

# Legal Memorandum

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## Punitive Damages and the Tax Code: Punishing Business and the Economy

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**Abstract:** *The Obama Administration and its allies in Congress want to eliminate the deductibility of punitive damages as a business expense. Such a move would increase the damages paid by businesses in lawsuits—a brilliant scheme sure to boost the stagnant economy. In fact, increased liability risks and costs will likely cause businesses to cut jobs, decrease investments in research and development, scale back expansion plans, and pass higher costs to consumers. And in addition to harming the economy, eliminating the deductibility of punitive damages will encourage plaintiffs' lawyers to file even more lawsuits, further clogging dockets across the country and increasing the cost of litigation.*

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There is a movement in Congress and the Obama Administration to increase the cost of punitive damages paid by businesses beyond the awards set by courts and juries by eliminating their deductibility as a business expense. One of the most recent attempts—the Reid Amendment<sup>1</sup> to the Unemployment Compensation Extension Act (UCEA) of 2010—was not included in the final version of the UCEA that passed Congress and was signed into law by the President on July 22, 2010.<sup>2</sup> This amendment would have changed a tax policy that has been in place for decades. A similar provision was introduced in the Job Creation and Tax Cuts Act of 2010 at the end of September.<sup>3</sup> This is part of a continuing effort to change federal law on this issue.

Ending the tax deductibility of punitive damages would harm the economy, create administrative obsta-

### Talking Points

- Congress and the Obama Administration want to increase the damages paid by businesses in lawsuits by eliminating the deductibility of punitive damages as a business expense.
- Punitive damages are imposed under very vague and uncertain standards, which combined with the loss of the deductibility, could force defendants to settle cases and forgo appeals even when they have valid reasons to believe they would win a lawsuit or have a successful appeal.
- Such a tax policy would reduce the total dollars business defendants have available to pay meritorious plaintiffs.
- Increased liability risks and costs will likely cause businesses to cut jobs, decrease investments in research and development, scale back expansion plans, and pass higher costs to consumers.
- Eliminating the deductibility of punitive damages will encourage plaintiffs' lawyers to file even more lawsuits in a country where the cost of litigation and liability concerns are already much greater than in many other industrialized nations.

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cles to the settlement of claims, and ultimately fail to meet the purported objectives of its proponents. It is not only bad tax policy; it is also inefficient policy that will only transfer more costs to the American consumer in an economy that is already suffering.

### Current Law and the Proposed Change

Under the federal tax code, businesses are entitled to deduct all ordinary and necessary business expenses, including operating costs, salaries, and compensation. “Ordinary and necessary business expenses” also include compensatory and punitive damages paid to settle a claim or as the result of a judgment awarded against the business as long as the acts that gave rise to the litigation were performed in the ordinary course of the taxpayer’s business.<sup>4</sup> Unlike compensatory damages for physical injuries or sickness, punitive damages are also generally considered income to the recipient.<sup>5</sup>

The text of the amendment sponsored by Senator Harry Reid (D–NV) (as well as the Job Creation and Tax Cuts Act) stated that “[n]o deduction shall be allowed under this chapter for any amount paid or incurred for punitive damages in connection with any judgment in, or settlement of, any action.”<sup>6</sup> This change was also proposed by the Obama Administration in its 2010 Revenue Proposals,<sup>7</sup> as well as by the Clinton Administration in its fiscal year 2000 and 2001 budget proposals.<sup>8</sup>

Proponents of this change in tax law argue that the “deductibility of punitive damages payments undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities,”<sup>9</sup> and that eliminating the deductibility will prevent businesses from circumventing punitive damages imposed on them through tax deductible write-offs. But, even under the current tax law, “[n]early all defendants already regard punitive damages as anathema”<sup>10</sup> because of the potential damage such an award can do to the reputation of a business, with a resulting loss in sales of products or services.

Proponents are also continuing the unwise practice of trying to use the tax code to achieve public policy or social objectives that have nothing to do with a fair and efficient tax system. Such objectives should be achieved either through the market or through legislative regulation that is not based on taxes.

