REPORT ON THE DEDUCTIBILITY OF PUNITIVE DAMAGES*

In 1999, and again in 2000, the Clinton Administration Budget Proposal for Fiscal Years 2000 and 2001, respectively, included a legislative proposal (the "Proposal") to disallow any deduction for punitive damages paid or incurred by a taxpayer, whether upon a judgment or settlement of a claim. The Proposal would have applied to damages paid or incurred on or after enactment. Where the liability for punitive damages is covered by insurance, the damages paid by the insurer would have been includible in the gross income of the insured person and the insurer would have been required to report the payments to the Internal Revenue Service (the "Service"). Although the Proposal did not see the light of day in the 106th Congress, and is not part of the current Administration's Budget Proposal for Fiscal Year 2002, we offer the following comments to supplement the analysis of the Proposal offered by the Joint Committee on Taxation,[1] and to advance the discussion of the issues if and when the Proposal or a variant thereof is presented for future consideration.

The Proposal was advanced on the grounds that the current deductibility of punitive damages "undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities."[2] The brief Joint Committee on Taxation's analysis of the issues raised by the Proposal explains that those who favor the proposal also note that the determination of the amount of punitive damages generally can be made by reference to the pleadings and that the determination already is made by plaintiffs to ascertain the taxable portion of any payment. Proposal opponents argue that a deduction should be allowed for all ordinary and necessary expenses incurred by a taxpayer in carrying on its trade or business and that determination of the amount of punitive damages will be difficult in many cases, especially where the payment arises from a claim settlement.[3]

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[1] Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal, JCS-2-00 at 403-405 (March 6, 2000).

[2] Office of Management and Budget, Analytical Perspectives, Budget of the United States for Fiscal Year 2001 at 76 (2000).

[3] Joint Committee on Taxation, *supra* n.1, at 404.

Two simple examples illustrate the tension between the Proposal's proponents and opponents:

Suppose a commercial truck owned and operated by X Corporation speeds through Times Square at 75 miles per hour at 2 p.m. on a Matinee Wednesday, hits a number of tourists and causes them great injury. The driver of the truck is fined $500 for his misconduct, which fine we know is not deductible by anyone. The injured tourists sue X Corporation and recover $500,000 in actual damages and $10 million in punitive damages. Should X Corporation, which did not countenance the driver's misconduct but is nonetheless liable for the full $10.5 million in damages, not be allowed to deduct its payment, even though that payment undisputedly arose in the course of its business and reduced its net income by that amount? The aggravated circumstances described tend to favor the "sting" proponents, who argue the punishment element of punitive damages should not be ameliorated by a 35% tax saving.

By contrast, assume a case where the medical doctor made a mistaken diagnosis -- ordinary malpractice negligence – and the jury for reasons known only to it returns a verdict of $10,000 actual damages and $2 million in punitive damages. We have been advised that in some states, juries routinely add punitive damages to a majority of their tort verdicts. In these circumstances, the imposition of punitive damages where no aggregated wrongful conduct is being judged seems an inappropriate distortion of true income, *i.e.,* the imposition of a Federal tax sting on top of the awarded damages to the plaintiff.

The Report proceeds as follows: Part I provides necessary background information regarding the deductibility of punitive damages under current law and the controversy surrounding the award of punitive damages with a focus on the underlying premises for awarding punitive damages, the constitutional guideposts applicable to the imposition of punitive damages, and the substantial criticism of the regime. Part II examines the arguments in favor of and against the Proposal.

PART I. BACKGROUND

A. Tax Treatment of Punitive Damages

Prior to the Tax Reform Act of 1969, the Internal Revenue Service and the courts had struggled with the application of the public policy exception to deny a deduction for certain expenses incurred by taxpayers in the pursuit of business or income-producing activities. In *Tank Truck Rentals, Inc. v. Commissioner*, the Supreme Court denied the deduction of fines paid by a trucking company for intentionally violating state highway weight laws.[4] The Court noted the fines had been imposed under penal statutes intended to be punitive, rather than remedial, that state policy would be frustrated by reducing the "sting" of the penalty, and that the allowance of a deduction would encourage violations of "declared public

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[4] 356 U.S. 30 (1958).

policy."[5]

