Damages Measurements and Income Tax Adjustments

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Damages analysts are often retained to measure the amount of economic damages suffered by the damaged party in commercial litigation claims related to either (1) a breach of contract or (2) a tort. These damages analysts can serve their clients as either (1) consulting experts or (2) testifying experts. Such analysts apply generally accepted damages measurement methods and procedures to measure the amount of the damages suffered by the injured party. If the damages measurement analysis involves a lost profits or similar damages claim, the analyst has to consider how to handle the income tax liability that will be created as a result of the damages award. That is, if the damaged party is awarded an amount equal to the analyst's damages measurement, that award may become taxable income to the recipient. In order to return the damaged party to the economic position that the party was in before the damages event occurred, the analyst may have to adjust the recommended judicial award amount (or the negotiated settlement amount) for this income tax liability. This discussion summarizes the income tax considerations related to the damaged party's receipt of—and the damaging party's payment of—a damages award.

Introduction

Damages analysts understand that industrial and commercial companies often suffer damages due to the wrongful actions of other parties. Those other parties may include the company employees, customers/clients, competitors, suppliers, company directors, joint venturers, potential acquirers, bankers, contract counterparties, and even government and regulatory authorities.

In addition, the company owners themselves (whether they are corporation shareholders, limited liability company members, or partnership partners) can also suffer damages due to the wrongful actions of other parties. These other parties may include the company itself, the company directors, other company shareholders/owners, the company acquirer (whether actual or attempted), contract counterparties, and others.

For purposes of this discussion, the party (whether institutional or individual) suffering the damages event or events is referred to as the "damaged party."

And, for purposes of this discussion, the party (whether institutional or individual) causing the damages event or events is referred to as the "damaging party."

When parties (whether the companies or the company owners) believe they have been damaged, they will often pursue a legal claim. The damaged party will pursue a claim in order to receive compensation from the damaging party for the amount of the damages suffered.

That legal claim may be pursued through litigation or through some alternative type of legal or dispute resolution proceeding. For example, according to the terms of a particular contract, many contract-related disputes may have to be prosecuted through an arbitration proceeding.

Regardless of the legal venue involved in the dispute, the damaged party typically retains legal counsel to prosecute the claim. And, the damaging party typically retains legal counsel to defend itself against the claim.

Counsel for both parties typically retain (or at least consult with) forensic specialists to assist them in the dispute process. These forensic specialists typically include (but are not limited to) damages analysts.

Damages analysts understand that there are numerous issues involved in any legal proceeding. With regard to most damages claims, there are at least three issues that are relevant to this discussion:

1. Causation
2. Liability
3. Damages measurement

Of course, these three issues are only relevant to this discussion if one first accepts the following foundational assumptions:

1. That the damaged party actually experienced a damages event that was caused by the damaging party
2. That the damaged party suffered a measurable amount of damages due to that damages event.

The principal question related to the causation issue is: who or what caused the damages event (or events) to occur?

The principal question related to the liability issue is: who or what is legally responsible for the damages event (or events)? That liability question considers what party has a duty (contractual or otherwise) to the damaged party.

In contrast, the principal question related to the damages measurement issue is: what is the amount of damages suffered by the damaged party? That damages measurement question typically considers the amount of cash (or the value of property) needed to restore the damaged party to the economic position that the party enjoyed prior to experiencing the damages event (or events).

First, the damages measurement analysis often considers what is typically called the "but for" scenario. That is, what economic (or wealth) position would the damaged party be in "but for" (or without experiencing) the impact of the damages event?

And, second, the damages measurement analysis considers what amount of compensation (whether in cash or in property) should be paid to the damaged party in order to restore that party to the economic (or wealth) position that it enjoyed before—or "but for"—the damages event?

This discussion considers one reason why the answers to the two above-mentioned questions may be different. That is, there may be one quantitative answer to the question: How much damages did the damaged party experience due to the wrongful action of the damaging party?

And, there may be a different quantitative answer to the question: How much should be paid to the damaged party to make that party economically "whole"?

