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Why Punitive Damages Should Remain Deductible

By Robert W. Wood

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As a frequent adviser to litigants about the tax treatment of settlements and judgments, I see some patterns repeat. As a rule, plaintiffs are considerably more concerned about tax issues than are defendants. This is logical. There are usually more tax planning opportunities available when one is receiving (as opposed to paying) money.

Defendants generally assume that if they are engaged in a trade or business, all payments they make during litigation (or to terminate it) — damage payments, settlement payments, and related counsel fees — are surely deductible. Some sophisticated defendants are aware of the rules requiring capitalization of some payments. Yet most seem to assume *everything* is deductible.

President John F. Kennedy once said that ''the phrase 'it's deductible' should pass from our scene.''[1] Although he was evidently referring to lavish business expenses, more than four decades later, Kennedy's remark could be used today to reflect a recessionary mentality. Yet oddly, an exception to businesses' almost primordial urge to deduct applies to punitive damages.

Surprisingly (at least to me), many defendants assume that punitive damages paid to private parties in civil lawsuits are not deductible. This is surprising because it is clear under current law that punitive damages paid in the course of a trade or business are deductible. There may be many reasons for this deductibility, but one reason is the involuntary nature of the payment.

Suppose you are engaged in the trade or business of making widgets. Suppose one of the widgets malfunctions and injures one or more persons. Thereafter, suppose you face a verdict for compensatory and punitive damages. If you end up paying both the compensatory and punitive damages, no one would argue that you were doing so voluntarily or for tax reasons. Assuming there is a logical connection between your business of making widgets and the payment, your tax deduction is assured. It does not matter whether the damages are compensatory, punitive, or both.

Fines and Penalties

By contrast, most fines or penalties paid to the government are nondeductible. The basis for the confusion over the deductibility of punitive damages, I believe, is the understandable tendency to confuse a fine or penalty (generally nondeductible if paid to the government or a government agency) with punitive damages paid to a private party (generally deductible). Even these categories can become confused.

For example, despite the ''fine or penalty'' nomenclature and despite the fact that a payment of that nature is made to a governmental entity, nondeductibility is not absolute. Even some fines or penalties have been held deductible. In general, the reason for making some fines or penalties deductible is that their intent is compensatory or remedial, not penal or punitive.[2] Thus, it is hardly surprising that there is confusion over these tax rules, even among fairly knowledgeable people.

To restate the axiom, under current law, punitive damages paid in civil cases are generally deductible. In the widget example above, there is no question that the punitive damages would be deductible as an ordinary and necessary business expense. That is plainly current law. But should this rule continue?

Obama Administration's Proposal

The Obama administration has proposed amending the tax law to make punitive damages nondeductible. According to a Treasury release, the reason for the change is that allowing a deduction for punitive damages undermines the role of those damages in discouraging and penalizing undesirable actions and activities.[3] Notably, this proposal has been made several times in the past, in particular during the Clinton administration.[4] The prior proposals were almost identical to the current iteration.

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[1]*See* Kennedy's April 20, 1961, speech to Congress addressing federal tax issues and reforms.

[2]For a collection of examples of fines or penalties and their tax character, see Robert W. Wood, *Taxation of Damage Awards and Settlement Payments* (3d ed. 2008), para. 10.26.

[3]For Treasury's general explanations of the administration's fiscal 2010 revenue proposals, see *Doc 2009-10664* or *2009 TNT 89-44*.

[4]*See* Joint Committee on Taxation, ''Summary of Tax Provisions Contained in the President's Fiscal Year 2001 Budget Proposal,'' Feb. 7, 2000 (JCX-13-00), *Doc 2000-3833*, *2000 TNT 27-25*; and JCT, ''Descriptions of Revenue Provisions Contained

(Footnote continued on next page.)

Specifically, the current proposal is to deny a deduction for punitive damages a taxpayer pays or incurs, whether paid pursuant to a judgment or in settlement of a claim. The proposal also covers the possibility that the defendant's liability to pay punitive damages is covered by insurance. It is becoming increasingly common for companies to carry insurance for punitive damages exposure.