The Supreme Court has applied public policy exception sparingly; the Court, for example allowed the deduction of legal fees in resisting a fraud order by the Postmaster General, noting that an expense is not rendered nondeductible merely because it bears a remote relation to an illegal act.[6] The Court also has allowed the deduction of kickback payments as ordinary and necessary business expenses where the kickbacks were not themselves illegal, pointing out that the public policy exception requires frustration of sharply defined national or state policies that proscribe particular types of conduct.[7] In *Commissioner v. Sullivan*, the Court allowed an illegally operated gambling establishment to deduct its ordinary operating expenses.[8] The illegal nature of the business was not sufficient to warrant an exception to the policy of taxing net, rather than gross, income. Finally, in *Commissioner v. Tellier*, the Supreme Court allowed the deduction of legal fees incurred by a securities dealer who had been convicted of securities fraud, repeating that the Federal income tax is a tax on net income and not a sanction against wrongdoing.[9]

Read together, the cases stand for the proposition that the public policy income tax deduction exception applies to expenses incurred for punishment on account of a violation of some governmental declaration of policy but not to expenses incurred in conducting a business, even if the business is illegal or the payments border on the unethical.[10] Notwithstanding the Supreme Court's pronouncements, confusion and inconsistency in treatment reigned as lower courts struggled with the application of the public policy doctrine.[11]

Against this backdrop, Congress, in 1969, adopted the current law provisions dealing with fines and penalties, unlawful bribes and other illegal payments, and a portion of treble damages paid under the antitrust laws.[12] Under present law, no deduction is allowed for a

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5 *Id.* at 35-36.

6 *Comm'r v. Heininger,* 320 U.S. 467 (1943).

7 *Lilly v. Comm'r*, 343 U.S. 90 (1952).

8 356 U.S. 27 (1958).

9 383 U.S. 687, 691 (1966).

10 Kimberly A. Pace, "The Tax Deductibility of Punitive Damages: Who Should Ultimately Bear the Burden of Corporate Misconduct?" 47 Ala. L. Rev. 826, 832-833 (1996) (suggesting also that the Court's analysis is based on concepts of federalism, *i.e.*, the Code should not frustrate clearly defined and articulated state policies because "deterring and enticing human behavior is the essence of the state's police powers").

11 John Y. Taggart, Fines, "Penalties Bribes and Damage Payments and Recoveries," 25 Tax L. Rev. 611 (1970); George G. Tyler, "Disallowance of Deductions on Public Policy Grounds," 20 Tax L. Rev. 665 (1965); Note, "Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code," 72 Yale L. J. 108 (1962).

12 The particular motivation to adopt legislation may well have been a ruling issued by the Service in 1964

"fine or similar penalty" paid to a government for the violation of any law. Section 162(f) reflects the judicial precedents recognizing the tax law should not frustrate the purposes of state or federal policy by allowing a deduction for fines and penalties as ordinary and necessary business expenses. The objective, therefore, is to prevent the tax deduction from reducing the "sting" of the penalty to the wrongdoer. Similarly, section 162(g) disallows a deduction of two-thirds of the amount of treble damage payments under the antitrust laws following a related criminal conviction, or plea of guilty or *nolo contendere,* and section 162(c) disallows deductions for bribes or kickbacks.

The Senate Finance Committee report accompanying the Tax Reform Act of 1969 explained that "[t]he 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 the deduction."[13] In 1971, the Senate Finance Committee attempted to clarify the term "fine or similar penalty" by specifying that it extends to civil penalties that "in general terms" serve the same purpose as criminal penalties.[14] Since then, both the Service and the courts have interpreted section 162 as allowing for no other public policy exception.

The regulations under Section 162(f) provide that a "fine or similar penalty" includes amounts paid as "civil penalty imposed by federal, state or, local law" and amounts paid "in settlement of actual or potential liability for a civil or criminal fine or penalty."[15] Both the Service and most courts interpret section 162(f) by ascertaining the purpose of the sanctions. Thus, for example, a civil penalty imposed to enforce the law and to punish violation of the prescribed law is similar to a fine because it has the same purpose as a fine imposed under a criminal statute.[16] On the other hand, a civil penalty imposed to encourage prompt compliance with the laws as a remedial measure to compensate another party for expenses incurred as a result of the violation is not a "fine or similar penalty" under section 162(f).[17] The focus of the inquiry in these cases is on the purpose of the sanctions. The courts appear

