

## Further Thoughts on Tax Treatment of Punitive Damages

To the Editor:

I read with interest the report by the New York State Bar Association Taxation Section on the deductibility of punitive damages (*Tax Notes*, Nov. 26, 2001, p. 1209). As is predictable with reports by that body, I found it thorough and helpful. It provides a useful analysis of the pros and cons. I found a couple of points worth underscoring.

First, in "The Case for Nondeductibility" (p. 1213), the report notes that supporters for the nondeductibility proposal mention various code provisions that attempt to impose social policy. Golden parachutes, greenmail, and excessive employee compensation are mentioned, but my guess is the list is much longer than this. To me, the argument that other code provisions do the same type of thing that nondeductibility for punitive damages would do begs the question. The real question (as the report suggests) is whether nondeductibility would have additional deterrent effects, and how this fundamental change would be received by juries that impose punitive damages and by the businesses that must pay them. I am not an economist, but I found the report's recitation of economic views on punitive damages to be quite important. And, I fully subscribe to the notion that if punitive damages are made nondeductible, there must be a fundamental change in the information provided to juries so they take into account the after-tax effects of the punitives.

The only omission I can find in the report that might provide a helpful analogy is the tax treatment of anti-trust payments. Two-thirds of a payment in that context may be treated as nondeductible (where there are related criminal proceedings leading to a conviction or nolo plea). However, this has been the law (in section 162(g)) for many years, and I do not believe there is substantial confusion about it. Without thorough economic analysis and empirical data, I don't think the nondeductibility proposal for punitive damages should be seriously considered.

Fundamental character questions may undermine any attempt to draw bright lines. As the report suggests, punitive damages awarded in a variety of types of cases may be premised on various theories, one of which is the potential inadequacy of compensatory damages where it may be too difficult or too costly to measure those damages accurately (p. 1215). This invites a kind of impossible inquiry: Just why were the punitive damages awarded? To me, this portion of the New York report is most persuasive.

We already have enormous characterization problems on the income side (a topic not discussed in the report). It is now clear that punitive damages always constitute income to the recipient. The IRS now commonly engages in a recharacterization battle to attempt to import punitive characterization to settlements (for example, in cases settling on appeal), where oftentimes it is not clear that punitives have been paid. Indeed, in some cases the IRS attempts to attribute punitive treatment to settlements before trial merely

because punitives were requested! Adding to such characterization problems on the deduction side would be a huge mistake.

Very truly yours,

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