TAXING PUNITIVES

by ROBERT W. WOOD

Uncertainty about the tax treatment of punitive damages supposedly ended with the Small Business Job Protection Act of 1996, which specifies that all punitive damages are taxable income to the recipient. A few months later, the U.S. Supreme Court reached the same conclusion for punitive damages under pre-1996 tax law. *O'Gilvie v. U.S.*, 117 S. Ct. 452 (1996).

Strangely, neither Congress nor the Supreme Court has defined exactly what constitutes punitive damages. Presumably they intend the term "punitive damages" to have its customary and common sense meaning: punitive damages paid pursuant to an award ordered by a court. Common sense (admittedly an unfamiliar concept as applied to most tax law!) would seem to dictate that out-of-court settlements should not invoke this kind of "punitive characterization." After all, defendants virtually always deny that they are paying punitive damages in the context of a settlement, even where that settlement occurs after a trial in which punitive damages were tentatively awarded.

It is not surprising that defendants frequently insist on the express negation of punitive damages in a settlement document. One reason is that many insurance policies exclude coverage for punitive damages paid. Another reason relates to the negation of any wrongdoing that defendants typically see. Punitive damages, by definition, involve asserted wrongdoing by defendant. For a defendant to concede that a portion of the settlement payment is attributable to punitive damages would amount to an admission by the defendant that the conduct was improper.

Finally, although it may not arise to a legal collateral estoppel effect, if a defendant admitted to paying punitive damages, there could be an effect on other litigation (or prospective litigation) by other parties. If the settlement documents became public (despite confidentiality clauses), a settlement may prompt other suits especially if it can be seen as consenting to the payment of any punitive damages.

How Are "Punitive Damages" Defined?

On the surface, any amount characterized as "punitive damages" would seem to be always so denominated by a court. However, in cases that settle while on appeal, questions about the character of a settlement amount may arise. For example, in *Hughes Bagley v. Commissioner*, 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997), Mr. Bagley filed a suit for compensatory and punitive damages and received a large jury verdict of $1.5 million in actual damages and $7.25 million in punitive damages. After a variety of procedural wranglings, and while the case was on appeal, there was a settlement in which the defendant paid $1.5 million to dispose of the case. The settlement agreement stated that the payment constituted damages for personal injuries (there were actually a variety of different claims involved in the suit), but it

made no express statement about the punitive damages.

The IRS in the *Bagley* case determined that $1.3 million of the $1.5 million payment constituted punitive damages, and were therefore taxable. The IRS based this argument on the notion that most of the damages awarded by the trial court were punitive (a total of $7.25 million in punitive damages, and only $1.5 million in actual damages). The IRS argued for the bulk of the settlement to be taxable as punitives. However, Mr. Bagley prevailed in his argument that the overwhelming purpose of the settlement was compensatory.

Arriving at its own figures for allocating the settlement, the Tax Court concluded that $500,000 was taxable as punitive damages, and the balance of $1 million should be treated as compensatory damages. The court went through a variety of reasoning for this conclusion. Most observers would probably conclude that, given the ratio between the trial court's award (which admittedly was on appeal) of $1.5 million in actual damages and $7.25 in punitive damages, Mr. Bagley did not come off too badly.

It may not be terribly surprising in a case such as *Bagley v. Commissioner* (where an award of "punitive" damages is made and the award is being appealed), that the IRS would seek to tax part of an award as punitive damages. One can argue about whether a negation of punitive damages in the settlement agreement is effective or not to avoid the "punitives" tax treatment. However, the situation is materially different where a case involving punitive damages has not proceeded to trial and settles long before any determination is made that punitives are appropriate.

Indeed, it is truly surprising that some courts are willing to make "punitives" determinations even where there has been no judgment. In *E. Pauline Barnes v. Commissioner*, T.C. Memo. 1997-25, T.C.M. (RIA) &97025, 73 T.C.M. (CCH) 1754 (1997), the Tax Court considered the tax treatment of a settlement in an action brought by a bookkeeper against her former employer. Pauline Barnes filed a wrongful termination suit under Oklahoma law. In 1992, she settled her case with her former employer for $27,000, and she 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' 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. 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.

The opinion in *E. Pauline Barnes v. Commissioner* raises huge questions about the appropriateness of determinations of punitive damages. Although one must acknowledge that a taxing authority or a court faces a difficult task in allocating a recovery for tax purposes, a 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 quite far-fetched.

Inconsistent Treatment

The treatment of these situations by the IRS and the courts does not seem consistent. For example, in Letter Ruling 9024017, the IRS determined that the full amount of payments received in settlement of a tort action could be excluded from income, even though the suit had sought both compensatory and punitive damages. The settlement agreement did not mention punitive damages. However, in Letter Ruling 9215041, the IRS determined that an amount received by parents in settlement of a suit relating to injuries sustained by their minor son had to be allocated between compensatory and punitive damages, the latter not being excludable. The ruling cites Revenue Ruling 85-98,1985-2 C.B. 51, for the proposition that where a suit seeking both compensatory and punitive damages is settled for a lump sum, the settlement amount must be allocated between the two based on the best evidence available.

Even the so-called "best evidence available" may not be too precise. In *Miller v. Commissioner*, T.C. Memo. 1993-49 (1993); supp., T.C. Memo. 1993-588 (1993); aff'd, 60 F.3d 823 (4th Cir. 1995), the court held that 47.36842%, or $248,684, of the net proceeds of the settlement should be allocated to punitive damages. The court agreed with the IRS that the allocation should be based on the jury award in the first

suit because it provided the clearest indication of the nature of the plaintiff's claim and the intent of the defendants when they paid her. The Fourth Circuit affirmed, 60 F.3d 823 (4th Cir. 1995).

