

Proposed Nondeductibility for Punitive Damages: Will It Work?

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Should punitive damages be nondeductible? The Senate seems to think so. The Jobs and Growth Reconciliation Tax Act of 2003, S. 1054, called for the disallowance of any tax deduction for punitive damages. Although this provision did not make it into the final version signed by the president on May 28, 2003, I do not think this issue is dead. Indeed, this marks the second time this provision was proposed, so I believe there will be a third. If I am right, there will be serious and unanticipated effects.

The deductibility question may seem to be purely a policy matter. Indeed, there appears to be little doubt that this provision in the Senate bill was prompted (in large part anyway) by the \$1.5 billion securities industry settlement.¹ Regardless of the impetus for this provision, my concern is primarily with whether this will be administrable in its current form if (or perhaps I should say when) it is enacted. As will become clear below, I think it will not be administrable.

Historic Confusion

It would seem to be a simple matter to discuss the tax treatment of punitive damages. One is either a recipient of punitive damages or a payor. If one receives the damages, the question is whether they are income or not. If one pays them, the question is whether they are deductible or not (or might have to be capitalized). Yet, aside from those simple dichotomies, the tax treatment of punitive damages has historically been confused, even anarchistic. I want to focus here on the payor's side of the aisle, not the recipient's.

Nonetheless, it is a disservice to this topic not to acknowledge that there has been great confusion on the treatment of punitive damages and this actually applies to both payors and payees. As to the recipients of those damages, way back in 1989, Congress attempted to draw a line between punitive damages for physical and nonphysical injuries. Despite what was generally supposed to be the intent of Congress in 1989

¹See Wood, "Should the Securities Industry Settlement Be Deductible?" *Tax Notes*, Apr. 7, 2003, p. 101.

(to restrict nontaxable treatment to punitive damages awarded in physical injury cases), this change to section 104 did nothing to stop the controversy.

In fact, notwithstanding the 1989 change, taxpayers continued to argue that punitive damages were excludable (at least in physical injury cases), while the IRS became increasingly opposed to any punitive damage exclusion. Then, in 1996, the statute was amended again, this time to make it crystal clear that all punitive damages constitute taxable income. The only exception relates to certain state law actions for wrongful death, where the applicable state law allows only an award for punitive damages (and no compensatory damages).

Only a few months after passage of the Small Business Job Protection Act of 1996, the Supreme Court decided *O'Gilvie v. United States*,² ruling that all punitive damages are taxable income, even in physical injury cases, and even for punitive damages paid before enactment of the 1996 act. With all this history, it would seem that there could no longer be any issue about the includability of punitive damages. But therein lies the fundamental problem: characterization. "Punitive damages" are defined in neither the code nor the regulations. This term would also not have been defined in the Senate provision of the Jobs and Growth Reconciliation Tax Act of 2003.

To Deduct or Not to Deduct?

What about the payor's side? Historically, punitive damages paid to private parties are deductible. Nonetheless, there seems to be recurring confusion about this topic, with business people, and even some tax practitioners. I do not know why. After all, there is plenty of authority. The IRS ruled that liquidated damages paid under the Fair Labor Standards Act are deductible as business expenses.³ The Tax Court held that liquidated damages paid under the Age Discrimination in Employment Act and the Fair Labor Standards Act are also deductible.⁴ As long as punitive damages are paid or incurred by a taxpayer in the ordinary conduct of its business, they will be deductible.⁵

There are some limitations, however. In an antitrust context, there is a statutory rule denying a deduction for two-thirds of the damages paid pursuant to a treble damage antitrust suit, if certain conditions are met.⁶ The deduction for two-thirds of the payment (in effect, the trebled portion), is disallowed only where there is a conviction in a related criminal proceeding, or a plea of guilty or *nolo contendere*. The Senate Finance Com-

²117 S. Ct. 452, *Doc 96-31894* (14 pages), 96 TNT 240-1 (1996).

³Rev. Rul. 69-581, 1969-2 C.B. 25.

