BP, Oil, and Deducting Punitive Damages

By Robert W. Wood

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In this article, Wood asserts that deducting compensatory and punitive damages is business as usual (even for BP), but says there's long been tension between the rules governing fines and penalties and their bearing on civil punitive damages. In the context of proposed legislation to make punitive damages nondeductible, he examines the debate and the authorities, concluding that those damages should remain deductible.

There is renewed debate whether punitive damages should be tax deductible. Unfortunately, this debate occurs amid considerable confusion. Business defendants generally assume most everything they pay to terminate litigation is deductible. Yet many defendants, lawyers, and members of the public assume that punitive damages paid to private parties in civil lawsuits are not deductible.

Even tax benefits from compensatory damages are sometimes debated, such as the recent buzz over whether BP should be allowed to deduct payments to compensate victims of its oil spill in the Gulf of Mexico.[1] Of course, compensatory damages are clearly deductible, as are punitive damages paid in the course of a trade or business.[2] However, a tax deduction for a putative wrongdoer who acted intentionally, negligently, or merely had bad luck will rub many the wrong way.

Sen. Bill Nelson, D-Fla., has now called for a congressional inquiry into BP's tax treatment.[3] Far from focusing solely on the extent to which BP would deduct fines or penalties or even related counsel fees, Nelson even asks whether BP should be allowed to claim deductions for the $20 billion to be placed in escrow for injured parties or the compensatory damages paid to federal and state governments.

After the *Exxon Valdez* oil spill, the government's $1.1 billion settlement had an after-tax cost to Exxon of only $524 million.[4] More than half of the $900 million in civil damages Exxon paid were also deductible.[5] There are many other examples of the public and the press noticing the discrepancy between the pre- and post-tax settlement costs.

For example, when Marsh & McLennan reached an $850 million settlement in 2005 over bid rigging and conflicts of interest, the press trumpeted the after-tax cost as hundreds of millions of dollars less.[6] In 2006 Boeing held the spotlight with a $615 million settlement over contract improprieties, spawning ire that taxpayers were subsidizing settlements by wrongdoers.[7] Eventually Boeing announced it would not claim a deduction.[8] In 2008 the tax deductibility of auction-rate securities settlements by financial institutions attracted similar outrage.[9]

There are many reasons for the deductibility current law accords to both compensatory and punitive damages, but one of them is the involuntary nature of the payment.

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[1] *See* Dan Freed, "BP Payments Likely Tax Deductible — Tax Expert," *The Street*, June 22, 2010, *available at* http://www.thestreet.com/story/10788668/1/bp-payments-likely-deductible-tax-expert.html?cm_ven=GOOGLEN.

[2] *See* LTR 7923006 (Feb. 27, 1979), ruling that a corporation could deduct punitive damages arising out of a lawsuit for an alleged breach of contract and fraud under section 162; Rev. Rul. 80-211, 1980-2 C.B. 57, ruling that a corporation could deduct as an ordinary and necessary business expense punitive damages arising out of a court judgment for breach of contract and fraud.

(Footnote continued in next column.)

[3] *See* letter from Nelson to Senate Finance Committee Chair Max Baucus, D-Mont., and ranking minority member Chuck Grassley, R-Iowa (July 28, 2010), *Doc 2010-17296, 2010 TNT 149-41*.

[4] *See* "Tax Deductions Will Help Exxon Slip Away From Much of Its Oil Spill Liability, Says CRS," *Highlights & Documents* (Mar. 21, 1991), p. 2853.

[5] *Id*.

[6] *See* Ian McDonald, "Marsh's Settlement Looks Likely Eligible for a Tax Deduction," *The Wall Street Journal*, Feb. 7, 2005, at C1.

[7] *See* Andy Pasztor, "Boeing to Settle Federal Probes for $615 Million," *The Wall Street Journal*, May 15, 2006, at A1; and Leslie Wayne, "3 Senators Protest Possible Tax Deduction for Boeing in Settling US Case," *The New York Times*, July 7, 2006, at C3.

[8] *See* memorandum to reporters and editors from Jill Gerber for Grassley (July 26, 2006), *Doc 2006-14093*, *2006 TNT 144-33*.

[9] *See* Amir Efrati, "Citigroup May Pressure Other Firms With Deal on Auction-Rate Securities," *The Wall Street Journal*, Aug. 7, 2006, *available at* http://www.wsj.com/article/SB121806922599718905.html.

> **Example:** You are engaged in the business of making widgets. One of the widgets malfunctions and injures several people. You are sued, and a verdict for compensatory and punitive damages is awarded. When you pay the compensatory and punitive damages, you are not doing so voluntarily or for tax reasons. The expense is ordinary and necessary, and your tax deduction is assured. It does not matter whether the damages are compensatory, punitive, or both.

