

Can Defamation Damages Be Taxed As Capital Gain?

By Robert W. Wood

Legal claims of harm to reputation can be about personal reputation, professional reputation or both. The IRS presumption with most litigation recoveries is settlements are ordinary income, but capital gain treatment is available in some cases, even some cases of defamation. Examples of legal claims where investigating capital gain treatment can be worthwhile include some intellectual property cases, landlord-tenant disputes and suits about damage or conversion of property.

Other likely suspects are claims about construction defects, harm to property, or diminution in its value. A suit against an investment adviser for losing your money can also produce capital gain and/or basis recovery. Wildfire cases too involve loss or damage to property, so capital recovery treatment is customary. Even a lemon lawsuit about a defective vehicle can produce capital gain or basis recovery in some cases.

In short, some litigation recoveries represent legitimate opportunities for capital gain rather than ordinary income tax treatment. The most obvious reason to think about this involves tax rates. The top federal tax rate on ordinary income is 37%. The capital gain rate depends on income level and the size of the gain. Depending on your income, the capital gain rate can be as low as 0% and as high as 23.8%, including the 3.8% Net Investment Income Tax.

But even at the highest rate, 23.8% is better than 37%. Moreover, this is not only about tax rates. Capital gain reporting can also involve recouping basis. If you owned a home worth \$1M that the defendant destroyed, suppose that you recover \$1M. If you paid \$1M for the home, you may be able to simply reduce your tax basis from \$1M to zero. No gain, and no tax. But if your basis in your home was only \$100k and it is now worth \$1M, you have \$900k of gain to consider.

For a business, goodwill is an asset that can grow in value and be damaged. When a business is compensated for damage to its goodwill, the business can recover its tax basis in its goodwill tax-free. Then, they have a capital gain on the damages exceeding its basis in its goodwill. *See, Durkee v. Comm'r*, 162 F.2d 184 (6th Cir. 1947), *aff'd* 181 F.2d 189 (6th Cir. 1950). In a professional context, an individual can also have goodwill that can be damaged by a defendant.

After all, employees and professionals invest time, money, and effort in developing their professional reputation with employers, colleagues, and clients. However, the tax law has been unclear about the idea that individuals have goodwill as an asset that can be damaged in the way a business does. At one time, the question of the nature of an individual's reputation for tax purposes regularly arose in the context of section 104(a)(2) of the tax code.

Until 1996, that tax law made "personal" injuries tax free. But since 1996, the exclusion has been limited to personal physical injuries or physical sickness. In the decades before the 1996 revisions, tax cases distinguished between defamatory statements that damaged a taxpayer's personal reputation and those of a non-personal nature. In general, defamatory statements regarding a taxpayer's business or professional

reputation were non-personal, and therefore taxable. *See, e.g., Roemer v. Comm'r*, 716 F.2d 693 (9th Cir. 1983), *rev'd* 79 T.C. 398 (1982).

But there was a second level of analysis. Were the damages taxable as ordinary income or as a capital recovery for damage to the individual's professional goodwill? If the underlying damages were for income the individual lost rather than for the value of the damage done to their professional reputation, that made it easy for the courts to say the recovery was ordinary income. *See, e.g., Roemer v. Comm'r*, 79 T.C. 398 (1982), *rev'd on other grounds*, 716 F.2d 693 (9th Cir. 1983). Compensation for lost business income or lost profits is taxed as ordinary income.

But when damage is to an individual's professional reputation, there are viable arguments for capital gain. The Tax Court has acknowledged that individuals and employees possess professional goodwill (which can include their relationships with key clients) as an asset that can be separately sold and is separate from the business goodwill of their employer. *See, Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 (1998); *Bross Trucking v. Comm'r*, T.C. Memo. 2014-107. When a recovery is attributable to both lost profits and harm to capital assets, the taxpayer is required to allocate the amounts received to lost profits and damage to capital assets.

Not surprisingly, many claims about damages to capital assets include references to the income the asset was expected to produce. However, the fact that the value of the asset was measured by reference to its anticipated income does not necessarily mean the recovery is ordinary. *See NCA Argyle LP v. Commissioner*, 119 T.C.M. (CCH) 1364, T.C. Memo. 2020-56. The recognition of an individual's professional goodwill as an asset that can be sold or damaged may be strongest when the individual is a key person for a business, someone who draws in clients and customers.

However, being an employee can itself be a trade or business for tax purposes. There are also cases where courts have determined that a legal recovery should be taxed as a capital recovery for damage to an individual's professional goodwill. These cases generally involve proprietors whose businesses are tied to their individual professional reputations. In *Durkee v. Commissioner*, the Tax Court and Sixth Circuit found that Mr. Durkee had professional goodwill as an electrician which entitled him to treat his recovery for damage to that goodwill as capital gain. *Durkee v. Comm'r*, 162 F.2d 184 (6th Cir. 1947), *on remand*, 8 T.C.M. (CCH) 701 (1949), *aff'd* 181 F.2d 189 (6th Cir. 1950).

Similarly, in *Wallace v. Commissioner*, the Tax Court allocated an individual taxpayer's legal recovery between damage to her personal goodwill and her professional goodwill. T.C. Memo. 1976-219 (1976). She operated as a sole proprietorship a beauty shop out of her home. Yet the IRS and the courts have often scrutinized business taxpayers who attempted to categorize their recoveries as being for damage to goodwill.

Often, these cases have been doomed by complaints and other litigation documents about lost profits that did not clearly say that the lost profits were being used solely to value

the damage done to the business goodwill. The causes of action under which the dispute is brought are important too. California has a cause of action for defamation that has been interpreted to provide relief for intentional misstatements regarding personal matters, and a cause of action for disparagement, which has been interpreted to provide relief for intentional misstatements regarding a plaintiff's business.

In one old case, the Ninth Circuit applying California law found that the fact that a case was brought under the California cause of action for "defamation" meant that the damages were for personal injuries, not business injuries. *See, e.g., Roemer v. Comm'r*, 716 F.2d 693 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982). Of course, damages to personal reputation are no longer tax-free under section 104(a)(2).

Nevertheless, the distinction between defamation claims and disparagement claims in California law has more recently been cited again by the Ninth Circuit in *Palone v. Commissioner. Palone, Gavin v. Comm'r*, T.C. Memo 2003-339 (Dec. 16, 2003), *aff'd* 449 F.3d 1041 (9th Cir. 2006), *amended and superseded by* 479 F.3d 1019 (9th Cir. 2007), *withdrawn and superseded by* 505 F.3d 966 (9th Cir. 2007), *cert. denied* 522 U.S. 1280 (2008). Notably, though, a capital gain argument was never made by Mr. Palone so was never considered.

Conclusion

It is now generally presumed that defamation claims involving only *personal* reputation are taxable as ordinary income. Even before the personal injury tax law changed in 1996, there were cases confirming that damages for harm to a taxpayer's *professional* reputation or goodwill can qualify for capital gain treatment. It is important to enunciate claims for damage to *professional* goodwill, and to make the professional qualifier prominent. A passing reference to defamation or reputational harm as part of a laundry list of claimed non-economic damages is unlikely to be sufficient to support a significant allocation to capital claims in a settlement agreement.

For businesses, there is a long body of case law differentiating between legitimate claims for damage to goodwill and claims that are in substance claims for lost income. The law on individual professional goodwill is developed. However, the prospect of capital gain in harm to professional reputation cases is worth considering.

Robert W. Wood practices law with www.WoodLLP.com, and is the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This discussion is not intended as legal advice.