⁴See *Downey v. Commissioner*, 97 T.C. 150, 91 TNT 161-10 (1991), *on reconsideration* 100 T.C. 634, *Doc 93-7379* (27 pages), 93 TNT 138-14 (1993), *rev'd and remanded* 33 F.3d 836, *Doc 94-8280*, 94 TNT 176-8 (7th Cir. 1994), *cert. denied* 550 U.S. 1141.

⁵Rev. Rul. 80-211, 1980-2 C.B. 57.

⁶Section 162(g).

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mittee Report to this provision (enacted in 1969), is crystal clear as to what Congress then meant:

This means that the deduction (of the penalty portion) is to be denied only in the case of “hardcore violations” where intent has been clearly proved in a criminal proceeding. The denial of the deduction is limited to two-thirds of the amount paid or incurred since this represents the “penal” portion of the payment. The remaining one-third is to continue to be deductible on the grounds that it represents a restoration of the amount already owing to the other party.⁷

One reason there may be confusion about the deductibility of punitive damages (that is, why many seem to think that payors have already been restricted in the deductibility of punitives), relates to fines or penalties. In contrast to the general rule that payments made in the course of a trade or business are deductible (either by settlement or judgment), the Internal Revenue Code expressly states that no deduction is allowed for “any fine or similar penalty paid to a government for the violation of any law.”⁸ This provision denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of potential liability for a fine.⁹ It is the latter element of the provision that often causes great controversy. It may (or may not) be clear that it is likely that a fine will be imposed when a potential liability is satisfied.

Whether a fine or penalty may be imposed may in some cases depend on the intent of the perpetrator. Even so, the denial of the deduction does not require that the violation of law have been intentional. No deduction will be permitted for the payment of a fine even if the violation is inadvertent, or if the taxpayer must violate the law to operate profitably.¹⁰ These rules are quite topical today, as the fine or penalty moniker is in the news a good deal. In fact, MCI was just fined a record \$500 million by the SEC over — you guessed it — accounting fraud.¹¹

The significance of the rule that fines and penalties are nondeductible — and the considerable incentives that taxpayers have to avoid it — are well-illustrated by Exxon’s liability in the Exxon Valdez oil spill litigation. The U.S. government’s \$1.1 billion Alaska oil spill settlement with Exxon actually cost Exxon a maximum of \$524 million when Exxon’s tax deductions for the payments were taken into account. The Congressional Research Service determined that more than half of the civil damages totaling \$900 million could be deducted on Exxon’s federal income tax returns.¹²

⁷Senate Finance Committee, Report on Tax Reform Act of 1969, Sen. Rept. No. 551, 91st Cong., 1st Sess., p. 274 (1969), reprinted at 1969-3 C.B. 597.

⁸Section 162(f).

⁹Reg. section 1.162-21(b).

¹⁰*Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

¹¹See Larsen and Michaels, “MCI fined Record \$500M Over Fraud Charges,” *Financial Times*, May 20, 2003, p. 1.

¹²See “Tax Deductions Will Help Exxon Slip Away From Much of Its Oil Spill Liability, Says CRS,” *Tax Analysts Highlights & Documents*, Mar. 21, 1991, p. 2853.

Often, the line drawing is not terribly precise. One of the more important cases to define the line between nondeductible fines or penalties and deductible compensatory damage payments is *Allied-Signal, Inc. v. Commissioner*.¹³ In this case, the Third Circuit affirmed the Tax Court’s denial of any deduction for an \$8 million payment Allied-Signal paid into a trust to eradicate a toxic chemical pesticide from the environment. The court found that the payment was made with the virtual guarantee that the district court would reduce the criminal fine by at least the amount previously levied against Allied-Signal. The issues surrounding these fine vs. compensatory demarcations have been discussed with increasing frequency by commentators.¹⁴

While a fine or penalty (nondeductible under section 162(f)) and a punitive damages payment both may relate to “bad” conduct, they really invoke different tax rules. Notwithstanding the confusion that exists, let’s now turn to the treatment of punitive damages, focusing particularly on the payor. Apart from the limited context of antitrust damages where there is a related guilty or *nolo* plea, punitive damages up to now have been deductible.

