The Tax Consequences of a Punitive Damages Award

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By Brock D. Phillips*

As punitive damages awards in civil litigation have grown in size and frequency,¹ the tax impact on the parties involved has become increasingly important. Two significant tax issues are presented by such awards: whether a business forced to pay a punitive damages award may deduct its payment as an ordinary and necessary business expense; and whether the recipient of such an award must include it in gross income. Both issues present tax practitioners with problems not soluble solely by reference to the Internal Revenue Code (Code or I.R.C.) and the regulations thereunder.

The deductibility issue has evaded precise resolution because punitive damages are not specifically addressed in the Code or regulations and because there has been no litigation directly addressing the issue. A number of early cases held that business litigation costs generally are deductible as ordinary and necessary expenses.² Other cases held that public policy precludes deduction of litigation expenses arising from illegal or immoral business activities.³ The deductibility issue accordingly could have turned on whether this public policy exception applied to a punitive damages award. In the Tax Reform Act of 1969,⁴ however, Congress limited the use of public policy as a basis for the denial of a deduction to specific situations delineated in section 162 of

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¹ DuBois, Punitive Damages in Personal Injury, Products Liability and Professional Malpractice Cases: Bonanza or Disaster, 43 INS. COUNSEL J. 344, 346 (1976).
² E.g., Lilly v. Commissioner, 343 U.S. 90 (1952); Commissioner v. Heininger, 320 U.S. 467 (1943); Kornhauser v. United States, 276 U.S. 145 (1928); Urquhart v. Commissioner, 215 F.2d 17 (3d Cir. 1954); Anderson v. Commissioner, 81 F.2d 457 (10th Cir. 1936); Howard v. Commissioner, 22 B.T.A. 375 (1931).
A punitive damages award assessed in civil litigation is not one of the proscribed deductions and hence should now be deductible. The early public policy exception to allowing deductions nevertheless continues to affect the deductibility of punitive damages payments; the Internal Revenue Service recently denied the deduction of such an expense apparently on the basis of public policy.

The taxability of a punitive damages award to the recipient appeared clearly resolved by the 1954 decision in Commissioner v. Glenshaw Glass Co., in which the Supreme Court held that such payments must be included in gross income. In 1975, however, Revenue Ruling 75-458 revived the issue by allowing the exclusion of punitive damages awarded on account of personal injury or sickness. Although tax writers in the tax field have recognized the importance of Revenue Ruling 75-45, it has received scant attention from the tax services. Consequently, the ruling could provide a serious trap for the unwary tax practitioner.

This Note examines the law in both of these areas. The Note first discusses the evolution of the public policy exception to the deductibility of business litigation expenses and the codification of the exception by Congress, concluding that punitive damages are not properly within its scope. Next, the propriety of allowing the deduction of punitive damages awards and the possibility of future attacks on such deductions on grounds other than public policy is analyzed. Turning to the excludibility of punitive damages awards, the Note considers the merits of Revenue Ruling 75-45 and argues that the ruling is a correct interpretation of the law and a sound application of the principles underlying the Internal Revenue Code. Finally, the types of actions properly within the scope of this exclusion are discussed.

Deductibility of Punitive Damages Awards

The deductibility of punitive damages payments arising out of civil litigation is not addressed in the Code or regulations, nor has it been directly litigated. As a general proposition, courts have considered all business-related litigation expenses, including the payment of

5. I.R.C. § 162(c) (bribes and illegal kickbacks), (f) (fines and penalties), (g) (antitrust treble damages).
judgments and settlements, to be deductible business expenses.\textsuperscript{11} The courts have recognized, however, an exception to the general rule and have held that public policy bars the deduction of litigation expenses arising from illegal or immoral conduct.\textsuperscript{12} Until 1978, no attempt had been made to apply the public policy exception to punitive damages. But in that year the Commissioner issued Private Letter Ruling 7816021,\textsuperscript{13} denying the deduction of a punitive award. Although no explicit reason was given for the denial, it may be inferred from the citations in the ruling that the decision was based on the public policy exception. An examination of the evolution and scope of the public policy exception to the deductibility of business litigation expenses reveals that despite this ruling punitive damages never were properly within its scope.

Evolution of the Public Policy Exception

\textit{Kornhauser v. United States}\textsuperscript{14} was the first major decision by the United States Supreme Court on the deductibility of litigation costs. In \textit{Kornhauser}, a taxpayer had expended $10,000 in attorney's fees defending a suit for accounting brought by a former partner. The Commissioner denied a deduction for the legal expense and the lower courts affirmed. The Supreme Court reversed and held that the expenditure was an ordinary and necessary business expense. The Court emphasized that when a suit is connected with or results from a taxpayer's business the litigation expenses are properly deductible.\textsuperscript{15}

