CONSIDERING TAXES IN THE COMPUTATION OF LOST BUSINESS PROFITS

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INTRODUCTION

On October 12, 1990, the federal district court for the District of Massachusetts issued its damages opinion in *Polaroid Corp. v. Eastman Kodak Co.*[1] Judge A. David Mazzone's award of almost $909.5 million represented the largest judgment in a patent infringement case in U.S. history.[2] Although his sixty-page opinion lucidly addressed and resolved scores of issues, one received remarkably little attention—the additional income taxes that Polaroid would have paid on its additional income if Kodak had not been in the instant photography market.[3]

Like a majority of courts in lost-profits cases, the *Polaroid* court simply awarded lost pretax income as the damages amount.[4] In commercial cases, the most frequently enunciated rationale is that the injured party will pay taxes on the damages award in the year of the award and that will serve as an adequate substitute for the income taxes that would have been paid during each year of the damages period.[5]

The purpose of awarding lost profits damages in a tort case is to compensate a party for the economic gains it would have received ab-

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1. 16 U.S.P.Q.2d 1481 (D. Mass. 1990).
2. *See id.* at 1541. The judgment was subsequently amended to $873.2 million to account for clerical errors that had been made in the original computation of damages. On July 18, 1991, the parties settled the case out of court, agreeing to drop all appeals and cross-appeals.
3. Judge Mazzone's discussion of the issue comprised only three paragraphs of his opinion. *Polaroid Corp.*, 16 U.S.P.Q.2d at 1541.
4. *Id.*
5. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955); Burnet v. Sanford & Brooks Co., 282 U.S. 359, 364 (1931); H. Liebes & Co. v. Commissioner, 90 F.2d 932, 935 (9th Cir. 1937).

sent the injury.[6] By ignoring taxes, courts make no provision for a cash outlay that a party clearly would have incurred absent the injury. Courts thereby put an injured party in a much different position than the party would have occupied. In some cases, this grants a windfall benefit to the injured party; in other cases, it unfairly penalizes that party. In *Polaroid*, had Judge Mazzone computed damages on an after-tax basis, the final judgment could have been more than $350 million lower.[7] The tax calculation clearly mattered in that case, and it undoubtedly does in many others.

The taxation of a lost-profits award usually is not an adequate substitute for yearly taxes. One reason is that the tax rate in the award year is often quite different from the appropriate rate in each year of the damages period. The decline in the maximum corporate tax rate from forty-six percent in 1986 to thirty-four percent in 1989 provides a perfect illustration. A firm that suffered damages in 1986, yet collected a pretax lost-profits award three years later, may well realize a windfall benefit of twelve percentage points. That plaintiff actually would have profited from being injured. Even if corporate tax rates remained constant over time, failure to account for taxes contemporaneously would lead to an incorrect damage award whenever lost profits must be converted into today's dollars.

The focus of this Article is lost business profits as contrasted with loss of earnings due to a personal injury or wrongful death. Damage awards in personal injury and wrongful death cases are not taxable under federal law.[8] Many courts have decided that Congress intended to confer a benefit on injured parties by making recoveries tax-free and have, therefore, dispensed with all tax considerations.[9]

6. 22 AM. JUR. 2d *Damages* § 624 (1988).

7. If Polaroid's incremental income streams had been reduced by the maximum statutory rate and the final damages award had been adjusted upward to allow for payment of taxes in the year of the award, Polaroid's judgment would be reduced by $357 million.

8. I.R.C. § 104(a)(2) (1991) excludes from gross income those damage awards that are received as a result of personal injuries or sickness. That section has been interpreted to include damage awards in wrongful death actions as well. *See* Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701, 701-02 (1986) (discussing judicial interpretation and application of I.R.C. § 104(a)(2)). In many jurisdictions, personal injury and wrongful death awards are similarly exempted from state income taxes. In order to minimize potential complications, the remainder of this Article will ignore the existence of state taxes. Nonetheless, the conclusions remain the same.

9. *See, e.g.*, Louissaint v. Hudson Waterways Corp., 111 Misc. 2d 122, 128-29, 443 N.Y.S.2d 678, 682 (Sup. Ct. 1981); Lumber Terminals, Inc. v. Nowakowski, 36 Md. App. 82, —, 373 A.2d 282, 291 (1977). *See also* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 8.8 at 576-77 (West 1973) (citing Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212, 227 (1958)) [hereinafter Dobbs]. *But see* Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L.R. 701, 706-07 (1977).

In spite of the relative merits of the "intent of the Congress" arguments, the reasons for considering contemporaneous taxes in a lost-business-profits case are equally applicable to personal injury and wrongful death actions.

Section II of this Article describes the principles underlying the calculation of lost profits. Simply put, a lost-profits award is meant to grant an injured party the net benefits of lost transactions. Those net benefits most often are measured as the difference between incremental accrued revenues and incremental accrued expenses. An alternative and preferable approach involves measuring the difference between incremental cash inflows and incremental cash outflows.

In Section III, I argue that net profits (or net cash flows) are fair indicators of what would have occurred but for the injury only if *all* expenses (or cash outflows) are deducted from revenues (or cash inflows). Incremental taxes can be computed in a fairly straightforward fashion and Section III explains the procedure.

Even if the fears of double-taxing an injured party were alleviated, it is likely that courts in commercial cases would have the same uneasiness as courts in personal injury and wrongful death actions. Section IV describes the reasons for the judicial uneasiness. Economic reality was recognized by the United States Supreme Court in *Norfolk & Western Railway Co. v. Liepelt*,[10] when it held that taxes are a proper consideration in personal injury and wrongful death cases.[11] The *Liepelt* decision, however, has been applied quite narrowly.

In Section V, I argue that the traditional arguments for ignoring taxes are unconvincing. Although the computation of incremental taxes may be difficult in some cases, the calculations are often no harder than those associated with other components of a lost-profits claim. Income taxes are a fact of life and would have to be paid in the but-for world just like labor, materials, and overhead expenses. Adjusting a final award upward to allow for full payment of taxes in the year of award will alleviate any fears of double-taxing an injured party.

To estimate yearly incremental taxes, a court may simply multiply incremental pretax income by the statutory tax rate for each year. Section VI describes alternatives for those situations in which incremental pretax income is viewed as an inadequate basis upon which to compute incremental taxes. The alternatives are no more

10. 444 U.S. 490 (1979), *reh'g denied*, 445 U.S. 972 (1980).

11. *Id.* at 496.

complex, and in many instances much less so, than most of the other calculations courts must undertake.

CALCULATION OF LOST PROFITS

Lost-profits calculations are governed by the general compensatory damages rule that a party who has sustained a loss or injury should receive "just compensation" for the loss or injury.[12] The injured party is not entitled to be made more than whole; that is, it should not be put in a better position than it would have been in but for the injury.[13] Nor should the party be made less than whole, granting an unfair advantage to the tortfeasor.

Lost profits represent the difference between the profits that would have been generated in a world but for the injury and the profits that would have been generated in the actual (or injured) world.[14] Many courts have cut short the calculation by directly computing incremental profits.[15] If undertaken correctly, calculating the difference between but-for profits and actual profits generates the same result as calculating only the increment.

The most common measure of profits (in both the but-for and the actual world) is the difference between the revenues that the injured party would have (actually) realized and the expenses it would have incurred (did incur) to generate those revenues.[16] In other words, the profits recoverable are the excess, or net, of revenue over costs. As the court wrote in *Lee v. Durango Music*:[17] "Profit . . . is the advantage or benefit remaining after expenses, charges, and costs are deducted from [revenues]; until then . . . one can not say whether there has been a profit or not." The deductible expenses include the value of the labor, materials, rents, and all other costs.[18] Robert L. Dunn has noted that there are some cases in which lost gross profits, rather than lost net profits, are recoverable, with lost gross profits simply equal to lost revenues.[19] Dunn points out that "[t]he fact situ-

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12. *See generally* 22 AM. JUR. 2d *Damages* §§ 23, 27, at 624 (1988).

13. 22 AM. JUR. 2d *Damages* § 27 (1988). In some cases courts may grant punitive damages. Lost-profits awards, however, are compensatory in nature.

14. *See, e.g.*, Deakle v. John E. Graham & Sons, 756 F.2d 821, 830 (11th Cir. 1985); Commercial Damages: A Guide to Remedies in Bus. Litig. ¶ 22.05(1) (C. Knapp 4th ed. 1990) [hereinafter COMMERCIAL DAMAGES].

15. *See, e.g.*, Paper Converting Mach. Co. v. Magna-Graphics Corp., 745 F.2d 11, 22 (Fed. Cir. 1984), *aff'd*, 785 F.2d 1013 (Fed. Cir. 1986).

16. *See, e.g.*, O'Brien & Meyer, *A Guide to Calculating Lost Profits*, THE NAT'L L. J., Jan. 29, 1990, at 19; COMMERCIAL DAMAGES, *supra* note 14, at ¶ 22.05(2)(a).

17. 355 P.2d 1083, 1088 (Colo. 1960).

18. *See, e.g.*, Guntert v. City of Stockton, 55 Cal. App. 3d 131, —, 126 Cal. Rptr. 690, 700 (1976).