Changing Landscape

The Senate Finance Committee Report to the 2003 tax bill suggested that allowing a tax deduction for punitive damages “undermines the societal role of punitive damages in discouraging and penalizing the activities or actions for which punitive damages are imposed.”¹⁵ The Committee Report suggested that taxpayers will not be burdened by this disallowance, because taxpayers should readily be able to determine what is not deductible. After all, says the Senate Finance Committee Report, taxpayers can make ready reference to pleadings filed with the court, and plaintiffs already have to make such a determination (that is, what is punitive and what is not) to determine their gross income.¹⁶

Unfortunately, I believe that both of these statements are incorrect. A reference to the pleadings filed with the court is often not enough to determine if the recovery ought to be treated as punitive for tax purposes. The verdict is the most telling item (does it say “\$_____ for punitive damages”?). Even so, the fact that under current law, recipients of punitive damages are always taxable on them does not mean that plaintiffs can easily make that determination. This is so particularly in cases settled on appeal, although the Service sometimes argues that punitive damages characterization is appropriate even where punitives

¹³54 F.3d 767, *Doc 95-2752 (23 pages)*, 95 TNT 47-8 (3rd Cir. 1995).

¹⁴See Raby, “When Will Public Policy Bar Tax Deductions for Payments to Government?” *Tax Notes*, Mar. 27, 1995, p. 1995. See also Manns, “Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?” 13 (2) *Virginia Tax Review* 271 (Fall 1993).

¹⁵Senate Report No. 108-26, 108th Congress, 1st Session, May 8, 2003, p. 63.

¹⁶*Id.*

are merely *requested* in a complaint, but there has been no verdict.

To prevent taxpayers who might be forced to pay punitive damages from obviating the effects of this nondeductibility rule with insurance, the proposed law would also provide that if liability for punitive damages is covered by the taxpayer's insurance, any punitive damages paid by the insurer must be included in the gross income of the insured. To enforce this income inclusion, the insurer would be required to report any such amounts to both the insured person and to the IRS via a Form 1099.

The amendment to the code that would be made by this bill was deceptively simple, merely denying any deduction for punitive damages paid or incurred by the taxpayer as the result of a judgment or settlement. Paying a judgment would presumably be quite straightforward because the judgment would typically be bifurcated into an award for compensatory damages and an award for punitives. Settlements, however, are not so clear.

Indeed, before we turn to what I see as the major interpretive problem with this proposal, it is worth noting that it is not the first time this proposal was made. President Clinton, in his 1999 budget package, included a proposal to tax companies on punitive damages paid to plaintiffs in civil lawsuits. Like the 2003 Senate bill, President Clinton's 1999 proposal would have amended section 162(f), and would also have taxed companies that had the foresight to have insurance covering punitive damage payments. The Clinton proposal even included the Form 1099 mechanism so that insurance companies would issue a Form 1099 for the amount of punitives paid. The proposal was not well-received in 1999, and went nowhere fast.¹⁷

But times have quite obviously changed since 1999, and it is today a different climate for this kind of measure.

What Constitutes Punitive Damages?

What constitutes "punitive damages"? This term is nowhere defined in the statute, nor is it defined in the regulations. Is it like pornography, so that we merely know it when we see it? The IRS is taking the position in some cases that if punitives are merely *alleged* in the complaint (even though the case never reaches trial), then some portion of the amount paid to settle the case ought to be allocated to punitive damages.

I believe this position is nearly always unreasonable, or at least I can't think of a circumstance where this "deemed punitive" characterization ought to be applied. No matter how egregious the conduct of the plaintiff, and no matter how likely the plaintiffs' lawyers or defense counsel think a punitives award *might* be, any such determination is actually quite speculative. There are just too many factual and legal hurdles that must be considered.

Plus, there are a host of variables, including geography, demographics, industry considerations, etc. Some kind of pro rata approach makes no sense at all even in cases settling on appeal, although admittedly the Service will have a stronger case for importing punitives characterization in a case settling on appeal than in the cases where it seeks the punitives taint based merely on a complaint. Nevertheless, there are some who believe it is sometimes appropriate (depending on the facts and circumstances surrounding the settlement).

