emotional distress, claims for punitive damages, and many other common claims.

85. Several bills have been proposed that would fix the AMT trap in discrimination cases, but they have not been enacted. See, e.g., Civil Rights Tax Relief Act of 2003, S. 557, 108th Cong. (excluding unlawful discrimination damages from gross income).

86. See NATIONAL TAXPAYER ADVOCATE REPORT, *supra* note 84, at 164-65 (describing the litigation).

87. *Id.* at 161-66 (describing the circuit split on the issue).

such a result.<sup>88</sup> Courts using the exclusion method appear to use a creative, arguably strained characterization of contingent fee arrangements to achieve a fair result.<sup>89</sup>

The issue centers on the characterization of the contingent fee agreement.<sup>90</sup> Courts using the exclusion method determine that the fee agreement operates to transfer a portion of the plaintiff's claim to the attorney.<sup>91</sup> Under this view, when the attorney is paid, the payment is attributable to the attorney's prior interest in the claim, and therefore, the payment is not included in the plaintiff's gross income.<sup>92</sup>

Courts using the inclusion/deduction method determine either that (i) the contingent fee agreement effects no such transfer of a portion of the claim,<sup>93</sup> or (ii) if such a transfer is deemed to occur, that the transfer is ineffective for tax purposes under the assignment of income doctrine.<sup>94</sup> As a result, these courts hold that the plaintiff must include the full amount of the recovery (including the attorney fee portion) in gross income and then take a deduction for the attorney fee portion.<sup>95</sup>

In determining which method is appropriate, some courts have analyzed the relevant state attorney lien law to determine the strength of the attorney's rights and powers with respect to the plaintiff's claim.<sup>96</sup> In general, these courts evaluate underlying attorney lien law to determine to what extent this law grants attorneys proprietary interests in plaintiffs' causes of action. It is beyond this scope of this Article to analyze in depth this tax issue,<sup>97</sup> though it is clear that the courts are woefully confused and that they have created a terrific mess. What is important for our purposes now is to explain

---

88. *E.g.*, *Alexander v. I.R.S.*, 72 F.3d 938, 946 (1st Cir. 1995).

89. *E.g.*, *Banks v. Comm'r*, 345 F.3d 373, 382–86 (6th Cir. 2003); *see also* *Polsky*, *supra* note 5, at 78–120 (describing and analyzing these characterizations).

90. *See* *Polsky*, *supra* note 5, at 74–78 (same).

91. *See, e.g.*, *Srivastava v. Comm'r*, 220 F.3d 353, 364 (5th Cir. 2000) (allowing a plaintiff to exclude the attorney fee portion of the award from gross income when the fee was contingent upon winning); *Davis v. Comm'r*, 210 F.3d 1346, 1347 (11th Cir. 2000) (same); *Estate of Clarks v. Comm'r*, 202 F.3d 854, 856 (6th Cir. 2000) (same); *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) (same).

92. *Srivastava*, 220 F.3d at 363; *Cotnam*, 263 F.2d at 125.

93. *Young v. Comm'r*, 240 F.3d 369, 376–77 (4th Cir. 2001).

94. *Campbell v. Comm'r*, 274 F.3d 1312, 1314 (10th Cir. 2001); *Sinyard v. Comm'r*, 268 F.3d 756, 758–59 (9th Cir. 2001). For a discussion of the assignment of income doctrine in the context of contingent fee arrangements, *see* *Polsky*, *supra* note 5, at 78–92.

95. *See, e.g.*, *Kenseth v. Comm'r*, 259 F.3d 881, 884 (7th Cir. 2001) (requiring inclusion of attorney fee portion of award in gross income); *Young*, 240 F.3d at 376–78 (same); *Coady v. Comm'r*, 213 F.3d 1187, 1189 (9th Cir. 2000) (same).

96. *See, e.g.*, *Raymond v. United States*, 355 F.3d 107, 114–15 (2d Cir. 2004); *Coady*, 213 F.3d at 1190; *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995).

97. For a full discussion of the attorney lien issue, *see* generally *Thad Davis, Cotnam v. Commissioner and the Income Tax Treatment of Contingency-Based Attorneys' Fees—The Alabama Attorney's Charging Lien Meets Lucas v. Earl Head-On*, 51 ALA. L. REV. 1683 (2000).

the state of the tax law as it exists right now, which the below chart demonstrates:

TABLE 2: STATE OF THE TAX LAW BY CIRCUIT

| CIRCUIT  | METHOD                             | DOES STATE LIEN<br>LAW MATTER? | WHAT STATE LAW<br>ANALYZED?  |
|----------|------------------------------------|--------------------------------|--|
| FIRST    | Inclusion/Deduction <sup>98</sup>  | No <sup>99</sup>               | N/A  |
| SECOND   | Inclusion/Deduction <sup>100</sup> | Yes                            | Vermont  |
| THIRD    | Inclusion/Deduction <sup>101</sup> | No                             | N/A  |
| FOURTH   | Inclusion/Deduction <sup>102</sup> | No                             | N/A  |
| FIFTH    | Exclusion <sup>103</sup>           | No                             | N/A  |
| SIXTH    | Exclusion <sup>104</sup>           | No                             | N/A  |
| SEVENTH  | Inclusion/Deduction <sup>105</sup> | No <sup>106</sup>              | N/A  |
| EIGHTH   | No decision yet                    | N/A                            | N/A  |
| NINTH    | Mixed <sup>107</sup>               | Perhaps                        | California, <sup>108</sup> Alaska, <sup>109</sup><br>Oregon <sup>110</sup> |
| TENTH    | Inclusion/Deduction <sup>111</sup> | No                             | N/A  |
| ELEVENTH | Exclusion <sup>112</sup>           | Yes                            | Alabama  |
| FEDERAL  | Inclusion/Deduction <sup>113</sup> | Yes                            | Maryland   |
| D.C.     | No decision yet                    | N/A                            | N/A  |

98. *Alexander v. I.R.S.*, 72 F.3d 938, 942-43 (1st Cir. 1995).

99. The *Alexander* court did not address state attorney lien law in its analysis. Though it did not explicitly disclaim the lien law's relevance, we assume that, in failing to address the question, it implicitly did so. *See id.*

100. *Raymond*, 355 F.3d at 117.

101. *O'Brien v. Comm'r*, 319 F.2d 532, 532 (3d Cir. 1963).

102. *Young v. Comm'r*, 240 F.3d 369, 372 (4th Cir. 2001).

103. *Srivastava v. Comm'r*, 220 F.3d 353, 355 (5th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119, 121 (5th Cir. 1959).

104. *Banks v. Comm'r*, 345 F.3d 373, 386 (6th Cir. 2003); *Estate of Clarks v. United States*, 202 F.3d 854, 858 (6th Cir. 2000).

105. *Kenseth v. Comm'r*, 259 F.3d 881, 883-85 (7th Cir. 2001).

106. While Judge Posner, writing for the Seventh Circuit in the *Kenseth* opinion, does refer to underlying attorney lien law, he does so only to note simply that the attorney is granted a security interest in, and not ownership of, the plaintiff's claim. *Id.* at 883. Since all attorney lien laws grant only such a security interest, it would appear that the Seventh Circuit would apply the inclusion/deduction method universally.

107. *See infra* notes 119-21 and accompanying text for a discussion of the Ninth Circuit's decisions.

108. *Benci-Woodward v. Comm'r*, 219 F.3d 941, 943 (9th Cir. 2000).

109. *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000).

110. *Banaitis v. Comm'r*, 340 F.3d 1074, 1083 (9th Cir. 2003).

111. *Campbell v. Comm'r*, 274 F.3d 1312, 1314 (10th Cir. 2001).

112. *Davis v. Comm'r*, 210 F.3d 1346, 1348 (11th Cir. 2000).

113. *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995).

Under current law, therefore, the AMT trap arises in all tax cases appealable to the First, Third, Fourth, Seventh and Tenth circuits, regardless of state attorney lien law.<sup>114</sup> On the other hand, the AMT trap will never arise in the Fifth and Sixth circuits.<sup>115</sup>

In the Second and Federal Circuits, the courts of appeal have used the inclusion/deduction method, but in so doing they analyzed underlying attorney lien law in Vermont<sup>116</sup> and Massachusetts<sup>117</sup> respectively. As a result, even though it is clear that plaintiffs whose fee arrangements were governed by the same state law would face the AMT trap in those circuits, it is unclear what these courts would do if they were faced with attorney lien law from other states. Likewise, the Eleventh Circuit, in following the exclusion method, relied on Alabama's attorney lien law; thus, while there would be no AMT trap for Alabama plaintiffs who were within the Eleventh Circuit's jurisdiction, the answer is not clear for plaintiffs whose fee arrangement is governed by non-Alabama lien law.<sup>118</sup>

The Ninth Circuit's jurisprudence on this issue is particularly bizarre in that it appears as if there is a "split" within the circuit. In *Sinyard v. Commissioner*, a panel of the Ninth Circuit followed the inclusion/deduction method and concluded that the underlying state attorney lien law was completely irrelevant to the issue.<sup>119</sup> In two earlier cases, panels of the Ninth Circuit followed the inclusion/deduction method only after analyzing California and Alaska attorney lien statutes.<sup>120</sup> Recently however, another panel of the court, in a case involving the Oregon attorney lien law, followed the exclusion method after an analysis of that law.<sup>121</sup> As a result, the most conservative conclusions to be drawn from the Ninth Circuit are the following: (i) plaintiffs within the Ninth Circuit's jurisdiction whose fee agreements are governed by California or Alaska law will be subject to the AMT trap; (ii) plaintiffs within the Ninth Circuit's jurisdiction whose fee agreements are governed by Oregon law will *not* be subject to the AMT trap; and (iii) the AMT trap implications for all other plaintiffs in the Ninth Circuit are not clear.

---

114. *Campbell*, 274 F.3d at 1314; *Young v. Comm'r*, 240 F.3d 369, 372 (4th Cir. 2001); *Alexander v. I.R.S.*, 72 F.3d 938, 942-43 (1st Cir. 1995); *O'Brien v. Comm'r*, 38 T.C. 707, 712, *aff'd*, 319 F.2d 532, 532 (3d Cir. 1963).

115. *Srivastava v. Comm'r*, 220 F.3d 353, 358 (5th Cir. 2000); *Banks v. Comm'r*, 345 F.3d 373, 386 (6th Cir. 2003).

116. *Raymond v. United States*, 355 F.3d 107, 117 (2d Cir. 2004).

117. *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995).

118. *Davis v. Comm'r*, 210 F.3d 1346, 1348 (11th Cir. 2000).

119. *Sinyard v. Comm'r*, 268 F.3d 756, 760 (9th Cir. 2001).

120. *Benci-Woodward v. Comm'r*, 219 F.3d 941, 943 (9th Cir. 2000) (California); *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000) (Alaska).

121. *Banaitis v. Comm'r*, 340 F.3d 1074, 1082-83 (9th Cir. 2003).

The chart below displays the above conclusions:<sup>122</sup>

TABLE 3: PLAINTIFF'S FEE AGREEMENT AND STATE LIEN LAWS

| CIRCUIT  | PLAINTIFFS WHOSE FEE AGREEMENTS UNDER THESE STATE ATTORNEY LIEN LAWS ARE CLEARLY SUBJECT TO THE AMT TRAP | PLAINTIFFS WHOSE FEE AGREEMENTS UNDER THESE STATE ATTORNEY LIEN LAWS ARE CLEARLY NOT SUBJECT TO THE AMT TRAP | LAW IS <i>UNCERTAIN</i> FOR PLAINTIFFS WHOSE FEE AGREEMENTS ARE GOVERNED BY THESE STATES' ATTORNEY LIEN LAWS |
|----------|--|--|--|
| FIRST    | All states   | None   | None   |
| SECOND   | Vermont  | None   | All but Vermont  |
| THIRD    | All states   | None   | None   |
| FOURTH   | All states   | None   | None   |
| FIFTH    | None   | All states   | None   |
| SIXTH    | None   | All states   | None   |
| SEVENTH  | All states   | None   | None   |
| EIGHTH   | None   | None   | All states   |
| NINTH    | California, Alaska   | Oregon   | All but California, Alaska and Oregon  |
| TENTH    | All states   | None   | None   |
| ELEVENTH | None   | Alabama  | All but Alabama  |
| FEDERAL  | Maryland   | None   | All but Maryland   |
| D.C.     | None   | None   | All states   |

In determining the existence of adverse tax consequences attributable to the AMT trap, cases in which it is clear that, based on current law, the AMT trap will apply (those cases in column two) or will not apply (those cases in column three) will provide for an easy determination. However, in all other cases (those cases in column four), determining the existence of the plaintiff's adverse tax consequences will prove to be more difficult, since it would be unclear whether the AMT trap will be implicated. Determining the amount of adverse tax consequences in these column four cases would require some speculation as to how the reviewing circuit court would analyze the tax issue.