One reason for that difference is the recognition that, in some instances, the judicial award (or negotiated settlement) payment of the damages amount is subject to income taxation.

As mentioned above, in these damages claim disputes, both parties—through their legal counsel—often retain damages-related forensic specialists (hereinafter referred to as damages analysts) to measure the amount of damages experienced by the damaged party.

The damages analyst can be a forensic accountant, an economist, a financial analyst, an engineer, an industry specialist, a valuation analyst, or some other type of forensic professional.

The important point is that the selected damages analyst should have the appropriate experience, expertise, training, and credentials to credibly develop the damages measurement.

Such a damages analyst measures, and provides expert opinions regarding, the amount of the damages suffered by the damaged party. Regardless of the professional background of the damages analyst, the damages measurement analysis should be appropriately supported. And, the damages measurement conclusion should be credible.

The damages analyst is typically not the same professional who assesses, and provides expert opinions regarding, the causation or the liability issues in the dispute.

The damages analyst measures the impact of the damages event (or events) on the damaged party. In so doing, the damages analyst may be instructed by counsel to assume that the damaging party:

1. performed a wrongful action,
2. caused the damages that were experienced by the damaged party, and
3. is legally liable for (and financially responsible for) the damages suffered by the damaged party.

It is typically not the responsibility of the damages analyst to assign fault or blame or responsibility to the damaging party. The damages analyst typically does not independently conclude that the damaging party is the wrongful party.

Rather, the damages analyst quantifies how much the wronged party was damaged—not who is responsible for the damages or who is legally liable for making the damaged party whole.

There is typically a causation expert who analyzes the facts of the dispute and then provides expert opinions regarding the causation issues.

And, there is typically a liability expert who analyzes the facts of the dispute and then provides expert opinions with regard to liability issues.

Defending in his or her expertise, the damages analyst may perform multiple roles in the dispute. That is, if the damages analyst is qualified, he or she may also save the function of the causation analyst or the liability analyst. However, typically, that is not the case.

This discussion focuses on commercial damages measurement issues—not on causation or liability issues. And, this discussion focuses on damages measurement issues in breach of contract or tort disputes in commercial litigation.

In particular, this discussion focuses on one technical, but important, issue related to the measurement of the amount of commercial damages: the income tax considerations related to the damages measurement.

The damages analyst—and the client's counsel—should understand that these income tax considerations relate to:

1. the income recognition and the taxation of any compensation-related payments received by the damaged party,
2. the tax deduction and the taxation of any compensation-related payments made by the damaging party, and
3. the measurement of the recommended amount of the judicial award (or the negotiated settlement) required to make the damaged party whole—after any adjustments necessary with regard to the related income tax considerations.

In addition, this discussion summarizes what the damages analyst—and the damaged/damaging party company, the damaged/damaging party company owners, and the legal counsel for these parties—need to know about the income tax considerations related to damages measurements and damages awards (or negotiated settlements).

Types of Damages Claims

Damages analysts understand that commercial damages claims are typically categorized into the following two categories:

1. Breach of contract claims
2. Tort claims

Of course, breach of contract claims typically generate from the terms and provisions of a commercial contract. Tort claims typically relate to an alleged breach of one party's duty to another party, where that duty is not documented in a contract.

Breach of contract claims may relate to the damaging party's alleged breach of, for example, a contractor/subcontractor agreement, a client/customer purchase agreement, an employment agreement, a noncompetition/nonsolicitation agreement, a supplier agreement, a stock purchase or asset purchase acquisition agreement, a joint venture or joint development agreement, a franchise agreement, an intellectual property license, a real estate lease, or any other type of commercial contract.

The contract should specify the respective duties and responsibilities of the counterparties. If one of the contract counterparties allegedly violates a specified duty or responsibility, then the other contract counterparty may be damaged as a result of that breach of contract.

Tort claims may relate to the damaging party's alleged breach of a noncontractual duty or a responsibility.

