Tax Effects of Antitrust Payments and Recoveries

By Robert W. Wood[1]

Antitrust enforcement has waxed and waned over the years. After a period of marked inactivity in the antitrust field, both private lawsuits and government enforcement have recently increased. Notably, the landmark Microsoft actions have occupied many antitrust lawyers in many states, and their full impact may not yet be clear.

As with many other types of litigation, payments and recoveries in antitrust actions are subject to tax rules. The treatment of such amounts by the payor can make a settlement or judgment payment significantly less painful to the defendant. Similarly, the tax rules governing antitrust recoveries can make a plaintiff's recovery in a private antitrust action better or worse than might on first glance appear. The payment of settlement amounts or damages in antitrust actions has always been subject to somewhat different rules than the payment of other types of settlement or damage payments.

A. Deducting Antitrust Payments. The most common type of suit in which tax issues arise is a treble damage suit brought by a private party.[2] From the payor's perspective, the best antitrust suit is one that ends with no amount being payable to the plaintiff. If some payment is required, either by way of settlement or judgment, the payor will clearly want to deduct the amount in determining its taxable income. In the antitrust field, several specific rules apply to modify in significant ways the normal rule of deductibility.

To consider the deductibility of payments made in settlement of an antitrust action, it is necessary to separate compensatory damage payments from punitive damages. Payments made or incurred for compensatory damages to a private party are deductible as ordinary and necessary business expenses of the payor. Under Section 162(g), a payor is denied a deduction for two-thirds of the damages paid pursuant to a treble damage antitrust suit if certain conditions are met. The theory that the first third of the damages represents actual or compensatory damages, while the remaining two-thirds of the payment is disallowed but only where there is a conviction in a related criminal proceeding or a plea of guilty of *nolo contendere*. The payor will have no difficulty in deducting the entire portion of a payment made to a private party in a treble damage suit as long as there is no related criminal proceeding brought or, if such a criminal proceeding is brought, as long as there is not a plea of guilty or *nolo contendere* or the case does not end in a conviction. Where one of these conditions does exist, only the first third of the damages would be deductible; the other two-thirds (the "penal" portion) would be nondeductible.

In *Federal Paper Board Company, Inc. v. Commissioner*,[3] the taxpayer was sued for price fixing by private parties, and indicted in criminal proceedings. The civil suit concerned the defendant's actions with respect to *both* folding paper cartons and milk cartons, while the criminal suit involved only folding cartons. The taxpayer settled the civil actions, agreeing to pay the plaintiffs monetary damages.

The IRS argued that Section 162(g) applied because of the related criminal proceedings in which the taxpayer entered a plea of *nolo contendere*. However, the Tax Court pointed out that the criminal proceeding involved only the taxpayer's actions with respect to folding paper cartons, not milk cartons. Accordingly, only the portion of the settlement payments allocable to the taxpayer's actions with respect to folding paper cartons was restricted under Section 162(g).

Related Criminal Proceedings. To evaluate the applicability of Section 162(g)'s restriction, one must determine whether there is a "related criminal proceeding." If there is no "related criminal proceeding," even if there are guilty pleas or pleas of *nolo contendere*, or even determinations that the defendant is guilty, the restriction of Section 162(g) does not apply.

As the limitation on deductibility of damages is geared to whether there is a conviction (or guilty or *nolo* plea) in a "related" criminal action, there must be a nexus between the civil and criminal proceedings. What is "related" is a question of fact. A violation of the federal antitrust laws is related to another violation if: (a) the United States obtains both a judgment in a criminal proceeding and an injunction against the taxpayer; and (b) the taxpayer's actions which constituted the prior violation would have contravened such injunction if such injunction were applicable at the time of the prior violation.[4]

Of course, the government may not seek an injunction, but may instead seek only a conviction. In such a circumstance, a civil damage suit for treble damages arising out of the same actions may (and typically will) be considered related to the criminal proceeding.[5]

In *McDermott Inc. v. Commissioner*,[6] the Tax Court determined that the appropriate standard for judging related criminal proceedings depends on the scope of the conduct the taxpayer admits in the criminal proceeding, and on whether that conduct is co-extensive with the conduct that gave rise to the civil settlement. In *McDermott*, the company pleaded *nolo contendere* to collusive bid rigging. Various contracts were listed in a bill of particulars.