Furthermore, because the Supreme Court recently granted certiorari with respect to the tax issue in two consolidated cases, predicting whether a plaintiff will be subject to the AMT trap is even more complicated, though the Court probably will clarify the matter for future cases. We discuss the

122. As previously noted *supra* note 71, the Supreme Court recently granted certiorari in two cases. The chart is based on the law that existed as of August 1, 2004, before the Court's decision in these two cases. For a discussion of the possible outcomes in these cases, see Part IV.C.2. *infra*.

upcoming Court decision in more depth in Part IV.C.2, but for all other parts of this Article we assume that the plaintiff lives in a jurisdiction where it is clear that the AMT trap will be implicated (i.e., column two cases).

#### 4. Does it Matter Whether the Fees Are Paid Pursuant to a Judgment Rather than a Settlement?

All of the reported decisions analyzing the AMT trap have involved settlements where either the plaintiff has paid his attorney the relevant amount of fees out of her total recovery, or where the defendant, pursuant to the terms of the settlement, wrote two different checks—one to the plaintiff representing his net recovery and one to the plaintiff's attorney representing his fee.<sup>123</sup> None have involved the situation that we address in this paper—where the defendant pays the plaintiff's attorney, not pursuant to a settlement, but rather pursuant to a court order under a fee-shifting statute after a victory by the plaintiff at trial.<sup>124</sup>

In order to explain this issue a bit better, consider the Ninth Circuit's decision in *Sinyard v. Commissioner*.<sup>125</sup> *Sinyard* involved the settlement of an age discrimination claim filed pursuant to the ADEA.<sup>126</sup> Upon settlement, one-third of the total settlement amount was paid directly to the plaintiff's attorney as his fee.<sup>127</sup> The tax issue was whether the plaintiff was required to include the entire settlement amount in his gross income (and receive a miscellaneous itemized deduction for the payment of the fees), or whether he could merely exclude the attorney fee portion of the recovery.<sup>128</sup>

Under the ADEA, like the other anti-discrimination statutes, a successful plaintiff is entitled to statutory attorney's fees.<sup>129</sup> This potential obligation of the defendant to pay the plaintiff's attorney's fees was presumably

123. See *Porter v. United States Agency for Int'l Dev.*, 293 F. Supp. 2d 152, 156 (D.D.C. 2003) (stating that “[n]o court has squarely held that a Title VII award (as distinct from a fee payable from a lump sum settlement) is as taxable to the successful plaintiff as the contingent fee payable from an ordinary award of damages”). One case that followed the inclusion/deduction method, *Coady v. Commissioner*, 213 F.3d 1187, 1187–88 (9th Cir. 2000), did involve payment of fees after a judgment, but that case did not involve a fee-shifting statute.

124. Cf. *Coady*, 213 F.3d at 1187–88 (exemplifying a case that involves payment of fees after a judgment, but not under a fee-shifting statute). One case assumed without any discussion whatsoever that the AMT trap would apply equally to cases in which the attorney's fees were paid under a court order pursuant to a fee-shifting statute. See *Spina v. Forest Pres. Dist.*, 207 F. Supp. 2d 764, 777 (N.D. Ill. 2002). This case is discussed in more detail in Part II.B.2 *infra*.

125. 268 F.3d 756 (9th Cir. 2001).

126. *Id.* at 757.

127. *Id.* The computation of the attorney's one-third portion of the settlement was computed after reducing the settlement amount by the amount of costs reimbursed to the attorney.

128. *Id.*

129. See ADEA, 29 U.S.C. § 626(b) (2000) (incorporating § 16 of the FLSA, which authorizes an award of attorney fees); see also Title VII, 42 U.S.C. 2000e-5(k) (2000) (allowing courts to award attorney fees to successful discrimination plaintiffs); ADA, 42 U.S.C. § 12117 (2000) (adopting the remedies and enforcement procedures of Title VII).

wrapped up into the settlement amount since, if the plaintiff had prevailed at trial, the defendant would be responsible for the plaintiff's fees. The plaintiff in *Sinyard* argued that because the underlying statutory claim provided for fee-shifting, the attorney's fees paid directly by defendant to the attorney should not be deemed to "flow through" the plaintiff.<sup>130</sup> To state the argument a bit differently, because the statute obligates the defendant to pay the attorney's fees, the plaintiff does not realize gross income upon such payment.

The court rejected this argument, citing the famous Supreme Court tax case of *Old Colony Trust Co. v. Commissioner*.<sup>131</sup> *Old Colony Trust* held that when a third party discharges the taxpayer's obligation, the taxpayer realizes gross income in the amount of the discharged obligation.<sup>132</sup> According to the *Sinyard* Court, such a discharge occurred because the contingent fee agreement obligated the plaintiff to pay the attorney an amount of fees, and the defendant paid them on the plaintiff's behalf pursuant to the settlement. In reaching this conclusion, the Court noted that the contingent fee agreement obligated the plaintiff to pay his lawyer the specified percentage of the recovery, and that under the ADEA "attorney's fees are available to prevailing plaintiffs, not to plaintiff's counsel."<sup>133</sup> According to the Court, when the defendant paid the plaintiff's attorney directly, it was merely discharging (on behalf of the plaintiff) the plaintiff's obligation to pay the attorney under the contingent fee agreement.<sup>134</sup> Consequently, the attorney fee portion of the settlement was included in the plaintiff's gross income.<sup>135</sup>

The question then arises whether the outcome in *Sinyard* would have been different if the case had proceeded to trial and the defendant had paid the statutory attorney's fees pursuant to a court order. We believe that the answer is no. Before we get to our analysis of this issue, it should first be pointed out that the typical contingent fee agreement in a discrimination claim obligates the plaintiff to pay the attorney the greater of (i) some specified percentage of the plaintiff's overall recovery (sometimes including court-awarded fees), or (ii) the amount of the court-awarded fees.

There are three reasons why the *Sinyard* analysis should apply equally to statutory attorney's fees paid after trial pursuant to a court order. First, as *Sinyard* itself notes,<sup>136</sup> it is the plaintiff and not the attorney who has the right under the statute to petition for court-awarded fees, and the court-awarded

---

130. *Sinyard*, 268 F.3d at 758.

131. 279 U.S. 716 (1929).

132. *Id.* at 726.

133. *Sinyard*, 268 F.3d at 759.

134. *Id.*

135. *Id.*

136. *Id.*



fees are payable to the plaintiff and not the attorney.<sup>137</sup> Second, assuming that a typical contingent fee agreement (as described above) governs the plaintiff's relationship with the attorney, by paying court-awarded fees to the attorney directly, the defendant is merely discharging the plaintiff's own obligation to pay the attorney that amount pursuant to the contingent fee agreement;<sup>138</sup> therefore, under *Old Colony Trust*, the discharge results in gross income to the plaintiff.<sup>139</sup> Third, a contrary rule would create the perverse tax incentive to *not* settle a case. If the only way to avoid the AMT trap would be to take the case all the way to trial and obtain and collect a judgment, then the AMT trap would constitute a significant economic impediment to settlement at any point during the case (i.e., before trial, during trial, after trial and pending appeal) in claims brought pursuant to fee-shifting statutes. For these reasons, whether the defendant pays the plaintiff's attorney's fees pursuant to a settlement or a court order should not affect whether the AMT trap is implicated.<sup>140</sup>

---

137. See 42 U.S.C. § 2000e-5(k) (2000) (providing that a prevailing plaintiff in civil rights litigation under Title VII is eligible to receive reasonable attorney's fees); *Blanchard v. Bergeron*, 489 U.S. 87, 94-95 (1989) (holding that the ordinary calculation of the statutory fee award is appropriate even if the plaintiff pays the attorney by the hour and the aggregate amount of such actual fee is different than the amount computed under the ordinary calculation); *Evans v. Jeff D.*, 475 U.S. 717, 730-32 (1986) (finding that in enacting the Civil Rights Attorney's Fees Act, "Congress bestowed on the 'prevailing party' a statutory eligibility for a discretionary award of attorney's fees in specified civil actions," but did not "bestow[ ] fee awards upon attorneys" and, as a result, holding that prevailing parties can waive, settle, or negotiate their rights to such fees without the consent of their attorney (emphasis added)); *Blum v. Stenson*, 465 U.S. 886, 897 (1984) (awarding statutory fee award even where plaintiff was represented for free by nonprofit legal aid organization).

138. Cf. *Vengas v. Mitchell*, 495 U.S. 82, 87 (1990) (holding that a statutory fee award is independent of any private agreement between the plaintiff and the attorney, and accordingly, that the parties may negotiate for a fee that exceeds the amount of the statutory fee award); see also *Gilbrook v. City of Westminster*, 177 F.3d 839, 872-75 (9th Cir. 1999) (holding that absent contractual arrangement to the contrary, § 1988 requires that statutory fee awards be paid to plaintiffs, not plaintiff's counsel).

139. *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 726 (1929).

140. Professors Laura Sager and Stephen Cohen have argued that in employment-related cases, the plaintiff's attorney's fee deduction should be characterized as a reimbursed employee business expense. Sager & Cohen, *supra* note 6, at 1096-97. If this characterization were to prevail, the AMT trap would not arise because the fee deduction would be unimpaired. However, the courts have not agreed with this analysis. See *Biehl v. Comm'r*, 351 F.3d 982, 987-88 (9th Cir. 2003) (holding that the attorney fee deduction is not considered a reimbursed employee business expense); *Alexander v. I.R.S.*, 72 F.3d 938, 944-47 (1st Cir. 1995) (same). Professors Sager and Cohen have further argued that the characterization of the fee deduction as a reimbursed employee business expense is particularly strong in employment-related cases where the fees are awarded pursuant to a court order. Sager & Cohen, *supra* note 6, at 1098-99. Although no decision has yet addressed this characterization issue with respect to cases involving court-awarded fees (as opposed to fees paid pursuant to a settlement), the most recent decision on the characterization issue suggests that Professors Sager's and Cohen's argument would fail even in cases involving court-awarded fees. See *Biehl*, 351 F.3d at 987 (holding that in order for a payment of plaintiff's attorney's fees in an employment-related case to be considered a reim-

## II. CASES THAT HAVE DIRECTLY ADDRESSED THE GROSS UP QUESTION

Part I demonstrated why discrimination plaintiffs who receive pecuniary damages may suffer adverse tax consequences. This Part considers the existing case law with respect to the question of whether judges have the ability to shift the burden of those consequences to defendants by requiring defendants to gross up plaintiffs.

### A. CASES ADDRESSING THE BUNCHING PROBLEM

Several cases have addressed the propriety of gross ups for adverse tax consequences caused by the bunching of multi-year income into a single year. Only two circuit court decisions have squarely addressed the issue, with each coming to a different conclusion.

#### 1. Cases in Support of Gross Ups for Bunching

The leading case in support of gross ups to compensate for adverse tax consequences caused by bunching is the 1984 decision of the Tenth Circuit Court of Appeals in *Sears v. Atchison, Topeka & Santa Fe Railway Co.*<sup>141</sup> In that case, the trial court had awarded seventeen years worth of back pay to a class of train porters to remedy a long-running race-based violation of Title VII.<sup>142</sup> The payment of this award in a lump sum would have placed most of the members of the class in the highest income tax bracket for the year of receipt. Noting the wide discretion that courts have in fashioning remedies to make victims of discrimination whole, the Tenth Circuit held that the trial court did not abuse its discretion “when it included a tax component in the back pay award to compensate class members for their additional tax liability.”<sup>143</sup> The court stated, “A tax component may not be appropriate in a typical Title VII case. But this case presents special circumstances in view of the protracted nature of the litigation.”<sup>144</sup> The special circumstance in the instant case was the extreme amount of bunching present—wages that the plaintiff would have earned over seventeen years were now bunched together into a single year.

Several lower court cases, as well as some agencies,<sup>145</sup> have followed the *Sears* decision and allowed gross ups for bunching. One of these cases,

---

bursed employee business expense, the payment would have to occur while the plaintiff was still employed by the payor and would have to represent an expense that was incurred by the plaintiff on behalf of the payor).

141. 749 F.2d 1451 (10th Cir. 1984).

142. *Id.* at 1453.

143. *Id.* at 1456.

144. *Id.*

145. See ERNEST C. HADLEY, A GUIDE TO FEDERAL SECTOR EQUAL EMPLOYMENT LAW & PRACTICE 1461–62 (2003) (discussing federal sector cases authorizing a monetary supplement to compensate for enhanced income tax liability); Memorandum from the NLRB General Counsel, to All Regional Directors, Officers in Charge and Resident Officers (Sept. 22, 2000)

*O'Neill v. Sears, Roebuck and Co.*,<sup>146</sup> is particularly instructive. The federal district court in that case awarded back pay, front pay, and liquidated damages under the ADEA as well as compensatory damages under the Pennsylvania Human Relations Act.<sup>147</sup> Upon plaintiff's motion, the court enhanced the back-pay and front-pay awards to compensate for the negative tax consequences of the lump-sum award.<sup>148</sup> The court explained:

As the television advertisement of a few years ago said: "It's not how much you make, it is how much you *keep*." The goal of the ADEA is to allow plaintiff to *keep* the same amount of money as if he had not been unlawfully terminated. Compliance with this goal requires reimbursement for the reduced amount of front pay money that the plaintiff has to invest as a result of higher taxes, as well as reimbursement for the higher taxes he must pay on his back wages by getting this money in a lump sum.<sup>149</sup>

The *O'Neill* court therefore explicitly "thought" in terms of after-tax dollars, at least with respect to pecuniary damages. Because the plaintiff, due to bunching, would have received fewer after-tax dollars than he would have had he earned the wages in due course, the court determined that a gross up was appropriate.<sup>150</sup>

The *O'Neill* court, however, declined to order a tax supplement for the compensatory and liquidated damage (i.e., the non-pecuniary) portions of the award. The court explained that the compensatory and punitive damage awards were not make-whole relief, but solely a product of the lawsuit.<sup>151</sup> According to the court: "Hence, allowing the plaintiff to recover the increased tax he will have to pay on these [compensatory and punitive] sums does

(on file with the Iowa Law Review) (advising regional directors to seek a tax component to reimburse discriminatees for excess tax liability resulting from a lump-sum-backpay award).