Although there is no doubt about this treatment under current law, there are serious questions whether it should remain. The Obama administration proposed eliminating the deduction, and the Senate voted to do just that on June 16.[10] It is unclear whether this bill will pass. Yet as in years past, the deductibility of punitive damages is a hot topic. Law professors are once again debating it,[11] and even mainstream newspapers are getting in on the act.[12]

History of Deductions for Penalties

Despite the clarity of current law, history reveals ambiguities. In *Commissioner v. Sullivan*,[13] the Supreme Court found that wages and rents paid to run an illegal bookmaking operation were deductible as ordinary and necessary business expenses. Otherwise, an illegal business would be taxed on gross receipts, while other businesses would be taxed on net income.[14] Legal and illegal should be taxed the same until Congress says differently, the Supreme Court ruled.[15]

However, in other cases,[16] the Court strove to reconcile Congress's intent to tax only net income, with overriding public policy concerns.[17] In *Tank Truck Rentals v. Commissioner*,[18] it ruled that a trucking company could not deduct Pennsylvania fines for intentionally violating maximum truck weights. The Court noted that a deduction for ''fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature.''[19] Thus, despite business nexus, the IRS and the courts may find a way to deny a deduction one way or another.[20]

Another case noting public policy limits to deductible business expenses is *Commissioner v. Tellier*.[21] There, the IRS attacked a taxpayer's legal expenses for defending a suit over securities violations. The Supreme Court disagreed, stating that it disallowed expenses only when allowing them would frustrate sharply defined national or state policies proscribing particular conduct.[22]

To be nondeductible, the policies frustrated must be national or state policies evidenced by some governmental declaration,[23] and the frustration must be severe and immediate.[24] Against that standard, the Court concluded Tellier's payments were deductible: ''No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense.''[25]

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[10]Voting on H.R. 4213, the Senate voted (60-37) to adopt S. Amdt. 4344, proposed by Senate Majority Leader Harry Reid, D-Nev., to the extenders bill (H.R. 4213).

[11]*See* Dan Markel and Gregg Polsky, ''Trying Punitive Damages,'' 96 *Va. L. Rev.* (forthcoming Oct. 2010).

[12]*See* Dan Markel and Gregg Polsky, ''Damages Control,'' *The New York Times*, July 1, 2010, at A31.

[13]356 U.S. 27 (1958); *see also New Colonial Ice Co., Inc. v. Helvering*, 292 U.S. 435, 440 (1934): ''whether and to what extent deductions shall be allowed depends on legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.''

[14]*See* Sen. John Sharp Williams's statements during the Senate debate in 1913 on the bill that became the first modern income tax law:

> The object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon ''futures,'' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.

50 *Cong. Rec*. 3,849. *See also* Justice Black's dissenting opinion in *McDonald v. Commissioner*, 323 U.S. 57, 66-67 (1944): ''Taxation on net, not on gross, income has always been the broad basic policy of our income tax laws. Net income may be defined as what remains out of gross income after subtracting the ordinary and necessary expenses incurred in efforts to obtain or to keep it.''

[15]*Sullivan*, 356 U.S. at 29.

[16]*Hoover Motor Express Co. v. United States*, 356 U.S. 38 (1958); *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

[17]*Tank Truck*, 356 U.S. at 35.

[18]356 U.S. 30 (1958).

[19]*Id*. at 35-36, citing *United States v. Jaffray*, 97 F.2d 488 (8th Cir. 1938), *aff'd on other grounds*, *sub nom*. *United States v. Bertelsen & Petersen Engineering Co*., 306 U.S. 276 (1939); *Tunnel R. Co. v. Commissioner*, 61 F.2d 166 (8th Cir. 1932); *Chicago, R.I. & P.R. Co. v. Commissioner*, 47 F.2d 990 (7th Cir. 1931); *Burroughs Bldg. Material Co. v. Commissioner*, 47 F.2d 178 (2d Cir. 1931); *Great Northern R. Co. v. Commissioner*, 40 F.2d 372 (8th Cir. 1930); *Davenshire, Inc., v. Commissioner*, 12 T.C. 958 (1949).

[20]Interestingly, in *Hoover Motor Express*, 356 U.S. at 39, the Court held that ''wholly apart from possible frustration of state policy, it does not appear that payment of the fines in question was 'necessary' to the operation of petitioner's business. This, of course, prevents any deduction.''

[21]383 U.S. 687 (1996).

[22]*Id*. at 694, quoting *Commissioner v. Heininger*, 320 U.S. 467, 473 (1943).