The company entered into settlements

involving the contracts listed in the bill of particulars. The question was whether even the non-listed contracts involved basically the same conduct and therefore should be covered by Section 162(g). The court concluded that McDermott had plead *nolo* to collusive bid rigging, not to collusive bid rigging of particular contracts. Consequently, the court applied the deduction restrictions of Section 162(g).

In *The Flintkote Co. v. U.S.*,[7] the court held that a manufacturer of gypsum could not fully deduct amounts it paid to settle a civil antitrust case. The company had plead *nolo contendere* during the same period of time that involved the civil suit, and the court found that the conduct in the criminal proceeding was coextensive with the conduct that gave rise to the civil settlement. The company argued that it had not considered the tax consequences of the plea of *nolo contendere*, and that therefore the court should give it relief. Not surprisingly, the court rejected this argument.

A good example of the necessary linkage between a civil antitrust matter and a criminal conviction (or *nolo* plea) came in *Fisher Companies, Inc. v. Commissioner*.[8] The company deducted amounts it paid in settlement of several civil suits brought under the Federal antitrust laws. A portion of the settlement payments related to years for which it had entered a guilty plea to Sherman Act violations. The remainder of the payments related to years for which the company had been accused (but not convicted) of criminal charges.

The Tax Court (and Ninth Circuit) determined that the company could not deduct two-thirds of the treble damages paid for years in which the criminal convictions had been sustained, but that the company *could* deduct the full amounts paid for years in which no conviction had been determined. The theory of the court was a fine reading of the "related violation" rules. Because there was no criminal conviction with respect to some of the years, there could be no restriction on the deductibility of the payments.

The IRS subsequently acquiesced on whether there was a related violation where there is no injunction against the taxpayer accompanying its guilty plea in the criminal proceeding.[9] However, the IRS did not acquiesce on whether a lump sum payment in settlement of a civil suit would have to be allocated in proportion to the length of time to which the guilty plea pertained in relationship to the period during which no criminal activity was admitted to occur.[10]

Deduction of Payments to Government. A major tax concern in the antitrust area is defendant's deduction of payments to private parties. Defendants are sometimes required to make a payment of damages to the federal government, and those payments raise special tax concerns. The Clayton Act provides for damages to the United States in some cases. Although damage claims brought by the United States government under this provision are relatively uncommon, when such a payment is made a deduction for the payment should be allowable. The Revenue Service once ruled that amounts paid under this provision were not deductible.[11] However, this Revenue Ruling was declared obsolete some years later.[12]

State antitrust laws may also provide for compensation/damage payments to the states under counterpart state antitrust legislation. If the state law provides for payments due to civil violations, which payments are in the nature of compensatory damages to the state, there should be no question as to deductibility. A penalty, however, is nondeductible and most of the authority has focused on this distinction.

For example, in *Commissioner v. Longhorn Portland Cement Co.*,[13] the taxpayer sought to deduct payments made to the state of under Texas' antitrust laws. The Fifth Circuit denied the deductions, concluding that Texas law imposed a statutory "penalty" for violation, and held that no deduction for a penalty could be allowed.[14] Although relatively few decisions have considered the deductibility of state antitrust payments, the *Longhorn Portland Cement Co.* decision, which distinguishes between damages to a state intended as compensatory and those intended as a penalty, seems firmly grounded in federal authority.[15]

Damages Paid Prior to Complaint Being Filed. If antitrust damages are paid *prior* to a complaint being filed, can the restriction on deductibility applicable when there has been a related criminal proceeding apply? In one case, the Tax Court held that the plain words of the statute (I.R.C. §162(g)) apply to limit the deduction for a payment only where the lawsuit has actually been filed.[16] The Ninth Circuit Court of Appeals affirmed, although the IRS continues to disagree with the case.

Suppose that: (1) a criminal proceeding has been brought; (2) a guilty verdict, or plea of guilty or *nolo contendere* has been made (or appears likely); and (e) it appears that a civil action *will* be filed. Here, the potential defendant in the related civil action may want to settle prior to the institution of the suit. A deduction for the full amount of the settlement, as opposed to only 1/3, may be compelling. It may even mean that a *larger* settlement will be arrived at than would be appropriate once the lawsuit is filed and the restrictions of Section 162(g) have taken hold. Of course, before taking such action, the payor should evaluate: (1) the likelihood of success of the claim; and (2) whether the criminal and civil proceedings would be considered related.