For example, a public company and its directors have duties to the company's shareholders. A private company's controlling shareholder has duties to the company's noncontrolling shareholders. A lender financial institution has duties to its borrowers. Competitor companies have certain duties to each other.

Partners have certain duties to each other (in addition to the duties that may be documented in the partnership agreement). Public companies have duties to both securities market regulatory authorities and to the investor market in general. Trustees have duties to the trust beneficiaries.

If one party commits a tortious action and violates its duty to another party, then that other party may be damaged as a result of the tortious action.

The damages analyst typically considers the above-described categorization of commercial damages claims. This damages claim categorization—as either a breach of contract or a tort—may affect which of the generally accepted damages measurement methods the analyst applies in a particular damages measurement analysis.

The damages analyst also typically considers another categorization regarding damages claims. That is, the analyst considers whether the receipt of the damages award (or of the negotiated settlement) is a taxable event to the damaged party.

In other words, the analyst considers if the receipt of the damages award (or the settlement) is ordinary income, a capital gain or loss, or a nontaxable event to the damaged party.

The analyst may also consider whether or not the payment of the damages award (or the settlement) results in an income tax deduction to the damaging party.

And, finally, the analyst may consider these income tax consequences when recommending the amount of the judicial award (or the amount of a negotiated settlement) with regard to the damages claim.

Income Tax Considerations

Even during the normal course of business, a company or a company shareholder may become the recipient of—or the payer of—a damages-related judicial judgment or negotiated settlement. That judicial judgment or negotiated settlement may be the result of a commercial litigation, an arbitration, or some type of alternative dispute resolution proceeding.

The damages analyst understands that the income tax considerations of such judgments, awards, or settlements can affect both the recipient and the payer.

And, the income tax considerations related to the commercial damages measurement may affect the amount of the judgment or the settlement that would be required to make the damaged party economically "whole."

The damages analyst understands that these income tax issues affect both the recipient and the payer of the damages judgment, award, or settlement.

The specific terms of the judgment or the settlement typically have an impact on whether the payment is:

- tax deductible or not tax deductible,
- taxable income or not taxable income, and
- if taxable income, whether the income is treated as ordinary income or capital gain.

As with most taxation issues, the taxpayer has the burden of proof regarding both the tax treatment and the income characterization (whether ordinary income or capital gain) of the judgment or settlement payment.

These issues are typically determined by reference to the particular language included in the underlying litigation documents. Such documents include the various pleadings, the court's order or the arbitration award, and/or the settlement agreement.

All parties to the dispute and their litigation counsel should consult with tax counsel regarding these taxation issues when drafting such litigation-related documents.

The income tax treatment of the payment is not influenced by whether the award is the result of a court order, an arbitration award, or a settlement agreement between the parties.

However, generally, taxation issues are easier to deal with in the case of a settlement agreement that is drafted by counsel to the parties. The reason for this statement is because the court or the arbitrator may not be particularly sensitive as to what wording to include in the final litigation documents in order to influence the desired income tax treatment.

Therefore, taxation issues are often more difficult to deal with in the context of a court's order or an arbitrator's award.

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The Origin of the Damages Claim

The origin of the damages claim may directly influence the tax treatment of the judicial award or the settlement payment. Many courts have applied the so-called origin-of-the-claim test with regard to this taxation issue. That is, the courts typically consider the question: "In lieu of what was the damages payment made?"

This consideration affects the tax characterization of the damages payment. This test has been applied by the courts for many decades, at least since the *Raytheon Production Corp v. Commissioner* decision.[1]

For the recipient of a judicial award or settlement payment, the origin-of-the-claim test may determine whether the payment receipt is taxable or not taxable. If the receipt of the judicial award or settlement payment is taxable, then this test may determine if the income should be characterized as ordinary income or as capital gain.

Typically, a damages award received pursuant to either a court's judgment or a negotiated settlement is considered to be taxable income to the recipient.

However, the receipt of certain types of damages payments is not considered to be taxable income.

