

---

---

# VIRGINIA LAW REVIEW

## *IN BRIEF*

---

---

VOLUME 97

SEPTEMBER 8, 2011

PAGES 73–82

---

---

### ***REPLY***

#### REVISITING THE TAXATION OF PUNITIVE DAMAGES

*Gregg D. Polsky\* and Dan Markel\*\**

**I**N our recent article, *Taxing Punitive Damages*,<sup>1</sup> we argued (i) that plaintiffs in punitive damages cases should be allowed to introduce to the jury evidence regarding the deductibility of those damages by defendants, and (ii) that this jury tax-awareness approach is better than the Obama Administration's suggested alternative of disallowing those deductions.<sup>2</sup> To our delight, Professor Larry Zelenak and Paul Mogin have each provided comments to our piece.<sup>3</sup> Professor Zelenak's thoughtful response focuses on our prescriptive claim that jury tax-awareness is better than nondeductibility while Mr. Mogin disputes our doctrinal claim that the tax evi-

---

\* Willie Person Mangum Professor of Law, University of North Carolina School of Law.

\*\* D'Alemberte Professor, Florida State University College of Law and Scholar in Residence, New York University Center on the Administration of Criminal Law. Thanks to John Coyle and Brant Hellwig for comments on an earlier draft and to Phillip Kovoor and Meg Powers for research assistance.

<sup>1</sup> Gregg D. Polsky & Dan Markel, *Taxing Punitive Damages*, 96 Va. L. Rev. 1295 (2010).

<sup>2</sup> The Obama Administration again proposed making punitive damages nondeductible in its 2012 budget proposal, which was released on February 14, 2011. Office of Mgmt. & Budget, Exec. Office of the President, *Budget of the United States Government, Fiscal Year 2012* (2011), available at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/budget.pdf>.

<sup>3</sup> See Paul Mogin, *Don't Tilt the Playing Field: A Response to Polsky and Markel*, 96 Va. L. Rev. In Brief 69 (2011); Lawrence Zelenak, *Of Punitive Damages, Tax Deductions, and Tax-Aware Juries: A Response To Polsky And Markel*, 96 Va. L. Rev. In Brief 61 (2011).

dence is admissible.<sup>4</sup> We thank them for their contributions and provide our replies below.

#### I. REPLY TO PROFESSOR ZELENAK

Professor Zelenak raises two challenges in response to our piece and offers a general reaction, as well. We address these in turn.

##### A. *Divorcing the Tax Treatment of Judgments and Settlements*

Although we are pleased by Professor Zelenak's general approval of our analysis,<sup>5</sup> we note our disagreement with his view that the preferable solution might be to disallow deductions for payments of punitive damage *judgments*, while still allowing full deductions for *settlements* that include a punitive damages component.

Professor Zelenak's alternative proposal would avoid the practical problems we describe in *Taxing Punitive Damages* relating to allocations of pretrial settlements because settlements would always be deductible in full. Also, as Professor Zelenak notes, the vast majority of fully litigated cases do not involve an award of punitive damages.<sup>6</sup> Accordingly, his proposal's "presumption" that settled amounts do not have a punitive damages component will usually be accurate.

Nonetheless, we still prefer our proposal over Professor Zelenak's suggestion. First, while it is true that the majority of cases do not involve a substantial punitive damages component (because most cases do not involve sufficiently egregious misconduct to warrant a threshold determination of malice or recklessness), the empirical reality is that some cases certainly do. In those "punitive-flavored" cases, defendants will, under Professor Zelenak's proposal, be able to avoid the full sting of their expected punishment simply by settling before a jury verdict; the resulting underpunishment effect is

---

<sup>4</sup> Zelenak, *supra* note 3, at 61–62; Mogin, *supra* note 3, at 69–70.

<sup>5</sup> See Zelenak, *supra* note 3, at 62.