allowing a deduction for treble damages paid to a private party under section 4 of the Clayton Act. The civil suits had been initiated after guilty or *nolo contendere* pleas by the defendants in criminal prosecutions for violations of the antitrust laws. The Service reasoned that the damages were remedial in nature because the purpose of the statute is to provide the victim with a means of recovering damages inflicted and not to punish the wrongdoer in the sense of a punishment "imposed and enforced by the State, for a crime or offense against its laws." Rev. Rul. 64-224, 1964-2 C.B. 52, modified by Rev. Rul. 66-330, 1966-2 C.B. 44, obsoleted by Rev. Rul. 83-122, 1983-2 C.B. 271.

13 S. Rep. No. 552, 91st Cong., 1st Sess. 274 (1969).

14 S. Rep. No. 437, 92d Cong., 1st Sess. 73-74 (1971).

15 Treas. Reg. § 1.162-21(b)(1)(ii) and (iii).

16 *Pacific Transportation Co. v. Comm'r*, 75 T.C. 497, 646-654 (1980) (penalty for violating Safety Appliance Act and the Twenty-Eight Hour Act (Care of Animals in Transit) not deductible).

17 *Bailey v. Comm'r*, 756 F.2d 44 (6th Cir. 1985).

to analyze three factors: (1) legislative intent with respect to the claim under which the government acted, (2) the facts and circumstances of the case, and (3) the method of calculating the damages under the claim. This "hierarchical" analysis apparently is consistent with the legislative history of section 162(f).[18]

Three other points are worth noting. First, at least one court specifically has rejected a taxpayer's contention that a civil penalty imposed in a civil proceeding does not constitute a "similar penalty" because the proceeding was not one in which the government has the burden of proof by clear and convincing evidence.[19] Second, the courts analyze the treatment of restitution payments and other payments to third parties under a similar standard, *i.e.*, whether the payment is punitive in nature.[20] Third, the courts, at least in this context, do not appear to draw a distinction between punishment and deterrence.[21]

Finally, although some have argued that punitive damages in civil actions may be treated as a fine or penalty (because of the punishment feature), no court has so held and the Service takes the opposite view.[22]

B. Punitive Damages

Outside the tax area, punitive damages are fraught with controversy. Although a powerful weapon to advance legitimate state interests, the Supreme Court has expressed concern about punitive damage awards "run wild," finding them inexplicable on any basis

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18 F. Philip Manns, Jr., "Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?" 13 Va. Tax Rev. 271, 274, 288-312 (1993). *See also*, Jacob L. Todres, "Internal Revenue Code Section 162(f): An Analysis of its Application to Restitution Payments and Environmental Fines," 99 Dick. L. Rev. 645 (1995).

19 *Huff v. Comm'r*, 80 T.C. 804 (1983). But see, Phillips, "The Tax Consequences of a Punitive Damages Award," 31 Hastings L.J. 909, 920-921 (1980) (arguing that Congress in 1969 intentionally limited the denial of a deduction to situations in which the standard of proof is higher than that of a civil trial).

20 *Compare, Waldman v. Comm'r*, 88 T.C. 1384 (1987) (stay of prison sentence in a conviction for conspiracy to commit grand theft conditioned on paying a specified amount of restitution to victims held not deductible because the restitution was imposed as a deterrent to future criminality for purposes of enforcing the law) with *Stephens v. Comm'r*, 905 F.2d 667 (2d Cir. 1990) (allowing deduction for payment under restitution order in criminal embezzlement case because the payment was found to be more compensatory than punitive in nature). *See also Spitz v. United States*, 432 F. Supp. 148 (E.D. Wisc. 1977) (restitution paid as a condition of probation in theft case is not a fine or penalty; no explanation offered). The holding in *Waldman* appeared to rest on an incorrect reading by the court that restitution was not a substitute for a civil action to recover damages under California law. *See* F. Philip Manns, Jr., "Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?" 13 Va. Tax. Rev. 271, 313-317 (1993).

21 *Waldman v. Comm'r, supra; Talley Industries, Inc. v. Comm'r*, 116 F.3d 382 (9th Cir. 1997) (settlement payment to Government based on claims of fraudulent conduct relating to billing practices for work performed under government contracts).