It will continue to be legitimate for a company to deduct insurance premiums for business insurance, including insurance premiums for punitive damage coverage. However, the proposed law would seek to ensure that a taxpayer cannot shift the burden of a nondeductible punitive damage payment to an insurer. If the policy does pay, the amount of that policy payment attributable to punitive damages would then be attributed as income to the policyholder.

Thus, the proposal would treat damages paid or incurred by the insurer as gross income of the insured. Moreover, as an enforcement mechanism, the insurer in that case would be required to report those payments to the insured and to the IRS (a Form 1099 obligation). As proposed, these changes would take effect for damages paid or incurred after December 31, 2010.

The Treasury Department's so-called green book[5] is chock-full of the current administration's wishes for tax reform. The descriptions are often fairly cryptic. Yet there are some comments about the punitive damage proposal that merit mention.

The green book notes that under current law, no deduction is allowed for a fine or similar penalty paid to a government for the violation of any law. This nondeductibility rule is embodied in section 162(f). Moreover, if a taxpayer is convicted of a criminal violation of the antitrust laws, or if the taxpayer's plea of guilty or nolo contendere to such a violation is entered or accepted in a criminal proceeding, there is a corollary. In that event, no deduction is allowed for two-thirds of the amount paid or incurred on the judgment or settlement of a civil suit brought under section 4 of the Clayton Antitrust Act on account of that violation or any related antitrust violation.[6]

Put simply, when there is a conviction or plea of guilty or nolo contendere, the trebled portion of the damages in a related antitrust case are essentially treated as if they were a fine or penalty. As expressed by one of the congressional committees in 1969 when section 162(g) was enacted:

> 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.[7]

The green book continues that when neither of these two nondeductibility provisions is applicable, a deduction is allowed for damages paid or incurred as ordinary and necessary business expenses in carrying on any trade or business. It does not matter to that deduction whether the damages are compensatory or punitive.

Apart from any revenue effects this may have,[8] the administration's proposal appears to be based on policy grounds. The idea is to make sure that the pain of the punitive damage payment is not ameliorated by a tax deduction. The proposal would ensure that the fisc would not subsidize punitive damages via a tax deduction.

On one level, this may make sense. I view this as primarily a policy question, which I leave to those more qualified than I to address it. From a technical perspective, however, I fear widespread confusion.

Business Expense Culture

The canvas of business expense deductions is broad. Most expenses occurring in a business context are deductible. Is there a need to make punitive damages nondeductible to achieve policy? If there is, one might reasonably assume that defendants would routinely argue that punitive damages are nothing to be afraid of because they are tax deductible. Yet this is clearly not occurring.

Nearly all defendants already regard punitive damages as anathema. That will continue to be the case whether or not they become nondeductible. Defendants engaged in a trade or business fight the imposition of both compensatory and punitive damages. They try mightily to avoid either one being imposed, but they already try particularly hard to avoid punitive damages.

A business taxpayer can deduct the cost of most settlements and judgments (both compensatory and punitive). Yet that fact hardly means that defendants ignore either compensatory or punitive verdicts. Axiomatically, a defendant in the 35 percent tax bracket may reduce its

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in the President's Fiscal Year 2000 Budget Proposal,'' Feb. 22, 1999 (JCS-1-99), *Doc 1999-7175*, *1999 TNT 37-11* (part one), and *1999 TNT 37-12* (part two).

[5]This is presumably to distinguish it from the blue book that tax lawyers commonly read. Blue books are issued by the JCT to explain recent tax laws. Although blue books are prepared after tax bills are considered, they are usually regarded as a compilation of legislative history, but not actual legislative history. *See* ''Background Information Relating to the Joint Committee on Taxation'' (2005) (explaining that after the close of each Congress, the staff of the JCT generally publishes a ''blue book'' that compiles the legislative history of each piece of legislation enacted during that Congress); *Birth v. Commissioner*, 92 T.C. 769, 774 (1989) (commenting that the JCT blue book is not technically considered legislative history).

[6]*See* section 162(g) and reg. section 1.162-22(a) (regarding treble damage payments under the antitrust laws).