### Civil and Criminal Fines and Punitive Damages

The Obama Administration claims that punitive damages are similar to civil and criminal fines—for which no tax deduction is allowed<sup>11</sup>—and, therefore, they should also not be deductible.<sup>12</sup> However, that argument overlooks significant, relevant

1. S.A. 4344, 111th Cong. (2010).
2. Pub. L. No. 111-205, 124 Stat. 2236 (2010).
3. S. 3793, 111th Cong. (2010), Sec. 422.
4. 26 U.S.C. § 162; Rev. Rul. 80-211, 1980-2 C.B. 57.
5. DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, PUBLICATION NO. 525, TAXABLE AND NONTAXABLE INCOME, at 31 (Jan. 26, 2010), available at <http://www.irs.gov/pub/irs-pdf/p525.pdf>; see also *O’Gilvie v. United States*, 519 U.S. 79 (1996).
6. S.A. 4344; S. 3793, Sec. 422.
7. DEPT. OF TREAS., GENERAL EXPLANATION OF THE ADMINISTRATION’S FISCAL YEAR 2010 REVENUE PROPOSALS, at 117 (May 2009), available at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>. [hereinafter 2010 REVENUE PROPOSALS]. Both the Reid Amendment and the Revenue Proposal would also include any damages paid or incurred by an insurer for punitive damages in the gross income of the insured.
8. U.S. GOV. PRINTING OFFICE, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2000, at 77–78; U.S. GOV. PRINTING OFFICE, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2001 at 76.
9. 2010 REVENUE PROPOSALS, at 117. There is a similar statement in the Obama Administration’s 2011 Revenue Proposals.
10. Robert W. Wood, *Why Punitive Damages Should Remain Deductible*, TAX NOTES 150 (July 13, 2009).
11. 26 U.S.C. § 162(f).

differences between government fines and punitive damages. Unlike fines that are usually fixed by statute, punitive damages can be imposed under very vague standards in almost any amount no matter how extreme or disproportionate “unless a judge decides that the amount awarded shocks the conscience or violates broad due process limitations.”<sup>13</sup> That very uncertainty, when combined with the loss of the deductibility of punitive damages, could force defendants to settle cases and forgo appeals even when they have valid reasons to believe they would have a successful appeal.

As the Tax Section of the New York Bar Association pointed out, “jurors are asked to determine an appropriate dollar amount based on amorphous, and arguably irrelevant, criteria.”<sup>14</sup> Supporters of this change also wrongly assume that all punitive damages are “punishment.” Punitive damages can be imposed based on punishment and deterrence, but juries may also award punitive damages if they believe that the legally allowable compensatory damages in a particular case are insufficient to adequately compensate a plaintiff. Punitive damages are “driven largely by subjective emotions like anger and sympathy.”<sup>15</sup> From a practical standpoint, “the jury can and will award whatever the plaintiff’s lawyer can justify in a powerful closing argument.”<sup>16</sup> Thus, punitive damages often are not the equivalent of a criminal punishment for a defendant or a civil fine but a redistributive boon for a plaintiff to provide even more compensation. Punitive damages

are, in effect, a dead weight cost for companies doing business in the United States, one that is far higher than in most other industrialized nations. What is really needed is fundamental tort reform, but in the meantime, it does not make sense to increase such dead weight costs for business.

### Of Passion and Caprice

The U.S. Supreme Court has “expressed concern about punitive damage awards ‘run wild,’ finding them inexplicable on any basis but caprice and passion.”<sup>17</sup> In *BMW of North America, Inc. v. Gore*, the Court outlined that the states have considerable flexibility in determining the level of punitive damages that they will allow and afford juries “similar latitude, requiring only that the damages awarded be reasonably necessary to vindicate the state’s legitimate interest in punishment and deterrence.”<sup>18</sup> It is very difficult to overturn even extremely large punitive damages awards that bear little relation to the acts of a particular defendant because only “when an award can fairly be categorized as ‘grossly excessive’ in relation to these interests does it enter the zone of arbitrariness that violates the Due Process Clause of the Fourteenth Amendment.”<sup>19</sup>

Criminal penalties also require proof beyond a reasonable doubt, a standard that does not apply in civil cases—punitive damages can be awarded in most states “by a mere ‘preponderance of the evidence.’”<sup>20</sup> Finally, criminal fines can be imposed only once for violations of the law because the Fifth

12. 2010 Revenue Proposals, at 117.

