Taxing Defamation and Professional Reputation Damages as Capital Gain

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In this article, Wood and Brown explore the tax characterization of damages to professional and personal goodwill and examine strategies that may help save significant tax dollars and improve net recoveries.

This discussion is not intended as legal advice.

Lawsuits involving harm to reputation may be stand-alone cases, such as a defamation claim against a publisher. Harm to reputation claims may also feature in employment disputes and other cases involving disparate types of recoveries with differing tax treatments. Some defamation claims are about personal reputation, and some are expressly about professional reputation. Often, though, the damages claimed seem to relate to both.

The IRS's presumption in virtually any litigation recovery is that the plaintiff should be taxed at ordinary income rates. The primary exception is for personal physical injury awards. There, the recovery should be excludable under section 104, unless punitive damages or interest are being paid. Those two items are always taxable. Unfortunately, the scope of the exclusion for physical injuries and physical sickness has been highly controversial since 1996 when Congress added "physical" to the statute.

Neither the IRS nor Congress has clarified the scope of the exclusion. The Tax Court has done its best, muddling through many cases and often disappointing taxpayers. In large part, though, litigation settlements and judgments are taxed as ordinary income. But what about capital claims? The fact that an award is taxable does not always mean that it must be taxed as ordinary income.

Origin of the Claim Doctrine

The origin of the claim doctrine controls the tax treatment of a litigation recovery, whether it is received as a result of a settlement or judgment.[1] To determine the origin of the claim, courts and the IRS ask in lieu of what damages a recovery was paid for.[2] A recovery should be taxed in the same manner as the item for which it is intended to substitute.[3]

[1] *See, e.g., United States v. Gilmore*, 372 U.S. 39, 49 (1963); *Hort v. Commissioner*, 313 U.S. 28 (1941).

[2] *See Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944).

[3] *See Raytheon*, 144 F.2d 110; *Knowland v. Commissioner*, 29 B.T.A. 618 (1933); LTR 200108029. IRS letter rulings do not constitute precedent, even though the Supreme Court has cited them. *See Rowan Cos. Inc. v. United States*, 452 U.S. 247 (1981). Letter rulings reveal the interpretation of statutes by the agency charged with the responsibility of administering the revenue laws. *See Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962).

The determination of the origin of the claim is factual and made by reference to the issues raised in the complaint that are litigated and resolved in a verdict or settlement.[4] The IRS and the courts generally view the complaint as the most persuasive evidence of the origin of the claim.[5] However, they also look to other documents, including the findings made by a judicial officer in a court opinion or a jury award.[6]

Indeed, one court observed that a "characterization agreed upon by the parties, and/or announced by a judicial officer, may well be determinative for purposes of taxation."[7] When a settlement agreement reasonably allocates the settlement payment among the plaintiff's claims, it can be difficult for the IRS to successfully challenge it. As the IRS was recently reminded by the Tax Court in *NCA Argyle*,[8] to successfully challenge an express allocation in a settlement agreement that was negotiated at arm's length by the settling parties, the IRS must generally show that the express allocation is unreasonable, not just that a more Treasury-friendly allocation would also be reasonable.

Capital Claims in General

Litigation proceeds can be taxed as a capital recovery when they substitute for amounts that would be taxable as a capital recovery if paid outside of litigation.[9] Some suits about intellectual property can produce capital gain. So can landlord-tenant disputes when the tenant is bought out of a lease.[10] A suit about damage to or conversion of property might be capital gain, too.[11] So may a suit about construction defects, harm to property, or the diminution in its value.

A suit against an investment adviser for losing your money could also produce capital gain or basis recovery. You might be getting your own money back with nothing taxable — assuming you have not deducted your loss. Even a lemon lawsuit about a defective vehicle can produce capital gain or basis recovery to the extent the manufacturer purchases your vehicle back from you or issues a refund of your purchase price as part of the settlement. In short, some litigation recoveries represent legitimate opportunities for capital gain rather than ordinary income.

Today, ordinary income is taxed at federal rates of up to 37 percent (before payroll taxes, self-employment tax, and other potential additions to ordinary income are factored in). Capital gain (depending on income level and the size of the gain) can be taxed as low as 0 percent and as high as 23.8 percent (including the 3.8 percent net investment income tax). Plainly, 23.8 percent is better than 37 percent. But it isn't entirely about tax rates, because capital gain reporting can involve recouping basis, too.