The Board of Tax Appeals expanded the \textit{Kornhauser} doctrine by allowing deduction of the cost of an out-of-court settlement in \textit{Howard v. Commissioner},\textsuperscript{16} observing: "Though the \textit{Kornhauser} case involved only legal fees, we believe the reasoning employed applies equally to the compromise payment made to settle the lawsuit. This expense grew directly out of, and proximately resulted from, the business dealings between the parties."\textsuperscript{17} Five years later, in \textit{Anderson v. Commissioner},\textsuperscript{18} the Tenth Circuit further expanded the \textit{Kornhauser} doctrine by permit-

\begin{footnotesize}
\bibitem{note11} \textit{E.g.}, \textit{Kornhauser v. United States}, 276 U.S. 145 (1928); \textit{Ditmars v. Commissioner}, 302 F.2d 481 (2d Cir. 1962); \textit{Anderson v. Commissioner}, 81 F.2d 457 (10th Cir. 1936); \textit{Howard v. Commissioner}, 22 B.T.A. 375 (1931).
\bibitem{note13} \textit{I.R.S. Letter Rulings 7816021} (1978).
\bibitem{note14} 276 U.S. 145 (1928).
\bibitem{note15} \textit{Id.} at 153.
\bibitem{note16} 22 B.T.A. 375 (1931).
\bibitem{note17} \textit{Id.} at 378.
\bibitem{note18} 81 F.2d 457 (10th Cir. 1936).
\end{footnotesize}
ting deduction of the cost of a judgment. The court held that in light of Kornhauser a farmer was entitled to deduct the amount of a judgment against him arising from a collision which occurred when the farmer was driving to pick up a laborer.19

As a result of these cases, later courts generally were prepared to consider all business-related litigation expenses—including court costs, legal fees, and settlement and judgment payments—deductible as ordinary and necessary business expenses.20 The Court of Appeals for the Second Circuit summed up the rationale for this line of decisions:

What is ordinary is that the conduct of almost any trade or business will give rise to claims, many invalid but some valid; resisting such claims, paying judgments rendered on some, and settling others, is thus an “ordinary and necessary” expense of “carrying on any trade or business” within § 162.21

This doctrine has become an accepted element of current tax law; the general rule is still that all litigation expenses related to the conduct of a business are deductible.22

Throughout the development of this doctrine, the courts were developing a public policy exception to its application. Legal expenses that resulted from certain types of illegal conduct were held to be nondeductible on the ground that allowing the deduction would weaken the punitive effect of the laws involved and thus be contrary to the public interest.23 In Burroughs Building Material Co. v. Commissioner,24 the Second Circuit Court of Appeals refused to allow the deduction of either a fine levied against a corporate taxpayer for price fixing or the legal expenses incurred in defending against the fine. The deduction of the fine was disallowed because the court felt it was contrary to public policy to recognize these fines, “in any way beneficial to the taxpayer”;25 the deduction for attorney’s fees was disallowed as tainted by the nature of the litigation.26

Because of the philosophical nature of the public policy exception and the lack of statutory guidance, courts have had difficulty agreeing on its exact nature and scope. Only four years after Burroughs, in Helvering v. Hampton,27 the Ninth Circuit allowed the deduction of a judgment rendered for fraudulent cancellation of a lease. The court

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19. Id. at 459.
22. See [1979] 2 STAND. FED. TAX REP. (CCH) ¶ 1348.
24. 47 F.2d 178 (2d Cir. 1931).
25. Id. at 179.
26. Id. at 180.
27. 79 F.2d 358 (9th Cir. 1935).
distinguished the payment of a fine for a public offense from restitution for tortious conduct in a private transaction.\textsuperscript{28} This distinction is sound. The commission of a public offense, meaning a statutory violation, hardly gives rise to an ordinary and necessary expense because clearly prohibited criminal conduct is not properly within the scope of any business. Tort liability, on the other hand, can arise from a multitude of business or professional transactions that are a normal part of doing business. Liability may arise, for example, from an innocent mistake or the unsanctioned conduct of a subordinate. The possibility that such events may occur and give rise to legal expenses, including the payment of a judgment, is an ordinary risk of business life. The \textit{Hampton} court properly concluded that it would be "difficult to believe" that Congress expected the taxing officials to determine which settlements made for alleged business torts involved unethical conduct and should be denied a deduction.\textsuperscript{29} Thus, the logical place to draw the line for deductions is where the conduct is criminal.

The Supreme Court implicitly approved of the distinction between public offenses and private misconduct in \textit{Commissioner v. Heininger}.\textsuperscript{30} \textit{Heininger} involved the deductibility of attorney's fees and other legal expenses incurred by a dentist in resisting the issuance of a "fraud order" by the Postmaster General which had threatened the survival of his business. The Court allowed the deduction, stating that the allegations of fraud in no way made his defense any less "ordinary and necessary."\textsuperscript{31} The Court emphasized that "the mere fact that an expenditure bears a remote relation to an illegal act does not make it nondeductible."\textsuperscript{32} The only examples cited by the Court as proper applications of the doctrine were cases in which a statutory fine or penalty had been imposed or in which expenses had been incurred to exert undue influence on federal legislation.\textsuperscript{33} The Supreme Court's refusal to expand the doctrine in \textit{Heininger} and the Court's limited citation to proper applications of the doctrine—statutory fines and the purchasing of political influence—both evince a desire to limit the applicability of the public policy exception.