22 Kimberly A. Pace, "The Tax Deductibility of Punitive Damage Payments: Who Should Ultimately Bear the Burden of Corporate Misconduct?" 47 Ala. L. Rev. 826, 870-878 (1996); Rev. Rul. 80-211, 1980-2 C.B. 57.

but caprice and passion.[23] When awarded, they tend to attract attention because of their magnitude and their potential threat to the viability of certain firms as on-going businesses. Examples abound – a $4.9 billion punitive damage award against General Motors in July 1999 (along with $100 million in compensatory damages for actual injuries); a $1.2 billion judgment against State Farm Insurance for specifying the use of after-market auto repair used parts, instead of new parts, to repair policyholders' cars involved in accidents (no compensatory damages because there was no injury to anyone), to say nothing of the jury awards in recent tobacco cases.

Punitive damages have evolved over time. Until well into the 19th century, punitive damages frequently operated to compensate for intangible injuries where compensation for those injuries was not otherwise available under the narrow conception of compensatory damages.[24] Today, section 908 of the Restatement (Second) of Torts defines "punitive damages" as "damages, other than compensatory or nominal damages, awarded against a person to *punish* him for his outrageous conduct and *deter* him and others like him from similar conduct in the future." (Emphasis added). Generally, a jury or a judge may render punitive damages where the defendant is found guilty, based on a preponderance of the evidence, of "wanton, willful, malicious or reckless conduct which shows indifference to the rights of others."[25]

The amount of punitive damages in a particular case is determined by the jury. Without substantial guidance, jurors are asked to determine an appropriate dollar amount based on amorphous, and arguably irrelevant, criteria such as the nature of the wrongdoing, the extent of the harm inflicted, the intent of the party who committed the act, the wealth of the defendant, as well as mitigating circumstances.[26] Juries are asked to bear in mind the dual function of punitive damages -- to punish the wrongdoer and to deter the wrongdoer from repeating wrongful acts. At the same time, punitive damages are designed to serve as a warning to others and prevent others from committing wrongful acts.[27]

The conventional argument for deterrence in this context is based on economics. Compensatory damages would be a sufficient deterrent if every wrongdoer could be identified and assessed damages. Compensatory damages are not adequate, however, if wrongdoers escape detection. Punitive damages are thus viewed as necessary to ensure that wrongdoers internalize the costs of their actions and hence deter them from engaging in

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23 *Pacific Mut. Life Ins.Co. v. Haslip*, 499 U.S.1, 9-12, 18 (1991).

24 *Id.* at 61 (Justice O'Connor dissenting).

25 *TXO Production Corp. v. Alliance Resources Corp.*, 509 U.S. 443, 463 n.29 (1993).

26 Cass Sunstein, Daniel Kahneman & David Schkade, "Assessing Punitive Damages (with Notes on Cognition and Valuation in Law)," 107 Yale L. J. 2071, 2081 (1998) ("scaling without a modulus").

27 *Id.* at 2081.

conduct where the social costs would otherwise exceed the social benefits.[28] Along the same lines, compensatory damages may be inadequate where the wrongdoer derives socially illicit utility gains (arising from intentional torts involving deliberate infliction of injury) that exceed the victim's compensatory damages. Yet another rationale for punitive damages is that compensatory damages may be lower than they should be where calculation costs are high.[29]

Punitive damages are also designed to punish. They have an "expressive" or retributive purpose. A punitive damages award may be viewed therefore as expression of the community's outrage at certain forms of conduct in a way that is designed both to reflect and entrench social norms.[30]

In today's environment, punitive damages arise principally in cases involving malpractice, products liability and business torts. The states have broad discretion in imposing criminal penalties and allowing punitive damages. Currently, 46 states permit the award of punitive damages under various circumstances.[31] Aside from limits imposed under the various state statutes, there are substantive limits on punitive damages awards imposed by the Due Process Clause of the Fourteenth Amendment, which brings into play the Eighth Amendment's prohibition against excessive fines and cruel and unusual punishments. Punitive damages are considered excessive when the defendant could not have had adequate notice of the damages at the time of the conduct.[32]

The relevant Constitutional line is inherently imprecise. The Supreme Court has focused on three criteria to determine whether punitive damages are excessive: (1) the degree of the defendant's reprehensibility, (2) the relationship between the penalty and the harm to the victim caused by the defendant, and (3) the sanctions imposed in other cases for comparable misconduct.[33] In each case, the appellate courts are required to engage in an independent examination of the relevant criteria (as opposed to applying an "abuse of discretion" standard in reviewing lower court determinations). The *de novo* review is thought to be essential to permit appellate courts to maintain control and clarify legal principles in an effort to unify and stabilize the law.[34]

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28 *Id.* at 2082.