Deduction for Fines and Penalties. Section 162(f) of the Internal Revenue Code provides that no deduction is allowed for any fine or similar penalty paid to a government for the violation of any law. This language seems to encompass a variety of types of payments beyond those incurred in criminal proceedings. However, the Treasury Regulations make it clear that a "fine or similar penalty" for this purpose is more restrictive than one might suppose. The regulations define a fine or similar penalty as:

- An amount paid pursuant to a conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding;

- An amount paid as a civil penalty imposed by federal, state or local law, including additions to tax and additional amounts and assessable penalties imposed under Chapter 68 of the Internal Revenue Code;

- An amount paid in settlement of the taxpayer's liability for a fine or penalty (whether civil or criminal); or

- An amount forfeited as collateral posted in connection with a proceeding which could result in the imposition of such a fine or penalty.[17]

In reviewing these categories of payments, it is noteworthy what this list does *not exclude*. A prior version of the regulations (the proposed regulations) had included a rule specifically *excluding* from the definition of a fine any payment designed to encourage prompt compliance with filing, or a payment in the nature of a late charge for interest rather in the nature of a penalty. The final regulations under Section 162 excluded in this limitation. Thus, it is no longer necessary to inquire why a payment is imposed.[18] If an amount is paid as a civil penalty under federal, state or local law, it constitutes a "penalty" for which no deduction is allowable.[19]

B. Taxation of Antitrust Recoveries. Rules governing the tax treatment of damages received by a plaintiff in an antitrust action are similar to the rules governing recoveries in any business context. The tax treatment of a recovery is governed by the origin of the claims test. However, the authority in the antitrust area bears particular discussion. The first point that should be noted with an antitrust recovery is the distinction between capital and ordinary income. If the plaintiff in the action has alleged that its business was destroyed through the actions of the defendant, the recovery may be purely of a capital nature—a payment designed to compensate the plaintiff for the damage to its business.[20] On the other hand, if the action alleges price fixing which resulted in the plaintiff losing income from sales, the recovery may be entirely taxable as ordinary income. The origin of the claims test controls.[21]

There are two broad types of recoveries in antitrust actions: compensatory damages and punitive damages. The rules respecting the tax treatment of each type of recovery are different, and within each category some further delineation is necessary. Any compensatory damage payment, whether received in an antitrust action or some other type of proceeding, is designed to compensate the plaintiff for an amount lost due to the defendant's actions. In the antitrust actions, by definition a business injury is at issue. The question, however, is whether to classify the compensatory payment as one in compensation for lost profits, damage to capital assets, or something else.

A compensatory payment generally represents lost profits, profits the plaintiff *would* have reaped had it not been for the defendant's actions. If the plaintiff's claim is based solely on the argument that the defendant's actions deprived it of profits it otherwise would have earned, the recovery will be taxable as ordinary income.[22]

The second major category of compensatory damage recoveries is a recovery for damage to, loss or destruction of capital items. The items fitting within this category would comprise both capital assets, such as goodwill, or property used in a trade or business (Section 1231 property). The taxpayer has a considerable incentive to have a compensatory payment characterized as made in compensation for harm to capital assets rather than as payment for lost profits. As noted above, a payment for lost profits will be fully includable in the plaintiff's income. In contrast, a payment for harm to capital assets will be tax-free up to the tax basis of the asset.

If the recovery exceeds the basis of the asset (as determined for tax purposes), the balance in excess of the basis will be taxable as a capital gain, except to the extent of any applicable depreciation recapture. Depending on the type of plaintiff, capital gain may be entitled to a tax rate preference. Even if the plaintiff pays the same rate on ordinary income and capital gain (such as a C corporation), it is important to distinguish between the two for a variety of reasons. Separate netting of ordinary and capital items is still required. Some taxpayers (such as individuals) face deduction limits on capital losses.

A third category into which compensatory recovery may fall is where the defendant's actions result in harm, loss or destruction of assets that do not qualify as either capital assets or Section 1231 assets. This category may be viewed as synonymous with the lost profits category. However, there are differences. For example, if the defendant's actions render the plaintiff's inventory valueless, the inventory obviously cannot qualify as a capital asset or a Section 1231 asset. A recovery with respect to that inventory might be placed into this third category.