<sup>6</sup> See *id.* at 63–64. However, even though the punitive damages rate in fully litigated cases is two to three percent, the proportion of settled cases that involve a punitive damages component is likely significantly higher because of various tax, public relations, and insurance considerations. See Tom Baker, Transforming Punishment into Compensation: In the Shadow of Punitive Damages, 1998 Wis. L. Rev. 211, 228 (arguing that, in light of these considerations, "it is almost a wonder that any punitive damages claim goes to trial"); see also *infra* note 10.

precisely the problem that has stimulated the various reform proposals.<sup>7</sup> In other words, while Professor Zelenak's proposal attempts to solve the underpunishment problem by disallowing deductions for paying punitive damages judgments, it simultaneously allows an extremely easy end-run: settle before the jury comes back for the expected jury award.<sup>8</sup> In fact, we expect that in practice Professor Zelenak's approach would work almost precisely like the Obama Administration's blanket nondeductibility approach. Under the blanket nondeductibility approach, it would be nearly impossible for the Internal Revenue Service (IRS) to find and prosecute those relatively few heavily punitive-flavored cases because both plaintiffs and defendants have significant incentives to downplay punitives at the point of settlement—a point we emphasized in our article.<sup>9</sup> Accordingly, the IRS would likely be successful in enforcing the nondeductibility rule only in those cases that have resulted in a jury verdict of punitive damages. Thus, Professor Zelenak's proposal merely formalizes the IRS practices that are expected under the Obama Administration's approach. As a result, our principal objection to both proposals is the same: they both permit easy circumvention of the solution to the underpunishment problem.<sup>10</sup>

---

<sup>7</sup> In all the other non-punitive-flavored cases, all of the proposals (ours, the Obama Administration's, and Professor Zelenak's), as well as current law, will have essentially the same effects.

<sup>8</sup> For discussion of whether such an incentive to settle might be beneficial, see Polsky & Markel, *supra* note 1, at 1346–47.

<sup>9</sup> *Id.* at 1330–41.

<sup>10</sup> In support of his proposal for allowing deductions for the punitive portions of pretrial settlements, Professor Zelenak argues that “the very small percentage of punitive damage awards in litigated cases suggests that a large proportion of defendants making payments to settle punitive damages claims would not have been found liable for punitive damages at trial.” Zelenak, *supra* note 3, at 64. Professor Zelenak appears to be concerned about the risk of overpunishment in cases where punitive damages are not warranted. However, settlements should take into account the risk-adjusted amount of expected punitive damages that would be awarded by the jury (or judge) if the case went to trial, which should resolve any concerns of overpunishment. If anything, the expected punitive damages amount is a better indicator of punishment-worthiness than what the jury actually decides in a one-off decision. Furthermore, as mentioned above in note 6, it is reasonable to expect that punitive-flavored cases settle at a substantially higher rate than other cases because of insurance, public relations, and tax concerns. See Baker, *supra* note 6, at 228. This means that the low incidence of actual punitive damage jury verdicts is not suggestive of the incidence of verdicts that would result if all potential punitive damages cases proceeded to trial. Finally, we note that very recent empirical studies conclude that, even in the small subset of punitive damages cases that do proceed to trial, the success rate of plaintiffs seeking punitive dam-

Second, while Professor Zelenak's proposal has the virtue of not even pretending to enforce the nondeductibility rule in settlements (unlike the Obama Administration's proposal), it is not devoid of administrative problems. Professor Zelenak's proposal would deny deductions for payment of punitive damages judgments. But what if the case settles after the jury verdict but before the judge formally enters the judgment? Does it matter if there remain outstanding legal issues, such as whether the judge ought to reduce the judgment or order a new trial, at the time of settlement? Likewise, what if the case settles after the judgment is entered but while it is being appealed? For instance, what if the judgment is for \$1,000,000 of compensatory damages and \$2,000,000 of punitive damages, and the case settles for \$500,000 or \$1,000,000 or \$1,500,000 while on appeal? Does it matter whether both the plaintiff and the defendant have appealed, such that a new trial could conceivably end up with a larger recovery for the plaintiff? The point is that even a seemingly bright line rule like "punitive damage judgments are nondeductible but settlement payments are" can be difficult to apply in a whole slew of cases. As a result of this difficulty, it can be gamed by the parties to their mutual advantage.