19. R. DUNN., RECOVERY OF DAMAGES FOR LOST PROFITS § 6.2, at 283-86 (3d ed. 1987) [hereinafter Dunn].

ations in which such a claim is proper are relatively few."[20]

In most damages cases, a claim is made for incremental profits that would have been generated in a year other than the year in which the court will award damages. Because a given amount of money has a different value at different points in time, most of those claims have led courts to discount (or compound) lost profits to the date of award.[21] Failure to adjust for the time value of money would put the injured party in a much different position today than the party would have been in absent the injury.[22] For example, if the lost profits of a company in 1980 were $100, the company would be undercompensated if it received the same amount today. One hundred dollars is worth much less today than it was worth in 1980. To compensate for this difference in purchasing power, courts have converted past (and future) damages into today's dollars using appropriate discount rates.[23] The procedure by which this is done is often called "discounting."

Most courts have accounted for the time value of money by discounting lost income, as opposed to lost cash flows. These courts calculate the difference between lost revenue and lost expenses using the principles of accrual accounting,[24] and have converted the difference into today's dollars. Table 1 illustrates a typical accrual-basis approach for computing after-tax lost profits. The cumulative dollar amount of damages in this example is $600. Future valuing (or discounting) those flows to Year Four generates an interest award of an additional $117. The result is a lost profit recovery of $717.

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20. *Id.* at 286. According to Dunn, gross profits may be recovered (1) if they are the same as net profits—that is, if no added expenses would have been incurred; (2) when the added expenses would have been so small that the court feels justified in ignoring them; (3) when the expense of performance is offset by losses or expenses that resulted from defendant's actions; and (4) when the defendant has made it impossible for the plaintiff to prove net profits. *Id.* at 283-86.

21. *See, e.g.*, Jones & Laughlin Steel Corp. v. Pfeifer, 462 U.S. 523, 537 (1983). A notable exception is an antitrust claim containing past damages. Prejudgment interest is not normally recoverable in such a case.

22. *See* Lanzillotti & Esquibel, *Measuring Damages in Commercial Litigation: Present Value of Lost Opportunities*, 5 J. ACCT., AUDITING, & FIN. 125 (1990).

23. For an exposition on the fundamentals of discounting, *see* R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE (3d ed. 1988). For a discussion of appropriate discount rates used in litigation, *see* Patell, Weil & Wolfson, *Accumulating Damages in Litigation: The Roles of Uncertainty and Interest Rates*, 11 J. LEGAL STUD. 341 (1982); Fisher & Romaine, *Janis Joplin's Yearbook and the Theory of Damages*, 5 J. ACCT., AUDITING, & FIN. 145 (1990).

24. Accrual accounting measures income for a period as the difference between the revenues recognized in that period and the expenses that are matched with those revenues . . . [T]he period's revenues are not necessarily the same as the period's cash receipts from customers, and the period's expenses are not necessarily the same as the period's cash disbursements.

R. ANTHONY & J. REECE, ACCOUNTING PRINCIPLES 70 (6th ed. 1989).

TABLE 1
ACCRUAL BASIS DAMAGES

	Year One	Year Two	Year Three	Total
Incremental Accrued Revenues	$800	$800	$800	$2,400
Incremental Accrued Operating Expenses	400	300	200	900
Incremental Book Depreciation (1)	100	100	100	300
Incremental Pretax Income	300	400	500	1,200
Incremental Tax Expense (2)	150	200	250	600
Incremental Net Income	150	200	250	600
Future Value in Year Four (3)	200	242	275	$ 717

NOTES:
(1) Using three-year, straight-line depreciation of an asset valued at $300 at the beginning of Year One.
(2) At fifty percent of incremental pretax income. In the real world, tax rates are applied against taxable income, which is the amount that is reported to taxing authorities, rather than against pretax income, which is the amount that is reported in the annual report of a firm. In many cases, parties assume that pretax income is a good surrogate for taxable income.
(3) Assuming mid-year flows and annual compounding at a ten percent rate.

Table 1 represents the most common approach for computing lost profits and adjusting them for the time value of money. Interest, which is used to adapt the flows to a date certain, is not earned on net (or book) income as calculated by generally accepted accounting principles ("GAAP"). The reason is that net income is not cash. Net income is what a company, in complying with Securities and Exchange Commission ("SEC") and Financial Accounting Standards Board ("FASB") requirements, presents in its annual reports. This measure of the financial well-being of a firm is usually quite different from its net cash flow. Only cash can earn interest. A company cannot use accrual income to pay bills, to acquire assets, to pay dividends, to pay off debt, or for any other financial purpose; these activities require cash. The amount on which interest should be calculated, therefore, is the difference between incremental cash inflow and incremental cash outflow.[25]

25. *See, e.g.*, Wagner, *How Do You Measure Damages? Lost Income or Lost Cash Flow?* J. ACCT., Feb. 1990, at 28.

Over an extended number of years, the sum of lost income will equal the sum of lost cash. The only true difference is one of timing. The timing of the lost flows, however, has a significant impact on the amount of money needed to convert damages into today's dollars.

One of the timing differences is due to depreciation. For purposes of reporting income in financial statements, most firms choose straight-line depreciation, by which an asset is written off in even annual amounts over the life of the asset. In Table 1, a $300 asset is written off in $100 increments over three years.

For tax purposes, however, firms are allowed to use accelerated depreciation for most assets, by which those assets are written off over a shorter period of time, with decreasing amounts each year. The result is that taxes actually payable to the Internal Revenue Service ("IRS") can be quite different from the tax expense shown in the annual report of a firm. Table 2 illustrates the impact of that difference on the calculation of incremental taxes.

TABLE 2
CALCULATING TAXES PAYABLE

	Year One	Year Two	Year Three	Total
Incremental Revenues (1)	$800	$800	$800	$2,400
Incremental Operating Expenses (2)	400	300	200	900
Incremental Tax Depreciation (3)	200	100	0	300
Incremental Taxable Income	200	400	600	1,200
Incremental Taxes Payable (4)	100	200	300	600
Incremental Income	100	200	300	600

NOTES:
(1) From Table 1.
(2) From Table 1.
(3) Assuming two-year, accelerated depreciation schedule in which two-thirds of the value of the asset is written off in Year One and the remainder is written off in Year Two. The asset is assumed to have a value of $300 at the beginning of Year One.
(4) At fifty percent of incremental taxable income.

Although the total amount of the depreciation write-off ($300) is the same whether one uses a straight-line method or an accelerated method, the timing of taxes is quite different. Table 2 shows that $100 is due and payable to the IRS in Year One, even though Table 1

reports a corresponding tax expense of $150. For purposes of presenting financial well-being in Year One to shareholders, a firm typically will adopt straight-line depreciation because the reported net income is much higher ($150 reported in Table 1 as opposed to $100 reported in Table 2) than if it had used accelerated depreciation.

A related timing difference that distinguishes the cash approach from the income approach results from the different treatment of capital expenditures. Table 1 assumes that an asset valued at $300 is purchased in Year One and written off over the life of the asset. Even though no actual expenditures are made in Years Two and Three, accrual accounting allows a firm to spread out the cost of an asset over several years. From a cash perspective, however, money ($300) flowed out of the firm only in Year One. To compute net cash flow, the capital expenditure should be recognized in the year it was undertaken, not over an artificial depreciable life. Table 3 presents the net cash flows of a damaged firm by year and the resulting interest award.

TABLE 3
CASH BASIS DAMAGES

	Year One	Year Two	Year Three	Total
Incremental Cash Flows (1)	$800	$800	$800	$2,400
Incremental Operating Cash Outflows (2)	400	300	200	900
Incremental Capital Expenditures	300	0	0	300
Incremental Taxes Payable (3)	100	200	300	600
Incremental Cash Flow	0	300	300	600
Future Value in Year Four (4)	0	363	330	$ 693

NOTES:
(1) From Table 1.
(2) From Table 1.
(3) From Table 2.
(4) Assuming mid-year flows and annual compounding at a ten percent rate.

Although the dollar amount of damages ($600) is the same in this example whether one uses an income approach or a cash approach, discounting the damages (future valuing to Year Four) results in two different damage awards. The former results in an award of $717, while the latter results in an award of $693. Although not all of the

differences between the income and cash approaches have been addressed, the timing of the flows, and the resulting interest award, are quite sensitive to the approach adopted. The arguments supporting consideration of taxes are equally relevant in both scenarios. The examples presented here will be used to illustrate points addressed in the final section of this article.

In computing the amount of lost profits, courts have consistently held that the amount need only be shown with a "reasonable degree of certainty."[26] In actual practice, much less certainty is required to prove the quantum than is required to show the fact that profits were lost.[27] A claim that is overly speculative, conjectural, or uncertain does not satisfy the standard of proof. However, the amount need not be calculated with absolute exactness or mathematical accuracy.[28]

RATIONALE AND METHODOLOGY FOR CONSIDERING INCREMENTAL TAXES

Just like any other corporate expense, taxes are a fact of life. When a company generates taxable income, it pays taxes. If it were to generate more taxable income, the company would probably pay more taxes. The fact that taxes must be paid is virtually indisputable.[29] As a result, not to account for taxes in a lost profits damages claim would necessarily result in an overly conjectural or speculative claim.[30] Taxes are just one of the many costs that would have been sustained in generating the incremental revenues in the but-for world.[31]

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26. *See, e.g.*, DUNN, *supra* note 19, §§ 1.2-1.3, at 4-11.