A second part of this third category is where the compensatory damages relate to damage to or destruction of assets that qualify as capital or Section 1231 assets, but there is no sale or exchange of the property so as to entitle the plaintiff to capital gain treatment.

A payment pursuant to a settlement or judgment may fit into the reductions in purchase price category where it is a compensatory payment with respect to an asserted overcharge made by the defendant. This category is more complicated than the others, in that the tax treatment of the payment will depend upon the item with respect to which the overcharge was purportedly made.

Ordinary Income (Lost Profits) Recoveries. It is not surprising that the Internal Revenue Service would like to see most compensatory antitrust payments treated as lost profits. Many antitrust actions lend themselves to such a characterization, since at least one element of the damages claimed will typically be profits the plaintiff lost due to the defendant's actions. That this recovery is not the only element of a settlement or judgment payment often must be demonstrated, as by showing that a portion or percentage of the recovery was for harm to capital assets (*i.e.*, destruction of a business' goodwill).

The IRS will treat *any* recovery of a compensatory nature in an antitrust action as lost profits unless the taxpayer can demonstrate otherwise. In the typical case, more than one claim will be alleged—damages due to lost profits as well as harm to capital assets. It will be the plaintiff's responsibility to show what portion of an amount received relates to each item in order to overcome the presumption that typically applies to ordinary income treatment.

As in other litigation contexts, the complaint is the most important document by which to establish the tax character of the settlement or judgment. If the complaint alleges only lost profits, the recovery can hardly be viewed as anything else. The burden of proof is firmly on the taxpayer to show that some portion (or all) of a recovery is attributable to a recovery of capital rather than to lost profits.[23]

The tax character of a recovery is typically not considered at the infancy of the litigation, when the complaint is filed. Yet from a tax perspective it is advantageous for a plaintiff in an antitrust action to allege harm or destruction to goodwill or other capital assets in addition to (or in lieu of) lost profits. Although other implications besides tax consequences must be considered, from a tax viewpoint the allegations of the complaint may well be critical.

Despite ample allegations of various claims in the complaint, it may be difficult to categorize a recovery as relating to one claim or another, or partially to several claims. This is perhaps most true where the litigation is settled and does not proceed to judgment. In any case, the complaint is a starting point for the proper tax characterization of the payment rather than the conclusion of it. It is clearly preferable in most situations to expressly allocate between types of damages received in a settlement agreement.

Express Allocations. If the settlement agreement expressly allocates amounts between the respective claims, the taxpayer may use it as evidence for allocating the recovery as long as the allocation is consistent with the complaint. The Internal Revenue Service is not bound by such an allocation. Nevertheless, if the allocation meets the following criteria, it is likely to be respected: (a) consistent with the complaint; (b) consistent with the evidence existing at the time the settlement is made; and (c) apparently consistent with the facts.[24]

Glenshaw Glass,[25] provides an example of how *not* to structure a settlement. In refusing to allocate any portion of the recovery to capital items, the court reviewed the pleadings and evidence. The court noted that the pleadings did not refer to any asset, tangible or intangible, that was damaged or destroyed. In particular, the court noted that intangibles such as goodwill or reputation were nowhere mentioned in the documents. No evidence was introduced in the litigation to establish that any asset could have been the basis for a claim for lost capital. The court was therefore more than justified in rejecting the taxpayer's claim that any portion of the amount was attributable to lost capital.

Similarly, the plaintiff in *W.W. Sly Manufacturing Co.*,[26] sued the defendant for patent infringement. In its complaint the plaintiff asked for an accounting of the "profits or income" unlawfully derived from the violation of plaintiff's rights. The plaintiff then reported the amount received as a result of this action as nontaxable income. Not surprisingly, the court held that the amount received from the defendant, which had been framed by the plaintiff as profits or income, was taxable income to the plaintiff in the year received.

Damages for Injury to Capital. The most litigated line in the taxation of antitrust recoveries is between the taxation of a recovery as ordinary income and capital gain. A recovery designated as made for harm to capital assets may be tax-free in part (up to the amount of the taxpayer's basis in the property) with only the *excess* being taxable as a capital gain. Loss of goodwill is a common basis of recovery in an antitrust action. A recovery of compensatory damages based upon an injury to goodwill is treated as a return of capital (and therefore nontaxable) up to the amount of the plaintiff's basis in the goodwill, with only the amount in excess of that basis taxable as a capital gain.[27]

In *Glenshaw Glass v. Commissioner*,[28] the Tax Court allocated settlement amounts between claims according to its perception fo the realities. The taxpayer's claims that its recovery was for lost capital only were rejected. In *Telefilm, Inc. v. Commissioner*,[29] a portion of the taxpayer's recovery was held attributable to the destruction of business and goodwill. However, the taxpayer could not show a basis in its goodwill, and therefore could not have a portion of that recovery excluded as a recovery of basis.