Treatment of Legal Fees

In *Banks*,[12] the Supreme Court held that as a general rule, when a litigant's recovery constitutes income, that income includes the portion of the recovery paid to the attorney as a fee. When a recovery consists of elements with differing tax characteristics, attorney fees and costs should be allocated among the elements.[13] This is generally done on a pro rata basis when there are multiple components to the principal recovery.[14]

To the extent you expended funds to purchase, develop, or improve the asset affected by your claim, those sunk costs (unless they somehow qualified to be immediately deducted) are usually added to your tax basis that can be repaid to you by a settlement payment or other legal recovery without tax before you start reporting gain. Other sunk costs that a capital recovery can make a little easier to recoup tax free are legal fees and expenses a plaintiff pays to recover damages. For recoveries taxable as ordinary income, plaintiffs are usually required to include their gross recovery in gross income, even

[4] *Raytheon*, 144 F.2d 110; *State Fish Corp. v. Commissioner*, 48 T.C. 465, 474 (1967); *acq.* 1968-2 C.B. 3, *modified*, 49 T.C. 13 (1967).

[5] Rev. Rul. 85-98, 1985-2 C.B. 51.

[6] *In re Valencia*, 278 B.R. 527, 531 (Bankr. D.N.M. 2002) (looking at jury award to determine origin of the claim); LTR 8437084 (looking at judge's findings in memorandum opinion to determine origin of the claim).

[7] *Fresenius Medical Care Holdings Inc. v. United States*, No. 1:08-cv-12118, at *7 (D. Mass. May 9, 2013), *aff'd*, 763 F.3d 64 (1st Cir. 2014).

[8] *NCA Argyle LP v. Commissioner*, T.C. Memo. 2020-56.

[9] *See*, *e.g.*, *Raytheon*, 144 F.2d 110.

[10] *See* section 1241.

[11] *See* section 1033.

[12] *Commissioner v. Banks*, 543 U.S. 426 (2005).

[13] *Metzger v. Commissioner*, 88 T.C. 834, 860 (1987).

[14] *See Robinson v. Commissioner*, 102 T.C. 116, 124 (1994).

the portion retained by counsel for legal fees and litigation expenses.[15]

To try to owe tax only on their net recoveries, plaintiffs must claim offsetting tax deductions for those fees and expenses. However, miscellaneous itemized deductions are suspended for tax years 2018 through 2025 (and may be further suspended under tax legislation expected to be enacted this year),[16] which means the usual tax deduction for legal fees and expenses outside a taxpayer's trade or business may not be available to many plaintiffs.[17] Even in cases in which nonbusiness taxpayers avoid the suspension of miscellaneous itemized deductions, the timing of legal fees and expenses can effectively prevent taxpayers from deducting all the amounts they paid to produce a legal recovery. This is particularly true when the legal fees and expenses were paid in a tax year before the year the taxpayers received their recovery.[18] This timing rule most often hurts taxpayers who pay hourly fees to their counsel, resulting in many of their legal fees being paid before the tax year in which they receive their legal recovery.

However, for capital recoveries, those limitations and timing concerns are largely moot. With a capital recovery, the legal fees and expenses are generally required to be treated as capital expenditures, capitalized into the taxpayer's adjusted tax basis of the affected asset.[19] This means that legal fees and expenses paid in previous tax years carry forward to offset the recovery they later produce. It also means that taxpayers with capital recoveries are effectively immune from the suspension of miscellaneous itemized deductions and can offset their recoveries by the adjusted tax basis created by all the capitalized legal fees and expenses on their schedules 8949 when they calculate the resulting gain from their recoveries.

Goodwill as a Capital Asset

In tax and accounting parlance, a taxpayer's goodwill essentially means reputation. Businesses spend considerable time and money trying to increase the value of their business goodwill because it means customers and clients are more likely to do business with them than with their competitors, and are more likely to remain loyal to their brand. For a business, goodwill is a capital asset that has a tax basis, can grow in value, and can be damaged. When a business is compensated for damage to its goodwill, the business can recover its tax basis in its goodwill tax free, and it usually owes only capital gain tax to the extent the damages received exceed the business's adjusted tax basis in its goodwill.[20]

However, in a professional context, can an individual have goodwill that can be damaged by a defendant and thus give rise to a capital recovery? In a practical sense, employees and professionals invest a lot of time, money, and effort in developing their professional reputations with their employers, colleagues, and clients. It is intended to make them more attractive to employers, customers, and clients. Damages to an individual employee's or professional's reputation in a field or industry can also damage their ability to conduct their trade or business.