27. *See* Story Parchment Co. v. Paterson Parchment Paper Co., 282 U.S. 555, 566 (1931).

28. *See, e.g.*, COMMERCIAL DAMAGES, *supra* note 14, at ¶ 5.05.

29. One exception is when taxable income in a given year is less than or equal to actual income.

30. *See, e.g.*, Floyd v. Fruit Indus., Inc., 144 Conn. 659, —, 136 A.2d 918, 925-26 (1957); William Z. Salcer, Panfeld, Edelman v. Envicon Equities Corp., 744 F.2d 935, 941 (2d Cir. 1984), *vacated on other grounds*, 478 U.S. 1015 (1986) (stating that "[t]o ignore the sizeable tax [impacts on] the plaintiffs would be unrealistic."); Bridgen v. Scott, 456 F. Supp. 1048, 1061 (S.D. Tex. 1978). In *Bridgen*, the court concluded that:

> [r]equiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial 'never-never land.' The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.

Id.

31. *See, e.g.*, USM Corp. v. Marson Fastener Corp., 392 Mass. 334, —, 467 N.E.2d 1271, 1279-80 (1984). In *USM Corp.*, the court reasoned that:

> [t]he goal is to determine the [party's] net profit, not its gross profit. Taxes, therefore, are as much a proper allowance against the gross profit as is any

Courts have consistently held that direct costs, such as additional expenses for raw materials and an expanded labor force that would have been incurred to generate incremental revenues, should be deducted from the award in order to generate a net-profits amount.[32] Courts have had more difficulty with the injured party's indirect costs, such as rent, salary of administrative personnel, utilities, and other overhead items.[33] The "weight of the authority" holds that those overhead expenses that are fixed (i.e., would not change with the level of activity at issue) "need not be deducted from [revenue] to arrive at the net profit properly recoverable."[34] Those overhead expenses that vary with the level of activity, however, have been held to be deductible in computing lost profits.[35]

To the extent that taxes would have been incurred over and above the level paid in the actual world, they are variable expenses and should likewise be deducted in computing net profits. The failure to deduct the cost of producing profits from an ultimate award results in the granting of more than adequate compensation.[36]

The following two subsections describe the procedures for properly handling incremental taxes. Contemporaneous taxes can be approximated quite easily by multiplying incremental pretax income by the maximum statutory tax rate. The resulting amount should then be adjusted upward to allow for payment of taxes on the damage

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> other cost obligation incurred in generating that profit. . . . There is no sound reason for treating income taxes paid as different from all the other expenses involved in generating the gain.

Id.; Independence Tube Corp. v. Copperweld Corp., 691 F.2d 310, 328 (7th Cir. 1982), *rev'd on other grounds*, 467 U.S. 752 (1984) (quoting Hemken v. First Nat'l Bank, 76 Ill. App. 3d 23, 27, 394 N.E.2d 868, 872 (1979)) (stating that "[n]et profits are determined by computing the difference between the gross profits and the expenses that would be incurred in acquiring such profits.").

32. *See* R. DUNN, RECOVERY OF DAMAGES FOR LOST PROFITS § 6.4, at 289 (3d ed. 1987).

33. *Id.*

34. *Id.* § 6.5, at 290. *See also* Taylor v. Meirick, 712 F.2d 1112, 1121 (7th Cir. 1983) (Judge Posner); Saf-Gard Prods., Inc. v. Service Parts, Inc., 491 F. Supp. 996, 1008 (D. Ariz. 1980).

35. For "damages calculation [purposes, profits are defined] as residual income after all costs necessary to generate the income [are] subtracted." Taylor, 712 F.2d at 1121. *See also* Lawton v. Gorman Furniture Corp., 90 Mich. App. 258, —, 282 N.W.2d 797, 801 (1979) (holding that "[a]ny other rule would obviously grant the offended litigant a greater sum than he would have earned had the [injury] not occurred").

36. *See* Guntert v. City of Stockton, 55 Cal. App. 3d 131, —, 126 Cal. Rptr. 690, 701 n.4 (1976) (quoting MCGREGOR ON DAMAGES 32-33 (13th ed. 1972)) (stating that expenses incurred "represent part of the price that the plaintiff was to incur in order to secure the gain"); Hollinger v. United States, 651 F.2d 636, 642 (9th Cir. 1981) (holding that failure to account for taxes "can result in the imposition of excessive compensatory damages or punitive damages"); Harden v. United States, 688 F.2d 1025, 1029 (5th Cir. 1982) (stating that income taxes should be deducted "to avoid an award of punitive damages").

award. The following subsections explain the necessity for the calculations.

ACCOUNTING FOR TAXES DURING THE DAMAGES PERIOD

Incremental taxes should be computed by multiplying an injured party's incremental taxable income for each year by the appropriate tax rate for that year. The equation is:

$$IT = ITI * TR \quad (1)$$

where:

IT = Incremental Taxes
ITI = Incremental Taxable Income
TR = Tax Rate

In most commercial cases, the appropriate tax rate is the maximum corporate statutory rate, which can be derived from the federal tax tables.[37] For those corporations whose alleged incremental income would not be in the highest marginal bracket, but that would still be interested in bringing a suit for lost business profits, incremental taxes are likely to be *de minimis*. In that case, the benefits of computing incremental taxes may not exceed the costs of calculation.[38]

From 1960 through 1990, the maximum statutory corporate rates and the corresponding taxable income levels were:

37. The last section of this Article deals with those cases in which the statutory rate is not the most appropriate rate to apply.

38. *See generally* Norfolk & Western Ry. Co. v. Liepelt, 444 U.S. 490, 494-95 n.7 (1980).

TABLE 4
MAXIMUM CORPORATE TAX RATES

Year	Maximum Statutory Rate	For Taxable Income Exceeding:	Year	Maximum Statutory Rate	For Taxable Income Exceeding:	
1960	52%	$25,000	1976	48%	$ 50,000	
1961	52	25,000	1977	48	50,000	
1962	52	25,000	1978	48	50,000	
1963	52	25,000	1979	46	100,000	
1964	50	25,000	1980	46	100,000	
1965	48	25,000	1981	46	100,000	
1966	48	25,000	1982	46	100,000	
1967	48	25,000	1983	46	100,000	
1968	48	25,000	1984	46	100,000	(1)
1969	48	25,000	1985	46	100,000	(1)
1970	48	25,000	1986	46	100,000	(1)
1971	48	25,000	1987: I	46	100,000	(2)
1972	48	25,000	1987: II	34	75,000	(2)
1973	48	25,000	1988	34	75,000	(3)
1974	48	25,000	1989	34	75,000	(3)
1975	48	50,000	1990	34	75,000	(3)

SOURCE: *Merten's Law of Federal Income Taxation*, §§ 2.16, 2.29 (1987).
NOTES:
(1) For taxable income over $1,000,000, but not over $1,405,000, a five percent additional tax was applied. For income over $1,405,000, the maximum statutory rate was forty-six percent.
(2) For 1987 tax years beginning before 1 July, the 1986 tax rates and rules applied (see Note 1). For 1987 tax years beginning after 30 June, the 1988 tax rates and rules applied (see Note 3). Corporations with a tax year including 1 July 1987 had to prorate their taxes. For calendar year taxpayers, that resulted in a maximum statutory rate of forty percent.
(3) For taxable income over $100,000, but not over $335,000, a five percent additional tax was applied. For income over $335,000, the maximum statutory rate was thirty-four percent.

It is easy to see that the maximum statutory rate has changed quite dramatically over time. From 1960 to 1990, the maximum rate fell by one-third. That change in rates alone justifies the need for consideration of taxes when computing past damages.

To estimate future taxes at any given point in time, the appropriate rate to use in most instances is the then-current rate, unless there is some basis to believe that future rates will differ from the current rate. Such a situation occurred in 1986, when it was known that the maximum average corporate rate in 1987 (for a taxpayer on a calendar basis) would be forty percent and it was reasonably certain that the maximum rate in 1988 would be thirty-four percent.

ACCOUNTING FOR TAXES IN THE YEAR OF A DAMAGES AWARD

Accounting for yearly incremental taxes enables a court to develop a reasonably certain but-for world. To put the injured party in the position the party would have been in absent the injury, however, requires that the final damage award be adjusted upward to allow for full payment of taxes in the year of recovery. The adjustment upward is often called the "gross-up" of an award.

The rationale for a gross-up is illustrated in the following example. If an injured party's lost profits (after-tax) were $100 and if a court were to award $100 today, that party would owe the taxing authorities a certain portion of the award. If the appropriate tax rate for the year of award is thirty-four percent, the injured party would have to pay $34 in taxes and would be left with $66. The party clearly would be undercompensated for the damage that was done.

The court would really need to increase the $100 award to allow the injured party to pay taxes at a thirty-four percent rate and still be left with $100. The equation for doing this is:

$$\text{GUA} = \frac{\text{ATD}}{1-\text{TR}} \quad (2)$$

where:

GUA = Grossed-Up Award
ATD = After-tax Damages
TR = Tax Rate

In the above example, the formula would result in the following:

$$\text{GUA} = \frac{\$100}{1-.34} \quad (3)$$

$$\text{GUA} = \frac{\$100}{.66} \quad (4)$$

$$\text{GUA} = \$151.52 \quad (5)$$

If the injured party were to receive $151.52 today, the party would pay $51.52 ($151.52 in damages times the thirty-four percent tax rate) to the taxing authorities. Therefore, the party would be left with $100, which equals the party's after-tax losses.