The Supreme Court spoke on the public policy exception for the second time in \textit{Lilly v. Commissioner}\textsuperscript{34} and again refused to expand the application of the exception. In \textit{Lilly}, the Court allowed the deduction of kickback payments, not illegal in themselves, made by opticians to

\textsuperscript{28} \textit{Id.} at 359-60.
\textsuperscript{29} \textit{Id.} at 360.
\textsuperscript{30} 320 U.S. 467 (1943).
\textsuperscript{31} \textit{Id.} at 472.
\textsuperscript{32} \textit{Id.} at 474.
\textsuperscript{33} \textit{Id.} at 473.
\textsuperscript{34} 343 U.S. 90 (1952).
doctors who referred patients to them. The Court noted that "[t]here is no statement in the Act, or in its accompanying regulations, prohibiting the deduction of ordinary and necessary business expenses on the ground that they violate or frustrate public policy."35 The Court further stated that if ordinary and necessary expenses are to be denied deduction they must "frustrate sharply defined national or state policies proscribing particular types of conduct,"36 and the "policies frustrated must be national or state policies evidenced by some governmental declaration of them."37 The clear intent of the Court in Lilly was to limit use of the public policy exception to instances in which a state or federal statute had been violated or the payment itself was illegal. The unanimous opinion confirmed and strengthened the circumscribed approach to the public policy exception expressed in Heininger.

Despite Heininger and Lilly, many tax courts continued to apply the public policy exception broadly,38 as exemplified by Faulk v. Commissioner.39 In Faulk, the tax court denied the deduction of the costs of a judgment rendered for presentation of false claims to the federal government on a milk supply contract and the attorney's fees incurred in fighting the charges. In an opinion rich in indignation the court asserted:

We cannot believe that payment of damages for fraud committed by a taxpayer against his Government where, as here, the fraud was knowingly, deliberately, and personally perpetrated by the taxpayer, can be claimed by him in a tax proceeding as either ordinary or necessary business expense.

Sound public policy would forbid such a deduction. The allowance of the instant deduction would frustrate the sharply defined national policy proscribing the conduct of knowingly presenting false claims to the Government. . . . Perpetration of fraud in the conduct of a business is neither ordinary nor necessary, and neither are the expenses resulting therefrom.40

The court went on to justify its denial of the deduction of attorney's fees by saying that such payments were in the same category as the penalty.41 The court distinguished Heininger, which had allowed a deduction for attorney's fees, on the grounds that in Heininger the tax-

35. Id. at 94.
36. Id. at 96 (quoting Commissioner v. Heininger, 320 U.S. 467, 473 (1943)) (emphasis omitted).
37. 343 U.S. at 97.
40. Id. at 950-51.
41. Id. at 952.
payers' survival as a business was threatened.\textsuperscript{42}

The \textit{Faulk} court's denial of the deduction for attorney's fees was severely out of step with the Supreme Court's decisions in \textit{Lilly} and \textit{Heininger}. \textit{Heininger} specifically allowed the deduction of attorney's fees in a fraud case and emphasized that simply because a normally deductible expense bears some relationship to an illegal act does not make that expense nondeductible.\textsuperscript{43} Moreover, the \textit{Faulk} court's refusal to allow the deduction of the fraud damages disregarded the Supreme Court's apparent attempts to limit the public policy exception to statutory violations.

Only two years after \textit{Faulk}, in the companion cases of \textit{Commissioner v. Sullivan}\textsuperscript{44} and \textit{Tank Truck Rentals, Inc. v. Commissioner},\textsuperscript{45} the Supreme Court reviewed its earlier decisions and reiterated the limitations on the public policy exception. In \textit{Sullivan}, the Court allowed an illegal gambling establishment to deduct its ordinary operating expenses. The Court stressed that taxation policy requires taxing a business on its net income, not its gross income, and that an exception to the taxing scheme is not warranted merely because the business is illegal.\textsuperscript{46} The Court commented that exceptions to the rule must be made by Congress, not by the courts.\textsuperscript{47}

The companion case, \textit{Tank Truck Rentals}, involved the deduction of fines paid by interstate truckers for truck weight violations. In denying deduction of the fines, the Court elaborated on the nature and scope of the public policy exception and reemphasized the limitations established in \textit{Heininger} and \textit{Lilly}.\textsuperscript{48} The Court stated that while a public policy exception does exist, its boundaries must be narrow to avoid conflict with the congressional intent to tax net income only.\textsuperscript{49} The level of "frustration of state policy" required to trigger the exception exists in two circumstances: (1) when the expenditure sought to be deducted is itself illegal; and (2) when the payment is a fine or penalty for a statutory violation.\textsuperscript{50} While the Court continued to advocate a flexible approach, both its insistence that the policy violated must be not merely a public policy, but rather a national or state policy evidenced by some governmental declaration, and its continued use of statutory fines and penalties or illegal expenditures as the only exam-

\textsuperscript{42} Id.
\textsuperscript{43} 320 U.S. at 474.
\textsuperscript{44} 356 U.S. 27 (1958).
\textsuperscript{45} 356 U.S. 30 (1958).
\textsuperscript{46} 356 U.S. at 29.
\textsuperscript{47} Id.
\textsuperscript{48} 356 U.S. at 34-35.
\textsuperscript{49} Id. at 35.
\textsuperscript{50} Id.
amples of proper applications of the exception, strongly suggest limiting the exception to these two situations.

The Supreme Court once again addressed the public policy issue in 1966 in *Commissioner v. Tellier*,\(^5\) its most forceful discussion of the public policy exception to date. In allowing the deduction of legal fees expended by a securities dealer who was convicted of violating various federal statutes the Court reemphasized the points previously made in *Heininger, Lilly, Sullivan,* and *Tank Truck Rentals*.\(^5\) The Court repeated that the income tax is a tax on net income, not a sanction against wrongdoing,\(^5\) and that exceptions to the rule allowing the deduction of all ordinary and necessary expenses must be legislative, not judicial, in all but the most limited circumstances.\(^5\) Accordingly, no judge or jury's concept of public policy is sufficient to invoke the exception; rather, only national or state policies evidenced by government declaration are sufficient.