[7]*See* Senate Finance Committee, ''Report on Tax Reform Act of 1969,'' S. Rep. No. 551, 91st Cong., 1st Sess., 274 (1969), reprinted at 1969-3 C.B. 597.

[8]A Ouija board might be needed to project those revenue effects, but they would probably be small.

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taxable income by deducting payments for compensatory and punitive damages, but the defendant still bears 65 percent of the cost.

Moreover, if this proposal becomes law, it seems reasonable to expect the market to adjust its behavior to the tax. If I were a plaintiff asking for punitive damages in a case under current law, I would make sure to apprise the judge or jury that under current tax law, the defendant could (and would) deduct the payment. I would therefore ask for *additional* punitive damages to gross up that amount.

Conversely, suppose the Obama proposal passes and punitive damages are made nondeductible. Then, if I were a defendant in the unenviable position of facing a punitive damage award, I would ensure that the judge and jury are aware of that nondeductibility. Moreover, I would ask for the denial of the deduction to be taken into account in setting the amount of punitive damages awarded.

I don't know how realistic it is to think that an award of punitive damages would take taxes into account in every case. It would seem to be an efficient theory, but it raises a difficult and controversial topic that itself causes confusion: How much do civil courts take tax issues into account?

Tax Effects on Damage Awards

There appears to be an increasing tendency on the part of civil judges to consider tax effects in awarding damages. Yet practice still varies enormously. This will be controlled by the nature of the causes of action, by applicable law, and even by the discretion of the judge.[9]

Asking for taxes to be taken into account can apply to increase or decrease damages. For example, a plaintiff may ask for additional damages to be awarded to make up for adverse tax consequences the plaintiff may incur. A defendant may ask for damages he would pay to be reduced because of tax effects to him, or more likely, because of the favorable tax effects the plaintiff will enjoy.

The point in time at which tax damages should be requested also varies, from pretrial to posttrial. There can even be constitutional implications to this issue, with courts in jury trials refusing to alter a jury verdict.[10] The Seventh Amendment to the Constitution generally prevents additur. Thus, a request to amend a judgment to take taxes into account may be denied as infringing on the jury's province.[11]

However, tweaking a judgment to reflect taxes may be no problem in a bench trial.[12] In a bench or jury trial, but especially in the latter, it may be best to raise these tax damage issues early. In any event, with the degree of sensitivity to tax damage claims today, it is at least arguable that the intended deterrent and social policy aspects of eliminating the tax deductibility of punitive damages can be circumvented.

New York Bar Report

Based on one of the previous proposals to make punitive damages nondeductible, the New York State Bar Association (NYSBA) Tax Section issued a thorough report on this subject in 2001.[13] This report is worth reading in its entirety. However, a couple points from the report deserve special mention.

In the list of points in favor of making punitive damages nondeductible, the report notes that supporters of nondeductibility mention other code sections that attempt to impose social policy. Examples include golden parachute payments, greenmail payments, and excessive employee compensation rules. Yet arguing that other code sections do the same kind of thing sought to be achieved by making punitive damages nondeductible raises certain questions.

For example, if social policy is the goal (and if that is a good goal), would making punitive damages nondeductible have any additional deterrent effects? How would this fundamental change in viewpoint be received by judges and juries who impose punitive damages? How would it be perceived by the companies that end up paying punitive damages?

I don't know if it is reasonable to believe that all the parties would react to a change in the tax treatment of punitive damages, and would adjust their awards accordingly. Without thorough economic analysis and empirical data, I don't think the nondeductibility proposal for punitive damages should be seriously considered. Perhaps it would merely take time for this to sink in. Perhaps it would help to have a fundamental change in the information provided to judges and juries, so they can take into account the after-tax effects of the punitive damages. Yet this still doesn't address the deterrence questions.

Characterization Debates

Moreover, I fear enormous characterization controversies. It is this overarching characterization question that suggests that attempting to make punitive damages nondeductible will be a mess. On the payee side of the equation, we already have inherent ambiguities between awards of compensatory and punitive damages. Punitive damages are awarded in a great variety of cases, and the nature of the awards seems to vary.