Still, the tax law has generally been much more ambivalent about the idea that individuals have goodwill as an asset that can be damaged in the way that a business uncontroversially does. The question of the nature of an individual's reputation for tax purposes regularly arose in the context of section 104(a)(2), which used to contain language that more broadly excluded from income amounts received for personal injuries. Since 1996, the exclusion has been limited to personal physical injuries or physical sickness.

[15] *Banks*, 543 U.S. 426.

[16] *See* section 67(g).

[17] *See* section 212.

[18] *See* section 62(a)(20) (limiting the tax deduction for unlawful discrimination claims legal fees in a particular tax year to the income produced from the same recovery in the same tax year).

[19] *See* section 263; *Woodward v. Commissioner*, 397 U.S. 572 (1970).

[20] *See Durkee v. Commissioner*, 162 F.2d 184 (6th Cir. 1947), *aff'd*, 181 F.2d 189 (6th Cir. 1950); *State Fish Corp.*, 48 T.C. at 474, *acq.* 1968-2 C.B. 3 (despite no sale or exchange of goodwill, the award was a tax-free recovery of basis), *modified*, 49 T.C. 13; *Daugherty v. Commissioner*, 78 T.C. 623 (1982); *Big Four Industries Inc. v. Commissioner*, 40 T.C. 1055 (1963), *acq.* 1964-1 C.B. (Pt. 1) 4; *Bresler v. Commissioner*, 65 T.C. 182, 184 (1975), *acq.*, 1976-2 C.B. 1; *Wheeler v. Commissioner*, 58 T.C. 459 (1972).

Relevant Pre-1996 Tax Cases

In the decades that preceded the 1996 revisions to section 104(a)(2), tax law regularly had to distinguish between defamatory statements that damaged a taxpayer's personal reputation (which qualified for exclusion from gross income under the older version of section 104(a)(2)) and defamatory statements of a nonpersonal nature (which did not qualify for exclusion).[21] The pre-1996 rules generally considered defamatory statements regarding a taxpayer's business or professional reputation to be nonpersonal and therefore outside the scope of the exclusion.[22]

For cases that fell outside the scope of a personal injury, there was a second level of analysis. Were the damages received for nonpersonal (professional) damage to reputation taxable as ordinary income, or were they received as a capital recovery for damage to the individual's professional goodwill?

If the underlying damages alleged to result from the defamatory statements were described in the litigation documents as being for the income that the individual lost rather than for the value of the damage done to the individual's professional reputation, that often made it easier for courts to conclude that the recovery should be taxable as ordinary income.[23] Compensation for lost business income or lost profits is typically taxed as ordinary income.[24]

Professional Reputation

But, when the damages alleged are appropriately framed as the damage to an individual's professional reputation, there are stronger arguments for treating the damages as capital for damage to the individual's professional goodwill. 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 employers.[25]

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.[26] The burden is on the taxpayer to show that a recovery (in whole or in part) is attributable to harm to capital assets.[27]

When the claim in a lawsuit is for the loss of a capital asset, the recovery should not be considered lost profits merely because the value of the capital asset is determined by reference to the income the asset was expected to produce.[28] The fact that the value of the asset was measured by reference to its anticipated income does not per se make a capital recovery for a damaged or lost asset an ordinary income recovery for lost income. This point was reaffirmed in *NCA Argyle*.[29]

The recognition of an individual's professional goodwill as an asset that can be sold (and, by extension, damaged) is most strongly suggested when the individual is a key person for a business, who clients and customers know by name and whose reputation is a driving factor in generating revenue for the business. Still, as a formal matter, being an employee can itself be a trade or business for tax purposes.[30] Defamation that damages an employee's ability to maintain or obtain new employment thus damages the goodwill of a trade or business.

There are also cases in which courts have determined that a legal recovery should be taxed as a capital recovery for damage to an individual's

[21] *See, e.g.*, *Agar v. Commissioner*, T.C. Memo. 1960-21, *aff'd*, 290 F.2d 283 (1961).

[22] *See, e.g.*, *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982).

[23] *See, e.g.*, *Roemer*, 79 T.C. 398, *rev'd on other grounds*, 716 F.2d 693.