Following *Tellier*, lower courts began to recognize the limitations on the scope of the public policy doctrine. In *Grossman & Sons Inc. v. Commissioner*,\(^5\) the tax court allowed deduction of a payment in settlement of a claim by the federal government for damages arising out of a fraudulent breach of contract. In reaching its decision the court chronicled the evolving restriction of the public policy exception, observing:

We feel that our position in the *Faulk* case must be reexamined in the light of the four or five cases decided by the Supreme Court since our decision in the *Faulk* case, which we believe tend to limit rather than expand the public policy concept and point up the fact that the lower courts appear to have been more prone in the past to rely on the public policy concept to disallow deductions than the Supreme Court.\(^5\)

As evidenced by the opinion in *Grossman*, the limited nature of the public policy exception finally may have been explicated often enough and with sufficient clarity to avoid future judicial confusion over its scope.

The development of the public policy exception thus makes clear that punitive damages awarded in civil litigation do not properly come within the scope of the exception. Early case law had established that litigation expenses, including attorney's fees, payment of the judgment itself, and settlement costs arising out of business activities are ordinary

\(^{52}\) Id. at 693-94.
\(^{53}\) Id. at 691.
\(^{54}\) Id. at 693-94.
\(^{55}\) 48 T.C. 15 (1967).
\(^{56}\) Id. at 31-32.
and necessary. The public policy exception to this general policy of deductibility was limited by the Supreme Court to only those situations in which the payment sought to be deducted was itself illegal or was a fine levied for a violation of an enunciated state or federal policy. A punitive damages award arising out of civil litigation does not fit into either category and thus, on this basis alone, should be deductible under the general rule applying to business litigation expenses.

Statutory Adoption of the Limited Public Policy Exception

In the Tax Reform Act of 1969, Congress ended its years of silence on the matter and enacted a statutory scheme that reflects the Supreme Court's narrow treatment of the public policy exception. Section 902 of the Act modified section 162 of the Internal Revenue Code by amending subsection (c) and by adding subsections (f) and (g). The Code now specifically forbids, on the basis of public policy, the deduction of fines or penalties paid to a government for the violation of any law, any portion of treble damages payments under the antitrust laws following a related criminal conviction, and bribes or kickbacks. The Senate committee that prepared the section noted: “The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions.” Congress thus strongly declared its intent to limit the application of the public policy exception, as the Supreme Court had been encouraging since Heininger.

In drafting the Revenue Act of 1971, Congress reaffirmed its desire to preempt judicial discretion in the application of the public policy exception. The committee report on section 310 of the Act, which

57. See, e.g., Lilly v. Commissioner, 343 U.S. 90 (1952); Commissioner v. Heininger, 320 U.S. 467 (1943); Kornhauser v. United States, 276 U.S. 145 (1928); Urquhart v. Commissioner, 215 F.2d 17 (3d Cir. 1954); Anderson v. Commissioner, 81 F.2d 457 (10th Cir. 1936); Howard v. Commissioner, 22 B.T.A. 375 (1931).


60. Id. § 902, 83 Stat. at 710, reprinted in 1969-3 C.B. 10, 147.

61. I.R.C. § 162(f).

62. Id. § 162(g).

63. Id. § 162(c).


67. Id. § 310, 85 Stat. at 525, reprinted in 1972-1 C.B. at 460-61.
modified and expanded the bribe and kickback provisions of I.R.C. section 162, declared: "The Committee continues to believe that the determination of when a deduction should be denied should remain under the control of Congress."\(^6\)

Congress' move to exercise exclusive control over the public policy exception was acknowledged by the Commissioner in Revenue Ruling 74-323.\(^6\) The ruling involved the deductibility of the cost of advertising which may have been in violation of the Civil Rights Act of 1964. In determining that the expenses were deductible, the Commissioner noted:

The legislative history of section 902 of the Tax Reform Act of 1969 discloses that an expenditure will be nondeductible under section 162 on public policy grounds only if it fits within one of the categories described in section 162(c), (f), or (g) of the Code. ... Thus, section 162(c), (f), and (g) obviates the necessity for determining whether particular trade or business expenditures violate sharply defined public policy by specifically stating what trade or business expenditures are nondeductible.\(^7\)

Moreover, a year later, in Treasury Decision 7345,\(^7\) the Commissioner amended section 1.162 of the regulations to acknowledge Congress' declarations on the public policy exception. This amendment provided that:

A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy. See section 162(c), (f), and (g) and the regulations thereunder.\(^8\)

The Commissioner thus has recognized the congressional intent to limit the scope of the public policy exception.

Congress has clearly delimited the scope of the public policy exception by codifying those circumstances to which it applies. All other ordinary and necessary business expenses are not to be denied as deductions on grounds of public policy. Punitive damages awarded in a civil suit are not one of the enumerated exceptions;\(^9\) accordingly, their deductibility should not be challenged.

Some Internal Revenue Service officers are either confused or unconvinced and would deny a deduction for the cost of a punitive damages award. In Private Ruling 7816021,\(^7\) a self-insuring medical


\(^{70}\) Id. at 40.