146. 108 F. Supp. 2d 443 (E.D. Pa. 2000).

147. *Id.*

148. *Id.* at 446.

149. *Id.* at 447; *see also* Gelof v. Papineau, 829 F.2d 452, 455, 455 n.2 (3d Cir. 1987) (remanding, after defendant conceded that a gross up for bunching was appropriate, back to the trial court for a precise computation of the amount of the gross up, but specifically noting that due to defendant's concession, it had no occasion to "address the question of whether [a gross up] award [to compensate for bunching] should be made in all back pay cases"); Arneson v. Sullivan, 958 F. Supp. 443, 446 (E.D. Mo. 1996) (following *Sears* in awarding a tax gross up where nine years of wages were bunched together into a single year); *cf.* Blim v. W. Elec. Co., 731 F.2d 1473, 1480 (10th Cir. 1984) (denying summarily age discrimination plaintiff's plea for gross up because the income-averaging provisions then in effect would sufficiently ameliorate any significant adverse tax consequences).

150. However, the court's gross up was inadequate because it did not take into account the fact that the gross up itself was taxable. *See* Ben-Zion, *supra* note 23, at 241 n.16 (explaining that because the gross up was taxable, the gross up in *O'Neill* should have been \$54,086 instead of \$38,780 in order to make the plaintiff whole).

151. *O'Neill*, 108 F. Supp. 2d at 448.

more than make him whole. It gives the plaintiff a windfall."<sup>152</sup> In other words, the *O'Neill* court recognized that while there was an obvious "baseline" to be used for determining adverse tax consequences for pecuniary awards—the amount of after-tax wages the plaintiff would have had in the absence of discrimination—there was no similarly obvious baseline for compensatory or liquidated damages. Although this computational point is important, and we will discuss it in more depth below,<sup>153</sup> the *O'Neill* decision clearly supports the proposition that courts may award gross ups to compensate the plaintiff for adverse tax consequences caused by bunching to the extent that the pecuniary damages are adversely affected.<sup>154</sup>

## 2. Cases Against Gross Ups for Bunching

The leading case against gross ups for adverse tax consequences caused by bunching is the 1994 D.C. Circuit case of *Dashnaw v. Pena*.<sup>155</sup> In that case, the court summarily denied the plaintiff's plea for a gross up as follows:

[The plaintiff] also argues that the District Court should have granted him additional compensation to help cover the higher taxes he will have to pay because he will receive his backpay in a lump sum rather than as salary paid out over a period of years. Absent an arrangement by voluntary settlement of the parties, the general rule that victims of discrimination should be made whole does not support "gross-ups" of backpay to cover tax liability. We know of no authority for such relief, and appellee points to none. Given the complete lack of support in existing case law for tax gross-ups, we decline to extend the law in this case.<sup>156</sup>

The *Dashnaw* court therefore denied the gross up based solely on the perceived absence of authority. Yet, as discussed above, the Tenth Circuit decision in *Sears* ten years earlier was directly on point and supported the proposition that gross ups were appropriate in certain instances to neutralize the adverse tax consequences caused by bunching.<sup>157</sup>

---

152. *Id.*

153. See discussion *infra* Part V (discussing gross ups in complex cases).

154. The *O'Neill* court noted that the calculation of a tax effect supplement generally will require an expert's analysis in a properly developed record. 108 F. Supp. at 447; see also *Gelof v. Papineau*, 829 F.2d 452, 455–56 (3d Cir. 1987) (remanding, after defendant conceded that a gross up for bunching was appropriate, the issue of a tax effect supplement for further expert testimony and findings as to the appropriate calculation); *Shovlin v. Timemed Labeling Sys., Inc.*, No. 95-CV-4808, 1997 U.S. Dist. LEXIS 2350, at \*6 (E.D. Pa. Feb. 27, 1997) (denying gross up because "there was no testimony by a tax expert calculating the 'negative tax consequences' to the Plaintiff in the future in connection with an award of back pay and front pay").

155. 12 F.3d 1112 (D.C. Cir. 1994).

156. *Id.* at 1116.

157. See *supra* notes 141–44 and accompanying text (discussing the *Sears* case).

Similarly, a 1998 federal district court in Illinois denied the plaintiff's request for a gross up to counteract bunching. Citing to *Dashnaw* without any discussion, the court accepted the defendant's argument that the plaintiff "is responsible for his own taxes just as if he had remained a[n] . . . employee" of the defendant.<sup>158</sup>

### B. CASES ADDRESSING THE AMT TRAP

Unlike the issue of gross ups for bunching, with respect to which two circuit courts and several lower courts have spoken, only one federal district court has directly addressed the gross-up question in the AMT trap context. Other cases have not addressed the precise question, although they remain relevant to the issue.

#### 1. Cases in Support of AMT Trap Gross Ups

The only case directly on point is *Porter v. United States Agency for International Development*,<sup>159</sup> a 2003 decision of the federal district court for the District of Columbia. In that Title VII case, the court awarded \$30,000 in compensatory non-pecuniary damages and more than \$200,000 in attorney fees and litigation expenses.<sup>160</sup> Given these figures, it was likely that, if the inclusion/deduction method were applied, the AMT trap would be implicated, causing the plaintiff to owe more in federal taxes than his \$30,000 recovery.<sup>161</sup> In an attempt to avoid this unfair result, the plaintiff requested that the court order the defendant to award a tax gross up.

In addressing the issue, the court first determined that it had the equitable power under Title VII to order such relief:

---

158. *Best v. Shell Oil Co.*, 4 F. Supp. 2d 770, 776 (N.D. Ill. 1998). The *Best* court also cited to *Hukkanen v. IUOE Local No. 101*, 3 F.3d 281 (8th Cir. 1993). However, although the court in *Hukkanen* ruled that the district court's denial of the plaintiff's plea for a gross up was not an abuse of discretion, the court explicitly acknowledged that the district court's denial was based strictly on evidentiary grounds (because the plaintiff did not produce expert testimony regarding the existence and amount of adverse tax consequences), not on the merits of the plaintiff's gross up argument. *Id.* at 287. Therefore, the *Hukkanen* decision is not relevant to the threshold issue of whether a gross up would be appropriate if adverse tax consequences were proven. Likewise, a federal district court in Pennsylvania, in summarily denying a discrimination plaintiff's tax gross up request, cited highly questionable authority. *Becker v. ARCO Chem. Co.*, 15 F. Supp. 2d 621, 639 (E.D. Pa. 1998). In support of its denial, the *Becker* court cited *Shovlin*, 1997 U.S. Dist. LEXIS 2350, at \*6, which denied a gross up request strictly on evidentiary grounds, and *Young v. Lukens Steel Co.*, 881 F. Supp. 962, 978 (E.D. Pa. 1994), which denied a gross up request because the court determined that there were no adverse tax consequences after concluding that the plaintiff's recovery was entirely non-taxable.

159. 293 F. Supp. 2d 152 (D.D.C. 2003).

160. *Id.* at 154. It is interesting to note that the plaintiff initiated the litigation pro se and sought counsel only upon repeated urging by the court. Because he obtained counsel and was awarded statutory fees (and because the court declined to order a gross up), he was potentially subject to the AMT trap, which could subject him to a tax liability well in excess of his \$30,000 recovery.

161. *Id.* at 155.

If Porter's liability to pay tax on the attorneys' fee award in this case was established as a matter of law, and if that tax could be calculated with precision, I believe that I could enter a gross-up order in the exercise of the "full equitable powers" I have to effectuate the purposes of Title VII. . . . Such an order would be necessary to "make [Porter] whole for injuries suffered on account of unlawful employment discrimination," because the imposition of a tax that would reduce his compensatory damage award would leave him less than whole.<sup>162</sup>

Nonetheless, the court ultimately declined to award a gross up in this case because the record did not establish the plaintiff's tax liability with precision.<sup>163</sup> The court determined that the potential adverse tax consequences resulting from the AMT trap were contingent, and as a result, the court declined to exercise its authority to award a tax gross up.<sup>164</sup>

Though not entirely clear, it appears that the court determined that the AMT trap implications were contingent for two reasons. First, the D.C. Circuit was one of two circuits that had not yet weighed in on the underlying tax issue.<sup>165</sup> If the D.C. Circuit faced the tax issue and decided to follow the exclusion method (rather than the inclusion/deduction method), then there would be no adverse tax consequences arising from the AMT trap, and a gross up would provide a windfall for the plaintiff.

Second, the court noted that "[n]o case has squarely held that a Title VII fee award (as distinct from a fee payable from a lump sum settlement)" is includible in the plaintiff's gross income.<sup>166</sup> The court apparently believed that because the attorney's fees paid in the instant case would be pursuant to court order rather than a negotiated settlement, the D.C. Circuit might exclude the fees from the plaintiff's gross income even if the circuit would hold otherwise in the case of a settlement. This possibility appeared to reinforce the court's view that the plaintiff's AMT trap implications constituted a contingent, rather than liquidated, liability for which no gross up would be appropriate. However, as discussed above, it should make absolutely no difference from a tax perspective whether the attorney's fees are payable out of a negotiated settlement or through a court order under a fee-shifting statute.<sup>167</sup>

The court did not indicate which of these two contingencies was more significant, or if the absence of one of these contingencies would have

---

162. *Id.* at 156 (citations omitted).

163. *Id.*

164. *Porter*, 293 F. Supp. 2d at 156.

165. See *supra* notes 98–113 and accompanying text (charting how the circuits have weighed in on the issue, the D.C. Circuit being labeled "no decision yet").

166. *Porter*, 293 F. Supp. 2d at 156.

167. See *supra* text accompanying notes 123–40.

changed the result. Thus, it is not clear whether the *Porter* court would have decided the case differently had it been within, for example, the Tenth Circuit, which applies the inclusion/deduction method to all cases.

In any event, even though the court declined to enter the gross up in the particular case, the *Porter* case suggests that judges have the authority to enter gross ups for plaintiffs who suffer adverse tax consequences arising from the AMT trap.<sup>168</sup> At the same time, the *Porter* decision requires that the adverse tax consequences be fixed in order for a gross up to be awarded.<sup>169</sup>

Two state court decisions also provide support for the notion that AMT trap gross ups are within the equitable authority of courts to redress discrimination, though each involves an interpretation of state rather than federal, discrimination statutes. The first of these cases is *Blaney v. International Ass'n of Machinists and Aerospace Workers, District No. 160*,<sup>170</sup> a 2004 Washington Supreme Court decision construing the Washington Law Against Discrimination ("WLAD") in a successful case of gender-based discrimination in which the plaintiff was awarded pecuniary and non-pecuniary damages. The court determined, under the WLAD's remedial authorization, that a gross up was appropriate to offset the adverse tax consequences resulting from the AMT trap.<sup>171</sup> In reaching this determination, the court reviewed the pertinent federal and state case law and found such an award to be consistent with both the make-whole principles espoused by the United States Supreme Court and the federal cases awarding a gross up to counteract bunching.<sup>172</sup> The *Blaney* court placed particular emphasis on the similarity of language in WLAD and Title VII empowering courts to employ equitable powers in fashioning remedies to deter discrimination.<sup>173</sup>

---

168. *Porter*, 293 F. Supp. 2d at 154. *Shoulin v. Timemed Labeling Systems, Inc.*, No. 95-CV-4808, 1997 U.S. Dist. LEXIS 2350, at \*6 (E.D. Pa. Feb. 27, 1997), also appeared to consider the question of whether a gross up would be permitted under the ADEA to counteract the adverse tax consequences caused by the AMT trap. In that case, the plaintiff requested a gross up to counteract adverse tax consequences caused by bunching "as well as the negative tax consequences he may incur in the future in the event the Internal Revenue Service determines that an award of attorney fees to his counsel . . . [is] taxable to the Plaintiff as gross income." *Id.* The *Shoulin* court denied the request based on evidentiary grounds because the plaintiff did not produce an expert to testify as to the calculation of adverse tax consequences. *Id.*

169. *Porter*, 293 F. Supp. 2d at 156.

170. 87 P.3d 757 (Wash. 2004).

171. *Id.* at 760 n.2. The court noted that Blaney would incur an additional \$244,753 in federal income taxes as a result of the operation of the AMT in disallowing portions of her attorney fees as a miscellaneous itemized deduction. *Id.*

172. *Id.* at 763-64.