Examples of such nontaxable receipt of payments include receipts of gifts or inheritances, payments as compensation for a personal physical injury, certain disaster relief payments, amounts for which the taxpayer did not previously receive a tax benefit, cost reimbursements, the recovery of capital or of property, or a business acquisition purchase price adjustment.

A damages award is typically taxable as ordinary income if the payment relates to a claim of lost profits. However, such an award may be characterized as a capital gain (to the extent that the amount of the damages exceeds the property's tax basis) if the claim relates to the damage of a capital asset.

For the payer of the damages award, the origin-of-the-claim test will determine whether the payment is tax deductible or not tax deductible. In addition, the test will determine:

1. whether a tax deductible payment will be currently deductible or
2. whether the payment has to be capitalized (and perhaps deducted at a later time).

For example, a damages payment related to a personal transaction will be considered a nondeductible personal expense.

In contrast, a damages payment related to a business activity may be deductible under Internal Revenue Code Section 162. And, business-related damages payments related to interest, taxes, or certain losses will be deductible under Section 163, Section 164, or Section 165, respectively.

Certain types of damages payments are not tax deductible to the payer. Other types of damages payments would have to be capitalized (and perhaps deducted at a later time).

For example, the damages payment would have to be capitalized when the payer receives an intangible asset or intellectual property license, say as part of a negotiated settlement, in exchange for the settlement payment.

Again, the burden of proof is on the taxpayer to establish the appropriate income tax treatment related to the receipt or the payment of the damages judgment or negotiated settlement.

The types of documents that the Internal Revenue Service (the "Service") typically considers with regard to the tax treatment issue include the following: the legal filings in the dispute, the terms of a settlement agreement, any correspondence between the parties to the dispute, any internal memos of the parties, any party press releases, company annual reports, and news-related publications.

As a general guideline, the Service considers the initial complaint (or the equivalent legal document) to be the most persuasive evidence. This general guidance is presented in Revenue Ruling 85-98.

Allocation of the Damages Payment

Sometimes the judicial award payment or the negotiated settlement payment can cover more than one damages claim. In that case, the parties to the dispute may have to allocate the payment for federal income tax purposes.

Such an allocation is necessary when:

1. one part of the payment represents a taxable event and
2. another part of the payment relates to a nontaxable event.

In addition, such an allocation may be necessary when there are either multiple plaintiffs (claimants) or multiple defendants (respondents).

Some of the factors that the parties to the dispute should consider in that payment allocation process include the following:

- Who made and who received the payment?
- Who was economically harmed or economically benefited by the damages event?
- Which party were the allegations asserted against?
- Which party controlled the litigation?
- Was the dispute-related costs or receipts required to be shared contractually?
- Was there joint and several liability among the parties related to the damages claims?

The court's order or the settlement document may provide for a payment allocation in the document's narrative text. If a payment allocation is already specified in

the judicial judgment, then the Service and the taxpayers are typically bound by that allocation.

In addition, the Service will typically accept a payment allocation that is specified in a negotiated settlement agreement.

However, the Service may challenge a settlement-related allocation if the Service concludes that the taxpayer had another (nontaxation) reason for the agreed-upon payment allocation.

As with most issues, the taxpayer has the burden of proof with regard to defending the claimed award allocation before the Service.

A Statutory Deduction Disallowance

The Internal Revenue Code specifically disallows an income tax deduction related to certain payments made or liabilities incurred with respect to a court's judgment or a negotiated settlement.

As amended by the Tax Cuts and Jobs Act ("TCJA"), Section 162(f) disallows a tax deduction (under any provision of Chapter 1) related to amounts paid or incurred:

1. by a lawsuit, an agreement, or otherwise;
2. to, or at the direction of, a government or governmental entity; and
3. in relation to a violation of law—or to an investigation or inquiry into a potential violation of law.

This tax deduction disallowance does not apply to payments for:

1. the restitution (including the remediation of property),
2. taxes due, and
3. amounts paid pursuant to a court order when no government or governmental agency is a party to the dispute.