\(^{71}\) T.D. 7345, 1975-1 C.B. 51.


\(^{73}\) I.R.C. § 162(c), (f), (g).

\(^{74}\) I.R.S. Letter Rulings 7816021 (1978).
association was informed that judgments against it for malpractice were deductible only to the extent that the payments were compensatory:

As a general proposition, we acknowledge that malpractice judgments and attendant costs are for physicians, "ordinary and necessary" and hence deductible business expenses under section 162(a) of the Internal Revenue Code of 1954. . . . Regarding the amount of the judgment that may be deducted, it is deductible to the extent that it compensates the plaintiff for his injuries; i.e. penalties or punitive damages, specifically designated as such, would not be deductible. Code section 162(g), sections 1.162-21 and 1.162-22 of the Income Tax Regulations.75

Although the ruling is not explicitly based on the public policy exception, such a basis can be inferred from its reliance on section 162(g), relating to antitrust treble damages. In this light, the ruling is clearly contrary to the repeated actions of Congress, which the Commissioner twice acknowledged. The section of the Code that the drafter of the private ruling cites does not support denial of the deduction of punitive damages.76 Section 162(g) disallows deductions of the penalty portion of a treble damages antitrust payment imposed for conduct which previously resulted in a criminal conviction.77 While section 162(g) did evolve from the public policy exception, it bars only the deduction of the punitive damages specifically addressed and says nothing about other types of penalties. Apparently the extensive earlier case law approving the use of a public policy rationale to deny deductions not specifically denied by statute continues to be applied, despite Congress' attempt to delineate the narrow scope of the public policy doctrine and to eliminate judicial discretion in the area.

Analysis of Decision to Allow Deduction of Punitive Awards

Arguably, public policy should preclude the tax system from softening judicially imposed punishment. By allowing a deduction for the payment of a punitive damages award, the tax system mitigates the punitive effect such awards generally are designed to impose; the practical effect of allowing the deduction may radically decrease the net economic burden depending on the tax circumstances of the offender. Allowing such a tax break to a business that has committed an act warranting the imposition of punitive damages may well strike many as

75. Id. at 1-2.
76. Additionally, the drafter cites Hawkins v. Commissioner, 6 B.T.A. 1023 (1927), and Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). Neither of these cases supports the ruling. Both cases address the issue of whether damages received by a litigant are taxable income. Neither case directly or indirectly addresses the question of whether the payor of such damages may deduct them as an ordinary and necessary business expense.
77. I.R.C. § 162(g).
morally offensive. This Note contends, however, that allowing a deduction for punitive damages awards is consistent with current taxation policy. Traditionally, the income tax system has been viewed as having very narrow purposes. This view, long held by the Supreme Court, considers the tax system to be a method of collecting revenue, not a method of regulating morality. *Commissioner v. Sullivan,*78 in which the Supreme Court held that an illegal business is to be subject to the same tax treatment as any other business, was perhaps the clearest example of this approach. Application of the public policy exception within the constraints of this narrow philosophy dictates that deductions for related litigation costs be disallowed only when the expenses arise from actions in violation of an announced public policy which provided a clear warning of the loss of the deduction. Only the payment of statutory fines, antitrust treble damages connected with a criminal conviction, and illegal bribes and kickbacks are statutorily nondeductible.79 In each of these situations the guilty business can be charged with knowledge at the time of the violation that the payment or penalty is not deductible. Congress apparently has decided to eliminate the power of a judge or jury to deny a deduction based on policy grounds where such policy was not made clear to the taxpayer before the fact. This is entirely reasonable; punitive damages can be imposed for infinitely varied types of conduct and a taxpayer is entitled to know in advance what conduct will have adverse tax consequences.

Another reason that punitive damages payments should be deductible is that Congress has intentionally limited the denial of a deduction to situations in which the standard of proof is higher than that of a normal civil trial. This was stressed in the Senate Report on the Tax Reform Act of 1969.80 This report noted that fines and penalties are not deductible only when imposed as a result of a criminal conviction, which requires an elevated standard of proof.81 With regard to the nondeductibility of portions of an antitrust judgment, the report noted:

> The deduction is denied in these cases (as well as in the case of bribes and kickbacks described below) only where there has been a criminal conviction (or plea of guilty or nolo contendere) in a related case. This means that the deduction is to be denied only in the case of "hard-core violations" where intent has been clearly proved in a

79. I.R.C. § 162(c), (f), (g).
The bribes and kickbacks referred to above as requiring a criminal conviction before a deduction can be denied are bribes and kickbacks to other than governmental officials and employees. The only situation in which a deduction for illegal bribes and kickbacks may be denied without a criminal conviction is where such payments are made to government officials and employees. This exception is based on the rationale that illegal payments to government officials are "sufficiently contrary to public policy as not to require the denial of the deduction to be preceded by the criminal conviction."

For bribes paid to foreign officials, the Treasury Department must meet a burden of "clear and convincing evidence" in showing the illegality of the payment. The requirement of an elevated standard of proof—almost uniformly a criminal standard—in combination with the limited purposes of tax law as a revenue producing system leads to the conclusion that punitive damages awards should be deductible legal expenses like almost all other litigation costs.