[23]*Id*., quoting *Lilly v. Commissioner*, 343 U.S. 90, 97 (1952).

[24]*Id*., quoting *Tank Truck*, 356 U.S. at 35.

[25]*Id*. at 694. Compare an earlier manifestation of the public policy exception that denied a deduction for legal expenses in a comparable situation. In *Backer v. Commissioner*, 1 B.T.A. 214 (1924), a taxpayer had attempted to deduct, as ordinary and necessary, legal expenses arising out of his criminal trial for perjury. The court wrote:

> Manifestly the commission of perjury can, under no circumstances, be recognized as part of a taxpayer's business; and so the expense incident to such criminal activity can likewise not be recognized. . . . We do not believe that it is in the interest of sound public policy that the commission of illegal acts should be so far protected or recognized that their cost is regarded as a legitimate and proper deduction in the computation of net income under the revenue laws of the United States.

By the mid-1960s, the contours of the public policy exception to deductible business expenses had been delineated. Although courts continued to struggle with its subtleties, a deduction was generally denied only for violating a declared governmental policy, and only for payments in the nature of punishment, as distinguished from business expenses, even in a business that was illegal.[26]

Codifying the Public Policy Exception

In 1969 the Senate Finance Committee noted its reluctance to deny deductions for business expenses, because taxes should be imposed on net income.[27] The committee nevertheless acknowledged that it was appropriate to deny deductions for bribes, illegal kickbacks, and the penalty portion of antitrust treble damages.[28] Thus, the Tax Reform Act of 1969 disallowed ordinary and necessary business deductions[29] for fines or similar penalties paid to a government for the violation of any law,[30] a portion of treble damage payments under the antitrust laws following a related criminal conviction (or plea of equity or nolo contendere),[31] deductions for bribes paid to public officials (whether or not foreign officials),[32] and other unlawful bribes or kickbacks.[33]

As expressed by the Finance Committee in 1969:

> This means that the deduction (of the penalty portion) is to be denied only in the case of "hard-core 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.[34]

The Finance Committee also wrote:

> The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is *intended to be all inclusive*. Public policy, in other circumstances, generally is *not sufficiently clearly defined* to justify the disallowance of deductions.[35]

This legislative history has generated many law review articles,[36] IRS interpretations,[37] and case law. However, the public policy exclusion is narrow, and the regulations state that a "deduction for an expense paid or incurred . . . which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy."[38]

Section 162(f) was designed to disallow payments of civil sanctions serving the same purpose as a fine exacted under a criminal statute.[39] For example, section 162(f) was intended apply to penalties provided in the form of assessable penalties (subchapter B of chapter 68 of the 1954 code) as well as to additions to tax (subchapter A of chapter 68 of the 1954 code) in those cases when the government has the fraud burden of proof (that is, proof by clear and convincing evidence).[40]

However, section 162(f) allows the deduction of payments imposed to encourage prompt compliance with law.[41] Despite "fine or penalty" nomenclature and the fact that a payment is made to a governmental entity, the nondeductibility under section 162(f) is not absolute. Many fines and penalties have been held deductible,[42] viewed as compensatory or remedial rather than penal or punitive.[43] With that tautological terminology, perhaps it is not surprising there is confusion.

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[26] *See* Kimberly A. Pace, "The Tax Deductibility of Punitive Damages: Who Should Ultimately Bear the Burden of Corporate Misconduct?" 47 *Ala. L. Rev*. 826, 832 (1996), summarizing the holdings of *Lilly*, *Sullivan*, and *Tellier*.

[27] Tax Reform Act of 1969, P.L. 91-172; and S. Rep. No. 91-552 at 273 (1969).

[28] *Id*. at 274.

[29] A 1958 amendment to the code had added a denial of deductions for payments to officials or employees of a foreign government if in the United States those payments would be unlawful. A 1962 amendment to the code had added a denial of a deduction for expenditures made to influence legislation.

[30] Now codified at section 162(f).

[31] Now codified at section 162(g).

[32] Now codified at section 162(c)(1).

[33] Now codified at section 162(c)(3).

[34] S. Rep. No. 91-551, 274 (1969).

[35] S. Rep. No. 91-552, at 274 (emphasis added).

[36] *See* Pace, *supra* note 25, at 834-835:

> While the use of the term "all inclusive" in the Senate Report expresses the legislature's intention that the judiciary was not to disallow unlisted deductions under the public policy doctrine, this mandate is not absolute. In the second sentence of the report, use of the term "generally," leaves open the possibility that there may be some public policy that is sufficient to justify the disallowance of deductibility; otherwise, Congress would have said that public policy in other circumstances is never sufficient.