The Treasury Regulations also indicate that this tax deduction disallowance does not apply:

1. to a dispute in which the government enforces its rights as a private party—for example, in a breach of contract dispute—or
2. to routine audits or inspections not related to a possible wrongdoing.

The restitution exception to the tax deduction disallowance only applies if the court order or the settlement agreement identifies the damages payment as:

1. a restitution or remediation payment or
2. a payment to come into compliance with the law (collectively referred to as the identification requirement).

In addition, the taxpayer has to establish that the damages payment was made:

1. for restitution or remediation or
2. to come into compliance with the law (collectively referred to as the establishment requirement).

The taxpayer may satisfy the identification requirement if the court order or the settlement agreement specifically states that the payment:

1. constitutes restitution or remediation or
2. is for coming into compliance with the law—or uses some form of similar language.

The taxpayer may satisfy the establishment requirement by providing the Service with documentation evidence of "the elements of establishment."

The TCJA also added Section 162(g) related to tax deductions with regard to damages payments. Section 162(g) disallows an income tax deduction (under any provision of Chapter 1) for:

1. a settlement or other payment related to sexual harassment or abuse and
2. the corresponding attorneys' fees—if there is a nondisclosure agreement.

However, this Section 162(g) tax deduction disallowance does not apply to the attorneys' fees incurred by the sexual harassment/abuse victim.

There are various other Internal Revenue Code sections that disallow income tax deductions related to certain types of damages payments.

For example, Section 162(i) disallows a tax deduction related to illegal bribes and kickbacks. And Section 162(q) disallows a tax deduction related to the treble damages imposed for antitrust violations.

Adjusting the Damages Measurement for Income Tax Consequences

The damages analyst will often adjust the initial damages measurement amount for the income tax consequences of the damages award receipt. Without such a tax-related adjustment to the recommended award/settlement, the damaged party may not be "made whole" by the receipt of the damages award.

The damaged party may not be "made whole" by the damages award receipt if the damages award or the settlement payment is recognized as taxable income to the damaged party recipient.

In addition, without such a tax-related adjustment, the damaging party may benefit from the income tax deduction associated with certain damages-related payments.

For example, let's consider a hypothetical breach of contract litigation claim. Let's assume that Alpha Company is the damaged party and that Beta Company is the damaging party. In this hypothetical example, Beta wrongfully caused Alpha to suffer $24 million of damages related to lost profits associated with the contract breach.

Alpha brings a damages claim against Beta. The judicial finder of fact concludes that Beta caused the lost profits damages event and is liable for the lost profits damages to Alpha.

The finder of fact orders Beta to pay a $24 million damages award to Alpha. In compliance with the judgment, Beta pays the $24 million damages award amount to Alpha.

Let's further assume that the receipt of the lost-profits-related damages award is recognized as taxable income to Alpha. To simplify the income tax liability calculation, let's assume a 25 percent effective combined federal and state income tax rate for Alpha.

Alpha suffered $24 million in lost profits damages related to Beta's wrongful breach of contract. If Alpha receives a $24 million damages award payment, Alpha will pay $6 million in income taxes. After tax, Alpha will be left with only $18 million cash remaining.

Accordingly, Alpha may not be "made whole" by the receipt of the $24 million damages award.

If Alpha recognizes taxable income related to the $24 million damages award receipt, it is likely that Beta will qualify for an income tax deduction related to the award payment. That is, after considering the income tax impact, Beta will end up with $18 million less cash (even though Beta paid the $24 million payment to Alpha).

So, while Beta was judicially determined to be liable for the $24 million of damages suffered by Alpha, Beta will only suffer an $18 million negative economic impact (after all income tax considerations).

And, although Alpha was judicially determined to have suffered $24 million in damages due to the wrongful actions of Beta, Alpha will only recover $18 million in economic benefit (after all income tax considerations).

Damages analysts should be aware that there are two different tax-related adjustment procedures that the analyst may apply to account for these income tax considerations. These adjustment procedures consider the impact of the above-illustrated income tax considerations on:

1. the damages measurement analysis and
2. the damages award recommendation conclusion.

