Federal Tax Deduction for Punitive Damage Payments Comes Under Fire

by

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Slipped into the Senate Finance Committee’s “Jumpstart Our Business Strength (JOBS) Act,” S. 1637, is a provision that has important ramifications for corporate defendants and the civil justice system. The JOBS Act predominately deals with changes in tax laws and the simplification of international tax rules. But, an overlooked section of the bill actually abolishes tax deductions for punitive damages payments; it is directly counter to the general purpose of the bill, which is to stimulate jobs and economic growth through selective tax incentives. The bill reported out of the Finance Committee provides: “No 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.” (S. 1637, Sec. 424 (a)). Additionally, Sec. 424(b) of the bill provides that “[g]ross income shall include any amount paid to or on behalf of a taxpayer as insurance or otherwise by reason of the taxpayer’s liability (or agreement) to pay punitive damages.”

For at least 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. The disallowance of a deduction for punitive damages in the JOBS Act would overturn this longstanding policy.

Trial lawyers would likely use the threat of unpredictable punitive damages, coupled with the JOBS Act’s 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 to take a case to trial.

Proponents for the denial of a deduction for punitive damages payments may believe 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 the “fact test” in four fundamental ways.

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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 that falls 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 the punishment must fit the crime. For example, violators of federal antitrust laws are subject to treble damages. In the vast majority of 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.

As long as unpredictable punitive damages can be awarded, without proof beyond a reasonable doubt of intentional misconduct, and without any statutory protections against excessive or repetitive punishment, the tax deduction for punitive damages payments is justified. If Congress is going to remove that deduction, it should do so only if it provides punitive damages defendants with the same basic protections that apply to defendants in criminal fine cases:

• 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, the denial of a tax deduction for punitive damages payments would be premature and unsound.