Tax-Free Wrongful Death Punitive Damages?

By Robert W. Wood

The IRS has long had a bee in its bonnet over the tax treatment of punitive damages. There’s probably good reason. For decades the Service has said that punitive damages (by definition) are designed not to compensate the plaintiff but to punish the defendant. In the language of section 104, that makes them damages that are simply not paid “on account of” personal injuries, physical or otherwise. The IRS ruled in 1975 that some punitive damages could be tax free.1 Yet taxpayers and the courts haven’t always agreed. A statutory change in 1989 attempted to end much of the dispute that exempts limited damages for wrongful death. Wood explores this aspect of the law of punitive damages.

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Punitive damages have long been viewed as taxable by the IRS, and that view was enshrined in 1996 with a U.S. Supreme Court case and a statutory change to section 104. Yet there remains a narrow exception from this treatment that exempts limited damages for wrongful death. Wood explores this aspect of the law of punitive damages.

1See Rev. Rul. 75-45, 1975-1 C.B. 47.
3See section 7641 of the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, adding language that section 104(a)(2) “shall not apply to any punitive damages in connection with a case not including physical injury or physical sickness.”

Despite the supposed intent of Congress, the 1989 change to section 104 did nothing to stop the controversy surrounding punitive damages. Taxpayers continued to argue that punitive damages were excludable, at least in cases of physical injuries.4 The government became increasingly opposed to any punitive damage exclusion.

Repeating History

The IRS kept on fighting, and taxpayers kept on arguing. The Supreme Court finally addressed the issue in 1996 in O’Gilvie v. United States,5 a case involving the toxic shock syndrome death of O’Gilvie’s spouse. There was no question that the compensatory damages awarded for her death were excludable under section 104. But were the punitive damages awarded against Playtex International on account of her death?

The Supreme Court held that the $2,483,646 punitive damage award was not excludable from O’Gilvie’s income. The 1989 amendment to section 104 was inapplicable because O’Gilvie’s recovery was before 1989. Moreover, the change only made it explicit that punitive damage awards were taxable when there was no physical injury. O’Gilvie argued that this made it obvious that punitive damage awards such as his were fully excludable before that amendment.

The Supreme Court viewed punitive damages as a windfall to plaintiffs, not awarded on account of personal (or physical) injuries. Interestingly, when President Clinton signed the Small Business Job Protection Act on August 20, 1996, to exclude punitive damages from the scope of section 104(a)(2),6 O’Gilvie was still pending before the Supreme Court. Four months later, on December 10, 1996, the Court put all prior case law to rest by simply stating that punitive damages were not awarded on account of personal injuries.7 After decades of controversy, we ended up in one year with both a prospective legislative clarification and a retroactive Supreme Court decision. Each

5See, e.g., Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994), Doc 94-7091, 94 TNT 147-8.
7Section 1605 of the Small Business Job Protection Act of 1996, P.L. 104-188, providing the current version of section 104(a)(2).
8O’Gilvie, 519 U.S. at 83-87.
saying punitive damages are taxable income to the recipient. Nevertheless, both the 1996 statutory change and the O’Gilvie decision may leave practitioners questioning just what constitutes punitive damages.

Punitive Damages Defined

The code, the regulations, and the case law all fail to define punitive damages. In O’Gilvie, there was a verdict, and the compensatory and punitive damages were each paid as such. That, in my experience, is unusual. A more likely fact pattern involves punitive damages awarded at trial but appealed, with the case settling before the appellate court rules. The allocation and characterization questions those fact patterns raise are obvious. They are also intensely fact specific.

The IRS addressed allocation questions in Rev. Rul. 85-98,8 ruling that when a suit seeking both compensatory and punitive damages is settled for a lump sum, the settlement must be allocated between the two based on the best evidence available.

In Rev. Rul. 85-98, the complaint (for libel) requested compensatory damages of $15x and punitive damages of $45x. The amount of compensatory damages requested relative to the amount of punitive damages requested (25 percent of the total $60x, we are told in the ruling) bore a reasonable relationship to what a jury might be expected to award under the facts and circumstances of the case. Shortly before trial, the taxpayer and the defendant agreed to a lump sum settlement of $24x. Therefore, 25 percent of the settlement amount ($6x) was allocable to compensatory damages.

In a real-world case (as opposed to one based on the hypothetical facts in a revenue ruling), it seems unlikely that anyone would be able to make this “reasonable relationship” assessment, particularly since there are high hurdles to getting punitive damages. Also, it is common in many jurisdictions not to specify the amount of punitive damages requested. Yet the mere possibility of punitive damages may cause some settling plaintiffs to want to document the likelihood of getting them. Indeed, focusing unduly on the complaint may suggest that any suit seeking punitive damages might fairly recover them.