Possible Future Attacks on Deduction of Punitive Damages Awards

Looking to the future, the question becomes whether the Commissioner and the lower courts will accept the deductibility of punitive damages awards. The many cases denying deductions on the basis of public policy demonstrate the reluctance of the lower courts and the Commissioner to allow a deduction for any "offensive" conduct. The most likely tool which might be used to deny such deductions is the basic requirement under Internal Revenue Code section 162 that business expenses must be ordinary and necessary to be deducted. Arguably, payment of a punitive damages award, linked as it must be to reckless or intentional misconduct, should not be considered an ordinary and necessary expense of doing business. Although there is no indication that this approach has been tried, it seems to present a possible avenue for barring deduction of punitive damages payments.

The requirement that a deductible business expense be ordinary and necessary, however, should not be sufficient grounds to deny such a

85. Id.
87. I.R.C. § 162(a) states: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."
deduction. While early case law established that payment of a judgment is ordinary and necessary, punitive damages awards received virtually no scrutiny. In Helvering v. Hampton,88 however, the Ninth Circuit Court of Appeals commented: "We cannot agree that private wrongdoing in the course of business is extraordinary within the meaning of the statute allowing deductions for 'ordinary and necessary expenses'."89 This appears to be the only language that conceivably addresses the question of whether punitive damages might be ordinary and necessary expenses. This language hardly can be considered conclusive; the court gave no indication that it even had considered the punitive damages issue. Perhaps the lower courts, in their haste to attack litigation expenses tainted by improper conduct as a violation of public policy, simply made no attempt to assess the expenses under the ordinary and necessary test.

The payment of a court-ordered damages award is certainly necessary,90 in the sense that it is judicially compelled, regardless of whether the award is punitive or compensatory. Consequently, any attack on the deductibility of punitive awards likely will concentrate on whether or not such a payment is ordinary. Current judicial interpretations of "ordinary" suggest that such payments likely will not be deemed extraordinary by the courts. In Welch v. Helvering,91 the leading case on the meaning of the term, the Supreme Court emphasized that the event giving rise to the expense need not be common in the life of a single business, but that it need only be an occurrence of a type known in the general business community as a whole.92 More recently, in Commissioner v. Tellier,93 the Court noted that the principal purpose of the "ordinary" test of section 162 is to distinguish between expenditures that are deductible currently as expenses and those that are in the nature of capital expenditures and which must be amortized.94 The payment of a punitive damages award easily satisfies both the Welch and the Tellier tests of an ordinary expense. Such payments certainly are known and experienced in the general business community, and they are definitely not capital expenditures that must be amortized. Hence, punitive damages payments should be considered both ordinary and necessary under section 162.

88. 79 F.2d 358 (9th Cir. 1935).
89. Id. at 360-61.
90. See note 11 & accompanying text supra.
91. 290 U.S. 111 (1933).
92. Id. at 113-14.
94. 383 U.S. at 689-90.
The evolution of the law on the taxability of punitive awards is considerably more straightforward than the law on the deductibility of such payments. Indeed, until recently there would have been no need for any discussion of the matter because the law seemed to have been settled by the Supreme Court over twenty years ago. In Commissioner v. Glenshaw Glass Co. the Supreme Court held that punitive damages were taxable income to the recipient. Chief Justice Warren reasoned that punitive damages were

undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. . . . It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury. And we find no such evidence of intent to exempt these payments.

The Glenshaw Glass ruling was incorporated in the regulations under the Code and remained unquestioned for twenty-one years.

In 1975, however, in Revenue Ruling 75-45, the Commissioner revived the question of the excludibility of punitive damages. The specific issue considered in the ruling was whether an amount received by the estate of a deceased employee under his employer's aircraft liability policy could be excluded from gross income. The policy payment was contingent upon a full release from all claims which were considered punitive, including payments arising under the local wrongful death statute. The ruling focused on section 104(a)(2) of the Code, which excludes from gross income any damages received on account of personal injuries or sickness, and concluded that punitive damages come within this exclusion:

Section 104 of the Code is a specific statutory exclusion from gross income within the "except as otherwise provided" clause of section 61(a). Section 104(a)(2) excludes from gross income "the amount of

95. 348 U.S. 426 (1955).
96. Id. at 431.
97. Treas. Reg. § 1.61-14(a) (1960) provides in part: "In addition to the items enumerated in section 61(a), there are many other kinds of gross income. For example, punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income."
99. I.R.C. § 104(a)(2) states in part: "Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include . . . the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness . . . ."
any damages received (whether by suit or agreement) on account of personal injuries or sickness". Therefore, under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income.\(^{100}\)

The impact of the ruling was to bifurcate the tax treatment of punitive damages. Under the ruling, section 104(a)(2) operates to exclude from gross income punitive damages arising out of personal injuries or sickness. Under *Glenshaw Glass*, all other punitive damages are included in gross income. Since publication of the ruling in 1975, the issue, not surprisingly, has not been litigated. No taxpayer would have reason to challenge the Commissioner’s willingness to grant an exclusion where none existed before.

Arguably, the language of section 104 does not warrant its extension to punitive damages. The section provides that “gross income does not include . . . the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness.”\(^{101}\) The statute does not specifically mention punitive damages as within its scope. Since its enactment in 1918, the statute’s substantive language has remained essentially the same,\(^{102}\) and until 1975 no court or Commissioner had seen fit to declare that section 104 encompassed punitive damages. Moreover, there is nothing in the legislative history that indicates whether the provision was intended to embrace punitive as well as compensatory damages.\(^{103}\) Nor are the regulations of any definitive assistance, providing only that “[t]he term ‘damages received (whether by suit or agreement) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.’”\(^{104}\) Thus, the Commissioner’s interpretation is not compelled by either the language or the history of section 104.