In *Telefilm*, a general release was executed, containing no allocation of the amount. However, the court found a ready basis for allocation, since the settlement had occurred *after* the jury trial and on the eve of judgment. The jury verdict had been for $250,000 in actual damages and $50,000 in punitive damages. Accordingly, the court allocated 5/6ths of the settlement amount to compensatory damages (allocated between capital recovery, loss of profits and harm to goodwill on the basis of the complaint) and 1/6th to punitive damages. The inability to show basis in goodwill is a common problem, particularly where the business has not been acquired in recent years with an express allocation of a portion of the purchase price to goodwill.

In *Phoenix Coal Co. v. Commissioner*,[30] the taxpayer was unsuccessful in showing that a portion of its recovery was allocable to goodwill. Although there was a claim for loss of goodwill in the complaint, the court in *Phoenix Coal* refused to make an allocation for injury to goodwill because there had been no proof that there really was a destruction of goodwill.

Burden of Proof. It is important to emphasize that it will be up to the taxpayer to show the extent to which a recovery relates to a harm to capital assets. Indeed, once that harm has been demonstrated, the taxpayer must also show a basis in the capital assets in order that a portion of the recovery (the amount up to the basis therein) will be nontaxable. Some courts have expressly stated that a taxpayer who cannot show another character to a recovery will be faced with ordinary income characterization for the entire recovery.[31]

Basis Recovery. Where the taxpayer is entitled to treat a portion of the recovery as a return of basis, a basis adjustment to reflect such a recovery is required. If the amount of the recovery exceeds the taxpayer's basis in the capital asset, of course, the recovery will be taxable income to the extent of this excess. Whether it will be taxable as a capital gain or as ordinary income will depend upon several factors. The status of the asset as a capital asset or Section 1231 asset is typically not a problem, so that from this perspective, capital gain treatment should be appropriate.

Some authorities suggest that for capital treatment there must be a "sale or exchange." This requirement that arguably would not be met in the case of a partial damage to an item, such as harm to (but not destruction of) goodwill. Nevertheless, the IRS and the courts have viewed the "sale or exchange" requirement as often being met in this circumstance.[32]

A special class of antitrust recoveries may be treated not as taxable income at all, but rather as a reduction in purchase price. The tax treatment to be accorded the reduction in purchase price depends on the tax treatment initially claimed by the taxpayer on the purchase price. The types of recoveries which are likely to be so treated are relatively few.

The most common type of action generating such a recovery is an action for illegal price fixing. The theory is that the plaintiff paid more for the goods or services than he lawfully should have, and the reduction in purchase price characterization for a recovery is therefore appropriate. A lawsuit for a conspiracy in restraint of trade may also generate such a recovery if the harm suffered by the plaintiff is property for which the plaintiff overpaid as a result of the defendant's actions.

The reason for the relevance of the tax treatment claimed by the plaintiff on the assets when they are purchased is straightforward. If the plaintiff has expensed the assets (*i.e.*, claimed an ordinary business expense deduction for them on purchase), then the plaintiff has already received a "tax benefit" for these items and the recovery should represent taxable income. On the other hand, if the plaintiff has not claimed any deduction whatsoever (not even any depreciation), the recovery represents purely a recovery of capital (nontaxable) up to the amount of the taxpayer's basis in the assets.[33]

In the more common case, however, the taxpayer will have claimed a depreciation deduction with respect to the purchases. In this circumstance, the recovery will have claimed a depreciation deduction with respect to the purchases. In this circumstance, the recovery will represent a nontaxable return of capital up to the amount of the taxpayer's basis in the assets. However, the basis of the assets would naturally have to be adjusted (downward) to take into account the recovery. In effect, the recovery is treated as a refund of items previously expensed, such as legal fees, would generally be taxable as ordinary income.[34]

<u>Deductibility of Recoveries Under Section 186</u>. Section 186 provides for a deduction with respect to a recovery of losses from a "compensable injury" from a patent infringement, breach of contract, breach of fiduciary duty or an antitrust injury under Section 4 of the Clayton Act.[35] Technically, one considers a deduction from income only after one has first included items in income. Although Section 186 does not provide an *exclusion* from gross income, the deduction it provides has the effect of reducing taxable income.