The approach described here is similar to that which has been adopted by a number of courts in dealing with interest that will be

earned on a personal injury or wrongful death award.[39] The reasoning in those cases is that while an award is not subject to income taxes, the interest it earns upon investment is taxable. Therefore, to make the injured party whole, the ultimate award must be increased to compensate for those tax losses.

Grossing-up an award is quite easy, particularly if the year of the award is included within the damages period.[40] The tax rate that should be used for the gross-up in such an instance should be equal to the tax rate that was used in establishing current-year damages.[41]

ELIMINATING THE AWARD OF A WINDFALL BENEFIT DUE TO A CHANGE IN TAX RATES

Not accounting properly for taxes almost always results in a windfall benefit to one of the litigating parties. This is certainly the case whenever the appropriate tax rate in the year of recovery differs from the appropriate tax rate in any year of the damage period.[42] Judge Mazzone clearly acknowledged that in *Polaroid Corp. v. Eastman Kodak Co.*[43] Windfalls resulting from a difference in tax rates have become prominent of late because, as Table 4 shows, the current maximum federal rate is substantially lower than it has been for

39. *See, e.g.*, Sosa v. M/V Lago Izabal, 736 F.2d 1028, 1033-34 (5th Cir. 1984); DeLucca v. United States, 670 F.2d 843, 844 (9th Cir. 1982); Hollinger v. United States, 651 F.2d at 642-43; Meehan v. Central R.R. Co. of New Jersey, 181 F. Supp. 594, 607 (S.D.N.Y. 1960). *See also* MCI Communications Corp. v. American Tel. & Tel. Co., 708 F.2d 1081, 1168 n.124 (7th Cir.), *cert. denied*, 464 U.S. 891 (1983) (involving an antitrust action in which a gross-up of the final award is suggested, but left for the determination of the lower court on remand).

40. Interest lost up to and including the date of the award is often part of the damages claim. In such a case, the year of the award is certainly included within the damages period.

41. An award that compensates a party for damages beyond the then-current year presents a more difficult case "due to the simultaneity between the value of lump-sum awards . . . and the level of taxes to be levied on investment income from those awards." Bruce, *An Efficient Technique for Determining the Compensation of Lost Earnings*, 13 J. LEGAL STUD. 375, 375 (1984). As a series of articles in the Journal of Legal Studies has shown, however, techniques do exist to solve for the value of the desired lump-sum award. *See* Bell, Bodenhorn & Taub, *Taxes and Compensation for Lost Earnings*, 12 J. LEGAL STUD. 181 (1983); Burke & Rosen, *Taxes and Compensation for Lost Earnings: A Comment*, 12 J. LEGAL STUD. 195 (1983); Bell, Bodenhorn & Taub, *Taxes and Compensation for Lost Earnings: Reply*, 14 J. LEGAL STUD. 457 (1985).

42. It also results in a windfall to a plaintiff who has made an investment for tax shelter purposes and subsequently sues either for damages or rescission. Note, *Harris v. Metropolitan Mall: The Need to Consider Tax Benefits When Awarding Damages in a Sale-Leaseback Situation*, 1985 WISC. L. REV. 375, 399 (1985). If a plaintiff receives damages for a full investment and retains tax benefits, that party receives more than was actually lost. The goal of compensatory damages is therefore distorted. *Id.*

43. 16 U.S.P.Q.2d 1481, 1541 (D. Mass. 1990).

many years.[44] Plaintiffs who were allegedly damaged in earlier periods, and are seeking recovery today, frequently (and successfully) have argued that the entire damage calculation should be done on a pretax basis. They have clearly benefitted from such an approach.

Assuming *arguendo* that the appropriate measure of lost profits is lost income, the proper measure of after-tax damages is:

$$ATD = ITI - IT \tag{6}$$

where:

ATD = After-tax Damages
ITI = Incremental Taxable Income
IT = Incremental Taxas

Substituting equation (1) into equation (6) reults in:

$$ATD = ITI - (ITI * TR) \tag{7}$$

By rearranging terms, we obtain:

$$ATD = ITI * (1 - TR) \tag{8}$$

In those cases in which damages are discounted to the date of award, a court must add up the discounted flows. The equation to do that is:

$$TATD_t = \sum_{n=1}^{\infty} DATD_n \tag{9}$$

44. *See* Micro Motion, Inc. v. Exac Corp., 761 F. Supp. 1420 (N.D. Cal. 1991).

> Exac introduced evidence showing that the maximum marginal federal tax rate for corporations has fallen from forty-six percent in 1985 and 1986, to forty-three percent in 1987, [and] to thirty-four percent in 1988, 1989, and 1990 . . . Exac argues that Micro Motion will enjoy an unfair 'tax windfall' because the taxes it will pay on the damage award it receives in this case may be substantially less than the taxes it would have paid had it actually earned those amounts in 1985, 1986, and 1987. Exac, therefore, suggests that the court adjust Micro Motion's award to reflect the difference between the marginal corporate tax rate in place when Mirco Motion sustained its injury and the marginal corporate tax rate in place when it receives it (sic) award.

Id. at 1435-36.

Although the court found "Exac's tax windfall theory quite interesting," it declined to apply it in the case at hand. *Id.* at 1436. One of the reasons for its holding was that "Exac failed to prove that Emerson Electric, Micro Motion's parent, paid taxes at the top marginal rate for corporations." The court went on to write that "there is not enough evidence before the Court to allow it to determine what tax rate should be applied to each year's earnings." *Id.*

where:

$TATD_t$ = Total After-tax Damages as of Year t (the assumed year of recovery)
$DATD_n$ = Discounted After-tax Damages as of Year t for each Year n of the Damages Period

To allow for the payment of taxes in the year of award, the court must then gross-up the resulting total after-tax damages amount. Expanding equation (2) results in:

$$GUA_t = \frac{TATD_t}{1 - TR_t} \quad (10)$$

where:

GUA_t = Grossed-Up Award in Year t
$TATD_t$ = Total After-tax Damages as of Year t
TR_t = Tax Rate in Year t

The approach suggested here would tax the 1980 income, for instance, at the appropriate rate for 1980 and would gross-up the discounted after-tax damages at today's rate. Assuming lost taxable income of $100 in 1980, no award of prejudgment interest, and payment of a damages award in 1990, use of statutory rates results in the following:

$$ATD_{80} = \$100 * (1 - .46) \quad (11)$$

$$ATD_{80} = \$100 * .54 \quad (12)$$

$$ATD_{80} = \$54 \quad (13)$$

$$GUA_{90} = \frac{\$54}{1 - .34} \quad (14)$$

$$GUA_{90} = \frac{\$54}{.66} \quad (15)$$

$$GUA_{90} = \$81.82 \quad (16)$$

Equation (16) shows that the grossed-up damages award today should be $81.82. After payment of today's taxes of $27.82 (which is $81.82 times thirty-four percent), the plaintiff would be left with $54 ($81.82 minus $27.82), which is exactly the after-tax amount that the plaintiff would have received in 1980. (See equation (13)). A plaintiff's pretax approach generates an award today of $100. After payment of today's taxes in the amount $34 (which is $100 times thirty-four percent), the plaintiff is left with $66, or a windfall benefit of $12 ($66 minus $54). Plaintiff clearly would benefit from the change

in the tax laws, resulting in a twelve-percentage-point difference in tax rates.

It is possible that the appropriate tax rate could be higher in the year of award than it was during the damages period.[45] In that case, the defendant would benefit from the change in taxes and would argue for computing damages on a pretax basis.[46] The recommendation to treat taxes correctly would remain the same and would continue to be based on notions of economic fairness.[47]

Today, taxes should be considered in virtually all cases that contain a claim for past damages. Tax rates and tax rules (e.g., the availability of research and development tax credits) have changed tremendously over the last few years. For the most part, failure to compute taxes on past damages will generate a windfall benefit to plaintiffs.

The example above, in which the statutory rate fell from forty-six percent in 1980 to thirty-four percent in 1990, showed the plaintiff realizing a $12 windfall benefit due to a change in the tax laws. In cases in which courts award prejudgment interest, the windfall could be substantially higher. The reason is that the plaintiff would be allowed to earn interest (and, in some instances, compound interest) on the amount of the plaintiff's windfall.

An illustration may help. According to a plaintiff's pretax approach, the plaintiff is entitled to $100 in 1980 and is allowed to bring forward that amount at an appropriate interest rate. Assuming that the appropriate pretax interest rate for each year of the damages period is ten percent, the plaintiff would argue for an award of $259.37 in 1990 ($100 times one plus the interest rate to the tenth power). Payment of taxes in 1990 at the statutory rate ($259.37 times thirty-four percent, equalling $88.19) would result in a net damages award of $171.18.