There are others, probably the IRS in particular, that think this punitives analysis is appropriate in virtually every case where punitives are alleged. In states such as California, a punitives claim may be added to virtually every type of claim, or at least that is how it seems.

Sometimes, the statements even from a court in a verdict are not so clear. What are "exemplary" damages? What are "noncompensatory" damages? Perhaps these questions are rhetorical, perhaps not. In *Brandriet v. Commissioner*,¹⁸ the Tax Court held that a \$200,000 award was taxable as punitives. Interestingly, the court expressly looked at state law governing the damages awarded, concluding that whether damages are compensatory or noncompensatory turns on applicable state law. In this case, South Dakota law provided that the sole object of compensatory damages is to make the injured party whole, while the purpose of punitive damage is to punish.

On the surface, any amount constituting "punitive damages" would seem to be so denominated by a court. However, particularly in cases that settle while on appeal, questions about the character of a settlement amount may arise.

Example: Tom is seriously injured and sues an automobile manufacturer, receiving a jury verdict for \$1 million in actual damages and \$3 million in punitive damages. The manufacturer appeals the verdict. After sparring in the appellate courts — but before there is a final decision — Tom and the manufacturer settle for \$2 million. If the injury to Tom was a physical injury, actual damages would be excludable from Tom's income under section 104. Punitive damages would not be excludable. How should the \$2 million be treated? Since Tom received only \$1 million in compensatory damages according to the jury verdict, can we assume that the other \$1 million he received (for a total of \$2 million) really should be treated as punitives? Irrespective of any tax consequences, the defendant manufacturer will doubtless contend that it did no wrong, and that it does not agree that any punitives should be or are payable. There may be public relations concerns, insurance law restrictions, shareholder relations problems, and a whole host of other reasons for a defendant to take this position.

¹⁷See Schlesinger and Hitt, "Clinton Wants to Tax Civil Damages," *The Wall Street Journal*, Feb. 1, 1999, p. A3.

¹⁸T.C. Memo. 2000-302, *Doc 2000-24671* (7 original pages), 2000 TNT 187-12.

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The IRS is likely to argue that the extra million cannot be thought of as anything but punitives, even though the settlement documents are likely to clearly negate punitive status. Tom, on the other hand, is likely to argue that he should have gotten more at trial in compensatory damages (and there may well be support for this). Who wins in this tax debate?

Let's modify the example to try to make an easier case. Assume the same fact pattern where the jury decides Tom should receive \$1 million in actuals and \$3 million in punitives. However, Tom eventually settles on appeal for only \$750,000. Here, Tom might persuasively argue that he was receiving only compensatory damages that would certainly be tax-free (for physical injuries). The IRS might try to pro rate the settlement recovery, treating a portion of it as attributable to the punitive damages. After all, the lion's share of the jury verdict (75 percent) was for punitive damages. The IRS might therefore argue that the 75 percent of Tom's settlement recovery of \$750,000 (or \$562,500) should also be so allocated. Who wins?

What I find very surprising is that some courts may be willing to ascribe punitive damage characterization even where there has been no judgment. The Tax Court in *E. Pauline Barnes v. Commissioner*,¹⁹ considered the tax treatment of a settlement in an action brought by a bookkeeper against her former employer. Pauline Barnes was a bookkeeper for the National Livestock Commission Association. She was subpoenaed to give a deposition in an action involving her employer, and the next day was fired. She suffered embarrassment, humiliation, and other mental distress as a result of her wrongful termination.

She filed a wrongful termination suit under Oklahoma law seeking damages of at least \$10,000 for future lost wages and mental distress. In 1992, she settled her case with her former employer for \$27,000, excluding the entire settlement from her 1992 income. The IRS argued that the entire \$27,000 was taxable, but the Tax Court determined that the settlement was based on tort or tort-type rights. The termination of an at-will employee under Oklahoma law was an action based on tort.