13. Mark A. Behrens & Christopher E. Appeal, *Denial of Federal Tax Deduction for Punitive Damages Threatens Job Growth*, WASHINGTON LEGAL FOUNDATION LEGAL OPINION LETTER Vol. 18, No. 12, June 5, 2009.

14. NEW YORK STATE BAR ASSOCIATION, REPORT ON THE DEDUCTIBILITY OF PUNITIVE DAMAGES, TAX SECTION REPORT NO. 1000, (2001).

15. Theodore Olson, Some Thoughts on Punitive Damages, Civil Justice Memo No. 15 (June 1989), Manhattan Institute for Policy Research; available at [http://www.manhattan-institute.org/html/cjm\\_15.htm](http://www.manhattan-institute.org/html/cjm_15.htm).

16. *Id.*

17. NEW YORK STATE BAR ASSOCIATION, *supra* note 14.

18. 517 U.S. 559, 568 (1996).

19. *Id.* The Court used a very broad test to examine the punitive damage award against BMW: the degree of reprehensibility of the defendant’s conduct; the award’s ratio to the compensatory damages awarded; and a comparison to the civil or criminal penalties that could be imposed for comparable misconduct. 517 U.S. at 574–586. However, some disagree with even this relatively weak due process protection against excessive and unjustified punitive damages even if it constitutes bad public policy; Justice Scalia wrote in a dissent that “[s]ince the Constitution does not make that concern any of our business, the Court’s activities in this area are an unjustified incursion into the province of state governments.” 517 U.S. at 598.

Amendment to the Constitution prohibits any person from being “twice put in jeopardy” for the same offense. That is not true of punitive damages, which can be imposed repeatedly on the same defendant for the same course of conduct that affects different plaintiffs.

Until—and unless—“punitive damages defendants are afforded the same basic protections that generally apply to criminal defendants,”<sup>21</sup> it would be unfair to treat punitive damages and criminal fines the same for tax purposes.

### Economic and Litigation Consequences

Punitive damages are most often awarded “in cases involving malpractice, products liability and business torts.”<sup>22</sup> By eliminating the deductibility of punitive damages, Congress will increase taxes on businesses, as well as the net costs of litigation, burdening the economy and increasing the costs of goods and services to the average consumer, including health care.

Assuming a corporate tax rate of 35 percent, punitive damage awards would actually cost companies an additional \$350 for every \$1,000 paid out to plaintiffs. Fearing the unpredictability of non-deductible punitive damages, risk-averse businesses will prudently choose to settle even frivolous claims with deductible settlements rather than undergo costly litigation that might result in taxable punitive damages. This risk shift will make businesses more hesitant to fight unwarranted liability claims. It will give plaintiffs’ lawyers an incentive to bring even more lawsuits against businesses without the expense of ever setting foot in a courtroom in the expectation that the businesses will be more likely to settle such suits. However, it may undermine the total dollars business defendants have available to pay plaintiffs in settlements.

When businesses prepare their annual operating budgets, they estimate the risk of damages and liti-

gation and their expected costs, setting aside assets that could otherwise be put toward productive ventures, such as expanding their production or research and development of new products.<sup>23</sup> Making punitive damages taxable will require businesses to set aside even larger amounts of assets in their budgets, which could include decreasing their business expenses by cutting jobs or increasing the prices of their goods and services. Just like any other business tax increase, the consumer (and the employee) will bear the costs.

As a result, consumers may see higher prices on all goods and services, and fewer new jobs will be created during troubled economic times. If businesses choose to go to trial, it will force them to spend more money on litigation because of the higher stakes involved. Litigation costs and taxes on businesses would increase significantly if the deductibility of punitive damages were eliminated.