According to the approach suggested here, plaintiff is entitled to a principal amount of $54 in 1980. (See equation (13)). Bringing that

45. Such a situation may occur when a large award in the year of recovery puts the plaintiff/taxpayer into a higher tax bracket than the party would have occupied in the but-for world. This phenomenon is often called "the bunching of income." *See* Squillante, *Taxation of Breach of Contract Damages*, COMMERCIAL DAMAGES REP: A GUIDE TO REMEDIES IN BUS. LITIG., 223-24 (Dec. 1989) [hereinafter COMMERCIAL DAMAGES]; Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 714-19 (1977). The bunching of income is much more likely to happen to an individual, rather than a corporate, taxpayer.

46. In this case, judicial attempts to grant the benefit of the doubt to the injured party would be undermined by ignoring yearly taxes.

47. *See* Fanetti v. Hellenic Lines Ltd., 678 F.2d 424, 431 (2d Cir. 1982), *cert. denied*, 463 U.S. 1206 (1983) (stating that "[f]ocusing upon after-tax earnings is an exercise in economic fairness.").

amount forward at an appropriate after-tax interest rate of, say, five and four-tenths percent (ten percent times one minus the forty-six percent tax rate of 1980) results in an after-tax damages award of $91.37 ($54 times one plus the interest rate to the tenth power).[48] When prejudgment interest is available, this hypothetical leads to a total windfall for the plaintiff of $79.82 ($171.18 minus $91.37).

CALCULATING INTEREST ON AN AFTER-TAX BASIS

As the above discussion suggests, the interest calculation should be done completely on an after-tax basis.[49] Interest could only have been earned on the cash that would have been retained by the injured party. And that cash is simply the difference between cash inflows and cash outflows.[50] Because taxes are a cash outflow, interest can only be earned on net, after-tax cash.[51]

Correspondingly, in most cases, interest income (expense) that is earned (paid) in a given year is subject to taxation (deduction).[52] As Fisher and Romaine point out:

> Making the plaintiff whole must mean making it whole after taxes. . . . Had the award . . . been made in year 0 (coinciding with the damage itself), the plaintiff would have paid taxes on it, invested the remainder . . . and paid taxes on the resulting earnings. . . . The net aftertax interest that would have been retained would therefore have been at the

48. Grossing-up that amount at the tax rate for this year results in a final award of $138.44 ($91.37 divided by one minus thirty-four percent). Payment of taxes at thirty-four percent will result in a net damages award of $91.37.

49. In fact, in the *Polaroid* case, Judge Mazzone considered taxes only in the context of computing the proper amount of prejudgment interest. *Polaroid*, 16 U.S.P.Q.2d at 1541. He did not discuss taxes in computing the amount of Polaroid's lost profits. *Id.* at 1530-31.

50. *See supra* note 12-28 and accompanying text.

51. *See, e.g.*, USM Corp. v. Marson Fastener Corp., 392 Mass. 334, —, 467 N.E.2d 1271, 1283 (1987) (holding that "Any award of prejudgment interest would have to be based on after-tax profits because it is only those amounts which . . . could have [been] used to . . . advantage.").

52. Taxes need not be deducted from interest generated by a tax-free instrument. The court stated in *Sosa*:

> In *Flannery v. United States*, 718 F.2d 108, 112 (4th Cir. 1983), the Fourth Circuit refused to adjust a lump sum damage award to counter income tax effects because the fiduciary handling the funds 'could invest them in whole or in part in tax exempt securities.' This approach would also be acceptable to us if the district court took into account the lower interest rates of tax exempt securities when fashioning the damage award. In sum, we will approve any reasonably safe arrangement that will produce an after-tax income equivalent to that lost by the plaintiff.

Sosa v. M/V Lago Izabal, 736 F.2d 1028, 1034 n.5 (5th Cir. 1984). *See also* DeLucca v. United States, 670 F.2d 843, 846 (9th Cir. 1982). Use of a "tax exempt securities" rate comprises use of an after-tax interest rate and that is precisely the kind of rate that should be applied to after-tax cash flows to generate the correct interest amount.

aftertax rate. . . .[53]

Economic and financial principles clearly dictate that interest should be calculated by applying an after-tax interest rate to aftertax cash flows.

Failure to account for taxes whenever lost flows need to be discounted (i.e., interest calculated) will lead to the award of an incorrect damage amount. This will occur regardless of whether the tax rates change between the damages period and the year of award. In the previous example, plaintiff's pretax approach led to a net damage recovery in 1990 of $171.18. The approach suggested in the previous section led to an after-tax damages award, before gross-up, of $91.37. Assuming that the 1990 tax rate were forty-six percent, equalling the assumed rate throughout the damages period, the grossed-up award would be $169.20. Taxing this award at a forty-six percent rate would result in a net damage recovery of $91.37, substantially different from that derived using the plaintiff's standard approach. The difference is due entirely to the impact of taxes on the proper amount upon which interest is calculated and not due at all to a change in tax rates.[54] Accordingly, incremental taxes need to be accounted for

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53. Fisher and Romaine, *Janis Joplin's Yearbook and the Theory of Damages*, 5 J. ACCT., AUDITING, & FINANCE 145, 148 (1990). *See also* COMMERCIAL DAMAGES, *supra* note 14, at ¶ 22.06(4) (stating "[I]nterest is taxable. It is clear that the lump sum award must be increased so that interest can be earned, taxes paid on the interest, and the after-tax interest and principal make the injured party whole.").

54. Proof of the result when there is no change in the tax rates overtime, is quite easy. A damages award, net of taxes on that award, according the standard plaintiff's pretax approach can be represented as follows:

$$NDA = (A) * (1 + B)^n * (1 - TR) \qquad (a)$$

where:

NDA = Damages Award, Net of Taxes on the Award
A = Pretax Damage Amount
B = Interest Rate
TR = Tax Rate
n = Period

Multiplying through results in

$$(A - ATR) * (1 + B)^n \qquad (b)$$

An after-tax award based on the approach suggested in this Article can be represented as:

$$(A) * (1-TR) * (1 + (B * (1-TR)))^n \qquad (c)$$

Multiplying through results in

$$(A - ATR) * (1 + B - BTR)^n \qquad (d)$$

While the first terms of equations (b) and (d) are identical, i.e., (A − ATR), the second terms clearly are not. The results under the two approaches will be equivalent, therefore, only in very unusual circumstances.

even in those instances in which all the damages are future damages and the tax rate is assumed to be constant from the date of award onward.

Regardless of which party realizes the windfall benefit, computing lost-profits damages on a pretax basis, in most instances, is incorrect.[55] As noted earlier, pursuing a pretax analysis does not necessarily confer a benefit to the tortfeasor at the expense of the injured party. If statutory tax rates are lower during the damages period than at the award date, the plaintiff/victim will benefit from the approach suggested here. The same will occur if the appropriate rate in the year of award is higher than prospective rates. To eliminate the awarding of a windfall and to return the injured party to the economic position the party would have occupied absent the injury, courts must fully account for incremental taxes.

TRADITIONAL ARGUMENTS FOR IGNORING INCREMENTAL TAXES

The old rule, which currently represents the majority rule, is that the incidence of income taxation should not be considered in computing damages in general and lost profits or lost earnings in particular.[56] Incremental taxes often are at issue in personal injury and wrongful death actions, but are hardly ever contested in commercial damages cases. Because of the taxability of a business profits award, imposing contemporaneous taxes is viewed as unduly burdensome to the injured party.[57] In *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*,[58] the United States Supreme Court wrote:

> [T]o diminish the actual damages by the amount of the taxes that [plaintiff] would have paid had it received greater prof-

55. In *Polaroid*, Judge Mazzone dealt with the windfall argument, in part, by adopting defendant's proffered one-month Treasury bill interest rates, rather than the plaintiff's proffered, and higher, prime lending interest rates. *Polaroid*, 16 U.S.P.Q.2d at 1541 (D. Mass. 1990). *See also* Micro Motion, Inc. v. Exac Corp., 761 F. Supp. 1420, 1436 (N.D. Cal. 1991) (stating that "prejudgment interest will be paid on the full amount of damages awarded [i.e., no incremental taxes should be deducted], but the interest payments will not be compounded.").

56. *See* 25A C.J.S. *Damages* § 194 (1966 & Supp. 1991); DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 8.8 at 576-77 (West 1973); Annotation, *Propriety of Taking Income Tax into Consideration in Fixing Damages in Personal Injury or Death Action*, 16 A.L.R. 4TH 589, 605 (1982 & Supp. 1990); R. DUNN, RECOVERY OF DAMAGES FOR LOST PROFITS, § 6.8 at 304-08 (3d ed. 1987).

57. COMMERCIAL DAMAGES: A GUIDE TO REMEDIES IN BUS. LITIG. ¶ 22.05(2)(b) (C. Knapp ed. 1990) (stating "[T]he real question is whether the damage award will be taxable to the business which was wronged. If so, it is net income before tax which must be projected as loss. Otherwise, the wronged business will be taxed twice."). *See also* Atlas Truck Leasing, Inc. v. First NH Banks, Inc., 808 F.2d 902, 905 (1st Cir. 1987); Polaroid Corp. v. Eastman Kodak Co., 16 U.S.P.Q.2d 1481, 1541 (D. Mass. 1990).