The first adjustment procedure is to calculate the present value of the pretax lost profits suffered by the damaged party using an after-tax present value discount rate.

In theory, this tax-related adjustment procedure increases the amount of the lost profits damages by the amount of the income tax impact on the receipt of the lost profits damages award.

This adjustment procedure may be the less frequently applied of the two tax-related adjustment procedures. This adjustment procedure works efficiently in a lost profits damages measurement calculation.

However, this adjustment procedure is generally less applicable to many other damages measurement methods—such as the cost to cure damages measurement method, for example.

And, the apparent mismatch in the damages measurement (i.e., the application of an after-tax present value discount rate to a pretax lost profits amount) may be somewhat difficult for a damages analyst to explain to a judicial finder of fact in the dispute.

To be clear, this pretax lost profits/after-tax discount rate procedure is in compliance with generally accepted damages measurement standards and practices. This adjustment procedure is described (and recommended) in several forensic accounting textbooks and other forensic analysis professional literature.

The benefit of this adjustment procedure is that it is relatively easy to apply mathematically. The drawback of this adjustment procedure is that it appears counter-intuitive to many finders of fact—and to many damages analysts.

The second adjustment procedure is generally applicable to all damages measurement methods. This second adjustment procedure is more frequently applied by damages analysts. Additionally, this adjustment procedure is fairly easy for a damages analyst to explain to a judicial finder of fact—and to other parties involved in the dispute.

In this second tax-related adjustment procedure, the damages analyst simply identifies and quantifies the two individual components of the recommended judicial award.

The two individual components of the recommended award are:

1. the amount of the damages suffered by the damaged party (on a tax neutral basis) and

2. the amount of the income tax liability (if any) created by the receipt of the damages award payment.

In this second tax-impact adjustment procedure, the analyst is not adjusting the measurement of the damages suffered by the damaged party. Rather, the analyst is reaching two conclusions:

1. The measurement of the amount of damages suffered
2. The measurement of the judicial award (or settlement amount) required to make the damaged party whole—after considering the payment of income taxes

Let's return to the Alpha and Beta breach-of-contract-related dispute example. To apply this second tax-related adjustment procedure, the damages analyst will quantify both:

1. the $24 million amount of the lost profits damages that Alpha suffered as a result of Beta's wrongful actions and
2. the amount of the income tax liability that Alpha will incur with regard to the receipt of the $24 million damages award payment.

The sum of these two economic components represents the total amount of the judicial award that the analyst would recommend to the finder of fact.

So, in the above example, the analyst would conclude the recommendation with regard to the total amount of the damages award (or the negotiated settlement) as presented in Exhibit 1.

That is, the analyst would recommend that the judicial finder of fact award (or that the parties agree to in a negotiated settlement of) a $32 million total payment to Alpha.

Based on the receipt of the $32 million total payment, Alpha will incur an $8 million (i.e., $32 million × 25 percent effective income tax rate) income tax liability. After that $8 million income tax liability is expensed (i.e., paid to the federal and state taxing authorities), Alpha will be left with $24 million.

That is, as a result of the receipt of a $32 million total judicial award payment, Alpha will be made whole with regard to the $24 million of lost profits damages. That $24 million damages measurement amount relates to Beta's wrongful breach of contract damages event.

In this simplified illustrative example, as a result of the damages event caused by Beta's wrongful actions, Alpha's economic position decreased by $24 million. This $24 million is the analyst's measurement of the amount of lost profits damages suffered by Alpha.

Based on the $32 million total payment from Beta, Alpha's economic position (after the payment of income taxes) would increase by $24 million. Accordingly, the $32 million (pretax) payment is required in order to make Alpha whole after experiencing the economic impact of Beta's breach of contract damages event.

This $32 million is the analyst's recommended judicial award related to the $24 million in lost profits damages suffered by Alpha.