The Commissioner’s interpretation, however, can be supported by

\(^{100}\) Rev. Rul. 75-45, 1975-1 C.B. 47, 47 (emphasis in original).

\(^{101}\) I.R.C. § 104(a).

\(^{102}\) The 1918 statute provided that gross income did not include “[a]mounts received, through accident or health insurance or under workmen’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.” Revenue Act of 1918, Pub. L. No. 254, § 213(b)(6), 40 Stat. 1057 (1919). This section was redesignated in 1928, Revenue Act of 1928, Pub. L. No. 562, § 22(b)(5), 45 Stat. 791 (1928), and again in 1954 when it was divided into multiple sections with the portion applying to damages received being designated § 104(a)(2). Internal Revenue Code of 1954, Pub. L. No. 591, § 104(a)(2), 68A Stat. 1, 30 (1954).

\(^{103}\) See J. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1961 at 909 (1938).

\(^{104}\) Treas. Reg. § 1.104-1(c) (1960).
a literal reading of the section’s language. Although the status of punitive awards arising out of personal injuries is not addressed specifically in either the Code or the regulations, the language of section 104 is very broad, exempting “any damages.” The phrase could encompass punitive as well as compensatory damages. In the absence of any indication of a congressional intent to limit the scope of the section to compensatory damages, the Commissioner’s interpretation seems to be within the spirit of the generally broad language of the section. The fact that no one previously recognized the potential application of this language should not detract from the soundness of the Commissioner’s belated acknowledgement of its applicability to a punitive damages award. Nor is the ruling necessarily inconsistent with Glenshaw Glass, in which the court ruled that punitive damages had to be included in gross income “in recognition of the intention of Congress to tax all gains except those specifically exempted.” Indeed, the Commissioner merely concluded that punitive damages fall within the specific exclusionary language of section 104.

Whether excluding punitive damages from gross income is sound tax policy is another matter. A number of arguments suggest that such damages should not be excluded. The general principle that underlies the income tax is that all new wealth is taxed. Generally, only income that is a return of previously invested capital, and therefore not new wealth, is allowed to escape taxation. Under this standard, a punitive damages award should be taxed. Typically, compensatory damages serve to reimburse victims for losses suffered; punitive damages, on the other hand, often serve no purpose other than to punish wrongdoers. Taxing a punitive award that is not in fact compensatory places no unwarranted economic burden on the recipient. The award is not intended to fulfill any needs of the victim, who presumably has been fully compensated.

The arguments in favor of allowing the exclusion of a punitive damages award are essentially twofold. The primary argument is that the general proposition that all new wealth should be taxed is not always followed nor should it be. In fact, Congress has found it desirable to make exceptions to this basic proposition to benefit taxpayers in difficult or special circumstances.

A well known example of these exceptions is the exclusion granted for life insurance payments received upon the death of an insured under section 101 of the Code. Receipt of life insurance proceeds is certainly income, yet Congress has decided that it should not be taxed.

105. I.R.C. § 104(a)(2).
106. 348 U.S. at 430.
The reason presumably is to assist the beneficiary in a time of personal and economic hardship. Similarly, section 105 excludes from gross income amounts received under accident and health plans. \textsuperscript{109} Under the general rule, the amount of such a payment normally would be taxable to the extent it exceeded the cost of the premiums. But Congress chose to temper the general policy and allow an exception for a taxpayer victimized by illness or injury. The Code contains numerous other examples of exclusions and deductions that create exceptions to the general rule which are in favor of a taxpayer perceived to need or deserve special relief. \textsuperscript{110}

Allowing the exclusion of all damages, including punitive damages, on account of personal injuries or sickness is entirely consistent with the policy of providing tax relief for someone who has suffered special misfortune. Courts have recognized that the congressional purpose in creating the various exclusions of section 104 was to provide relief otherwise unavailable for "'a taxpayer who has the misfortune to become ill or injured.'"\textsuperscript{111} This purpose is served by excluding punitive damages as well as compensatory damages. Lost wages recovered in a compensatory award represent income which would have been taxed had the accident not occurred. In addition, damages for pain and suffering or emotional distress are clearly new wealth and would be taxable under the general rule; yet these payments have always been sheltered from taxation under section 104. The exclusion of punitive damages accomplishes exactly the same goal as the exclusion of these other damages—to provide special tax relief to the victim of tortious conduct. The relief applies to all damages awarded, regardless of whether they constitute new wealth. The argument that allowing the exclusion of punitive damages received on account of personal injuries is inappropriate because it is inconsistent with the general principle of taxing all new wealth thus ignores the many other exceptions to this principle in favor of unfortunate taxpayers.

The second reason for allowing the exclusion of punitive damages is that many states consider them to be additional compensation for the victim,\textsuperscript{112} often in lieu of compensation for emotional distress. It would

\textsuperscript{109} I.R.C. § 105.

\textsuperscript{110} E.g., I.R.C. §§ 117 (exclusion of scholarships and fellowship grants), 121 (exclusion of gain from sale or exchange of residence by individual over 55), 151(d) (additional exemption for blindness), 213 (deductions for medical, dental, and like expenses), 217 (deductions for moving expenses), 219 (special deductions for certain types of retirement savings).