Section 186 provides a means of not paying tax on certain types of recoveries (patent infringement, breach of contract, breach of fiduciary duty or antitrust), but only up to certain limits. The deduction is limited to the lesser of:

1. The amount which is received or accrued during the taxable year as damages resulting from an award in or settlement of a civil action for recovery of a compensable injury, reduced by amounts paid or incurred during the taxable year in securing the award or settlement (this amount is the "compensatory amount");[36] or

2. The gross amount of "net operating losses attributable to the compensable injury," reduced by the sum of Section 172 loss carrybacks and carryovers allowed in prior years which relate to the compensable injury, and reduced further by any prior deduction under Section 186 with respect to the same compensable injury (this amount is referred to as "unrecovered losses").[37]

There is no direct tracing whether a compensable injury actually resulted in or contributed to a taxpayer's net operating loss. A net operating loss is treated as attributable to a compensable injury to the extent of the compensable injury sustained during the year of the net operating loss.[38] Net operating loss carryovers are to be adjusted in cases in which a deduction under Section 186(a) is taken.

When a compensatory amount is accrued or received, any portion of a net operating loss carryover to that year which is attributable to the relevant compensable injury must be reduced by the amount of the Section 186 deduction with respect to that compensatory amount.[39] The reduction in NOL carryover is lessened, however, by any portion fo the "unrecovered losses" sustained as a result of the compensable injury with respect to which the carryover period under Section 172 has expired.[40]

The regulations under Section 186 impose a number of additional requirements and limitations on the use of the deduction. The "compensatory amount," for example, does not include an amount received or accrued in settlement of a claim for a compensable injury if the amount is received or accrued prior to the institution of an action.[41] The suit must already have been brought.

<u>RICO Cases</u>. There have been relatively few cases decided dealing with the tax effects of a payment made under the Racketeer Influenced and Corrupt Organizations Act ("RICO"). The most famous case in the RICO area is *Accardo v. Commissioner*.[42] Accardo was prosecuted under the RICO Act for alleged racketeering in labor unions. Accardo was acquitted and deducted his legal fees, arguing that the fees were deductible since the indictment sought a forfeiture judgment. Accardo said he needed to incur the legal fees (as he doubtless did) to preserve and maintain income-producing assets. The Tax Court nonetheless concluded that the legal fees were nondeductible under the origin of the claims test. The Seventh Circuit affirmed and the Supreme Court denied *certiarrari*.

On the income side, there has been little analysis of what RICO recoveries might be. In *Clarence D. Kightlinger v. Commissioner*,[43] the Tax Court considered settlement proceeds received by an individual as a participant in a class action lawsuit against his employer under RICO. Relying on *Commissioner v. Schleier*,[44] the Tax Court found that the RICO recovery was not excludable under Section 104.

The Tax Court had little difficulty in doing this. After all, the joint stipulation in Kightlinger's class action did not specifically allocate the settlement proceeds to any particular claim. The economic harm in the case would have been based on the loss of wages resulting from the loss of employment. There was no reference in the stipulation to personal injury.

The Tax Court looked to the complaint, but found that RICO, like the ADEA considered in *Schleier*,[45] does not provide a remedy for personal injuries. The complaint alleged injury to business and property, and interference with the prospective economic advantage as employees of class members. Recovery on those claims, said the Tax Court, was simply not on account of personal injury. Since the plaintiffs also claimed punitive damages in the underlying litigation, the court easily found that Section 104 did not apply to punitive damages.

The Tax Court even went on to find that the notices relating to the class action that Kightlinger received clearly described the class action as one for the recovery of lost wages and employment-related economic harm. Even the distribution arrangement for the class proceeds, said the court, revolved around lost wages and retirement benefits. The court acknowledged that using economic loss to measure the extent of personal injury does not bar exclusion under Section 104 as a matter of law, but the court pointed out that the key requirement *is* personal injury. That simply was not a factor in this case.