58. 392 U.S. 481 (1968), *reh'g denied*, 393 U.S. 901 (1968).

its in the years it was damaged would be to apply a double deduction for taxation, leaving [plaintiff] with less income than it would have had if [defendant] had not injured it. . . . [T]he *rough result* of not taking account of taxes for the year of injury but then taxing recovery when received seems the most satisfactory outcome.[59]

In many cases, it may appear as if courts are accounting for incremental taxes because they calculate so-called "net profits." In most of these cases, however, "net profits" has taken on a meaning quite different from what accountants mean by the term. Some courts define lost "net profits" as the difference between incremental revenues and incremental production or operating costs.[60] Other courts further subtract incremental overhead costs.[61] Very few courts deduct incremental taxes in computing a business' lost profits.[62]

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59. *Id.* at 503 (emphasis added). The court held so in spite of the fact that "accounting for taxes in the year when damages were received rather than the year when profits were lost can change the amount of taxes [owed]; as [defendant] shows, actual rates of taxation were much higher in some of the years when [plaintiff] was injured than they are today." *Id. See also* ITT Corp. v. United States, 11 U.S.P.Q.2d 1657 (Cl. Ct. 1989). The court stated that:

> Here, defendant argues that a hypothetical tax applied at the times of hypothetical royalty and interest payments demonstrates that compound interest overcompensates plaintiff. This is no different than stating that because earlier taxation would have resulted in less total interest accumulation for plaintiff, its taxable recovery measured by compound interest should be reduced correspondingly. The court rejects this theory. If changes in tax rates from the time of injury to the time of recovery do not justify predicating a taxable recovery on the effect of the earlier rates, neither should the practice of compounding.

Id. at 1692-93.

60. *See, e.g.*, McKinney v. Grace Distrib. Servs., Inc., 660 F. Supp. 1092 (S.D. Miss. 1986) (involving damages due to the loss of a tractor/trailer rig); C&K Coal Co. v. United Mine Workers, 537 F. Supp. 480 (W.D. Pa. 1982) (involving damages arising out of a labor strike); Melton v. United States, 488 F. Supp. 1066 (D.D.C. 1980) (involving an action alleging negligent rehabilitation of homeowner's property).

61. *See, e.g.*, Taylor v. Meirick, 712 F.2d 1112, 1121 (7th Cir. 1983) (involving copyright infringement); Reed Brothers, Inc. v. Monsanto Co., 525 F.2d 486, 499 (8th Cir. 1975), *cert. denied*, 423 U.S. 1055 (1976) (involving an antitrust action in which net profits are defined as gross profits minus allocated general and administrative expenses); Paper Converting Mach. Co. v. Magna-Graphics Corp., 576 F. Supp. at 967, 978 (E.D. Wis. 1983) (involving trademark infringement). In O. Hommel Co. v. Ferro Corp., 659 F.2d 340 (3rd Cir. 1981), both of the parties, as well as the appellate court, accepted the following lower court jury instruction:

> [I] instruct you that only lost *net profits, before taxes*, may constitute an item of actual damages in antitrust cases. *Net profit before tax* is the total revenues received from sales minus the cost of goods sold, including labor and material costs, and minus operating expenses and overhead.

Id. at 363 n.5 (emphasis added).

62. In determining *defendants'* profits for purposes of trademark liability, courts routinely allow defendants to deduct incremental operating expenses, overhead and income taxes from incremental net sales. *See, e.g.*, Murphy Door Bed Co. v. Interior Sleep Sys., 874 F.2d 95, 103 (2d Cir. 1989). In a federal antitrust action, the Fifth Cir-

Courts could adopt the gross-up adjustment suggested here in order to neutralize the impact of current-year taxes and, therefore, overcome the fear of double-taxing an injured party. Nonetheless, those courts may still be reluctant to deduct incremental taxes for the same reasons that many courts in personal injury and wrongful death cases are reluctant.

Many of the courts conclude that the estimation of incremental taxes is too speculative and complex.[63] Much of that is due to perceived fluctuations in tax rates from year to year and to the difficulty of predicting exclusions, exemptions, deductions, and credits to which the taxpayer would have been entitled.[64]

Estimating what the tax impacts would be in a but-for world, according to those courts, would not only be extremely time consuming, but would be virtually impossible to do with reasonable certainty.[65] This is particularly true with respect to estimating taxes on projected future earnings.[66] According to the Supreme Court of Alaska:

> Income tax rates, provisions relating to deductions and exemptions, and other aspects of income tax laws and regula-

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cuit, citing *Liepelt*, held that a credible damage model must allow for the deduction of federal income taxes. Mid-Texas Communications Inc. v. American Tel. & Tel. Co., 615 F.2d 1372, 1392 n.19 (5th Cir.), *cert. denied*, 449 U.S. 912 (1980).

63. *See generally* McWheeney v. New York, N.H. & H. R.R., 282 F.2d 34 (2d Cir.), *cert. denied*, 364 U.S. 870 (1960). It is worth noting that the *McWheeney* decision would not exclude consideration of taxes in all cases. Judge Friendly conceded that where plaintiff's income is very large (for example, $100,000 a year) the "failure to make some adjustment for the portion . . . earnings that would have been taken by income taxes would produce an improper result." *McWheeney*, 282 F.2d at 38. *See also* G&R Corp. v. American Sec. & Trust Co., 523 F.2d 1164, 1176 (D.C. Cir. 1975) (involving an action brought to recover funds diverted by a bank from a joint venture account in which the court adopts the holding in *Hanover Shoe* and adds that "accurate valuation of tax benefits and burdens cannot be accomplished for several years . . . It is unrealistic and impractical to compute now what may, or may not, be the ultimate effects . . ." (citations omitted)); In re IBM Peripheral EDP Devices Antitrust Litigation, 459 F. Supp. 626, 630 (N.D. Cal. 1978) (involving an antitrust action in which the court cites *Hanover Shoe* in concluding that the "difficulty" and "speculation" involved in computing but-for taxes "would complicate this already complex litigation").

64. *See* In Re Air Crash Disaster Near Chicago, Ill. on May 25, 1979, 701 F.2d 1189, 1193-94 (7th Cir.), *cert. denied*, 464 U.S. 866 (1983).

65. *See, e.g.*, Micro Motion, Inc. v. Exac Corp., 761 F. Supp. 1420, 1436 (N.D. Cal. 1991). The court stated that:

> . . . to be completely fair, a tax adjustment would have to take into account changes to a firm's entire tax burden, not just changes to its federal taxes. Such an inquiry, which was not performed in this case, would add to the complexity of already difficult damage cases and could add significantly to the cost of litigating such actions.

Id.

66. *See, e.g.*, Combs v. Chicago, St. P., M. & O.R. Co., 135 F. Supp. 750 (N.D. Iowa 1955); Abele v. Massi, 273 A.2d 260 (Del. 1970); Beaulieu v. Elliott, 434 P.2d 665 (Alaska 1967).

tions are so subject to change in the future that we believe that a court cannot predict with sufficient certainty just what amounts of money a plaintiff would be obliged to pay. . .[67]

The same difficulty has been recognized by courts that have attempted to estimate lost historical earnings. In the *Polaroid* case, Judge Mazzone wrote:

> . . . I do not believe it sound to calculate interest to be paid *now* based on tax rates in effect at the time the injury was sustained. That approach lends itself to unbounded speculation and uncertainty and can result in a potential windfall to either party. I have no basis upon which to decide how Polaroid could have sheltered that income and any effort to learn would have complicated this area unnecessarily.[68]

Another reason for the reluctance to consider taxes is that those considerations are often viewed as extraneous to the issues being tried. Invoking the collateral source rule,[69] some courts have held that taxes are not a matter between the injured party and the wrongdoer and, therefore, should not be considered in computing a damages award.[70] Taxes are an issue between the injured party and the government, akin to a party's relationship with its insurance company. As in the case of insurance, because the transaction was negotiated independently of the defendant, courts and juries should not consider those dealings in determining the amount of money owed by the wrongdoer to the injured party.[71] The collateral source rule often has been invoked so as to grant the benefit of any doubt to the tort victim, rather than to the tortfeasor.[72]

Economic reality was recognized in the personal injury and wrongful death realm in 1979 when the United States Supreme Court issued its opinion in *Norfolk & Western Railway Co. v. Liepelt*,[73] a wrongful death action brought under the Federal Employers' Liability Act ("FELA"). The measure of recovery under FELA, according

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67. *Beaulieu*, 434 P.2d at 673.

68. *Polaroid Corp.*, 16 U.S.P.Q.2d at 1541.

69. The collateral source rule provides that the amount of damages that may be recovered from a wrongdoer should not be affected by any amount that is or will be received from a collateral source. *See generally* RESTATEMENT (SECOND) OF TORTS § 920A (1979).

70. *See, e.g.*, Huddell v. Levin, 395 F. Supp. 64, 88 (D.N.J. 1975).

71. *But see* Salcer v. Envicon Equities Corp., 744 F.2d 935, 941 (2d Cir. 1984).

72. *See, e.g.*, Lumber Terminals, Inc. v. Nowakowski, 36 Md. App. 82, —, 373 A.2d 282, 291-92 (1977); Reeves v. Louisiana & Ark. Co., 304 So. 2d 370, 377 (La. Ct. App. 1974); Hall v. Chicago & N.W. Ry. Co., 5 Ill. 2d 135, —, 125 N.E.2d 77, 86 (1985). *See also* Note, Harris v. Metropolitan Mall: The Need to Consider Tax Benefits when Awarding Damages in a Sale-Leaseback Situation, 1985 WISC. L. REV. 375, 382 (1985).