F. Philip Manns Jr., "Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?" 13 *Va. Tax Rev*. 271, 277 (1993): "Through codification of four specific applications of the public policy disallowance, Congress usurped the courts' authority to deny deductions on public policy grounds."

[37] *See, e.g.*, LTR 8715006 (Dec. 29, 1986): "In other words, Congress expressed a general rule that, except for the payments specifically covered by the Tax Reform Act of 1969, public policy should not be utilized as a standard for disallowing deductions."

[38] Reg. section 1.162-1(a).

[39] S. Rep. No. 92-437, 73 (1971).

[40] *Id*.

[41] *Id*. at 74.

[42] *See, e.g.*, *Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990), in which the taxpayer was allowed to deduct a restitution payment, despite the fact that the IRS argued the deduction would take the "sting" out of his punishment; *Mason and Dixon Lines v. United States*, 708 F.2d 1043 (6th Cir. 1983), in which a taxpayer was able to deduct liquidated damages paid to a state government, because those damages were compensatory in nature.

[43] *See* reg. section 1.162-21(a)(2): Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. section 15a, as amended)) paid to a government do not constitute a fine or penalty. For a collection of examples of fines

(Footnote continued on next page.)

Obama Administration Proposal

Like the Bush and Clinton administrations before it, the Obama administration proposes making punitive damages nondeductible. According to Treasury's release, allowing a deduction for punitive damages undermines their role in discouraging and penalizing undesirable actions and activities.[44] This is not a new argument. The Clinton and Bush administrations made attempts to disallow deductions for punitive damages[45] and their proposals were almost identical to the current iteration.

The current proposal would deny a deduction for punitive damages a taxpayer pays or incurs, whether paid under a judgment or in settlement of a claim. The proposal covers the possibility that the defendant's liability to pay punitive damages is covered by insurance, a type of coverage that has become increasingly common. The proposal would not disturb a company's ability to deduct insurance premiums for business insurance, including premiums for punitive damage coverage.

However, if the policy pays, the amount of the policy payment attributable to punitive damages must be attributed as income to the policyholder. As an enforcement mechanism, the insurer would be required to report those payments to the insured and to the IRS on a Form 1099. As proposed, these changes would take effect for damages paid or incurred after December 31, 2010. Although it may have revenue goals too, the administration's proposal appears to be based on policy grounds.

Defenders of the deduction argue that escalating tort awards in our litigious nation make paying punitive damages truly ordinary and necessary. Thus, the deductibility of damages provides needed (albeit limited) relief to businesses that are penalized (whether appropriately or not) by a tort system many businesspeople consider broken. Defenders of the deduction also identify fundamental differences between civil punitive damages and payments in criminal cases, which cannot be deducted.

Criminal cases must be proven beyond a reasonable doubt, while civil cases are governed by the weaker preponderance of the evidence standard. Moreover, the nature of these payments is arguably different. Criminal penalties are set to ensure that the punishment fits the crime. In contrast, most states have no limit on the punitive damages that can be awarded. Finally, criminal offenders are protected from double jeopardy, while in most states civil defendants can be sued repeatedly for the same actions.

Punitive Impact

Is there a policy need to make punitive damages nondeductible? If so, one might assume that defendants today would routinely guffaw that punitive damages are nothing to be afraid of because they are tax deductible. Yet that is clearly not occurring. Nearly all defendants already regard punitive damages as anathema.

Defendants engaged in a trade or business fight the imposition of both compensatory and punitive damages. They try mightily to avoid either one, and try particularly hard to avoid the taint of punitive damages. That will surely continue whether or not they become nondeductible.

If this proposal becomes law, perhaps the market would adjust to the tax rules. If a plaintiff asks for punitive damages under current law, he may wish to apprise the judge or jury that the defendant will deduct the payment. The plaintiff could even ask for *additional* punitive damages to gross-up that amount, because a tax deductible tranche of punitive damages is less punitive than a nondeductible one.

Conversely, if punitive damages are made nondeductible, defendants facing punitive damages could attempt to ensure that the judge and jury are aware those damages are nondeductible. Defendants could even ask for the denial of the deduction to be taken into account in awarding the punitive damages.[46] Yet while this seems an efficient theory, it may not be realistic to think that awards of punitive damages will take taxes into account.

Regrettably, this is not a matter of just telling the judge about the tax rule. There is already enormous variation in the extent to which civil courts take tax issues into account. Some plaintiffs ask for additional damages to make up for adverse tax consequences the plaintiff may incur. Some defendants ask for damages to be reduced because of adverse tax effects to the defendant, or more likely, because of favorable tax effects to the plaintiff. These issues turn on the nature of the causes of action, applicable law, and the discretion of the judge. Guidelines are few.