Interestingly, the Tax Court noted that Barnes's attorney had testified that Barnes had a strong case for mental distress with the "likelihood" of punitive damages. The Tax Court found this persuasive, and consequently bifurcated the settlement amount between mental distress and punitive damages. With this conclusion behind it, the Tax Court held that the one-half of the recovery representing mental distress was "on account of" personal injuries and hence excludable under section 104. The court noted that the termination of her employment directly caused her mental distress, and that Oklahoma state law allowed a recovery in tort. As to the one-half of the recovery that the court deemed

to be punitive in nature, however, the court found that amount to be taxable income.

Taxpayers, the IRS, and the courts may all have to make this "just-what-is-punitive" characterization call. For all of them, these issues can be problematic. *E. Pauline Barnes v. Commissioner* raises obvious questions about the appropriateness of determinations of punitive damages. A finding that an amount ought to be treated as punitive damages for tax purposes seems more than far-fetched when the parties have not even gone to trial, and where the most that exists in the way of proof is an aggressive plaintiff's lawyer's statement that punitives should be recoverable.

The fact that punitives have received such harsh treatment in most of the case law has actually led some to suggest that attorneys should avoid punitive damage requests in complaints.²⁰ Indeed, the fact that punitives are uniformly held to be taxable to the plaintiff can result in problems in settling cases where some portion of the settlement may be treated as attributable to the punitive damage claim. This situation is well understood when there is a judgment and a settlement is reached pending appeal. However, the situation may now be somewhat awkward even where there is no judgment.²¹

The treatment the IRS and the courts have given does not seem consistent. For example, in Letter Ruling 9024017, the IRS determined that the full amount of payments received in settlement of a tort action could be excluded from income, even though the suit had sought both compensatory and punitive damages. The settlement agreement did not mention punitive damages. However, in Letter Ruling 9215041, the IRS determined that an amount received by parents in settlement of a suit relating to injuries sustained by their minor son had to be allocated between compensatory and punitive damages, the latter not being excludable. The ruling cites Revenue Ruling 85-98²² for the proposition that where a suit seeking both compensatory and punitive damages is settled for a lump sum, the settlement amount must be allocated between the two based on the best evidence available.

'Best Evidence'?

I think I remember the term "best evidence" from my law school evidence class 25 years ago. Apart from miscellaneous painful memories, I don't think I ever understood the best evidence rule, except that it calls for introducing in evidence only the most qualitative

²⁰See Palmer, "Recent Developments in the Taxation of Punitive Damage Awards," 73 *TAXES* 596 (Nov. 1995).

²¹See *Kari Lane v. United States*, 902 F. Supp. 1439, *Doc 95-8356* (12 pages), 95 *TNT* 171-7 (W.D. Okla. 1995). For an article arguing about the punitive damage issue, see Kahn, "Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax," *Tax Notes*, Feb. 20, 1995, p. 1185. See also Robertson, "Application of the Income Exclusion of IRC Section 104(a)(2) to Liquidated Damages in Age Discrimination Actions Under the ADEA," 28 *Creighton Law Review* 347 (Feb. 1995); and "Here We Go Again: Are (Punitive) Damages Excludable?" *Tax Notes*, Apr. 8, 1996, p. 164.

²²1985-2 C.B. 51.

¹⁹T.C. Memo. 1997-25, *Doc 97-1505* (12 pages), 97 *TNT* 11-13.

proof available. Here, these semantics are pretty vacuous.

In fact, the best evidence available may not be remotely precise. It seems appropriate in every case to specifically address the intended tax treatment in the language of the settlement agreement. Failing to do so is missing an important opportunity. Of course, the IRS and courts are not bound by such language, but how do they seek to make their own determination of the tax allocation?