[24] *See W. Walley Inc. v. Commissioner*, No. 13499 (T.C. 1948).

[25] *See, e.g.*, *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998); *Bross Trucking v. Commissioner*, T.C. Memo. 2014-107.

[26] *Collins v. Commissioner*, T.C. Memo. 1959-174; *Levens v. Commissioner*, No. 27283 (T.C. 1951).

[27] *Glove Corp. v. Commissioner*, 311 F.2d 2010 (7th Cir. 1962), *aff'g* 36 T.C. 1173 (1961).

[28] *See, e.g.*, *Raytheon*, 144 F.2d 110 ("The allegations and evidence as to the amount of profits were necessary in order to establish the value of the good will and business since that is derived by a capitalization of profits."); *Farmers' & Merchants' Bank v. Commissioner*, 59 F.2d 912 (6th Cir. 1932) ("Profits were one of the chief indications of the worth of the business; but the usual earnings before the injury, as compared with those afterward, were only an evidential factor in determining actual loss and not an independent basis for recovery.").

[29] *See NCA Argyle*, T.C. Memo. 2020-56.

[30] *See, e.g.*, *Primuth v. Commissioner*, 54 T.C. 374, 377 (1970); *see also* section 62(a)(2) (allowing above-the-line deductions for certain expenses by employees in the course of their trade or business of being an employee).

professional goodwill. These cases generally involve sole proprietors whose businesses are clearly tied to their individual professional reputations. For example, the Tax Court and Sixth Circuit found in *Durkee*[31] that an individual plaintiff, R.J. Durkee, had an individual professional goodwill in his trade as an electrician that he conducted as sole proprietor, which entitled him to treat his recovery for damage to that goodwill as capital gain.

Similarly, in *Wallace*,[32] the Tax Court allocated an individual taxpayer's legal recovery between damage to her personal goodwill and her professional goodwill. The taxpayer, a widow, operated a beauty shop out of her home as a sole proprietorship. The damages allocable to her personal reputation were held to be tax free under the pre-1996 version of section 104(a)(2). However, to the extent her settlement compensated her "for injury to her business reputation, they would be analogous to a loss of good will, a capital asset."

Crafting Claims and Settlements

These authorities suggest that with the appropriate facts and wording, it is possible for some recoveries for damage to reputation to qualify for capital gain treatment. Still, it can be difficult to prove that a plaintiff's claims were for damage to a capital asset instead of claims that result in ordinary income. This is so even in the context of businesses for whom the existence of goodwill is beyond doubt.

The IRS and courts have notoriously scrutinized business taxpayers who tried to categorize their recoveries as being for damage to goodwill. Cases are legion in which businesses have had recoveries for what they reported as damage to their business's goodwill recharacterized as ordinary income recoveries for lost profits. Often, these cases were doomed by complaints and other litigation documents containing language about lost profits that did not clearly assert that the lost profits were being used solely to value the damage done to the business's goodwill.

There is no reason to expect the IRS or courts to scrutinize recoveries by individuals any less, and there are many traps that can prevent a recovery for defamation from qualifying for capital gain treatment. For example, the defamation could relate to a taxpayer's personal reputation. The claim could inadequately support that the damages are for the damage to the individual's professional goodwill, particularly if they overemphasize claims for lost income or emotional distress.

The causes of action under which the dispute is brought may also control the tax treatment in the view of some courts. For example, California has a cause of action for defamation, which 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 (or goods). Under the pre-1996 version of section 104(a)(2), the Ninth Circuit, applying California law, found that the fact that a case was brought under the cause of action for defamation meant that per se the damages were for personal injuries, not business injuries.[33]

That meant under the pre-1996 law that the plaintiff's recovery was tax free, so the taxpayer was likely relieved the Ninth Circuit applied that bright-line rule to the question of whether the damages related to the taxpayer's personal or professional reputation. Of course, damages to personal reputation are no longer tax free under section 104(a)(2), so the plaintiff in *Roemer* would likely not have been as pleased with the Ninth Circuit's bright-line analysis under current law.

Most authorities addressing the personal-professional distinction for defamation claims do not take that bright-line approach to this distinction. Still, the distinction between defamation and disparagement claims in

[31] *Durkee v. Commissioner*, 162 F.2d 184 (6th Cir. 1947), *on remand*, No. 5892 (T.C. 1949), *aff'd*, 181 F.2d 189 (6th Cir. 1950).