I cannot recall a case in which a plaintiff seeks to introduce evidence about the tax deductibility of punitive damages to pump them up, nor a case in which the defendant seeks to reduce a fine or penalty by introducing evidence that it will not be deductible.[47] Despite the lack of case law concerning what we might call "punitive damage tax gross-ups" or "punitive damage tax gross-downs," we have some indication they might not fare well. The evidence of courts willing to take tax issues into account in clear and helpful fashion is hardly impressive, much as I would like to say otherwise.

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or penalties and their tax character, see Robert W. Wood, *Taxation of Damage Awards and Settlement Payments* (4th ed. 2008), para. 10.26.

[44]*See* Treasury Department, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (May 2009), *Doc 2009-10664, 2009 TNT 89-44*.

[45]*See* Joint Committee on Taxation, "Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal," JCX-1-99 (Feb. 22, 1999) at 256, *Doc 1999-7175, 1999 TNT 37-12*; JCT, "Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal," JCX-20-00 (Mar. 6, 2000), at 404, *Doc 2000-6731*, *2000 TNT 45-15*; Finance Committee, "Report on Jumpstart Our Business Strength (JOBS) Act," S. Rep. No. 108-192, 122 (2003), *Doc 2003-24258, 2003 TNT 217-31*; Finance Committee, "Report on Small Business and Work Opportunity Act of 2007," S. Rep. No. 110-1, 35 (2007), *Doc 2007-1778, 2007 TNT 15-34*.

[46]Markel and Polsky make this "tax awareness" argument in "Trying Punitive Damages," *supra* note 10, and in "Damages Control," *supra* note 11.

[47]Of course, there could be no case in which a defendant seeks to show that punitive damages are nondeductible, because under current law, they clearly are deductible.

Sure, there have been some notable successes, including the Third Circuit's decision in *Eshelman v. Agere Systems, Inc*.[48] There, the Third Circuit upheld an award of damages under the Americans with Disabilities Act for increased tax burdens on lump sum back pay. This is a good case approving the ''tax damages'' notion, and there may be more in the future. I've collected some of the positive cases, but most occur in employment litigation.[49]

However, some plaintiffs making a good case they should receive higher damages because of adverse tax effects are still denied.[50] Even if a claim is allowed, standards of proof are high,[51] and many litigants cannot meet it.[52] Similarly, some defendants fail to convince courts that damages awarded against them should be reduced by tax advantages the plaintiff will reap.[53]

Sometimes both parties invoke tax consequences and seek offsets.[54] Even the Supreme Court has suggested there's often rough justice about taxes in litigation.[55] Underlying this position is the notion that there are many uncertainties in our tax rules — good reasons not to deal with tax subjects. The Supreme Court noted that the proper amount of tax liability ultimately depends on a plethora of factors. Many courts don't use the ''speculative'' moniker, but there is an almost palpable fear of nailing down tax issues, even if they seem simple (as the question of deductibility clearly should be).

The time at which tax damages should be requested also varies, from pretrial to posttrial. In jury trials, there can even be constitutional implications.[56] The Seventh Amendment to the U.S. Constitution generally prevents additur, so a request to amend a judgment to take taxes into account may infringe on the jury's province.[57] In contrast, tweaking a judgment to reflect taxes may be no problem in a bench trial.[58]

[48]554 F.3d 426 (3d Cir. 2009), *Doc 2009-2478*, *2009 TNT 23-7*.

[49]*See* Wood, ''Getting Additional Damages for Adverse Tax Consequences,'' *Tax Notes*, Apr. 27, 2009, p. 423, *Doc 2009-6560*, or *2009 TNT 79-11*.

[50]*See Pytka v. Gadsby Hannah LLP*, 15 *Mass. Law Reporter* 451 (Mass. Sup. Ct. 2002) (despite expert testimony that the judgment was taxable and that a tax gross-up was needed to make the plaintiff whole, the court denied the gross-up).

[51]*See Eckert Cold Storage Inc. v. Behl*, 943 F.2d 1230 (D.C. Cal. 1996).

[52]*See Lewin v. Miller, Wagner and Co*., 725 P.2d 736 (Ariz. Ct. of App. 1986) (''speculative''); and *DCD Programs, Ltd. v. Leighton*, 90 F.3d 1442 (9th Cir. 1996) (noting that everyone has to pay taxes).

[53]*See DePalma v. Westland Software House*, 225 Cal. App. 3d 1534 (1990).

[54]*See, e.g., Pham v. Seattle*, Wash. Ct. App. No. 52356-2-I (2004).