Furthermore, to the extent the rule becomes more formalistic (for example, by applying nondeductibility only where a formal judgment is entered), the end-run strategy becomes that much clearer (for example, simply settle before the judge enters the judgment). Meanwhile, if the rule is less formalistic (for example, by applying a rule of reason to apportion post-judgment settlements pending appeal), the rule operates more like the Obama Administration's pro-

---

ages is actually about thirty percent, which is much higher than the two to three percent statistic noted by Professor Zelenak. The difference is attributable to the fact that plaintiffs only seek punitive damages in ten percent of the cases that go to trial, reflecting the screening that plaintiffs do before pleading punitive damages. See Theodore Eisenberg et al., *The Decision to Award Punitive Damages: An Empirical Study*, 2 J. Legal Analysis 577 (2010) (noting that plaintiffs' lawyers in fact only seek punitive damages in roughly ten percent of the cases that go to trial, and then in fact win punitive damages in about thirty percent of the cases generally and roughly sixty percent of cases involving intentional torts such as fraud). Based on the thirty to sixty percent trial success rate and the high settlement rate of punitive damages cases, we disagree with Professor Zelenak's claim that "[i]t is surely true that, in many settlements with a punitive component (whether acknowledged or unacknowledged by the parties), the likelihood that a jury would have awarded punitive damages if there had been a trial is well below fifty percent." Zelenak, *supra* note 3, at 63.

positional. Either way, we prefer our rule, which neutralizes the tax consequences between paying settlements and paying judgments.

*B. What About Optimal Deterrence and Punitive Damages?*

Professor Zelenak also argues that our proposed solution to the underpunishment problem, like other solutions, would be inapposite if the current punitive damages system were designed to achieve optimal deterrence.<sup>11</sup> We wholeheartedly agree with this view and said as much in the piece itself<sup>12</sup> and in a companion piece authored by one of us.<sup>13</sup> Our proposal is premised on current punitive damages regimes,<sup>14</sup> which, by requiring a threshold showing of reprehensibility, very clearly do not attempt to achieve optimal deterrence.<sup>15</sup> Indeed both proponents and critics of the idea of using punitive damages to achieve optimal deterrence acknowledge that the current landscape does not even remotely resemble an optimal deterrence regime.<sup>16</sup> Consequently, readers interested in a comprehensive analysis of the proper tax treatment of punitive damages meant to achieve optimal deterrence should consult Professor Markel's companion article.<sup>17</sup>

*C. Solving the Puzzle of the Twenty Dollar Bill Found on the Street*

Last, Professor Zelenak asks why, if evidence of tax consequences is both admissible and useful to plaintiffs' lawyers, it has not been sought to be admitted.<sup>18</sup> We share his curiosity. Anecdotally, we have heard a number of conjectures ranging from "litigators don't

---

<sup>11</sup> Zelenak, *supra* note 3, at 65–67.

<sup>12</sup> Polsky & Markel, *supra* note 1, at 1312 n.37.

<sup>13</sup> See Dan Markel, *Overcoming Tradeoffs in the Taxation of Punitive Damages*, 88 *Wash. U. L. Rev.* 609 (2011).

<sup>14</sup> See Polsky & Markel, *supra* note 1, at 1324 (noting that our tax analysis is based on current tort law principles).

<sup>15</sup> A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 *Harv. L. Rev.* 869, 897 (1998) (noting that optimal deterrence regimes are unconcerned with proof of the defendant's reprehensibility as such).