[32] *Wallace v. Commissioner*, T.C. Memo. 1976-219.

[33] *See, e.g.*, *Roemer*, 716 F.2d 693, *rev'g* 79 T.C. 398.

California was again cited by the Ninth Circuit as part of the unusual series of rulings in *Polone*.[34] In that case, Gavin Polone was defamed in various entertainment industry trade publications regarding the reason for his termination as a talent agent. The statements clearly targeted his profession and pertained to his termination.

However, the timing and history of *Polone* merit additional discussion. Polone signed his settlement agreement in May 1996, before the amendment to section 104(a)(2) was enacted. Expecting his settlement to be excludable if he could characterize it as a personal injury, he and his counsel did not try to characterize the settlement agreement payment as being for his professional goodwill, despite that factually the allegations seem to entirely relate to his professional relationships. Instead, he negotiated and obtained settlement language saying that his settlement would be entirely for personal damages.

Polone's expectation was almost certainly that he would be able to exclude his settlement payments under section 104(a)(2). However, the defendant could not immediately pay the $4 million settlement in a lump sum. Thus, the settlement agreement provided for four payments of $1 million each starting in May 1996 and continuing through November 1998.

Unfortunately for Polone, in August 1996, section 104(a)(2) was amended, making personal damages for defamation no longer excludable from income for most payments received after the August 1996 date of enactment, and $3 million of the $4 million payable under Polone's settlement was to be paid after August 1996.

Polone nevertheless excluded all four payments from his gross income, but prudently disclosed the exclusions on his tax returns.[35] His returns were audited, and Polone took the position that because his settlement was signed before August 1996, and because the amendment to section 104(a)(2) was unconstitutionally retroactive, he should still obtain the benefit the pre-August 1996 exclusion for personal damages for all four of his settlement payments. In 2003, the Tax Court found for the IRS,[36] holding that the post-August 1996 payments were not excludable because of the amendment to the underlying statute and that the August 1996 amendments to section 104(a)(2) were not unconstitutionally retroactive.

The Tax Court opinion does not address a capital gain position, likely because the settlement agreement clearly allocated the payments to personal damages. The Tax Court noted that this allocation language was negotiated in good faith by adversarial parties, so it was not inclined to upset it. Therefore, because the settlement payments were allocated to personal injury claims, the Tax Court affirmed that the recovery should be taxed as ordinary income.

Polone appealed to the Ninth Circuit, which in 1996 issued the first of three opinions affirming the Tax Court's ruling.[37] The first Ninth Circuit ruling focused entirely on the topics addressed by the Tax Court; namely, whether payments received after August 1996 could be excluded if the settlement agreement was signed before August 1996.

However, in 2007, as part of its rejection of Polone's request for rehearing, the Ninth Circuit amended and superseded its 2006 ruling.[38] In addition to the topics addressed in its 2006 affirming opinion, the March 2007 Ninth Circuit opinion also addressed a new argument raised by Polone to support the excludability of his settlement payments. Polone asserted that settlement agreements should be viewed as analogous to sales agreements when the sourcing and other attributes of the sale are set at the time of sale, even if the sales proceeds are received later or through installments.

Under Polone's new argument, the settlement agreement fixed the timing of the settlement as being before August 1996, qualifying all the settlement payments for exclusion even if received after August 1996. The Ninth Circuit

[34] *Polone v. Commissioner*, T.C. Memo. 2003-339, *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).

[35] The fact that Polone adequately disclosed his exclusion and sought the advice of tax counsel before claiming it ultimately avoided accuracy-related penalties.

[36] *See Polone*, T.C. Memo. 2003-339.

[37] *See Polone*, 449 F.3d 1041.

[38] *See Polone*, 479 F.3d 1019.

rejected this argument, too. However, in so doing, it used reasoning similar to the *Roemer* bright-line rule for defamation claims. The Ninth Circuit noted that under California law, the defamation cause of action can only be used for personal injuries.

But the Ninth Circuit determined that personal injury claims cannot be bought or sold under California law, so Polone's comparison of his settlement agreement to a sales agreement failed. The March 2007 opinion was withdrawn and superseded in October 2007 by a new opinion,[39] and the October 2007 superseding opinion retained the *Roemer*-like discussion of California's limitations for defamation claims.

