

Tax Notes

Viewpoint

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WILL COURTS IMPORT PUNITIVE CHARACTERIZATION.

In a viewpoint, Robert W. Wood wonders how courts will determine whether damages are "punitive."

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With the long-running (but now resolved) debate about the appropriate tax treatment for punitive damages, one may well question whether there would be a problem in determining just what was punitive. With the Supreme Court's decision in *O'Gilvie v. Commissioner* 78 AFTR2d Par. 96-5636, Doc 96-31894 (14 pages), holding punitive damages to be taxable, and the amendment to section 104 affected by the Small Business Job Protection Act of 1996 (H.R. 3448), punitive damages will now always be taxable. The one exception, according to the Small Business Job Protection Act, is a case where only punitives (and no actual damages) are available under the terms of a wrongful death statute. But this quirk aside, punitive damages are simply taxable.

I recently posited several examples of circumstances in which it may be difficult to determine whether or not punitives have been paid. For example:

Suppose Tom is seriously injured and sues a manufacturer, receiving a jury verdict for \$1 million in actual damages and \$3 million in punitive damages. The manufacturer does not want to pay this money, and feels it is correct, so it appeals the verdict. After sparring in the appellate courts -- but before there is a final decision -- Tom and the manufacturer eventually settle for \$2 million.

If the injury to Tom was a physical injury, actual damages would be excludable from Tom's income even under the current version of 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 million he got in settlement (for a total of \$2 million) really should be treated as punitives? Irrespective of any tax consequences, the defendant manufacturer will doubtless be saying 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.

How should this be resolved? 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.

Let's modify the example to try to make an easier case. Let's use 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, which would certainly be tax-free (for physical injuries). The IRS, however, might try to prorate 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 75 percent of Tom's settlement recovery of \$750,000 (or \$562,500) should also be so allocated. Who wins?

What seems surprising, at least to me, is the willingness that it now appears courts may take in rendering "punitives" determinations even where there has been no judgment. Take the recent Tax Court case of *E. Pauline Barnes v. Commissioner*, T.C. Memo. 1997- 25, Doc 97-1505 (12 pages). That case involved the tax

treatment of a settlement in an action brought by a bookkeeper against her former employer. The bookkeeper, Pauline Barnes, worked 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 state (Oklahoma) law seeking damages of at least \$10,000. Ms. Barnes's action sought damages for future lost wages and mental distress. In 1992, she settled her case with her former employer for \$27,000. Barnes excluded the entire settlement amount for her 1992 income. The IRS determined that the entire \$27,000 was taxable.

The Tax Court determined that the settlement was based on tort or tort-type rights because 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. [\[P. 1201\]](#)

The question this case raises is the appropriateness of a determination for tax purposes that punitive damages were paid. While one must acknowledge that a taxing authority or a court faces a difficult task in allocating a recovery for tax purposes, finding that an amount ought to be treated as punitive damages for tax purposes when the parties have not even gone to trial, and where the most that exists is an aggressive plaintiff's lawyer's statement that punitives should be recoverable, seems far-fetched. Surely we did not wait years to have the tax treatment of punitive damages resolved to now face these characterization issues.

#### Tax Analysts Information

**Code Sections:** Section 104 -- Damage Awards/Sick Pay

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