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Dear Ladies and Gentlemen:

I am pleased to enclose NYSBA Tax Section Report No. 1000 addressing the Deductibility of Punitive Damages, adopted by the Tax Section's Executive Committee on July 22, 2001.

In 1999, and again in 2000, the Clinton Administration Budget Proposal for Fiscal Years 2000 and 2001, respectively, included a legislative proposal (the "Proposal") that would 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 governed damages paid or incurred on or after the date of 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 those 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 our comments to supplement the analysis of the Proposal offered by the Joint Committee on Taxation, and to advance the discussion of the issues when and if the Proposal surfaces again.

Part I of the Report 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 of the Report examines the arguments in favor of and against the Proposal.

The principal case for nondeductibility 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 cost of the damages imposed and hence the "sting." Because punitive damages serve many of the same purposes as civil fines and penalties, they should be subject to the same tax treatment (nondeductible).

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, adoption of the Proposal would be a continuation of the haphazard reliance on the tax system to achieve social objectives that may be otherwise best addressed by non-tax legislative or regulatory action, or by market forces. Second, it is not clear that disallowing the 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 administrative enforcement concerns.

We would be pleased to meet with you to discuss the matters raised in the Report.

Respectfully submitted,

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