Axiomatically, we think of compensatory damages as always putting the plaintiff back in the *status quo ante.* We also may think of punitive damages as having no compensatory purpose whatsoever. Maybe in the dictionary that is so.

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[9]For discussion, see Wood, "Getting Additional Damages for Adverse Tax Consequences," *Tax Notes*, Apr. 27, 2009, p. 423, *Doc 2009-6560*, or *2009 TNT 79-11*.

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

[11]*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).

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

[13]*See* NYSBA Tax Section report on the deductibility of punitive damages, *Tax Notes*, Nov. 26, 2001, p. 1209, *Doc 2001-27630*, or *2001 TNT 213-21*.

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Nevertheless, there is often a far more complex interrelationship between compensatory and punitive damages than might be evident at first blush. Indeed, one of the indices for an award of punitive damages is when compensatory damages are potentially inadequate. Another is when it may be too difficult or too costly to measure compensatory damages adequately.[14]

These issues would seem to invite a kind of impossible inquiry of just *why* the punitive damages were awarded in a particular case. Classically, punitive damages are meant to be penal or punitive in nature, as their moniker plainly suggests. Yet the fact is that punitive damages may be quasi-compensatory.

Fine or Penalty Analog

Recall that some fines or penalties paid to the government are now deductible (if they are compensatory or remedial in nature). Indeed, this is so despite their "fine or penalty" nomenclature. Should that not also be true for civil punitive damages? I don't see how it could be otherwise.

Assuming one can sidestep this quicksand, however, there are greater problems still. Are punitive damages *always* purely penal in nature to the payer, and always purely a windfall (and noncompensatory) to the plaintiff? I don't think so. Yet even if that is a reasonable assumption, just how do you determine when "punitive damages" have been paid?

There may occasionally be situations in which a verdict is awarded for X dollars in compensatory damages and Y dollars in punitive damages, after which the defendant simply makes the payments in exactly those amounts and referring to that nomenclature. There will probably be no confusion in such a case.

Similarly, suppose the award of $X in compensatory damages and $Y in punitive damages goes on appeal. Suppose the appellate court affirms the verdict and that the affirmance is followed by the payment of $X and $Y (plus interest). That too will likely not be confusing.

Yet in my experience, these two fact patterns are nearly unheard of in the real world of litigation. In the vast majority of cases, punitive damage awards go on appeal. Most of those cases are settled. Both plaintiff and defendant tend not to like allocations to punitive damages.

For tax reasons, a plaintiff will typically not like a punitive damage characterization, because punitive damages will always be taxable income. Defendants, however, are more likely to be concerned about nontax considerations. That would surely change if punitive damages became explicitly nondeductible. Plainly, there is not unfettered flexibility in those situations, but a change in the law would make this dynamic even more troubled.

What Constitutes Punitive Damages?

On the surface, any amount characterized as punitive damages would seem to be always so denominated by a court. However, particularly in cases that settle while on appeal, questions do arise about the character of a settlement amount.

For example, assume 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 the verdict. After sparring in the appellate court but before there is a final decision, Tom and the manufacturer settle for $2 million. If the injury to Tom was a physical injury, compensatory damages would be excludable from Tom's income under section 104. However, punitive damages would not be excludable. How should the $2 million be treated?

Because Tom received only $1 million in compensatory damages according to the jury verdict, can we assume the other $1 million he received (for a total of $2 million) should be treated as punitive damages? Regardless of any tax consequences, the defendant manufacturer will doubtlessly contend that it did no wrong, and the defendant will contend that it does not agree that any punitive damages should be or are payable. There may be public relations concerns, insurance law restrictions, shareholder relations problems, and a host of other reasons for a defendant to take this position.

The IRS is likely to argue that the extra $1 million cannot be thought of as anything *but* punitive damages, even though the settlement documents are likely to clearly negate punitive status. Tom, however, might argue that he should have received a larger amount of compensatory damages at trial, so his settlement is all compensatory.

Let us modify the example to make an easier case. Assume the same fact pattern, except that Tom eventually settles on appeal for only $750,000. Here, Tom might persuasively argue that he was receiving only compensatory damages, which should be tax free because they were received on account of personal physical injuries or physical sickness. The IRS might try to prorate the settlement, treating a portion of it as attributable to the punitive damages. Because 75 percent of the jury verdict was for punitive damages, the IRS might argue that 75 percent of Tom's settlement of $750,000, or $562,500, should also be so allocated.