Given the possible avenues that the IRS can employ to characterize a recovery as ordinary income, significant effort should be made to articulate claims for damage to professional goodwill, and to make the professional qualifier clear and unambiguous. A passing reference to defamation or reputational harm as part of a laundry list of claimed noneconomic damages (next to emotional distress, pain and suffering, annoyance, etc.) is not likely to be sufficient to support a significant allocation to capital claims in a settlement agreement.

IRS Form 1099 Reporting

If you receive an IRS Form 1099 saying that you received "other income," is that ordinary or capital? Most of us would likely presume that it means ordinary income. In principle, a Form 1099-MISC can report capital gain, not simply ordinary income. However, a defendant is supposed to issue a Form 1099-MISC for a capital recovery only when they can identify the portion of the settlement payment that constitutes capital gain to the recipient.

Notably, only the portion that constitutes capital gain (and not the portion that is a recovery of adjusted tax basis) is gross income to the recipient.[40] Of course, when an amount is reported on a Form 1099, the default IRS position is that the amount reported is likely ordinary income. But a tax adviser may say that it is capital, and your tax return may never be audited. Even in an audit, you may convince the IRS that it is capital. Failing that, you can go up the administrative chain to the IRS Independent Office of Appeals. You can even go to court.

Conclusion

The tax treatment of defamation claims underwent a sea change when section 104(a)(2) was amended in 1996 to require physical injuries or sickness for an exclusion from ordinary income. Before 1996, plaintiffs understandably went to great lengths to try to position their recoveries as personal damages (even simply emotional distress damages), because a personal injury was enough for an exclusion. This was so even when the allegedly false statements directly concerned and affected their businesses or employment.

However, the section 104(a)(2) amendment in 1996 eliminated the benefit of trying to categorize defamation claims regarding one's trade, business, or employment reputation as personal damages. It is now generally presumed that defamation claims involving only personal reputation are taxable as ordinary income. Even before the law changed, some cases confirmed that for individuals, damages for harm to a taxpayer's professional reputation or goodwill could qualify for capital gain treatment, just as a business's goodwill was considered a capital asset.

Still, because so many individual taxpayers sought the section 104(a)(2) exclusion, these authorities are not as developed as they otherwise would be. Thus it is likely that many plaintiffs and their counsel fail to consider the possibility of including claims for damage to professional

[39] *Polone*, 505 F.3d 966.

[40] *See, e.g.*, Rev. Rul. 80-22, 1980-1 C.B. 286; LTR 201810004; LTR 201444001; LTR 200704004; LTR 200046014; LTR 199945023; LTR 9623025; LTR 9806008; LTR 9451052; LTR 9437033; LTR 9405010; LTR 9322026; LTR 9305011. *See also* section 61(a)(3) (defining gross income to include gains derived from dealings in property) and section 1001(a) (defining gain to be the extent that the amount realized on a sale or exchange exceeds the taxpayer's adjusted tax basis).

goodwill in their litigation documents, even in cases in which the facts suggest that the plaintiff's professional reputation has been severely damaged. Rather than directly and clearly alleging harm to the plaintiff's professional reputation, the litigation documents may leapfrog to the consequences of that damaged reputation — in particular, the plaintiff's lost past and future income.

These litigation decisions can create a self-fulfilling prophecy, making it more difficult for plaintiffs to later allocate their damages to the damage done to their professional goodwill under an origin-of-the-claim analysis. Plaintiffs may be able to save significant tax dollars and improve their net recoveries if they remember that their names are assets they own and have spent years investing time and effort to cultivate, promote, and defend. When defendants' conduct damages how employers, colleagues, clients, and customers view the plaintiffs and the likelihood of choosing to work with them, that damage should not be ignored or fail to be alleged.

For businesses, a long body of case law distinguishes legitimate claims for damage to goodwill from claims that are in substance claims for lost income. There is no body of case law for individuals' professional goodwill that rivals the body of case law that exists for businesses' goodwill. We should expect the IRS and courts to establish tests and limits in this area, just as they have developed tests and limits for the tax treatments of other types of claims. Some of these tests may build on the authorities previously developed under section 104(a)(2) for distinguishing between personal and nonpersonal reputational damages.

However, the prospect of IRS and court scrutiny should not dissuade plaintiffs from making claims for damage to professional reputation when the facts support it. Otherwise, plaintiffs will effectively default to treating all defamation and reputational claims, even those directly affecting and relating to their professional reputations in their trades or businesses, including their employment, as ordinary income. ■