[55]*See Hanover Shoe, Inc. v. United Shoe Machinery Corp*., 392 U.S. 481 (1968) (refusing to reduce an award for taxes).

[56]*See Judith K. Kelley v. City of Albuquerque*, No. 03-507 (D.N.M. 2006), *Doc 2006-9776*, *2006 TNT 98-7*.

[57]*Traylor v. United States*, 396 F.2d 837, 840 n.4 (6th Cir. 1968) (citing *Dimick v. Schiedt*, 293 U.S. 474 (1935), for the premise that additur is not permitted in federal court when a jury verdict is found to be inadequate).

[58]*See Traylor*, 396 F.2d at 840 n.4; *Sears v. Atcheson Topeka & Sante Fe Ry. Co*., 749 F.2d 1451 (10th Cir. 1984).

Characterization Debates

Based on prior proposals to make punitive damages nondeductible, the New York State Bar Association Tax Section issued a seminal report on this subject in 2001.[59] It is still worth reading in its entirety, but several points deserve special mention. The report notes that supporters of nondeductibility mention other code sections that attempt to impose (or affect) social policy. Examples include golden parachute payments, greenmail payments, and excessive employee compensation.

Yet arguing by analogy to other code sections begs key questions. If social policy is the goal (and if that is a good goal), would making punitive damages nondeductible have additional deterrent effects? How would this fundamental change be received by judges and juries who award punitive damages? How would it be perceived by the companies paying them? How would settlements on appeal expressly requesting punitive treatment be handled?

I am most influenced by practical realities, and I believe overarching characterization questions would make nondeductible punitive damages a mess. On the payee side of the equation, we already have inherent ambiguities between compensatory and punitive damages. Punitive damages are awarded in a wide variety of cases, and the nature of those awards varies. We may think that compensatory damages always put the plaintiff back in the *status quo ante*[60] and that punitive damages never have a compensatory purpose.

Yet there is often a complex interrelationship between compensatory and punitive damages. Indeed, one index for punitive damages is when compensatory damages are potentially inadequate. Another is when it may be too difficult or too costly to adequately measure compensatory damages.[61] An even more fundamental problem inherent in the treatment of punitive damages is their definition. The code does not define them, nor do the regulations.[62]

The Restatement (Second) of Torts provides that punitive damages are damages, other than compensatory or nominal damages, awarded against a person to punish him for his outrageous conduct and to deter him and

[59]*See* New York State Bar Association (NYSBA) Tax Section, ''The Deductibility of Punitive Damages,'' *Tax Notes*, Nov. 26, 2001, p. 1209, *Doc 2001-27630*, or *2001 TNT 213-21*.

[60]*Colt Industries, Inc. v. United States*, 11 Cl. Ct. 140, 146 (1986), *aff'd*, 880 F.2d 1311 (Fed. Cir. 1989).

[61]The points are noted in the NYSBA report, *supra* note 58.

[62]In fact, the term ''punitive damages'' occurs in only three instances in the code: section 104(a)(2), in the context of an a disallowance from the general exclusion from income for amounts paid on account of personal physical injuries or physical sickness, when those amounts paid are for punitive damages; section 7431, in the context of the proper damages to be paid to a taxpayer in the event an officer or employee willfully inspects or discloses the taxpayer's return or return information; and section 9507, when punitive damages paid under section 107(c)(3) of the Comprehensive Environmental Response, Compensation, and Liability Act are appropriated to the Hazardous Substance Superfund.

others from similar conduct.[63] Interestingly, the Restatement distinguishes between punitive damages and fines:

> Although the purposes are the same, the effect of a civil judgment for punitive damages is not the same as that of a fine imposed after a conviction of a crime, since the successful plaintiff and not the state is entitled to the money required to be paid by the defendant.[64]

These issues invite an impossible inquiry: Just *why* were these punitive damages awarded in this particular case? Classically, punitive damages are penal in nature, subjecting the defendant to punishment.[65] Yet punitive damages are sometimes compensatory or at least quasi-compensatory.

Would any amount intended to be caught within the concept of punitive damages always be so denominated by a court? It seems unreasonable to think so. Particularly in cases settling on appeal, questions often arise about the character of a settlement and the constituent payments made under it.

> **Example:** Tom is seriously injured and sues an automobile manufacturer, receiving a jury verdict for $1 million in compensatory damages and $3 million in punitive damages. The manufacturer appeals, and during the appeal Tom and the manufacturer settle for $2 million. The compensatory damages are excludable from Tom's income, but punitive damages are not. How should the $2 million be treated?