173. *Id.* at 764. The intermediate court of appeals decision affirmed by the Washington Supreme Court in *Blaney* noted that gross ups also serve sound policy ends in that they compensate for tax consequences that "threaten[] to thwart meritorious suits because a highly successful plaintiff runs the risk of having the entire benefit of a judgment eliminated plus incurring a substantial tax liability to the Internal Revenue Service." *Blaney v. Int'l Ass'n of Machinists & Aerospace Workers, District No. 160*, 55 P.3d 1208, 1217 (Wash. Ct. App. 2002).

The second state court decision that supports AMT trap gross ups is *Ferrante v. Sciarretta*,<sup>174</sup> a 2003 decision of the New Jersey Superior Court. A jury in that case awarded Mary Ferrante, a victim of sexual harassment, approximately \$340,000 in back and front pay, \$26,000 for emotional distress, and \$895,000 in attorney fees and disbursements.<sup>175</sup> The jury awarded these amounts under New Jersey's Laws Against Discrimination. These laws, according to the court, share with federal anti-discrimination statutes the goal of making whole the victims of discrimination.<sup>176</sup> In a supplemental proceeding, the New Jersey court reviewed favorably the *O'Neill* and *Blaney* decisions and concluded that the make-whole statutory objective supported a gross-up award of \$107,000.<sup>177</sup> Although the court described the award as compensation for a lump-sum award,<sup>178</sup> the large amount of the supplement,<sup>179</sup> the high ratio of attorney's fees to overall recovery, as well as the court's discussion of AMT computations and its reliance on *Blaney*,<sup>180</sup> suggests that the gross up related, at least in part, to adverse tax consequences resulting from the AMT trap.

Although these two state court decisions are not directly on point in that they interpret state, rather than federal, anti-discrimination law, they are relevant for two reasons. First, the underlying state laws share the same broad make-whole purposes as federal anti-discrimination law. Second, both cases favorably cite federal cases that allowed gross ups for bunching to support their decisions to award AMT trap gross ups.

This second point raises the question of whether gross ups might be permitted only for bunching, but not for the AMT trap, or vice versa. There is no reason to treat adverse tax consequences differently depending on the source of that consequence. One can debate the basic question of whether gross ups are permissible (or even required) for adverse tax consequences suffered by plaintiffs, but it seems to us that one must conclude that the answer is the same whether the consequences arise from bunching or the AMT trap. A tax supplement in each instance serves the same core purpose of making the victims of discrimination whole in an economic sense. Of course, as the *Porter* case recognizes, there may be some uncertainty in determining whether the AMT trap will be implicated in cases where the underlying tax issue is unclear. But that is not an issue regarding the propriety of a gross

---

174. No. HNT L-584-02, 2003 N.J. Super. LEXIS 408 (N.J. Super. Ct. Aug. 14, 2003).

175. *Id.* at \*2.

176. *Id.* at \*5.

177. *Id.* at \*6-8.

178. *Id.* at \*8.

179. The total amount of damages (not including attorney's fees or the tax gross up) awarded to the plaintiff was approximately \$440,000. *Ferrante*, 2003 N.J. Super. LEXIS 408, at \*2. Because of the large size of the gross up relative to these damages, it is unlikely that the gross up was merely the result of bunching.

180. *Id.* at \*7-9.



up, but rather that is an issue regarding the existence and amount of adverse tax consequences.

## 2. Case Against AMT Trap Gross Ups

While *Porter* is the only case to address squarely the AMT trap gross-up issue under federal anti-discrimination law, another district court case, while not directly addressing this precise issue, supports the view that such gross ups are not permitted. In *Spina v. Forest Preserve District*, the plaintiff sued her employer under Title VII and § 1983, claiming sexual discrimination, harassment, and retaliation.<sup>181</sup> Pursuant to these claims, a jury awarded the plaintiff \$3,000,000 in non-pecuniary damages to compensate the plaintiff for emotional distress and damage to her reputation.<sup>182</sup> After the trial, the defendant argued that the award was clearly excessive and should be reduced.<sup>183</sup>

The court agreed with the defendant, concluding that \$300,000 was the appropriate amount of compensatory damages.<sup>184</sup> In a final attempt to defeat a reduction of the damages, the plaintiff pointed to the AMT trap, arguing that such reduction “would actually result in [the p]laintiff paying her entire award, plus [some] of her own money (money which she d[id] not have) to the IRS in income taxes.”<sup>185</sup> The court acknowledged the possibility of this result,<sup>186</sup> but concluded that it was irrelevant to the issue at hand:

The Court is not unsympathetic to Plaintiff's plight. Plaintiff waged a courageous fight for what she believed was just . . . . However, the Court will not sneak through the back-door of equitable relief, what the Seventh Circuit, by means of its standards for reviewing excessive verdicts, prohibits in the first instance. In this regard, the Court notes that Plaintiff cites absolutely no caselaw authorizing the Court to exercise its equitable powers in the manner that Plaintiff suggests.

To be sure, the application of the current tax law, as Plaintiff interprets it, appears to produce an anomalous, unjust result. But, . . . the perceived inequities of the tax code are simply not at issue

---

181. *Spina v. Forest Pres. Dist.*, 207 F. Supp. 2d 764, 767 (N.D. Ill. 2002).

182. *Id.* at 769. The compensatory portion of the award exceeded the maximum amount allowable under Title VII, *see supra* text accompanying notes 10–11, because of the § 1983 claim, which has no such limit.

183. *Spina*, 207 F. Supp. 2d at 771.

184. *Id.* at 776. Based on this conclusion, the court offered a remittitur to the plaintiff, pursuant to which she had the choice to either accept the \$300,000 award or retry the issue of damages alone. *Id.*

185. *Id.* at 777.

186. *Id.*

here. *Congress, not this Court, must correct any shortcomings in the tax code's application.*

. . . With little more than general legal principles and rhetoric on Plaintiff's side, . . . the Court declines Plaintiff's invitation to venture down a slippery slope and wade into this legal morass under the guise of equitable relief.<sup>187</sup>

The *Spina* decision is not directly on point because the plaintiff never requested a gross up for adverse tax consequences; rather she used the AMT trap as a defense to the claim that her award was excessive. Perhaps the court might have been more receptive to a limited gross up claim since the \$2,700,000 excessive portion of the award would clearly have overcompensated the plaintiff,<sup>188</sup> particularly if the plaintiff backed up such a claim by cites to the *Sears* and *O'Neill* decisions. However, the italicized language above suggests otherwise, clearly asserting the view that the plaintiff's tax problems are strictly a matter between her and Congress.

### III. PRIMA FACIE CASE FOR GROSS UPS

This Part describes and analyzes the arguments that discrimination plaintiffs would make in their attempt to shift the burden of adverse tax consequences from themselves to the defendants. These arguments are based on the notion that Title VII, the ADEA, and the ADA provide courts with broad equitable powers to remedy violations and to make victims of discrimination whole. As previously discussed, some recent decisions provide support for the position that this grant of remedial powers may include the ability to gross up a plaintiff's award to neutralize adverse tax consequences.<sup>189</sup> This Part considers the merits of this position, examining the text of the remedial provisions of federal anti-discrimination statutes, pertinent legislative history, and judicial decisions interpreting these provisions.

The three principal federal anti-discrimination statutes, namely Title VII,<sup>190</sup> the ADEA,<sup>191</sup> and the ADA,<sup>192</sup> employ two different remedial formulas. Congress, in enacting Title VII in 1964, borrowed the remedial model embodied in the National Labor Relations Act.<sup>193</sup> This scheme, in turn, was in-

187. *Id.* (citations omitted and emphasis added).

188. The court determined that \$300,000 was the appropriate award. Thus, the amount of adverse tax consequences would be determined based on that amount.

189. *See supra* notes 141-54, 159-80 and accompanying text (discussing cases that support gross ups for bunching).

190. Title VII, 42 U.S.C. § 2000e-17 (2000).

191. ADEA, 29 U.S.C. §§ 621-634 (2000).

192. ADA, 42 U.S.C. §§ 12101-12213 (2000).

193. *See* 110 CONG. REC. 7,214 (1964) (interpretive memorandum by Sens. Clark and Case); *id.* at 6,549 (statement of Sen. Humphrey). Section 10(c) of the National Labor Relations Act (NLRA) provides, "[W]here an order directs reinstatement of an employee, back pay may be required of the employee or labor organization, as the case may be, responsible for the dis-

corporated by reference in the ADA when that statute was enacted in 1990.<sup>194</sup> The remedial approach of the ADEA, adopted in 1967, was borrowed instead from the Fair Labor Standards Act.<sup>195</sup> While these provisions differ in language and origin, they nonetheless share a commonality in substance and in purpose.<sup>196</sup>

The original remedial provision of Title VII, § 706(g), authorized courts to enjoin discriminatory practices and “order such affirmative action as may be appropriate, which may include, but is not limited to, reinstatement or hiring of employees, with or without back pay.”<sup>197</sup> Congress significantly expanded this grant of authority in its 1972 amendments to Title VII by adding the phrase “or any other equitable relief as the court deems appropriate.”<sup>198</sup> More recently, Congress amended Title VII in 1991 to provide for compensatory and punitive damage awards in cases of intentional discrimination.<sup>199</sup> The 1991 Civil Rights Act defines compensatory damages to include “future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses,”<sup>200</sup> but not back pay

---

crimination suffered by him.” 29 U.S.C. § 160(c). In contrast to the NLRA, which is enforced through administrative proceedings initiated by the National Labor Relations Board’s general counsel, 29 U.S.C. §§ 153, 160, 161, Congress authorized private lawsuits under Title VII following the exhaustion of administrative remedies. Civil Rights Act of 1964, Pub. L. No. 88-352, §§ 705–708, 78 Stat. 241, 258–62. *See generally* Minna J. Kotkin, *Public Remedies for Private Wrongs: Rethinking the Title VII Back Pay Remedy*, 41 HASTINGS L.J. 1301, 1316–20 (1990) (describing Title VII as embodying a private model of enforcement in contrast to the NLRA’s public model of regulation).

194. The ADA states:

The powers, remedies, and procedures set forth in sections 705, 706, 707, 709, and 710 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-4, 2000e-5, 2000e-6, 2000e-8, & 2000e-9) shall be the powers, remedies, and procedures this title provides to the Commission, to the Attorney General, or to any person alleging discrimination on the basis of disability in violation of any provision of this Act, or regulations promulgated under section 106, concerning employment.

42 U.S.C. § 12117.

195. Section 7(b) of the ADEA, 29 U.S.C. § 626(b), expressly incorporates the remedial provisions of the FLSA, codified at 29 U.S.C. §§ 201–219. Section 7(b) states, “the provisions of this chapter shall be enforced in accordance with the powers, remedies, and procedures provided in section 211 (b), 216 (except for subsection (a) thereof), and § 217 of this title, and subsection (c) of this section.” 29 U.S.C. § 626(b).

196. *See* McKennon v. Nashville Banner Publ’g Co., 513 U.S. 352, 358 (1995) (stating that “[t]he ADEA and Title VII share common substantive features and also a common purpose: ‘the elimination of discrimination in the workplace’” (quoting *Oscar Meyers & Co. v. Evans*, 441 U.S. 750, 756 (1979))).

197. Civil Rights Act of 1964, Pub. L. No. 88-352, § 706, 78 Stat. 241, 259–61.

198. Equal Employment Opportunity Act of 1972, Pub. L. No. 92-261, § 4, 86 Stat. 103, 104–07 (codified as amended at 42 U.S.C. § 2000e-5(g) (2000)).

199. Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071. The 1991 amendments also provided for a right to a jury trial in cases in which a plaintiff seeks compensatory or punitive damages. *See id.* (codified at 42 U.S.C. § 1981A(c)).

200. 42 U.S.C. § 1981A(b)(3).

or other types of relief authorized under § 706(g).<sup>201</sup> The 1991 amendments place a cap on the total amount of compensatory and punitive damages that a court may award. The cap varies depending upon the size of the offending employer.<sup>202</sup>

The ADEA's remedial provision has remained unchanged since its adoption in 1967. Section 7(b) of the ADEA provides that courts "shall have jurisdiction to grant such legal or equitable relief as may be appropriate to effectuate the purposes of this Chapter, including without limitation judgments compelling employment, reinstatement, or promotion."<sup>203</sup> While the ADEA does not provide expressly for compensatory and punitive damages, it does authorize the doubling of back pay in the form of "liquidated damages" in the event of a willful violation.<sup>204</sup>

Although these two formulas are not identical, courts frequently view the case law with respect to remedies as interchangeable under these statutory schemes since both "vest trial courts with a similar broad discretion in awarding such legal or equitable relief as the courts deem appropriate."<sup>205</sup> Significantly, the same administrative agency, the Equal Employment Opportunity Commission ("EEOC"), is charged with enforcing each of these statutes,<sup>206</sup> and the EEOC utilizes the same policy statement on remedies with respect to cases arising under each statute.<sup>207</sup> All three statutes also provide for a grant of attorney fees to the prevailing party as a means to encourage private enforcement of their respective anti-discrimination mandates.<sup>208</sup>

#### A. THE MAKE-WHOLE OBJECTIVE

The most important shared characteristic of these statutes, at least for our purposes, is their overarching objective to make whole the victims of employment discrimination. The pertinent legislative history and judicial construction underscore that these statutes confer broad discretion on courts to fashion equitable remedies in order to restore workers injured by

201. *Id.* § 1981A(b)(2).