Most plaintiff lawyers regard this as poppycock. Generally, parties do not consider any allocation to punitive damages unless a case has settled on appeal after a punitive damages verdict at trial. Yet, there are a few cases in which the IRS has prevailed with its punitive damages witch-hunt even though the case settled before trial and any allocation to punitive damages was clearly speculative.

In Barnes v. Commissioner,9 the Tax Court imported punitive damage characterization to a pretrial settlement. It did so ostensibly because the plaintiff’s lawyer testified in Tax Court that his client had a strong case for punitive damages. It seems speculative to suggest that punitive damages should be attributed for tax purposes when none were ever awarded. However, one reading of the case is that the Tax Court was simply trying to split the settlement between tax-free and taxable damages, so the “punitive” label it attached was unimportant.

Cases on Appeal

It is easier to understand the allocation of amounts to punitive damages in cases that settle while on appeal. Thus, in Miller v. Commissioner,10 the Tax Court held that 47 percent of the net proceeds of a settlement should be treated as punitive. That percentage closely tracked the jury award. In several letter rulings and technical advice memorandums, the IRS has sought to determine the intent of particular payments and the appropriate allocation of recoveries between compensatory and punitive amounts.11 The facts and procedural posture of the case on appeal are important.

For example, assume a verdict for $5 million in compensatory damages and $10 million in punitive damages. If the case settles on appeal for $7 million, it should matter to the characterization of the settlement whether only the punitive damages were on appeal. If the plaintiff had cross-appealed requesting additional compensatory damages, he would have a stronger claim that all of the settlement is compensatory.

Depending on the facts and the procedural posture, the range of punitive damages in the $7 million settlement could be, $2 million, or $4.66 million (based on the ratio of the verdict). There may be other possibilities.

Are Any Punitive Damages Tax Free?

When punitive damage tax issues arise today, the question is generally whether any punitive damages have been paid, and if so, how much. In the face of those controversies, there is one sleeper issue that surprises many. It concerns a narrow exception that allows some admitted punitive damages to escape taxation.

In the 1996 statutory amendment to clarify that punitive damages are taxable, Congress carved out

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a narrow exception for punitive damages awarded for wrongful death in states where damages are limited to punitive damages. As amended in 1996, section 104(c) states that the taxable treatment of punitive damages does not apply to punitive damages awarded in a civil action for wrongful death, if applicable state law allows only for punitive damages. The exclusion views the applicable state law as of September 13, 1995, without regard to any subsequent modification.

I am aware of only one state supposedly falling into this rather odd category: Alabama. In Burford v. United States, a federal court interpreting the Alabama wrongful death statute concluded that a recovery of punitive damages was excludable. However, there may be some room for interpretation, and at least one case tested the boundaries of this exception.

Benavides

In Benavides v. United States, the taxpayers had received punitive damages in a Texas wrongful death action. The case arose out of an industrial accident in which Mr. Benavides fell through a poorly maintained cover into a vat of caustic chemicals and died. Mrs. Benavides received workers’ compensation death benefits under the Texas Workers’ Compensation Act. If she does, she argued. That was exactly what happened, she argued.

The lawsuit sought only punitive damages, because the Texas Workers’ Compensation Act limits the available recovery in wrongful death actions to punitive damages if the decedent was covered by workers’ compensation insurance. In other wrongful death actions under Texas law, both compensatory and punitive damages are available. However, the rule excluding compensatory damages in a Texas wrongful death action when workers’ compensation coverage applies appears to be absolute.

At the time of initial employment, a Texas employee has the right to waive coverage under the Texas Workers’ Compensation Act. If he does, he would retain his right to bring a common-law action against his employer for subsequent work-related injuries. Mr. Benavides failed to elect out of the workers’ compensation system.

The litigation was bitterly fought and took 10 years to come to jury trial. The jury found the employer grossly negligent and awarded the family $25 million in punitive damages. Before judgment, the family accepted a settlement that reduced the amount and apportioned the recovery 50 percent to Mrs. Benavides and 25 percent to each child. They each paid their taxes and asked the IRS for a refund, eventually suing for one.

The refund suit claimed the damages were excludable under section 104(c) because they were state court wrongful death damages and only punitive damages had been available. Indeed, the jury could not have awarded compensatory damages. The district court rejected that position, considering that Texas law had allowed compensatory remedies. Texas allowed one to elect the compensatory remedies of either workers’ compensation payments or, if declined by the decedent, a common-law action.