<sup>16</sup> Compare *id.* at 896–97 (acknowledging that current punitive damages law is flatly inconsistent with promotion of optimal deterrence), with Anthony J. Sebok, *Punitive Damages: From Myth to Theory*, 92 *Iowa L. Rev.* 957 (2007) (“[I]t is very hard to make a convincing case for the current practice of punitive damages based on a theory of efficient deterrence.”).

<sup>17</sup> Markel, *supra* note 13.

<sup>18</sup> Zelenak, *supra* note 3, at 68.

think about tax” and “litigators lack imagination” to “it’s too complex for juries” and “tax evidence is generally inadmissible.” We have attempted to show that it is not all that complex and that this particular type of tax evidence should be admissible.<sup>19</sup> As to lack of imagination or education, our hope is that our article should solve that problem to the extent it exists.

## II. REPLY TO MR. MOGIN

As noted at the outset, we argue that under current law, evidence of punitive damages tax deductibility ought to be admissible against the defendant in cases where those damages are deductible. In his response to this claim, Mr. Mogin, an experienced advocate with an extensive practice in defending corporations against punitive damages awards, raises several issues, which we take up in turn below.

### A. *The Concerns About Symmetry Between Plaintiffs and Defendants*

Mr. Mogin first registers concern that our analysis “would create a substantial pro-plaintiff imbalance.”<sup>20</sup> The purported imbalance stems from the fact that while tax evidence regarding *plaintiffs* is generally inadmissible by defendants, we are asserting that punitive damages tax evidence regarding *defendants* is admissible. In our article, we address this precise argument and we would call Mr. Mogin’s attention to that discussion; in fact, it is the first counterargument we discuss and we devote three full pages to it.<sup>21</sup> Given that we

---

<sup>19</sup> Polsky & Markel, *supra* note 1, at 1313–15, 1321–22.

<sup>20</sup> Mogin, *supra* note 3, at 70. The title of Mr. Mogin’s piece implies that there is currently an even playing field between plaintiffs and business defendants in tort cases that would be endangered by our analysis. Many have strongly disagreed with this premise. See, e.g., In *Litigation: Do the “Haves” Still Come Out Ahead?* (Herbert M. Kritzer & Susan Silbey eds., 2003); Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System—And Why Not?*, 140 U. Pa. L. Rev. 1147, 1183 (1992) (“One of the most remarkable features of the tort system is how few plaintiffs there are. A great many potential plaintiffs are never heard from by the injurers or their insurers.”); see also Richard L. Abel, *The Real Tort Crisis—Too Few Claims*, 48 Ohio St. L.J. 443 (1987); Marc Galanter, *Real World Torts: An Antidote to Anecdote*, 55 Md. L. Rev. 1093, 1159 (1996) (stating that “relatively few” tort claims are brought to court and that, even if more claims were filed, the tort system may not have the capacity to handle them). Moreover, the wave of “tort reform” over the last two decades has almost certainly not been tilted in the direction of plaintiffs.

<sup>21</sup> Polsky & Markel, *supra* note 1, at 1310–13.

fully develop the response in our article, we will merely provide the Cliff's Notes version here.

While the symmetry argument touted by Mr. Mogin is superficially attractive, it breaks down once one considers the reasons that courts are reluctant to allow defendants to introduce tax evidence against plaintiffs. First, there is the complexity concern, which Mr. Mogin notes. We argue that the punitive damages tax evidence sought to be introduced by plaintiffs is not complex and certainly not as complex as the tax evidence that defendants have sought to introduce.<sup>22</sup> Second, and more significantly, we note how courts faced with admitting plaintiff-related tax evidence are forced into a dilemma: they can either overcompensate plaintiffs (by disallowing the tax evidence) or underdeter defendants (by allowing the tax evidence).<sup>23</sup>