202. *Id.* § 1981A(b)(3). The damage caps range from a low of \$50,000 for an employer with between 15 and 100 employees to a high of \$300,000 for an employer with more than 500 employees. *Id.*

203. 29 U.S.C. § 626(b) (2000).

204. *Id.* (incorporating §§ 16 and 17 of the FLSA, which authorize an award of liquidated damages).

205. *McKnight v. Gen. Motors Corp.*, 973 F.2d 1366, 1369 n.1 (7th Cir. 1992) (quoting *Sycock v. Milwaukee Boiler Mfg. Co.*, 665 F.2d 149 (7th Cir. 1981)).

206. *See Grebeldinger*, *supra* note 16, at 325 (noting that the EEOC is charged with enforcing Title VII, the ADEA, and the ADA).

207. Policy Statement on Remedies and Relief for Individual Cases of Unlawful Discrimination, 29 C.F.R. pt. 1613, app. A (1995).

208. ADEA, 29 U.S.C. § 626(b) (incorporating § 16 of the FLSA, which authorizes an award of attorney fees); Title VII, 42 U.S.C. 2000e-5(k) (2000); ADA, 42 U.S.C. § 12117 (2000) (adopting the remedies and enforcement procedures of Title VII).

civil rights violations to the economic position they would have occupied but for the unlawful discrimination.<sup>209</sup>

The 1972 amendments to Title VII provide the most meaningful legislative history. As noted above, the Equal Employment Opportunity Act of 1972 expanded the arsenal of remedies enabled by Title VII to go beyond the original authorization of injunctive relief and back pay to also encompass "any other equitable relief as the court deems appropriate."<sup>210</sup> This language was added by amendment on the Senate floor,<sup>211</sup> with a subsequent Conference Committee Report providing the only relevant contemporaneous explanation. This report states:

The provisions of this subsection are intended to give the courts wide discretion exercising their equitable powers to fashion the most complete relief possible. In dealing with the present section 706(g) the courts have stressed that the scope of relief under that section of the Act is intended to make the victims of unlawful discrimination whole, and that the attainment of this objective rests not only upon the elimination of the particular unlawful employment practice complained of, but also requires that persons aggrieved by the consequences and effects of the unlawful employment practice be, so far as possible, restored to a position where they would have been were it not for the unlawful discrimination.<sup>212</sup>

In short, Congress intended the "any other equitable relief" language as a broad grant of discretion to the courts to fashion such make whole relief as might be appropriate under the circumstances.

The Supreme Court warmly embraced this notion in *Albemarle Paper Co. v. Moody*.<sup>213</sup> In that case, a southern paper mill had eliminated its segregated job classes following the enactment of Title VII, but placed black workers at the end of the seniority line which had the effect of disqualifying them for most higher-paying skilled positions.<sup>214</sup> The trial court ruled that the employer had acted unlawfully and ordered the implementation of a system of plant-wide seniority, but declined to award back pay to the plaintiff class on the ground that the employer had not taken its actions in bad faith.<sup>215</sup> The Supreme Court, after reviewing the pertinent legislative history, disagreed

---

209. See *supra* notes 203–08 and accompanying text (discussing the ADEA's remedial structure).

210. Equal Opportunity Act of 1972, Pub. L. No. 92-261, § 4, 86 Stat. 103, 104–107 (codified as amended at 42 U.S.C. § 2000e-5(g)).

211. See *supra* note 199 (discussing this amendment).

212. 118 CONG. REC. 7,168 (1972).

213. 422 U.S. 405 (1975).

214. *Id.* at 409.

215. *Id.* at 409–10.

and created a presumption in favor of back-pay awards.<sup>216</sup> The Court grounded this presumption in what it viewed as the twin objectives of Title VII. One of these objectives, the Court noted, is to deter discrimination and achieve "equality of employment opportunities."<sup>217</sup> The second objective is "to make persons whole for injuries" resulting from unlawful discrimination.<sup>218</sup> This latter objective, the Court observed, is demonstrated by the fact that Congress empowered the courts with "full equitable powers" to provide restorative justice.<sup>219</sup> The Court, accordingly, concluded that "backpay should be denied only for reasons which, if applied generally, would not frustrate the central statutory purposes of eradicating discrimination throughout the economy and making persons whole for injuries suffered through past discrimination."<sup>220</sup>

The Supreme Court has found that the ADEA embodies a similar set of objectives. That statute, similar to the post-1972 version of Title VII, authorizes courts to grant "such legal and equitable relief as may be appropriate to effectuate the purposes of the Act."<sup>221</sup> In *McKennon v. Nashville Banner Publishing Co.*,<sup>222</sup> the Supreme Court stated that the ADEA and Title VII share in common the goals of deterrence and compensation. The *McKennon* Court went on to explain that the purpose of the compensation goal is "to restore the employee to the position he or she would have been in absent the discrimination."<sup>223</sup>

Thus, under both statutory schemes, Congress sought to establish a regime in which courts would be vested with broad discretion to redress the economic injuries flowing from illegal discrimination.<sup>224</sup> It is important to recognize that this grant of authority is not limited to awarding only the back-pay and reinstatement relief specifically mentioned in the two statutes. A great number of decisions demonstrate that these powers encompass other equitable remedies that, while not expressly listed, nonetheless are appropriate and necessary in order to make a successful plaintiff whole.

The non-listed equitable remedy most commonly invoked by the courts is that of front pay. Front pay is an equitable post-judgment remedy in the form of pay for a predictable period of unemployment or under-

---

216. *Id.* at 417-21.

217. *Id.* at 417 (quoting *Griggs v. Duke Power Co.*, 401 U.S. 424, 429 (1971)).

218. *Albemarle Paper*, 422 U.S. at 418.

219. *Id.*

220. *Id.* at 421.

221. 29 U.S.C. § 626(b) (2000).

222. 513 U.S. 352, 358 (1995).

223. *Id.* at 362.

224. *See, e.g.*, *Thurman v. Yellow Freight Sys., Inc.*, 97 F.3d 833, 834 (6th Cir. 1996) (discussing the court's wide discretion to award front-pay damages under Title VII); *Fitzgerald v. Sirloin Stockade, Inc.*, 624 F.2d 945, 957 (10th Cir. 1980) (same).

employment going into the future.<sup>225</sup> Courts tend to award front pay when reinstatement to the appropriate position is not possible either because no vacancy currently exists,<sup>226</sup> or because hostility between the parties makes reinstatement unfeasible.<sup>227</sup> The Supreme Court, in *Pollard v. E.I. du Pont de Nemours & Co.*,<sup>228</sup> endorsed front pay under these circumstances as an appropriate component of make-whole relief. The Court in *Pollard* further ruled that the authority of a court to award front pay flows from § 706(a) rather than the 1991 amendments to Title VII and as such, is not subject to the damage caps applicable to compensatory and punitive relief.<sup>229</sup>

Front pay, however, is only one of a host of equitable adjustments that courts use to provide full make-whole relief in employment discrimination suits. Other examples of monetary relief that courts award under Title VII and the ADEA include such items as lost overtime pay,<sup>230</sup> fringe benefits,<sup>231</sup> bonuses,<sup>232</sup> the cost of replacement insurance,<sup>233</sup> and the cost of travel and moving expenses for interim employment.<sup>234</sup> Equitable relief also can take a non-monetary form such as an affirmative grant of seniority<sup>235</sup> or a promotion to a new position.<sup>236</sup>

In addition, courts increasingly have become aware of the need to fine-tune a pecuniary award in order to accomplish the make-whole objective. This is particularly true with respect to adjustments needed to account for the time value of money. Most courts now adjust the amount of back-pay and front-pay awards in order to reflect the current value of such awards. Courts

225. Grebeldinger, *supra* note 16, at 327–28.

226. See, e.g., *Williams v. Pharmacia, Inc.*, 137 F.3d 944, 951 (7th Cir. 1998) (awarding front pay because the division in which the plaintiff worked was eliminated during a merger); *Briseno v. Cent. Tech. Cmty. Coll. Area*, 739 F.2d 344, 348 (8th Cir. 1984) (allowing the lower court to award front pay if it finds that no comparable vacancy exists to that which the plaintiff would have received if no discrimination occurred).

227. See, e.g., *Bingman v. Natkin & Co.*, 937 F.2d 553, 558 (10th Cir. 1991) (ordering reinstatement instead of front pay because of the absence of hostility between the parties); *Brooks v. Woodline Motor Freight, Inc.*, 852 F.2d 1061, 1065–66 (8th Cir. 1988) (awarding front pay because the hostility between the parties was great enough to discourage reinstatement).

228. 532 U.S. 843, 853 (2001).

229. *Id.* at 854.

230. E.g., *United States v. City of Warren*, 138 F.3d 1083, 1097 (6th Cir. 1998); *Kossmann v. Calumet County*, 800 F.2d 697, 703 (7th Cir. 1986).

231. See, e.g., *Sharkey v. Lasmco (AUL Ltd.)*, 214 F.3d 371, 375–76 (2d Cir. 2000) (including value of lost pension benefits); *Cox v. Am. Cast Iron Pipe Co.*, 784 F.2d 1546, 1562 (11th Cir. 1986) (including value of lost vacation, sick pay, pension benefits, and shift differentials in pay award).

232. E.g., *Sinclair v. Auto. Club*, 733 F.2d 726, 729 (10th Cir. 1984); *EEOC v. Domino's Pizza*, 909 F. Supp. 1529, 1537 (M.D. Fla. 1995).

233. E.g., *Farriss v. Lynchburg Foundry*, 769 F.2d 958, 965–66 (4th Cir. 1985).

234. E.g., *Williams v. Albemarle Bd. of Educ.*, 508 F.2d 1242 (10th Cir. 1974).

235. E.g., *Franks v. Bowman Transp. Co.*, 424 U.S. 747, 765 (1976).

236. E.g., *Jepsen v. Fla. Bd. of Regents*, 754 F.2d 924, 926–27 (11th Cir. 1985); *Hayes v. Shalala*, 933 F. Supp. 21, 25 (D.D.C. 1996).

add, pursuant to their equitable powers, pre-judgment interest on back-pay amounts to make up for the fact that the plaintiff did not enjoy the use of such funds at the time when the plaintiff would have earned them but for the unlawful discrimination.<sup>237</sup> Similarly, courts routinely discount the amount of front-pay awards to reflect the current value of compensation that would be due and owing in the future.<sup>238</sup>

This was not always the case. An award of pre-judgment interest, for example, is a matter within the trial court's discretion, and a number of decisions, particularly those in the earlier days of Title VII, declined to make such an award.<sup>239</sup> Over time, however, courts have come to view pre-judgment interest as a necessary component in structuring make-whole relief. Courts now generally presume that pre-judgment interest should be added to back-pay awards.<sup>240</sup> Many reviewing courts find that it is "ordinarily an abuse of discretion" for the trial court not to include pre-judgment interest in a back-pay award.<sup>241</sup> Under such an approach, courts will award pre-judgment interest in the absence of exceptional or unusual circumstances.<sup>242</sup>

A tax gross up fits comfortably within the make-whole objective of federal anti-discrimination statutes. As the *O'Neill* court stated, "[i]t's not how much you make, it is how much you keep."<sup>243</sup> In light of the bunching problem and the AMT trap, many successful employment discrimination plaintiffs will be made whole only if the courts award tax gross ups.

The time value calculations used by courts in awarding pre-judgment interest and in discounting front-pay amounts provide a useful analogy.<sup>244</sup> At first glance, a straightforward award of lost earnings might appear to be the appropriate touchstone for calculating pecuniary damages in an employment discrimination suit. Upon closer inspection, however, it becomes clear that time value adjustments more accurately place a plaintiff in the economic position he or she would have occupied in the absence of discrimination. The same is true with respect to a tax gross up. Because of adverse tax

237. See, e.g., *Frazier v. Iowa Beef Processors, Inc.*, 200 F.3d 1190, 1194 (8th Cir. 2000) (awarding pre-judgment interest); *EEOC v. Ky. State Police Dep't*, 80 F.3d 1086, 1097-98 (6th Cir. 1996) (same). Courts also award post-judgment interest in appropriate circumstances. E.g., *Skalka v. Fernald Envtl. Restoration Mgmt. Corp.*, 178 F.3d 414, 428-29 (6th Cir. 1999).

238. E.g., *Rhodes v. Guiberson Oil Tools*, 82 F.3d 615, 622 (5th Cir. 1996); *Cassino v. Reichhold Chems., Inc.*, 817 F.2d 1338, 1347 (9th Cir. 1987).

239. See, e.g., *Hannan v. Chrysler Motors Corp.*, 443 F. Supp. 802, 805 (E.D. Mich. 1978) (declining to award pre-judgment interest); *Bowe v. Colgate-Palmolive Co.*, 272 F. Supp. 332, 366 (S.D. Ind. 1967) (same).

