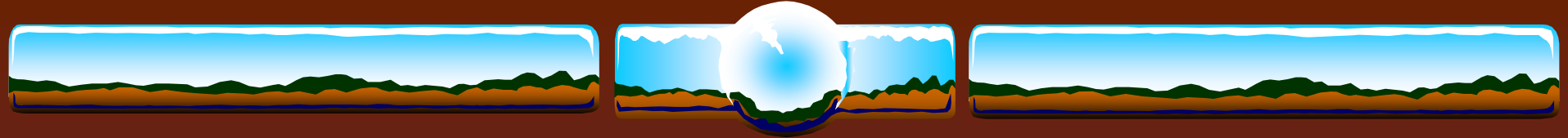


Federal Taxation of Punitive Damages

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26 USC § 61(a)

- ❖ Except as otherwise provided in the Internal Revenue Code, gross income means all income from whatever source derived.



26 USC § 104(a)(2)

- ❖ Gross income does not include the amount of any damages (*other than punitive damages*) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries or *physical* sickness.

P.L. 104-188, Sec. 1605(a)-(c), the Small Business Job Protection Act of 1996, added the reference to punitive damages and twice inserted the word “physical.”



IRS Position Has Been Inconsistent

- ❖ Rev Rul 58-418: Punitive damages do not qualify for exclusion under IRC § 104(a)(2)
- ❖ Rev Rul 75-45: Punitive damages are excludable
- ❖ Rev Rul 84-108: Addressing Alabama wrongful death statute (the only recovery is as punitive damages), IRS ruled that punitive damages were again taxable



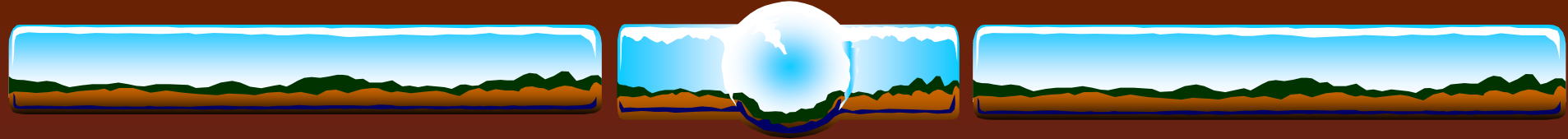
Courts Also Were Inconsistent

- ❖ *Burford v. U.S.*, 642 F. Supp. 635 (N.D. Ala. 1986), disagrees with Rev Rul 75-45
- ❖ *Comm. v. Schleier*, 515 U.S. 323 (1995), U.S. Supreme Court, in a non-physical injury employment discrimination case, held that there are two independent tests for a section 104(a)(2) exclusion:
 - 1. Underlying cause must be based on tort or tort-type rights
 - 2. Damages must “have been received on account of personal injuries or sickness”



Supreme Court and Congress Settle Issue

- ❖ *O’Gilvie v. U.S.*, 95-2 U.S.T.C., ¶50,508, 66 F.3d 1550 (10th Cir. 1995), 519 U.S. 79 (1996), applied *Schleier* to case involving wrongful death, holding that punitive damages are taxable in personal injury cases.
- ❖ P.L. 104-188, the Small Business Job Protection Act of 1996, Section 1605(d), essentially codified *O’Gilvie*, amending 26 USC § 104(a)(2)



Rule: **Punitive damages are taxable**

“Alabama Rule” makes an exception in any state where the only recovery for wrongful death is as punitive damages



Reasons for Change

“Punitive damages are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering. Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income.”

House Rpt 104-586 to accompany H.R. 3448, Small Business Job Protection Act of 1996



Effects of the Rule

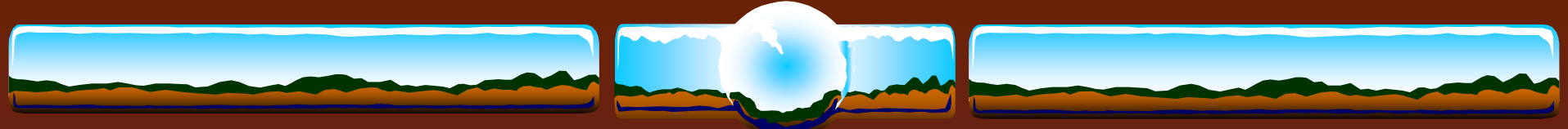
- ❖ Punitive damages are taxable to plaintiff
- ❖ Attorney contingent fees are first taxed to plaintiff, then to the attorney in all taxable damage cases
 - See *Comm. v. Banks*, 125 S. Ct. 1025 (2005)
- ❖ Plaintiff may not take above-the-line deduction for attorney fees; below-the-line deduction is subject to 2% floor and overall deduction limit
 - IRS allows deduction of attorney fees allocable to a state's share of punitive damages, Chief Counsel Advice 200246003
- ❖ Alternative minimum tax (AMT) may apply, meaning no below-the-line deduction at all



*Paula Jones v. Bill Clinton**

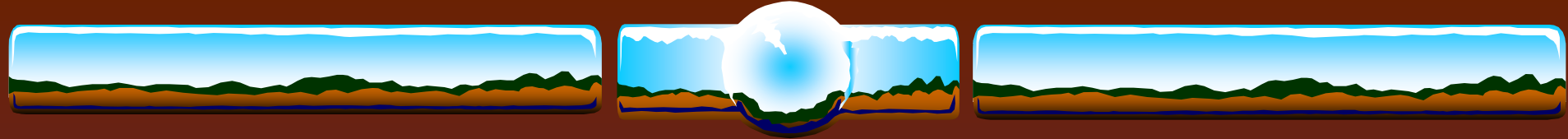
- Obtained taxable settlement of \$850,000
- Incurred attorneys' fees of almost \$650,000
- With deduction, she keeps \$200,000, paying regular taxes of \$72,000, leaving her \$128,000
- If AMT applies, liability on the whole \$850,000 is about \$238,000 and she has only \$200,000 with which to pay it
- She would owe IRS **\$38,000**

*This is mere conjecture by one law professor, as her tax return is private



The American Jobs Creation Act of 2004, P.L. 108-357, provides relief of double taxation of attorney fees in Civil Rights cases, leaving contingent attorney fees double taxed for:

- Defamation
- False imprisonment
- Negligent infliction of emotional distress
- Abuse of legal process
- Property rights
- Insurance bad faith
- Invasion of privacy
- Contractual relations litigation
- Punitive damages



Plaintiff may wind up owing IRS!