They review the entire record. Sometimes, it's relatively easy. Thus, in *Miller v. Commissioner*,²³ the court held that 47.36842 percent, or \$248,684, of the net proceeds of the settlement should be allocated to punitive damages. The court agreed with the IRS that the allocation in a case settling on appeal should be based on the jury award because it provided the clearest indication of the nature of the plaintiff's claim and the intent of the defendants when they paid her. The Fourth Circuit affirmed.²⁴

Interestingly, in *Talley Industries v. Commissioner*,²⁵ the Tax Court suggests that there may be a grey area between damages that are compensatory and those that are punitive. A subsidiary of Talley Industries had been indicted on various counts involving Navy contracts, and civil claims were later filed by the government. The civil claims alleged actual losses of approximately \$1.6 million, with punitive damages (under a statutory doubling provision) added on top. The company paid \$2.5 million pursuant to this asserted liability in exchange for a release of all claims. After the company deducted this \$2.5 million payment, the question was whether all of it was compensatory or in effect representative fine or penalty not deductible under section 162(f).

Technically, this was a fine or penalty case, because the payment here was to the federal government. From an evidentiary and allocation question, though, *Tally* raises the same issue as is present when attempting to separate compensatory from punitive damages. The IRS treated the amount as nondeductible, but the Tax Court allowed a deduction for the full \$2.5 million payment, less only \$1,885 representing the Navy's actual losses for the 10 incidents for which a guilty plea was entered.

Although the court had to admit that the \$2.5 million settlement was in excess of the amount originally claimed for "actual compensatory" damages, the court found no evidence in the settlement agreement that any punitive payment or fine was intended. Consequently,

the court respected the language of the settlement agreement.

Notably, the court made this ruling on summary judgment, granting it to the taxpayer, making the court's endorsement of the taxpayer's position even stronger. The fact that the court sought evidence of a punitive intent in the record suggests that the court was implicitly acknowledging that there may be some grey area between a compensatory and punitive (or fine) payment.²⁶ Unfortunately, the Ninth Circuit Court of Appeals then reversed, holding that there was a material issue of fact about the settlement and that the case had not been ripe for summary judgment.

Conclusion

Maybe I am wrong about this issue, but I don't think so. Indeed, the fact that this nondeductibility treatment was not included in the enacted 2003 law is only timing. True, the legislative line-drawing that is occurring in this post-Enron environment is understandable.

Nevertheless, the issues surrounding this kind of thing have been in place for many years. It seems that every time a widely watched dispute is settled that involves something especially noxious, public (or congressional) ire about tax deductions mounts. Today it may be the global securities settlement and a raft of accounting fraud cases. A decade ago, it was the Exxon Valdez oil spill litigation. But the themes are recurrent.

Ultimately, whether it is appropriate to winnow the tax breaks that a wrongdoer should enjoy, it is understandable that legislators, particularly in the current climate, would want to place a double-whammy on bad conduct. Viewed from another perspective, it is equally understandable that taxpayers will seek to salve the wounds of bad conduct with tax deductions, at least importing a modicum of silver lining to the cloud of a large settlement or judgment.

Just how should all this be balanced? That is a policy question. My pedestrian concern is with administrability. I believe there will be significant disputes about characterizing punitive damages if this nondeductibility restriction becomes law.

We are already seeing this on the income side, where the IRS wants to stretch to impart the dreaded "punitive damages" rubric to settlement payments, payments that under any stretch of the imagination are not punitive. We will see more of this, plus the corollary issue for payors, if this provision is enacted. Payors and payees alike are likely to fight the punitives treatment unless they are actually writing a check to pay a judgment that is expressly labeled punitive damages.

²³T.C. Memo. 1993-49, *Doc 93-1970*, 93 TNT 32-24 (1993); *supp.* T.C. Memo. 1993-588, *Doc 93-12978*, 93 TNT 254-29 (1993); *aff'd mot. denied* 60 F.3d 823, *Doc 95-7392*, 95 TNT 148-48, (4th Cir. 1995).

²⁴60 F.3d 823 (4th Cir. 1995).

²⁵T.C. Memo. 1994-608, *Doc 94-10953* (27 pages), 94 TNT 244-9 (1994), *rev'd remanded* 116 F.3d 382, *Doc 97-18539* (12 pages), 97 TNT 121-31 (9th Cir. 1997).

²⁶For discussion, see Manns, "When Does the Payment of Damages Punish the Payor?" *Tax Notes*, Jan. 9, 1995, p. 276.