240. E.g., *Ky. State Police Dep't*, 80 F.3d at 1098.

241. E.g., *Sharkey v. Lasmo*, 214 F.3d 371, 375 (2d Cir. 2000); *Ky. State Police Dep't*, 80 F.3d at 1098.

242. *Frazier*, 200 F.3d at 1194; *Starceski v. Westinghouse Elec. Corp.*, 54 F.3d 1089, 1103 (3d Cir. 1995).

243. *O'Neill v. Sears, Roebuck & Co.*, 108 F. Supp. 2d 443, 447 (E.D. Pa. 2000).

244. However, as discussed *infra* note 250, defendants would argue that time value of money adjustments are distinguishable from tax gross ups.



consequences, a plaintiff's pecuniary damage award leaves him with fewer after-tax dollars than if no discrimination had taken place. As a result, true make-whole relief can be accomplished only by taking into account these tax consequences. Courts that are now "inflation-aware" should also become "tax-aware." In short, the computation of make-whole relief should not stop with calculating what plaintiffs receive in pre-tax damages, but should go further to consider what the tax code allows them to keep.

#### B. THE DETERRENCE OBJECTIVE

Tax gross ups also would further the other objective underlying the remedial provisions of federal anti-discrimination statutes—detering discrimination in the workplace. The Supreme Court in *Albemarle* expressly noted that the deterrence of discrimination is a prime objective of Title VII's remedial scheme.<sup>245</sup> The Court subsequently echoed this deterrence objective in *McKennon* with respect to the ADEA.<sup>246</sup> By serving as an incentive to employees to vindicate the anti-discrimination goals of these statutes through private litigation, these remedial provisions, along with the attorney-fee-shifting provisions, deter discrimination.<sup>247</sup> In other words, federal anti-discrimination statutes impose meaningful remedies in part to encourage meritorious litigation that will root out and deter discrimination in the workplace.

Without a tax gross up, the adverse tax consequences described in this Article reduce this incentive and its resultant deterrent effect by reducing the ultimate fruits of a successful discrimination lawsuit.<sup>248</sup> This is particularly true with respect to adverse tax consequences caused by the AMT trap, since these consequences can easily consume most or all of a plaintiff's pre-tax recovery and, in certain extreme instances, can even result in an after-tax loss.<sup>249</sup> Accordingly, a tax gross up, which ensures that the plaintiff receives the full benefit of his pecuniary damages, furthers this deterrent objective.

#### IV. ARGUMENTS AGAINST GROSS UPS

As Part III discussed, the plaintiff's argument primarily focuses on the broad make-whole purpose of the anti-discrimination statutes. It is a truism that in cases where the plaintiff suffers adverse tax consequences with respect to pecuniary damages, the plaintiff is economically worse off than she would have been had no discrimination taken place unless the plaintiff re-

---

245. *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 417 (1975).

246. *McKennon v. Nashville Banner Publ'g Co.*, 513 U.S. 352, 358 (1995).

247. *Sager & Cohen*, *supra* note 6, at 1076–78.

248. *Blaney v. Int'l Ass'n of Mechanists & Aerospace Workers*, Dist. No. 160, 55 P.3d 1208, 1217 (Wash. Ct. App. 2002) (noting that the AMT trap "threatens to thwart meritorious suits"); *Sager & Cohen*, *supra* note 6, at 1104 (concluding that the "overtaxation of plaintiff's taxable income [resulting from the AMT trap] discourages the pursuit of civil rights claims").

249. *See supra* Part I.B.1 (describing the impact of the AMT trap).

ceives a gross up award. Nevertheless, a defendant has several compelling arguments against such a gross up. We develop these arguments below.

A. *NO TAX SHIFTING UNLESS SPECIFICALLY AUTHORIZED*

The question of whether federal law authorizes gross ups is at its heart an issue of statutory interpretation. In particular, the resolution of the issue depends on which of two congressional directives takes precedence. On the one hand, Congress imposes through the Code the obligation of the plaintiff to pay a specified amount of taxes on his income, which includes an award of pecuniary damages.<sup>250</sup> On the other hand, Congress imposes through the anti-discrimination laws the obligation of defendants to pay successful plaintiffs an amount of money to put the plaintiffs in the same economic position they would have occupied had no discrimination occurred.<sup>251</sup>

The question then is which congressional directive (for the plaintiff to pay his own taxes or for the defendant to make the plaintiff economically whole) controls. The answer is not apparent based on the text of the statutes,<sup>252</sup> though the case law supporting gross ups simply assume without discussion that the "make-whole directive" trumps the "pay-your-taxes directive."<sup>253</sup> Defendants, however, would argue otherwise.

In support of this argument defendants would cite the canon of statutory interpretation that "where there is no *clear* intention otherwise, a specific statute will not be controlled or nullified by a general one."<sup>254</sup> The defendants' argument using this canon goes as follows. The statutes that impose a tax on plaintiff are specific in that they obligate the plaintiff (and only the plaintiff) to pay a precise dollar amount in tax. On the other hand, the anti-discrimination remedial statutes are general in that they obligate the defendant to make the plaintiff whole. If a court did award a gross up to the plaintiff, a portion of the plaintiff's tax burden would be shifted so that

250. See I.R.C. § 1 (2000) (imposing regular tax liability on taxpayer); *id.* § 55 (imposing alternative minimum tax liability on taxpayer). Defendants would argue that the source of adverse tax consequences (i.e., congressional action) sufficiently distinguishes tax gross ups, which they would argue should not be allowed, from time value of money adjustments, which are clearly allowed. While the time value of money results from economic forces, the burden caused by adverse tax consequences results solely from prior congressional action. While this distinction is certainly true, it should not be determinative on the gross up issue because, as we explain in this Part IV.A, Congress's make-whole directive should prevail as a matter of statutory interpretation.

251. See *supra* Part III.A (discussing the make-whole objective).

252. The tax statutes and the anti-discrimination statutes provide no guidance as to how they interact.

253. See, e.g., *O'Neill v. Sears, Roebuck & Co.*, 108 F. Supp. 2d 443, 447 (E.D. Pa. 2000) (awarding tax gross up for bunching without discussing the conflict between these two congressional directives).

254. *Crawford Fitting Co. v. J.T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987) (quoting *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 153 (1976)).

the incidence of such portion would fall upon defendant rather than plaintiff. In such a case, the specific taxing statutes would be nullified in part by a general statute because, instead of the plaintiff-taxpayer paying the full amount of taxes imposed by the Code, the defendant would pay some portion of those taxes. If Congress wanted to impose an extra tax on defendants responsible for unlawful discrimination, then Congress would have either (a) explicitly taxed defendants directly, or (b) made clear its intention that the general anti-discrimination remedies shifted part of plaintiff's tax burden to the defendant.<sup>255</sup>

This argument fails for two reasons. First, in a practical sense, it is the anti-discrimination statutes rather than the tax code that provide the more specific set of rules applicable in this context. The anti-discrimination rules expressly regulate workplace behavior and provide for make-whole relief when employers violate those rules. The tax rules, in contrast, apply to all taxpayers without any specific reference to the workplace or to employment discrimination. The tax rules that create the bunching problem and the AMT trap do not by their terms target employment discrimination plaintiffs; it just so happens that employment discrimination plaintiffs are the taxpayers who are usually most adversely affected by these rules.<sup>256</sup> Since the make-whole principles embodied in federal anti-discrimination statutes more directly speak to the amount of money remaining in a discrimination plaintiff's pocket at the end of the day than does the tax code, that set of rules should be given precedence in this setting.

Second, the make-whole directive should prevail because such a result is more consistent with congressional intent. One must remember that statutory canons of construction are merely inferences of legislative intent.<sup>257</sup> Though one can infer that Congress *generally* would prefer that a specific statute trump a more general statute, such an inference should not be applied blindly. In this case, we believe that even if the anti-discrimination remedial provisions are deemed to be the more general rules, they should trump the tax rules.

A thought experiment might be helpful to illustrate this point. Imagine that Congress decides that discrimination recoveries represent windfalls or that it wants to reduce the frequency of employment discrimination litigation. To remedy the situation, Congress imposes an excise tax of ten percent on all discrimination recoveries. In such a case, it is clear that a gross up pursuant to the make whole directive would not be appropriate because it

---

255. Cf. *McLaughlin v. Union-Leader Corp.*, 127 A.2d 269, 273 (N.H. 1956) (concluding that a tax gross up for adverse tax consequences caused by bunching was not appropriate because the plaintiff's "remedy [for excessive taxation on bunched income] should be sought at the source—in federal legislation").

256. See *supra* Part I.B.2 (explaining the source of the AMT trap).

257. Geoffrey P. Miller, *Pragmatics and the Maxims of Interpretation*, 1990 WIS. L. REV. 1179, 1224.

would be shifting a liability that Congress clearly intended that plaintiffs, and not defendants, pay. If Congress wanted defendants to pay the excise tax, then Congress would have imposed the excise tax directly on defendants.

Defendants would argue that the adverse tax consequences caused by bunching and the AMT trap are effectively such an excise tax on plaintiffs that cannot be shifted without specific authority to do so. The retort to this argument is obvious. While the excise tax in the thought experiment was based on a substantive policy decision to excessively tax discrimination plaintiffs, the adverse tax consequences described in this Article lack such a substantive foundation.

As previously discussed, the bunching problem arises from having progressive tax rates combined with annual accounting.<sup>258</sup> Arguably, the repeal of income averaging could be interpreted as a congressional directive to require recipients of bunched income to pay a greater amount of tax than if the income was earned over time. However, the repeal of income averaging is best seen as a mere simplification measure, not as a decision that bunched income, as a matter of substantive policy, should be taxed at a greater rate. In other words, getting the right conceptual answer in the huge number of instances<sup>259</sup> in which a taxpayer receives bunched income was determined to be simply not worth the administrative inconvenience.<sup>260</sup> Therefore, unlike in the case of the hypothetical excise tax, the adverse tax consequences caused by bunching are not the product of a substantive policy choice to excessively tax certain employment discrimination plaintiffs. As result, Congress's repeal of income averaging should not be understood to foreclose the courts' ability to award gross ups for bunching, a remedy based on Congress's make-whole directive, which was clearly the product of a substantive policy decision.

While Congress's repeal of income averaging suggests that the bunching problem might have been contemplated, it is obvious that the AMT trap was an unforeseen and unintended consequence of the 1996 legislation that

---

258. See *supra* Part I.A (discussing the bunching problem).

259. The bunching problem is not unique to employment discrimination recoveries. In all instances in which a taxpayer receives compensation attributable to two or more taxable years in a single taxable year, the taxpayer has received bunched income which may be taxed at inappropriately high rates. Thus, for example, the receipt of a bonus for work performed in two or more years is a common example of bunched income.

260. See *supra* notes 40–47 and accompanying text (discussing repealed income-averaging provisions). The administrative problem is relevant to the gross up issue. As we discuss *infra* Part IV.C.3, the fact that a court has the authority to provide a gross up to neutralize adverse tax consequences does not necessarily mean that a court should always use this authority whenever these consequences arise. Rather, the court should balance the administrative difficulty in computing gross ups against the amount of the probable adverse tax consequences. In this regard, the court has the advantage of making a case-by-case, after-the-fact administrative difficulty analysis, unlike the Code, which must provide global rules *ex ante*.

required non-physical personal injury recoveries to be included in gross income.<sup>261</sup> The AMT trap is a mistake, a statutory flaw, with no policy justification (not even simplicity) to support its presence.<sup>262</sup>

It is clear then that the adverse tax consequences described in this Article were not the product of a deliberate choice to excessively tax discrimination plaintiffs. In contrast, the anti-discrimination remedial provisions are the product of explicit and reasoned decisions to put discrimination victims in the same economic position that they would have occupied but for the discrimination and to provide incentives for employees to vindicate anti-discrimination goals through private litigation.<sup>263</sup> Thus, these provisions reflect a deliberate congressional choice supported by clear substantive policy justifications. The federal anti-discrimination statutes, accordingly, should prevail in this context regardless of whether they are viewed as the more general or the more specific set of rules because, under either view, such a result will be most consistent with congressional intent.

### B. COURTS AWARD PRE-TAX, NOT AFTER-TAX, DOLLARS

To support its position that the plaintiff's tax consequences should not be considered by courts, defendants might point to the general rule that juries and judges award damages in the form of pre-tax dollars.<sup>264</sup> This rule, which defendants might argue is analogous to the "American rule" that parties are generally responsible for their own attorney's fees,<sup>265</sup> provides that plaintiffs are responsible for their own taxes. Just as a plaintiff's attorney's fees are generally a matter between the plaintiff and her attorney, a plaintiff's taxes are a matter between her and the taxing authority. Under this view, a court awards pre-tax dollars and lets the tax "chips" fall where they may.<sup>266</sup> Defendants would argue that Congress, in enacting the anti-

261. See *supra* notes 76-78 and accompanying text (discussing the AMT's unintended consequences for discrimination plaintiffs).