Ending the deductibility of punitive damages will also promote further intrusion by the Internal Revenue Service (IRS) into the liability and litigation arena. Under the proposed law, compensatory damages would remain tax-deductible while punitive damages would not. Although the current distinction between punitive and compensatory damages is somewhat inconsequential to business from a tax point of view when executives are pulling out their checkbooks, this distinction would become crucial under the proposed tax change.<sup>24</sup>

### Increased Government Intrusion

The IRS already intrudes into the settlement of lawsuits. IRS guidelines warn that the “allocation among the various claims of the settlement can be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement.”<sup>25</sup> The IRS may disregard the terms of a written settlement to recat-

20. Behrens, *supra* note 13.

21. *Id.*

22. NEW YORK STATE BAR ASSOCIATION, *supra* note 14.

23. See e.g., Financial Accounting Standards Board, “Litigation, Claims, and Assessments,” Statement of Financial Accounting Standards No. 5, at 11–13, March 1975.

24. See Wood, *supra* note 10. The current distinction is consequential to plaintiffs because punitive damages are taxable to them as income.

egorize compensatory damages as punitive damages so they will count as income to a plaintiff.<sup>26</sup> Sometimes the IRS even questions the characterization of damages awarded by a jury or judge.<sup>27</sup>

Ending the deductibility of punitive damages would give the IRS even more incentive to question the categorization of damages by the parties in a lawsuit, particularly when payment arises from a claims settlement. While currently only the claimant has a tax incentive relating to whether damages are categorized as compensatory or punitive, if the law is changed, both parties will have an incentive to categorize all damages as compensatory for tax purposes. Neither would want the damages to be labeled as punitive because both the payer and the recipient would be taxed on them. This would be made more difficult in litigation because while punitive damages are theoretically meant to punish and deter bad behavior, and compensatory damages serve to return the plaintiff to his former state, in practice these damages can, and do, often overlap because of the “inherent ambiguities between awards of compensatory and punitive damages.”<sup>28</sup>

This added tax would not help victims and indeed is likely to hurt them through added governmental intervention, bureaucracy, and a higher probability that a larger proportion of their award will be made taxable. Even if the parties themselves agree on how to characterize the settlement being paid, this new policy will encourage the revenue-hungry IRS to fight both parties and to question the characterization of damages in every lawsuit settled or litigated in the country to maximize tax receipts. The IRS will have the ability to increase the transaction cost between settling parties and override the intent of their agreement by disputing the sometimes-murky distinctions between compensatory and punitive damages.

## Misguided Objectives

Finally, if enacted, the Reid amendment, along with the Obama Administration’s proposal, would ultimately undermine the very policy objectives they seek to advance. The goal is to prevent businesses from supposedly escaping court-imposed punishments by deducting punitive damage payments as business expenses.<sup>29</sup> The change would, however, encourage businesses and claimants to characterize all damages paid as compensatory.

Proponents are misguided in assuming that businesses are avoiding a court-imposed punishment because they can deduct the cost of punitive damages as a cost of doing business. Judges and juries are increasingly made aware by trial lawyers of the effect of taxes on damages and take them into account when determining the damages awarded to a plaintiff. It follows that rather than enforce court-ordered punishments, this new policy could lead juries to distort the value of awards.

## Conclusion

Ultimately, making punitive damages nondeductible will not create American jobs or end unseemly tax loopholes for corporations. Rather, it will increase taxation and cause businesses to cut jobs, decrease investments in research and development, scale back expansion plans, pass higher costs to consumers, and encourage the filing of even more lawsuits in a country where the cost of litigation and liability concerns is already much greater than in many other industrialized nations.

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25. Lawsuit Awards and Settlements,” <http://www.irs.gov/businesses/page/0,,id%3D7050,00.html#Award2> (last visited November 4, 2010).

26. *LeFleur v. Commissioner*, T.C. M. (RIA) 1997-312.

27. *Robinson v. Commissioner*, 102 T.C. 116 (1994); *Kightlinger v. Commissioner*, T.C. M. (RIA) 1998-357.

28. *Id.*

29. See Marcia Coyle, *Senate Moves to End Punitive Damages*, NATIONAL LAW JOURNAL, June 21, 2010, available at <http://www.law.com/jsp/article.jsp?id=1202462845366>.