73. 444 U.S. 490 (1980).

to the Court, is "the damages . . . [that] flow from the deprivation of the pecuniary benefits which the beneficiaries might have reasonably received."[74] Because the "amount of money that a wage earner is able to contribute to support his family is unquestionably affected by the amount of the tax he must pay,"[75] the Court wrote, "the wage earner's income tax is a relevant factor in calculating the monetary loss suffered by his dependents when he dies."[76]

The Court pointed out, however, that federal courts "have generally not considered the payment of income taxes as tantamount to a personal expenditure and have regarded the future prediction of tax consequences as too speculative and complex for a jury's deliberations."[77]

The Court, writing a decade ago, responded by noting that the trial bar and trial bench have made tremendous advances in the presentation of what were once complicated issues so that introduction of such evidence could no longer be called "too speculative or complex."[78] The Court held that the trial court had erred in excluding evidence showing the effect of income taxes on decedent's estimated future earnings.[79]

The *Liepelt* decision has formed the basis for the majority rule in wrongful death actions brought under FELA. The holding, however, has not been applied broadly. The Eighth Circuit in *Austin v. Loftsgaarden*[80] attempted to apply the reasoning to a securities fraud case in which the plaintiffs had realized tax shelter benefits. This decision, however, was overruled by the United States Supreme Court in *Randall v. Loftsgaarden*.[81] In *Randall*, the Court held that as a matter of statutory construction and on the facts presented, tax benefits should not be offset against a recessionary[82] recovery under § 12(2) of the Securities Act of 1933 or § 10(b) of the Securities Exchange Act of 1934. The Court did not address the question of whether taxes should be considered when the measure of damages is out-of-pocket losses or lost profits.

A number of courts applying state law have written that

74. *Id.* at 493 (quoting Michigan Central R.R. Co. v. Vreeland, 227 U.S. 59, 70 (1913)).
75. *Id.* at 493.
76. *Id.* at 494.
77. *Id.*
78. *Id.*
79. *Id.*
80. 675 F.2d 168 (8th Cir. 1982).
81. 478 U.S. 647 (1986).
82. Rescission calls for canceling the contract and returning the parties to their original positions. *See generally* A. CORBIN, CORBIN ON CONTRACTS § 1236, at 989 (1952).

although the *Liepelt* decision may be binding in federal court because the claim arose under FELA, it is not binding under state law.[83]

Courts have been unwilling to adopt the *Liepelt* holding in cases in which there is a threat of double taxation. Because *Liepelt* represented a wrongful death action, the ultimate award was not subject to taxation. In fact, the Court wrote that the trial court had erred in refusing to offer the requested jury instruction that "your award will not be subject to any income taxes, and you should not consider such taxes in fixing the amount of your award."[84] Estimating future taxes, in such a case, would not represent two bites of the apple.

The *Liepelt* Court limited its holding in a footnote when it wrote: "This is not to say, however, that introduction of such evidence must be permitted in every case. If the impact of future income tax in calculating the award would be *de minimis*, introduction of the evidence may cause more confusion than it is worth."[85] The Court fully recognized that the costs associated with the calculation of incremental taxes may, in some cases, exceed the benefits of obtaining a more precise damage amount.

PROBLEMS WITH THE TRADITIONAL ARGUMENTS FOR IGNORING INCREMENTAL TAXES

As noted above, many courts have refused to undertake a computation of incremental taxes because of the complexity of the calculation and, therefore, the speculative nature of the result. It is difficult to understand why the complexity of the calculation necessarily leads to an overly speculative result. Courts undertake complex calculations all the time.[86] Sophisticated econometric models, containing scores of variables, are often used to compute incremental revenues

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83. *See, e.g.*, Fenasci v. Travelers Ins. Co., 642 F.2d 986, 989 (5th Cir. 1981), *cert. denied*, 454 U.S. 1123 (1982) (applying Louisiana state law); Savic v. United States, 702 F. Supp. 695, 698 (N.D. Ill. 1988); Gerbich v. Evans, 525 F. Supp. 817, 819 (D. Colo. 1981); Newlin v. Foresman, 103 Ill. App. 3d 1038, —, 432 N.E.2d 319, 325 (1982); Terveer v. Baschnagel, 3 Ohio App. 3d 312, —, 445 N.E.2d 264, 268 (1982).

84. *Liepelt*, 444 U.S. at 492.

85. *Id.* at 494-95 n.7 (citing FED. R. EVID. 403). *See also* Schuler v. United States, 675 F. Supp. 1088, 1095 (W.D. Mich. 1987), *rev'd on other grounds*, 868 F.2d 195 (6th Cir. 1989); Martinez v. United States Fidelity and Guar. Co., 423 So. 2d 1088, 1091 (La. 1982).

86. *See* Floyd v. Fruit Indus., 144 Conn. 659, —, 136 A.2d 918, 926-27 (1957) (stating that taxes are no more uncertain, speculative or conjectural than many of the other factors which must be admitted for the consideration of the jury). In Smith v. Industrial Constructors, Inc., 783 F.2d 1249 (5th Cir. 1986), the court stated that:

> In most situations, the estimation of future taxes would be no more difficult than other items of damages. Either side could prepare a reasonably accurate estimate of future taxes from current generally applicable tax rates. . . This estimate could then be challenged with evidence that the decedent's personal situation required higher or lower rates. . . . The factfinder would then be in a

and incremental manufacturing costs. Although some of the models are ultimately thrown out, the attempts are not precluded because they are *per se* too speculative. One commentator has pointed out:

> [C]onjecture and speculation could be found in such things as . . . possible changes in the exemption and deduction provisions of the tax law . . . possible changes in the rates of taxation . . . possible changes in the cost of living . . . These items are speculative. But are they so speculative that we should refuse to let the defendant even try to show them? Indeed, which is more conjectural: the existence of income tax in this country along the pattern we now know it, or the continuance of the plaintiff's salary during exactly the same period? Yet, we have no real difficulty in letting the jury speculate as to the existence of the latter.[87]

Additionally, the calculations are not necessarily overly complex. As the Supreme Court wrote in *Liepelt*:

> Admittedly there are many variables that may affect the amount of a wage earner's future income-tax liability. The law may change, his family may increase or decrease in size, his spouse's earnings may affect his tax bracket, and extra income or unforeseen deductions may become available. But future employment itself, future health, future personal expenditures, future interest rates, and future inflation are also matters of estimate and prediction. Any one of these issues might provide the basis for protracted expert testimony and debate. But the practical wisdom of the trial bar and the trial bench has developed effective methods of presenting the essential elements of an expert calculation in a form that is understandable by juries that are increasingly familiar with the complexities of modern life.[88]

Indeed, although not widespread, an increasing number of courts have applied the reasoning of *Liepelt* in contexts other than wrongful death actions brought under FELA.[89]

> position to weigh all the evidence and arrive at a damage figure (citations omitted).

Id. at 1254 (citing Cox v. Northwest Airlines, Inc., 379 F.2d 893, 896 (7th Cir. 1967); Brooks v. United States, 273 F. Supp. 619 (D.S.C. 1967)). *See also* F. HARPER, F. JAMES & O. GRAY, THE LAW OF TORTS § 25.12 (2d ed. 1986). The authors stated:

> [F]uture taxes are no more speculative than many other items that go into prophecies about future losses in this uncertain world of ours. . . . With anything as sure as 'death and taxes,' the courts are avoiding their responsibilities when they decline to make the best guess they can, once all the reasonably available evidence has been brought before them.

Id.

87. Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212, 227 (1958) (emphasis omitted).

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

89. *See, e.g.*, Madore v. Ingram Tank Ships, Inc., 732 F.2d 475, 478-79 (5th Cir.

Part of the fear of computing incremental taxes is the fear of reliance upon financial or accounting experts. The calculation of incremental taxes, however, need not even rely on expert testimony. In fact, in most cases it should not. Multiplying incremental taxable income by the appropriate statutory rate is quite easy. There are situations, however, in which the statutory rate is not appropriate. The final section of this Article addresses those situations and offers alternative, yet straightforward, methods for calculating incremental taxes.

In addition to the "speculative and complex" objection, calculation of incremental taxes has been precluded by invocation of the collateral source rule. To whom the expenses are paid, however, should not matter in computing the amount of lost-profits damages. Materials are purchased from third-party suppliers. Labor dollars are paid to employees. Advertising expenses are provided to television and radio stations. Similarly, taxes are paid to governmental authorities. In computing lost-profits damages, all that matters is computing the amount of additional funds that would have flowed into the firm in the but-for world, and the amount of additional funds that would have flowed out. The net flow is at issue, not the collateral source or collateral recipient of the funds.

The collateral source rule has been invoked in wrongful death and personal injury cases so as to carry out the intent of the tax laws to grant a benefit to the injured party.[90] In a case of commercial damages, however, there exists no congressional intent to benefit the tort victim. The only policy aim is to put the injured party back into the position the party would have occupied had the injury not occurred.