Because Tom received a verdict for only $1 million in compensatory damages, the IRS could argue that the other $1 million must be treated as punitive. Alternatively, the IRS could assert that only $500,000 is excludable and $1.5 million is taxable based on the verdict's ratio of compensatory to punitive damages. At the other extreme, Tom may argue that no amount is punitive, at least if he has cross-appealed for $2 million or more of compensatory damages.

Looking only at Tom, such incentives already exist in current law. If one also considers the defendant and deductibility issues, the stakes are even higher. Of course, irrespective of tax consequences, the defendant manufacturer will contend it did no wrong and that it does not agree any punitive damages are payable. The defendant may have public relations concerns, insurance restrictions, shareholder relations problems, and a host of other reasons.

> **Example:** Assume the same facts, except that Tom settles on appeal for only $750,000. Even without a cross-appeal Tom will argue he is receiving *only* compensatory damages on account of personal physical injuries. Yet since 75 percent of the jury verdict was for punitive damages, the IRS might assert that 75 percent of Tom's settlement of $750,000 ($562,500) should be too.

63Restatement (Second) of Torts, section 908.

64*Id.* at comment (a).

65Etymologically, the words ''punitive'' and ''penal'' are both derived from the same Latin word ''*poena*'' or ''punishment.''

Punitive Damages Without a Judgment

Some courts may be willing to import punitive damage characterization even when there has been no trial. For example, *Barnes v. Commissioner*[66] involved an action by a bookkeeper against her former employer. Barnes was subpoenaed to testify about her employer and the next day was fired. She suffered embarrassment, humiliation, and mental distress. Barnes filed a wrongful termination suit seeking damages for future lost wages, mental distress, and punitive damages.

In 1992 Barnes settled for $27,000, which she excluded from her income (in 1992 it was unnecessary for an injury to be physical to be excludible).[67] Because of the punitive element, the IRS determined that the entire $27,000 was taxable. Noting that Barnes had a strong case for mental distress with the likelihood of punitive damages, the Tax Court split the settlement between mental distress and punitive damages, the latter being taxable.

Although courts face a difficult task in parsing a recovery for tax purposes, finding that an amount represents punitive damages when the parties have not gone to trial is hard to justify.[68] At the very least, those authorities make clear that explicit allocations in settlement agreements are imperative. Expressly negating punitive damages is often a good idea.

Indeed, the fact that punitive damages receive harsh tax treatment on the income side has already led some practitioners to suggest that attorneys should avoid even asking for punitive damages in complaints.[69] This may be hyperbolic, but it is true that the always taxable treatment of punitive damages can create problems settling cases. This situation may be unavoidable when compensatory and punitive damages are awarded at trial and a settlement is reached pending appeal, but worrying about punitives characterization seems bizarre when there is no verdict.[70]

66T.C. Memo. 1997-25, *Doc 97-1505*, *97 TNT 11-13*; *see also* Wood, ''Will Courts Import Punitive Characterization?'' *Tax Notes*, Mar. 3, 1997, p. 1200, *Doc 97-5998*, or *97 TNT 41-84*; Wood, ''Proposed Nondeductibility for Punitive Damages: Will It Work?'' *Tax Notes*, July 7, 2003, p. 99, *Doc 2003-16011*, or *2003 TNT 130-43*.

67Before its amendment by the 1996 act, section 104(a)(2) merely required recoveries to be on account of personal injuries or sickness rather than personal physical injuries or physical sickness. To qualify for exclusion under section 104(a)(2) after 1996, a recovery must be on account of personal physical injuries or physical sickness.

68*See* Wood, ''Will Courts Import Punitive Characterization?'' *supra* note 65; Wood, ''Proposed Nondeductibility for Punitive Damages,'' *supra* note 65.

69*See* Kevin A. Palmer, ''Recent Developments in the Taxation of Punitive Damage Awards,'' 73 *Taxes* 596 (1995).

70*See Lane v. United States*, 902 F. Supp. 1439 (W.D. Okla. 1995). For an article arguing about the punitive damage issue, see Douglas A. Kahn, ''Compensatory and Punitive Damages for a Personal Injury: To Tax or Not To Tax,'' *Tax Notes*, Feb. 20, 1995, p. 1185, *Doc 95-1944*, or *95 TNT 30-96*. *See also* Bryan P. Robertson, ''Application of the Income Exclusion of I.R.C. § 104(a)(2) to Liquidated Damages in Age Discrimination Actions Under the ADEA,'' 28 *Creighton L. Rev*. 347 (Feb. 1995).

If punitive damages are made nondeductible, wouldn't this situation get worse?