262. See *supra* notes 68-70 and accompanying text (discussing how the AMT trap violates tax policy).

263. See *supra* Part III.A (discussing the make-whole objective).

264. See *Estate of Spinosa v. Int'l Harvester Co.*, 621 F.2d 1154, 1158 (1st Cir. 1980) (asserting that "a mountain of . . . state [law] authority" exists supporting the view that courts should not consider the impact of taxes on recoveries); *Rodriguez v. McDonnell Douglas Corp.*, 151 Cal. Rptr. 399, 421 (Cal. Ct. App. 2d 1978) (recognizing and following the majority rule holding "that income tax consequences are of no relevance in personal injury litigation").

265. See *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247 (1975) (describing the American rule that, unless a statute provides otherwise, each party is responsible for his own attorney's fees).

266. This view appears closely related to the argument that the "proximate cause" of adverse tax consequences is the tax laws giving rise to the adverse tax consequences rather than the defendant's unlawful conduct. See *McLaughlin v. Union-Leader Corp.*, 127 A.2d 269, 272-73 (N.H. 1956) (refusing, in a breach of contract case, to augment damages to neutralize adverse tax consequences caused by bunching because the "situation results primarily from the provisions of the federal income tax statute which sometimes produces inequities" and because

discrimination remedial provisions, legislated against this backdrop rule and, accordingly, any deviation from this rule would require specific authorization.

In support of this argument, defendants could cite to § 914A of the very influential Second Restatement of Torts, which provides that in general the tax consequences of a tort recovery are immaterial in determining the amount of the recovery.<sup>267</sup> This rule requires courts to ignore the effect of taxes even in instances in which a tax-free recovery represents future wages that would have been fully taxed if earned in due course.<sup>268</sup> In other words, the Restatement provides that even if the recovery would be tax-free, pre-tax earnings (rather than after-tax earnings) should generally form the basis for the recovery.<sup>269</sup>

Although the Restatement's "tax-blind" rule may represent the majority view, that view is by no means universal.<sup>270</sup> In fact, the Supreme Court rejected that view in *Norfolk & Western Railway Co. v. Liepelt*, a 1980 case involving the Federal Employers' Liability Act ("FELA").<sup>271</sup> In that case, the estate of a fireman who died as the result of the defendant's negligence sued the defendant under FELA, which entitled the estate to a recovery of "the damages . . . [that] flow from the deprivation of the pecuniary benefits which the beneficiaries might have reasonably received."<sup>272</sup> The estate argued that the Court should use the fireman's hypothetical future gross earnings in calculating this recovery, while the defendant argued that only after-tax earnings should be used.<sup>273</sup>

The Court agreed with the defendant, concluding that after-tax earnings are to be used under FELA:

The amount of money that a wage earner is able to contribute to the support of his family is unquestionably affected by the amount of the tax he must pay to the Federal Government. It is his after-tax income, rather than his gross income before taxes, that provides the only realistic measure of his ability to support his family. It fol-

---

the "remedy should be sought at the source—in federal legislation"); see also *Blaney v. Int'l Ass'n of Machinists & Aerospace Workers*, Dist. No. 160, 55 P.3d 1208, 1217–18 (Wash. Ct. App. 2002) (explaining and rejecting defendant's proximate cause argument against tax gross ups).

267. RESTATEMENT (SECOND) OF TORTS § 914A (1979).

268. *Id.* cmt. b.

269. There are two justifications for § 914A's focus on pre-tax dollars. First, in cases in which the award is tax-free, using after-tax wages would shift a tax benefit intended for plaintiffs to defendants. Second, using after-tax dollars to compute an award could be complex, possibly involving a great deal of speculation. *Id.*

270. See John E. Theuman, Annotation, *Propriety of Taking Income Tax into Consideration in Fixing Damages in Personal Injury or Death Action*, 16 A.L.R. 4TH 589 (1982) (citing cases that both follow and refuse to follow the "tax-blind" rule).

271. *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490, 491 (1980).

272. *Id.* at 491–93.

273. *Id.*

lows inexorably that the wage earner's income tax is a relevant factor in calculating the monetary loss suffered by his dependents when he dies.<sup>274</sup>

Though *Liepell* did not involve federal anti-discrimination statutes, it is problematic for the defendant with respect to its argument that courts are to award pre-tax dollars, leaving the plaintiff to deal with his own tax consequences. The Court, recognizing that from an economic perspective only after-tax dollars are meaningful, interpreted FELA to provide a recovery that takes into account tax consequences. Lower federal courts have extended *Liepell*'s "tax-aware" rule to other federal causes of actions that include claims for lost earnings.<sup>275</sup>

The defendant might attempt to distinguish the *Liepell* case by noting that, in that case, the hypothetical future wages would have been taxable, while the FELA recovery was tax-free under the Code.<sup>276</sup> This wholly inconsistent tax treatment is not present with respect to anti-discrimination pecuniary awards because both the award and the wages it represents are taxable.<sup>277</sup> This distinction, however, is not meaningful because although both the awards and the wages are taxable, they are simply not taxed equivalently. This lack of equivalence gives rise to the adverse tax consequences described in this Article. *Liepell* stands for the proposition that, at least under FELA's broad remedial provisions, only after-tax dollars are important. Thus, *Liepell* appears to support a similar conclusion under the broad anti-discrimination remedial provisions. At the very least, *Liepell* and its progeny are evidence that the Restatement's tax-blind rule does not reflect a consensus view that would have provided a clear backdrop rule to the anti-discrimination remedial provisions.

---

274. *Id.* at 493-94.

275. *See, e.g.*, *Kirchgessner v. United States*, 958 F.2d 158, 161 (6th Cir. 1992) (applying the tax-aware rule in computing damages under the Federal Tort Claims Act); *Davis v. Little*, 851 F.2d 605, 611 (2d Cir. 1988) (applying tax-aware rule in computing damages under 42 U.S.C. § 1983); *Fanetti v. Hellenic Lines Ltd.*, 678 F.2d 424, 431 (2d Cir. 1982) (noting that a rule that "focus[es] upon after-tax earnings is an exercise in economic fairness" and extending the rule "at least to all federal law claims for future lost wages"). In addition, though *Liepell* itself involved a wrongful death claim, lower federal courts have applied the tax-aware rule to federal personal injury claims not involving wrongful death. *See Paquette v. Atlanska-Plovidba*, 701 F.2d 746, 748 (8th Cir. 1983) (noting that the tax-aware rule also "appl[ies] to lost future earnings for one who is injured but not killed in an accident"); *Fanetti*, 678 F.2d at 430 (applying rule to claim not involving wrongful death under the Longshoremen's and Harbor Workers' Compensation Act).

276. *Liepell*, 444 U.S. at 500-02 (Blackmun, J., dissenting).

277. *See supra* notes 79-82 and accompanying text (discussing the taxation of discrimination awards).

## C. COMPLEXITY AND SPECULATION

A defendant might also argue that even if the court would otherwise permit tax gross ups, determining the amount of adverse tax consequences would involve an undue amount of complexity and speculation.<sup>278</sup> We address this issue below.

## 1. Bunching

In computing the amount of adverse tax consequences caused by bunching, one needs to determine two separate tax rates: (1) the tax rates that would have been applied to the hypothetical wages had they been earned in due course, and (2) the tax rates that will be applied to the lump-sum recovery. In determining these tax rates, one needs to know the amount of taxable income the taxpayer earned (or would in the future earn) in the year in question, as well as the § 1 tax rates for such year.

Determining the tax rates applicable to the lump-sum recovery is straightforward, as it would be easy to determine the plaintiff's income (before taking into account the award) and the applicable tax rates in the year of the recovery. Likewise, to the extent that the award represents a loss of back pay, determining the tax rates that would have applied to the back pay is straightforward since it would be easy to determine the plaintiff's income and applicable tax rates for years in the past.<sup>279</sup> However, to the extent the award represents a loss of future earnings, determining the tax rates that would have applied to these hypothetical future wages involves some speculation and, as a result, additional complexity.<sup>280</sup>

In determining the tax rates applicable to this hypothetical front pay, one would need to know what the plaintiff's gross income and deductions

---

278. See *Paris v. Remington Rand, Inc.*, 101 F.2d 64, 68 (2d Cir. 1939) (refusing to augment damages for adverse tax consequences caused by bunching in a breach of contract case because "[t]o calculate such an item of damages permits of wide speculation"); *DePalma v. Westland Software House*, 225 Cal. App. 3d 1534, 1544 (Cal. Ct. App. 1990) (rejecting defendant's argument that plaintiff's damages should be reduced by tax benefits received in a breach of contract case in part because of "the necessarily complex and speculative nature of inquiring into tax consequences"). One might also object to gross ups on the basis that they would be extremely costly to employers because, as described in note 34 *supra*, the gross ups themselves are taxable, requiring a further gross up, which itself would be taxable, requiring a further gross up, and so on. For example, assuming that the amount of adverse tax consequences suffered by a plaintiff equals \$300,000 and the tax rate applicable to the gross up is 35%, a judge would have to order a gross up equal to \$461,538, which would be deductible by the defendant, in order to neutralize the adverse tax consequences. It may seem, at first glance, unduly expensive to charge the defendant with a \$461,538 gross up in order to "solve" a \$300,000 tax problem. However, absent a gross up and assuming a constant tax rate of 35%, the plaintiff would have to earn \$461,538 of pre-tax earnings himself in order to absorb the adverse tax consequences. Therefore, someone, either the plaintiff or the defendant, will have to come up with \$461,538 of pre-tax dollars to satisfy the excess tax liability—ordering a gross up would put that burden on the defendant.

279. RESTATEMENT (SECOND) OF TORTS § 914A cmt. c (1979).

280. *Id.* cmt. b.



would be in the future years to which the front pay relates.<sup>281</sup> Gross income would include not only the plaintiff's estimated future wages, but if the plaintiff is or will be married, the plaintiff's spouse's future wages. Gross income would also include any future passive income, such as dividends from stocks. Possible deductions would include dependency deductions for the plaintiff's children, as well as deductions for home mortgage interest and state and local taxes.

In addition to speculating about the plaintiff's future tax circumstances, one would also have to speculate about future tax law.<sup>282</sup> Tax laws change frequently, especially the tax rates set forth in § 1.<sup>283</sup> In addition to rate changes, there may be substantive changes to the tax law that affect the taxpayer's tax liability.

Despite this conjecture, it seems to us that the amount of speculation involved in computing adverse tax consequences caused by the bunching of future income is no greater than the amount of speculation typically involved in computing pecuniary damages under anti-discrimination statutes.<sup>284</sup> In computing these damages, courts may need to consider a number of variables, such as the amount of back-pay or front-pay loss, the age at which the plaintiff would retire, and future inflation.<sup>285</sup> All of these variables involve inexact speculation about the future, yet courts are forced to make a best guess in order to fashion a remedy that has the greatest chance of making plaintiffs perfectly whole.<sup>286</sup> There is no reason why a court should treat the variable of future tax consequences any differently.

## 2. AMT Trap

Determining the amount of adverse tax consequences caused by the AMT trap presents more difficulty. With respect to a recovery (or portion thereof) that represents future wages, the complexity and speculation issues with respect to computation discussed above in Part IV.C.1 remain relevant. These issues are not insurmountable. However, because of the uncertain tax law surrounding the AMT trap, it may be very difficult to determine whether adverse tax consequences even *arise* in a given case.

---

281. *Id.*; *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490, 494 (1980).

282. *Liepelt*, 444 U.S. at 494.

283. *See, e.g.*, Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 41-44 (changing marginal tax rates). For an example of how a court dealt with the uncertainty regarding future tax rates, see *Oddi v. Ayco Corp.*, 947 F.2d 257, 261-62 (7th Cir. 1991) (applying a presumption that current tax rates will persist).

284. *See Liepelt*, 444 U.S. at 494.

285. *See id.*

286. *See id.* As we discuss in Part IV.C.3 below, the administrative difficulty in computing gross ups should not be entirely ignored because in certain cases the benefits of providing a gross up are outweighed by the administrative burden in computing them.

The tax law is uncertain because of the upcoming Supreme Court decision regarding the taxation of contingent fee arrangements. In two consolidated cases, the Supreme Court will decide the issue of whether the inclusion/deduction method or the exclusion method is appropriate. There are three possible outcomes. First, the Court could determine that the inclusion/deduction method applies in all cases, regardless of underlying state attorney lien law.<sup>287</sup> Second, the Court could determine that the exclusion method applies in all cases, regardless of underlying state attorney lien law.<sup>288</sup> Finally, the Court could determine that the appropriate method is dependent on underlying state attorney lien law.<sup>289</sup>

Under the first outcome, the AMT trap would apply to all discrimination plaintiffs, subject only to a retroactive legislative fix. Under the second outcome, the AMT trap would completely disappear. Only under the third outcome would there remain any doubt about whether, absent retroactive legislation, the AMT trap would apply to a particular plaintiff since the application would depend on an analysis of state law.

We predict that the first outcome (i.e., that the inclusion/deduction method applies in all cases) is the most likely and that the third outcome (i.e., that underlying state law is determinative) is highly unlikely. As several commentators have explained, the Code appears to clearly require the inclusion/deduction method even though it yields the wrong policy result.<sup>290</sup> The current Court, with its emphasis on textualism,<sup>291</sup> will likely agree.