C. <u>Punitive Damages in Antitrust Actions</u>. By definition, punitive damages are designed to punish, to penalize the defendant. The tax treatment of such items was long quite controversial in a variety of types of litigation. In the antitrust arena, the taxation of punitive damages is grounded in the *Glenshaw Glass* case.[46] In *Glenshaw Glass*, the U.S. Supreme Court held that punitive damages received in an antitrust action constituted ordinary income subject to tax. Although *Glenshaw Glass* and its principle are now immutable, it is an interesting historical note that prior to the *Glenshaw Glass* decision the generally accepted tax treatment of punitive damages in antitrust actions was quite different: they were not taxable. *Glenshaw Glass* did away with this liberal rule, making clear that all punitive damages in antitrust actions will be taxable—and taxable as ordinary income.

In harmony with the *Glenshaw Glass* decision, the Internal Revenue Service has stated that it will always view punitive damages awarded in an antitrust context as ordinary income.[47] This result is not subject to challenge, and statements by the Tax Court support the settled nature of this rule.[48] With the amendment of Section 104 of the Code in 1996 to make clear that punitive damages are taxable even in personal (and physical) injury cases, no argument about nontaxability of punitives in the antitrust arena will be voiced.[49]

D. <u>Other Types of Antitrust Decrees</u>. Apart from damages, one result of an antitrust proceeding may be a decree for the defendant to divest itself of particular businesses or assets. If this occurs, the actions contemplated by the decree may have tax consequences. Although in the current climate of antitrust enforcement, such decrees are highly unusual, brief discussion of their tax treatment is appropriate. It is first necessary to distinguish between decrees to dispose of assets, decrees to distribute stock of a company (so-called spinoffs), and decrees to dissolve or liquidate.

The easiest situation to discuss is where an antitrust decree requires the disposition of certain assets. No special tax treatment for such a disposition is provided by the Internal Revenue Code. Accordingly, a sale pursuant to an antitrust decree becomes nothing more than a sale, with attendant tax consequences. If a sale prompted by some other event would have produced a gain or loss, the same tax consequences would follow from a sale consummated pursuant to the antitrust decree. Sales pursuant to an antitrust order are *not* treated as involuntary conversions under Internal Revenue Code Section 1033. They therefore do not qualify for those special nonrecognition benefits.

Where a decree requires a corporation to distribute the stock of a subsidiary, the tax consequences are more favorable. Provided that certain requirements are met, a distribution of this type (often denominated a "spinoff") are tax-free under Section 355 of the Internal Revenue Code. Various percentage tests and other requirements must be met in order for this tax-free treatment to apply. One of these requirements is a corporate business purpose for the distribution. The Revenue Service has ruled that an antitrust decree satisfies the business purpose requirement.[50]

When an antitrust decree requires a dissolution of a corporation, the tax consequences will flow from the corporate liquidation tax rules. There is no special rule which will tax such dissolutions more favorably than they would be taxed outside the antitrust decree context. Since the 1986 Tax Reform Act and its repeal of the *General Utilities* doctrine, such a liquidation would be taxable to the liquidating corporation unless falling within Section 332. Section 332 provides for tax-free liquidations (as between parent and subsidiary) when an 80% stock ownership requirement and certain other tests are met.

ENDNOTES:

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2. See §4(a) of the Clayton Act, 15 U.S.C. §15.

3. 90 T.C. 1011 (1988).

4. Reg. §1.162-22(c).

5. For an example of this, see Private Ltr Rul 8319005 (May 13, 1983).

6. 101 T.C. 155 (1993).

7. 7 F.3d 870 (9th Cir. 1993).

8. 84 T.C. 1319 (1985), *aff'd in unpublished opinion*, 806 F.2d 263 (9th Cir. 1986), *acq'd in part, non-acq'd in part*, 1990-20 I.R.B.4.

9.1990-20 I.R.B.4.

10. *Id*.

11. Rev Rul 64-224,1964-2 C.B. 2 (1964).

12. Rev Rul 83-122,1983-1 C.B. 271 (1983).

13. 148 F.2d 276 (5th Cir. 1945), *cert. den.*, 326 U.S. 728 (1945).

14. For the Tax Court's opinion, see 3 T.C. 310 (1944).

15. For examples, see *Commissioner v. Tellier*, 383 U.S. 687 (1966). See also *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958) (denying a deduction for fines and penalties imposed upon the taxpayers for violating state penal statutes).