29 *Id.* at 2083.

30 *Id.* at 2086.

31 Michigan, Nebraska, New Hampshire and Washington do not permit punitive damages awards. Louisiana does not permit punitive damages for product liability or medical malpractice.

32 *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996) (compensatory damages of $4,000 and punitive damages of $2 million imposed on car dealer for representing that a car was new when in fact it had been repainted by the dealer; punitive damages found excessive).

33 *Id.* at 575-586.

34 *Cooper Industries, Inc. v. Leatherman Tool Group, Inc.*, 2001 U.S. Lexis 3520, slip op.18-24 (May 14, 2001).

It is not clear how well the Supreme Court guideposts prescribed in the *Gore* case have functioned. They fail to articulate a bright line standard, and they provide no meaningful guidance or notice of potential liability.[35] The resulting lack of predictability has important implications. First, it raises a question as to whether the due process requirement of adequate notice can be satisfied. Second, to the extent that punitive damages are justified on the basis of their deterrent effect, the underlying economic analysis becomes less reliable as parties struggle with uncertainty in making *ex ante* calculations of liability. As a result, defendants wind up pressured into less than optimal litigation settlements.[36]

PART II. THE ARGUMENTS FOR AND AGAINST THE PROPOSAL

A. The Case for Nondeductibilty

The principal case for nondeductibility of punitive damages is based on the characterization of punitive damages as "quasi-criminal" sanctions to punish the wrongdoer and to deter similar conduct by the defendant and others. They are imposed because of conduct that violates public policies of the state or the federal government. Rather than further the punishment and deterrence objectives of punitive damages, allowing a deduction for punitive damages effectively thwarts those objectives by reducing the amount of the damages and hence the "sting."[37] Because punitive damages serve the same purposes as civil fines and penalties, they should be subject to the same tax treatment (nondeductible).

Supporters of the Proposal acknowledge that the Federal income tax should be imposed on net income (rather than gross income) and that as a matter of sound policy tax laws should be neutral but are willing to cross the line when it comes to the deductibility of punitive damages. They point out, correctly, the Code already contains several provisions that attempt to reform the moral character of taxpayers and highlight the golden parachute provisions of sections 280G (no deduction for "excess parachute payments") and 4999 (20% excise tax on recipient), the excise tax on recipients of greenmail payments under section 5881 (50% excise tax on "greenmail), the nondeductibility under section 280E of expenses of a business involved in drug trafficking and the nondeductibility of certain "excessive employee remuneration" under section 162(m).[38]

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35 *See* "Developments in the Law The Paths of Civil Litigation III. Problems and Proposals in Punitive Damages Reform," 113 Harv. L. Rev. 1783 (2000).

36 *Id.* at 1785-1787.

37 Kimberly A. Pace, "The Tax Deductibility of Punitive Damages: Who Should Ultimately Bear the Burden of Corporate Misconduct?" 47 Ala. L. Rev. 826, 863-865 (public policy "mandates" Congress amend the Code to prohibit the deduction of punitive damages).

38 *Id.* at 865-868; *see also* Note, "Should Punitive Damages be Nondeductible? The Expansion of the Public-Policy Doctrine," 68 Tex. L. Rev. 819, 838 n. 163 (1990).

Although opponents of the Proposal argue that punitive damages are out of control and unpredictable, there is some evidence to the contrary.[39] Moreover, to the extent those who oppose the Proposal rely on the economic aspects of deterrence, they tend to ignore the retributive aspects of punishment. A principal point of punitive damages is to "send a message" for past bad conduct, making them more akin to criminal punishment.[40] They are an "unusual remedy to punish unusually serious misconduct" and are awarded only against defendants who have been "really mean" or "really stupid."[41] This characterization of punitive damages justifies the Proposal.

B. The Case for Retaining the Status Quo

The Proposal to disallow any deduction for punitive damages on the grounds that the "current deductibility undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities" effectively confronts two competing considerations: (1) the need for an accurate measurement of net income and (2) the notion that the allowance of a deduction for punitive damages frustrates public policy and resolves the conflict between them based on questionable assumptions.