Again, assuming the type of damages in this illustrative example relates to a taxable event, Beta will typically benefit from a $32 million income tax deduction if Alpha recognizes $32 million in taxable income.

In other words, after considering the income tax impact (assuming the illustrative 25 percent effective income tax rate), the $32 million payment will decrease Beta's economic position (after considering the income tax impact) by $24 million.

The damages analyst should be aware that this second tax adjustment procedure is often applied by analysts when recommending the total amount of a judicial award (or a negotiated settlement). This is because this second tax adjustment procedure separately identifies and quantifies the impact of income taxes on the recommended amount of the damages award.

This tax-related adjustment procedure clearly identifies that the total recommended damages award should include two separate components:

Exhibit 1
Alpha Company v. Beta Company Damage Claim
Total Amount of the Analyst's Damages Award Recommendation
Applying the Income Tax Adjustment Procedure

Measurement of the Amount of the Lost Profits Damages Suffered by Alpha	$24 million
Divided by: 1 – the 25% Effective Income Tax Rate	75%
Equals: Total Damages Payment (the analyst's recommended total judicial award or total settlement amount) Required to Make Alpha Whole after the Damages Event	$32 million

"In the development of the damages analysis, . . . all of the parties to the dispute . . . should consider all of the income tax consequences to the parties to the dispute."

1. The measurement of the amount of the damages suffered by the damaged party
2. The income tax impact on the damaged party of the receipt of the damages award payment (or the settlement payment)

Summary and Conclusion

Damages analysts understand that industrial or commercial companies may suffer commercial damages due to the wrongful actions of various parties.

These commercial damages may be caused by a breach of contract, a tortious act, or some other reason. And, the wrongful party (i.e., the damaging party) may be a competitor, customer, employee, shareholder, banker, supplier, potential or actual acquirer, joint venturer, licensor/licensee, government agency, or some other party.

When an industrial or commercial company is damaged, the company typically retains legal counsel to prosecute the legal claim. Such counsel typically retain a forensic accountant, economist, engineer, valuation specialist, industry consultant, or some other type of damages analyst to measure the amount of damages suffered by the damaged party.

The damages analyst is typically retained to measure the amount of damages suffered by the damaged party as a result of the alleged wrongful actions of the damaging party. The damages analyst typically applies generally accepted damages measurement methods and procedures.

Typically, the damages analyst does not assess or opine on the causation issues or the liability issue related to the litigation claim. Typically, other specialists serve as causation analysts and/or liability analysts in the commercial damages dispute.

In the development of the damages analysis, the damages analyst—and all of the parties to the dispute—should consider all of the income tax consequences to the parties to the dispute.

Tax counsel may have to advise all of the parties to the dispute—including each party's litigation counsel and each party's damages analyst—regarding such income tax considerations.

Damages analysts understand that there are income tax consequences related to the receipt of—and the payment of—amounts related to a damages-related judicial order or negotiated settlement.

The taxable income recognition, the tax deduction, and the income character (whether ordinary income or capital gain) of the payments typically depend on:

1. the type of the damages claim and
2. the identity of the damaged party and the damaging party.

These taxation-related issues are typically reflected in the legal documents related to the dispute. In particular, analysts should be aware that certain income tax deduction disallowances may apply with regard to the damages award payments.

All parties to the commercial dispute should consider the income tax consequences of any damages payment:

1. when negotiating a dispute settlement agreement or
2. when recommending a court order or an arbitrator's award.

In addition to the damaged party and the damaging party, damages analysts, litigation counsel, and other professionals involved in the dispute should consider these taxation issues.

Tax counsel may be called on to advise the parties with regard to such tax consequences. With some planning on the part of tax counsel—and the damages analyst—and with the cooperation among the parties to the dispute—some unfavorable tax consequences could be avoided.

In any event, all relevant income tax consequences should be accounted for:

1. in the analyst's damages measurement,
2. in the analyst's damages award recommendations or deliberations,
3. in the dispute settlement negotiations, and
4. in the counsel's litigation prosecution and defense.

Note:

1. Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944).

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