Punitive Damages Without a Judgment

Some courts may be willing to import punitive damage characterization to monies even when there has been no trial. For example, *Barnes v. Commissioner*[15] involved the tax treatment of a settlement in an action brought by a bookkeeper against her former employer. She was subpoenaed to give a deposition in an action involving her employer, and the next day she was fired. She suffered embarrassment, humiliation, and other mental distress as a result of her wrongful termination.

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[14]The points are noted in the NYSBA report, *supra* note 13, at p. 1215.

[15]T.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*.

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She filed a wrongful termination suit under applicable state law seeking damages of at least $10,000. Barnes's action sought damages for future lost wages and mental distress. In 1992 she settled her case with her former employer for $27,000, and she excluded the entire settlement amount from her 1992 income (note that in 1992 it was not necessary for an injury to be ''physical'' to be excludable under section 104).

Nevertheless, 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 is an action based in tort. The Tax Court noted that Barnes's attorney (in the underlying wrongful termination action and settlement) 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 between mental distress and punitive damages.

With this conclusion behind it, the Tax Court held that half of the recovery representing mental distress was for personal injuries or sickness and hence excludable under section 104, as it existed before amendment by the 1996 act.[16] The court noted that the termination of her employment directly caused her mental distress, and that applicable state law allowed a recovery in tort. As to the half of the recovery that the court deemed to be for punitive damages, however, the court found that amount to be taxable income.

The issue *Barnes* raises about the nature of punitive damage characterization is obvious. One must acknowledge that a taxing authority or a court faces a difficult task in allocating a recovery for tax purposes. Yet finding that an amount represents punitive damages for tax purposes when the parties have not even gone to trial seems wrong.[17]

That punitive damages to payees receive harsh tax treatment has actually led some to suggest that attorneys should avoid asserting claims for punitive damages in complaints.[18] That punitive damages are always taxable can result in problems in settling cases when an allocation might result in some portion of the settlement being treated as attributable to a punitive damage claim. This situation is understandable when there is a judgment and a settlement is reached pending appeal. However, the situation is awkward even when there is no judgment.[19]

'Best Evidence'

In Rev. Rul. 85-98,[20] the IRS determined that when 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.'' In *Miller v. Commissioner*,[21] the court held that 47 percent of the net proceeds of a 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 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.[22]

In TAM 200243021,[23] the IRS ruled that exemplary damages awarded under state law to a surviving widow were punitive in nature. This technical advice memorandum involved an employee who was killed in the line of duty. His wife filed a wrongful death action against his employer. After trial, the jury awarded his wife $5 million in punitive damages and various other allocated amounts.

Following the jury allocations, the trial court approved a settlement of $2.1 million. The widow included her share of the proceeds in gross income. The following year, she filed a refund claim arguing exemplary damages were excludable from gross income under section 104. In the memorandum, the IRS pointed out that the widow claimed the punitive damages served a quasi-compensatory purpose under applicable state law. Accordingly, the widow argued that this amount was excludable under section 104(a)(2).

The IRS noted that an appellate court in that jurisdiction had concluded that punitive damages served a punitive purpose rather than a quasi-compensatory purpose. The IRS went on to say that the jury instructions specifically indicated that the damages were punitive in nature, and were not intended to compensate any personal injury suffered by the taxpayer's deceased husband. Accordingly, the IRS concluded that the widow's damages were not excludable from income under section 104(a)(2).

TAM 200243021 is yet another reminder to be careful with what you put in jury instructions, or for that matter, any document filed with a court. The IRS cited jury instructions from an underlying lawsuit, commenting that the tenor of those instructions revealed that the exemplary damages awarded bore no relationship to the extent of personal injuries suffered by the plaintiff.

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[16]Before its amendment by the 1996 act, section 104(a)(2) merely required recoveries to be for 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 for personal physical injuries or physical sickness.