The district court distinguished the Benavides family from the taxpayers in Burford, who were allowed to exclude their punitive damages from gross income. Burford had involved punitive damages awarded under Alabama’s wrongful death statute, under which only punitive (and never compensatory) damages could be awarded. The Burford plaintiffs had received only the punitive damages resulting from their suit. In contrast, the Benavides family had received punitive damages plus workers’ compensation benefits.

All Cases v. This Case

On appeal to the Fifth Circuit, Mrs. Benavides reiterated the common-sense proposition that section 104(c) exempts punitive damages from taxation if they are paid on account of a state law wrongful death action in which only punitive damages could be awarded. There was no question that applicable state law — in this case, Texas — provided that Mrs. Benavides could sue only for punitive damages. The language of section 104(c) and its legislative history made it clear that applicable state law was what controlled. That was exactly what happened, she argued.

The IRS argued that “applicable State law” in section 104(c) meant the Texas state wrongful death statute and that this phrase modified the civil action noted in section 104(c). Thus, argued the IRS, the state law would have to make punitive damages the sole recourse in every wrongful death case covered by the law, not merely in some of them. The Fifth Circuit felt constrained to interpret the exclusion from income narrowly.

Although the appellate court conceded that section 104(c) was not a model of clarity, it ruled that the statute’s reference to applicable state law had to mean the law governing wrongful death actions. The court pointed out that it was the Texas Workers’ Compensation Act that served as the operative limitation, preventing Mrs. Benavides from bringing suit for compensatory damages. The act imposed limits, specifying that only persons who

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12642 F. Supp. 635 (N.D. Ala. 1986); note as well that Burford preceded the 1989 change to section 104.

1397 F.3d 526 (5th Cir. 2007), Dec 2007-19259, 2007 TNT 162-7.
recover workers’ compensation benefits for the wrongful death of a covered worker are restricted to punitive damages.

In contrast, in Burford, Alabama’s wrongful death statute restricted the recovery in all wrongful death actions to punitive damages. The court even attempted to address the equities of the situation. Section 104(c) was enacted to address the seemingly inequitable cases in which the taxpayer might have her entire recovery taxed even though the genesis of the claim was the wrongful death of a loved one. That would have occurred in Burford or in any other Alabama wrongful death recovery.

Which Recovery?

The death of Mr. Benavides produced two recoveries, one under the Texas workers’ compensation system and one through a wrongful death suit. It was true that the wrongful death suit might have produced (and did here) a vastly greater sum than could have been available through a state workers’ compensation act. But that was irrelevant, said the court.

By not electing out of the Texas Workers’ Compensation Act, it was the decedent who had elected the more limited recovery of workers’ compensation benefits in exchange for the more certain and expeditious recovery that the workers’ compensation system provided. The Benavides children argued on appeal that they had an additional and superior claim to an excludable recovery. Only their mother, as the decedent’s surviving spouse, had received any workers’ compensation benefits.

That made it doubly unfair to subject the children’s recoveries to taxation. It was the sole money they would receive on account of their father’s wrongful death. Taxation would result in precisely the lack of equity section 104(c) was designed to redress. Nevertheless, the court rejected this notion on two bases.

First, it noted that the stipulated facts in the case referred to Mrs. Benavides and her children having received workers’ compensation benefits. Second, the court read the gravamen of section 104(c) as addressing the situation in which applicable state law prevents an award of compensatory damages. The court found that nothing in section 104(c) expressed any concern with whether any particular plaintiff actually recovered any compensatory damages.

The IRS took Benavides a step further in TAM 200243021.14 There, the IRS considered a wrongful death award under a state statute that called for workers’ compensation to be the exclusive compensatory remedy in that state, but that allowed an action for wrongful death solely for punitive damages. Thus, the technical advice memorandum considers the fact pattern in Benavides without the election out that was (at least theoretically) available to Mr. Benavides. With considerably less reasoning and justification than that advanced by the Fifth Circuit in Benavides, the IRS concluded that any punitive damages awarded for the wrongful death do not qualify for the increasingly narrow exception provided by section 104(c).

Conclusion

It seemed obvious when section 104(c) was enacted in 1996 that its scope was quite narrow. Both the IRS and the courts have drawn it narrower still. For most of us, however, the larger problems are presented by the more global murkiness of damages characterized as punitive. Rarely are punitive damages paid following a judgment in which the punitive character of the damages can be determined without question. The question will usually be whether any punitive damages have been paid, and if so, just how much.

We think of these questions as being exclusively a plaintiff’s problem, albeit one influenced by defendants. Defendants, after all, have their own nontax reasons for their dislike of the punitive label. But as Congress for a third time considers a bill to make punitive damages nondeductible to payers,15 we may see further scuffling around this already ambiguous line.

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