Allocation Fodder

Allocation issues arise in nearly every settlement, whether before, during, or after trial. They arise between taxable and tax-free amounts, between recovery of basis and gain, between ordinary and capital, and so on. However, allocations of punitive damages seem different from any other.

If a plaintiff sues for employment discrimination, some of the damages are probably intended as wages and some are probably nonwage damages. One does not need a trial to see this, although after trial and on appeal the allocation may be more circumscribed. With punitive damages, however, the penal or retributive nature of the payment makes the allocation inquiry fundamentally different.

> **Example:** Don Defendant faces a products liability suit in which compensatory damages may be $100x, but the more ominous exposure is a potential punitive award. Whatever Don's internal (attorney-client privileged) discussions may be about his potential exposure, if the case settles for $200x before trial (and possibly even before a complaint is filed), does any of this amount represent punitive damages?

Neither Don nor any other defendant would think so, nor would any plaintiff. The legal and factual hurdles to an award of punitive damages are simply too great. The inquiry about whether some portion of the payment should be attributed to a potential punitive award is speculative and circular. If a defendant fears exposure to compensatory and punitive damages, one of the reasons to settle before trial is to avoid the possibility of punitive damages. If punitive damages have not been awarded by a court, *there can be no punitive damages*.

Exactly what does one consider when divining the allocation between compensatory and punitive damages? In Rev. Rul. 85-98,[71] the IRS determined that if a suit seeking compensatory and punitive damages is settled for a lump sum, the settlement must be apportioned based on the best available evidence. Jury awards are certainly relevant. In *Miller v. Commissioner*,[72] the court held 47 percent of the settlement proceeds to be punitive, agreeing with the IRS that the jury award was the clearest indication of the nature of the claim and the intent of the defendants. The Fourth Circuit affirmed.[73]

[71]1985-2 C.B. 51. *See also* Wood, "Proposed Nondeductibility for Punitive Damages," *supra* note 65; Wood, "Tax Language in Settlement Agreements: Binding or Not?" *Tax Notes*, Dec. 31, 2001, p. 1872, *Doc 2001-31594*, or *2001 TNT 248-13*.

[72]*See Miller v. Commissioner*, T.C. Memo. 1993-49, *supp.*, T.C. Memo. 1993-588, *aff'd*, *mot. denied,* 60 F.3d 823 (4th Cir. 1995).

[73]60 F.3d 823 (4th Cir. 1995).

Jury instructions are also relevant. In TAM 200243021,[74] the jury in a wrongful death case awarded $5 million in punitive damages and various other amounts. When the case settled for $2.1 million, the widow argued her damages were excludable because they served a quasi-compensatory purpose under applicable state law. However, the jury instructions and state law indicated that the exemplary damages were measured by the defendant's conduct and were punitive in nature, so the settlement was taxable.

The IRS might be expected to exploit authorities from the fine or penalty area. If there is a proposed or threatened fine or penalty assessment, it may not be unfair to suggest that some portion of the settlement be attributed to the fine or penalty exposure. The facts and the evidence may make the connection and the dollar amounts patent. That is quite different from a possible punitive damage award exposure on a case settling before trial.

Clearly, defendants can and do consider their potential exposure to punitive damages before trial. However, even defenders of the deduction for punitive damages seem to assume that if this proposal becomes law, they will still be able to *settle* their cases and avoid the punitive taint. Indeed, they suggest that this obvious stratagem will give rise to a kind of legalized extortion:

> Personal injury lawyers . . . will use this new tax to pressure defendants into settlement because penalties paid under settlement will remain deductible. Defendants thus will be encouraged to waive their right to legal process.[75]

When a case is on appeal, one must consider the facts, figures, and issues on appeal to determine whether any portion of the settlement must be regarded as punitive and if so, what amount. If punitive damages become nondeductible, this dynamic will become considerably messier than it is today.

Conclusion

Not all punitive damages are purely penal in nature to the payer, nor are they always a pure windfall (and noncompensatory) to the plaintiff. Even if they were, how does one determine when punitive damages have been paid? Occasionally, a verdict for $X in compensatory damages and $Y in punitive damages is paid in exactly those amounts and using that nomenclature. There should be no confusion in such a case.

Yet in most cases punitive damage awards go on appeal. Most of those cases are settled, and there is already confusion in those cases. Plaintiffs know that punitive damages are taxable income, while defendants are more likely to be concerned about nontax considerations. The confusion would get worse if punitive damages became explicitly nondeductible, and I am not optimistic that judges and juries will start taking the tax treatment of these payments into account.

[74]Oct. 25, 2002, *Doc 2002-24001*, *2002 TNT 208-21*.

[75]*See* http://www.ima-na.org/-Federal-Tax-Deduction-of-Punitive-Damages.