16. See *Fisher Companies, Inc. v. Commissioner*, 84 T.C. No. 1319 (1985), *aff'd in unpublished opinion*, 806 F.2d 263 (9th Cir. 1986), *acq'd in part, non acq'd in part* 1990-20 I.R.B. 4.

17. Reg. §1.162-21(b)(1).

18. See T.D. 7345 (Feb. 19, 1975), and T.D. 7366 (July 10, 1975).

19. I.R.C. §162(f), Reg. §1.162-21(b)(1).

20. Rev Rul 70-510, 1970-2 C.B. 159 (1970).

21. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952); *reh'g denied*, 344 U.S. 900 (1952).

22. For an example of lost profit recoveries, see *Sager Glove Corp. v. Commissioner*, 311 F.2d 210 (7th Cir. 1963), *cert. den.*, 373 U.S. 910.

23. See *Freeman v. Commissioner*, 33 T.C. 323 (1959); see also *H. Liebes Co. v. Commissioner*, 90 F.2d 932 (9th Cir. 1937).

24. For examples, see *Charles Parker v. U.S.*, 573 F.2d (Ct. Cl. 1978), *cert. den.*, 439 U.S. 1046 (1978); *Basle v. Commissioner*, 16 T.C.M. 745 (1957), *aff'd percuriam*, 256 F.2d 581 (3d Cir. 1958). For articles on the topic, see Koenig, Taxing Antitrust Recovery," 13 *Stanford Law Review* 264 (1960); and McCaffrey, "Taxpayers Choice in Damage Suit," 29 *TAXES* 879 (1951).

25. 18 T.C. 860 (1952), *aff'd*, 211 F.2d 928 (3d Cir. 1954), *rev'd*, 348 U.S. 426 (1955);*reh'g denied*, 349 U.S. 925 (1955).

26. 24 B.T.A. 65 (1931).

27. See *Raytheon Products Company*, 144 F.2d 110 (1st Cir. 1944), *cert. den.*, 323 U.S. 779 (1944).

28. 18 T.C. 860 (1952), *aff'd*, 211 F.2d 928 (3d Cir. 1954), *rev'd*, 348 U.S. 426 (1955).

29. 21 T.C. 688 (1954), *rev'd on other grounds* (on the excludability of punitive damages), 55-1 U.S.T.C. ¶9453, 5 A.F.T.R.2d 1804 (9th Cir. 1955).

30. 14 T.C.M. 96 (1955), *aff'd*, 231 F.2d 420 (2d Cir. 1956).

31.See, *Messer v. U.S.*, 52 T.C. 440 (1969), *aff'd*, 438 F.2d 774 (3d Cir. 1971).

32. *Big Four Industries, Inc. v. Commissioner*, 40 T.C. 1055 (1963), *acq'd*, 1964-1 C.B. (Part I) 4. See also *Raytheon Products Co.*, 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944).

33. Rev Proc 67-33, 1967-2 C.B. 659.

34. Rev Proc 67-33, 1967-2 C.B. 659. Note that even for the ordinary income items, the recovery exclusion rule of §111.

35. I.R.C. §186(a), (b).

36. I.R.C. §186(c).

37. I.R.C. §186(d)(1).

38. I.R.C. §186(d)(3).

39. I.R.C. §186(e).

40. I.R.C. §186(e); Reg. §1.186-1(e)(4).

41. Reg. §1.186-1(c)(3).

42. 94 T.C. 96 (1990), *aff'd*, 942 F.2d 444 (7th Cir. 1991), *cert. denied*, 12 S.Ct. 1266 (1992).

43. T.C. Memo 1998-357 (1998).

44. 515 U.S. 323 (1995).

45. 515 U.S. 323 (1995).

46. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *reh'g denied*, 349 U.S. 925 (1955); *related proceeding*, 25 T.C. 1178 (1956).

47. Rev Proc 67-33, §3.03, 1967-2 C.B. 659.

48. *Freeman v. Commissioner*, 33 T.C. 323, 328 (1959) (in dicta).

49. Note also the Supreme Court's decision in *O'Gilvie v. U.S.*, 519 U.S. 79 (1996).

50. Rev Ruls 83-22, 1983-1 C.B. 17 (1983), and 75-321, 1975-2 C.B. 123 (1975). See also Reg. §1.355-2(b)(5), Example (1). See also *Lester v. Commissioner*, 40 T.C. 947 (1963), *acq'd*, 1964-2 C.B. 6.