\textsuperscript{111} Huddell v. Levin, 395 F. Supp. 64, 87 (D.N.J. 1975) (quoting Epmeier v. United States, 199 F.2d 508, 511 (7th Cir. 1952)).

\textsuperscript{112} States which have found punitive damages to be at least in part compensatory include Arkansas, South Farm Bureau Cas. Ins. Co. v. Daniel, 246 Ark. 849, 440 S.W.2d 582 (1969); Georgia, Wright v. Hollywood Cemetery Corp., 112 Ga. 884, 38 S.E. 94 (1901); Iowa, Brause v. Brause, 190 Iowa 329, 177 N.W. 65 (1920); Kentucky, Louisville & N.R. Co. v.
be difficult to justify granting or denying the exclusion for damages intended to compensate for emotional suffering simply because one state considers such damages compensatory and another state considers them punitive. In sum, the arguments in favor of granting an exclusion for punitive damages are stronger than those against. While exclusion of punitive awards is an exception to the general rule of taxing all new wealth, it is a justifiable exception created by Congress as one of several provisions designed to provide relief for a taxpayer who has suffered a catastrophic loss. Many states recognize the compensatory aspects of a punitive award. It would be inequitable to disallow exclusion merely because a court labels an award "punitive" when another state would label the award "compensatory."

A final area of concern is the type of actions to which Revenue Ruling 75-45 applies. Section 1.104-1(c) of the regulations defines section 104(a)(2) as encompassing amounts received as a result of "a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." While recoveries for physical injuries undoubtedly are covered by the section, recoveries based on mental or emotional injuries are not so obviously covered.

There is a split in the law over whether the term "personal injury" includes nonphysical injuries. The basic definition limits the term to injuries to the body. But many courts and statutes have expanded the definition to include all actionable injuries to the individual, as distinguished from injuries to property. Under this approach, "personal injury" may include injury affecting the reputation, character, or

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Ritchel, 148 Ky. 701, 147 S.W. 411 (1912); Louisiana, Loeblich v. Garnier, 113 So.2d 95 (La. Ct. App. 1959); Michigan, Tenhopen v. Walker, 96 Mich. 236, 55 N.W. 657 (1893); Missouri, Beck v. Dowell, 111 Mo. 506, 20 S.W. 209 (1892); New Hampshire, Vratsenes v. N.H. Auto, Inc., 112 N.H. 71, 289 A.2d 66 (1969); Utah, Palombi v. D & C Builders, 22 Utah 2d 297, 452 P.2d 325 (1969). These states either do not allow damages for emotional distress or simply recognize that the victim of an intentional tort is entitled to additional compensation based on the nature of the wrong suffered. This suggests a belief that ordinary compensatory damages cannot really make the victim whole. The Michigan Supreme Court commented in Tenhopen: "Usually, where an act is done with design, and from willful and malicious motives, the law compels full compensation, and full compensation may not be awarded by the payment of the actual value. Damages in excess of the real injury are never appropriate where the injury has proceeded from misfortune, rather than from any blamable act; but, where the act or trespass complained of arises from willful and malicious conduct, exemplary damages are recoverable. These damages are not awarded as a punishment to the wrong-doer, but to compensate the injured party." 96 Mich. at 240, 55 N.W. at 658.

conduct of a person.\textsuperscript{116} The issue has not been directly addressed in tax litigation. In \textit{Seay v. Commissioner},\textsuperscript{117} the tax court was asked to consider the exclusion of damages for "embarrassment." Although the court observed that both the courts and the Commissioner "have long recognized that amounts received in settlement of claims arising out of the alienation of affection or defamation of character are exempt from taxation,"\textsuperscript{118} it specifically refused to consider the exclusion of damages levied purely for embarrassment.\textsuperscript{119} The court held, however, that damages for embarrassment were excludable if incidental to otherwise excludable personal injury damages.\textsuperscript{120} The approach of the \textit{Seay} court was correct and should be followed even when the sole injury is nonphysical. There is no sound reason not to recognize mental or emotional injuries under section 104(a)(2). Certainly tort law has long since recognized the significance of nonphysical injuries. Accordingly, the Internal Revenue Code should be interpreted as having adopted the more expansive definition of personal injury to protect awards for all injuries to the person, both mental and physical.

\textbf{Conclusion}

Some uncertainties still exist regarding the deductibility and excludibility of punitive damages award. Nevertheless, proper interpretation of recent events should clarify the general area. The payor of a punitive damages award should be entitled to deduct the cost of the award so long as the litigation arises out of business activity and the deduction is not specifically forbidden by section 162 of the Code. The recipient of the award should be permitted to exclude it from gross income only if it arises out of a personal injury or sickness. Otherwise, the award should be included in gross income and taxed like other gain.

\textsuperscript{849} (1906); Tisdale v. Eubanks, 180 N.C. 153, 104 S.E. 339 (1920); Morton v. Western Union Tel. Co., 130 N.C. 299, 41 S.E. 484 (1902).
\textsuperscript{116} See cases cited note 115 \textit{supra}.
\textsuperscript{117} 58 T.C. 32 (1972).
\textsuperscript{118} \textit{Id.} at 40.
\textsuperscript{119} \textit{Id.}
\textsuperscript{120} \textit{Id.}