First, adopting the Proposal would be a continuation of the haphazard reliance on the tax system to achieve social objectives that may be better addressed by non-tax legislative or regulatory action, or by market forces. Second, it is not clear the disallowance of a deduction for punitive damages would be efficient because the resulting disparity in the tax treatment of precautionary measures (which would be deductible as incurred as ordinary and necessary expenses or amortized if subject to capitalization) and punitive damages (nondeductible) may lead to socially wasteful precautions. Third, to the extent that the disallowance may be justified as a desirable symbolic gesture, it would be appropriate to limit the disallowance to the portion of the award that constitutes the punishment element. Unfortunately, the near impossibility of making that determination raises troubling administrative enforcement issues.

1. Tax System Neutrality

The federal income tax is intended to be a tax on net income and not to act as a sanction against wrongdoing. Thus, an accurate measurement of net income necessitates taking into account all expenses associated with the production of income, regardless of moral or legal considerations. The public policy exception embraced by Congress in 1969 is

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39 Theodore Eisenberg and Martin T. Wells, "Punitive Damage Awards after BMW, a New Capping System, and the Reported Opinion Bias," 1998 Wis. L. Rev. 387; Theodore Eisenberg, "The Predictability of Punitive Damages," 26 J. Legal Stud. 623 (1997).

40 David Luban, "A Flawed Case Against Punitive Damages," 87 Geo. L. J. 359 (1998); Marc Galanter and David Luban, "Poetic Justice: Punitive Damages and Legal Pluralism," 42 Am. U. L. Rev. 1393, 1432-1438 (1993).

41 David Luban, "A Flawed Case Against Punitive Damages," 87 Geo. L. J. 359 (1998) (quoting Judge Richard Neely in *TXO Products Corp., v. Alliance Resources, Corp.*, 419 S.E.2d 870, 877-878 (W.Va. 1992)).

to disallow a deduction only in cases where the payment itself is illegal, is a fine or penalty levied for violation of state or federal policy or represents the punitive portion of antitrust treble damages following a related criminal proceeding.

Aside from the fact that the provisions applying the public policy exception to deductibility were enacted at the same time, there is no particular coherence to the exceptions. Thus for example, deductions for certain antitrust damages are disallowed but deductions for damages under other regulatory regimes are allowed; penalties that are remedial in nature are allowed but those that are punitive are not; illegal bribes and kickbacks are not deductible, but only if the state law that prohibits them is enforced. Expansion of the exception to include punitive damages awards would exacerbate the incoherence in the use of tax penalty provisions and run counter to the neutrality principle of sound tax policy.[42]

Moreover, in much the same way that the disallowance of a deduction may be justified so as to ensure that the "sting" of a fine or penalty is not reduced (or to avoid an unwarranted "tax subsidy"), it is equally possible to view the effect of the disallowance as the imposition of an additional direct federal fine.[43] The question to be addressed is whether the government imposing the underlying fine intended it to be deductible or nondeductible. Congress did not address that issue in 1969; it simply determined that the deduction should not be allowed. With respect to punitive damages, absent a specific jury instruction as to deductibility, it would be impossible to determine whether the jury based its award on the assumption that all or a portion of a punitive damages award would or would not be deductible. State laws dealing with punitive damages do not address the issue. Congress thus could be viewed as imposing a direct federal fine without coordination between the tax system and the states' regimes that sanction punitive damages.

2. Efficiency

The Proposal assumes or presumes punitive damages are an effective deterrent of undesirable activities and that the deduction will somehow diminish that efficacy. It is not all that clear that punitive damages are effective deterrents. Although there is scant empirical work in this area, some studies suggest that punitive damages have no deterrent effect at all.[44] Moreover, while it may be appropriate in some cases to rely on the tax system to encourage or discourage behavior, it is not clear that reliance on tax penalties (such as the disallowance

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42 Eric M. Zolt, "Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions," 37 UCLA L. Rev. 343,356-359 (1989).

43 *Id.* at 351.