The third outcome is, in our opinion, by far the most unlikely because it would improperly elevate the formal attributes of state law over substance.<sup>292</sup> As a practical matter, all state attorney lien laws operate in precisely the

---

287. See, e.g., *Campbell v. Comm'r*, 274 F.3d 1312, 1314 (10th Cir. 2001) (following the inclusion/deduction method); *Young v. Comm'r*, 240 F.3d 369, 372 (4th Cir. 2001) (same).

288. See, e.g., *Banks v. Comm'r*, 345 F.3d 373, 386 (6th Cir. 2003) (following the exclusion method); *Srivastava v. Comm'r*, 220 F.3d 353, 355 (5th Cir. 2000) (same).

289. See, e.g., *Raymond v. Comm'r*, 355 F.3d 107, 114–18 (2d Cir. 2004) (concluding that the inclusion/deduction method applies after analyzing Vermont attorney lien law); *Banaitis v. Comm'r*, 340 F.3d 1074, 1082–83 (9th Cir. 2003) (concluding that the exclusion method applies after analyzing Oregon attorney lien law).

290. See, e.g., Geier, *supra* note 53, at 549; Timothy R. Koski, *Should Clients Escape Tax on Lawsuit Proceeds Retained by Attorneys?*, 92 TAX NOTES 93, 97 (2001); Polsky, *supra* note 5, at 63; Lawrence M. Stone et al., *High Court Should Deny 'Stealth' AMT Relief in Att'y Fee Cases*, 103 TAX NOTES 1407, 1407 (2004).

291. See Ellen P. Aprill, *The Law of the Word: Dictionary Shopping in the Supreme Court*, 30 ARIZ. ST. L.J. 275, 277–78 (1998) (describing the Rehnquist Court's use of textualism).

292. In addition, as a technical tax matter, it is difficult to see how attorney lien law impacts the tax consequences for the plaintiff. See Polsky, *supra* note 5, at 95–111 (concluding that, even if the contingent fee agreement is treated as effecting a transfer of a portion of the claim for tax purposes, the entire recovery is still included in the plaintiff's gross income).

same manner.<sup>293</sup> Tax law is concerned with the substance of transactions; as a result, a plaintiff's tax consequences should not "depend on the intricacies of an attorney's bundle of rights against the [client]."<sup>294</sup> Furthermore, the Court would be loathe to affirm a "state-by state approach [which] would not provide reliable precedent . . . or provide sufficient notice to taxpayers as to [the] tax treatment of contingency-based attorney's fees."<sup>295</sup> In addition, such a formalistic approach would likely cause state legislatures to amend their attorney lien statutes to add the magic, though substantively meaningless, words in order to achieve the better federal tax results for their residents, perhaps generating the next round of litigation over whether the magic words are sufficient.<sup>296</sup>

For the reasons discussed above, after the Supreme Court speaks on the issue, it is likely that the AMT trap will apply to all discrimination plaintiffs wherever situated. If so, absent retroactive legislation fixing the flaw, a judge will know with certainty that a plaintiff will suffer adverse tax consequences resulting from the AMT trap and can order a gross up to neutralize these consequences.<sup>297</sup>

### 3. De Minimis Rule

We have argued that courts have the authority, under the anti-discrimination remedial provisions, to enter a gross up to compensate plain-

---

293. See *Young v. Comm'r*, 240 F.3d 369, 378 (4th Cir. 2001) (noting that courts relying on state attorney lien law have reached different conclusions even though there was "no relevant distinction" between the state law analyzed).

294. *Srivastava v. Comm'r*, 220 F.3d 353, 364 (5th Cir. 2000); see also *Banks v. Comm'r*, 345 F.3d 373, 385 (6th Cir. 2003) (rejecting distinctions based on state attorney lien law differences that lack substantive effect); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (same).

295. *Banks*, 345 F.3d at 385; see also *Campbell v. Comm'r*, 274 F.3d 1312, 1314 (10th Cir. 2001) (concluding that a "universal standard independent of" formalistic differences in state attorney lien laws would be desirable).

296. See, e.g., Wash. S.B. 58-6270, 2nd Sess. (2004) (explaining a proposal to amend Washington's attorney lien statute retroactively for the sole "purpose of making attorney's fees taxable solely to the attorney"); cf. Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 515-17 (1995) (describing the proliferation of limited liability company (LLC) statutes after the IRS issued Rev. Rul. 88-76, 1988-2 C.B. 360, which announced that LLCs could be taxed as partnerships even if they operated in all important respects like closely held corporations).

297. A judge may be concerned, however, that if a retroactive legislative fix is made, the plaintiff would be left with a windfall since the adverse tax consequences resulting from the AMT trap would evaporate. For example, § 643 of the JOBS Act, recently passed by the Senate but not included in the corresponding House bill, would fix the AMT trap and would apply retroactively to all attorney's fees paid after December 31, 2002. This is a difficult problem. A judge concerned about the windfall could retain jurisdiction over the case during the statute of limitations applicable to the taxpayer's tax return and order the taxpayer to reimburse the defendant for any adverse tax consequences that fail to come to fruition because of retroactive tax legislation.

tiffs for adverse tax consequences. However, we believe that courts do not have the obligation to do so in every case in which adverse tax consequences are present. Because of the broad discretion given to courts to fashion appropriate make-whole relief, courts can award a tax gross up in situations where adverse tax consequences are severe, while denying or limiting such relief when the circumstances are not so compelling.<sup>298</sup>

In making the determination of whether to exercise this authority, courts should determine the relevant weight of two factors: (1) the amount of the adverse tax consequences that probably would be suffered by the plaintiff in the absence of a gross up, versus (2) the difficulty and cost of computing the precise amount of an appropriate gross up.<sup>299</sup> Because computing the precise amount of adverse tax consequences will never be an easy exercise, courts may properly decline to order a gross up that is *de minimis* either in absolute terms or in relation to the plaintiff's recovery.

This *de minimis* rule will generally impact cases in which only bunching concerns are present since the consequences of the AMT trap tend to be quite severe. Attempting to alleviate a modest bunching problem (e.g., one that bunches only a few years of wages into a single year) may simply not be worth the effort.

#### V. COMPUTING GROSS UPS IN MORE COMPLEX CASES

This Article thus far has considered cases in which only pecuniary damages (i.e., losses of back pay or front pay) are awarded. In these cases, the appropriate formula for determining the amount of adverse tax consequences is readily apparent—the excess of (i) a baseline amount equal to the after-tax dollars the plaintiff would have received had the back pay and front pay represented by the award been received in due course, over (ii) the actual amount of after-tax dollars recovered by the plaintiff. More simply, the formula is the excess of (i) the amount of after-tax dollars the plaintiff would have gotten had he not suffered discrimination, over (ii) the amount of after-tax dollars the plaintiff actually gets. This formula is apparent because the baseline—the amount of wages the plaintiff would have been able to keep (after the payment of taxes) had no discrimination occurred—is apparent. In order to fulfill Congress's make-whole directive, the

---

298. See *supra* Part III.A (discussing the make-whole objective).

299. All of the difficulty and cost relate to the problems discussed in Parts IV.C.1 and 2 above regarding the complexity and speculation involved in computing the amount of adverse tax consequences. Because of this complexity and speculation, the parties would have to expend time and resources (in particular relating to expert witness testimony) in fashioning their arguments, and the court would be burdened with assimilating this information and arriving at a precise gross up figure.

plaintiff should be compensated for the amount by which an award does not meet this baseline amount.<sup>300</sup>

However, the relevant baseline is not nearly as apparent when an award (or portion thereof) represents non-pecuniary damages, such as compensatory damages for emotional distress or punitive damages. Unlike pecuniary damages, these damages do not represent amounts that would have been received and taxed had no discrimination occurred.<sup>301</sup> In amending § 104(a)(2) Congress explicitly decided that these non-pecuniary damages were to be taxable when such damages are attributable to a non-physical injury; therefore, it seems clear that the baseline tax treatment should include the taxation of these awards.<sup>302</sup> But at what level of taxation?

Defendants would argue that because there is no clear baseline tax treatment for non-pecuniary damages, a court may augment only the pecuniary damage portion of an award to compensate for adverse tax consequences.<sup>303</sup> After all, how does a court fulfill the make-whole prerogative with respect to amounts that would not have been paid but for the litigation?<sup>304</sup>

On the other hand, plaintiffs may argue that the baseline amount for non-pecuniary damages is equal to the highest marginal tax rate to which plaintiff could be subject. Currently, the highest marginal tax rate is 35%.<sup>305</sup> This would appear to be the highest marginal tax rate that Congress could have contemplated would apply to non-pecuniary awards, but because of the unforeseen consequences of the AMT trap, marginal rates may in fact be higher on these awards. Under this method courts would gross up plaintiffs with respect to non-pecuniary damages in order to ensure that they end up

300. As discussed *supra* note 34, in addition to awarding this amount, the court, in order to make plaintiff whole, would also need to award an additional amount because the gross up itself is taxable.

301. See *O'Neill v. Sears, Roebuck & Co.*, 108 F. Supp. 2d 443, 448 (E.D. Pa. 2000) (concluding that, because "[t]he compensatory and liquidated damages . . . are *only* a product of th[e] lawsuit [and] . . . would not have [been] received . . . but for the defendant's discriminatory action," no gross up was appropriate with respect to these damages).

302. Some commentators have argued that, as a tax policy matter, compensatory damages for emotional distress should be excluded from gross income since these damages result from an involuntary liquidation of human capital. *E.g.*, Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43, 46-47 (1987); Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 FLA. TAX REV. 327, 347-48 (1995). Under this view, one could argue that the appropriate baseline is the gross amount of these compensatory damages, unreduced by any tax. While this baseline might be appropriate as a normative matter, using it would disregard the clear congressional directive that these compensatory damages are taxable when they are not attributable to a physical injury.

303. This method effectively treats the baseline amount of non-pecuniary damages as exactly equal to the amount of after-tax dollars the plaintiff recovers attributable to such damages, so that no adverse tax consequences are deemed to result from the receipt of these damages.

304. See *O'Neill*, 108 F. Supp. 2d at 448 (concluding that a gross up for bunching with respect to compensatory damages would result in a windfall for plaintiffs).

305. I.R.C. § 1 (2000).

with at least 65% of the gross non-pecuniary damage award after payment of taxes.

It seems to us that defendant's position has greater merit, with one caveat discussed below. Without a clear baseline amount, it is simply impossible to determine how exactly the plaintiff can be made whole.

The caveat involves the extreme case where the AMT trap causes the plaintiff to owe more in taxes than the pre-tax recovery. Even if only compensatory and punitive damages are awarded in such a case, a tax gross up should be awarded to prevent the plaintiff from suffering an after-tax loss as a result of the discrimination and ensuing successful litigation. For example, in the *Porter* case discussed above, the plaintiff received \$30,000 in compensatory and punitive damages, but no pecuniary damages.<sup>306</sup> Due to the \$200,000 attorney's fee award, the plaintiff would likely end up with an after-tax loss due to the effect of the AMT trap.<sup>307</sup> In such a case, the make-whole directive is implicated—the court should ensure that, at the very least, the plaintiff is not in a worse economic position after the discrimination and ensuing successful litigation than before. The court can do this by ordering a tax gross up to offset the plaintiff's after-tax loss resulting from the litigation.<sup>308</sup>

To summarize, courts should ordinarily not gross up non-pecuniary awards because, unlike with respect to pecuniary awards, there is no clear baseline tax treatment for the components of these awards. As a result, it is impossible to determine how exactly to make a plaintiff whole. However, in cases in which the plaintiff will experience an after-tax loss resulting from her receipt of non-pecuniary damages, courts should provide a gross up to offset this loss.

#### CONCLUSION

The overarching purpose of anti-discrimination remedies is to put the victim of discrimination in the same economic position he would have occupied if no discrimination had occurred. However, absent a tax gross up, the Code would frustrate this objective by taxing pecuniary awards more heavily than the lost wages they represent. As a result of these adverse tax consequences, unless courts award tax gross ups, discrimination plaintiffs will not be made whole.

We have argued that the broad remedial powers granted to courts under the anti-discrimination statutes provide authority for courts to award tax gross ups, effectively shifting the burden of these adverse tax consequences

---

306. See *supra* note 160 and accompanying text (discussing *Porter*).

307. *Porter v. U.S. Agency for Int'l Dev.*, 293 F. Supp. 2d 152 (D.D.C. 2003). This assumes that a reviewing court would apply the inclusion/deduction method, thereby triggering the AMT trap. See *supra* text accompanying notes 86–114.

308. As described in note 34 *supra*, the tax gross up would have to be greater than the plaintiff's after-tax loss because the tax gross up itself would be taxable.

from plaintiffs to defendants. Such tax gross ups are necessary to ensure that successful discrimination plaintiffs are made whole in a meaningful, after-tax sense.

Shifting the burden of adverse tax consequences to defendants would also provide an incidental benefit. The AMT trap, the statutory flaw that is the major cause of adverse tax consequences, persists only because the victims of the trap—employment discrimination and other civil rights plaintiffs—lack sufficient political coordination and muscle to stimulate Congress to act. Perhaps by shifting the burden of the AMT trap to the more politically savvy employer-defendants, tax gross ups might finally produce the long awaited legislative solution.