Interestingly, in *Talley Industries v. Commissioner*, T.C. Memo. 1994-606 (1994), rev'd and remanded, 116 F.3d 382 (9th Cir. 1997), the Tax Court suggested that there is a grey area between damages that are compensatory and those that are punitive. A subsidiary of Talley Industries had been indicted on various counts involving Navy contracts, and civil claims were later filed by the government. The civil claims alleged actual losses of approximately $1.6 million, with punitive damages (under a statutory doubling provision) added on top. The company paid $2.5 million pursuant to this asserted liability in exchange for a release of all claims. After the company deducted this $2.5 million payment, the question was whether all of it was compensatory or in effect representative fine or penalty not deductible under Section 162(f).

The IRS treated the amount as nondeductible, but the Tax Court allowed a deduction for the full $2.5 million payment, less only $1,885 that was the Navy's actual losses for the ten incidents with respect to which a guilty plea was entered. In fact, the court granted summary judgment for the taxpayer on this issue. Although the court had to admit that the $2.5 million settlement was in excess of the amount originally claimed for "actual compensatory" damages, the court found no evidence in the settlement agreement that any punitive payment or fine was intended.

Consequently, the court respected the language of the settlement agreement. granting summary judgment to the taxpayer, and implicitly acknowledging that there may be some grey area between a compensatory and punitive (or fine) payment. Unfortunately, the Ninth Circuit Court of Appeals then reversed, holding that there was a material issue of fact about the settlement and that the case had not been ripe for summary judgment.

President Clinton's Proposal

Given all this controversy, it is all the more surprising that President Clinton's budget includes a proposal to tax companies on punitive damages paid to plaintiffs in civil lawsuits. Fines or penalties that are paid to governmental entities are nondeductible under Internal Revenue Code Section 162(f). However, punitive damages paid to private parties have always been deductible. See Schlesinger and Hitt, "Clinton Wants to Tax Civil Damages," *Wall Street Journal*, February 1, 1999, p. A3. This article notes that the proposal would deny a deduction to any party paying punitive damages.

Furthermore--and this may be the most Draconian of the two proposals--it would require that a company that had the foresight to have insurance for punitive damages would have to take into income any amount that the insurance company actually paid for punitives. As an enforcement device, the new law would require the insurance company to issue an IRS Form 1099 to the defendant in the suit specifying the amount of punitive damages that the insurance company paid on the defendant's behalf.

A Rose Is a Rose?

Whether or not these two changes represent good social policy, they will clearly exacerbate the lack of definition in the tax law for punitive damages. Maybe Congress (or the IRS) feels that they know it when they see it. Yet, as noted above, in many cases the IRS asserts that a portion of a settlement or award should be allocated to punitive damages, when in fact as a strictly legal matter punitive damages have not been paid.

I predict continuing controversies for plaintiffs who are trying to avoid the income attributed to punitive damages. If President Clinton's new proposal passes, defendants (with the proposed nondeductability taint) will have an even greater reason to avoid punitive characterization. If the past is any indication, the IRS will not necessarily believe a defendant when it confirms that it did not pay any punitive damages. Who will decide?

The stakes are huge, given how many punitive damages are requested and awarded each year. To take a rather famous example, the Exxon Valdez oil spill litigation involved enormous punitive damages that the general public probably assumed were nondeductible. On the contrary, they were clearly deductible by Exxon. And there are new punitives awarded almost every day. A recent case involved an Exxon Valdez

oil spill clean-up worker who received a $3.7 million punitive damage award because she was allegedly sexually harassed while performing clean-up work. (The jury's $3.7 million punitive damage award was recently reduced to $500,000 by the Alaska Supreme Court. See *Norcon, Inc. v. Kotowski*, Ak.S.Ct. No. S-6390 (12/31/98).) In another recent sexual harassment case, a $3 million punitive damage award to a car dealership employee was reduced to $1.5 million in punitive damages. See *McIntyre v. Manhattan Ford, Lincoln-Mercury, Inc.*, N.Y.App.Div. No. 90104079 (12/29/98).

Conclusion

Exactly who will decide when "punitives" are paid for tax purposes, particularly in a settlement context after an appeal, is an issue that neither Congress nor President Clinton seem to have considered. Defendants, especially companies that are the primary targets of punitive damage claims, should worry about this. So should lawyers, even litigators who normally do not worry about tax treatment.

For in-house counsel, it would be a good idea in any settlement agreement (where the settlement occurs prior to trial, during trial, or while a case is on appeal), to specifically negate the payment of any punitive damages. Most in-house counsel will probably already have a provision in their standard settlement document to the effect that the fact that the defendant is paying any amount should not be considered for any purpose as an admission of wrongdoing. I recommend going further, however, and specifically referencing the fact that there was a claim for punitive damages, and that no amount is being paid for it. Most plaintiffs will agree to such a provision, since punitive damages will always be taxable to plaintiffs.

Most defendants, even without President Clinton's proposal, already have an incentive not to have punitive damages paid. Then, too, the payment of punitive damages will, as mentioned above, have possible adverse insurance policy implications, as well as potentially adverse publicity consequences in the event that the terms of the settlement are ever disclosed. Ultimately, in-house counsel should closely monitor the way in which settlement agreements are documented. Failing to expressly negate punitive damages may be considered (at least for tax purposes) as an implicit statement that perhaps punitives were intended.

Without President Clinton's proposal, the tax issue (for plaintiffs) of what constitutes punitives will take years to resolve in the courts. If the President's proposal passes, the interpretive question will be of much greater magnitude. The stakes for plaintiffs and defendants will go up enormously. Defendants will bear the major brunt of this change, and in-house counsel should be prepared to deal with it.

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