[17]*See* Wood, ''Will Courts Import Punitive Characterization?''; and Wood, ''Proposed Nondeductibility for Punitive Damages: Will It Work?'' *supra* note 15.

[18]*See* Palmer, ''Recent Developments in the Taxation of Punitive Damage Awards,'' 73 *Taxes* 596 (Nov. 1995).

[19]*See Lane v. United States*, 902 F. Supp. 1439 (W.D. Okla. 1995). For an article arguing about the punitive damage issue, see 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* Robertson, ''Application of the Income Exclusion of I.R.C. Section 104(a)(2) to Liquidated Damages in Age Discrimination Actions Under the ADEA,'' 28 *Creighton Law Review* 347 (Feb. 1995).

[20]1985-2 C.B. 51. *See also* Wood, ''Proposed Nondeductibility for Punitive Damages: Will It Work?'' *supra* note 15; and Wood, ''Tax Language in Settlement Agreements: Binding or Not?'' *Tax Notes*, Dec. 31, 2001, p. 1872, *Doc 2001-31594*, or *2001 TNT 248-13*.

[21]*See Miller v. Commissioner*, T.C. Memo. 1993-49, supp., T.C. Memo. 1993-588, *Doc 93-12978*, *93 TNT 254-29*.

[22]60 F.3d 823 (4th Cir. 1995).

[23]*Doc 2002-24001*, *2002 TNT 208-21*.

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Rather, the instructions made it clear that the recovery of exemplary damages was measured by the defendant's conduct, such that the damages were meant to be punitive in nature.

Explicit Allocations

It is unreasonable to think that allocation issues will go away. They 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, I believe the allocation question with punitive damages is different from any other. If a plaintiff sues for employment discrimination, it may be quite reasonable to think that some of the damages are likely to be intended as wages, and some of the damages are likely to be intended as nonwage (typically Form 1099) damages. One does not need a trial to think that is a reasonable assumption.

After trial and on appeal, of course, one can put a finer point on the allocation. There will usually be considerably less flexibility in an allocation after trial, because the data points of what the court or jury did will feature so prominently. That is as it should be. Yet there is still no fundamental difference in the allocation methods in cases that do not involve punitive damages.

With punitive damages, the fundamental character of the penal or retributive nature of the payment makes the allocation inquiry fundamentally different. Suppose a defendant faces a products liability suit in which compensatory damages are arguably $100X but the more ominous exposure to the defendant is to a potential punitive award. Whatever the defendant's internal (attorney-client privileged) discussions have been about its potential exposure, if the case settles for $200X before trial (and possibly even before a complaint is filed!), is it fair to suggest that any of this amount really represents punitive damages?

I don't think so, nor do I think any payer of such settlements would think so, either. The legal and factual hurdles to achieving punitive damages for a plaintiff are simply too great. This inquiry — about whether some portion of the payment should be attributed to a potential punitive award — is simply too speculative. Indeed, it presents a circular problem.

If a defendant thinks it has exposure to compensatory and possibly even to punitive damages, one of the very reasons that defendant may choose to settle before trial is to avoid the possibility of its conduct giving rise to punitive damages. If punitive damages have not been awarded by a court, there can be no punitive damages. How could it be otherwise?

The IRS might be expected to exploit authorities from the fine or penalty area. There, a proposed fine or penalty to be collected by a government agency may be settled. That can be a way for the putative wrongdoer to avoid a formal fine or penalty assessment.

If there is a proposed fine or penalty assessment, or perhaps even the threat of a fine or penalty assessment, it may not be unfair to suggest that some portion of the monies the defendant pays to settle the matter might be attributed to the fine or penalty exposure. The facts and the evidence may make the connection and the dollar amounts quite patent. Yet that is different from a possible punitive damage award exposure on a case settling before trial.

If a case with punitive damage elements is settling on appeal, it may well be that some portion of the payment (by the defendant and to the plaintiff) should be regarded as punitive, depending on the facts, the numbers, and the pendency of the issues in the appeal for both plaintiff and defendant. In a case that has not yet proceeded to trial, however, I can find no justification for it. If punitive damages become nondeductible, we can expect this dynamic to become messier still.

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