The considerations underlying the application of the collateral source rule in the case of insurance are not appropriate here. As the court wrote in *Smith v. Industrial Constructors, Inc.*[91]

Among other economic reasons, the collateral source rule [in

1984) (involving a personal injury action brought under the Jones Act); Flannery v. United States, 718 F.2d 108, 111 (4th Cir. 1983), *cert. denied*, 467 U.S. 1226 (1984) (involving a personal injury action brought under the Federal Tort Claims Act); Fanetti v. Hellenie Lines, Ltd., 678 F.2d 424, 431 (2d Cir. 1982) (involving a lost wages action brought under the Longshoremen's and Harbor Workers' Compensation Act); Brown v. United States, 615 F. Supp. 391, 394-95 (D. Mass. 1985), *cert. denied*, 479 U.S. 1058 (1987) (involving a wrongful death action brought under the Death on the High Seas Act).

90. The collateral source rule is discussed and critiqued in F. HARPER, F. JAMES & O. GRAY, *supra* note 86, at § 25.22. The authors argue that courts that apply the rule "measure 'compensation' by the total amount of harm done, even though some of it has been repaired by the collateral source, not by what it would take to make the plaintiff whole." *Id.*

91. 783 F.2d 1249 (5th Cir. 1986).

the insurance context] makes economic sense because it encourages potential victims to buy insurance. R. Posner, *Economic Analysis of Law*, 152-53 (2d ed. 1977). The collateral source rule is also fair because plaintiffs have bought the right to insurance benefits and should not be denied these benefits by having their award reduced by the amount of those benefits. The same economic and equitable justifications are clearly not applicable to income taxes.[92]

The judicial fear of double-taxation should be entirely alleviated by the approach offered here. By grossing-up the damage award to allow for the payment of taxes in the year of award, courts will effectively nullify the impact of current-year taxes. What will be left is a stream of after-tax flows that represent the financial position that the plaintiff would have been in had the injury not occurred.

ALTERNATIVE METHODS TO ACCOUNT FOR INCREMENTAL TAXES

As discussed earlier, in order to estimate incremental taxes payable, a court may multiply incremental taxable income by the appropriate statutory tax rate for each year. This means that there are really two pieces to the puzzle. The first (incremental taxable income) is the amount that is taxed, and the second (the maximum statutory tax rate) is the rate at which taxes are computed. The simplest surrogate for the first piece (incremental taxable income) is simply incremental pretax income, with the latter defined as the difference between incremental accrued revenues and incremental accrued expenses. Pretax income is the amount reported in the income statement of a company and is prepared in accordance with GAAP. As illustrated in Table 1, in those cases in which incremental taxes are considered, pretax income is usually the basis upon which taxes are computed. In the real world, however, pretax income is not the amount that is reported to taxing authorities—taxable income is the reported amount.

There are two important classes of difference between pretax income and taxable income.[93] The first type is permanent differences. One example is amortization of goodwill, which is an expense under GAAP, but cannot be deducted under the income tax laws. The second type is timing differences, which are differences that will be reversed, or turned around, in subsequent years. For example, the tax laws require certain businesses to use the delivery method for recog-

92. *Id.* at 1255.

93. The following relies heavily upon the Book-to-Tax Difference discussion in R. ANTHONY & J. REECE, ACCOUNTING PRINCIPLES 241-43 (6th ed. 1989).

nizing revenues, even though the company uses the installment method for financial reporting, in accordance with FASB rules. The total amount of revenue recognized for book (delivery method) and tax (installment method) purposes will be the same over the entire life of a contract, but yearly book and tax revenues are likely to differ. Another timing difference may be due to differences in depreciation schedules. As discussed in the second section of this Article and illustrated in Table 2, the tax expense will equal taxes payable over the life of the underlying asset(s), but the timing of the flows may be quite different. In many cases, the differences between incremental pretax income and incremental taxable income will be imperceptible. In those cases, the former is likely to be a good estimator of the latter.

The second piece of the puzzle is the maximum statutory tax rate. Multiplying incremental pretax income by that rate for each year of the damages period is simple and may be quite correct in the sense that any incremental (or new) income generated in the historical world would most likely be taxed at the taxpayer's highest marginal rate. And as noted earlier, most firms bringing lost-profits cases are probably in the highest tax bracket already. It would be particularly appropriate in those cases in which the statutory rate is substantially the same as the rate at which the firm actually paid, or will pay, taxes to the IRS. That latter rate is known as the effective tax rate of the firm and is equal to taxes payable divided by pretax income.

Non-trivial, historical differences between statutory tax rates and the effective tax rates for the firm primarily reflect perceptible differences between pretax income and taxable income. An illustration may help. If we assume that Tables 1 and 2 reflect historical financial condition of a firm, rather than its incremental financial condition, the income statement covering years One through Three that would be reported to shareholders is shown in Table 5.

Because pretax income differs from taxable income in Years One and Three, the effective tax rates in those years (thirty-three percent and sixty percent, respectively) differ from the appropriate statutory rates (fifty percent). In addition to the explanations already discussed, there are many possible reasons for noticeable differences between pretax income and taxable income. These include deferred tax debits (e.g., accounting for termination payments), transnational transactions, and loss carryforwards and carrybacks. There may be reasons to believe that those explanatory factors will impact taxable income in the but-for world to the same extent that they impacted taxable income in the historical world. In that case, a court may

TABLE 5
HISTORICAL INCOME (PROFIT & LOSS) STATEMENT

	Year One	Year Two	Year Three
Revenues (1)	$800	$800	$800
Operating Expenses (1)	400	300	200
Depreciation (1)	100	100	100
Pretax Income	300	400	500
Taxes (2)	100	200	300
Net Income	200	200	200
Statutory Tax Rate (3)	50%	50%	50%
Effective Tax Rate (4)	33%	50%	60%

NOTES:
(1) From Table 1.
(2) From Table 2.
(3) From Table 2, n.4.
(4) Taxes divided by Pretax Income. The SEC requires companies to report their yearly effective tax rates.

choose to estimate incremental taxes payable by multiplying incremental pretax income by the effective tax rate of the firm for each year of the damages period. Use of the effective rate of a firm is tantamount to assuming that the differences between the statutory rate and the effective rate would be the same in the but-for world as they were in the real world.

Multiplying incremental pretax income by the effective tax rate for the firm may be appropriate for estimating historical incremental taxes. However, it will not work for estimating future taxes because future effective rates simply do not exist; they are computed after the fact. In such a case, a court may revert to adjusting the first piece of the puzzle (incremental pretax income) to account for the factors that are likely to make it differ noticeably from incremental taxable income. Incremental depreciation, for instance, may be a significant factor when substantial new capital expenditures would need to be undertaken in a but-for world. Table 2 illustrates how a court would directly compute incremental taxable income to account for an accelerated depreciation schedule. The incremental taxable income would then be multiplied by the appropriate statutory rate to derive tax liability for that year.

A final option would entail use of incremental pretax income times the statutory rate as a starting point and adjustment of the resulting tax amount for tax credits. One item that often is relevant in computing past damages is the investment tax credit ("ITC"). In some years, the tax laws permitted a reduction in the income taxes

for the year equal to a percentage (often ten percent) of the cost of any business machinery and equipment (but not buildings) acquired by a company during the year. The resulting ITC is a direct reduction in the income tax bill of the company (as contrasted with an item deducted from revenues in arriving at the amount of taxable income). Often times ITCs explain much of the difference between the effective tax rate of the firm and the appropriate statutory rate. Computing taxes in the fashion described here may well assuage courts that feel uncomfortable when confronted with firms whose effective tax rates differ substantially from statutory rates.

The previous two approaches may be used for estimating future incremental taxes as well as for estimating historical incremental taxes. They are alternatives to simply multiplying pretax income by either the statutory rate or the effective rate. It is worth noting that these alternatives may be most appropriate when using effective rates and when encountering years in which the effective rate was negative.[94]

CONCLUSION

Taxes are indisputably a fact of life. And if courts, in the process of computing lost-profits damages, intend to create a world that would have been, they must account for that indisputable fact of life.

It is just as indisputable that there is a widespread fear of both the payment and computation of taxes. Courts are in the business of making hard decisions. With the options presented here, the calculation of incremental taxes may well be much easier than the calculation of other components of a lost-profits claim. The calculation is just as necessary, however, for, as the United States Court of Appeals for the Ninth Circuit in *Burlington Northern, Inc. v. Boxberger*,[95] wrote:

> [Consideration of taxes] more accurately harmonizes with fair economic reality, more justly achieves the goal of com-

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94. A negative effective rate means that a party received a tax benefit in that year rather than incurring a tax cost. The question of whether plaintiff's tax benefits must be offset against a damage recovery has been the subject of considerable recent litigation in federal securities law cases.

> [Some] courts have reasoned that in a tax shelter transaction, tax benefits are part of what is bought and sold. Because tax shelter investors actively seek tax benefits, these courts have concluded that defendants should not be held liable for tax benefits that the plaintiff did, in fact, receive. The reasoning follows that if received tax benefits are not accounted for in damage awards, plaintiffs may be compensated for more than they actually lost.

Note, Harris v. Metropolitan Mall: The Need to Consider Tax Benefits When Awarding Damages in a Sale-Leaseback Situation, 195 WISC. L. REV. 375, 386-87 (1985) (citations omitted).

95. 529 F.2d 284 (9th Cir. 1975).

pensating claimants for the actual loss suffered, and safeguards against the injustice of overcompensation.[96]

96. *Id.* at 298 (footnote omitted).