

Tax Notes

Letters to the Editor

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TAXATION OF PUNITIVE DAMAGES: NO EASY ANSWERS?

To the Editor:

Douglas Kahn's article on punitive damages ("Taxation of Punitive Damages Obtained in a Personal Injury Claim," Tax Notes, Oct. 24, 1994, p. 487) lays out strong arguments that I have never seen made before concerning the impact of the 1989 amendment to section 104. However, I found the concluding portion of Professor Kahn's article troubling. The last paragraph of his article says that:

If the victim of a dignitary tort has a mental breakdown as a consequence of the humiliation he suffered, could punitive damages acquired because of that tort be excluded from income by section 104(a)(2) because the victim incurred a "physical sickness"? In such a case, the injury inflicted by the wrongdoer would not be physical, but one of the consequences of that injury would be a physical reaction.<sup>1</sup>

After raising this question, Professor Kahn answers it by referring again to the legislative history of the 1989 amendment to section 104, opining that Congress intended to bar the exclusion of punitive damages when the tort itself did not constitute a physical intrusion to the person of the injured party. Professor Kahn then concludes that the purpose of the 1989 amendment would be frustrated if punitive damages received in connection with discrimination and defamation cases could be excluded when the victim became ill as a consequence of the wrongful act.

I do not think a reading of the legislative history impels one to this conclusion. Indeed, I see nothing to suggest that one must look at the tort itself versus the physical consequences that flow from the tort. I am not a personal injury lawyer, but if one "takes his plaintiff as he finds him," I think courts may have a difficult time distinguishing between damages (including punitive damages) that are awarded when the plaintiff is reckless and: (1) runs over the defendant with a car; or (2) defames the plaintiff and the plaintiff then becomes catatonic.

Punitive damage awards (at least ones that actually get paid) are not all that frequent, at least in my practice. On the other hand, I predict we will see litigation over the tax treatment of punitive damages awards when, in Professor Kahn's parlance, the tort itself is not physical, but the plaintiff does suffer physical injury. Ulcers, sleeplessness, impotence, nervous disorders, and even dramatic weight gain or loss all can be physical manifestations of harm. I suppose it is a question of degree whether these are persuasive when stacked up against someone in a body cast.

However, it well may be that physical consequences such as those mentioned above can be considerably more dramatic than the physical consequences of a simple battery. If a public figure is slapped on the street and recovers for the tort of battery one dollar in actual damages and \$100,000 in punitives, should the punitives be excludable (or, according to Professor Kahn, at least not within the proscription on exclusion!) because battery is a tort that is manifestly physical?

The courts will have to grapple with how to treat manifestations of physical harm when punitive damages are awarded in cases that do not involve a physical touching. Speaking of physical touching, by the way, I suppose it may be possible to look at sexual harassment and sexual discrimination cases as physical if in fact there has been physical contact. Would that change Professor Kahn's view?

As a policy matter, perhaps it makes sense for all punitive damages to be includable in income. Perhaps not. As a practitioner, I avoid such policy musings. However, I would take advantage of favorable authority from the courts concerning the excludability of punitive damage awards when there has been a physical injury. I predict there will be cases upholding the excludability of punitive damage awards when serious physical consequences flow from ostensibly non-physical harms. If one puts aside taxpayers who try to manufacture manifestations of physical harm (of which there certainly will be some), I think it will be difficult to distinguish between punitive damage recipients who are each equally harmed but who proceed under different legal theories.

Sincerely,

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San Francisco  
October 25, 1994

Robert W. Wood is the author of *Taxation of Damage Awards & Settlement Payments* (Tax Institute 1991, with 1994 Supplement) (to order, call 1-800-852-5515).

FOOTNOTE:

<sup>1</sup> I'm not positive I even know what a "dignitary tort" is, although I gather it must refer to a tort that is not itself physical.

**END OF FOOTNOTE**

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