44 W. Kip Viscusi, "The Social Costs of Punitive Damages Against Corporations in Environmental and Safety Torts," 87 Geo. L. J. 285 (1998) (concluding, based on analysis of various safety indices, that there is no evidence of any deterrent effect of punitive damages in states that have them as opposed to those that do not and that, therefore, punitive damages should be abolished). *But see*, David Luban, "A Flawed Case against Punitive Damages," 87 Geo. L. J. 359 (1998) (ascribing at least thirteen significant errors to Professor Viscusi's analysis).

of a deduction), whether coupled with an efficient or inefficient non-tax deterrent, achieves an efficient deterrence level. The disallowance of a deduction, at the margin, will discourage certain behavior but may not approximate the optimal fines necessary to deter efficiently.[45]

As noted above, the conventional argument for deterrence is based on economics. The economists tell us that optimal deterrence is achieved when the magnitude of the total damages (compensatory and punitive) is equal to the harm caused by the wrongdoer.[46] If damages equal harm, the argument goes, potential wrongdoers will have socially correct incentives to take precautionary measures (*e.g.* spend $50,000 to avoid a harm of $100,000). If the damages are less than the harm, a firm might not take the precautions that it should (*e.g.* why spend $50,000 to avoid a harm of $30,000) and if the damages exceed the harm, firms might be forced to take socially excessive precautions (*e.g.* spend $100,000 to avoid a harm of $50,000).

Under this approach, where the goal of punitive damages is to create appropriate deterrence, the economists argue that punitive damages in a business context should remain deductible. A change in the treatment, to render the payment of punitive damages nondeductible, would result in undesirable over-deterrence because the punitive damage component would become more significant than it should be. This argument is premised on the discontinuity that would result when precautionary measures are deductible but punitive damages are not. The "desirable" behavior is to choose precaution when its costs are less than the damages generated by the harm. If the tax rate is the same as to precautionary measures or punitive damages, the taxpayer will act to maximize the after-tax rate of return and will elect to take precautionary measures if their cost is less than the amount of damages. On the other hand if punitive damages are not deductible, the taxpayer would be willing to spend more than a socially desirable amount for precautions. For example, if the marginal rate were 35% and punitive damages of $100,000 were not deductible, the taxpayer might be willing to make up to $153,846 of tax deductible expenditures to prevent a nondeductible harm of $100,000.[47] The economists view that expenditure as socially wasteful.

3. Symbolic Gesture

It is arguably appropriate to deny a deduction for the portion of punitive damages that constitutes punishment on the theory that reduction of the "sting" is a desirable symbolic gesture to demonstrate the government does not condone the type of activities that lead to the imposition of punitive damages.

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45 Tax penalties may, depending on the circumstances, both over-penalize and under-penalize. Eric M. Zolt, "Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions," 37 UCLA L. Rev. 343, 360-374 (1989).

46 A. Mitchell Polinsky and Steven Shavell, "Punitive Damages: An Economic Analysis," 111 Harv. L. Rev. 869, 873 (1998).

47 At a tax rate of 35%, a deductible expense of $153,846 results in an after-tax cost of $100,000.

As noted above, punitive damages imposed by a judge or jury in private malpractice, product liability or business torts cases are premised on a number of possible theories that include punishment, deterrence and making up for the potential inadequacy of compensatory damages in cases where it may be too difficult or too costly to measure those damages accurately. While it may be possible in some cases to ascertain the amount of compensatory and punitive damages based on jury findings or the pleadings, the state of the law of punitive damages, however, is such that it is virtually impossible to determine with any degree of confidence the portion of the punitive damages that is awarded to "punish" the wrongdoer.[48]

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48 David Schkade, Cass R. Sunstein and Daniel Kahneman, "Empirical Study: Deliberating About Dollars and the Severity Shift," 100 Colum. L. Rev. 1139, 1144-1146, 1167-1173 (2000) (noting that it is extremely difficult even for experts (as opposed to juries) to agree on what dollar amount constitutes adequate "punishment" or produces an appropriate deterrent signal and concluding, based on empirical work, that the problem of unpredictable and erratic dollar verdicts is increased, not alleviated, by the fact that juries are deliberative bodies). *See also* W. Kip Viscusi, "The Challenge of Punitive Damages Mathematics," 30 J. Legal Stud. 313, 342-43 (2001) (concluding, based on experimental studies, that providing jurors with a detailed rationale and mathematical formula for setting punitive damages does not appear to solve the problem of random and highly variable punitive damage awards).