



DENIAL OF FEDERAL TAX DEDUCTION FOR PUNITIVE DAMAGES THREATENS JOB GROWTH

by

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Slipped into the Obama Administration's 2010 revenue raising proposal is a provision which threatens to upend long-standing tax law and the dynamics of litigation by abolishing the current deduction for punitive damages payments. *See* General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, Dept. of Treasury, May 2009, at 117, at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>. For over two decades, a deduction has been allowed for damages paid or incurred as ordinary and necessary expenses in carrying on a trade or business, regardless of whether such damages were compensatory or punitive in nature.

Under the plan, no deduction would be allowed for any amount paid or incurred for punitive damages, whether upon a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, such damages paid or incurred by the insurer would be included in the gross income of the insured person or entity. The insurer would be required to report such payments to the insured person and to the Internal Revenue Service. These changes would apply to punitive damages paid or incurred after December 31, 2010.

Similar changes to the tax code have been introduced in prior sessions of Congress, but none have gained final approval. Now, however, the federal government's increased need for revenue and the Administration's support for the current proposal may give the change some traction.

Plaintiffs' lawyers would likely use the threat of unpredictable punitive damages, coupled with the new tax liability, to force early settlement of civil actions. This may occur because an amount paid in settlement, however unwarranted, could be deducted as a business expense, but a punitive damages payment would come off the "bottom line." Defendants would need to factor the tax implications of any potential punitive damages award into their calculus in deciding whether to take a case to trial.

Furthermore, businesses recently hit with a punitive damages verdict may effectively lose their right to appeal and be forced into extortionate settlements. There would be pressure on defendants to settle and forego appeals that could result in punitive damages payments being made on or after December 31, 2010.

Those favoring the proposal may argue that a change in the tax code is warranted because punitive damages are akin to criminal fines, which are currently not deductible. This assumption fails

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the “fact test” in four fundamental ways.

First, the activities for which criminal fines are imposed are statutorily defined with at least some degree of precision. By way of contrast, punitive damages are awarded under vague and unpredictable standards that have been substantially weakened over the past thirty years. For example, very few states now require proof of actual malice before punitive damages can be awarded. In the vast majority of states, punitive damages can be awarded for lesser conduct, such as if the defendant acted in a reckless or wanton fashion or was grossly negligent.

Second, criminal constitutional law decisions by the United States Supreme Court hold that criminal liability must be proven “beyond a reasonable doubt.” Only one state, Colorado, requires punitive damages liability to be proven by this standard. Punitive damages may be awarded in many jurisdictions by a mere “preponderance of the evidence.” Most states set a level of proof below the criminal standard but above the ordinary civil preponderance of the evidence standard (i.e., “clear and convincing evidence”).

Third, criminal fines are fixed and set in proportion to the offense so that the punishment fits the crime. For example, violators of federal antitrust laws are subject to treble damages. In most states, however, the sky is the limit on punitive damages unless a judge decides that the amount awarded shocks the conscience or violates broad due process limitations.

Fourth, criminal defendants are not subject to double jeopardy. By way of contrast, in most states, civil defendants can be subjected to repeated punitive damages judgments for the same act or course of conduct.

Changes to the deduction should only be made if punitive damages defendants are afforded the same basic protections that generally apply to criminal defendants:

- Actual malice should be required to support a punitive damages award;
- Punitive damages liability should be based on proof beyond a reasonable doubt;
- There should be clear statutory limits to ensure that any punitive damages award is proportional to the plaintiff’s actual harm; and
- Punitive damages should only be imposed once for the same act or course of conduct.

If a federal reform of punitive damages encompassing each of the four basic protections available to criminal defendants were adopted, then it may be fair and reasonable to discuss whether punitive damages payments should be deductible from taxable income. Until that time, however, the denial of a tax deduction for punitive damages payments would be premature and unsound, and negatively impact job creation and investment.