Both options are theoretically unsatisfying from a conventional torts policy perspective. Faced with this unfortunate choice in the context of compensatory damages, courts generally (but not universally) choose to overcompensate plaintiffs by excluding the evidence. But, in the punitive damages context, there simply is no such dilemma because the focus is on punishing and completely deterring the defendant's malicious or reckless misconduct; the plaintiff's enrichment is simply an incidental by-product of those goals. As we show in our article, courts can thus either advance existing punitive damages policy by educating juries about tax effects or undermine it by obscuring the fact that there are tax deductions available to business defendants that pay punitive damages.<sup>24</sup>

In addition, as we argued, it is clear that there is no blanket rule about tax evidence admissibility.<sup>25</sup> In some contexts and jurisdictions, the tax evidence is excluded; in others, it is admitted. The trend appears to be towards admissibility.<sup>26</sup> Regardless, like all rel-

---

<sup>22</sup> See *id.* at 1313–15 (comparing the complexity resulting from introducing punitive damages tax evidence with the complexity from introducing other tax evidence).

<sup>23</sup> See *id.* at 1311–12; see also Joseph M. Dodge, *Taxes and Torts*, 77 *Cornell L. Rev.* 143, 146 (1992) (explaining the dilemma).

<sup>24</sup> Polsky & Markel, *supra* note 1, at 1311–12.

<sup>25</sup> See *id.* at 1312–13 (noting the lack of uniformity regarding tax evidence admissibility).

<sup>26</sup> See generally Richard A. Epstein, *Cases and Materials on Torts* 871 (7th ed. 2000) (noting that despite early tort cases that excluded tax evidence, “[m]ore recent cases . . . have tended both to take taxes into account and to instruct the jury of that fact”). For specific recent examples, see *Eshelman v. Agere Sys. Inc.*, 554 F.3d 426, 440–43 (3d Cir.

evant evidence, a very good reason should be required to keep it away from juries. None exists with respect to punitive damages tax evidence.

Mr. Mogin also points to the collateral source rule as another rule where juries are precluded from hearing certain evidence that, like evidence regarding the plaintiff's taxes, relates to the plaintiff's true harm. Again, the argument seems to be that it is unfair to exclude this pro-defendant evidence while admitting our suggested pro-plaintiff evidence. But again, there is a plausible policy reason for the collateral source rule: the concern about underdeterrence. When courts apply the collateral source rule, they are saying that it is more important to properly incentivize defendants than it is to accurately compensate plaintiffs.<sup>27</sup> While everyone may not agree with this view, it is undoubtedly plausible. On the other hand, there is no justifiable policy rationale to keep juries in the dark about the tax effects of punitive damage payments by defendants.

### *B. Defendant's Wealth and Punitive Damages*

Mr. Mogin next argues that "existing law is already skewed in favor of overly large punitive awards against organizational defend-

---

2009) (augmenting an award to counteract adverse tax consequences suffered by the plaintiff in a federal discrimination lawsuit); *Blaney v. Int'l Ass'n of Machinists & Aerospace Workers*, Dist. No. 160, 87 P.3d 757, 761-64 (Wash. 2004) (allowing similar augmentation under Washington state discrimination law); see also Gregg D. Polsky & Stephen F. Befort, *Employment Discrimination Remedies and Tax Gross Ups*, 90 Iowa L. Rev. 67 (2004) (discussing award augmentations for tax effects under federal discrimination statutes).

<sup>27</sup> See Dodge, *supra* note 23, at 172 n.142 (noting that "the collateral source rule is accepted in order to impose a proper level of deterrence on defendants, even though the effect of the rule is to overcompensate plaintiffs"); Thomas C. Galligan, *Disaggregating More-Than-Whole Damages in Personal Injury Law: Deterrence and Punishment*, 71 Tenn. L. Rev. 117, 123 (2003) (explaining that "the collateral source rule leads to more efficient deterrence than nonrecovery of the loss because it forces defendants to take account of these reimbursed losses or costs before acting"); Robert A. Katz, *Too Much of a Good Thing: When Charitable Gifts Augment Victim Compensation*, 53 DePaul L. Rev. 547, 584 n.191 (2003) ("A key rationale for the collateral source rule . . . is efficiency: to achieve optimal deterrence, tortfeasors must bear the full costs of their risky behavior, even if this overcompensates the occasional tort victim."); Paul H. Rubin & Joanna M. Shepherd, *Tort Reform and Accidental Deaths*, 50 J. L. & Econ. 221, 226 (2007) (stating that collateral source rules "promote efficient deterrence by requiring tortfeasors to pay damages even when victims have received payments from a collateral source").

ants because of the way it treats evidence of wealth.”<sup>28</sup> In our piece, we addressed the argument that tax blindness is justified on the ground that punitive damage amounts are “too large.”<sup>29</sup> Unfortunately, Mr. Mogin provides no benchmark or analysis as to what is the optimal amount of punitive damages for society to have.<sup>30</sup> Even assuming arguendo that punitive damages are too high, solving that problem through tax blindness is extremely imprecise because the blunting effect depends idiosyncratically on the defendant’s marginal tax rate.<sup>31</sup>

*C. How Important is the Intent of the Jury (or Judge)?*

Mr. Mogin also argues that the jury’s intent in a punitive damages case is not “critically important.”<sup>32</sup> We disagree. Under our system, the jury hears the evidence and, absent exceptional circumstances, determines the punishment. Given that responsibility, the jury (or the judge in certain situations) should be educated as much as reasonably possible to the real, after-tax cost of the punishment. While we firmly agree with Mr. Mogin that judicial review of jury determinations is appropriate, we would add that appellate judges should

---

<sup>28</sup> Mogin, *supra* note 3, at 73.

<sup>29</sup> See Polsky & Markel, *supra* note 1, at 1317–18.

<sup>30</sup> In this respect, he becomes exposed to the kind of critique Anthony Sebok made so effectively in *Punitive Damages: From Myth to Theory*, 92 *Iowa L. Rev.* 957, 962–76 (2007).

<sup>31</sup> See Polsky & Markel, *supra* note 1, at 1318. Mr. Mogin endorses the view that the wealth of punitive damages defendants should never be admitted into evidence. As previously mentioned, our article is premised on the current state of punitive damages law, which nearly universally allows this evidence. See generally *TXO Prod. Corp. v. Alliance Res. Corp.*, 509 U.S. 443, 462 n.28 (1993) (describing as “well-settled law” that financial evidence is admissible in the punitive damages context). Accordingly, we will not respond to this claim by Mr. Mogin in depth but, as courts and commentators acknowledge, there are a number of reasons why wealth and size should matter for punitive damages. For a sampling, see generally *Mathias v. Accor Econ. Lodging, Inc.*, 347 F.3d 672, 677 (7th Cir. 2003) (Posner, J.) (noting that a wealthy defendant can “mount an extremely aggressive defense . . . and by doing so . . . make litigating against it very costly, which in turn may make it difficult for the plaintiffs to find a lawyer willing to handle their case, involving as it does only modest stakes, for the usual 33%–40% contingent fee”); Dan Markel, *Punitive Damages and Private Ordering Fetishism*, 158 *U. Pa. L. Rev. PENNumbra* 283, 288–91 (2010).

<sup>32</sup> Mogin, *supra* note 3, at 75.

also be tax-aware and consider after-tax effects in assessing the constitutional implications of large punitive damage awards.<sup>33</sup>

#### CONCLUSION

We are grateful to Professor Zelenak and Mr. Mogin for their responses and to the *Virginia Law Review* for the opportunity to continue the conversation about this important and difficult set of issues.

---

<sup>33</sup> See Polsky & Markel, *supra* note 1, at 1322–24 (arguing that appellate judges should be tax-aware in assessing the due process issues stemming from punitive damages awards).